An Analysis of the Valuation Practices in Sell-Side Equity Analyst Reports Regarding the Banking & Pharmaceutical Sectors in United Kingdom

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ABSTRACT

This study employs a structured, positive approach to investigating the choices of financial analysts for valuation models in their reports on firms drawn from the banking and pharmaceutical sectors in UK. It examines 141, sell-side analysts' equity reports issued by international brokerage houses, covering 9 banking and 15 pharmaceutical firms listed on the London Stock Exchange. It provides a descriptive analysis of the range of valuation models appearing in these reports and the factors that drive analysts' choices. It postulates and tests four, discrete hypotheses related to their preferences for specific valuation methods and the variations of these across the two sectors. The statistical analysis performed on these hypotheses leads to the following conclusions: firstly, valuation by single-period comparatives is more often in the banking than the pharmaceutical industry. The valuation models financial analysts most often adopt as dominant are the PE multiple and the multi-period DCF model. Analysts do not include dividends in the value-relevant features of banking firms they seek to predict and base their valuations on; the dividend yield along with the DDM and GGM models only seldom appear as dominant in analysts' banking reports. Finally, the different nature of assets comprising the firms of the two sectors does not seem to induce a variation in the methodologies analysts adopt when valuing them; it is their expertise as well as investors' familiarity with certain valuation models that appear to lead their choices instead. These findings shed additional light on the available knowledge on this topic area so far and constitute the basis for further and deeper research on analysts' valuation methodologies.

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About the Author

The author of this study has been employed for the past 4 years by a German multinational gypsum products industry as a financial analyst. In 2006 and 2007, she followed the MSc Programme in Finance of Manchester Business School, where she gained her degree with a merit. She has also gained a first-class Bachelor degree from the Accounting & Finance Department of the Athens University of Economics and Business in Greece in 2006 with a specialization in Finance. Her interests include the financial statement analysis and valuation of securities and these are reflected in the current study. This is the first study the author conducts but she is highly interested in continuing her research in this topic area in the future.

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Chapter 1
Introduction

The analysis of the content and usefulness of sell-side analysts' equity reports has occupied the minds of valuation theorists and investors for decades. Both base their interest in the belief that analysts' earnings forecasts, target prices and stock recommendations play a critical role in the formation of stock prices and prior literature has validated this belief. But it is not only these elements of analysts' reports that have attracted researchers' interest; the various valuation methods analysts employ in order to determine a firm's intrinsic value have also preyed on their minds and have been the subject of numerous studies. Analysts have at their disposal a large variety of models ranging from simple valuation multiples to explicit, multi-period techniques. While the former models appear to be favored by analysts in general, recent evidence suggests that the latter category of models appears to be constantly gaining ground.

As a continuation to earlier research on this topic area, this study examines the valuation models sell-side analysts employ in order to value firms from the banking and pharmaceutical sectors in the UK. The research undertaken is based on a structured, positive approach. This study intends to shed light on the value-relevant features on which analysts focus and the methodologies they finally adopt in order to determine the intrinsic value of the firms comprising the two sectors. Based on prior literature, four discrete hypotheses related to the frequency with which analysts adopt specific categories of models in the two sectors and the ways these models vary across the two industries are examined. The content analysis conducted includes reading thoroughly each sampled report, recording the frequency with which each model appears and conducting statistical analysis. A random sample of 141, sell-side analysts' equity reports regarding banking and pharmaceutical firms listed on the London Stock Exchange is investigated. The sample runs the period from June 2005 to December 2006.

The statistical analysis of the hypotheses leads to illuminating conclusions. First of all, single-period, comparatives is the most popular category of valuation techniques in the evaluation of both banking and pharmaceutical companies, with the price to earnings multiple (PE) ranking first in analysts' preferences. Nevertheless, whereas valuation by comparatives is also dominant in the majority of banking reports, analysts appear skeptical about using this category of techniques to assess the intrinsic value of pharmaceutical firms. Instead, they appear to prefer sophisticated, multi-period valuation methods and especially the discounted cash flow (DCF) model. Price-to-book value, sales multiples, accrual accounting, hybrid models and real option style models are also used as dominant in a number of cases. However, no instance of use of the RIV model in any of the reports is recorded. The findings also suggest that despite the signaling role dividends are believed to play and the high and steady payout ratios that banking firms maintain, analysts valuing the specific industry hardly ever take dividends into consideration in their evaluations. Banking reports may often contain the use of the dividend yield model as a first approximation of a firm's intrinsic value but this model hardly ever plays a dominant role in their reports. Similarly, analysts preferring sophisticated, multi-period models to value banking firms rarely employ the dividend discount (DDM) or Gordon's growth model (GGM) in their reports and even more rarely constitute these models their dominant valuation methods. Finally, analysts appear to disregard the different nature of assets comprising the firms of the two sectors and the extent to which they can base their analysis on accounting information. Instead, they appear to rely on models that both themselves and investors are well acquainted and content with.

The remainder of this study proceeds as follows: section 2 reviews, compares and contrasts prior literature on this area. Section 3 discusses the methodology followed and the specific hypotheses set, whereas section 4 describes the data and sample collection and the scoring system adopted in the content analysis. Section 5 presents and discusses the findings of this study. Section 6 outlines the sensitivity analysis and section 7 denotes the limitations of this study. In section 8, the conclusions reached through this study and the suggestions for further research are discussed. Finally, the appendix cites an example of the statistical tests performed on the hypotheses.

NOTES

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