Pre-requisites

Process

1. **Clear understanding of business**
   - What does the company do?
   - Major business segments
   - Value chain of the business, position of company's activities in the value chain, understanding of the suppliers and customers, consumers
   - Major competitors, industry structure/consolidation
   - Rank in industry
   - Major suppliers, customers

2. **Understanding of the economics of the business (rough P&L statement and CF statement for both overall and per unit product/service sold)**
   - Revenue – how is it recorded
   - Gross margin (major raw materials and their costs)
   - Overhead costs margin
     - ✓ Major overhead costs – employee costs, manufacturing, selling, distribution, freight & transportation, commissions and others (extent of economies of scale?)
   - Depreciation cost margin
   - Interest cost margin
   - Tax margin
   - EBITDA margin (Level of margin? Is it sustainable? → function of barriers to entry)
   - Delta (WC) margin = WC/sales * sales growth (Is it working capital intensive? → Function of bargaining power with supplier and customer? function of barriers to entry)
   - Capex /sales margin (Is it capex intensive? → function of nature of industry, extent of outsourcing, function of where the barriers to entry exist)
   - FCFF margin → understanding of what $1 increase in revenue translates to in terms of increase in FCFF
   - ROIC/ROEs
   - Current leverage, sustainable leverage

- Assets, asset turnover (high or low asset turnover? Can be increased by higher operational efficiency, or also price increases based on pricing power)

3. Understanding the barriers to entry, if any

- Test for the existence of barriers to entry
  - ✓ ROICs – high
  - ✓ Stable market share
  - ✓ Consolidated industry structure (be careful to classify the relevant industry/market – geographically or product/service wise)

- Identify the barriers to entry
  - ✓ Customer captivity
    - Habit e.g. Coke, Pepsi – more relevant for regular small pocket purchases
  - ✓ **High switching costs**
    - Network effect e.g. Microsoft Windows, Office
    - Risk of change/switch e.g. Flavors and fragrances
    - Switching that requires money, time and effort
    - Deep entrenchment with customer – planning, logistical software integrated
  - ✓ Search costs e.g. Professional services, complicated service which cannot be objectively measured, e.g. Facility management, security services, fire safety services
  - ✓ Importance of product and service along with a smaller share of wallet e.g. Paints, flavors and fragrances
  - ✓ **Access to resources**
    - Access to raw materials – *access* e.g. Limestone for cement
    - Access to raw materials – *proximity* e.g. Posco for iron-ore
    - Product patents, process patents, trademarks,
    - Technology know how, complicated process, learning curve – *'Soft Patents'*
    - Regulation – Is it temporary and highly uncertain?

- ✓ **Economies of scale -** *Magnitude difference in market share of incumbent with nearest rival within the **relevant market** (relevant market means geographical area or product line)*
  - ▪ Generally local economies of scale and in some ways it's the density (concentration) that matters
- ✓ Fixed costs that are spread across a larger number of units e.g. Distribution costs, marketing costs, freight & transportation costs (both inbound and outbound) and bargaining power for raw materials etc.

- Do barriers to entry exist?
  - ✓ No – operational efficiency, management quality
  - ✓ Yes – Single dominant firm structure
    - ▪ Single dominant firm – the firm is in a very strong position, take a call on its numbers with this view
    - ▪ Other than the single dominant firm – the firm may not be in a strong position, take a call on its numbers with this view
  - ✓ Yes – almost equally dominant firms (most likely when the number of firms are few in number)
    - ▪ Understand the nature of competition; is there a history of the firms co-existing peacefully with each other, thus making the industry highly profitable as a whole? This is most likely to exist if there are a few firms and thus can interact with each other meaningfully

4. Valuation – Putting the above into context

- Use the understanding from 3 above to take a call on
  - ✓ EBIDTA margins
  - ✓ Delta (WC) margin
  - ✓ Capex margin
  - ✓ Hence FCFF margin
- Understand top-line growth based on
  - ✓ Volume growth for industry
  - ✓ Price growth for industry

    - ✓ Understanding of 3 above for market share and company factors to translate industry growth to company growth
- Translating top-line growth into FCFF and FCFF growth using the FCFF margin above
- Do a simple valuation based on the FCFF and an assumed WACC

Investment Checklist

Business fundamentals

1. What is the long term pricing power of the business?
2. How does the business perform in an inflationary environment?
3. Local/regional or national/international business
4. Who controls distribution?
5. Do customers pay in cash – e.g. McDonald's
6. Is it a lightly or heavily regulated industry?
7. Length of production and distribution cycle
8. Any history of getting stuck with excess inventory? Is inventory perishable, e.g. in technology companies or fashion retailers
9. How vulnerable is the business to low cost substitutes – e.g. Chinese players in manufacturing
10. Customer / supplier concentration
11. Major input costs – oil / petroleum / other raw material driven
12. Order book based business? Order book size and duration, risk of order cancellations

Ownership

13. Major shareholders
14. Insider ownership and recent insider buying/selling

Governance

15. Board composition
16. Separation of Chairman and CEO roles

Management/Employees

17. Background and experience of top management
18. Is the company an employer of choice in its industry?
19. What is the employee turnover rate?

Compensation

20. Compensation and ESOP policy
21. Pension liabilities, if any

Country risk

22. How much government interference is there in the sector – e.g. sugar in India
23. Any history of expropriation or nationalization of assets?
24. Any price controls in the sector?

Track record

25. How long has the company been in existence?
26. Historical financial performance for the last 10 years – gross margin, EBITDA margin, EBIT margin, ROA, ROIC and ROE
27. Dividend payment track record - % of free cash flow and net income
28. Long term book value and dividend growth rate
29. Any history of buybacks?

Valuation

30. Multiples based on current and 5-yr average earnings. Are earnings at a cyclical high?
31. What is the historical P/B and P/E range?

Derivatives

32. Any derivative exposures?
33. Hedging policy employed

Balance Sheet/Accounting quality

34. Net income vs. cash flow comparison. Is depreciation > capex?

35. What is the total goodwill recorded on the balance sheet?

Leverage

36. Current and past leverage levels
37. Debt maturity profile – sufficient cash flows to pay down maturing debt?
38. CDS spreads, if any

Capital Raising/Acquisitions

39. Historical growth – accrual / new equity / debt / working capital financed
40. Acquisition track record

Possible Dilution

41. Outstanding warrants / preferreds / ESOPs – possible dilution impact