

Ch. 3 & 4

Developing Assumptions

Industry & Company Analysis

Rich Jakotowicz CFA, CFP®

richj@udel.edu

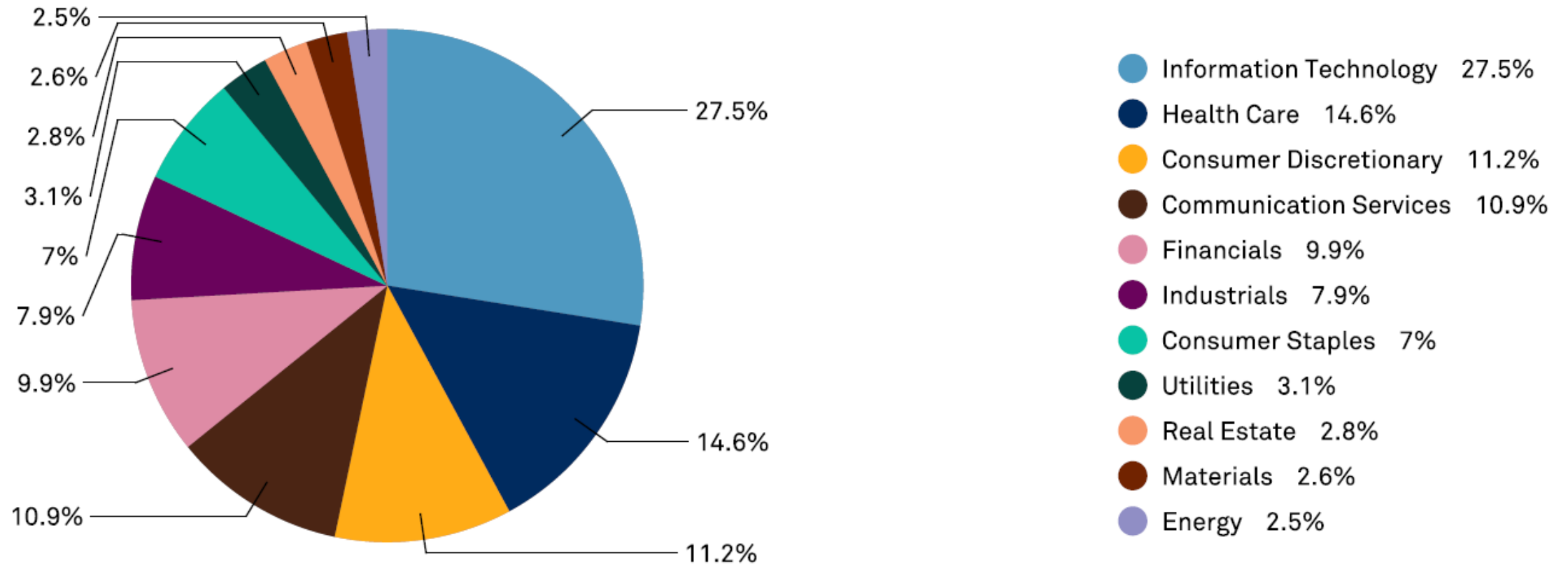
INTRODUCTION

Company analysis is the analysis of an individual company, and it requires understanding a company's industry and identifying its peers. Thus, it requires **Industry analysis** too

- An **industry** is a group of companies offering similar products and/or services, whereas a **sector** is a group of related industries.
- A **peer group** is a group of companies that are engaged in similar business activities, and whose economics and valuation are influenced by closely-related factors.

S&P500 SECTORS

WWW.SPGLOBAL.COM



As of August 2020

INDUSTRY CLASSIFICATION SCHEMES

•Global Industry Classification Standard (GICS)

- Developed by Standard & Poor's and MSCI
- Classifies companies for developing and developed countries
- Based on business activity, classifies each company into a sector, industry group, industry, and sub-industry

Russell Global Sectors (RGS)

- Classifies companies by products and services
- System has sectors, sub-sectors, and industries.

Industry Classification Benchmark (ICB)

- Developed by Dow Jones and FTSE
- Classifies companies by source of revenues
- System has supersectors, sectors, subsectors, and industries

GOVERNMENTAL INDUSTRY CLASSIFICATION SCHEMES

International Standard Industrial Classification of All Economic Activities (ISIC)

Statistical Classification of Economic Activities in the European Community (NACE)

Australian and New Zealand Standard Industrial Classification (ANZSIC)

North American Industry Classification System (NAICS)

IDENTIFYING PEER GROUPS

Examine classification systems

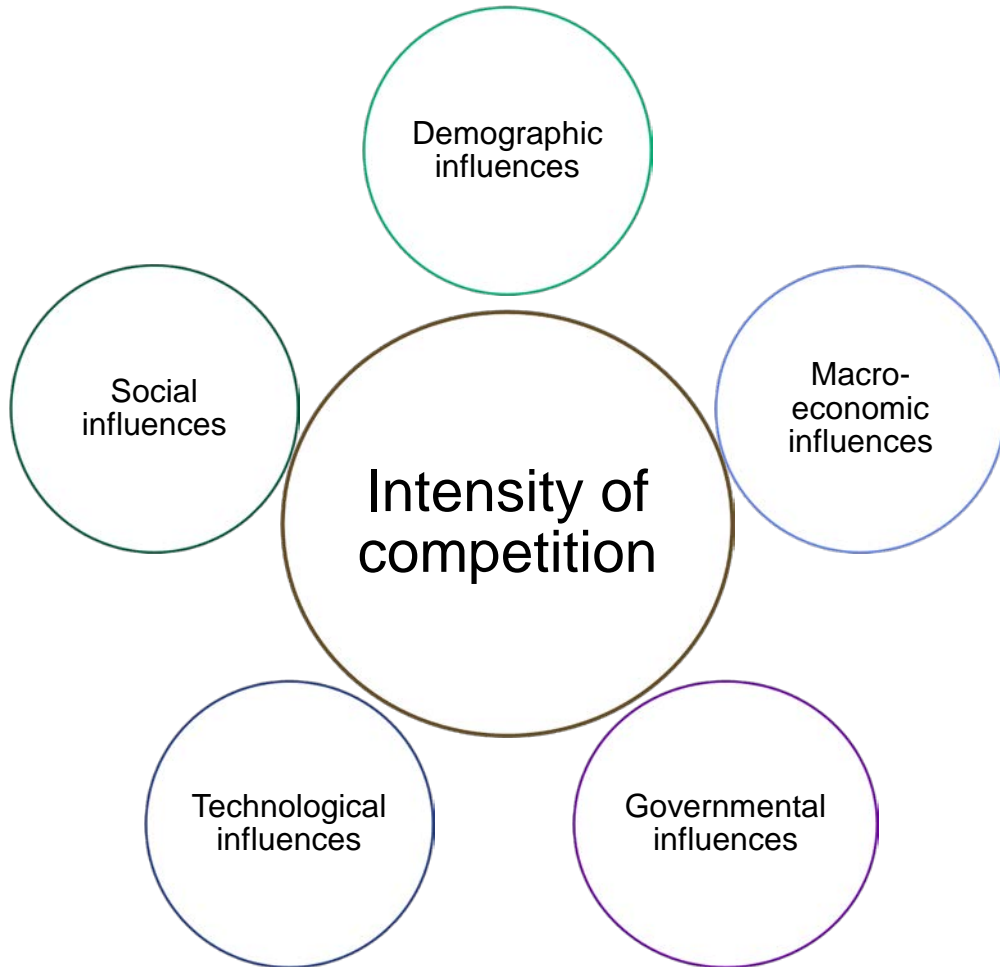
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graph TD; A[Examine classification systems] --> B[Review subject company's annual report]; B --> C[Review company's competitors' annual reports]; C --> D[Confirm comparability with potential peers];
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Review subject company's annual report

Review company's competitors' annual reports

Confirm comparability with potential peers

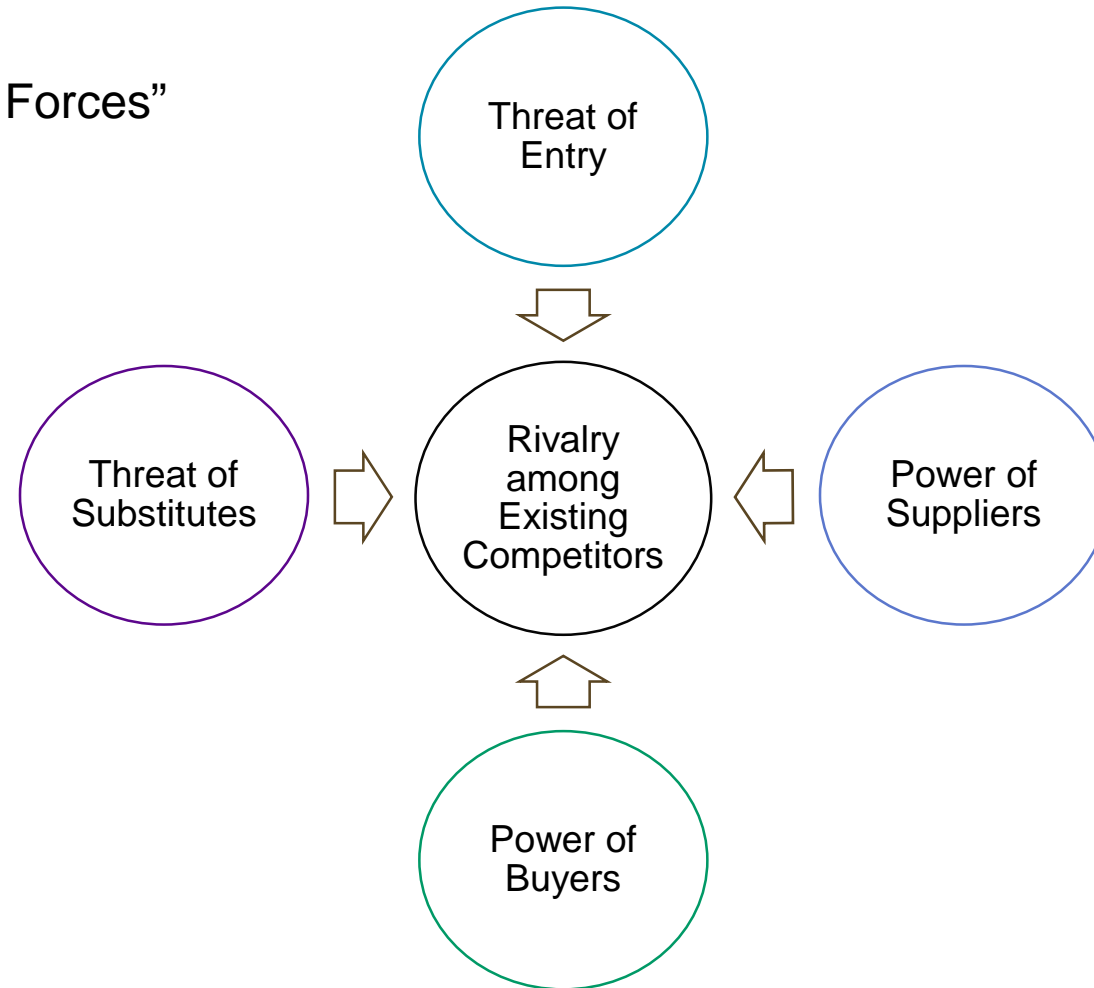
FRAMEWORK FOR INDUSTRY ANALYSIS



- Macroeconomic influences include the level of production, interest rates, availability of credit, GDP growth, and inflation
- Technological influences include new products that change how companies do business and enhance productivity
- Demographic influences include the distribution of consumers by age, location, and gender
- Governmental influences include tax rates and regulations
- Social influences include how people work and spend.

STRATEGIC ANALYSIS OF AN INDUSTRY

Porter's "Five Forces"
Framework



FACTORS AFFECTING PRICING POWER AND PRICE COMPETITION

- **Barriers to entry** are obstacles or hurdles that limit or restrict the entry of new competitors in the market
 - These barriers keep or discourage new entrants, hence reducing competition
- **Industry concentration** is the degree to which some companies may dominate the industry in terms of market share.
 - Generally, the more concentrated an industry, the less competitive it is
- **Industry capacity** is the maximum amount of a good or service that can be supplied in a given time period
 - The more limited the capacity, the greater the companies' pricing power
- **Market share stability** is the degree to which market shares change over time
 - The more stable the market shares, the less competitive the industry

EVALUATING PROFITABILITY

- Useful measures of profitability include:
 - **Return on invested capital (ROIC)**

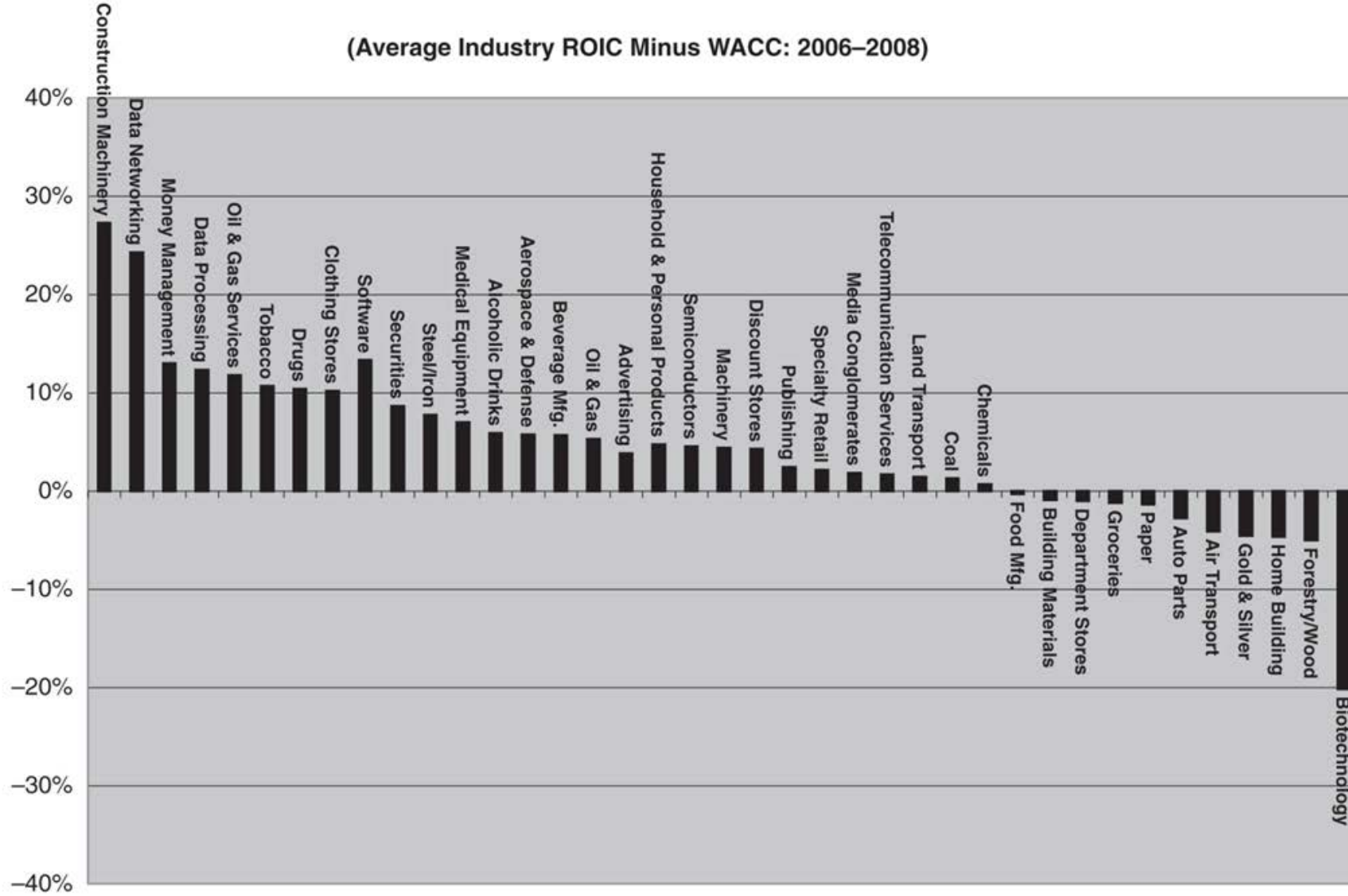
$$\text{ROIC} = \frac{\text{Net operating profit less adjusted taxes (NOPLAT)}}{\text{Operating assets} - \text{Operating liabilities}}$$

It is helpful to compare ROIC to WACC.

Ideally, the company generates $\text{ROIC} > \text{WACC}$

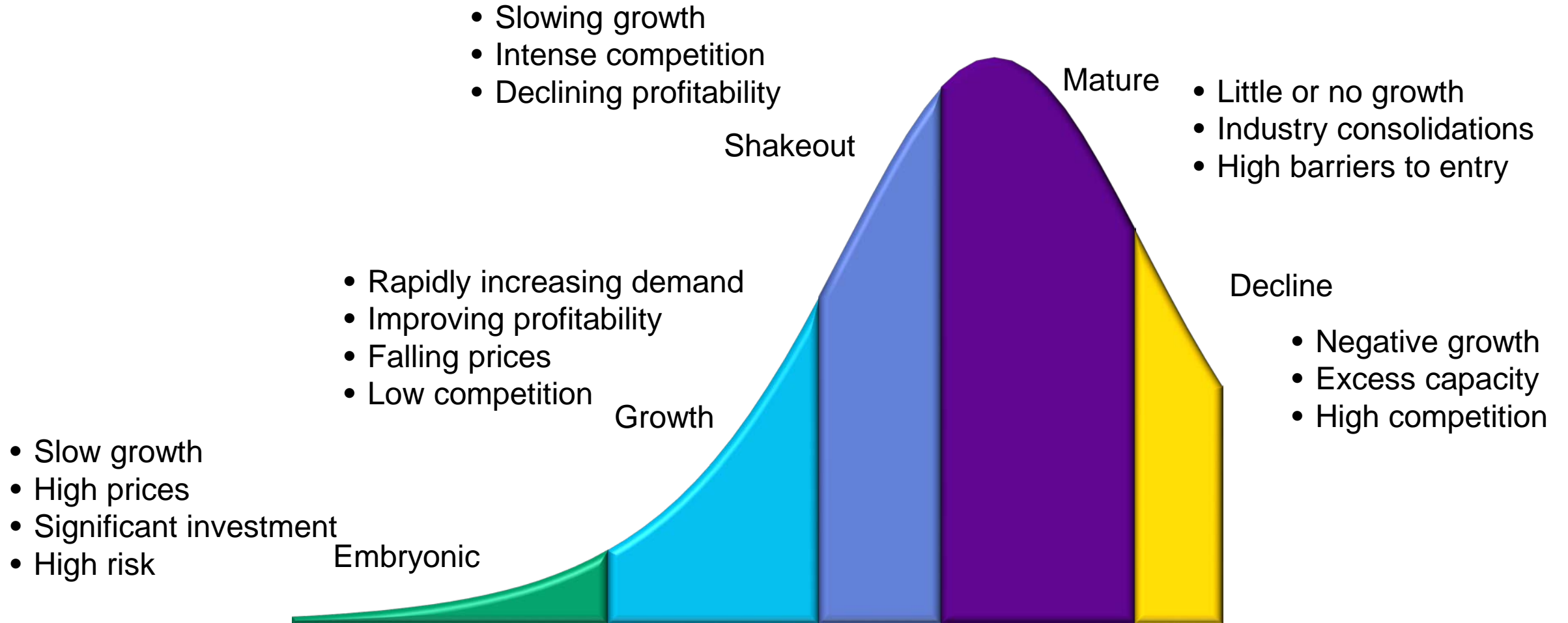
Economic Value Added - EVA

(Average Industry ROIC Minus WACC: 2006–2008)

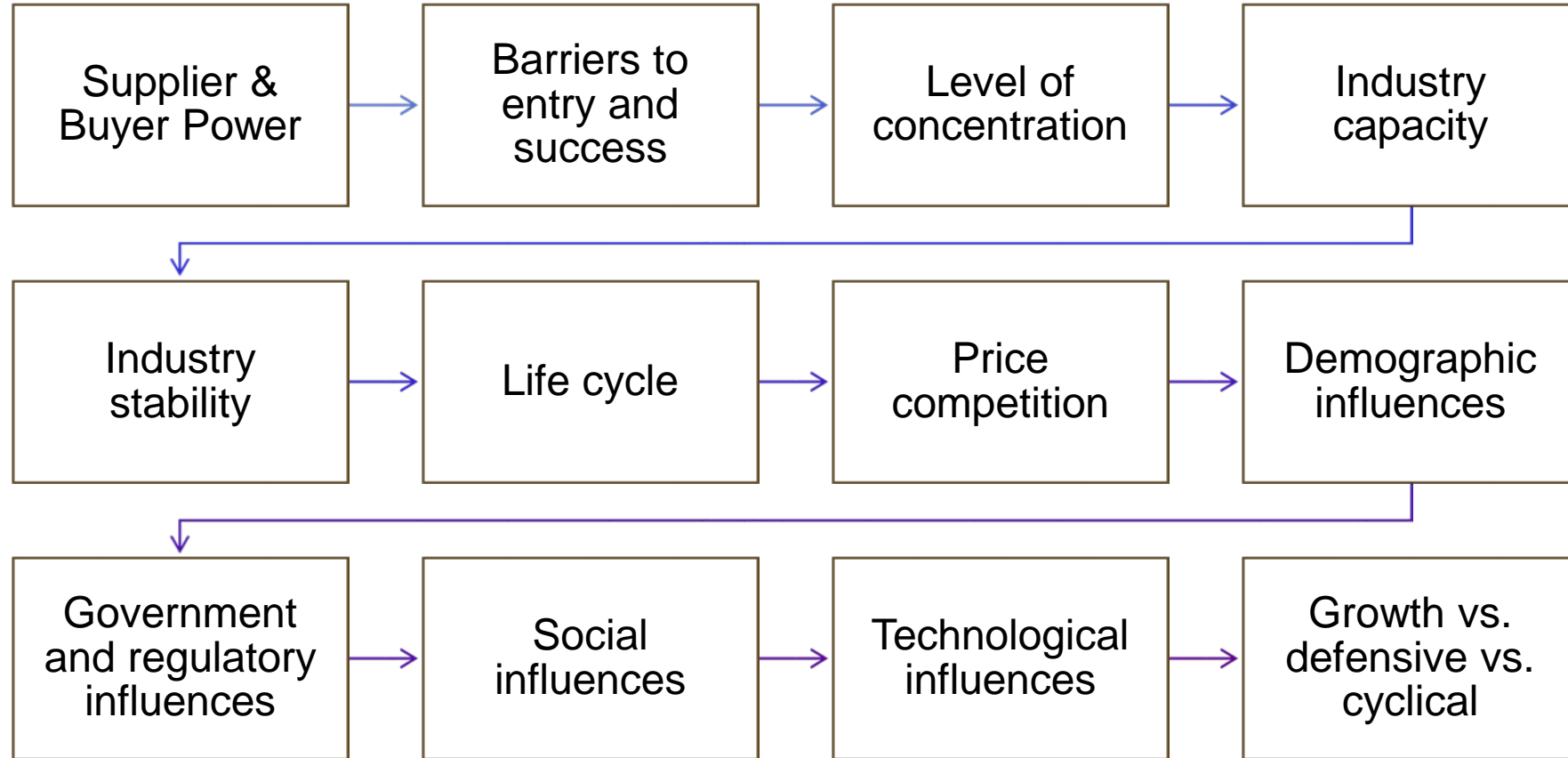


Source: Morningstar, Inc.


UNDERSTAND INDUSTRY LIFE CYCLE



INDUSTRY ANALYSIS - SUMMARY



COMPANY ANALYSIS

- 
- Company profile: Management team assessment
 - Trends for the company's products and services
 - MD&A and Conference Call review
 - Corporate Governance and Supply Chain review
 - Financial ratio analysis

APPROACHES TO MODELING REVENUE

Top-Down Approach

- Start with the economy
- Look at successively more narrowly defined levels

Bottom-Up Approach

- Begin with individual product lines, locations, or business segments
- Aggregate projections over products or segments to reach the company level
- Aggregate company revenues to reach the industry level

MANAGEMENT DISCUSSION & ANALYSIS (MD&A)

- Section of the Companies 10-Q or 10-K Filing
Q=Quarterly K=Annual
- In this section of the report management discusses:
 - Trends
 - Future outlook
 - Significant events and uncertainties
 - Capital resources
 - Effects of changes in inflation
 - Off-balance sheet obligations
 - Accounting estimates that were used in generating financial statements

MD&A is very useful in developing your qualitative opinion by considering future risks and opportunities

QUARTERLY EARNINGS CONFERENCE CALLS

- Every quarter companies have a conference call to announce their earnings, current sales, costs, and other relevant data.
- Most useful part of the call is towards the middle when it becomes an open Q&A with Analysts
 - Various equity analysts from Wall Street will ask pointed questions to management.
 - These questions, and their answers, will help you uncover the biggest uncertainties facing the company.
- **READ** the transcript from the call or **LISTEN** to it!

BOARD OF DIRECTORS – CORPORATE GOVERNANCE

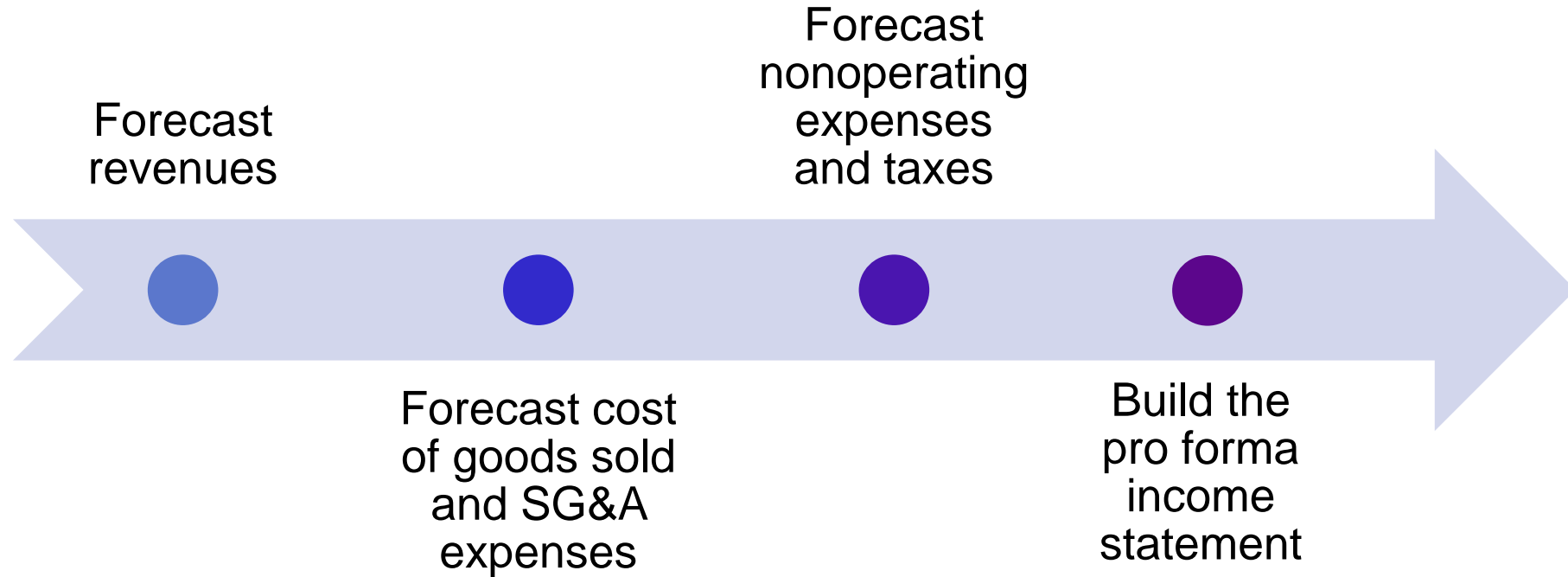
Best Practices:

- 75% of board members are independent.
- CEO and chairman are separate positions.
- Directors are knowledgeable and experienced and serve on only two or three boards.
- The board holds annual elections (not staggered elections).
- The board is annually evaluated and assessed.
- Board members meet annually without management present.
- The finance committee includes only independent directors with finance expertise, and the committee meets annually with auditors.
- Only independent directors serve on the nominating committee.
- Most of senior management's compensation is tied to performance.
- The board uses independent and outside counsel.
- The board is required to approve any related-party transactions.

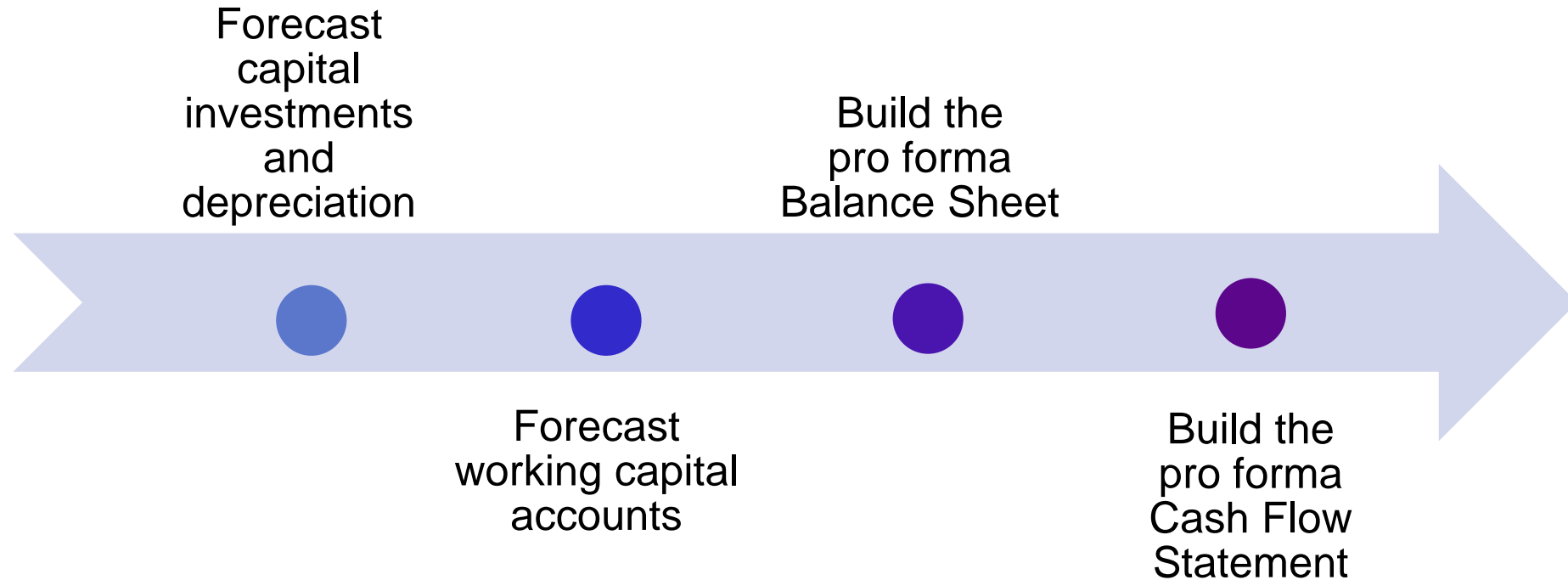
The key is to remember the link between valuation and corporate governance. Empirical studies show that:

- Strong corporate governance increases profitability and shareholder returns.
- Weak corporate governance decreases company value by increasing risk to shareholders.

CONSTRUCTING THE PRO FORMA INCOME STATEMENT



CONSTRUCTING THE PRO FORMA CASH FLOW STATEMENT AND BALANCE SHEET



USING THE PRO FORMA FINANCIALS

- Once pro forma income, cash flow, and balance sheet statements are constructed, an analyst can use this information in valuation metrics, such as free cash flow, EPS, EBITDA, or EBIT.
- Company-specific information would be required to build a discounted cash flow (DCF) model using these metrics, but these statements and the information used to construct these statements contribute significantly to the basic data needed for a DCF valuation.