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Industry analysis

Porter's 5 analysis

Loosely following Michael Porter's original article (HBR, 1979 issue).

Strategy formulation is coping with competition. Competition in an industry is rooted in its underlying economics and competitive forces exist that go beyond the jockeying for position and market share among established market players.

The state of competition in an industry depends on 5 basic forces: industry rivalry, bargaining power of customers, bargaining power of suppliers, threat of new entrants and threat of substitutes. The collective strength of these forces determines the ultimate profit potential of the industry.

Figure 1 Source: HBR.org, https://hbr.org/1979/03/how-competitive-forces-shape-strategy

A few characteristics are critical to the strength of each competitive force.

1. Threat of entry – sources of barriers to entry
    a. Economies of scale – forcing the aspirant to come in on a large scale or to accept cost disadvantage
    b. Product differentiation – forcing entrants to spend heavily on overcoming customer loyalty
    c. Capital requirements – especially unrecoverable up-front expenditures such as advertisements or R&D and capex on fixed facilities, inventory, etc.
    d. Cost disadvantages independent of size – entrenched companies are ahead on the learning curve and on the experience curve
    e. [sample cut]

Relative valuation

How to find comparables / peers?

- Use GICS code to find companies that share core business characteristics / business mix tend to serve as good comparables (same sector or sub-sector, similar products and services).
- Shared customers/ end markets or distribution channels
- Size (EV or market cap mainly but you can use sales, number of assets or employees)
- Geography
- Growth or life-cycle profile
- Profitability, ROI, bottom line growth
- Capex spending
- [sample cut]

How to do relative valuation from scratch?

- Annual reports, quarterly reports, current reports, proxy statements are available for data
- Equity research provided by individual analysts gives estimates of future company performance, which may be used to calculate forward-looking multiples. Includes estimates of sales, EBITDA, EBIT, EPS, etc. Sourced from FactSet, Thompson Reuters, OneSource
- [sample cut]

Multiples

If the numerator is equity (firm) value, use equity (firm) value in the denumerator like for P/E (EV/EBITDA).

P/E – equity value multiple

- Share price/ Diluted EPS or Equity value/ Net income (if constant share price)
- A measure of how much investors are willing to pay for a dollar of a company's current or future earnings, PE is typically based on forward estimates
- Higher PE reflects higher earnings growth expectations
- More relevant for mature companies, with consistent growth in earnings
- Not relevant for companies with little or no earnings

- Since it uses the EPS or Net income, it is dependent on the capital structure, accounting treatment (incl. noncash expenses DA), and tax systems

Enterprise Value / EBIT(DA) – firm value multiple

- EV = MV(Equity value) + MV(Total debt) + Preferred stock + Non-controlling interest – Cash
- [sample cut]

Trading v Transaction multiples

Trading multiples are calculated using similar companies that are traded on the stock market. Multiples are expressed relative to current or most commonly future performance, as trading multiples are forward-looking.

Transaction multiples are [sample cut]

Recognising industries on common-sized financial statements

Online retailer (Amazon back when it started out 20 years ago): no receivables, buyers pay first. Also, when they start out they lose money first.

Hotel chain: consolidation, acquisitions, goodwill is high.

Airline: PPE high, unearned revenue high (people bought tickets well ahead of flying)

Staffing agency: no R&D, no inventory

Software company: high cash, low inventory, high R&D

Pharmaceutical: high R&D, lots of consolidation, acquisition, goodwill is high; high barrier to entry > high margin on (patented) products[sample cut]

Adjustments to data

A number of critical adjustments may need to be made.

- [sample cut]
- Pension accruals: add PV of pension liabilities to EV, remove income or add back expense to EBIT
- Operating lease: add the MV of leased assets to EV and add back the implied interest expense to EBIT