

# 3. STRATEGY AND COMPETITION

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- Valuation process begins with an analysis of a firm's external environment.
  - Projection of sales are dependent on the conditions under which a firm operates.
- Study of a firm's environment is a **top-down** exercise – sales is estimated by:
  - Projecting sales for the **industry as a whole**; and
  - Projecting the **market share of the firm**.

Typical analysis of a firm's environment

- 1. Look at the macro economy.**
  - If necessary, look at international trends (even if the firm is not involved in import/export activity).
- 2. Look at the industry.**
  - Take into account how the industry is linked to the macro economy.
  - Cyclical or counter cyclical?
  - How will inflation and unemployment impact on sales?
- 3. Look at the firm.**
  - Macro conditions may not affect all firms equally.
  - In a recession, firms in the lower price range would expected increased sales at the expense of high price firms.

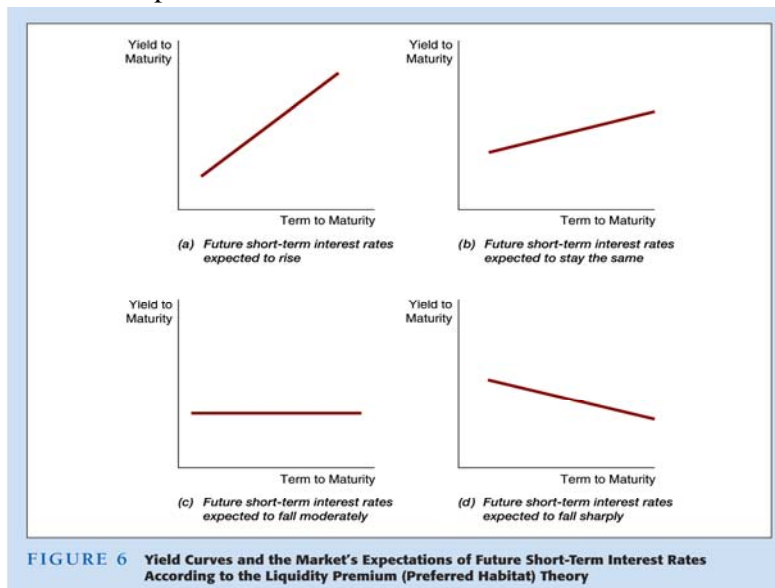
## 3.1 MACROECONOMIC ACTIVITY

- Economic activity varies over time – business cycle.
  - Worthwhile to measure and attempt to predict this activity.
  - Must look at the success of the treasury.
- Two most widely used measures of economic activity:
  - GNP – gross national product (home and foreign land)
  - GDP – gross domestic product (home land only)
- **Interest rates** and **inflation** are also predicted due to their widespread influence across the economy.
- Ultimately, we need to know where the economy is now, and where it is heading – we use indicators to help us with this analysis

Economic indicators

- Types of indicators:
  - **Leading**
    - Variables that tend to rise and fall ahead of economic activity.
    - Useful for looking forward
  - **Coincidental**
    - Tend to move with the level of the economic activity.
    - Useful for assessing the current state of the economy.

- **Lagging**
  - Follow movements in the economy.
  - Useful for establishing relationships between economic statistics.
- Many governments and other agencies publish useful (but imperfect) leading indicators of economic activity.
  - E.g. government – ABS publishes a number of leading economic indicators.
  - E.g. other – OECD Composite Leading Indicators, IMF World Output.
  - Most leading economic indicators are produced by private organisations.
- Governments generally produce lagging indicators.
  - E.g. GDP.
- Leading indicators in the US – components of the Index of LEI:
  - Average number of initial applications for unemployment insurance.
  - Number of manufacturer’s new orders for consumer goods and materials.
  - Speed of delivery of new merchandise to vendors from suppliers.
  - Amount of new orders for capital goods unrelated to defence.
  - Amount of new building permits for residential buildings
  - S&P 500 stock index.
    - Stock markets usually always move ahead of economic indicators.
  - Inflation-adjusted money supply (M2).
  - **Credit spreads** – spread between long and short interest rates (yield curve).
    - **Upward sloping** yield curve indicates **expansionary** monetary policy.
    - **Downward sloping** indicates expected **lower economic growth** in the future – lower interest rates in the future, so growth will fall off.
    - The distance between yield curves (credit spread) tends to contract when we expect things to improve.
    - If we expect things to worsen, then they start to separate (spread enlarges).
    - Based on historical data, US treasury yield curve has some degree of correlation with US GDP growth.
    - Credit spreads are also an indicator of the likelihood of bankruptcy.



- Consumer sentiment.
  - Westpac Consumer Sentiment Index
  - NAB Business Confidence Index
- Average weekly hours worked by manufacturing workers.
- Other leading economic indicators:
  - Retail Sales Index
  - Market share of retail firms
    - E.g. if market shares are dominated by DJ's and Myer, we can infer that people are generally better off.
    - However, if they start losing market share to Kmart, Target, Lowes or even the Reject Shop etc., we can assume people are becoming worse off.
  - Home loan approvals

### Predicting macroeconomic activity

- We don't understand what drives the business cycle, so we rely on statistical relationships.
- Over longer time frames, it is **usual to assume 'average' levels of activity**, where the average is **calculated over one or more cycles**.
  - Therefore, we usually have some idea of activity over 6-12 months, but further out it becomes unclear.
- Where possible, it is best to use consensus predictions of many forecasters.
  - Note that some firms will even require you use the 'house view'.
- Macroeconomic conditions can affect:
  - The levels of sales in an industry; and
  - The composition of the sales (market share).
- These two inputs allow us to project sales using a top down approach.
  - This is done by projecting the level of sales in an industry and then proceed to analyse market share.

### Industry sales projection

- Industry sales typically reflect macroeconomic conditions
  - Most industries tend to be pro-cyclical (i.e. sales move with the business cycle).
  - Some industries are more volatile than others.
  - A smaller number of industries are counter-cyclical.
- Example – the automotive industry.
  - Car sales (cars per year) tend to be highly positively correlated with real GDP growth.
    - This high correlation is useful as forecast real GDP growth can be used to predict car sales.
    - Regress car sales on real GDP
    - Use a forecast of real GDP growth to compute a forecast of car sales.
    - Use current prices and a price growth assumption to forecast dollar car sales.
  - When estimating this relationship, it is important to be careful about whether you are analysing levels, changes or a combination → take care with data mining.

- Potential drivers for the auto industry:
  - Saturated market would result in low growth.
  - Gasoline prices
  - Consumer confidence
  - New vehicle services (rebates, financing rates, extended warranties etc.)
  - Automobile redesigns (which can lead to production delays)
  - Environmental concerns.
- Then look at the company:
  - SWOT
  - Resource view of strengths and weaknesses – organisational capabilities, competencies, processes and knowledge.
  - The opportunities and threats combined with the firm’s strengths and weaknesses will determine the firm’s available **strategy options**.
- Principles of industry sales projection
  - Begin by looking for **historical patterns**.
    - I.e. patterns relating the industry sales to other variables, such as lagged sales, size of the economy, average wage.
  - Analyse the consumer demands for goods **only after adjusting for inflation**.
    - I.e. only look at demand in real terms
    - The accumulated effect of inflation on nominal sales may be material, even if the annual inflation rate is small.
  - Think at the ‘margin’.
    - Rather than projecting levels, it is often easier to deal with **changes in the level of sales** (or the **growth rate**).
    - This growth can be driven by technological change, changes in consumer taste or income, and by changes in the industry.
  - Is the industry in a phase of development, expansion, maturity or decline?
    - Product Life Cycle
    - Porter’s Five Forces

### Porter’s Five Forces

- Logic of the PFF system flows from industry structure → competitive position → company product and market strategy.
  - Idea is that individual firm profitability, the driver of the stock valuation, arises from the interaction of:
    - Its industry’s attractiveness.
    - Firm’s relative position within the industry.
- Porter suggests 3 generic strategies for establishing a ‘defendable position’:
  - Overall cost leadership
  - Differentiation
  - Focus
- Many things to consider: industry concentration, industry growth rate, fixed costs, switching costs, scale issues, exit barriers, diversity of competitors, economies of scale, government

policy, power of buyers/seller, marketing efforts of industry/firm, effective of technology and further industry innovation.

### Projection of the firm's sales

- Once industry forecast is made, we can convert it to a firm forecast by using:

$$\text{Projected firm sales} = \text{Project industry sales} \times \text{Projected market share}$$

- Requires a projection of market share for the firm:
  - Concentration Ratio
  - Herfindahl Index
  - Marketing Share Ratio
- Like with predicting sales, projecting is usually done in terms of **change in market share**.
- Even for industries where aggregate sales are not heavily exposed to macroeconomic conditions, market shares may still be sensitive to macroeconomic conditions.

### Three stage growth model

- We make three types of growth projections – short, medium and long run.
  - The most you'll ever need is 3 stages – any more is redundant.
- Short run – we make specific projections on an annual basis.
- Long run – given the tendency of firm's profits to revert to the mean, we project the firm's sales will grow at the **long run growth rate of the economy**.
- Medium run – **interpolate** between the short and long run rates.