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Becoming a Great Equity Research Analyst

Learner Workbook

NOTE: Please ensure you can interact with this document during the workshop in one of these methods:

- With a keyboard (as a Word document);or
- With pen (as a hard copy)

Acknowledgements

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Overview

Purpose & Learning Objectives

AnalystSolutions offers this intensive training as part of its program to help students gain the practical skills required to be successful equity research analysts. We find most students who go on to become analysts struggle to overcome these challenges:

■ Being overwhelmed by excessive "noise" about their universe of stocks, which prevents them from discovering the insights required for great stock calls

■ Overreliance on information provided by the companies they cover, which is not only biased but lacks the unique insights required for great stock calls

■ Communicating backward-looking or poorly constructed research that doesn't add value to most portfolio managers

This program consists of a highly-interactive workshop that empowers you to:

■ Assess the most important elements required for a role as an equity research analyst or associate

■ Utilize our ENTER™ framework to identify when research meets or exceeds a quality threshold, to determine if it's ready to be communicated to others

■ Utilize a process that exposes the key elements of setting price targets

■ Identify the 1-4 critical factors most likely to explain a stock's unique relative performance

■ Identify the financial statement impact zone for a potential critical factor

■ Quickly compute materiality to determine how much a factor may impact a stock's price

■ Identify the proprietary sources of information necessary for great stock picking

■ Be expectational in conducting research, even when analyzing historical data

■ Utilize our TIER™ framework to identify the stock picking techniques of highly-experienced analysts

■ Avoid the most common psychological pitfalls that lead to poor investment decisions

■ Use the ENTER™ and ADViCE™ frameworks to identify the required elements for impactful stock communications

ENTER™ Quality Framework

Evaluate Two Analysts

Instructions:
- ■ The purpose of this exercise is to become familiar with the ENTER™ quality framework which focuses on creating high quality stock research worth communicating to others
- ■ After watching the videos, evaluate the analyst's efforts using the ENTER™ checklist below, with 1 = "not apparent" and 5 = "clearly achieved

Exhibit 1: ENTER™ Quality Checklist

ENTER™ Quality Checklist	1 to 5
Expectational	
Does the analyst have a <u>forward-looking</u> view in terms of the stock and the critical factor(s) likely to move the stock?	
Has the analyst identified the catalyst(s) likely to move his stock and important dates when the catalyst is most likely to cause the stock to move to his price target?	
Has the analyst framed company management's forecast in terms of his <u>independent</u> financial forecast (rather than just repeat management)?	
Novel	
Does the analyst have a piece of information or insight that is new and not widely understood within the financial markets?	
Has the analyst explained where his view falls within the FaVeS™ framework, in terms of identifying if he has a superior <u>F</u>inancial forecast, <u>V</u>aluation method/multiple, or unique view about market <u>S</u>entiment?	
Does the analyst know why the market does not have his view?	
Thorough	
For the critical factors that are key to the stock call, did the analyst research more than one source or confirm the insight with an independent source?	
Did the analyst conduct detailed modeling in the area surrounding the critical factor(s)?	
Does the analyst avoid using management guidance as the primary justification for the call?	
Examinable	
Do you think the analyst has the following details that he could present to the committee? • Data or insights about the critical factor(s)? • Detailed financial forecast or valuation analysis, key to the investment thesis?	
Revealing	
Has the analyst created upside, downside, and base-case scenarios to identify where the investment thesis could have flaws?	
Has the analyst identified specific risks beyond the macro?	
Has the analyst provided his conviction level to others, even if it is not strong?	

Identify Critical Factors

"Is It Worth Your Time?" Exercise

Instructions for "Is It Worth Your Time?" Exercise:

■ From your research, you have come across the following scenarios. Using the basic income statement data below, determine if each is material, assuming "materiality" is defined as a 10% change to EPS.

– FDX has invoiced customers a 4% fuel surcharge for the past year but only collected half (2%) (some customers refuse to pay it). You believe the company has instructed its salespeople to get more aggressive in collecting the surcharge, likely resulting in the company collecting 3%. Is this 1 percentage point increase material? To keep the math simple, assume the surcharge covers all of FDX's revenue (in reality some of its revenue is not subject to a fuel surcharge).

– Your research concludes FDX will likely need to change a pension assumption that will raise its overall costs by $150 million per year

– Your research concludes there is a high likelihood FDX will win a new agreement with the U.S. Postal service to haul Priority Mail, which will likely result in $1 billion of additional annual revenue for FDX. You assume this new contract will be priced to achieve the overall company's existing margins.

Data Below is Actual for Fiscal Year Ending:	2016
Total Revenue (as reported)	$50,365
Total Expenses	$45,350
EBIT (adjusted)	$5,015
EBIT margin (adjusted)	10.0%
Interest Expense	$336
Other	$16
Pre-tax Income (adjusted)	$4,695
Tax Expense	$920
Effective Tax Rate	19.6%
Net Income (adjusted)	$3,016
EPS (adjusted)	$10.81
Fully Diluted Share Count	279

Answer Key

Scenario	EPS Impact	Change to EPS
1% higher pricing from better fuel surcharge collection	$1.45	13%
$150 million higher pension costs	$0.43	4%
$1 billion of USPS revenue	$0.29	3%

Computing Materiality Thresholds

	FDX	IBM	SBUX	WMT
Ticker:	**FDX**	**IBM**	**SBUX**	**WMT**
Period (year)	**2016**	**2016**	**2016**	**2016**
Amount EPS needs to change to be "material":	**10%**	**10%**	**10%**	**10%**
Step 1: Compute 10% of net income				
10% change to EPS	1.08	1.37	0.19	0.44
Materiality threshold as measured in net income	$302	$1,317	$286	$1,414
Step 2: Convert to pre-tax EBIT (MAGIC NUMBER)				
Materiality threshold as measured in pre-tax EBIT	$375	$1,359	$424	$2,036
Step 3: Compute threshold for changes from pricing and expenses				
Materiality threshold as measured in changes to pricing[1]	0.7%	1.7%	2.0%	0.4%
Materiality threshold as measured in changes in expenses[2]	0.8%	2.0%	2.5%	0.4%
Step 4: Compute threshold for change in revenue from sales/volume				
Materiality threshold as measured in changes from sales/volume[3]	$3,767	$8,117	$2,135	$40,980
As a percent of revenue	7.5%	10.2%	10.0%	8.5%
Data Below is for Fiscal Year Ending:	**2016**	**2016**	**2016**	**2016**
Total Revenue (as reported)	$50,365	$79,919	$21,316	$482,130
Total Expenses	$45,350	$66,534	$17,087	$458,179
EBIT (adjusted)	$5,015	$13,385	$4,229	$23,951
EBIT margin (adjusted)	10.0%	16.7%	19.8%	5.0%
Interest Expense	$336	$630	$81	$2,548
Other	$16	$1,516	$108	$81
Pre-tax Income (adjusted)	$4,695	$14,271	$4,256	$21,484
Tax Expense	$920	$449	$1,380	$6,558
Effective Tax Rate	19.6%	3.1%	32.4%	30.5%
Net Income (adjusted)	$3,016	$13,166	$2,862	$14,144
EPS (adjusted)	$10.81	$13.73	$1.93	$4.40
Fully Diluted Share Count	279	959	1,487	3,217

[1] Assuming pricing drops directly to EBIT

[2] Assuming expenses change with no change in volumes or sales

[3] Assuming all incremental revenue is at average EBIT margins

Monitoring Critical Factors

Flow Chart

Flow Chart for "Monitor" Process (see next 2 pages for enlarged details)
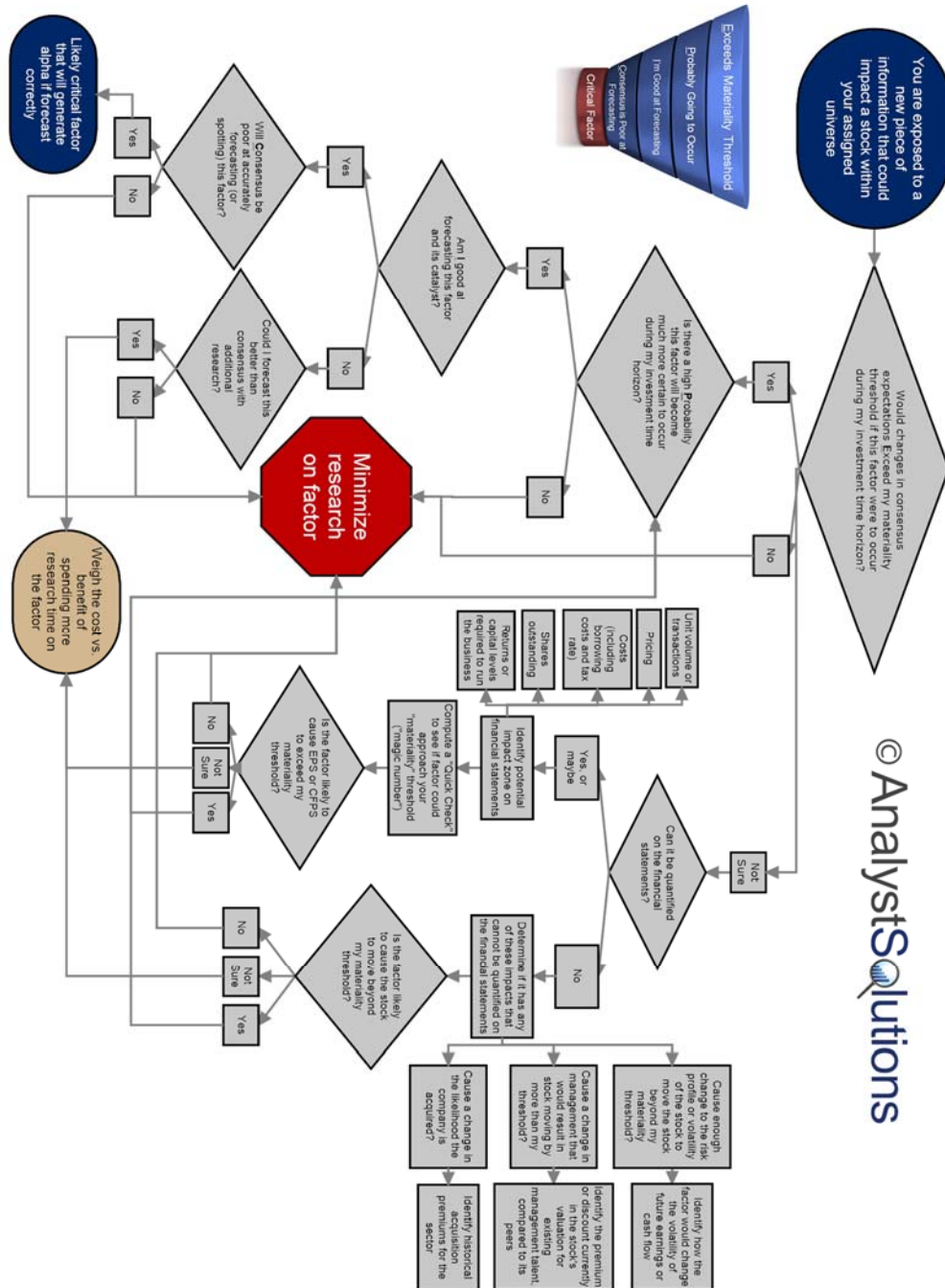
Flow Chart

Flow Chart for "Monitor" Process (left side expanded)

You are exposed to a new piece of information that could impact a stock within your assigned universe
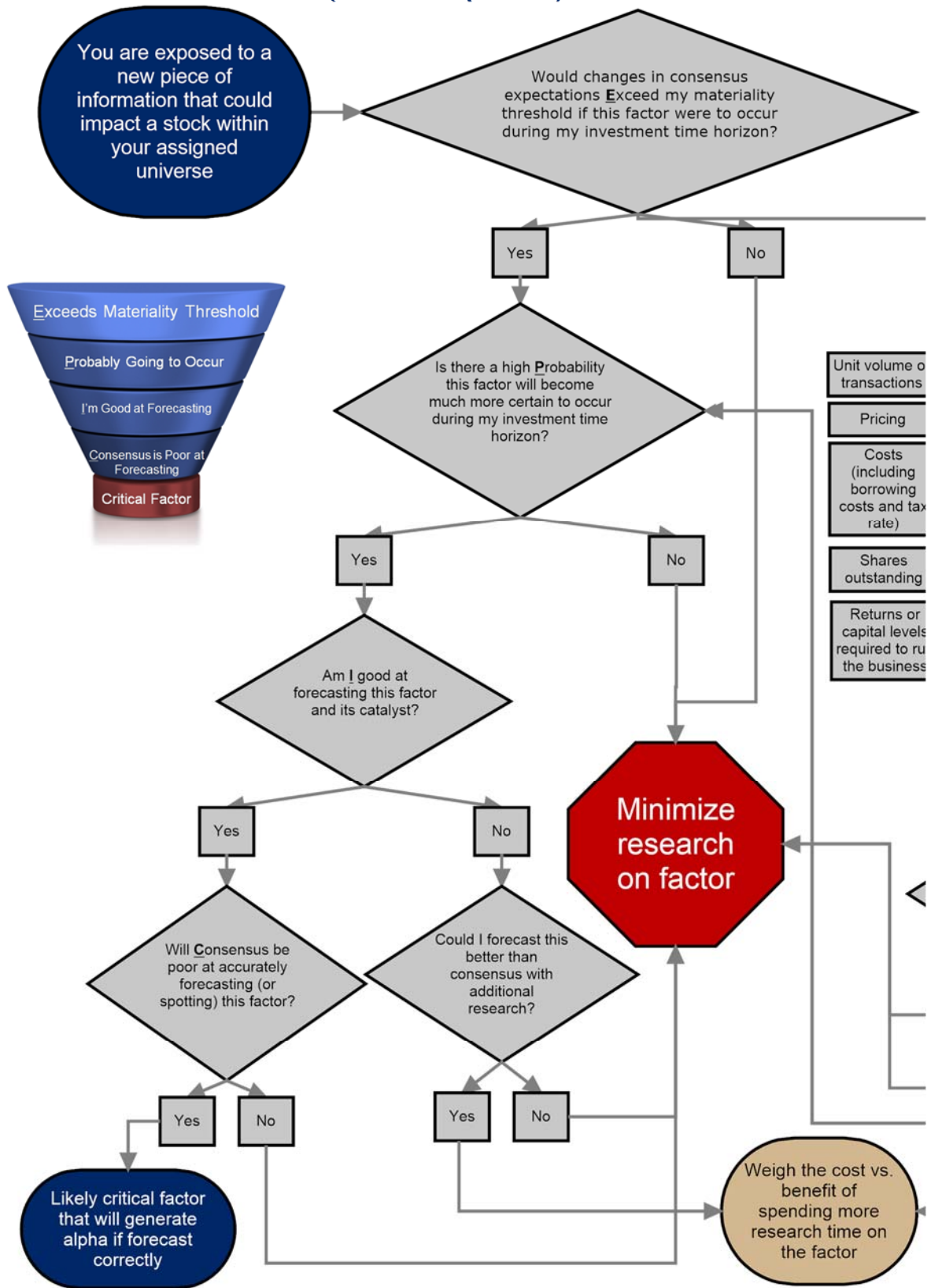
Would changes in consensus expectations **E**xceed my materiality threshold if this factor were to occur during my investment time horizon?

Yes   No

Exceeds Materiality Threshold

Probably Going to Occur

I'm Good at Forecasting

Consensus is Poor at Forecasting

Critical Factor

Is there a high **P**robability this factor will become much more certain to occur during my investment time horizon?

Yes   No

Am **I** good at forecasting this factor and its catalyst?

Yes   No

Will **C**onsensus be poor at accurately forecasting (or spotting) this factor?

Could I forecast this better than consensus with additional research?

Yes   No   Yes   No

Unit volume of transactions

Pricing

Costs (including borrowing costs and tax rate)

Shares outstanding

Returns or capital levels required to run the business

Minimize research on factor

Likely critical factor that will generate alpha if forecast correctly

Weigh the cost vs. benefit of spending more research time on the factor

Flow Chart

Flow Chart for "Monitor" Process (right side expanded)

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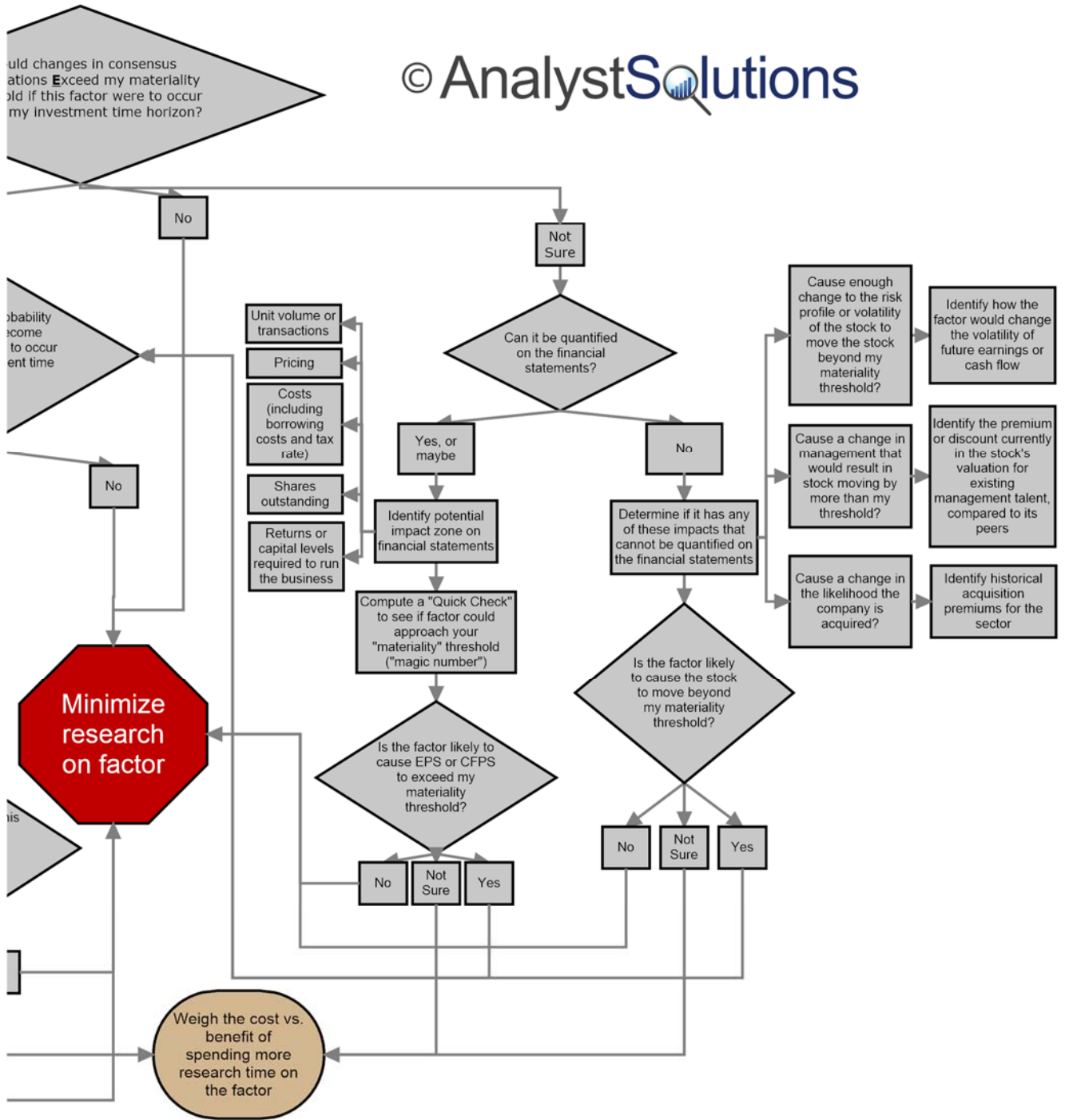
Generating Differentiated Insights

Case: Is Lucas generating differentiated insights?

Instructions for the case:
- The purpose of the case is to identify areas where an equity research analyst could generate unique insights for stock picking through better discovery, questioning and influencing
- First review the entire case, reading one row of the table at a time (read through to the last table)
- Then go back and read again, making notes in the right-most columns of the tables, where you sense the analyst is not using best practices
- At the end of each module of this workshop we will review the relevant areas of the case where the analyst should have performed better

For the past 18 months, Lucas Gallo has been an equity research analyst covering about 30 stocks in the transportation, chemical, and auto sectors for Nickel Mine Asset Management (NMAM). He meets monthly with his mentor David Torres, a senior portfolio manager, who many years ago also covered the same sectors as Lucas.

During this month's meeting, David addresses Lucas' one-year stock picking performance, which is dreadful. The conversation goes something like this…

Lucas' dialogue	David's dialogue	Your thoughts
"I'm not sure why my stock picking performance isn't better. I'm doing everything I can to stay on top of my stocks. I read every news story, sell-side report and regulatory filing for my universe of stocks."	"Where do you get your unique insights for stock picking?"	
"It's usually from something I learn from speaking to the company's IR contact or a sell-side analyst"	"Do they help you better understand the critical factors for your stocks?"	
"What are critical factors?"	"They're the factors most likely to drive a stock's relative performance, but that's another conversation we should have. Are there other sources you could contact to develop unique insights?	
"I have a friend who works for ExpBitz which is an on-line travel site for booking flights and hotels. I speak to him about once a month about the airline sector."	"He must be a great resource for understanding airline pricing and traffic."	

Case: Is Lucas generating differentiated insights?

"Not really…he's in charge of their IT department and so we usually discuss IT issues for the industry"	"Hmmm…not sure that's a great use of time. Among your sectors, which industry groups host the best industry events to make good connections and develop new insights?"	
"I'm not sure because I haven't spent any time learning about industry groups"	"I'd like you to develop your industry contacts by going to Air-Con, which is the largest airline industry conference and it's taking place next month."	

Lucas' thoughts and actions…	Your thoughts
Lucas considers this Air-Con event to be a big interruption to his normal routine and so he decides he'll wait to learn more about it on his flight there.	
As the date draws closer, he figures he can use the event to seek information that will support his view that trans-Pacific pricing is likely to increase over the next two years.	
Although the conference is being held at a major conference hotel, Lucas stays down the street at the hotel chain where he has gold status so he can get upgraded to a nicer room. He's booked a flight that gets him there too late to attend the pre-conference social event at the conference hotel because he doesn't like social events.	
He arrives at the conference the next morning, realizing he's under-dressed, wearing jeans and a polo shirt while everyone at the conference is in full professional attire. In the hall during the morning break, a fellow conference attendee, Sunil, starts making small talk with Lucas and when he sees Sunil works for an airline he follows, Lucas asks if there are any senior management at the conference he could speak with. Sunil isn't sure and so Lucas thanks him and moves onto the next session.	
After the lunch keynote presentation Lucas approaches the speaker, who is the CEO of a small cap regional airline that he doesn't cover. Lucas doesn't know much about the CEO or company. The conversation takes place in the table that follows.	

Lucas' dialogue	Executive's dialogue	Your thoughts
"Hi, I'm Lucas Gallo of Nickel Mine Asset Management. I don't cover your stock because it's too small and so I don't know much about your airline"	"Well, nice to meet you"	
"How long have you been CEO?"	"About ten years"	
"I'd like to know how much you are taking up ticket pricing in the trans-Pacific market"	"I'm not sure because we don't operate in that market. Have you spoken with the guys at McFinsey Consulting who specialize in forecasting airline pricing by route?"	
"No, I didn't know there were consultants who focus on airline	"As we mentioned during our quarterly call just over a month ago,	

Case: Is Lucas generating differentiated insights?

pricing. So how's business in the areas where you operate?"	we believe we'll see a 5% increase in passenger seat miles and a 2% increase in revenue per available seat mile this quarter"	
"Do you expect to change your guidance before you report the current quarter?"	"Well, I'm not sure I can answer such a direct question"	
"In your presentation you referenced bidding on another regional airline last year but didn't succeed in acquiring it. Who's to blame in your firm for messing up such a great opportunity?"	"We walked away because valuation was too rich. We determined we could build more cheaply than buy. I need to get to another meeting and so I'm sorry but I need to run. It was nice meeting you."	
"Same here, thanks"		
Lucas' thoughts and actions…		**Your thoughts**
Immediately before the last session of the day, Lucas sees Sunil (whom he met earlier in the day) and since Lucas hasn't made any contacts with senior executives of the companies he covers, he decides he should probably ask Sunil to get together before the dinner session. Sunil (who doesn't drink alcohol) suggests they meet in the hotel lobby, but Lucas says he's had a long day and would prefer to meet at the hotel bar for a drink.		
Lucas goes back to his hotel for an hour to check stock prices and news flow for the day. Realizing he's running 10 minutes late for his meeting with Sunil, he jogs to the conference hotel where he goes to the bar (which is quite noisy and has no seating) to find Sunil waiting for him. The conversation takes place in the table that follows.		
Lucas	**Sunil**	**Your thoughts**
"So what do you do for Trans Global Airlines?"	"I work in our purchasing department where I help determine our long-term need for aircraft"	
"So how's business?"	"It's good"	
"I've seen you guys have had some IT integration problems. Are those resolved?"	"I'm not sure because that's really not my area of expertise. I focus on purchasing equipment. The areas where…(Lucas interrupts Sunil)"	
"I'm building a DCF valuation model and need help in forecasting the RASM in order to compute the ROIC. What's your current WACC and where do you see it 2-3 years from now?"	"Sorry but I don't understand some of those terms"	
"Maybe I should start with my basic view in that I expect trans-Pacific ticket pricing to increase over the next 2 years. Do you agree?"	"I think pricing might go up"	
"Thanks, my boss is going to be pleased I found someone in the industry to confirm my thesis."	"I'm glad I could help"	

Case: Is Lucas generating differentiated insights?

"Didn't you guys order a bunch of those enormous A380 aircraft? Who's in charge of that massive gamble?"	"That's my boss. I worked on that project for him. It's actually quite sound, given our strategy of focusing on hub-to-hub routes…"	
Lucas' thoughts and actions…		**Your thoughts**
As Sunil explains the strategy, Lucas feels his phone vibrate and it's a text showing that his favorite team is losing an important playoff game. So he shifts his stance so he can see a TV in the bar showing the game, now standing almost side-by-side with Sunil, and continues to show mild interest in the conversation. Lucas, feeling confident Sunil has answered his question about trans-Pacific pricing, decides there's nothing else to discuss and thinks of a strategy to end the conversation. Lucas spends a few minutes telling Sunil about his buy-side job and then says he needs to go back to his hotel to catch up on work.		
Before Lucas departs, Sunil asks why he's not going to the conference dinner featuring a panel discussion of four of the industry's top journalists/bloggers. Lucas tells him, "If they have something really important to say, I'm sure I'll read about it in the *Financial Journal* or CNBC tomorrow."		
Lucas flies home the next day, feeling a bit anxious because he's missed two days of news flow. In his effort to catch up, he doesn't take the time to follow up with Sunil or the CEO, or share with his internal colleague who covers the aerospace sector that Trans Global Airlines sees a design flaw in the next generation of planes being produced by a major manufacturer held in the company's portfolio.		

- ■ If this workshop is being taught live (web-based or in-person), notify the facilitator when you have reached this point for your first read-through. If time is available, read again, noting in the right column where the analyst was not using a best practice
- ■ If you are taking this workshop as On-demand, continue to the next topic. The case will be discussed at the end of each module

"Quality Control Inspector" Exercise

Instructions for the "Quality Control Inspector" exercise:
- You are a quality control manager in a game card plant and need to determine if any of the playing cards are defective
- There are three assembly lines, each with separate, unrelated types of cards you need to inspect
  – Type #1
  – Type #2
  – Type #3
- Each type of cards will have a unique set of features unrelated to the other types
- Your job is to review a sample from the assembly line and then determine which card(s) you will need to turn over to determine if that deck of cards is defective

<center>Please do not go to the next page until told to do so</center>

"Quality Control Inspector" Exercise

Instructions for the "Card Type 1" exercise:

■ Look at the four "Type 1" cards that immediately follow below these instructions

■ These cards are unique in that they each have a:
  – Color on one side; and
  – Shape on the other

■ This aspect does not need to be inspected – we know all cards have a color on one side and shape on the other

■ To ensure this batch of cards was assembled correctly, you need to make sure this rule is followed:
  – <u>If a card has a circle on one side, then it must have the color yellow on the other side</u>

■ You've entered the inspection room where you are presented with the four cards below from the current production batch and you need to determine if they are defective

■ Based on these four cards alone, which do you need to turn over to see if the cards are defective?

■ Put an "X" below the card(s) you need to turn over to confirm if this rule has been broken

Card Type #1:

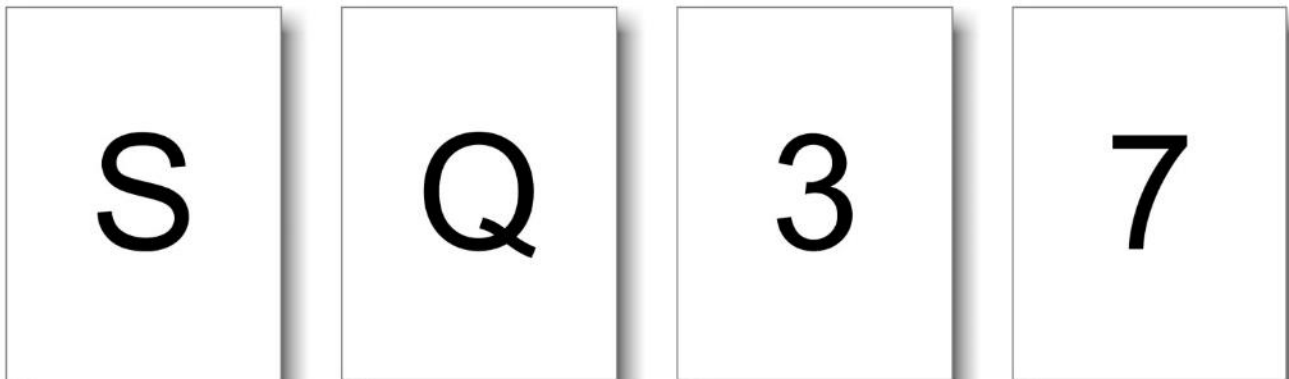*Please do not go to the next page until told to do so*

"Quality Control Inspector" Exercise

Instructions for the "Card Type 2" exercise:
- Look at the four "Type 2" cards that follow immediately below these instructions
- These cards are unique in that they each have a:
  - Number on one side; and
  - Letter on the other
- This aspect does not need to be inspected – we know all cards have a number on one side and letter on the other
- To ensure this batch of cards was assembled correctly, you need to make sure this rule is followed:
  - <u>If a card has the letter S on one side, it must have the number 3 on the other side.</u>
- You've entered the inspection room where you are presented with the four cards below from the current production batch and you need to determine if they are defective
- Based on these four cards alone, which do you need to turn over to see if the cards are defective?
- Put an "X" below the card(s) you need to turn over to confirm if this rule has been broken

Card Type #2:

S	Q	3	7

Please do not go to the next page until told to do so

"Quality Control Inspector" Exercise

Instructions for the "Card Type 3" exercise:
- Look at the four "Type 3" cards that follow immediately below these instructions
- These cards are unique in that they each have a:
  - Statement about a specific company's unique quality (green border) on one side; and
  - Indication if the stock has outperformed or underperformed the market over the long-term (red border) on the other side
- This aspect does not need to be inspected – we know all cards have a statement about a specific company's unique quality on one side and how the stock has performed relative to the market over the long-term on the other side
- To ensure this batch of cards was assembled correctly, you need to make sure this rule is followed:
  - <u>Companies with earnings growth rates faster than the market always outperform the market over the long term</u>
- You've entered the inspection room where you are presented with the four cards below from the current production batch and you need to determine if they are defective
- Based on these four cards alone, which do you need to turn over to see if the cards are defective?
- Put an "X" below the card(s) you need to turn over to confirm if this rule has been broken

Card Type #3:

Company has pricing power	Company has earnings growth faster than the market	Stock ABC has outperformed over the long term	Stock XYZ has under-performed over the long term

Sources of Insight

Networking Self-Assessment

Instructions for the Networking Self-Assessment
- The purpose of this assessment is to identify your strengths and potential weaknesses as it relates to networking skills, which are critically important for successful equity research
- Rate each statement below on a scale of 1-5, according to how it relates to you with:
    - 1 = I NEVER exhibit this behavior
    - 5 = I ALWAYS exhibit this behavior
- Try to answer based on your most recent real-life situations
- Your scores will not be collected or shared and so be as honest as you can

Networking Self-Assessment

1=Never 5=Always	Part 1: General Networking Skills
	A. I find it easy to initiate conversations with strangers
	B. People I know think that I am a good listener
	C. Before attending a networking event, I usually stress out
	D. When I meet people for the first time, I make an effort to get to know them by asking a lot of questions.
	E. At social and business events, I clearly remember the people I have met before.
	F. I feel comfortable calling/emailing people that I have been referred to by people I know
	G. I find it easy to talk about and sell myself to people I hardly know

Scoring:
- Score as follows:
    - Step 1: Add your scores for ALL BUT question C and put in box below:

    - Step 2: Convert your score to question C by using the following table:

If your score for C was…	Add this to the score for the questions above
1	5
2	4
3	3
4	2
5	1

    - Step 3: Add Step 1 to Step 2 for your total score:

    - Review the scoring key below

Networking Self-Assessment

Scoring Key

| Score	Level
7-18	**Developing Networker:** You may feel uncomfortable when meeting people for the first time and may encounter difficulties when networking. Try to come out of your shell by approaching strangers and selling your skills and attributes. If networking is something you don't feel comfortable with, remember, if done correctly, it should be mutually beneficial to both parties. Always follow up with the contacts you have made and remember, networking isn't only about meeting the right people, it's about getting to know the people you have met.
19-26	**Competent Networker:** You feel comfortable meeting people in some situations more than others. Although you may not encounter a great deal of difficulty when networking, you are probably not utilizing your full networking potential. Approach as many people as possible and make sure to get their contact details, and conduct follow-ups via email, instant message or the phone.
27-35	**Confident Networker:** You feel comfortable when meeting people for the first time and likely have little or no problems networking and developing relationships with your contacts. Remember to immediately follow up any contacts you have made and conduct follow-ups via email, instant message or the phone. Also ask them for additional referrals that may be of help.

Inspired by Morton Phillips, Search, Selection and HR Strategy

Valuation

Valuation Flow Chart

Valuation Flow Chart
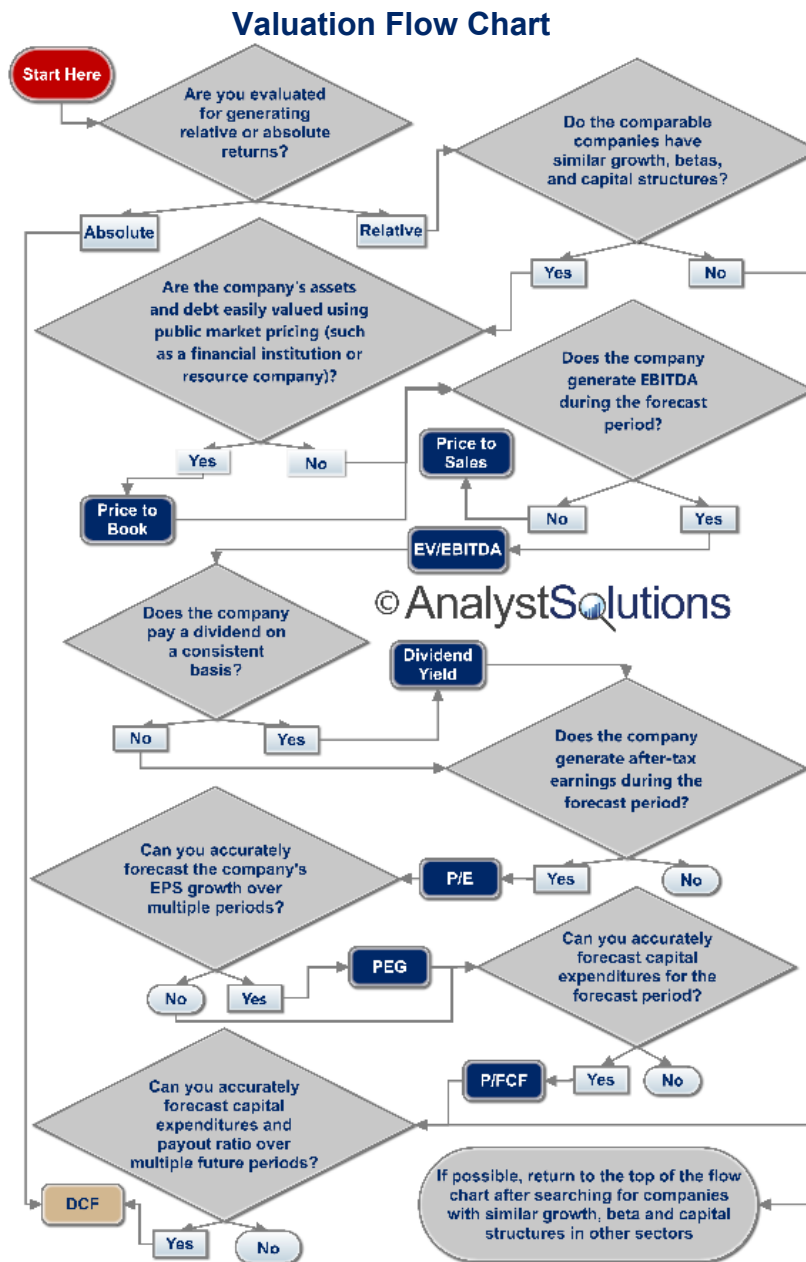
Mastering Stock Picking

Case: David Plans SBUX Upgrade

Instructions for the Potential Upgrade of SBUX:
- David, who covers the restaurant sector, has had trouble with some of his stock picks in the past. In fact, during his mid-year review his boss said if his stock picking doesn't improve he likely will not receive a bonus this year and be put on probation (which is the first step to having his employment terminated from the firm). David would like to upgrade Starbucks (SBUX) and decides he should discuss it first with a more senior member of the firm, Pablo, who has been a successful analyst for 10 years.
- As you're reading the passage that follows keep track of "best practices" (something you would do or advocate other analysts to do) and "bad practices" (those things you would recommend an analyst not do). We encourage you to use underlining, bolding (if using electronic version) or the right column for notes so that you can keep track of the best and bad practices.
- The left column in the table that follows is David's dialogue and the center is Pablo's. Read one entire row before proceeding to the next. You may not have anything to enter in the "Notes" column for some rows.

Potential Upgrade of SBUX Script

David's Dialogue:	Pablo's Dialogue:	Notes
Hi Pablo. I was hoping you could give me some feedback about a stock call I would like to make.	I'd be happy to help. What's the stock?	
I've wanted to upgrade SBUX for years and now I have my opportunity because it's launching new breakfast sandwiches and a new cold drink	Interesting…what's your price target?	
There's at least 20%-30% upside…putting a price target on it is difficult because there's a lot of uncertainty about the company's long-term earnings power. I'm not sure why, but some analysts in the market are valuing using a PEG ratio while others are using a P/E ratio	How are you valuing the stock?	
I'm using $0.87 of earnings for the upcoming year and $1.00 for the year after.	That's 15% growth. Where's consensus in terms of estimates?	

Case: David Plans SBUX Upgrade

Very close to my numbers.	If you see 25% upside in the stock and the company is growing EPS 15%, you must be assuming the P/E multiple expands.	
I'm not sure I follow your logic. The stock is trading at a 28x multiple, but it was trading as high as a 42x multiple just 3 months ago.	Has the multiple expanded in the past?	
I'm not sure -- when I pulled up the historical valuation metrics for the past two years, it showed a historical peak of 48x forward earnings	What about the trough?	
I'm not sure, but the stock is up 18% for this year – I don't want to miss a further move.	But the market is up about that much.	
…And SBUX has climbed along with it, despite nothing really new to the story. They're poised for a break-out. One sell-side analyst I speak with said if you buy SBUX late in the year, you always see upside by the end of February.	Do you know when the new products will be released?	
Not entirely, but I just read in *The Financial Journal* that a supplier to SBUX said they've been asked to build equipment to make the frozen drink. I've wanted to upgrade this stock for a while and this now gives me the opportunity.	How does the risk/return trade-off for SBUX compare to the other stocks in your universe?	
SBUX has the most upside.	What about risk?	
I don't follow your point.	What's the downside in the stock?	
Why would it go down from here?	Could something go wrong?	
Not likely because the new products haven't been debuted yet.	Didn't the company struggle with its same-store-sales comps in the recent quarter?	
Yes, they grew only 4%, but it's due to a slower morning throughput caused by the increased popularity of Frappuccinos. The company still plans to generate 20%-25% EPS growth for the next 3-5 years and recently raised its long-term global unit target to 40,000 stores, up from 30,000.	Have you looked into how much stock management owns?	

Case: David Plans SBUX Upgrade

I'm not sure, but it's a young company and so management must own a big chunk of the stock.	What are your thoughts about the current quarter?	
Last time I looked, consensus was at 18 cents but I think everyone knows the near-term numbers need to come down by a penny or two.	David, I want to help you avoid making a call similar to the two problematic ones earlier this year.	
Thanks, but those calls weren't my fault – consensus dropped for both of those companies, showing that everyone was surprised	Wasn't Golden Bull Securities recommending shorting one of those names before the drop?	
True. But even a blind squirrel finds a nut every once in a while.	I think we need to discuss this potential upgrade a bit further.	

- ■ If this workshop is being led by a facilitator, alert him/her after you have noted "best practices" and "bad practices above, then continue onto the answer key
- ■ If you are taking this workshop without a facilitator, continue to the answer key

Answer Key for "Potential Upgrade of SBUX"

All of the answers below will be discussed throughout the workshop's four-step TIER™ framework and so do not be concerned if you do not have time to read through or fully understand before moving onto the next module.

Best Practices by Pablo and David:

1. David is aware of how his estimate compares to consensus
2. Pablo breaks down the potential upside into the two key components: the forecast or valuation
3. Pablo correctly notes that most of the upside in the stock over the past year has been in line with the market's move
4. Pablo is trying to ascertain the catalyst that will move the stock (i.e. the date of the new products being released)
5. Pablo wants to explore what could go wrong
6. Pablo is looking for imminent risks such as a potential disappointment in the current quarter
7. Pablo is questioning if David has selective memory, where he revises history to meet his needs

Bad Practices by David:

1. Says he's been wanting to "upgrade SBUX for years" suggesting he has a pre-existing bias that could be clouding his view (aka "confirmation" bias)
2. Doesn't have a price target or range of targets
3. Doesn't know if the stock has seen an expanding P/E in the past
4. Is impressed the stock has moved 18% this year even though this is likely due to the overall market move
5. Is relying on a basic rule of thumb (heuristic) in terms of buying the stock late in the year to get upside by February, which he doesn't appear to have validated
6. Doesn't know when the new products will be released, which is the catalyst for his stock call
7. When asked to compare SBUX to other stocks in his universe, he's only looking at returns and appears to have excluded an assessment of risk
8. Hasn't considered what could go wrong with his call
9. Doesn't seem to be concerned with the company having poor same-store-sales comps or the amount of stock owned by management
10. Doesn't seem to be concerned by the company's potential for falling short of the current quarterly consensus estimates
11. Dismisses prior bad calls to things that were a surprise to everyone even though a sell-side firm had correctly made an accurate call on one of the stocks

Postscript:

The passage above was inspired by actual events occurring from 2006 to 2008. (The EPS were slightly modified so the math would be easy to compute without a calculator.) Here are some actual events that occurred after David's proposed upgrade:

- In late 2006, Howard Schultz, the company's founder and chairman at the time, wrote a memo (leaked to the press) that identified challenges caused by the company's excessive growth. In addition to specific concerns, he closed the letter with, "I have said for 20 years that our success is not an entitlement and now it's proving to be a reality. Let's be smarter about how we are spending our time, money and resources."
- Due to weaker-than-expected growth and margins, the stock dropped 42% in 2007, while the S&P 500 was up 3%
- In January 2008, Howard Schultz took back the CEO role
- Breakfast sandwiches were discontinued in 2008
- The frozen drink "Sorbetto" was discontinued after a debut to 300 stores

Four Scenarios Table

This table is also found in your Slide Booklet

	Scenario			
	A	B	C	D
1. Current data				
Current stock price	$50.00	$50.00	$50.00	$50.00
Next 12-month ("NTM") consensus EPS forecast at present (we call this "Year 1")	$5.00	$5.00	$5.00	$5.00
Stock's current valuation multiple based on Year 1 EPS	10.0	10.0	10.0	10.0
Current market multiple	15.0	15.0	15.0	15.0
Stock's current premium or discount to the market multiple	-33%	-33%	-33%	-33%
2. Change from consensus EPS between Year 1 and Year 2				
NTM consensus in Year 2 (i.e. forecast at beginning of Year 2 for Year 2)	$5.60	$5.60	$5.60	$5.60
Difference between Year 2 and Year 1 consensus forecasts	12%	12%	12%	12%
Item #2 above is due to passage of time while #3 and #4 below are influenced by the analyst				
3. Change due to analyst's financial forecast differing from consensus				
Analyst's NTM EPS forecast in one year (i.e. forecast for Year 2)	$5.60	$6.00	$6.00	$6.60
Premium or discount of analyst's EPS estimate in Year 2 compared to consensus'	0%	7%	7%	18%
4. Change due to analyst's future valuation multiple differing from current multiple				
Analyst's estimate of market multiple at beginning of Year 2 (typically keep same as present)	15.0	15.0	15.0	15.0
Analyst's estimate of stock's premium or discount to market multiple at beginning of Year 2	-33%	-33%	-27%	-20%
Valuation multiple used for price target at beginning of Year 2	10.0	10.0	11.0	12.0
Difference between analyst's future multiple and stock's current multiple				
5. Price target	$56.00	$60.00	$65.70	$79.20
Change from current price	12%	20%	31%	58%

* NTM = next twelve months

"How Do You Differ?" Exercise

Instructions for the "How Do You Differ?" exercise:

- This exercise helps to reinforce the critically-important concept that all great stock calls must differ from consensus. You will do this using the FaVeS framework, specifically, looking for an out-of-consensus view in one of these areas:
  - Financial forecast; or
  - Valuation multiple or method; or
  - Sentiment towards the stock (void of impending changes to the financial forecast or valuation multiple/method above, which is rare, but does occur)
- If you brought or can quickly access example research reports that contain recommendation/ratings changes that include price targets (if not, go to the next square bullet below):
  - Review page 1 of each report to identify where the author (which could be you) differs from consensus using the FaVeS framework.
  - If you would like to use a standard format to lay out your answers, feel free to use the blank columns under "Your Answer" in the 3 scenario worksheets that follow. (If you brought your own reports, you will not need the upcoming pages for any other purpose)
- If you do not have access to recommendation/ratings change reports that contain price targets:
  - Review the 3 scenarios below, noting they are occurring at the start of calendar Year 1 (Y1) and so one-year price targets are based on forecast earnings for Y2. The term "NTM" is "next 12 months."
  - To ensure you arrive at the same answer as our answer key, we assume the market's multiple is 15x NTM earnings (not the stock's multiple)
  - Before reading the scenario, cover up or minimize your window so that you do not see the two right-most columns until after you have tried to complete the scenario
  - After reading the passage, complete the column titled "Your Answer" and then check the right-most columns to see if you were correct
  - After reviewing the answer key, answer the question "Did the analyst have a unique call" which can be found below each answer key
- Note the answer key may differ slightly from your answer due to rounding issues
- Using a calculator will likely speed up the exercise

"How Do You Differ?" Exercise

Scenario 1: McDonald's
(Reminder: cover up or minimize your window so that you do not see the two right-most columns below until after you have attempted to complete the scenario.)

"We are recommending purchasing McDonald's Corp (MCD) and have a one-year price target of $116 (up 21% from its current $96). We believe a recovering Europe and growing emerging markets will allow the company to beat Y2 consensus EPS of $6.20 (we are at $7.00). Our price target assumes the stock continues to trade at its current 10% premium to the market's 15x multiple (putting MCD at a 16.6x forward multiple)."

	Your Answer	Answer Key	Stock Price Impact
1. Current data			
Current stock price	$96.00	$96.00	
Next 12-month ("NTM") consensus EPS forecast at present (we call this "Year 1")	5.80	$5.80	
Stock's current valuation multiple based on Year 1 EPS	16.6	16.6	
Current market multiple	15.0	15.0	
Stock's current premium or discount to the market multiple		10%	
2. Change from consensus EPS between Year 1 and Year 2			
NTM consensus in Year 2 (i.e. forecast at beginning of Year 2 for Year 2)		$6.20	
Difference between Year 2 and Year 1 consensus forecasts		7%	$6.62
Item #2 above is due to passage of time while #3 and #4 below are influenced by the analyst			
3. Change due to analyst's financial forecast differing from consensus			
Analyst's NTM EPS forecast in one year (i.e. forecast for Year 2)		$7.00	
Premium or discount of analyst's EPS estimate in Year 2 compared to consensus'		13%	$13.24
4. Change due to analyst's future valuation multiple differing from current multiple			
Analyst's estimate of market multiple at beginning of Year 2 (typically keep same as present)	15.0	15.0	
Analyst's estimate of stock's premium or discount to market multiple at beginning of Year 2		10%	
Valuation multiple used for price target at beginning of Year 2		16.6	
Difference between analyst's future multiple and stock's current multiple		0%	$0.00
5. Price target	$116	$115.86	$19.86
Change from current price	21%	21%	

* NTM = next twelve months

"How Do You Differ?" Exercise

Breakdown of Analyst's Price Target vs. Current Price

Elements of FaVeS

Did the analyst have a unique call?

_____

_____
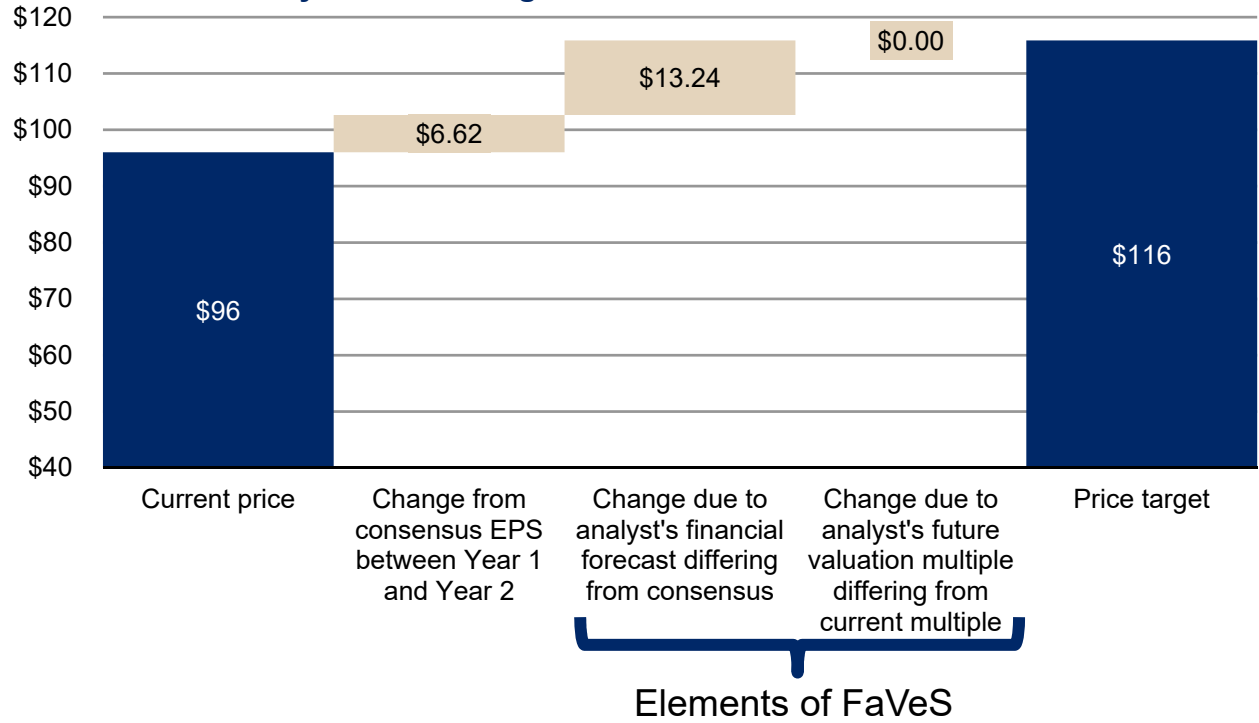
"How Do You Differ?" Exercise

Scenario 2: Starbucks (SBUX)

(Reminder: cover up or minimize your window so that you do not see the two right-most columns below until after you have attempted to complete the scenario.)

"We are no longer recommending purchasing SBUX because we believe the consensus expectations for the next fiscal year (Y2) are 11% too high. Using our EPS forecast for next year (our Y2 estimate is $2.85, while consensus is at $3.20); we arrive at a base-case scenario price target of $68, which would be a 9%-10% drop from the stock's close of $75. Our proprietary work (survey and interview with industry sources) suggests the company will be unable to pass through the upward labor cost pressure driven by increases in minimum wages. The company will see higher cost inflation or, if it raises prices, slower unit sales, either of which will slow EPS growth. Given the company's current above-average valuation multiple of 28x current consensus Y1 earnings (which is an 85% premium to the market multiple of 15x), we believe this multiple will contract to 24x when the market realizes next year's consensus earnings are too high."

Scenario 2: Starbucks (SBUX)

	Your Answer	Answer Key	Stock Price Impact
1. Current data			
Current stock price	$75.00	$75.00	
Next 12-month ("NTM") consensus EPS forecast at present (we call this "Year 1")	$2.70	$2.70	
Stock's current valuation multiple based on Year 1 EPS	27.8	27.8	
Current market multiple	15.0	15.0	
Stock's current premium or discount to the market multiple		85%	
2. Change from consensus EPS between Year 1 and Year 2			
NTM consensus in Year 2 (i.e. forecast at beginning of Year 2 for Year 2)	$3.20	$3.20	
Difference between Year 2 and Year 1 consensus forecasts	19%	19%	$13.89
Item #2 above is due to passage of time while #3 and #4 below are influenced by the analyst			
3. Change due to analyst's financial forecast differing from consensus			
Analyst's NTM EPS forecast in one year (i.e. forecast for Year 2)		$2.85	
Premium or discount of analyst's EPS estimate in Year 2 compared to consensus'		-11%	-$8.40
4. Change due to analyst's future valuation multiple differing from current multiple			
Analyst's estimate of market multiple at beginning of Year 2 (typically keep same as present)	15.0	15.0	
Analyst's estimate of stock's premium or discount to market multiple at beginning of Year 2		60%	
Valuation multiple used for price target at beginning of Year 2		24.0	
Difference between analyst's future multiple and stock's current multiple		-14%	-$12.09
5. Price target	$68	$68.40	-$6.60
Change from current price	-9%	-9%	

* NTM = next twelve months

"How Do You Differ?" Exercise

Did the analyst have a unique call?

_____

_____

"How Do You Differ?" Exercise

Scenario 3: Chipotle (CMG)
(Reminder: cover up or minimize your window so that you do not see the two right-most columns below until after you have attempted to complete the scenario.)

"We are recommending the purchase of CMG because we believe the market doesn't appreciate the company's earnings power. Specifically, we believe as the company expands into the Northeast, revenue (and profit) per store should increase faster than its historical trend, based on experience we have witnessed from other chains that expand into the Northeast. Our $720 one-year price target, which is 30% above yesterday's close of $554, is based on the company trading at a 45x P/E ratio (slightly above its current 42.6x) on our $16.00 EPS estimate for next year (Y2) (compared to consensus at $15.50)."

Scenario 3: Chipotle (CMG)

	Your Answer	Answer Key	Stock Price Impact
1. Current data			
Current stock price	$554.00	$554.00	
Next 12-month ("NTM") consensus EPS forecast at present (we call this "Year 1")	$13.00	$13.00	
Stock's current valuation multiple based on Year 1 EPS	42.6	42.6	
Current market multiple	15.0	15.0	
Stock's current premium or discount to the market multiple		184%	
2. Change from consensus EPS between Year 1 and Year 2			
NTM consensus in Year 2 (i.e. forecast at beginning of Year 2 for Year 2)	$15.50	$15.50	
Difference between Year 2 and Year 1 consensus forecasts	19%	19%	$106.54
Item #2 above is due to passage of time while #3 and #4 below are influenced by the analyst			
3. Change due to analyst's financial forecast differing from consensus			
Analyst's NTM EPS forecast in one year (i.e. forecast for Year 2)		$16.00	
Premium or discount of analyst's EPS estimate in Year 2 compared to consensus'		3%	$22.50
4. Change due to analyst's future valuation multiple differing from current multiple			
Analyst's estimate of market multiple at beginning of Year 2 (typically keep same as present)	15.0	15.0	
Analyst's estimate of stock's premium or discount to market multiple at beginning of Year 2		200%	
Valuation multiple used for price target at beginning of Year 2		45.0	
Difference between analyst's future multiple and stock's current multiple		6%	$36.96
5. Price target	$720	$720	$166.00
Change from current price	30%	30%	

* NTM = next twelve months

"How Do You Differ?" Exercise

Breakdown of Analyst's Price Target vs. Current Price

Did the analyst have a unique call?

_____

_____
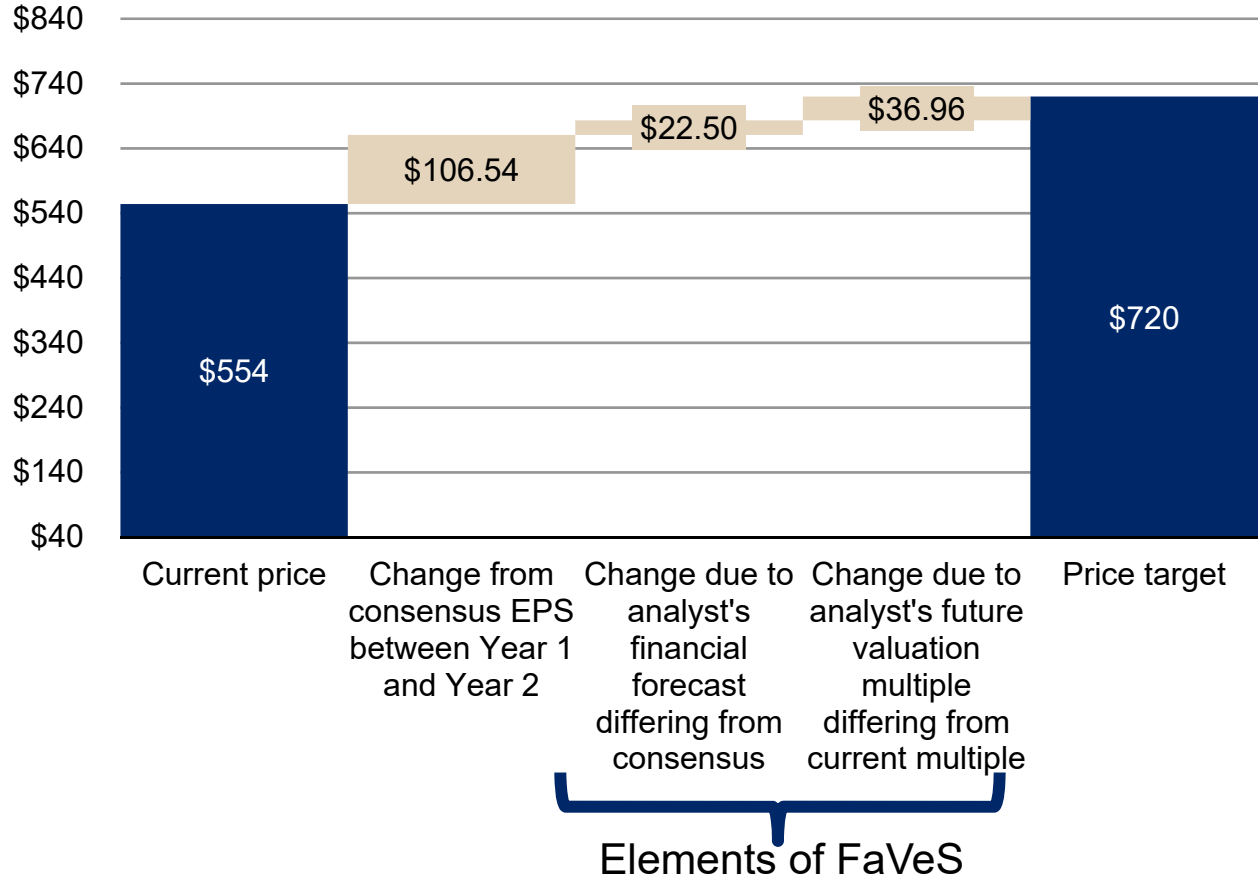
"How Do You Differ?" Exercise

Answer Key for "Did the analyst have a unique call?"

- McDonald's
  - Using the FaVeS framework, the biggest driver to the 21% upside to the analyst's price target is driven by an EPS estimate that is 13% ahead of consensus for next year, and so this is where we need to look to determine if it's a unique call. The analyst cites "recovering Europe and growing emerging markets", but it's not clear if this is based on a hunch or due to unique research. The best stock calls are based on factors that can be forecast better than the market and therefore it's not clear this is a truly "unique" call
- Starbucks
  - This call is somewhat unique in that it involves an EPS estimate and valuation multiple that are both out of consensus, which means they should both be examined. It appears the analyst has a unique call in terms of the financial forecast (based on a proprietary survey and conversations with industry sources), but it's not clear that the valuation multiple is truly "unique" because there's no explanation why 24x is being used versus the stock's current 28x (why not 25x? or 20x?).
- Chipotle
  - What makes this call interesting is that the analyst's EPS forecast is only 6% higher than consensus and the P/E ratio is essentially in line with consensus (i.e. the current P/E multiple). About two-thirds of the upside to the price target is driven simply by the company continuing to grow its earnings near 20%. Regardless of how the analyst wants to pitch the story, given that his EPS estimate and multiple do not differ much from consensus, he doesn't have a "unique" stock call. (Unfortunately, this happens all too often.)

3-Step Communication Process

Case: Lucas' first attempt at communicating his stock call

Instructions for the case:
- Read the following case study of an analyst's initial presentation to his investment committee to ensure he has researched the investment thesis thoroughly enough to justify his recommendation
- Evaluate the analyst using the checklist that follows the case by responding Yes, No or Not Clear
- After you are done, review the answer key on the page following your answers
- For the purpose of evaluating a one-year price target, assume the case is occurring on January 1st and therefore any reference to "next year" begins in 12 months

Lucas Gallo is an equity research analyst at Nickel Mine Asset Management (NMAM), having graduated with an MBA from a prestigious university before joining the firm five months ago. Lucas covers the transportation, chemical, and auto sectors. He has not made any changes to the ratings of the stocks since being given the group because he is still conducting initial research to develop his own unique view.

For their first year at NMAM, each new analyst is assigned to a senior portfolio manager (PM) to be his or her mentor. Lucas has been assigned to David Torres, an experienced PM and chair of NMAM's 5-member investment committee.

The investment committee of four portfolio managers and two senior analysts has just come together in the firm's conference room to hear Lucas' presentation. Nadia is a portfolio manager and member of the firm's investment committee.

David: Lucas, please share your thoughts with the committee.

Lucas: I've been doing work on Tonda Motor Company for the past 3 months, and have decided to initiate coverage with a buy rating. My $30 price target is 20% above the stock's $25 closing price. I get to my target by applying a 10x P/E multiple on my forecast of $3.00 for next year. The reason for the upgrade is based on a meeting I had with management about a month ago. I went to their headquarters with a sell-side analyst and a few other buy-side analysts, where we heard management tell us it's comfortable with the consensus estimate for this year and next, which are currently $2.77 and $2.98, respectively. During the meeting, they reiterated points made during their last investor day, by showing us some of their upcoming new car and truck models and saying their preliminary research suggested they are going to be hot sellers.

Case: Lucas' first attempt at communicating his stock call

David: Thank you, Lucas. What are the critical factors that will move the stock from $25 to $30?

Lucas: I suspect the market doesn't believe in the $2.98 EPS consensus estimate, or maybe it doesn't understand how well the new models are going to sell.

Nadia: What research have you done to confirm these views?

Lucas: I've read all of the company's regulatory filings for the past 3 years, and reviewed the quarterly transcripts from the past 4 quarters.

Nadia: Have you spoken to anyone about your view? Specifically, this notion you have that the market doesn't believe in the $2.98 estimate?

Lucas: No. But I have a gut feeling I'm right.

David: What are the catalysts that will bring the market around to your thinking and drive the stock from $25 to $30?

Lucas: Hmmm…maybe when the new models start selling really well, the market will get excited.

David: Can you show us your earnings model?

Lucas: Here is a basic model that shows my forecast. (Lucas presents it to the committee.)

Nadia: Lucas, this model is formatted like MCG's models (a sell-side firm). Did you create this on your own?

Lucas: I used MCG's Excel model but made a few changes.

Nadia: Such as?

Lucas: I have Tonda's pricing improving slightly more than MCG's forecast.

David: How does the pricing assumption relate to your investment thesis that Tonda's cars are selling better than expected?

Lucas: I guess if the cars are selling hot, that will lead to better pricing.

Nadia: Lucas, where could you be wrong?

Lucas: I'm sorry, I don't understand the question.

Case: Lucas' first attempt at communicating his stock call

Nadia: What part of your thesis could turn out to be incorrect, and thus lead the stock to be dead money or even drop from current levels?

Lucas: Well, I can't imagine the stock going down from here, because management said on its last quarterly call that it's comfortable with consensus expectations. Also, valuation levels seem low.

David: How do you draw this conclusion?

Lucas: I read in a sell-side analyst's report that the stock has been trading between a 9x and 10x forward earnings multiple for the past two years, and right now it's at 9x.

David: Is there anything else you would like to share with us?

Lucas: No, that sums up my work.

David: Thank you, Lucas. Please stop by my office later so we can discuss.

Exhibit 2: ENTER™ Quality Checklist

ENTER™ Quality Checklist	Yes/No/Not Clear
Expectational	
Does the analyst have a <u>forward-looking</u> view in terms of the stock and the critical factor(s) likely to move the stock?	
Has the analyst identified the catalyst(s) likely to move his stock and important dates when the catalyst is most likely to cause the stock to move to his price target?	
Has the analyst framed company management's forecast in terms of his <u>independent</u> financial forecast (rather than just repeat management)?	
Novel	
Does the analyst have a piece of information or insight that is new and not widely understood within the financial markets?	
Has the analyst explained where his view falls within the FaVeS™ framework, in terms of identifying if he has a superior <u>F</u>inancial forecast, <u>V</u>aluation method/multiple, or unique view about market <u>S</u>entiment?	
Does the analyst know why the market does not have his view?	
Thorough	
For the critical factors that are key to the stock call, did the analyst research more than one source or confirm the insight with an independent source?	
Did the analyst conduct detailed modeling in the area surrounding the critical factor(s)?	

Does the analyst avoid using management guidance as the primary justification for the call?	
<u>E</u>xaminable	
Do you think the analyst has the following details that he could present to the committee? • Data or insights about the critical factor(s)? • Detailed financial forecast or valuation analysis, key to the investment thesis?	
<u>R</u>evealing	
Has the analyst created upside, downside, and base-case scenarios to identify where the investment thesis could have flaws?	
Has the analyst identified specific risks beyond the macro?	
Has the analyst provided his conviction level to others, even if it is not strong?	

After you have completed your responses above, review the answer key on the following page

Exhibit 3: ANSWER KEY TO LUCAS' FIRST ATTMEPT CASE STUDY

ENTER™ Quality Checklist (to be used <u>before</u> starting the communication of a stock recommendation)	Yes/No/Not Clear
<u>E</u>xpectational	
Does the analyst have a <u>forward-looking</u> view in terms of the stock and the critical factor(s) likely to move the stock?	Not clear: He has a forecast but it's not clear he's done any work on understanding the critical factor(s) that will drive his forecast.
Has the analyst identified the catalyst(s) likely to move his stock and important dates when the catalyst is most likely to cause the stock to move to his price target?	No: He's unsure as to what will move the stock.
Has the analyst framed company management's forecast in terms of his <u>independent</u> financial forecast (rather than just repeat management)?	Not clear: It appears as though he's just accepting management guidance.
<u>N</u>ovel	
Does the analyst have a piece of information or insight that is new and not widely understood within the financial markets?	Not clear: He doesn't offer any unique insight based on research.
Has the analyst explained where his view falls within the FaVeS™ framework, in terms of identifying if he has a superior <u>F</u>inancial forecast, <u>V</u>aluation method/multiple, or unique view about market <u>S</u>entiment?	No: He has the same estimates as consensus and believes the stock will trade within its historical valuation multiple range.
Does the analyst know why the market does not have his view?	No: He says he hasn't spoken to anyone about his view.
<u>T</u>horough	
For the critical factors that are key to the stock call, did the analyst research more than one source or confirm the insight with an independent source?	No. He only read regulatory filings, transcripts and met with management.
Did the analyst conduct detailed modeling in the area surrounding the critical factor(s)?	No: He mentioned his modeling is for better pricing, not volume growth due to the new models selling better than expected.
Does the analyst avoid using management guidance as the primary justification for the call?	No: It appears based primarily on management guidance.
<u>E</u>xaminable	
Do you think the analyst has the following details that he could present to the committee? • Data or insights about the critical factor(s)? • Detailed financial forecast or valuation analysis, key to the investment thesis?	No: It doesn't appear as though he has any unique data or a detailed financial forecast to support his view.
<u>R</u>evealing	
Has the analyst created upside, downside, and base-case scenarios to identify where the investment thesis could have flaws?	No: He doesn't have an answer when Nadia asks him, "Where could you be wrong?"
Has the analyst identified specific risks beyond the macro?	Same as above
Has the analyst provided his conviction level to others, even if it is not strong?	No

Be Expectational in Your Approach

Instructions for the "Be Expectational in Your Approach" Exercise:
- Too often, analysts are focusing on historical data and past events, at the expense of conducting research to forecast the future
- Read the example quotes below which could be from a typical analyst's report or presentation, and notice how the "Bad Practice" in column 1 is converted to a "Best Practice" in column 2
- Even though you are being asked to review the analyst's *message* (which is covered later as Step 3 of our 3-step process), try to focus on Step 1, by specifically asking, "Is the analyst approaching his or her *research efforts* in a manner to be expectational?"
- If you brought your own sample research, review to see if it focuses primarily on the past, present or future

Exhibit 4:Examples for "Be Expectational in Your Approach" Exercise

Bad Practice: Backward looking (reviewing old news)	Best Practice: Using the past to support forward-looking view	Recommendations
"Apple's quarterly results fell short of consensus expectations because iPhone sales were weaker than expected."	"Even though Apple's near-term results fell short due to weak iPhone sales, we should note the stock outperformed the S&P 500 more than 10% during the three months leading up to prior iPhone product launches, which we forecast to occur again in the upcoming months before the next launch."	If referencing the past, analyze and quantify historical trends as they pertain specifically to the critical factors likely to impact the stock in the <u>future.</u> (Don't review the past unless it helps forecast the future.)
"We attended AT&T's analyst meeting on Wednesday where management discussed its strategy."	"Our bullish view towards AT&T was further confirmed at Wednesday's analyst meeting because the company continues to succeed in improving margins by moving more of its mobile subscribers to data-centric pricing."	Prepare for the meeting by focusing on the critical factors likely to be discussed. If you differ from consensus on any critical factor, probe that area with management. (Make the meeting an opportunity to compare your scorecard against theirs, rather than be a passive journalist.)
"During Daimler's quarterly call, management reiterated its €6B cost savings and goal to keep truck margins at least flat."	"Based on our work, we believe Daimler's €6B cost savings plan will take at least 12 months longer to achieve than the target management discussed on its quarterly call."	Prepare for the call by focusing on the critical factors likely to be discussed. If you differ from consensus on any critical factor, probe that area in advance with your information sources.

Is the Analyst's Research Expectational and Novel?

Instructions for the "Is the Analyst's Research Expectational and Novel?" exercise:

- This exercise has two brief examples of bullet points found in an analyst's report about a stock
- In the table that follows, identify if the analyst's approach is missing either of these elements:
  - Expectational
  - Novel
- When you have finished, read the answer key that follows
- If you brought your own sample research, review to see if the first 2-3 bullets or paragraphs are expectational and novel

Example 1: Excerpt from analyst's report on company ABC (household and personal care company):

"Based on its quarterly release, ABC's 2Q sales increased 3% year-over-year, which compared to the 2% growth in 1Q. The data shows the strong volume growth in paper towel and toilet tissue were offset by weakness elsewhere in the portfolio. Market share was up in paper towels, toilet tissue, toothpaste, and deodorants, but down in diapers, laundry, batteries, and razor blades. We continue to recommend buying the stock."

ENTER™ Element	Does it have this element?	What does the reader want the analyst to convey in the first paragraph to fully meet this criteria?
Expectational (the analyst should offer a unique, forward-looking view in terms of the stock or the critical factor being discussed)		
Novel (the analyst should have a new piece of information or insight impacting a critical factor that is not widely understood by the market)		

Is the Analyst's Research Expectational and Novel?

Example 2: Excerpt from analyst's report on company DEF (clothing retailer targeted to adolescents):

"We toured seven of DEF's stores in the suburbs of Metropolis, where we made some very insightful observations. Most stores had a larger stock of blue jeans than we expected, and were out of the new line of Pinky Inky shoes. We didn't like the new layout of the stores, where the merchandise is more dense in the front of the store, but we were impressed to see that the company is using new environmentally-friendly hangers that are recyclable. We continue to rate DEF over-weight."

ENTER™ Element	Does it have this element?	What does the reader want the analyst to convey in the first paragraph to fully meet this criteria?
Expectational (the analyst should offer a unique, <u>forward-looking</u> view in terms of the stock or the critical factor being discussed)		
Novel (the analyst should have a <u>new</u> piece of information or insight impacting a critical factor that is <u>not widely understood by the market</u>)		

After you have finished above, continue to the answer key that follows

Is the Analyst's Research Expectational and Novel?

Exhibit 5: ANSWER KEY for "Is the Analyst's Research Expectational and Novel?"

ENTER™ Element	Does it have this element?	What does the reader want the analyst to convey in the first paragraph to meet this criteria?
Example 1		
Expectational (the analyst should offer a unique, <u>forward-looking</u> view in terms of the stock or the critical factor being discussed)	No	Are these trends sustainable into the future or one-time in nature? If sustainable, do these observations impact future earnings or cash flow growth?
Novel (the analyst should have a <u>new</u> piece of information or insight impacting a critical factor that is <u>not widely understood by the market</u>)	No	Is this trend different than consensus, and if so why is it occurring and will it continue?
Example 2		
Expectational (the analyst should offer a unique, <u>forward-looking</u> view in terms of the stock or the critical factor being discussed)	No	Do these observations impact future earnings or cash flow growth? If so, by how much?
Novel (the analyst should have a <u>new</u> piece of information or insight impacting a critical factor that is <u>not widely understood by the market</u>)	Maybe (it was unique work, but not clear if it's material)	Are these observations from only seven store material? If so, are they different than consensus? If so, why is it occurring and will it continue?

Lucas Tries Again

Instructions for "Lucas Tries Again" Exercise:
- Similar to the earlier case, evaluate the case below using the ENTER™ checklist that follows by responding Yes, No or Not Clear
- After you are done, review the answer key on the page following your answers
- For the purpose of evaluating a one-year price target, assume the case is occurring January 1st and therefore, "next year" begins in 12 months

Lucas Tries Again…

The committee of four portfolio managers and two senior analysts has just come together in the firm's conference room to hear Lucas' new presentation.

David: Lucas, please go ahead and present your thoughts.

Lucas: Thank you. First, I want to apologize for being unprepared for my last stock call. I hope you'll see that I've done quite a bit of additional work. I would like to initiate coverage of General Bavarian Motors, ticker GBM, with a buy rating and a one-year price target of €75, which would be 18% upside from last night's close of €63.50. The buy-rating is based on the stock maintaining its current 11x forward earnings on my estimate of €6.80 per share for next year, which is about 15% above consensus expectations. Based on three conversations I've had with sell-side analysts and three other buy-side analysts, I believe the market is overly concerned with two issues:
- Potential labor unrest by GBM's unionized employees in Europe, who have their labor contract coming due in four months, and
- Competitive pressures in emerging markets such as China and India.

David: Have you done any work on these issues?

Lucas: Yes. Here's what I've discovered: The European labor union suffered a bad defeat five months ago when it went on strike at another company's plant that was subsequently shut down and all of the employees lost their jobs. The union leaders are potentially going to be voted out of office by their members because so many jobs have been lost. Based on our conversation with two labor consultants, the union leadership is much more concerned about improving its members' job security than trying to increase wages above inflation.

Nadia: How does your estimate differ than consensus?

Lucas: As you can see on row 35 of my earnings model, our €6.80 EPS estimate assumes labor costs rise only 4% next year, whereas most sell-side analysts have it increasing 6-7%.

David: And what about competition in the emerging markets?

Lucas: As for China and India, we've read a number of trade journals that explain that lower-cost domestic start-ups are struggling to maintain quality levels as they expand, which

Lucas Tries Again

is allowing GBM to capitalize on its higher quality products. We confirmed our thesis by speaking with two industry consultants who specialize in the emerging market auto sector. As you'll see in row 18 of our earnings model, our forecast does not have any decline to pricing in those markets, but the average sell-side model expects it to drop 3%-5%. Under our upside scenario, the company's higher quality could allow it to raise pricing 3%-4%, similar to levels over the past four years.

David: Why is the market missing these two points?

Lucas: Management says it's comfortable with next year's consensus estimate of €5.90 per share, but we believe the company is taking a conservative stance because it's about to begin labor negotiations and doesn't want to appear too profitable. We went back and looked at the last three rounds of labor negotiations over the past 10 years, and each time, after the negotiations are settled, the company beats numbers, presumably because management kept a lid on sell-side expectations during the negotiations.

Nadia: So what's going to bring the market around to your thinking?

Lucas: I believe once the labor agreement is reached, the company will be more vocal about putting to rest concerns about competitive pressures in China and India. Based on my estimates, the company should start to beat current EPS expectations in about two quarters, and should significantly beat estimates four quarters from now. I also expect J&J Auto Quality awards to be released in three months, which should show the quality challenges of GBM's competitors in China and India.

Nadia: What are the risks to your thesis?

Lucas: Our €75 price target is our base-case scenario, whereas we have a downside scenario of €60 and an upside scenario of €85. The biggest risk to our thesis is if the labor negotiations go bad and the company experiences much higher wage inflation. There's also the risk that the competition in China and India cut prices, which could have a negative impact, but only if they can close the quality gap. For a down-side scenario, we assume labor costs rise at the company's 10-year average and auto pricing drops 3% in China and India, which lowers our €6.80 EPS estimate to €5.75. If we apply the 10-year average multiple of 10.5x on our €5.75, we arrive at a downside of €60. I'm still relatively new to this business, so I can't say that I have 100% conviction, but I'm much more confident with this call than I was with my earlier Tonda call.

Exhibit 6: ENTER™ Quality Checklist

ENTER™ Quality Checklist	Yes/No/Not Clear
Expectational	
Does the analyst have a <u>forward-looking</u> view in terms of the stock and the critical factor(s) likely to move the stock?	
Has the analyst identified the catalyst(s) likely to move his stock and important dates when the catalyst is most likely to cause the stock to move to his price target?	
Has the analyst framed company management's forecast in terms of his <u>independent</u> financial forecast (rather than just repeat management)?	
Novel	
Does the analyst have a piece of information or insight that is new and not widely understood within the financial markets?	
Has the analyst explained where his view falls within the FaVeS™ framework, in terms of identifying if he has a superior <u>F</u>inancial forecast, <u>V</u>aluation method/multiple, or unique view about market <u>S</u>entiment?	
Does the analyst know why the market does not have his view?	
Thorough	
For the critical factors that are key to the stock call, did the analyst research more than one source or confirm the insight with an independent source?	
Did the analyst conduct detailed modeling in the area surrounding the critical factor(s)?	

Does the analyst avoid using management guidance as the primary justification for the call?	
Examinable	
Do you think the analyst has the following details that he could present to the committee? • Data or insights about the critical factor(s)? • Detailed financial forecast or valuation analysis, key to the investment thesis?	
Revealing	
Has the analyst created upside, downside, and base-case scenarios to identify where the investment thesis could have flaws?	
Has the analyst identified specific risks beyond the macro?	
Has the analyst provided his conviction level to others, even if it is not strong?	

After you are done above, review the answer key on the following page

Example Page 1 of Report

The following is an example page 1 of a research report using the ADViCE™ template format

Element	Wording	Text for the Report
Brief Conclusion	We are or I am… • recommending the purchase of… • upgrading/downgrading… • more bullish/more bearish towards… • raising/lowering our estimate/price target for… • reinforcing/revisiting our positive/negative view towards… …[stock name(s) followed by ticker(s)] because… • our work shows/suggests… • we can now conclude… • we have discovered… …[the critical factor(s)] is/will likely… • be better/worse than consensus/we expected. • occur sooner/later than consensus/we expected	I am recommending the purchase of Northern & Southern Railroad (NSR) because my work suggests the company's customer pricing will be much better than consensus expects.
FaVeS™ element that is being changed (be brief)	Our/my view is more positive/negative/bullish/bearish than consensus/our prior view, which compels/allows/motivates us/me to… [here is where you discuss the change in your superior view, as defined by at least one of the following 1) a superior forecast 2) superior valuation method/multiple; or 3) superior short-term read of sentiment] • …raise/lower our/my earnings/cash flow/growth rate forecast for this year/next year from X to Y, which puts us/me XX% higher/lower than consensus. • …justify a valuation multiple of XX, which is XX% above/below its current/historical level. • …expect the stock to move XX% up/down in the near-term [only use this option if you have a superior view toward the short-term sentiment towards the stock].	My view is more bullish than my prior view and current consensus, which compels me to raise my EPS forecast for 2017 from $1.02 to $1.20 [from **Error! Reference source not found.**], putting me 18% higher than consensus. In addition, I believe NSR's relative valuation multiple will rise from its current 21% discount to the market [from **Error! Reference source not found.**] to only a 10% discount [from **Error! Reference source not found.**].

Example Page 1 of Report

Price target math	Applying a X [valuation multiple] multiple on our/my XX.00 [EPS, CFPS, BV] estimate for 20XX [time period], results in a year-end/six-month/one-year price target of XX, which is XX% above yesterday's close.	Applying a 10% discount to the market multiple to my $1.20 EPS estimate for 2017, results in a one-year price target of $15.00, which is 50% above yesterday's close [from **Error! Reference source not found.**].
Research to support unique FaVeS™ element	[If there is more than one critical factor driving the story, you may want to communicate this element and the one directly below for each critical factor at a time] Our/my conclusion is based on… • our/my analysis of… • discussions with… • data we/I collected from… • our/my unique modeling of…	My above-consensus EPS is based on discussions with multiple industry participants whom I met at Ship-Con, a large industry conference. Furthermore, about half of the shippers I spoke with said the economy appears to be accelerating faster than consensus expectations. The industry's association president stated railroad customer rates are going up 4%-6% which was confirmed by three large shippers I spoke with. This compares to 1%-2% consensus expectations. One of the founders of the conference who has been in the industry for 32 years said he's never seen a better environment for railroads to take up pricing. The better pricing is being driven by a shortage of railroad cars and locomotives. Based on my work, NSR has the least amount of its revenue under long-term contract (only 25%) compared to its peers and therefore will see the greatest near-term benefit from better customer pricing.

Quantify unique FaVeS™ element	Specifically, we/I believe this results in $XX/XX%…
	• higher/lower EPS/CF/BV…
	• faster/slower EPS/CF growth rate…
	…for 20XX [time period] than…
	    o current consensus expectations
	    o our/my prior estimate
	AND/OR
	• expansion/contraction of the stock's relative/absolute valuation multiple from X to Y
		Specifically, I forecast better customer pricing will result in $0.18 higher EPS than my prior 2017 forecast. Given that this trend is likely to continue into 2018 and the company is still in a turnaround phase, I believe its relative valuation multiple will rise from its current 21% discount to the market to only a 10% discount.

Example Page 1 of Report

When and why will consensus adopt your view?	We/I… • differ from consensus because… • believe consensus does not understand/appreciate… [reason why consensus hasn't come around to your way of thinking yet]. We/I believe consensus will adopt/understand our/my view by [specific quarter or time of year] due to [catalyst that will drive the market to your way of thinking].	I differ from consensus because I do not believe consensus understands the car and locomotive shortage is leading to improved pricing initiatives. I spoke to 3 sell-side analysts yesterday and they each have only 1%-2% pricing in their models and do not appear to have an accelerating economy in their estimates. I believe consensus will adopt my view no later than this time next year when the higher pricing will result in EPS much higher than consensus. It may occur sooner, as railroad management discusses these better pricing initiatives during their quarterly calls and analyst meetings.
What could go wrong?	We/I have a high/low/modest degree of conviction/confidence in our/my call because [explain why your analysis above is valid or uncertain]. Our/my downside scenario results in a stock price of XX (XX% below yesterday's close) and our/my upside scenario is XX (XX% above yesterday's close).	I have a high degree of conviction in my call because I spoke to so many individuals who corroborated my thesis. My downside scenario results in a stock price of $6.60 (34% below yesterday's close) which could occur if pricing is only 1%-2%, the economy weakens, the company cannot pass along fuel inflation to its customers and the stock trades near a trough multiple (unlikely in our view). My upside scenario calls for a stock price of $20.60 (106% above yesterday's close), which is driven by pricing at the higher end of my expectations, an accelerating economy and the stock trading at only a 5% discount to the market. [The logic for the text in this box is from **Error! Reference source not found.**]

Example Page 1 of Report in Non-table Format
This is how the text from the answer key above might look like as page 1 of an authentic report:

Raising Recommendation for NSR Based on Better Customer Pricing
Conclusion: I am recommending the purchase of Northern & Southern Railroad (NSR) because my work suggests the company's customer pricing will be much better than consensus expects. My view is more bullish than my prior view and current consensus, which compels me to raise my EPS forecast for 2017 from $1.02 to $1.20, putting me 18% higher than consensus. In addition, I believe NSR's relative valuation multiple will rise from its current 21% discount to the market to only a 10% discount.

- **Price target:** Applying a 10% discount to the market multiple to my $1.20 EPS estimate for 2017, results in a one-year price target of $15.00, which is 50% above yesterday's close.
- **Research:** My above-consensus EPS is based on discussions with multiple industry participants whom I met at Ship-Con, a large industry conference. Furthermore, about

Example Page 1 of Report

half of the shippers I spoke with said the economy appears to be accelerating faster than consensus expectations. The industry's association president stated railroad customer rates are going up 4%-6% which was confirmed by three large shippers I spoke with. This compares to 1%-2% consensus expectations. One of the founders of the conference who has been in the industry for 32 years said he's never seen a better environment for railroads to take up pricing. The better pricing is being driven by a shortage of railroad cars and locomotives. Based on my work, NSR has the least amount of its revenue under long-term contract (only 25%) compared to its peers and therefore will see the greatest near-term benefit from better customer pricing.

- **Change in Estimates and Multiple:** Specifically, I believe better customer pricing will result in $0.18 higher EPS than my prior 2017 forecast. Given that this trend is likely to continue into 2018 and the company is still in a turnaround phase, I believe its relative valuation multiple will rise from its current 21% discount to the market to only a 10% discount.

- **How I Differ**: I differ from consensus because I do not believe consensus understands the railcar shortage is leading to improved pricing initiatives. I spoke to 3 sell-side analysts yesterday and they each have only 1%-2% pricing in their models and do not appear to have an accelerating economy in their estimates. I believe consensus will adopt my view no later than this time next year when the higher pricing will result in EPS much higher than consensus. It may occur sooner, as railroad management discusses these better pricing initiatives during their quarterly calls and analyst meetings.

- **Where Could I Be Wrong?:** I have a high degree of conviction in my call because I spoke to so many individuals who corroborated my thesis. My downside scenario results in a stock price of $6.60 (34% below yesterday's close) which could occur if pricing is only 1%-2%, the economy weakens, the company cannot pass along fuel inflation to its customers, and the stock trades near a trough multiple (unlikely in our view). My upside scenario calls for a stock price of $20.60 (106% above yesterday's close), which is driven by pricing at the higher end of my expectations, an accelerating economy and the stock trading at only a 5% discount to the market.

Appendix

Transformation Action Plan (TAP)

Instructions for the Transformation Action Plan (TAP):
- Throughout this workshop complete the TAP below
- Apply the key points after the workshop to help you improve your performance.
- This will not be collected and so write in a manner that will help you utilize the concepts being learned.

Section 1. Build to a Price Target

Build to a Price Target:
- With direction from the facilitator, complete the table below for a stock of interest to identify the key elements of a price target

Transformation Action Plan (TAP)

Building to a Price Target

	MCD	Your Stock	
1. Current data			
Current stock price	$158.41		A
Next 12-month ("NTM"[1]) consensus EPS forecast for STOCK at present (we call this "Year 1")[2]	$7.58		B
Stock's current valuation multiple based on Year 1 EPS (divide row A by row B)	20.9		C
Current value of a market index (e.g. S&P 500)	2,605		
Next 12-month ("NTM") consensus EPS forecast for INDEX at present	$160.99		
Current market multiple on NTM consensus (for the broad market such as S&P 500)[3]	16.2		D
Stock's current premium or discount to the market multiple (divide row C by row D, expressed as a percentage above or below 100%: a "discount" should be shown as a negative number)	29.1%		E
2. Change from consensus EPS between Year 1 and Year 2			
NTM consensus in Year 2 (i.e. forecast at beginning of Year 2 for Year 2)[4]	$8.23		F
Difference between Year 2 and Year 1 consensus EPS forecasts (divide row F by row B)	8.5%		
3. Change due to analyst's financial forecast differing from consensus			
Analyst's NTM EPS forecast in one year (i.e. forecast for Year 2)[5]	$8.80		G
Difference between analyst's estimate in Year 2 and that of consensus (divide row G by row F)	7.0%		H
4. Change due to analyst's future valuation multiple differing from current multiple			
Analyst's estimate of market multiple at beginning of Year 2[6]	16.2		J
Analyst's estimate of stock's premium or discount to market multiple at beginning of Year 2[7]	35.0%		K
Valuation multiple used for price target at beginning of Year 2 (multiply row J x (1+row K))	21.8		L
Difference between analyst's future multiple and stock's current multiple (divide row L by row C)	5%		M
5. Price target (your base-case)	$192.23		N
Change from current price (divide row N by row A)	21%		

* NTM = next twelve months

Transformation Action Plan (TAP)

Information for Setting MCD's Price Target

MCD $ Mark ⌇⌇ K158.7/159.3 1×1

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MCD US Eq	96) Actions	Output to E>	98) Settings	Consensus Ov

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Bro... ------ ▾ ▢Gui...

▦ Estimates for several more measures are ava

1)Values 2)Growth 3)Retail

	FY 2017 A	FY 2018 Est		FY 2019 Est		FY 2020 Est		FY 2021 Est	
12 Months Endin	12/31/20	12/31/2	#	12/31/2	#	12/31/2	#	12/31/2	#
11 EPS, Adj+	6.660	7.583	31	8.228	30	9.054↑	7	10.320	1
12 EPS, GAAP	6.370	7.549	17	8.181	17	8.877↑	3	10.320	1
13 Revenue	22.820B	21.045	26	20.893	25	21.169	6	21.430	2
14 Gross Margin %				54.100	1				
15 Operating Profit	9.553B	9.072B	20	9.563B	20	10.181	6	10.702	2
16 EBIT	8.853B	9.086B	10	9.447B	9	10.028	2	10.425	1
17 EBITDA		10.390	23	10.861	23	11.647	4	12.499	1
18 Pre-Tax Profit	7.874B	8.070B	24	8.493B	22	9.177B	5	9.817B	1
19 Net Income Adj	5.400B	5.974B	24	6.282B	23	6.778B	5	7.264B	1
20 Net Income, GA	5.192B	5.959B	9	6.253B	10	6.701B	2	7.264B	1

Current Multiples   5) Hide Multiple ⌄

	Last 4 Qtrs	Next 4 Qtrs	FY 2018	FY 2019	FY 2020
Price/EPS, Adj+	23.74	20.88	20.89	19.25	17.50
Price/Book					
Price/Cash Flow	23.06	16.52	16.55	15.38	
EV/Revenue	6.70	7.27	7.27	7.32	7.22
EV/EBITDA	14.01	14.92	14.72	14.08	13.13
EV/EBIT	16.01	16.97	16.83	16.19	15.25
EV/OPP	16.01	16.90	16.86	15.99	15.02
Dividend Yield	3.01	2.58	2.59	2.73	2.80

∗Period Notes ‹‹ ‹ More Period › ›› Reported, Estimat

Australia 61 2 9777 8600 Brazil 5511 2395 9000 Europe 44 20 7330 7500 Germany 49 69 9204 1210 Hong Kong 852 2977 6000
Japan 81 3 3201 8900   Singapore 65 6212 1000   U.S. 1 212 318 2000   Copyright 2018 Bloomberg Finance L.P.
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Transformation Action Plan (TAP)

Information for Setting MCD's Price Target

Transformation Action Plan (TAP)

Section 2. List Everything (PART 1)

Instructions, **Part 1**:

- The initial purpose of this exercise is to list 5 to 10 of the top newsworthy events that have pertained to a single stock over the past year
- This list will be used for multiple exercises throughout the workshop
- You can select a stock you know very well (such as one you have covered for more than two years) or from those found on our website (see the workshop slides for the URL)
- Once you have selected a single stock, go to the table on the next page (labeled "List Everything" Exercise) and put the ticker at the top of the table
- In the table's first column, for one stock, list 6-12 "newsworthy" items that the financial media associates with the stock that may occur or re-occur in the future.
  - If you're using a headline list we provided, summarize the 5-10 for one stock that you know best
  - If you're using a company that's not among those we provided, feel free to search your news source (e.g. Bloomberg, Thomson, FactSet, etc.), but if it's not accessible from your current location, use these sites which are accessible from a mobile device:
    - finance.yahoo.com (enter the stock ticker in the search box)
    - news.google.com (search for "[TICKER] stock news")
- For this step, please complete only the first column (you will be instructed on how to use the other columns at a later stage)

Transformation Action Plan (TAP)

Exercise: "List Everything"

Ticker: _____

(ONLY COMPLETE EACH COLUMN WHEN INSTRUCTED)

(Scale of 1 to 5 with 5=strongly agree)

Company-specific "newsworthy" issues	E	Zones	P	K, U-R, U-I	Source	I	C	T
EXAMPLE: Company is trying to improve its network efficiency	5	OC	4	U-R	• Industry consultant • Private competitor	4	4	17
1.					•			
2.					•			
3.					•			
4.					•			
5.					•			
6.					•			
7.					•			
8.					•			
9.					•			
10.					•			

Please do not continue until told to do so

Transformation Action Plan (TAP)

Instructions for "List Everything" (PART 2)

Instructions, **Part 2**:

- The purpose of Part 2 is to evaluate the list of newsworthy issues using the EPIC™ framework to determine if a "factor" is a "critical factor."
- Using the directions below, complete the "List Everything" table, but **only the specific line items when instructed:**

1. In the column labeled "E", do your best at ranking each item on an "**E**xceed my materiality threshold" scale, <u>if it were to occur or recur</u> (use a 1 to 5 scale with 5 as strongly agree). Don't get frustrated for not having the company's financial details (which you will likely need to provide a definitive answer), but instead focus on the process.

2. In the column labeled "Zone" list the impact zone(s) for the factor (good or bad), by using:
   a. "V" for "Volumes" (revenue from additional transactions)
   b. "P" for "Pricing" (revenue from better pricing)
   c. "OC" for "Operating costs"
   d. "O" for "Other" (such as a stock buy-back or lower tax rate)
   e. "N" "None" (because it's not likely to impact earnings)

3. Using the column labeled "P", try to rank each issue on "there a high **P**robability this factor will become much more certain to occur (or deviate materially from the expected trend) during my investment time horizon" (using a 1 to 5 scale with 5 as strongly agree). If the newsworthy issue is focused on something that already occurred, rank the likelihood that a similar event will recur during your investment time horizon.

4. In the column labeled "K, U-R, U-I" include one of these letters:
   a. "K" for "Knowable": Your prior research provides the insight you need to forecast this factor if it should occur or recur
   b. "U-R": "Unknowable, Research Required": You need to conduct research to accurately forecast this factor
   c. "U-I": "Unknowable, Impossible to Forecast": Nobody can forecast with accuracy even if more research is conducted (e.g. direction of interest rates or oil prices)

5. In the column labeled "Source" for those factors you labeled "K" or "U-R" try to explain where you already received or could get information to better assess if this is a critical factor (e.g. industry consultant, private competitor, company source, sell-side analyst, etc.).

6. Based on your response to the two items above, in the column labeled "I", do your best at ranking the statement "**I** could forecast this factor and its catalyst accurately with a moderate amount of research" using a 1 to 5 scale with 5 as strongly agree. If the issue already occurred, rate the likelihood of forecasting this issue recurring.

7. In the column labeled "C", do your best at ranking each item on "the general **C**onsensus will be poor at accurately forecasting/spotting this factor (or a change from trend)." Remember, "5" is strongly agree which means consensus will be POOR at forecasting if you put a high number.

8. In the last column (labeled "T"), add up the four numbers within that row

Transformation Action Plan (TAP)

Factors for: FedEx in the 2005-2006 time period, ranked by "Total" column

Factor to Potentially Be Researched	If this factor were to occur or change from trend, it would cause changes in consensus' expectations to Exceed my materiality threshold	This factor will Probably deviate materially from consensus expectations during my investment time horizon	Based on my research on the factor, I'm good at forecasting this factor and its catalyst (it's not just a guess)	The overall Consensus will be poor at accurately forecasting or spotting an anomaly for this factor	Total
Cost management/productivity/Improved network efficiency	5	4	4	5	18
Level of fuel surcharge collected	5	4	4	4	17
Acquisition(s)	5	3	2	5	15
Ground package volume growth	3	4	4	4	15
Domestic Express package pricing/yield	4	3	4	3	14
Ground package pricing/yield	4	3	3	4	14
International Priority package pricing/yield	3	4	3	4	14
International Priority package volume growth	2	4	4	4	14
Service levels other than during the holiday season	3	2	4	5	14
Change in senior management	5	2	2	4	13
Electronic documents reducing need for overnight envelopes	2	4	3	4	13
GDP growth	5	3	2	3	13
Labor cost trends	3	3	3	4	13
Domestic Express package volume growth	2	3	4	3	12
Service levels at holiday season	2	2	3	5	12
Asia-Pacific volume growth	2	3	4	2	11
Change in level of tech shippers vs. non-tech shippers	4	2	3	2	11
Purchase of new aircraft	1	3	3	4	11
Level of major weather disruptions	1	3	1	5	10
Depreciation rate	1	2	2	4	9

Transformation Action Plan (TAP)

Section 3: Identify Critical Factors and Key Assumptions

- The purpose of this portion of the TAP is to identify the key assumptions surrounding the critical factors for at least one stock, which is the first step before reaching out to information sources
- Properly identifying the 1-4 critical factors for a given stock requires detailed research (typically 3-10 hours of work), which is beyond the scope of this workshop and so it's worth noting the steps below are an abbreviated (and inferior) method compared to the full method (discussed in our workshop *Identify & Monitor a Stock's Critical Factors*)
- Recall from the EPIC™ framework (in your slides) that an ideal critical factor will meet all of these criteria:
  - **E**xceed my materiality threshold
  - **P**robably going to occur during my time horizon
  - **I**'m good at forecasting factor and catalyst
  - **C**onsensus is poor at forecasting or spotting factor
- After reviewing the examples in the table below, list 1-3 critical factors for a stock of interest. If you cannot identify any *current* critical factors for that stock, feel free to use critical factors from the *past*. It's most important to list critical factors you understand well because you will be using them throughout the rest of the workshop
- In the two right-most columns below, provide assumptions that must be better understood to gain greater clarity around each of your critical factors
- Avoid falling into the "confirmation bias" mind trap, by:
  - Not creating assumptions like this: "Worsening regulatory environment"
  - Instead phrase the assumption more neutrally, like this: "Changes in regulatory environment." This keeps you open to the idea that your research may find the environment isn't worsening but is actually improving
- Recall the goal is to identify the *assumptions* for the critical factors, because we will use them in the next step of the ASPIRE™ framework

Transformation Action Plan (TAP)

Identify Critical Factors and Key Assumptions Table

Sector or Stock	Critical Factor	Assumption #1	Assumption #2
Airbnb (online travel agency)	Growth of online travel agencies	Rate of market share gains from traditional hotel channels	Cost advantage of online travel agency vs. traditional channels
Amazon.com	Market share shift from traditional retailers	Adoption rate of e-commerce within emerging markets	Adoption rate of mobile apps for retail purchases
IBM	Migration to cloud-based solutions	Rate of growth of cloud-based enterprise applications	Level of security offered in the cloud vs. in-house options
Nike	Top line growth rate keeping up with historical trends	Changes in demand from international markets	Changes in broad athletic activities
NVIDIA (graphics tech)	Growth of virtual reality as mainstream product	Adoption of virtual reality by mass markets	Cost to produce high quality virtual reality devices that can be used in the home
SolarCity	Growth of renewable energy revenue	Changes in energy storage costs	Impact from changes in oil and natural gas prices
The Gap	Apparel pricing deflation	Adoption of off-price and low-price fashion	Use of mobile devices for price discovery
Time Warner Cable	Growth of competing content providers such as Netflix, Amazon and HBO	Customer loyalty for the cable bundle vs. new entrants	Potential growth of cable-provider broadband offering (which is required to access new entrants)
T-Mobile	Competitive pricing among the wireless carriers	Timing when domestic smartphone becomes saturated	Changing regulations
VMware (software)	Growth of Open Source software vs. traditional vendors	Open Source providers going public	IT leaders selling services that rely on Open Source solutions
Walgreens (drug retailer)	Generic drug price inflation	Changes in FDA regulation of non-generic drug manufacturers	Distribution channel consolidation
Your Stock:	Your Critical Factor #1:	Your Assumption #1:	Your Assumption #2:
Your Stock (does not need to be same as above):	Your Critical Factor #2:	Your Assumption #1:	Your Assumption #2:
Your Stock: (does not need to be same as above):	Your Critical Factor #3:	Your Assumption #1:	Your Assumption #2:

Transformation Action Plan (TAP)

Section 4: Research Methods' Ability to Provide Unique Insights

- The purpose of this portion of the TAP is to evaluate the most traditional research methods based on their ability to provide the unique insights required for great stock calls
- In the table that follows, the first column consists of typical methods equity research analysts use to collect and analyze information
- Using the scale below, rank each method under the first empty column heading "*Method tends to lead to information that is*":
  - 1 = Not differentiated because it's *widely accessed* by other analysts
  - 2 = Possibly differentiated because it's *not widely accessed* by other analysts
  - 3 = Highly differentiated because it's *not typically accessed* by other analysts

"How Unique Are Your Information Sources?" Table

Research Method for Collecting Information	Method tends to lead to information that is…* 1=Not diff. 3=Highly diff.
1. Review company documents, website, and conference call	
2. Monitor financial press	
3. For buy-side only: read sell-side reports	
4. Speak with company investor relations contact	
5. For buy-side only: proactively interview sell-side analyst, beyond listening to their pitch	
6. Review industry trade journal, website, or blog	
7. Interview company management (other than investor relations)	
8. Analyze publicly-available economic data in a manner that differs from how it is delivered to the market	
9. Proactively interview buy-side analyst, portfolio manager, sell-side salesperson or trader to understand investor psychology of a stock	
10. Interview management of publicly-traded competitor of the stock being researched	
11. Interview management of publicly-traded customer of, or supplier to, the stock being researched	
12. Interview consultant, expert, or company retiree who is part of an expert network	
13. Analyze information from private forecasting service in a manner other than for which it was intended	
14. Interview journalist, blogger or noted book author for unpublished insights	
15. Interview government official, staffer, lobbyist or association executive	
16. Interview management of privately-held competitor of the stock being researched	
17. Interview management of privately-held customer of, or supplier to, the stock being researched	
18. Interview consultant, expert, or company retiree who is not in an expert network	
19. Conduct survey, formal or informal	

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15. Caterpillar Crushes Bears as China Growth Boosts Sales: Chart, July 25, 2017

Notes