

# ACCT7106 – Session #4: The Valuation Process II

## PART 1 – Background

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**Issue #1** – discount rate ( $k$ ):

**Issue #2** – investment horizon ( $n$ ):

**Issue #3** – choice of flow measure ( $x$ ): (e.g., dividends, free cash flow, earnings)

**Issue #4** – estimating future values of ‘ $x$ ’ (on a year-by-year basis for ‘ $n$ ’ years, and then the ‘on average’ growth rate,  $g$ , over the extended period)

## Issue #1 – discount rate:

The CAPM, which is one relatively well accepted approach to developing a discount rate, predicts that the required rate of return on common equity as:

$$k_e = R_F + \beta [E(R_M) - R_F]$$

$[E(R_M) - R_F]$   $\equiv$  'market price of risk' (historic range approximately 5%  $\rightarrow$  7%)

$\beta$   $\equiv$  measure of the firm's systematic risk (broadly available for most major companies)

$R_F$  = risk-free rate of return  $\equiv$  yield

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## Issue #2 – investment horizon: Add WeChat edu\_assist\_pro

predict future year-by-year flows for some finite number of years and then estimate the terminal value at the end of this forecast horizon.

$\rightarrow$  determination of an appropriate forecast horizon involves trade-offs (between ability to forecast year-by-year accurately and the weight placed on the terminal value component)

*Analysts typically select a forecast horizon in the range of 3 to 5 years*

### Issue #3 – flow measure:

- earnings
- cash flow
  - cash flows to the firm
  - ☞ cash flows to the investor (dividends)

*Conceptually*, the choice of a 'flows measure' should not matter (i.e., the dividend, free cash flow, and abnormal earnings valuation *all* estimates of value!)

*Practically* – for equivalence, app **consistent estimates which**  
**adhere to the 'clean surplus' relation** (equivalen scores defensible estimates)

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## Issue #4 – estimating future values of ‘x’

⇒ on a year-by-year basis over the forecast horizon (‘ $n$ ’ years)

the ‘on average’ growth rate,  $g$ , that applies over the foreseeable future post the forecast horizon

***fundamental analysis*** represents an exercise designed to determine ‘intrinsic value’

it involves analyzing both quantitative and qualitative aspects of the company and the environment within which it operates including –

- ❑ macroeconomic & industry factors (e.g., the state of the overall economy; industry conditions and prospects)
- ❑ company-specific factors (e.g., financial conditions; effectiveness of management; strategic initiatives; consumer behaviour)

As investors / analysts (external to the firm), to estimate the firm’s ‘intrinsic value’ through an application of ‘fundamental analysis’, **we need to develop an understanding of the firm’s value drivers including the policies and strategies implemented by management**

*assumed objective* of management = *maximize shareholders' wealth*

⇒ *maximize share price!*

➤ roles / functions management executes in generating value –

1. **Controller function** ⇒ asset efficiency (efficient use of working capital)
2. **Treasury function** ⇒ long-term financing (debt or equity?)
3. **Capital budgeting** ⇒ real (productive) asset investment (fixed productive assets)

⇒ the fundamental decisions that ultimately determine the firm's profitability and its operating risk

There are a number of templates that detail the type of information that is necessary for the development of an understanding of the firm's value drivers

One such template is represented in the 'top down approach that might be used by analysts, as well as a schematic representation of process (reproduced from Session #3)

Other templates include the structures and coverage detailed under what I called 'Approaches A & B' in Session #3 (slides #50 - #58)

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Ultimately these templates distill basic aspects / dimensions:

- ☐ external environment e.g., environmental factors, etc. <https://eduassistpro.github.io/> regulatory factors, social /  
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- ☐ industry setting and dynamics
- ☐ firm specific factors e.g., management, product and technology, financial performance

Understanding how each of these dimensions affects the firm's performance is critical to developing an understanding of the firm's value drivers, and then translating that understanding into projections of the firm's future performance – the proforma F/S

○ *Typical analyst's report - Top down approach*

- **Macroeconomic factors** e.g.,
  - GDP; Interest rates; Inflation
  - Foreign exchange (FOREX) rates; Oil and commodity prices
  - Hedging
  - Business cycle
- **Industry factors** e.g., <https://eduassistpro.github.io/>
  - Sensitivity to macroeconomic factors
  - Industry operation, ratios and stats
  - Competition
- **Firm level** e.g.,
  - Strategy
  - Synergy
  - Financial Performance

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**Bradshaw**, 2011

“Analysts’ forecasts: What do we know after decades of work?”

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Penman presents an overview of the 'process of fundamental analysis' in Figure 3.1 (page 85)

Step #1 Knowing the business



Step #2 Analyzing information



Step #3 Forecasting payoffs



Step #4 Converting forecasts to valuation



Step #5 Trading on valuation

**Step #3** involves interpretation of the information developed in the first two steps (subjective → 'the art')

**#5** are then mechanical in nature

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**S** **2** are critical to the process of developing the inputs for use in implementing of the fundamental valuation model(s)

*WHY?* they are critical to development of the 'pro forma' financial statements

# – Strategy Analysis

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## Step #1 Knowing the business

- ☐ the products
- ☐ the knowledge base
- ☐ the competition
- ☐ the regulatory constraints

## Step #2 Analyzing information

- ☐ in financial statements
- ☐ outside financial statements

As a further alternative template ('check list'), Penman summarises six categories covering 'details of the business' he deems necessary to understand before making forecasts (pg. 16):

1. Know the firm's products
2. Know the technology required to bring products to market
3. Know the firm's knowled
4. Know the competitiveness of the industry
5. Know the management
6. Know the political, legal, regulatory, and ethical environment

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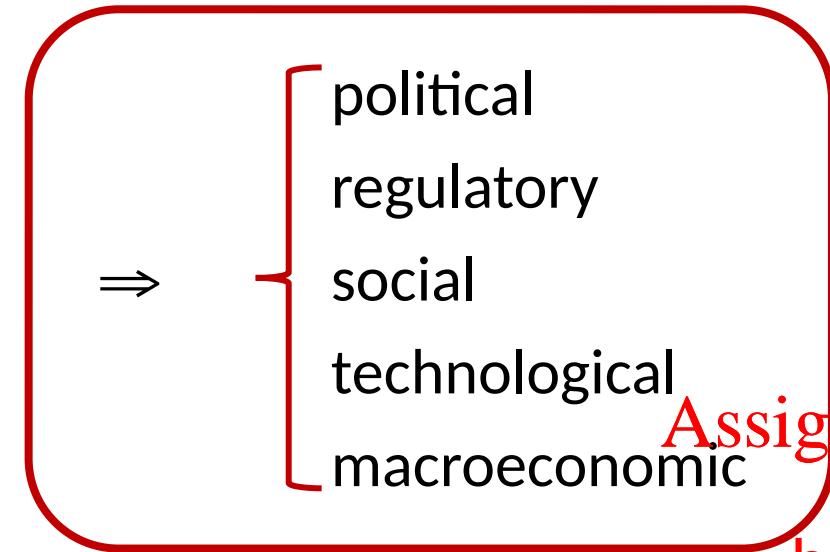
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- b.* Legal constraints on the firm, including antitrust law, consumer law, labor law, and environmental law.
- c.* Regulatory constraints on the firm, including product and price regulations.
- d.* Taxation of the business.

## □ external environment



### ➤ **Situational Analysis – general external environment**

- political / legal
- socio-cultural
- technological
- demographic

### ➤ **PEST analysis**

- *Political forces*
- *Economic forces*
- *Social changes*
- *Technological change*

### ➤ **SWOT**

- *Strengths*
- *Weaknesses*
- *Opportunities*
- *Threats*

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For Coles, how might we summarise the various factors that potentially affect the company, its policies and strategies, and ultimately its performance?

**Political:**

**Regulatory:**

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**Socio-cultural:**

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**Technological:**

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**Macroeconomic:**

e.g., exposure, hedging strategy

**Strategy analysis involves judgement – interpretations and conclusions regarding the firm's circumstances and exposures will differ**

❑ industry environment → setting and dynamics

⇒ Porter's five forces model

the bargaining power of suppliers

the bargaining power of the buyers

the threat of potential

the threat of substitute

the extent of competitive rivalry

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## Why is industry analysis important?

the level industry competition tends to determine how profitable the industry is  
i.e., if the Five Forces are favourable to firms in the industry, they will tend to be profitable

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You can start to think about each of the industry sectors in terms Porter's 'five forces model'

namely: new entrants; substitutes; rivalry

and use your interpretations against the stability of the various sectors



**“How competitive forces  
shape strategy” M.E. Porter,  
*Harvard Business Review*,  
1979 March/April**

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## PART 3 – Porter's Five Forces

### 1. *Bargaining power of suppliers*

- substitutes (lack of substitutes increases the power of suppliers relative to the buyers)
- product differentiation
- numbers of suppliers versus numbers of buyers (fewer suppliers compared with buyers increases the power of the
- where suppliers have alternative products and channels they have greater power
- switching costs
- suppliers could bypass buyer and sell directly to customer
- what suppliers could do:
  - increase prices
  - alter the quality of goods and services supplied
  - not supply goods or services

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Suppliers are more powerful if:

- **The supplier's industry is more concentrated than the industry it sells to**  
e.g., Microsoft used to dominate the operating systems industry, so it had a lot of power over PC manufacturers, which was a fragmented industry
- **The supplier group does not depend heavily on the industry for its revenues.** In this case the suppliers are more powerful because they have the option of selling their goods/services to another industry
- **Industry participants face high switching costs when changing suppliers,**  
e.g., because they have invested in using a particular service and it is costly for customers to change  
e.g., many trading firms have trained their staff on how to use Bloomberg terminals. It is costly to change to a competitor like Factset or Thomson Reuters Eikon

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- **Suppliers offer products that are differentiated**, i.e. offer unique quality, features, service, etc.  
e.g., pharmaceutical companies that offer unique and patent-protected drugs have power over hospitals, since the hospital cannot easily substitute another drug.  
On the other hand, suppliers that sell a 'commodity' product with many substitutes will have less power, e.g. suppliers of stationery.
- **There is no substitute for w** **vides**  
e.g., train drivers can threaten **cannot be replaced**
- **The supplier group can credibly threaten to** **rward into the industry**  
e.g., an iron ore company might start smelting its own steel, and therefore start competing directly with its customers

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## ***2. Bargaining power of buyers (customers)***

- volume of purchases (larger volume of purchases → better prices)
- limited number of buyers
- undifferentiated products or substitute products
- product discretionary/ not essential
- if the product makes up a larger portion of total cost of item, buyers will be more price sensitive
- low switching costs
- where margins are high – buyers will be more active in negotiating lower prices.
- in-house production
- more information, better position to bargain

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## Customers are more powerful if:

- **There are few buyers**, or each purchases in volumes that are large relative to the size of a single vendor  
e.g., Australian supermarkets are very powerful buyers, because the two biggest supermarkets (Coles and Woolworths) have large market shares, whereas their suppliers are more fragmented
- **The industry's products are standardized or undifferentiated**  
e.g., this is true of a lot of non-luxury, basic car brands. Most of us are indifferent between buying a basic Honda, Ford, VW, etc. of basic cars down
- **Buyers face few switching costs in changing**  
e.g., you can switch from Pepsi to Coca Cola fairly easily if prices stay quite similar! UQ vending machines sell both!
- **Buyers can credibly threaten to integrate backward** and produce the industry's product themselves if vendors are too profitable  
e.g., Apple recently announced it will produce its own chips for its Mac computers, rather than using Intel chips

## Customers are more price-sensitive if:

- the product it purchases from the industry represents a significant fraction of its cost structure or procurement budget  
e.g., people shop around a lot when looking for a home mortgage
- the buyer group earns low profits, is strapped for cash, or is otherwise under pressure to trim its purchasing costs
- the quality of buyers' product is affected by the industry's product  
e.g., the movie industry has the opposite situation of mind paying a lot for cameras, because they need high quality equipment
- the industry's product has little effect on the buyer's other costs

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### 3. *Threat of New Entrants* (new competition)

- **Barriers to entry**

1. product differentiation – brand identification
2. economies of scale
3. capital requirements
4. other cost disadvantages
5. access to distribution networks
6. government policy

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- **Retaliation by existing competitors**

1. increase productive capacity, protect distribution channels and customers (first mover advantage)
2. cut prices
3. industry has slow growth – impacting all competitors



new entrants **threaten the profitability of existing companies**

e.g., Toys R' Us, once a very successful toy store, has gone out of business in the U.S. because Walmart and Amazon started selling toys

the treat of entry depends on how difficult it is for a new company to enter the industry

→ **barriers to entry**

**Seven major barriers to entry:**

**1. Supply-side economies of scale:** do existing firms benefit from spreading fixed production costs over a large number of units?

e.g., in the car industry it costs of millions of dollars to develop a new vehicle - some car firms have resorted to partnerships to achieve greater economies of scale, such as Renault and Nissan

e.g., service industries have relatively low economies of scale, such as consulting firms

**2. Demand-side benefits of scale:** do existing firms benefit from large networks of consumers that are difficult to replicate?

e.g., consumers want to use ebay or Facebook because so many *other* people use these platforms - a new auction site or social media site would struggle to replicate their network

**3. Customer switching costs:** are customers locked in to a product/service because it would be very expensive to change?

e.g., changing from Microsoft Office to a competitor's software would be costly for many consumers

**4. Capital requirements:** is a large amount of capital needed up-front to enter the industry?

e.g., most manufacturing industries require building a large factory and warehouse, and buying equipment

e.g., most software products have low capital requirements, so the Google PlayStore and Apple AppStore have many competing

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**5. Incumbency advantages independent of size:** e.g. proprietary technology, access to the most favourable locations, establish brand name, etc.

e.g., Coles and Woolworths tend to have the best locations, because they have been operating for decades. Aldi, which entered Australia in 2001, has had to struggle to find good locations.

**6. Unequal access to distribution channels:** e.g. existing companies might have already locked in the best retail channels

e.g., major airlines historically had agreements with travel agents, locking up this distribution channel; but discount airlines bypassed this by selling directly to consumers online

**7. Restrictive government policy:** the government might somehow restrict access to the industry

e.g., Australian governments casino companies (Crown Resorts) which is a barrier to entry that protects the market (Crown Resorts Group)

Restrictive government policy is not always effective. Uber has been able to push governments into allowing it to compete with taxi companies in many countries

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#### 4. *Threat of substitutes*

- existence of substitutes puts a ceiling on the price that can be charged for a product.
- the cost for customers to switch to the substitute product
- the likelihood that buyers will purchase substitute products.

A substitute product is more of a threat if:

**It offers an attractive price**

e.g., Skype (which is a free service) has put pressure on long-distance telephone companies by providing a good substitute for telephone calls. Now Skype is under pressure from a variety of competitors (e.g., WhatsApp, WeChat, etc.) mainly because it lacked any patents or other barriers to entry.

**It offers a better quality than the industry's product**

ure on long-distance telephone calls. Now Skype is under pressure from a variety of competitors (e.g., WhatsApp, WeChat, etc.) mainly because it lacked any patents or other barriers to entry.

**The buyer's cost of switching to the substitute is low**

e.g., once the patent expires on drugs, other pharmaceutical firms can make 'generic' substitute drugs that are identical to the original drug.

## 5. *Rivalry among existing competitors*

- Outcomes of rivalry
  - aggressive pricing
  - aggressive marketing
  - battles for customers
  - battles for distribution channels
  - increased service levels
- Factors likely to lead to rivalry
  - many and/or equally balanced competitors
  - slow industry growth
  - high fixed costs and asset bases
  - products perceived as a commodity and low switching costs
  - diversity of competitors
  - high exit barriers and excess capacity
  - no product differentiation

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## Industry rivalry is greater if:

- **Competitors are numerous or are roughly equal in size and power**
  - e.g., the budget Android segment of the smartphone market is like this
  - e.g., the opposite is industries where large companies have near-monopolies, such as Google in search engines
- **Industry growth is slow**, as slow growth precipitates fights for market share
  - e.g., Coles and Woolworths are always fighting each other over grocery market share, since the industry grows slowly (b
- **Exit barriers are high**, e.g. ly shift to another industry/market because its assets are specialised or because of government regulation
  - e.g., newspapers are moving online - companies will struggle to redeploy their printing presses
- **Rivals are highly committed to the business** and have aspirations for leadership, especially if they have goals that go beyond economic performance in the particular industry
  - e.g., state-owned companies (or state supported industries) might attempt to maximise production/employment/exports rather than profit. This has tended to happen with steel in recent years

Competition can take place on price or on other dimensions such as quality, features, brand image, etc.

**Price competition** is more likely if:

- **products or services of rivals are nearly identical and there are few switching costs for buyers**  
e.g., cheap Android phones. There are few switching costs since they all run the same operating system and can run the similar features as well.
- **fixed costs are high and marginal costs encourages overproducing to benefit from economies of scale**
- **capacity must be expanded in large increments to be efficient**
- **the product is perishable**, meaning it must be sold quickly or becomes worthless  
e.g., fruits and vegetables. They can be canned rather than selling them fresh, but the market for canned fruits/vegetables is limited

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For Coles, we can possibly summarise the Five Forces analysis as follows:

**Power of Suppliers:** extremely low

**Power of Buyers:** moderate – price sensitive

**Threat of New Entrants:** low, but possible

**Threat of Substitute Products:**

**Rivalry Among Existing Competitors:** moderate

You are welcome to disagree! Strategy analysis involves judgement

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## PART 4 – Firm specific factors

### ➤ Strategic analysis

1. *key success factors* e.g., first mover advantage; marketing & distribution; production efficiencies
2. *strategies* → business level, competitive level, corporate level  
e.g., high price strategy; market penetration strategy: first mover into industry; diversification into new areas; core business
3. *core competencies*
  - **resources** → tangible - financial; human  
intangible resources for innovation; reputation
  - **capabilities** re: operations; marketing and sales; management; technology

### ➤ Performance appraisal

- ⇒ historical financial performance (e.g., ratios)
- ⇒ concerns regarding the historical financial statements  
i.e., needs for restatement and/or restructuring of the financial statements as presented

## ‘Step 1’ – Competitive Strategy

⇒ **firm’s position within industry and sustainability of its competitive advantage**

- competitive strategy involves looking for a profitable and sustainable position in a competitive industry
- factors that contribute to a competitive position are innovation, cohesiveness of a business culture, and good im
- considerations in determining a competitive :
  - long-term profitability of the industry
  - the position of a business within the industry, relative to competitors
- these two considerations are dynamic, in that, performance of an industry and a firm’s competitive position within the industry change over time, with individual firms having the ability to influence these factors
- the greatest influence an individual firm can have is on its positioning within the industry

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## ❖ Porter – Competitive Strategy

- Porter's 'five forces' provide insights into the attractiveness of an industry
- further, they help identify the causes of these forces; explains how they change over time; and how businesses can use strategies to influence them
- they analyse competitors in order to predict and explain their behaviour
- they group competitors on the basis of strategy in order to identify a competitive position within the industry
- they examine specific structural settings and is framework to those settings
- competitive advantage grows from a business creating value in excess of the cost of creating value (*similar to residual income concept*)
- value represents what buyers are willing to pay and stems from
  - offering goods/services at lower prices than competitors (**cost leadership**)
  - providing a unique product that buyers are willing to pay more for (**differentiation**)

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## ‘Step 1’ – Competitive Strategy

⇒ firm’s position within industry *and* sustainability of its competitive advantage

1. **Cost leadership**

2. **Differentiation**

3. **Focus**

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Most businesses compete on the basis of either **cost leadership** or **differentiation**, or a **mix of both**

Having an effective and sustainable cost leadership or differentiation strategy is the source of a company’s competitive advantage

# 1. Cost Leadership

- strategy – firm aims to be the lowest cost producer in its industry
- the firm needs to have a broad scope, serving many industry segments and perhaps related industries.
- sources of cost advantage include
  - economies of scale
  - proprietary technology
  - simpler product designs
  - lower input costs
  - low-cost distribution; good supply relations
  - little R&D or brand advertising
- product will be standard
- cost benefits will come from all sources

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## 2. Differentiation

- strategy – aims to be unique on some dimension that is highly valued by customers, which then allows the company to charge a higher price
- premium priced product
- some bases for uniqueness
  - superior product quality
  - superior customer service
  - investment in brand image; commitment to positive marketing
  - investment in R&D; control system for quality and innovation
- need to ensure that costs are similar to competitors in all areas that do not affect differentiation

*note* – many Australian companies compete on ‘differentiation’ because of Australia’s high labour costs

### 3. Focus

- narrow scope within an industry – focus on a particular segment or groups of segments within an industry.
- cost focus – strategy is to have lowest cost in focus segment
- differentiation focus – strategy is to have uniqueness in focus segment
- need to be special require that differentiates it from the rest of the industry.

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## Competitive advantage from being both a Cost leader and Differentiator

- three conditions under which a firm can be both a cost leader and have product differentiation:
  1. competitors are stuck in the middle
  2. when costs are determined by market share or there are interrelationships between industries that the business can exploit.
  3. major innovation

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## Sustainability

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- to benefit from the competitive strategies that are sustainable
- need barriers to stop imitation
- need to ensure that differentiation proximity or cost proximity is not lost
- there may be some industries where it is very difficult to be either a cost leader or differentiate from competitors.



Australian supermarkets provide an example of somewhat different strategies

- Aldi competes purely on cost leadership
  - offers few alternative brands and products
  - never advertises
  - in store displays are generally basic
  - fewer staff in store
  - efficient supply chain
  - less expensive locations
- Coles and Woolworths compete on a mixture of cost leadership and differentiation
  - offer a wider range of brands and products
  - spend a lot of money on brand image, e.g. advertising, magazines with recipes, elaborate displays in-store
  - have stores all around Australia, even in fairly remote areas (especially Woolworths)
  - on the other hand, Coles and Woolworths also compete on low prices. They use their buying power, economies of scale and 'home brands' to drive down costs, as well as encouraging use of 'Self Check Out'

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## PART 5 – Summary: Sessions #1 → #4

*overarching focus – fundamental value*

→ requires an understanding of the ‘value drivers’

### Firm – Management

assumed objective = maximize share price

value created through execution of 3 roles

1. *Controller function* → operations level (of NWC)
2. *Capital budgeting* → composition of long-term productive assets
3. *Treasury function* → acquisition of long-term finance to support asset acquisition (debt, equity)

*relevant factors / forces* for management to consider when making strategic decisions –

- external environment
- industry setting
- firm specific

### Investor / Analyst

focus – ‘intrinsic value’

approach – fundamental analysis

application of the fundamental valuation model

+ ... +

*required inputs/decisions:*

1. discount rate ( $k$ ):
2. investment horizon ( $n$ ):
3. choice of flow measure ( $x$ ): (D, FCF, and/or E)
4. estimating future values of ‘ $x$ ’ (yearly for ‘ $n$ ’ years, and then the ‘on average’ growth rate,  $g$ , post ‘ $n$ ’)

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*re: investor / analyst*

fundamental analysis  $\Rightarrow$  estimation of ‘intrinsic value’  $\Rightarrow$  fundamental valuation model

= + ... + +

*Application –*

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1. *discount rate (k)*  $\rightarrow$  CAPM

$$k_e = 0.03 + \beta [0.06]$$

2. *investment horizon (n)*  $\rightarrow$  3

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circumstances (‘predictability’)

3. *choice of flow measure (x)*  $\rightarrow$

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conceptually

lly valuation based on

dividends (D), free cash flow (FCF), and earnings / accounting (AE) will lead to the same estimate but requires internally consistent estimates adhering to ‘clean surplus’

4. *estimating future values of ‘x’ and of ‘g’*  $\rightarrow$  developing an understanding of the firm’s value drivers  $\Rightarrow$  external environment, industry dynamics, firm-specific factors

sources of information *include* – analysts, management, press, *Financial*

*Statements*

*re: estimating future values of 'x' and 'g'*

→ developing an understanding of the firm's value drivers

❑ external environment

- ❖ e.g., macroeconomic factors, regulatory factors, social / environmental factors, etc.

❑ industry setting and dynamics → Porter's 'five forces'

- ❖ the bargaining power of suppliers
- ❖ the bargaining power of the buyers
- ❖ the threat of potential new entrants
- ❖ the threat of substitutes
- ❖ the extent of competitive rivalry

❑ firm specific factors

- ❖ e.g., management, product and technology, financial performance

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# Stages of the Analysis

## Stage 1 – Understanding the Business

→ ‘Strategy Analysis’

- product market
- competition
- regulatory constraints
- business strategies
- technology



## Stage 2 – Analysing Information

### Accounting Analysis & Financial Analysis

- quality of accounting information
- reformulating the F/S to uncover business activities
- ratio and cash flow analysis

## Stage 3 – Prospective Analysis: Forecasting

⇒ *pro-forma*

- Income Statement
- Balance Sheet
- Statement of Cash Flows



## Stage 4 – Prospective Analysis: Valuation

- Abnormal Earnings Model
- Alternative Valuation Models
- Statement of Cash Flows



## Stage 5 – Prospective Analysis: Application

→ Investment decision

investor – decision to buy, hold, sell

manager – decision to adopt strategy or not

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