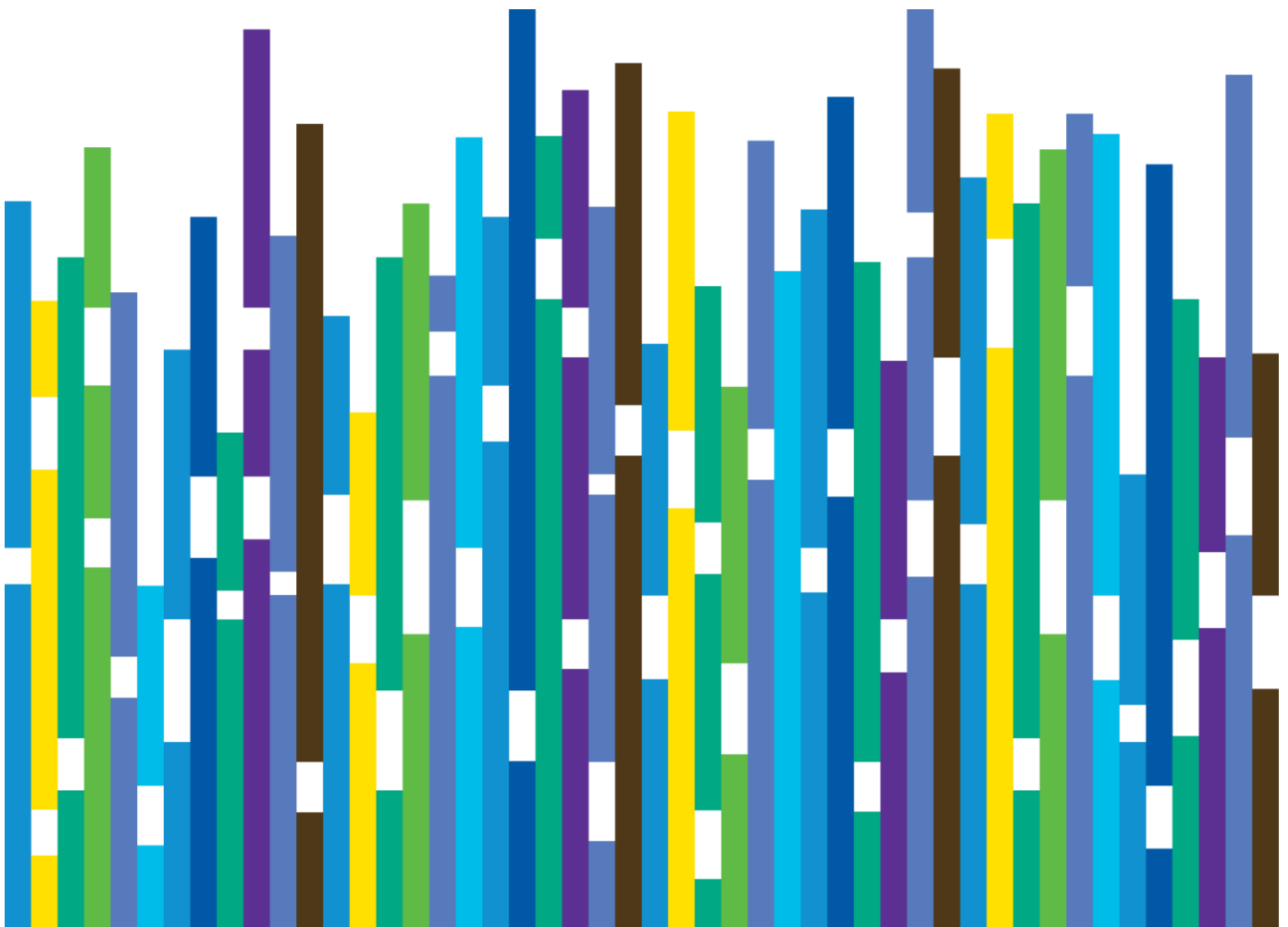




CFA Institute

EQUITY RESEARCH REPORT ESSENTIALS



An equity research report can include varying levels of detail, and while there is no industry standard when it comes to format, there are common elements to all thorough and effective equity research reports. Highlighted below are some fundamental features and information that should be considered essential to every research report, as well as some tips for making your analysis and report as effective as possible.

BASIC INFORMATION

The research report should begin with some basic information about the firm, including the company's ticker symbol, the primary exchange upon which its shares are traded, the primary sector and industry in which it operates, the investment recommendation, the current stock price and market capitalization, and the target stock price.

In addition, the liquidity and float of a security are important considerations for the equity analyst. The liquidity of a stock refers to the degree to which it can be purchased and sold without impacting the price. It should be understood by the analyst that periods of financial stress can affect the liquidity of a security. A stock's float refers to the number of shares that are publicly-owned and available for trading, and generally excludes restricted shares and the holdings of insiders. The float of a stock can be significantly smaller than its market capitalization and thus is an important consideration for large institutional investors, especially when it comes to investing in companies of smaller market capitalizations. Consequently, a relatively small float deserves mention. Finally, it is good practice to identify the major shareholders of a firm.

INVESTMENT SUMMARY

This section should include a brief description of the company, significant recent developments, an earnings forecast, a valuation summary and the recommended investment action. If the purchase or sale of a security is being advised, there should be a clear and concise explanation as to why the security is deemed to be mispriced. That is, what is the market currently not properly discounting in the stock's price, and what will be the catalyst to prompt the market to reprice the security?

BUSINESS DESCRIPTION

This section should include a detailed description of the company and its products and services. It should also convey a clear understanding of the company's economics, including a discussion of the key drivers of revenues and expenses. Much of this information can be sourced from the company itself and via its regulatory filings, as well as industry publications.

MANAGEMENT & GOVERNANCE

This section should include a critique of the firm's management and board. Senior management's history with the firm and their record of capital allocation are important considerations, as are their compensation and incentive plans, and levels of stock ownership. Is there a succession plan in place for senior management? A review of the composition of the company's board of directors should note whether it is sufficiently independent or if there is evidence or risk of entrenchment.

INDUSTRY OVERVIEW AND COMPETITIVE POSITIONING

This section should include an overview of the industry dynamics, including a competitive analysis of the industry. Most firms' annual reports include some discussion of the competitive environment. A group of peer companies should be developed for purposes of a competitive analysis. The "Porter's Five Forces" framework for industry analysis is an effective tool for examining the health and competitive intensity and of an industry. Additionally, production capacity levels and pricing are important considerations, as are the distribution and stability of market share.

It is important to note that there are different paths to success. Strength of brand, cost leadership, and access to technology or resources that are protected are just some of the ways in which companies set themselves apart from the competition. Famed investor Warren Buffett describes a firm's

competitive advantage as an economic “moat.” Buffett has said, “In business, I look for economic castles protected by unbreachable moats.”

VALUATION

This section should include a thorough valuation analysis of the company using conventional valuation metrics and formulas. Equity valuation models can derive either absolute or relative values. Absolute valuation models derive an asset’s intrinsic value, and generally take the form of discounted cash flow models. Relative equity valuation models estimate a stock’s value relative to another stock, and can be based on a number of different metrics, including price/sales, price/earnings, price/cash flow, and price/book value. Because model outputs can vary, as a check, more than one valuation model should be used.

FINANCIAL ANALYSIS

This section should include a detailed analysis of the company’s historical financial performance, and a forecast of future performance. Financial results are commonly manipulated to portray firms in the most favorable light. It is the responsibility of the analyst to understand the underlying financial reality. Accordingly, a careful reading of the footnotes of a company’s financial disclosures is an essential part of any examination of earnings quality. Non-recurring events, the use of off-balance sheet financing, income and reserve recognition, and depreciation policies are all examples of items that can distort a firm’s financial results.

Financial modeling of future financial results helps to measure the effects of the changes in certain inputs on the various financial statements. Analysts should be especially careful, however, about extrapolating past trends into the future. This is especially important in the case of cyclical firms. Projecting forward from the top or bottom of a business cycle is a common mistake. Finally, it can be informative to employ industry-specific financial ratios as part of the financial analysis. Examples include proven reserves/share for oil companies, revenue/subscriber for cable or wireless companies, and revenue/available room for the hotel industry.

INVESTMENT RISKS

This section should address potentially negative industry and company developments that could pose a risk to the investment thesis. Risks can be operational or financial in nature, or related to regulatory issues or legal proceedings.

While companies are generally obligated to discuss risks in their regulatory disclosures, risks are often subjective and hard to quantify (e.g. the threat of a competing technology). It is the job of the analyst to make these determinations. Of course, disclosures of “qualified opinions” from auditors and “material weakness in internal control over financial reporting” should be automatic red flags for analysts.

CFA INSTITUTE RESOURCES

The following CFA Institute resources codify the ethical standards and best practices that are the responsibility of all investment professionals.

[CFA Institute Code of Ethics and Standards of Professional Conduct](#)

[Best Practice Guidelines Governing Analyst/Corporate Issuer Relations](#)