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Equity Valuation in Emerging Markets: An Exploratory Study

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Abstract

The unique characteristics of emerging markets, alongside the involvement of personal judgement in determining value metrics, make equity valuation in these markets particularly challenging. Using a phenomenological approach, this study seeks the expert opinion of academics on both objective and subjective elements of equity value in these markets. The thematic analysis of their responses reveals that quality of earnings, diverse and distinctive sources of risks in emerging markets to be included in the risk premium, and uncertainty surrounding the growth rate must be carefully assessed and evaluated. While selecting the models, analysts should consider not only integration of emerging markets with global markets but also potential inconsistencies in the model inputs. This study finds that discounted cash flow models are preferred over price-based, relative valuation models because of the instability of the market prices, and within discounted cash flow models, free cash flow models are favored over the dividend discount model. The findings are expected to guide the investors and analysts in the selection of the right valuation metrics and models for accurate equity valuation.

Keywords: Equity valuation, emerging markets, phenomenology, thematic analysis

JEL: G11, G12, G41

1. Introduction

Emerging markets are associated with developing economies that are at different stages of development (Herbert, 1996; Barry et al., 1998). These markets differ from the developed markets and are characterized by comparatively weak financial infrastructure (Eom & Park, 2011), monetary asymmetry (Osmanovic & Alvi, 2022), higher liquidity risk, and scarcity of large cap value stocks (Kohers et al., 2006). Despite that, emerging markets have attracted investors around the globe because they provide them with opportunities to diversify the systematic risk of their portfolios. The diversification potential exists due to their partial integration with developed markets (Soenen & Johnson, 2008; Foong & Goh, 2010), and investors typically expect higher returns alongside the benefits of diversification (Osmanovic, 2022). Moreover, the diversification benefit prevails even in the presence of the recently introduced volatility transmitter asset classes

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and during periods of crisis (Ali et al., 2024; Ali et al., 2025)

The continued attractiveness of emerging markets is contingent on investors' ability to assess the values of investment options with a fair degree of accuracy. However, equity valuation in these markets poses unique challenges to both investors and analyst because the available valuation models are primarily designed for developed markets, which not only differ significantly from emerging markets but are partially integrated with them (Bekaert et al., 2023). The partial integration of emerging markets with developed markets necessitates customization of models to the local settings (Soenen & Johnson, 2008). Several researchers have attempted to customize the determinants of equity value, such as macroeconomic variables (Kohers et al., 2006; Carrieri et al., 2006; Eom & Park, 2011; Al-Jafari et al., 2011), discount rate (Soenen & Johnson, 2008; Foong & Goh, 2010)); and valuation models, particularly price-based models (Omran, 2003; Saadouni & Simon, 2004; Sehgal & Pandey, 2010). Nonetheless, these studies have not been able to devise a conclusive model for equity valuation in emerging markets.

The equity valuation models are primarily mathematical in nature, but the model inputs are subject to the personal prejudices of the model user. The objective of this study is to look beyond the mathematical aspect of valuation and explore its subjective components in the emerging markets. Using a phenomenological approach, this study aims to gather insights from academicians who stay informed about the developments in global financial markets through their teaching and, more importantly, their research.

This study contributes to the equity valuation literature by exploring and offering an understanding of the subjectivity inherent in the equity valuation metrics, which are often influenced by personal judgements and biases (Jaiyeoba & Haron, 2016; Rajakumar et al., 2019). These biases arise from the nature of the valuation process itself: estimating value on the bases of the expectation of the model inputs variables. For example, projections regarding earnings, inflation, interest rates, and growth rates differ significantly among analysts, reflecting variations in their expectations. A thorough understanding of these subjective elements—which contain valuable information—and considering them in the valuation process may help inform and improve the investment decisions of analysts and investors (Olsen, 1998; Jaiyeoba & Haron, 2016; Rajakumar et al., 2019).

The remainder of the paper is organized as follows: section 2 reviews literature on equity valuation; section 3 presents the methodology used, section 4 explains thematic analysis of the data, and section 5 concludes the paper.

2. Literature Review

2.1. Emerging markets

Emerging markets are rapidly growing markets, with growth rates of two to three times than those of developed markets. They differ from developed markets in several ways, including lower transparency in financial information disclosure, lower liquidity, weaker corporate governance, higher taxes and transaction costs (Bruner et al., 2002). They assert that the flow of investments into emerging markets is expected to have a material impact on improving their valuation mechanisms.

Emerging markets have witnessed phenomenal growth over the past three decades and emerged as important players in the global marketplace (Foster & Young,

2013). Their contribution to the global gross domestic product (GDP) increased from 30% in 1990 to 45% in 2020 (Cavusgil, 2021). However, the GDP per capita in emerging markets, which is much lower than that of the developed markets, has not witnessed any visible improvement over more than two decades (Bekaert et al., 2023). Moreover, they are becoming increasingly important sources of funds for the local investments (Hearn et al., 2010).

Emerging markets possess distinctive characteristics and are expected to behave differently from developed markets. They have higher country-specific volatilities (Bekaert et al., 2023) but compensate investors by offering higher equity risk premium, which however, is not distributed uniformly over time and investors should focus on the downside risk (Salomons & Grootveld, 2003). However, earlier studies, such as Fayyad & Daly (2010) report higher average rates of return in emerging markets that are more predictable and have lower correlations with other markets. Demirtas & Zirek (2011) observe that emerging markets feature fewer industries with highly correlated stocks. They argue that a higher level of comovement of market fundamentals leads to a greater degree of mean reversion, which enhances the predictability of earnings.

Pereiro (2010) argues that emerging markets differ from US with respect to their absolute and relative size, lower liquidity, higher leverage, heavy concentration, and higher volatility. He states that the median contribution of stock markets to GNP was 40% in emerging markets compared to 180% in the US. Emerging markets are one-third as liquid as US market. The top 10 companies in emerging markets account for 56% of market capitalization, while in the US, they contribute only 23%. The average returns were 34.8% for emerging markets and 9.1% for the US, with corresponding volatilities of 16.2% and 8.1%.

Emerging markets have drawn investors from around the world because they offer higher expected returns due to their growth rates that are higher than those of the developed markets (Hooker, 2004). However, besides higher returns, these markets are partially integrated with developed markets and offer global investors with avenues for diversifying their portfolios through maximizing returns and minimizing returns (Soenen & Johnson, 2008; Foong & Goh, 2010). In their studies on BRICS markets, Ali et al. (2024) and Ali et al. (2025) assert that the diversification potential of the markets prevails despite the introduction of new classes of assets, like ESG stocks and digitals assets, which act as uncertainty transmitters, particularly during periods of crises.

2.2. Equity valuation models

Valuation of a stock refers to estimating of its value based on factors that have bearing on its future returns or by comparing it to the stocks of similar companies (Stowe, et al., 2010). Penman (2005) states that valuation models play five important roles: 1) specify what needs to be forecasted to value a firm, 2) guide the forecasting process, 3) prescribe methods for converting forecasts into value, 4) explain how to derive forecasts from valuation, and 5) provide guidance on h accounting practices. The valuation models are classified into discounted cash flow (DCF) models and relative valuation.

2.2.1. Discounted cash flow models

Discounted cash flow (DCF) models or the absolute value models adopt a fundamental approach to equity valuation by focusing on the drives of the value. It is one of the

widely used methods in the equity valuation, and wider application across different phases in the lifecycle of a company has been advocated by many studies (Laitinen, 2019). The models view value as the present value of expected cash flows. Accordingly,

$$V_0 = \sum_{t=1}^{\infty} \frac{CF_t}{(1+r)^t}$$
$$CF_t = CF_{t-1}(1+g)$$

where, V_0 represents the value of stock, CF_t the expected cash flow at time *t*, g stands for growth rate of the cash flows, and *r* for the investors' required rate of return. The cash flows can be one of the multiples forms, depending on the scope of the valuation. The growth rate represents the future prospects of the firm with respect to the firms' ability to generate the cashflows. The required rate of return is the minimum rate of return that investors desire from the investment. It is a representative of the reward for assuming the risk by investing in a stock. Based on the nature of the cash flows, three popular DCF models have emerged:

1. Dividend discount model (DDM), proposed by William Burr in 1938 uses dividends as cash flow. Dividends comprise of the portion of earnings attributable to the shareholder paid to them. The size of dividends is decided by the board of directors and investors are not promised any amount in dividends beforehand.
2. Free cash flow model, presented by (Copeland et al., 2000), uses free cash flow (FCF) as cash flow metric. FCF is the amount of cash that, if distributed among investors, will not impair the operations of the firm (Stowe, et al., 2010). FCFs are derived from the earnings and are subject to fluctuation based on the company's level of cyclicality.
3. Residual income model uses residual income (RI) as cash flows. RI is the difference between net income and cost of equity employed by the firm.

Besides difference in the cash flows used, the above listed models have their unique applications. DDM capture an investor's perspective by considering dividends as the cash flows in the model. The model is useful only if the dividends bear a realistic and understandable relationship with the earnings. The FCF models take a control perspective, and although applicable to non-dividend paying companies, they are primarily applied to estimate the overall value of a firm or its overall equity. The RI model can be used to value both non-dividend paying and negative free cash flows companies (Stowe et al., 2010).

2.2.2. Relative valuation models

Relative valuation models or price multiples use ratios to relate the price of a stock with some measure of value, such as, earnings, book value, cash flow, sales, etc. The objective is to compare the value of stock with that of similar stocks to judge whether it is relatively fairly-, over-, or under-valued. The underlying principle of price multiples is the *law of single price*, which states that similar assets should sell for the same price. The most popular relative valuation models are price to earnings (P/E) and price to book value (P/B) models; however, many other versions, such as price to cash flow, price to sales, are also used.

The relative valuation models can also be represented in terms of fundamentals. For example, the two popular models, P/E and P/B, can be presented as:

$$\frac{P}{E} = \frac{(1-b)}{(r-g)} \quad \frac{P}{B} = \frac{(ROE-g)}{(r-g)}$$

where, b represents earnings retention rate, *g* is the growth rate, and *ROE,* return on equity (net earnings/owners' equity).

2.3. Drivers of equity value

The drivers of equity value used in the models are not stand-alone variables. They are a composite of multiple underlying factors, which have an element of analysts' judgement and bias.

2.3.1. Earnings and Cash flows

The cash flows used in the aforementioned models are derived from the net earnings, the portion of revenue attributable to the equity owners of a firm after paying operating and financing expenses, and taxes. Dividends represent the portion of earnings paid to the shareholders, whereas free cash flow represents the amount of earning that can be distributed among the investors without impairing the operations of the firm. The free cash flows are obtained from earnings after adding noncash expenses to it and subtracting investments in fixed assets and working capital. The residual income considers the opportunity cost of investing in a firm and is obtained by cost of equity capital from the earnings (Damodaran, 2012).

Recognizing the importance of earnings in equity valuation, many researchers have focused on this component of value. Barth, et al. (2005) disaggregated earnings into cash flows and accruals, and further breaking accruals into four components: account receivables, accounts payables, inventory, and depreciation. This disaggregation of earnings helps in assessing the quality of earnings. The higher the proportion of cash flow in earnings indicates higher quality of earnings. The higher quality of earnings enhances persistence and predictability of future earnings, resulting in a positive impact on the equity value (Ebaid, 2011).

Landsman, et al. (2007) study whether the items excluded from pro forma statements—total exclusions, special items, and other exclusions—are 'forecast irrelevant' and 'value irrelevant'. They find that exclusions caused inconsistencies in forecasting and valuation coefficients, leading to inaccurate valuation of stocks.

Penman (1998) argues that stock prices are driven by earnings and investment in net assets, which affects a firm's ability to earn, should be considered in valuation. He asserts that investors buy both earnings and assets of a company and combining P/E and P/B would model all possible combinations of value driven by earnings and the value driven by assets.

On the qualitative side, the earnings mentioned in the aforementioned cases are the expected future earnings, shaped by analysts' outlook on the prospects of a company. Analysts make projections based on their assessment of the conditions of the company's industry as well as the overall economy in the foreseeable future. It is common practice among analysts to conduct scenario analysis, assign probabilities to various potential outcomes, and combine these probabilistic scenarios into a single earnings projection. The nature of scenarios and the assignment of probabilities to the scenarios involves personal judgment of the analyst (Jaiyeoba & Haron, 2016; Rajakumar et al., 2019).

2.3.2. Required rate of return

Required rate of return, also known as capitalization rate or discount rate, is the minimum rate of return that an investor expects in order to invest in an asset (Damodaran, 2012). The rate of return is representative of the risk assumed by investors, who have the option of investing in risk-free assets or risky assets or combining both in their portfolios. However, they are willing to invest in risky assets only if they are compensated for additional risks, they assume in the from a risk premium. The risk premium demanded by the equity investors is the equity risk premium (ERP), which is a composite of multiple sources of risk. Mozes & Cooks (2010) studied ex-ante ERP, and posit that ERP is driven by: 1) economic risk, confidence, and GDP growth, 2) inflation, 3) interest rates, 4) mean reversion tendency of ERP, 5) credit spread, and 6) value factor.

Several asset pricing models encapsulate the drivers of equity risk to determine the required rate of return. The pioneering work in this area is the capital assets pricing model (CAPM) by Willian Sharpe (1964). CAPM assumes an investment universe of a risk-free asset and a risky, but fully diversified, market portfolio and derives the required rate of a risky asset by combining the return on risk-free asset and the product of market risk premium (difference between return on market portfolio and risky asset) and standardized covariance of stock returns and market portfolio returns; the standardized covariance represents the *beta* of the risky asset.

Several studies that followed CAPM challenged the sufficiency of the market portfolio in capturing the required rate of return. Researchers proposed improvised multifactor models, such as the Fama and French three-factor model and its extensions, and macroeconomic models. The Fama & French (1993) three-factor model incorporated size (market capitalization) of firm, and value (high vs low book to market value) with the market portfolio of CAPM. Carhart (1997) added the momentum factor to three factors of the FF model. Similarly, Pastor & Stambaugh (2003) extended the FF model by adding liquidity of the stock as a factor.

Chen et al. (1986) made a maiden attempt at using macroeconomic vaiables to compute the required rate of return. The five macroeconomic factors are monthly production index, expected inflation, unexpected inflation, risk premium, and term structure. Burmeister et al. (1994) included investors' confidence in economy, time horizon, inflation, business cycle, and market timing as factors for determining the required rate. Cornaggia, et al. (2020) contend that home bias and institutional differences in emerging markets impede their integration with developed markets and result in a higher cost of capital.

2.3.3. Growth rate

Growth rate is the rate at which firms' earnings are expected to grow in the foreseeable future. Growth depends on firm-specific characteristics, such as the quality of management and employees, availability of resources as well as the macroeconomic factors, such as the growth potential of a firm's industry and the nature of the economy. Moreover, companies go through multiple growth phases and the identification of the growth phase of a company is indispensable for its reliable valuation. Additionally, the identification of the growth phase poses the challenge of estimating the duration of the

growth phase for the companies that are yet to enter a maturity phase (Reilly & Brown, 2018). GDP is used as proxy for growth if a firm has entered a maturity phase (Stowe, et al., 2010).

There are several gray areas in growth rate estimation for which analysts rely on their hindsight and judgment. The growth of a company is dependent on the growth prospects of its industry and the overall economy. In other words, the growth estimates of a company depend on the analyst's assumptions regarding growth drivers and their interplay at company, industry, and economy levels. Furthermore, as mentioned above, the challenge of identifying the growth phase of a company and projecting its trajectory to the maturity phase involves personal judgement. The representative growth rates are the estimates of individual analysts, and consensus among different analysts cannot be expected. A similar challenge is posed by the estimation of the durations of the growth phases (Stowe et al., 2010; Damodaran, 2012).

2.4. Valuation in emerging markets

Equity valuation in emerging markets exposes analysts to unique challenges that ought to be identified and addressed in the valuation process. The distinctive features of emerging markets include weak financial infrastructure (Eom & Park, 2011; Bekaert et al., 2023), illiquid markets with higher liquidity risk (Stankov et al., 2024), and scarcity of large cap value stocks (Kohers et al., 2006). The impact of macro factors, such as inflation, interest rate, money supply, industry productivity index, and exchange rate is more severe (Al-Jafari et al., 2011). In addition, the currency risk in these markets is distinctively different from other risk factors (Carrieri et al., 2006).

With respect to the models, Soenen & Johnson (2008) applied the test of correlation between various emerging market equity indexes and US equity market index, and concluded that US-based CAPM should be modified by adding country risk premium in case a country's market is not perfectly correlated to the US equity market. Foong & Goh (2010) arrived at a similar conclusion in their study on the application of two-factor CAPM in the Malaysian market; two factors used were local and global beta. Abuaf (2011) argues that in valuation models, cash flows should be adjusted to account for change in currency value, and discount rate should be adjusted to accommodate micro and macro risk factors. However, Sabal (2004) argues that all projects do not carry the same country risk and country risk is not totally systematic, and opposes blanket application of country risk in required returns estimation in emerging markets.

A number of studies focused on the application of multi-factor models in emerging markets. The Fama and French three-factor model does not apply to emerging markets in the long run, but it does apply in the short run (Eom & Park, 2011). Chen & Tu (2002) studied the Taiwanese market by combining market risk premium from CAPM, company size, and book to market value from the Fama and French three-factor model, the momentum strategy from the Jagdeesh and Titman model, and liquidity from the Pastor and Stanbaugh model, and found that they have a significant impact on equity returns.

On the other hand, Saadouni & Simon (2004) report that analysts in Malaysia and Thailand prefer prospective P/E ratio in valuing equity securities over all other methods. There analysts rely heavily on the information

disclosed by companies in their financial statements and during company visits.

3. Methodology

Equity valuation is predominantly conducted by using objective econometric models. Depending on the scope of the analysis and the availability of information, multiple models can be used employed simultaneously to value the same entity. This implies that analysts have discretion in their choice of models, indicating the application of *epistemic pluralism* in their analysis. As a result, different analysts may value the same company differently. Moreover, the analysts' estimated values become objectified, as a reality, in the form of market prices that represent the consensus of the majority of market participants. However, the market prices, as objective reality are not stable as they fluctuate with the arrival of new information, rendering them *ontologically amorphous* (Cetina & Bruegger, 2000). With the blend of objective ontology, encompassing socially created realities, subjective epistemology and the meaningful behavior of analysts, equity valuation falls in the paradigm of *critical theory* (Collier, 1994).

3.1. Research method

In line with the underlying philosophical assumptions of critical theory, a semi-structured interview was used for data collection. According to Berg (2007), the semi-structured interviews use of pre-determined questions grants interviewers the freedom to probe far beyond the answers and recognize that different individuals perceive the world in different ways. As suggested by Berg (2007), in interview essential questions, probing questions, and throw-away questions were asked; there were no extra questions. Essential questions were directed at the core themes of the study: the nature of emerging markets, drivers of equity value, and valuation models. During interviews, probing questions were asked to seek additional information from informants and to provide them leads. Throw-away questions are customarily used to build a rapport with the participants.

Initially, faculty members in the Department of Finance at the Kulliyah of Economics and Management Sciences (KENMS) were identified as potential informants. They were contacted through their International Islamic University (IIUM) email, and out of four responses, three faculty members agreed to be interviewed, while one could not participate due to being on leave. Of the three faculty members who agreed to participate, one later excused himself at the time of interview, saying that the subject area of study was not within his specialization. Consequently, three doctoral candidates at KENMS, who were at the stage of writing their theses, in the focal area of this study, were included. The interview of faculty members were conducted in their offices, while the interviews of the doctoral candidates were held in the PhD Students' Room and the Central Library at IIUM. The interviews lasted approximately between 21 minutes and 30 minutes. With permission from the interviewees, the interviews were recorded and transcribed. The interviewees are referred to as 'informants' in the data analysis section to acknowledge their sharing of expert knowledge and perspectives on equity valuation.

The transcripts were coded to extract meaningful themes following the guidelines laid out by Miles & Huberman (1994). The themes used in the data analysis were primarily determined *a priori* based on the literature, while also allowing for the emergence of

new themes from the informants' responses. To preserve the originality of informants' statements and to minimize personal biases, one author conducted and coded all interviews, while coded data was jointly analyzed by both authors to interpret the themes.

Following Nowell, et al. (2017), the informants' statements were quoted verbatim in the analysis and interpretation of the themes to ensure transparency. In addition, Braun & Clarke (2006) argue that the use of direct quotes enhances the readers' understanding of the thematic analysis and adds credibility to the findings.

One limitation of this study is that, due to the limited number of participants, it cannot claim to have reached data saturation. Although recurring themes emerged across participants, additional interviews might have provided new perspectives.

3.2. Data Analysis

The transcribed data was analyzed following the three-step frameworks proposed by Spencer, et. al. (2003), and Berg (2007). However, we condensed three steps into two: 1) data reduction or data management, and 2) descriptive and explanatory accounts.

Data reduction or data management

Data reduction or data management entails "making data readily accessible and understandable and to draw out various themes and patterns" (Berg, 2007, p. 47); it involves identifying themes and concepts according to which the data are labeled (Spencer et al., 2003). The themes applied in this study are drawn from the literature. Table 1 presents the thematic chart for this study.

Descriptive and explanatory accounts

Descriptive accounts use the "actual words used by participants" to understand how they conceive a phenomenon, whereas explanatory accounts provide explanation of why patterns in the data exist. The following sections present these descriptive and explanatory accounts in light of the assigned themes.

Theme 1: Nature of emerging markets

Informants conceive that emerging markets have distinctive characteristics, and are structurally different from developed markets. The distinctive characteristics highlighted by the informants are high growth rate, high riskiness, less developed market structure, and absence of efficient markets.

High growth

> "Emerging markets are developing or growing at a very fast rate, therefore it causes a lot of ambiguities …. for investors …. they need to ….. understand, at least in general terms what is going on in particular emerging country's economy." (Informant 5)

High growth, says informant 5 is a distinctive feature of emerging market, it agrees with the findings of a number of researchers, like Carrieri et al. (2006), Kohers et al. (2006), Al-Jafari et al. (2011), and Eom & Park (2011). The high growth potential has been instrumental in attracting foreign investors to emerging markets. However, informant's saying that the fast pace of the economy "causes a lot of ambiguities for investors" holds ground only in the context of the challenge posed by estimation of the duration of growth phases while valuing stocks (Reilly & Brown, 2018).

High risk

> "what really differentiates between these markets is basically discounting

because discounting is the measure of risk. …. you have to consider it because people consider risk as a function of many factors, …. the sovereignty of the nation, ….. the corruption level, …… and political risk…". (Informant 2)

"Unlike developed markets, emerging markets lack a "large number of companies, very sound infrastructure, sound corporate governance, tax regime, …. political stability" (Informant 1)

All the determinants of high risk in emerging markets conveyed by informants enjoy theoretical and empirical support. Emerging markets differ from developed markets in the limited availability of large cap, value investments (Al-Jafari et al., 2011), dominance of few companies in an industry (Pereiro, 2010), weak financial infrastructure (Chen & Tu, 2002), and economic and political risk (Carrieri et al., 2006). However, Jaiyeoba & Haron (2016) in their study in Malaysia observe that investors' investment decisions are influenced by psychological biases due to herd behavior, whereby they rely on market information and tend to overlook financial and economic settings.

Table 1. Thematic Chart

Theme	Informant comments
Nature of emerging markets	"Emerging markets are … growing at a very fast rate." (Informant 5) "…emerging markets lack "large number of companies, …. political stability" (Informant 1) "what really differentiates between these markets is basically discounting …". (Informant 2)
Cash flows	"Basically, the cash flow depends on the ..ability of the asset to generate the future cash flows". 2 "Cash flow itself it depends on for instance the assets are allowed to depreciate ..." (Informant 1). "…earning disclosed by the company whether these are true or not remains an issue." (Informant 5). " … accounting figures that we have, but there can be adjustments to see how … impact of such …" (Informant 1)
Return rate (risk)	"Because there was hyperinflation …. all these things affected the premium …" (Informant 3). ".. high inflation rate increases nominal interest rate.." (Informant 4). "When interest rate increases, … it affects the discount rate." (Informant 4) "…what really differentiates …. discounting is the measure of risk… a function of many factors, …." (Informant 2) "…lack of this transparency contributes to higher risk, and we add to the risk premium …" (Informant 3) "… cost of equity, you have CAPM, or you have dividend growth model … combine the methods to find the average." (Informant 1)
Growth	"If GDP increases, it will also increase cash inflow to the country" (Informant 4) "The growth will remain a very controversial issue ..." (Informant 2)
Integration with global markets	"…look at the effect of contagion, … it is already proven as a theory that whatever happens in developed markets somehow has systematically an effect on developing markets" (Informant 2) " …whole capital markets in emerging and developed countries are interconnected .." (Informant 3) "… financial crisis … impact is due to the integration of markets around the world." (Informant 4) "It depends on the extent to which the company is also involved in international transactions." (Informant 1) "..the risk …related to the magnitude of integration of markets…." (Informant 5)

Theme	Informant comments
Valuation models	"…can come up with better model or you quantify a subjective variable and it suits the data..." (Informant 2) "… model …if it suits the kind of data that we have obtained". (Informant 1) "The problem is that you can use the dividend discount model only if the company pays dividends. ..." (Informant 2) ".. companies are paying dividends they may not be able to sustain those dividends …". (Informant 5) "If companies do not pay the dividend and yet we want to value them … FCF models.." (Informant 1) "…. free cash flow model works better." (Informant 2) "Free cash flow model is the ideal model for capturing value …". (Informant 4) "Free cash flow model will be a better model …." (Informant 5) "P/E We have to use these models with caution ..." (Informant 1) "… numerator in price-based model is market driven…" (Informant 2) "There is an issue…due to transparency and other issues (Informant 5)

Source: Compiled by author's

Theme 2: Earnings and cash flows

Earnings represent the net income generated by a company during a financial period. Cash flows are at the core of financial analysis, and realized cash flows depend on the nature of a company's earnings. Informants identified a number of factors pertinent to the realization of cash flows.

Investment in assets. Penman (1998) asserts that stock prices are driven by investment in net assets, which affect the earning potential of firms. Informant 2 had a similar opinion:

> "Basically, the cash flow depends on the ..ability of the asset to generate the future cash flows".

Accounting policies and quality of earnings. Accounting standard offer firms a leeway in reporting some items in the financial statements. For example, depreciation can be reported on a straight-line basis or a rapid declining basis, as a result the cash flows and earnings of a firm will vary with the use of these methods.

> "Cash flow itself depends on for instance the assets are allowed to depreciate ... it affects the income statement side…" (Informant 1). "… earning disclosed by the company whether these are true or not remains an issue. If companies can have chance to manipulate their earning ….they may do so." (Informant 5).

The quality of reported earnings can improve if reported financial statements are properly studied and adjusted for the possible manipulation.

> " … accounting figures that we have, but there can be adjustments to see how … impact of such manipulations can be reduced…" (Informant 1)

Earnings quality has received a lot of attention from researchers and practitioners; the research in this area has far exceeded what informants were able to relate. Barth et al. (2005) disaggregated earnings at three levels—aggregate earnings, cash flow and accruals, and cash flow and four components of accruals; disaggregation increased the quality of earnings used in valuation. In both, developed and emerging markets, high level of accruals reduces the quality of earnings and

affects expected future earnings negatively (Ebaid, 2011). In addition, Landsman et al. (2007) found a significant impact of including items excluded from pro-forma statements on the quality of earnings used in valuation.

Middleton et al. (2007) conducted interviews with fund managers in ten emerging markets and found that the information in financial statements is less reliable due to poorly governed firms. Moreover, these markets are characterized by lower levels of market development (Bekaert et al., 2023).

Theme 3: Required rate of return

Required rate of return is the rate expected by investors on their investments, based on the risk inherent in the investment. Informants discussed a number of macro and a single micro factor that affect the riskiness of assets. The macro-factors include inflation, interest rate, lack of transparency, socio-cultural and political factors, and flow of foreign funds. The micro-factor was firm size.

> "Because there was hyperinflation there was higher fluctuation…. all these things affected the premium that was estimated…" (Informant 3). ".. high inflation rate increases nominal interest rate, an important component of the discount rate" (Informant 4).
>
> "When interest rate increases, it has a negative impact on the equity value because it affects the discount rate." (Informant 4)
>
> "…what really differentiates between these markets is basically discounting because discounting is the measure of risk... a function of many factors, … the sovereignty of the nation, … corruption level, … and political risk." "…inflow and outflow of foreign investments has a significant impact on the volatility of the market then obviously there is a risk." (Informant 2)
>
> "…lack of this transparency contributes to higher risk, and we add to the risk premium …" (Informant 3)
>
> "… the size of the company, if .. a company is large, it will help the company to reduce the risk by increasing the diversification." (Informant 4)

The factors identified by informants have been tested in developed as well as emerging markets. Their impact is more prominent in emerging markets; the impact of macroeconomic variables: inflation, interest rate, money supply, industry productivity index, and exchange rates is more dominant (Al-Jafari et al., 2011).

Required rate estimation models

Informants were asked about the use of a single factor and multifactor models.

> "…the risk premium is basically the overall market risk. ..So, in one sense if you still apply CAPM in emerging markets, I think it is possible if you treat the whole market or a whole country as an aggregate market." (Informant 5)
>
> "You can plug in whatever variables, but whatever variables you are planning to choose must: 1) explain the model better, and 2) have some solid finance or economics backing, then only we can say, look, we have a better model. You know in econometrics, if you add more variables, the r^2 will be higher, does it mean that model is explaining better than the previous model (Informant 2)

Informants advocate the use of models with caution; they did not favor any of the models. In fact, the combination of models was proposed by informant 1:

"There are so many ways of valuating same thing, depending on the type of data you have. Look at your cost of equity, you have CAPM, or you have a dividend growth model … you have… better way, combine the methods to find the average because the strength of one takes care of weaknesses of the other."

Literature on the use of required rate models in emerging markets supports the cautious use of return models mentioned by informants. Previous studies propose the use of CAPM, single factor model, after modifying it to local conditions, but are more inclined towards the multi-factor model. In emerging markets, not fully integrated with global markets, CAPM should be modified by adding country risk (Soenen & Johnson, 2008; Foong & Goh, 2010). Eom & Park (2011) found that the Fama and French three-factor model does not hold in emerging markets in the long-run, while Chen & Tu (2002) successfully applied the Fama and French three-factor, Jagdeesh and Titman momentum strategy, and liquity as a composite model.

Theme 4: Growth

Emerging markets are marked by a high level of growth, which is expected to influence the growth of the companies operating in these markets.

"If GDP increases, it will also increase cash inflow to the country" (Informant 4)

However, estimation of growth is beset with a number of issues because it depends on the interaction of firm specifics and macroeconomic factors.

"The growth will remain a very controversial issue. I doubt whether people can come out … perfect estimation of growth. Sometimes, people take the easy way out taking the GDP, growth of the industry may be. I do not think there is such a thing as the right or wrong way of estimating growth". (Informant 2).

Literature supports informants' stand on estimation of growth. The major challenge in growth estimation is assessing the growth phase of a firm or its industry. A correct identification of the growth phase is ensued by a second riddle, assessing the expected duration of growth phase (Stowe, et al., 2010; Reilly & Brown, 2018). GDP is used as proxy for growth if a firm has entered a maturity phase (Stowe, et al., 2010).

Theme 5: Integration with global markets

Integration was selected as a theme because previous studies have revealed that integration of emerging markets has a significant impact on all aspects of equity valuation. Informants too had a stand on the relevance of integration to valuation.

"…look at the effect of contagion, … it is already proven as a theory that whatever happens in developed markets somehow has systematically an effect on developing markets" (Informant 2)

" …whole capital markets in emerging and developed countries are interconnected due to the globalization and it is very hard for a country to operate in isolation." (Informant 3)

"… financial crisis affecst equity markets in emerging markets… This impact is due to the integration of markets around the world." (Informant 4)

Informants believe that the impact of integration is dependent on the emerging market's degree of integration with global markets

"It depends on the extent to which the company is also involved in international transactions. If they have international subsidiaries then translation issues and transaction exposure and stuff like that it is absolutely ok to factor exchange rate into it" (risk) (Informant 1)

"..the risk associated with investing in EM is higher and I think it is related to the magnitude of integration of markets… higher integration will reduce the level of perceived risk." (Informant 5)

Informants' position on integration and level of influence is mostly supported by the existing literature. Soenen & Johnson (2008) tested the application of US-based CAPM in emerging markets, and found that in less than fully correlated markets, country risk must be added to CAPM to account for the additional risk. Foong & Goh (2010) used the two-factor extension of CAPM using local CAPM and global CAPM; they found that global model was relevant in case markets were integrated. Cornaggia et al. (2020) report that investors' home bias in emerging markets and differences in institutional settings have impeded integration with foreign markets.

Theme 6: Valuation models

Selection of an appropriate model is critical in equity valuation. The model should be relevant to the characteristics of the firm being valued, suitable for the data, and align with the purpose of valuation (Stowe, et al., 2010). Informants in this study had similar opinions.

"…can come up with better model or you quantify a subjective variable and it suits the data, explains the model better and enhances your theoretical understanding, then by all means you can adjust the model because you cannot simply say this model is better than the other model by just based on … how you feed the data." (Informant 2)

"The discounted cash flow model is one of the ways of estimating value if it suits the kind of data that we have obtained". (Informant 1).

The theme of valuation models has two subthemes, related to the two categories of models, discounted cash flow and price-based models

Discounted cash flow (DCF) models

Three popular DCF models that have emerged over time are dividend discount model (DDM), free cash flow model (FCFM), and residual income model (RIM). About the use of these models, informants presented the following arguments:

About DDM

"The problem is that you can use dividend discount model only if the company pays dividends. When you are using DDM you need to understand does it really reflect how much dividend they can generate, and dividends are quite subjective, controlled by owners and subject to other factors as well. So, the free cash flow model may really capture how much cash flows are generated by the firm." (Informant 2)

".. companies are paying dividends they may not be able to sustain those dividends in the long run, in that case, the multi-growth model will be more appropriate". (Informant 5)

About FCFM

"If companies do not pay dividends and yet we want to value them … of course there will be some other scientific models that can be used … like FCF models.." (Informant 1)

"..in my point of view, the free cash flow model works better. Whatever dividend a company pays does not necessarily reflect the cash flows generated by the company" (Informant 2)

"The Free cash flow model is the ideal model for capturing value in EM if we incorporate in it the factors discussed earlier". (Informant 4)

"The Free cash flow model will be a better model for the reason that many companies will not be paying dividends, and even if they are paying the amount paid will not be relevant to value." (Informant 5)

Informants' observation about the applicability of DCF models is harmonious with the notions held by researchers and practitioners. According to Stowe, et al., (2010), DDM is useful if companies pay dividends and the dividends are in the right proportion to the earnings of the company. They argue if these conditions are not met, then the better alternative is FCFM. As emerging markets grow at a high rate, most of the firms operating in there are expected to be in a growth phase of their lifecycle. At that stage, firms need more funds to invest in their operating so that they can meet the market demand of their products. Retained earnings being the fastest and the cheapest source of funds prompt firms to defer the payment of dividends.

The relevant qualitative studies mostly recommend the use of fundamental analysis with DCF models. For example, studies by Almujamed et al. (2013) in Kuwait, Tijjani et al. (2009) in Nigeria, and Maditinos et al. (2007) in Greece report that investors, particularly professional investors believe that fundamental analysis is more appropriate for stock analysis.

Price-based models

Price-based models or price multiples compare price of a security with some underlying driver of value, like earnings, book value, sales, and cash flows (Stowe, et al., 2010). The models use publicly available information.

"P/E We have to use these models with caution for the reasons that emerging markets are not fully transparent, have lower liquidity. P/E ratio, P/B, P/S, P/CF if you look at all these maybe in a way can give an indication of composite estimate of what is taking place." (Informant 1)

"The k you use in price-based models comes from the multi-factor model, so how can you separate the discount and price-based model. For that we can say that numerator in the price-based model is market driven, while that in the case of factor models is cash flows, which are independent of the market" (Informant 2)

"..the model itself is not a big problem. There is not a big difference in use of this model in.. There is an issue, however, as you mentioned the reliability of prices used in models, due to transparency and other issues (Informant 5)

The reservations about the use of price-based models, expressed by informants, do not conform with the practices in the real world and the researchers' predilections. The P/E model is preferred to all other models

by Malaysian and Thai analysts (Saadouni & Simon, 2004). Price-based models are more relevant because investors value securities in relation to other securities (Sehgal & Pandey, 2010) and help in overcoming the problem of paucity of historical data required for the use of DCF models in emerging markets (Omran, 2003). Tijjani et al. (2009) in their interviews with brokers and retail investors in Nigeria observed that they prefer to apply price multiples for estimating the intrinsic value of the stocks.

Pinto et al. (2019) conducted a survey of 1,980 CFA members and report variation in the use of equity valuation models across regions, analysts' job type, firm types, and client types: DCF models are more popular in Asia Pacific and Europe, Middle East and African (EMEA) regions than in America; brokerage and investment firms favor DCF than do hedge funds; and equity analysts with institutional clients are inclined more towards DCF models than are the analysts with private clients.

Conclusions

This study presents a qualitative perspective of equity valuation in emerging markets using the insights of the academics. They provided a detailed perspective on the nature of emerging markets, drivers of equity value, and the application of valuation models. They acknowledge high risk, high return feature of these markets but caution about the potential impact of the weaker institutional framework and governance, and political instability on risk/return dynamics. The critical components of the drivers of the value that needs careful study while conducting valuation include quality of earnings, risk premium, growth rate, and integration with global markets.

The quality of earnings needs close monitoring for potential earnings manipulation, which if found must be adjusted. The estimation of the equity risk premium is complicated and investors should consider political risk, corruption level, volatility of foreign investments, and exchange rate stability. Growth rate ought to be estimated with extra care considering the prospective growth rates of the industry and the economy. In addition, the level of integration is necessary for understanding the contagion effect of the global events and the risk exposure of the investors.

With respect to the application of valuation models, the interviewees predominantly support the use of discounted cash flow models, with free cash flow models being preferable because dividends are not true representatives of the earnings or cash flows generated by the company. Furthermore, the discounted cash flow models are preferred over relative valuation, price multiple models because the market driven prices are not reliable due to the lack of depth and lower transparency of the emerging markets.

The findings of this study are expected to guide the investors and analysts in exploring the dynamics of the drivers of equity value in emerging markets and selecting the most appropriate valuation model to estimate the fair value of the equity investments.

Limitation and Future Research

Although this study provides valuable insights into the perspective of academics on equity valuation in emerging markets, its scope is limited due to its exclusive focus on academics from only one country, Malaysia. There is a need for exploring the qualitative dimensions of equity valuation in other emerging markets. Future research could

extend our study to the institutional investors who play a critical role in the functioning of the financial markets, and seek their perspective on equity valuation in emerging markets. Furthermore, the findings of this study can be further explored to identify the right methodological approaches for equity valuation in emerging markets.

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