NPTEL Course

Course Title: Security Analysis and Portfolio Management

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Module-9

Session-17

Company Analysis – I

Outline

- Importance of Company Analysis
- Company Analysis and Stock Valuation
- Broad Methodology of Company Analysis
- Strategy Analysis

Importance of Company Analysis: In the previous two modules, we discussed about analyzing economy and industry for investment selection. That analysis possibly helps investors in identifying the economy and then the industries where one can invest. Having done that, one has to look for those companies which offer better return for the investment or stocks of those companies which are likely to outperform others. One should also be able to find the stocks that are available cheap, i.e. the market price is more that the intrinsic value. For estimating the intrinsic value of the company one has to look at two major aspects: the company's business in terms of products, services, capabilities, competitiveness etc. and corresponding business strategy & the resultant financial performance. In this module we will focus more on the first part i.e. strategy analysis with some emphasis on new financial performance tools. The financial performance analysis is already discussed in Module # 5.

Company Analysis vs. Stock Valuation: Having identified a good company in terms of earnings and growth potential, one has to value the stock of the company separately. It is quite likely that the stock of a good company is priced very high in the market, i.e. market price is higher than the intrinsic value of the stock. The reverse can also be true.

Growth Companies vs. Growth Stocks: Growth companies are those that show more than average growth in sales and earnings. Growth companies can also be defined as those earning rate of return more than the expected rate of return from the investors' point view, i.e. weighted average cost of capital. However growth stocks are those that show higher rate of return than other stocks in the market with similar risk characteristics. Such stocks show a superior risk adjusted rate of return. It is also true that such stocks will not consistently show superior adjusted rate of return. Because of superior performance, there will be more demand for the stocks and the stocks will be priced high in the market. As a result the superior return will vanish and the stocks will show normal return.

Defensive Companies vs. Defensive Stocks: Companies with ability to show earnings while withstanding an economic downturn are known as defensive companies. These companies are characterized with low business and financial risk. Whereas stocks with a negative systematic risk i.e. of β (as per CAPM) are known as defensive stocks. Such stocks are likely to show positive return when market moves downward. Such stocks are to be avoided in a bull phase.

Cyclical Companies vs. Cyclical Stocks: Cyclical companies are those whose sales and earnings will be greatly influenced by aggregate business activity. These companies do well during economic expansion and poorly during economic contraction. Cyclical stocks are those that will experience changes in their rates of return greater than changes in overall market rates of return. Such stocks will have high beta.

Value versus Growth Investing: Growth stocks will have positive earnings surprises and above-average risk adjusted rates of return because the stocks are undervalued. Value stocks appear to be undervalued for reasons besides earnings growth potential. Value stocks usually have low P/E ratio or low P/B ratio.

It is imperative for investors to analyze the companies for their performance and subsequently find the intrinsic value of the stocks of the companies. If the intrinsic value of the stock is higher than the market price, one can take a buy decision.

Economic, Industry, and Structural Links to Company Analysis

Strategy Analysis: Strategy refers to a plan of action designed to achieve a particular goal. The word is of military origin, deriving from the Greek word στρατηγός (stratēgos), which roughly translates as "general"[1]. Firms without proper strategies from time to time can face premature death. Such firms have a passive management that does not explore new opportunities and adapt to the changes happening in the surrounding. Table 17.1 lists different levels of strategy and corresponding management decisions for a typical firm. All the decisions affect the cash flows of a company, hence are important from analysis and valuation point of view.

Table 17.1: Multiple Layers/ Levels of Strategy

Levels of Strategy	**Management Decision**
Corporate Strategy	Activities to enhance substantial competitive advantage • Selecting the Business to do? • Entering New Market • Exiting/ withdrawal from market
Business Strategy	• Decisions to maximize competitive position within the chosen market
Operational Strategy	• Planning for execution of the goal of the strategic business unit (SBU)

Firm Competitive Strategies: As discussed in Industry Analysis, five competitive forces as suggested by Michael E Porter are: Current rivalry, Threat of new entrants, Potential substitutes and Bargaining power of suppliers. Porter's five force analysis helps in determining potential attractiveness of an industry-insight of margins. One can take a decision about exit from or entry into an industry. With the help of a systematic and structured analysis of market structure and competitive situation, one can define different strategies that reduces power of competitive forces. Company can adopt defensive or offensive

[1] Source: http://en.wikipedia.org/wiki/Strategy, accessed on 20 June, 2010

competitive strategy. Defensive strategy involves positioning firm so that it its capabilities provide the best means to deflect the effect of competitive forces in the industry. Offensive strategy involves using the company's strength to affect the competitive industry forces, thus improving the firm's relative industry position. Porter also suggested two major strategies:

Low-Cost Strategy: The firm seeks to be the low-cost producer, and hence the cost leader in its industry. This could be because of economies of scale, technology, access to cheap resources etc.

Differentiation Strategy: Firm positions itself as unique in the industry. The differentiating factor needs to be truly unique so that it generates more revenue for the firm compared to other competitors. The incremental revenue because of uniqueness also should exceed the cost of creating that uniqueness.

However, companies may opt for different strategies depending upon the products.

<u>SWOT and PEST Analysis</u>: SWOT analysis involves the examination of a firm's Strengths, Weaknesses, Opportunities and Threats. Strengths and Weaknesses are internal to the firm where as Opportunities and Threats are external to the firm. A firm should continuously build upon its strength [like, R&D, Brand Power, Good Customer Service etc.] and mitigate the weaknesses. Simlarly, a firm must grab the opportunity like entering a new market and be ahead of its competitors. Threats need to be mitigated so that the goals are achieved as expected. One should also focus on PEST analysis that consists of:

- Political & Legal Changes [e.g. change in government regulation and policy]
- Economic Changes [e.g. change in business condition, interest rates etc.]
- Social Changes [e.g. Change in demography]
- Technological Changes [e.g. new inventions, patents etc.]

Finally the firm should analyze its internal capabilities and resources and augment those to be ahead of others.

Session 18 discusses about other mechanism and tools involved in company analysis.

References:

Bodie *et al* (2009), Investments, 8e, Tata McGraw Hill, New Delhi

Hagstorm, Robert G: The Essential Buffet, Wiley, 2001

Porter, Michael E.: Competitive Strategy: Techniques for Analyzing Industries and Competitors, 1998

Reilly and Brown (2006), Investment Analysis and Portfolio Management, 8e, Thomson (Cengage) Learning, New Delhi

Prasanna Chandra (2008), Investment Analysis and Portfolio Management, 3e, Tata McGraw Hill, New Delhi

Questions and Answers

Q.1: Define growth company and growth stock.

Ans.: **Growth companies** have historically been defined as companies that consistently experience above-average increases in sales and earnings. Financial theorists define a growth company as one with management and opportunities that yield rates of return greater than the firm's required rate of return.

Growth stocks are not necessarily shares in growth companies. A growth stock has a higher rate of return than other stocks with similar risk. Superior risk-adjusted rate of return occurs because of market undervaluation compared to other stocks.

Q.2: Explain value vs. growth investing.

Ans.: **Growth stocks** usually have positive earnings surprises and above-average risk adjusted rates of return because the stocks are undervalued. **Value stocks** appear to be undervalued for reasons besides earnings growth potential. Value stocks usually have low P/E ratio or low P/B ratio.

Q.3: Define strategy. State different levels of strategy in an organization and associated management decisions at such levels.

Ans.: Strategy refers to a plan of action designed to achieve a particular goal. The word is of military origin, deriving from the Greek word stratēgos, which roughly translates as "general".

The different levels/ layers of strategy and associated management decisions in an organization are as below:

Levels of Strategy	Management Decision
Corporate Strategy	Activities to enhance substantial competitive advantage • Selecting the Business to do? • Entering New Market • Exiting/ withdrawal from market
Business Strategy	• Decisions to maximize competitive position within the chosen market
Operational Strategy	• Planning for execution of the goal of the strategic business unit (SBU)

Q.4: In the backdrop of Michael Porter's Five Forces Model, explain defensive and offensive strategies.

Ans.:

Defensive strategy involves positioning firm so that it its capabilities provide the best means to deflect the effect of competitive forces in the industry.

Offensive strategy involves using the company's strength to affect the competitive industry forces, thus improving the firm's relative industry position.

Q.5: What is PEST analysis? State examples for different components of PEST analysis.

Ans.: PEST analysis as part of strategy analysis comprises of the following (with examples given in parentheses):

- Political & Legal Changes (A Change in Government, Policy or Law)
- Economic Changes (Rising level of living standards or interest rate change)
- Social Changes (More Working Women going out to work)
- Technological Changes (New Inventions and Ideas)