What's in an Equity Research Report?

Morgan Stanley

What's in an Equity Research Report?

What's in an Equity Research Report?

Goldman Stanley

Jazz Pharmaceuticals

Strong Q1 FY14 & Multiple Catalysts Ahead

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What's in an Equity Research Report?
“What’s in an equity research report?”
“Can you share a sample equity research report?”

This is a very common question and a possible case study task if you’re interviewing with equity research groups – so we’re going to answer it here.
This Lesson: Our Plan

• **Part 1:** Stock Pitches vs. Equity Research Reports

• **Part 2:** The 4 Main Differences in Research Reports

• **Part 3:** Sample Reports and the Typical Sections
Stock Pitches vs. Equity Research Reports

• **Stock Pitch:** Very strong views about a company and why it might be mispriced by 50%, 100%, or more

• **Idea:** “This company is mispriced and misunderstood by the market for reasons A, B, and C. There are specific events, AKA catalysts, that will make its stock price double in 6-12 months.”

• **Explain** why your views of a company are *extremely* different, and how, even if you’re slightly wrong, you’ll still make money with your recommendations

• **Equity Research:** A watered-down version of this argument
Stock Pitches vs. Equity Research Reports

• Typical Components of a Stock Pitch:
  • Part 1: Recommendation
  • Part 2: Company Background
  • Part 3: Investment Thesis
  • Part 4: Catalysts
  • Part 5: Valuation
  • Part 6: Investment Risks
  • Part 7: The Worst-Case Scenario

• Logic: “We think this company’s stock price will increase from $50 to $80 – $100, but if we’re wrong, it might fall to $30 – $40. Therefore, let’s protect ourselves with put options around that level to limit our losses.”
Stock Pitches vs. Equity Research Reports

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  • Part 4: Catalysts
  • Part 5: Valuation
  • Part 6: Investment Risks
  • Part 7: The Worst-Case Scenario

• **Most In-Depth Parts:** Catalysts, Valuation, and Investment Risks – establish *why* your views are so different

• **Equity Research:** Similar points, but very different distribution
Stock Pitches vs. Equity Research Reports

• Typical Components of an Equity Research Report:
  • Part 1: Recommendation
  • **Part 2:** Company Background
  • Part 3: Investment Thesis
  • Part 4: Catalysts
  • **Part 5:** Valuation
  • Part 6: Investment Risks

• **Most In-Depth Parts:** Company Background and Valuation... the Investment Thesis, Catalysts, and Risks get far less space

• **Why:** In research, you want to *promote* the companies you’re covering, so you very rarely see far-outside-the-mainstream views
The 4 Main Differences in ER Reports

• **#1: Recent Results and Announcements** – How does a recent product launch, clinical trial, or earnings release change things?

• You’ll see a “Recent Updates” section on the first page or two of a research report that describes these updates

• **Stock Pitches:** Updates and recent news tend to be more important in **Short** recommendations, where timing is essential

• **Long Recommendations:** Tend to focus on longer-term issues that may not be tied to timing as specifically
The 4 Main Differences in ER Reports

• #2: Rare to See Far-Outside-the-Mainstream Views – Remember how 15 out of 15 equity research analysts rated Enron a “Buy” right before it collapsed?

• Why: The incentives are different, and research analysts are not investing their own money – little motivation to go completely outside normal views

• Also: If research publishes a report that’s overly negative – or too positive to believe! – it could hurt the company’s trading volume and reduce the bank’s commissions from institutional clients...
The 4 Main Differences in ER Reports

• **#3: “Target Prices” Rather Than Valuation Ranges** – You’ll almost always see a “target price” in research (e.g., “Company is trading at $50.00 right now, but we expect it to reach $75.00 in 12 months”)

  • **Truth:** Completely ridiculous because valuation is all about the range of outcomes – a company might be worth between $70.00 and $90.00, but it’s not worth exactly $83.41

  • **Truth:** Academics have studied this and found horrendously low accuracy in these forecasts

  • **Slightly Better:** Give several “target prices” for different cases
The 4 Main Differences in ER Reports

• **#4: “Looser” Investment Thesis, Catalysts, and Risk Factors** – You’ll see references to these, but there are two big differences:

  • **Difference #1:** These are **NOT** tied to the share-price impact as they are in stock pitches; a bank won’t say, “Successfully launching Drug X might make the pharma company’s share price go up by 15%”

  • **Difference #2:** These items are used to *support* the overall recommendation rather than to *form* the recommendation

• **View:** “This company is pretty good... oh, and by the way, here are some other reasons why its share price might increase”
Sample Reports and the Typical Sections

• **Examples:** I’m sharing here two examples from our modeling courses, one for Jazz Pharmaceuticals (Healthcare) and one for Shawbrook (FIG/Commercial Banks)


• **Approach:** We start with a hedge fund stock pitch, create the model and outline, and then modify it to create a research report

• **Jazz:** Went from a LONG to a mild BUY
• **Shawbrook:** Went from a SHORT to a HOLD
Sample Reports and the **Typical Sections**

- **Page 1: Update, Rating, Price Target, and Recent Results**
  
  - Give a *Buy, Hold, or Sell* rating (Really just Buy or Hold...), give a target price, and mention a few catalysts to support your views

- **PROBLEM:** If you’re giving a specific price target, you also have to cite specific multiples and DCF assumptions to support it

- **Here:** 20.7x and 15.3x EV/EBITDA multiples for Jazz, discount rate of 8.07%, and Terminal FCF Growth of 0.3%... yes, really
Sample Reports and the **Typical Sections**

- **Operations and Financial Summary:** How the research analyst/associate came up with the forecast

- **Typical:** Revenue by product, market share, unit sales and average selling prices, EBITDA and cash flow projections

- **Industry-Specific (FIG):** Loan growth, interest rates, interest income and net income, and regulatory capital (CET 1, etc.)

- **Stock Pitch:** All of this is “background information” and therefore less important than explaining how your views differ
Sample Reports and the **Typical Sections**

• **Valuation:** This section might *look* similar, but the assumptions are very different – more extreme numbers in stock pitches

• **Equity Research:** More likely to point to *specific* multiples, such as the 75th percentile or median EV/EBITDA, and explain why they are the most meaningful

• **Stock Pitches:** It’s more about the **range** of multiples (or range of assumptions in a DCF) and explaining where the company fits in
Sample Reports and the **Typical Sections**

- **Investment Thesis, Catalysts, and Risk Factors**: The biggest differences emerge here

- **Equity Research**: This part is more of an “afterthought,” where the bank might give reasons why a company is mispriced...

- **BUT**: Each reason is not linked to a share-price impact, and the reasoning isn’t too detailed

- **Investment Risks**: Mostly there to “cover the bank” if something goes wrong, but not as a critical part of the investment strategy
Sample Reports and the Typical Sections

• Jazz Pharmaceuticals research report vs. stock pitch:

• **Intrinsic Value:** $180 – $220 in the stock pitch vs. **$170 in the report**

• **Catalysts:** Price increases add 15% to the share price, marketing and more patients add 10%, and late generics competition adds 15%; mentioned in the report, but no percentages are assigned

• **Risk Factors:** Might reduce the company’s share price to $75 – $80, so we recommend hedging with put options; **mentioned in the report, but no dollar value is assigned and there’s no hedging strategy**
Recap and Summary

• Part 1: Stock Pitches vs. Equity Research Reports

• Part 2: The 4 Main Differences in Research Reports

• Part 3: Sample Reports and the Typical Sections