

# **1.0 INTRODUCTION**

Financial or research analysts, commonly referred to simply as “analysts”, conduct research on stocks by studying a firm’s revenues, costs and earnings drivers, and relevant market indicators to forecast the firm’s future earnings and issue buy, sell, or hold investment recommendations (Schipper, 1991, and Brown, Chan and Ho, 2009). Many institutional and individual investors rely on analysts’ stock recommendations to make investment decisions such as which stocks to trade, when to buy, and when to sell (Mikhail, Walther and Willis, 2007).

## **1.1 Buy-side and Sell-side**

The investment sector largely comprises of two distinct groups: the buy-side and the sell-side. The so-called buy-side consists of individual or retail investors and what one might call institutional investors such as money management firms, insurance firms, and hedge funds. The so-called sell-side is largely institutions such as investment banks and brokerage firms who sell securities to the buy side (Schipper, 1991). The sell-side markets and recommends stocks that may yield positive returns to the buy-side who decide which stocks they want to trade. The sell-side executes buy and sell orders for the buy-side and is compensated by making a brokerage commission on the trades that are carried out based on their recommendations (Irvine, 2004, and Groysberg, Haley and Chapman, 2008).

Analysts at financial organizations on both the buy-side and sell-side conduct research on stocks and make buy, sell, or hold investment recommendations. Buy-side research usually serves as the buy-side firm's internal check to support or reject the findings of sell-side analysts so the buy-side firm can better assess which stocks they should trade (Flöstrand, 2006, and Groysberget. al, 2008). Buy-side research departments are usually smaller than those of the sell-side (Groysberget. al, 2008). Buy-side analysts also generally cover a lot more stocks, usually over several industries, and write less lengthy reports compared to their sell-side counterparts (Groysberget. al, 2008). As sell-side analyst reports are widely distributed to their buy-side clients, buy-side analysts also commonly consider sell-side analysts' investment recommendations when deciding which stocks to trade (Groysberget. al, 2008). Buy-side analysts' reports are generally considered internal information and are not made available to the public.

Research by Groysberget. al (2008) also indicated that buy-side analysts' earnings forecasts are more optimistic and less accurate than those of sell-side analysts. Groysberget. al (2008) attributed the discrepancy between sell-side and buy-side earnings forecasts to the buy-side's retention of poorly performing analysts and the method in which they are appraised. Sell-side analysts' earnings forecasts and investment recommendations are constantly measured relative to their counterparts in other sell-side firms but buy-side analysts' earnings forecasts and stock recommendations are not subject to the same amount of scrutiny (Groysberget. al, 2008).

As the sell-side analysts' research has been found to be more accurate, is targeted directly at institutional and individual investors and is written for public dissemination, this study will focus solely on sell-side analyst reports including their earnings forecasts, valuations, and buy, sell, or hold stock recommendations. From this point forward, all references made to analysts will mean sell-side financial analysts.

## **1.2 Impact of Analyst Reports on Stock Prices**

Numerous studies have found evidence that analysts' stock recommendations influence stock prices and reduce investors' tendency to "sell winning stocks too soon and hold losing stocks too long" (Stickel, 1995, Desai, Liang and Singh, 2000, and Krishnan and Booker, 2002). Previous works by Stickel (1995) and Womack (1996) indicated that the market generally reacted more to revisions, and not the occurrence, of analysts' stock recommendations. Stickel (1995) and Womack (1996) observed that stock prices generally increased (decreased) when analysts upgraded (downgraded) their investment recommendation. The market also generally reacted more to downgrades than upgrades, i.e. the absolute value of stock price movement is higher following a downgrade than an upgrade (Stickel, 1995 and Womack, 1996) and more trading, both buying and selling, was generated at an analyst's brokerage firm following an analyst's buy recommendation (Irvine, 2004).

### **1.3 Background Information on AirAsiaBerhad**

AirAsiaBerhad (AirAsia) is Asia's largest low cost carrier. Based in Malaysia, AirAsia, with its affiliates Indonesia AirAsia, Thai AirAsia, and its long-haul low cost carrier, AirAsia X (collectively "the AirAsia Group"), offers no-frills air transport services at low fares to more than 20 countries in Asia, Australia and Europe. It has one of the lowest, if not the lowest, operating cost per seat-kilometer in the world.

Started in 2001 when Tune Air SdnBhd, a Malaysian company founded by AirAsia's current CEO, Dato' Sri Tony Fernandes and his partners Dato' PahaminRejab, Dato' KamarudinMeranun and Dato' Aziz Bakar, bought the then loss making AirAsia from its Malaysian owner HICOM Holdings Berhad (now known as DRB-HICOM Berhad) for a token sum of RM1 plus the assumption of all liabilities, the fledgling airline was re-launched as a low cost carrier, then the first of its kind in Asia.

Pioneered by Southwest Airlines in the US in the 1980s, the low cost carrier business model eliminates many of the services usually offered by full-service air carriers, also known as legacy carriers. Using the "no frills" concept, AirAsia's main objective is to transport passengers from point A to point B at the cheapest cost. AirAsia then charges a fee for virtually everything above this. This includes food and beverage on board the flights, counter check-ins, convenience fees for payments made by credit cards and baggage handling.

AirAsia also employs a host of other cost-cutting measures to drive down operation costs such as using only one type of aircraft to reduce pilot training and maintenance expenses, flying to and from non-major airports at non-peak times to reduce airport fees and maintaining a high aircraft utilization rate by having a fast turnaround time on the ground.

The low cost business model was initially viewed with wide skepticism but has since proved to be surprisingly resilient throughout the highly volatile aviation industry. AirAsia survived the SARS outbreak in 2002, the tsunami tragedy in 2004 and steep hikes in fuel prices in 2008. The company's Initial Public Offering (IPO) was oversubscribed when it was listed on Bursa Malaysia on 10 November 2004, raising a total of RM863 million. Its stock was priced at RM1.25 and RM1.16 for institutional and individual investors respectively.

Over the last ten years since its re-launch, AirAsia's route network has steadily grown from five destinations in Malaysia to more than 60, spanning over 20 countries, flying from hubs in Malaysia, Thailand and Indonesia. The company plans to continue expanding its route network and is scheduled to take delivery of 14 new aircraft in 2012. AirAsia have also ordered 72 more aircraft from Airbus, which are scheduled for delivery through 2015. The airline employs 7,500 staff and flew its 100<sup>th</sup> million passenger in the fourth quarter of 2010. They also received Skytrax's 'World's Best Low Cost

Airline'award in 2009 and 2010 and was named 'Airline of the Year' by the Centre for Asia Pacific Aviation (CAPA) in 2009.

In 2010, AirAsia's Malaysian operations reported a net profit of RM1 billion (revenue of RM5.6 billion in 2010, up from RM4.8 billion in 2009), assisted by lowered operating costs and increased ancillary income (among others, baggage check-in and cargo fees, pre-booking of in-flight meals, seat selection and travel insurance). Both its associates, Thai AirAsia and Indonesia AirAsia, have also reported four straight quarters of profitability after incurring losses since 2004 and 2005 respectively.

AirAsia's shares have been steadily gaining local and foreign analyst coverage since 2008, approximately three years after it was listed in 2004. Its financial statements indicate increasing profitability and an improving financial position attributed to higher profit margins, increased ancillary income and lower net gearing. AirAsia's annual financial statements 2005 – 2010 and quarterly financial statements for the quarter ended 31 March 2011 can be found in **Appendices I – VI**.

#### **1.4 Problem Statement**

Firm valuation exercises are vital in investment banking, particularly in the areas of investment research and mergers and acquisitions. However, the valuation methods used by analysts to value a share of a public-listed firm's stock remain an under-researched topic, particularly in Malaysia. Although well-established valuation models such as the Discounted Cash Flow Model (DCF) and the Dividend Discount Model (DDM) have solid foundations in theory, numerous studies have indicated that these two methods are not generally used in practice (Pike, Meerjanssen and Chadwick, 1993, Block, 1999, Bradshaw, 2002 and Demirakos, Strong and Walker, 2004). Analysts have reported that they typically do not use DCF and DDM because it is difficult to determine the necessary inputs such as a firm's projected future cash flows and its appropriate discount rate (Block, 1999).

#### **1.5 Scope of Study**

The general aim of this study is to investigate the practical usability of theoretically-superior valuation models such as DCF and DDM in a firm valuation exercise. The main objective of this study is to investigate how analysts value a share of a public-listed firm's stock and arrive at a buy, hold, or sell investment recommendation.

## **1.6 Research Questions**

This study attempts to answer the following five research questions relative to sell-side analysts in Malaysia:

1. What are the valuation methods used by analysts to value a share of a public-listed firm's stock?
2. Based on previous works, the Price-to-Earnings (P/E) ratio is expected to be the most used in (1). If this is true, how do analysts determine the target P/E ratio for the firm they are valuing?
3. Does the valuation method used by an analyst to value a share change over his/her coverage of the share? If so, why?
4. Do analysts use beta, a measure of the variability of a firm's returns relative to the market, in their research and if so, how?
5. What are the factors that analysts take into consideration when deciding whether they should initiate coverage on a share?

## **1.7 Significance of Study**

This study, which serves to narrow the gap in the literature in corporate finance studies, maybe of particular interest to managers of public-listed firms and financial advisors. The former because this study attempts to shed some light on how an analyst arrives at a buy, hold, or sell recommendation and the latter because firm valuation exercises are vital not only in investment research but also in merger and acquisition activities. As analysts are primary users of accounting information (Schipper, 1991), regularly extracting figures



and ratios from interim and annual financial statements to forecast a firm's future earnings, this study may also be of interest to researchers in accounting studies.

### **1.8 Organization of Study**

The first section of this paper outlined the scope and emphasis of this study. The second section will review previous literature on valuation methods used by analysts to determine a share's target price and the impact of analyst reports on investors and share prices. We discuss our research methodology in the third section and research findings in the fourth. Finally, we highlight the limitations of this study, together with suggestions for further research, in the fifth section.