Financial Statement Analysis and Company Valuation

MN50440

Lecture 2

Dr Pietro Perotti

Notes on group coursework

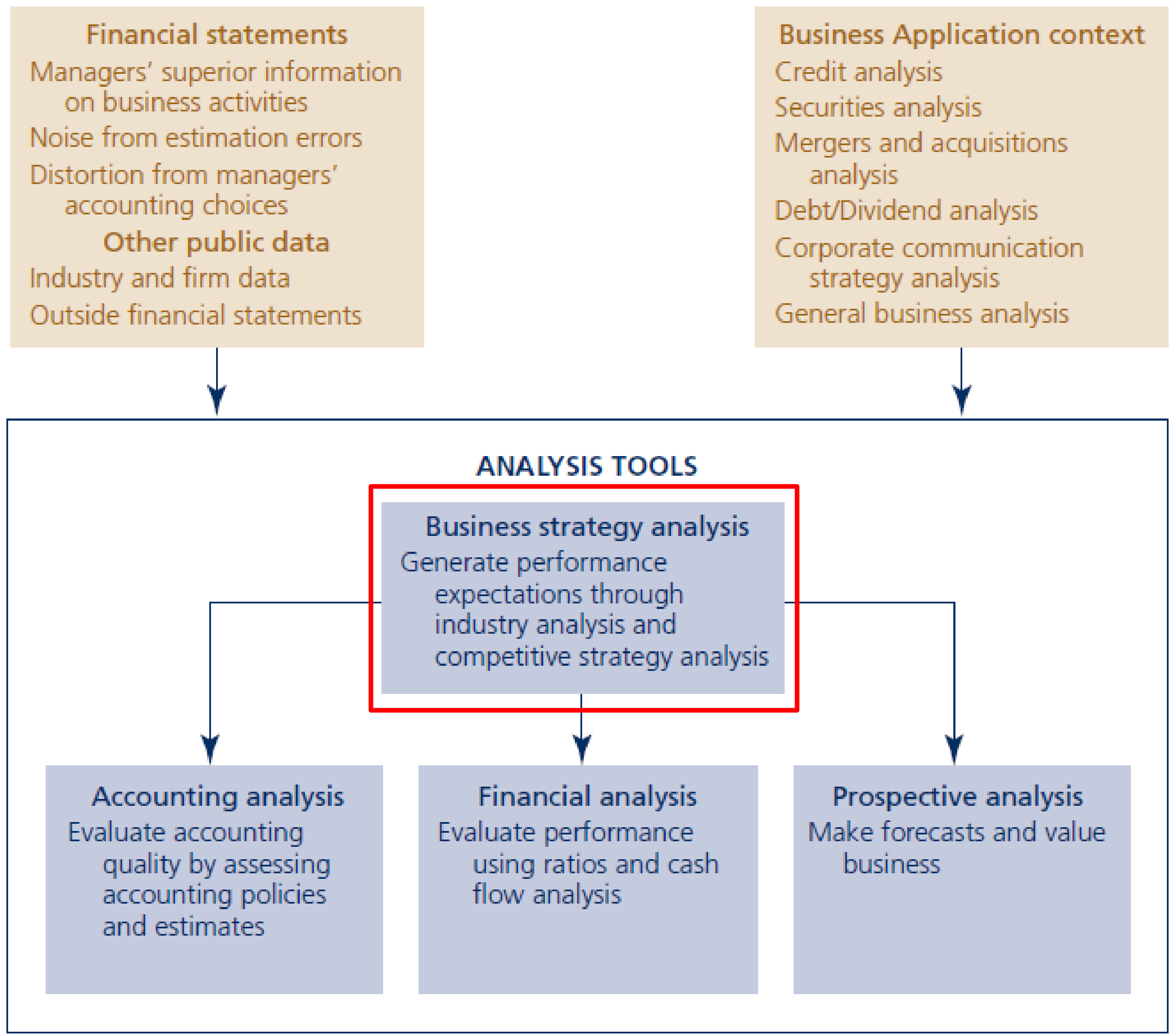
- Please email me by 17 February the **components of the groups (four or five).**
- If you have **any questions**, please ask me.

Plan of the lecture

- **The three steps of business strategy analysis**
  - Industry analysis
  - Competitive strategy analysis
  - Corporate strategy analysis
- **Practical examples:**
  - European airline industry in the years 2000s (industry analysis)
  - IKEA (competitive strategy analysis)
  - easyGroup (corporate strategy analysis)

Revision: FSA Framework

FIGURE 1.3 Analysis using financial statements



Strategy analysis

- The **objective** of strategy analysis is to **identify the key profit drivers and business risks**. It involves analysing a firm's competitive environment and its strategy to create a **sustainable competitive advantage** (a combination of attributes which allow the firm to outperform its competitors).

The three steps of strategy analysis

- **Three Steps of Business Strategy Analysis:**

(1) **Industry Analysis** (e.g., Porter's 'five forces' framework): understanding the profit potential of the industry.

(2) **Competitive Strategy Analysis:** examining the manner in which the firm competes.

(3) **Corporate Strategy Analysis** (for multi-business organisations): examining the way in which the firm creates or exploits synergies across the set of businesses it operates in.

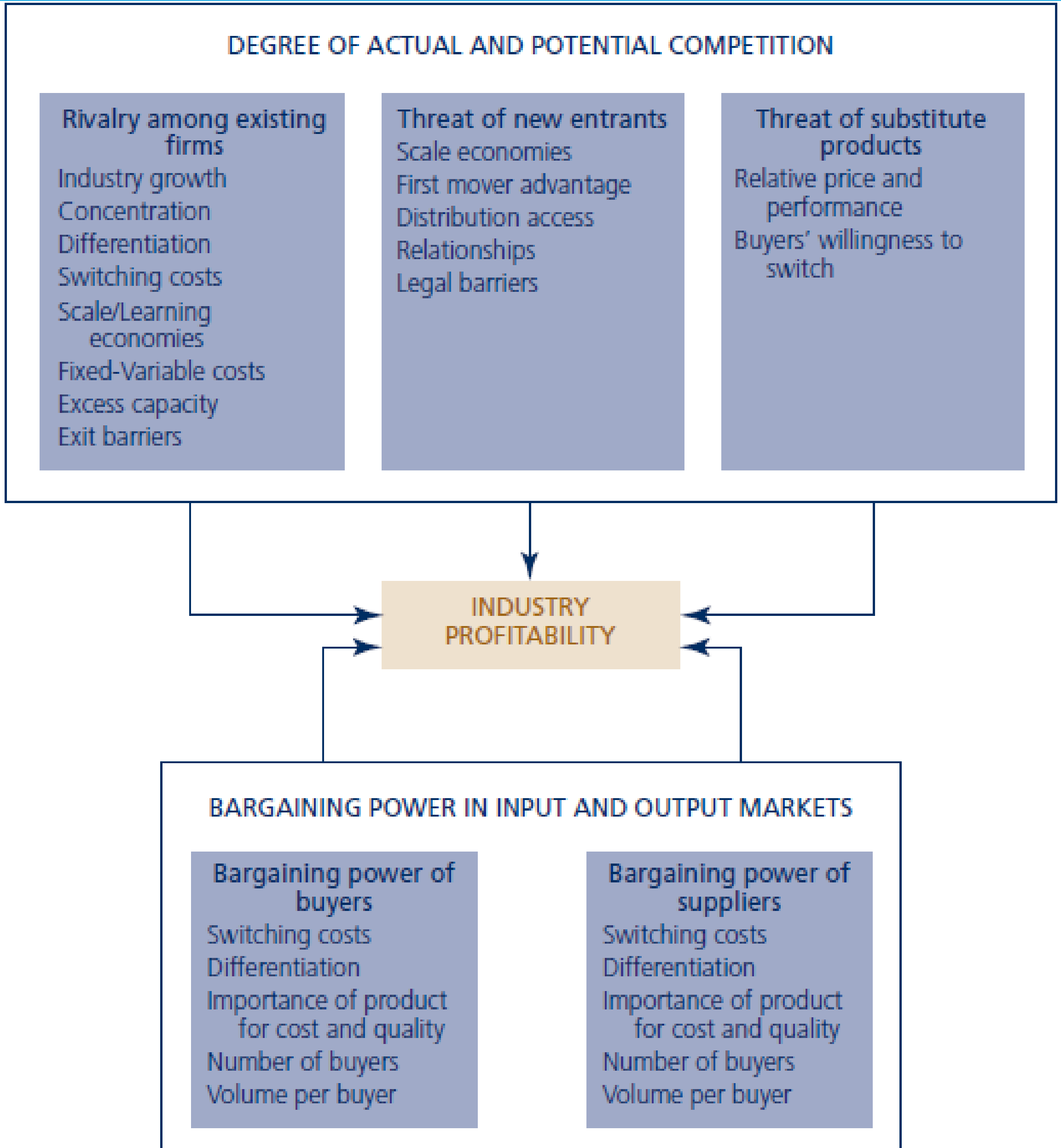
Industry Analysis

Industry analysis

- **The profit potential of a firm is highly influenced by the industry it belongs to.**
  - For example, using the data available for the last reported fiscal year (update January, 2020), the average **Return on Equity** (ratio of net income to equity) **in Western Europe for listed companies** is equal to 14.73%. But there is a **large variation across industries** (e.g., for the Green & Renewable Energy, it is equal to -5.80%, for the transportation industry it is equal to 21.61%).
  - Source for the above statistics: Aswath Damodaran's website (NYU). It contains many useful resources for corporate finance.

- Industry analysis aims to **understand the sources of potential profitability of an industry.**

- **Porter** created a useful framework to evaluate the **'forces'** in an industry that determine average profitability.


DEGREE OF ACTUAL AND POTENTIAL COMPETITION
Rivalry among existing firms
Industry growth
Concentration
Differentiation
Switching costs
Scale/Learning economies
Fixed-Variable costs
Excess capacity
Exit barriers
Threat of new entrants
Scale economies
First mover advantage
Distribution access
Relationships
Legal barriers
Threat of substitute products
Relative price and performance
Buyers' willingness to switch
INDUSTRY PROFITABILITY
BARGAINING POWER IN INPUT AND OUTPUT MARKETS
Bargaining power of buyers
Switching costs
Differentiation
Importance of product for cost and quality
Number of buyers
Volume per buyer
Bargaining power of suppliers
Switching costs
Differentiation
Importance of product for cost and quality
Number of buyers
Volume per buyer

Competitive force 1:
Rivalry among existing firms

- **Determinants of the intensity of competition (i.e., rivalry) among firms:**
  - **Industry growth rate (-)**. If industry growth rate (demand growth) is high, incumbent firms can increase profits without grabbing market shares from each other. Therefore, the incentives to compete aggressively decrease.
  - **Concentration of competitors (-)**. If concentration is high (i.e., there are few firms in the industry), incumbent firms can make high profits by colluding and without grabbing market shares from each other. Therefore, the incentives to compete aggressively decrease.

Competitive force 1: Rivalry among existing firms

- **Determinants of the intensity of competition (i.e., rivalry) among firms (cnt'd):**
  – **Degree of differentiation in products and services and switching costs (-)**. If products are substantially different or if switching costs are high, it is difficult for incumbent firms to steal customers from each other. Therefore, the incentives to compete aggressively decrease.
  – **Economies of scale (cost advantages with increased output) and ratio of fixed to variable costs (+)**. If there are economies of scale, firms with a higher level of output have higher profits. Therefore, the incentives to compete aggressively to grab market share from the others increase (in order to reach a large output level). Similarly if the ratio of fixed to variable costs is high, firms need to reach a high level of output to break even.

Competitive force 1:
Rivalry among existing firms

- **Determinants of the intensity of competition (i.e., rivalry) among firms (cnt'd):**
  - **Excess capacity (capacity>output produced and sold) and exit barriers (+)**. If incumbent firms have excess capacity, it is likely (depending on the cost structure and the price that can be charged), that they can increase their profits by increasing the output. Therefore, the incentive to compete aggressively to grab market share from the others increase. The effect if stronger if there are exit barriers (it is costly to exit the industry).

Competitive force 2: Threat of new entrants

- **The ease with which a new firm can enter an industry** will affect the profitability of other firms within the industry.

- **Factors creating the barriers to entry are:**
  - Economies of scale. If there are economies of scale, firms with a large level of output can achieve a higher profit than the others. Therefore, new entrants need to have a large output (which is difficult and risky to obtain) to be competitive.
  - First mover advantage (advantages from being in the industry, e.g., existing relationships with suppliers and customers).
  - Legal barriers (some industries are highly regulated).

Competitive force 3:
Threat of substitute products

- **The ease with which a new product can substitute existing products** will affect the profitability of other firms within the industry.

- **The degree to which substitutes exist depends upon** the relative price and performance of competing products or services, and the willingness of customers to accept substitutes.

Competitive force 4: Bargaining power of buyers

- Buyer bargaining power can exert **downward pressure on prices.**

- **Factors that can affect this bargaining power are:**
  - Demand sensitivity to the price of the product or service
  - Availability (to buyers) of information on the products of competitors

Competitive force 5: Bargaining power of suppliers

- **Factors that can affect this bargaining power:**
  - Suppliers have bargaining power when there are few substitutes and/or few suppliers relative to the number of customers demanding a product or service.
  - When the suppliers' product is critical to buyers' business, suppliers' bargaining power increases.

European airline industry in the years 2000s

- In the **early 1980s, the European airline industry was highly regulated.** Bilateral agreements between European governments severely restricted competition by determining which airlines could operate which routes at what fares.
- During the ten years **from 1987 to 1997, the European Union (EU) gradually liberalized the industry**, and reduced government intervention. The industry exhibited **steady growth.** While the four largest European airlines carried 54 million passengers in 1980, the same airlines carried 147 million passengers in 2000.

European airline industry in the years 2000s

- **Many of the large European airlines**, such as British Airways, KLM, Lufthansa, and SAS, **reported volatile performance during the 2000s** and on occasion were forced to undergo internal restructuring. Other national carriers, such as Sabena, Swissair, and Alitalia, went bankrupt.

- *What accounted for this low profitability? Use the Porter model of five forces.*

Rivalry among existing firms

- **Industry growth:** Between 2000 and 2010, the average annual industry growth was a **moderate** 2 percent (negative peak after September 11, 2001).
- **Concentration:** The industry was **fragmented**. While several new airlines had entered the industry after the liberalization period, very few of the inefficient and loss-making national carriers left the industry. EU regulation also made mergers more difficult.

Rivalry among existing firms

- **Differentiation and switching costs: Services** delivered by different airlines on short-haul flights, within Europe, were **virtually identical. Switching costs** across different airlines were also **low.**
- **Excess capacity:** The European airlines had a **structural excess capacity problem.** Between 2000 and 2010, the average annual passenger load factor, which measures the percentage of passenger seats filled, was 75 percent.

Threat of new entrants

- **Access to distribution channels:**
  - **Time slot allocation in airports** could have initially created barriers to entry. This was gradually deregulated starting from 1993.
  - **Early new entrants were low-cost carriers,** e.g., easyJet and Ryanair, which experienced explosive growth and forced the incumbent airlines to start competing on price.

Threat of new entrants

- **Access to capital:** New entrants had **easy access to capital.**
  - Purchased aircrafts served to **securitise loans**, or aircrafts could be **leased.**
  - Further, **second-hand aircrafts** became cheap during industry downturns, when troubled airlines disposed of excess capacity.
- **Legal barriers: After 1997, European airlines faced no legal barriers to enter European markets** outside their domestic market. Measures taken by the EU to deregulate the industry made it possible for the airlines to freely operate on any route within the EU, instead of having to conform to bilateral agreements between countries.

Threat of substitute products

- **High-speed rail networks** were being expanded and provided a potential, not yet fully exploited, substitute for air travel over shorter distances.

Buyers' bargaining power

- **Web booking systems helped buyers to gain more power** as the market became more transparent.

Suppliers' bargaining power

- European airline **employees had high bargaining power over their employers** since their job security tended to be well-protected and the threat of a strike was an efficient bargaining tool in labour negotiations.
- **Medium bargaining power of aircraft suppliers.** 90% of the aircrafts that European airlines had acquired or leased came from two commercial aircraft manufacturers, Airbus and Boeing. **On the one hand**, the strong dependence on only two aircraft suppliers increased the bargaining power of these suppliers. **On the other hand**, the overall demand for new aircrafts was low; this reduces the bargaining power of suppliers of aircrafts.

What was the consequence of the competitive environment on profitability?

- To sum up:
  - **A number of factors** (moderate growth, industry fragmentation, low differentiation and switching costs, structural excess capacity) **led to high intensity of rivalry within the industry.**
  - **Regulation changes and capital market circumstances (**easier access to distribution channels, reduction in legal barriers, easy access to capital**) led to low entry barriers and high threat of new entrants.**
  - **Potential threat of new products developed.**
  - **Buyers' baragaining power was high.**
  - **Suppliers' bargaining power was relatively high (**high bargaining power of employees; medium bargaining power of aircraft suppliers**).**

What was the consequence of the competitive environment on profitability?

- **These factors led to a low profit potential in the industry**.

Competitive strategy analysis

Competitive strategy analysis

- The firm's profitability is influenced not only by the industry structure, but also by **the way in which a firm positions itself in the industry.**
- Individual firms must **choose appropriate strategies to succeed** within their industry segment.
- **Two basic competitive strategies are:**
  - **Cost leadership** (e.g., Aldi and Lidl)
  - **Product / service differentiation** (e.g., Sainsbury: high quality)

Cost leadership

Supply same product or service at a lower cost
Economies of scale and scope
Efficient production
Simpler product designs
Lower input costs
Low-cost distribution
Little research and development or brand advertising
Tight cost control system

Differentiation

Supply a unique product or service at a cost lower than the price premium customers will pay
Superior product quality
Superior product variety
Superior customer service
More flexible delivery
Investment in brand image
Investment in research and development
Control system focus on creativity and innovation

Competitive advantage

- Match between firm's core competencies and key success factors to execute strategy
- Match between firm's value chain and activities required to execute strategy
- Sustainability of competitive advantage

Cost leadership

- A cost leader can earn **above-average profits by merely charging the same price as the rivals.**

- **Alternatively**, a cost leader **can force the incumbent firms to cut prices to avoid exiting the market** (e.g., low-cost airlines in the 1990s and 2000s).

- **Typical ways to achieve cost leadership:** investments in efficient scale plants, focus on product design which reduces manufacturing costs, minimise overhead costs, little investment in risky R&D.

Product differentiation

- **Trying to be unique in the industry** along some dimensions that are highly valued by customers.

- **Necessary conditions to be successful:**
  - **Identify one or more attributes** of a product or service that customers value.
  - Position oneself to **meet the chosen customer need in a unique manner.**
  - Achieve differentiation at **a cost that is lower than the price the customer is willing to pay for the differentiated product or service.**

- **Typical ways to achieve product differentiation:** product quality, product variety, bundled services, delivering time.

Discussion question

- *What are other examples of companies following a cost leadership strategy?*

- *What are other examples of companies following a product differentiation strategy?*

Cost leadership vs. Product differentiation

- Cost leadership and product differentiation are **normally seen as alternative.**
- However, **a firm cannot ignore the dimension on which it is not primarily competing.**

Achieving and sustaining competitive advantage

- **Choice of strategy is an important first step for a firm.** The likelihood of achieving and sustaining competitive advantage (a combination of attributes which allow the firm to outperform its competitors) should be evaluated.

- **Factors to evaluate the sustainability of a competitive advantage (e.g., IKEA example) include:**
  - Unique core competencies. They can be, for example, physically unique resources, or the result of a long history of development.
  - Coherent system of activities. This makes it more difficult for competitors to imitate.
  - Positioning. This can mean choosing or carving out a subsegment of business.

Competitive strategy analysis: IKEA

- **Sweden-based IKEA is one of the world's largest furniture retailers.** The company, founded by Ingvar Kamprad as a mail-order company, bought its first furniture factory and showroom in 1953.
- During the 1960s, IKEA started to develop the operating concept that the company is still **renowned for: selling flat-packed furniture through large warehouse stores.** In those years, IKEA also started to expand internationally.

IKEA

- While continuously expanding its worldwide store base, IKEA firmly established itself in the furniture retailing industry by following a **low-cost strategy.**
- In the last 15 years, IKEA has been one of the most successful furniture retailers in the industry.
- *How did IKEA achieve such performance?*

IKEA – Example of low-cost strategy

- IKEA's superior performance was based on a **low-cost competitive strategy.**
- As a result of this strategy, **IKEA achieved a significant cost advantage over its competitors in the furniture retailing industry.**
- Consequently, IKEA was able to continuously cut prices and maintain the price difference with its competitors. **Over the years, the company made large investments in knowledge of low-cost** furniture design, store design, and logistics.
- Some of the **key success factors** are the following five.

IKEA – factors of success

- **Global strategy.** In each of the 37 countries where the retailer operates its stores, it targeted the **same customer group** – young families and young couples – **and offered virtually the same selection of furniture.** This strategy of **strong economic integration and low responsiveness to national cultures helped** the company to achieve economies of scale.
- **Sourcing of production. IKEA outsourced its production to manufacturers located throughout the world.** IKEA developed a network including a large number of manufacturers in different countries**.** High relative **bargaining power.**

IKEA – factors of success

- **Economic designs.** Although IKEA outsourced its production, the company kept tight **control of the design of its furniture.** Its designers worked two to three years ahead of production to have sufficient time to find the most economic design solutions and review potential suppliers.
- **Logistics.** IKEA incorporated logistics into its strategy. The company operated **large warehouse stores on relatively cheap locations outside the city centres** (e.g., Bristol outskirts). These warehouse stores sold furniture in flat-pack format that customers assembled at home. The integration of stores and warehouses and the use of flat-packs helped IKEA to economize on costs for storage and transportation.

IKEA – factors of success

- **Sales.** IKEA stores were able to **employ a lower amount of sales staff than other stores because customers needed little assistance.** All warehouse stores were designed such that customers, after having made their choice, picked the flat-packs from the shelves and paid for their purchases at a central location in the store. IKEA also provided its customers with **limited after-sales service.** Through this strategy, the company was able to **keep personnel expenses to a minimum.**

IKEA – factors of success

- **To sum up, IKEA became a cost leader based on these factors:**
  - Global strategy
  - Outsourcing of production
  - Centralised decisions on designs
  - Incorporation of logistics
  - Sales concept
- **Factors increasing the likelihood of sustaining the competitive advantage:**
  - **Unique core competences:** large investments in knowledge of low cost furniture design, store design and logistics.
  - **Coherent system of activities**: coherent combination of strategies over production, logistics, sales.
  - **Positioning:** the company became a leader in the business subsegment targeted to young families and couples.

Discussion question

- *How can a cost leadership strategy or a product differentiation strategy create barriers to entry?*

Corporate Strategy Analysis

Corporate Strategy Analysis

- **Most large companies are multi-business organisations that operate in several industries.** For these firms the analyst must undertake the **above steps for each line of business.**
- The analysis should **also focus on the economic consequences of managing all the various businesses under one umbrella** - how the separate segments are managed within the corporate governance structure.

Sources of value creation at the corporate level

- Corporate strategy analysis aims to find the **sources of value creation at the corporate level.**

- **Multi-business organisations might be able to add value, for example:** (1) by reducing communication costs; (2) by efficiently enforcing agreements through a headquarter office; (3) by sharing, among organisational subunits, non-divisible assets (e.g., brand names) and non-tradable assets (e.g., organisational skills).

In practice: does diversification add value?

- Empirical evidence shows that **diversified companies often trade at a lower value in the stock market** relative to a comparable portfolio of focused (i.e., single business) companies.

- **Possible explanations:** (1) managers diversify to increase size and not to maximise shareholder value; (2) diversified companies often suffer from incentive misalignment problems across subunits; (3) it is difficult for capital markets to monitor and value diversified companies.

Discussion question

- *We will see the case of easyGroup in detail. What are other examples of multi-business companies?*

Corporate strategy analysis: easyGroup

- easyGroup, a **privately-owned company that licenses the ‘easy’ brand name** to, and holds shares in, various no-frills, low-cost businesses.
- **The first and primary holding of easyGroup is easyJet.** The company then expanded to other industries (car rental, pizza delivery, bus transport, cruise travel, office space rental, cinemas, and hotels).

Corporate strategy analysis: easyGroup

- easyGroup's profits come from **licensing/franchising the 'easy' brand and holding financial stakes in the new ventures.**
- **The new ventures that easyGroup started had a few common characteristics:**
  - Online selling
  - No-frills services
  - Demand-based prices
  - Common brand

easyGroup: Brand values

- See **group website** (http://www.easy.com/the-brand.html) to know more about the business strategy and brand values.
- **Brand values:**
  1. great value
  2. taking on the big boys
  3. for the many not the few
  4. relentless innovation
  5. keep it simple
  6. entrepreneurial
  7. making a difference in people's lives
  8. honest, open, caring and fun

easyGroup – Factors of success

- **Making use of easyJet's valuable brand name and its established reputation in offering no-frills services at low prices**, the company could increase the success of the new ventures. At least two reasons:
  - Customers are likely to have **greater trust in new businesses that operate under a familiar brand name.**
  - **Brand-stretching can help to economise on advertising.**
- easyGroup had been able to acquire **critical expertise in flexible pricing and online selling.** This is a general competency that can be exploited in many industries.

Question to wrap up the class

- ‘**Strategy analysis seems to be an unnecessary detour in doing financial statement analysis.’** Why is this wrong?

Concluding remarks

Key points of the lecture

- **Introduction to business strategy analysis:** industry analysis (European airline industry in the years 2000s), competitive strategy analysis (IKEA), corporate strategy analysis (easyGroup).

Concluding remarks

- For **more examples on industry analysis:** application to the pharmaceutical and tour operating industries (see Moodle).
- **Next week** we will see Step 2 of financial statement analysis, namely **accounting analysis.**
- **Please read the text on Euro Disney.** I will use it for a **discussion question** on how to perform accounting analysis. **The text is available on Moodle.** The text is also available in Chapter 3 (Problem 3) of the core textbook.