

Chp 3. STRATEGIC MANAGEMENT AND INDUSTRY ANALYSIS

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CFA Institute

CONTENT

1. Strategic Management

2. Industry Overview



3. Competitive Positioning

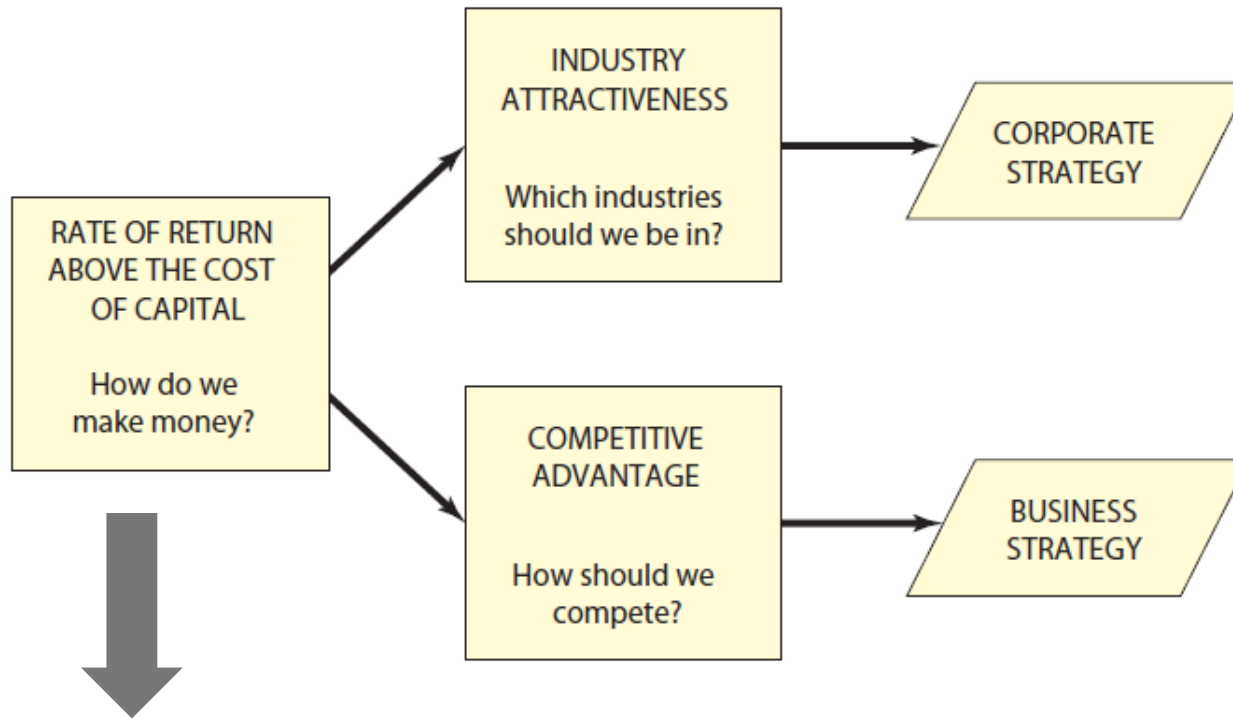
4. Example: Airline Industry

1

Strategic Management

STRATEGIC MANAGEMENT AND INDUSTRY ANALYSIS

SOURCES OF SUPERIOR PROFITABILITY CORPORATE VERSUS BUSINESS STRATEGY



If **ROIC < WACC**, is the company able to add value?

$ROIC = (\text{Net Income} - \text{Dividends}) \div \text{Invested Capital}$ [as book values]

$\text{Invested Capital} = \text{Equity} + \text{Net Debt} = \text{Fixed Assets} + \text{Intangible Assets} + \text{Current Assets} - \text{Current Liabilities} - \text{Cash}$

DESCRIBING STRATEGY

Strategy as Positioning

- *Where are we competing?*
 - Product market scope
 - Geographical scope
 - Vertical scope
- *How are we competing?*
 - What is the basis of our competitive advantage?

*COMPETING FOR THE
PRESENT*

Strategy as Direction

- *What do we want to become?*
 - Vision statement
- *What do we want to achieve?*
 - Mission statement
 - Performance goals
- *How will we get there?*
 - Guidelines for development
 - Priorities for capital expenditure, R & D
 - Growth modes: organic growth, M & A, alliances

*PREPARING FOR THE
FUTURE*

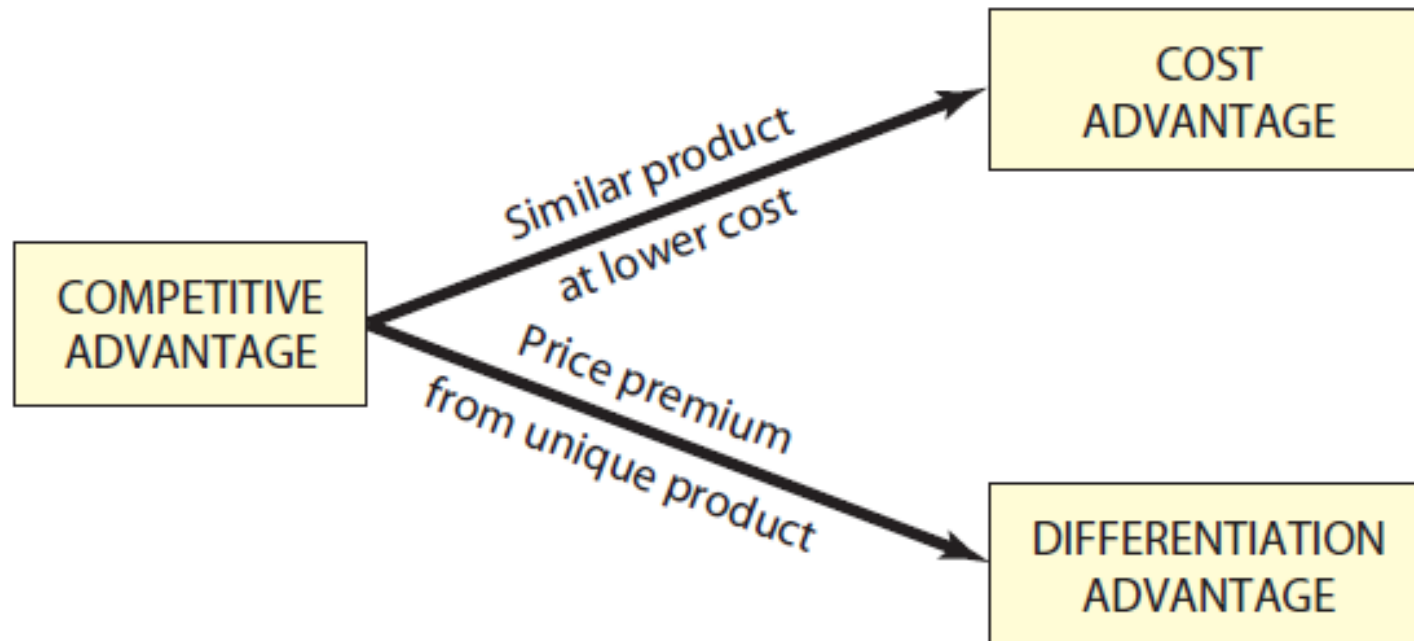
THE BASIC FRAMEWORK: STRATEGY AS A LINK BETWEEN THE FIRM AND ITS ENVIRONMENT



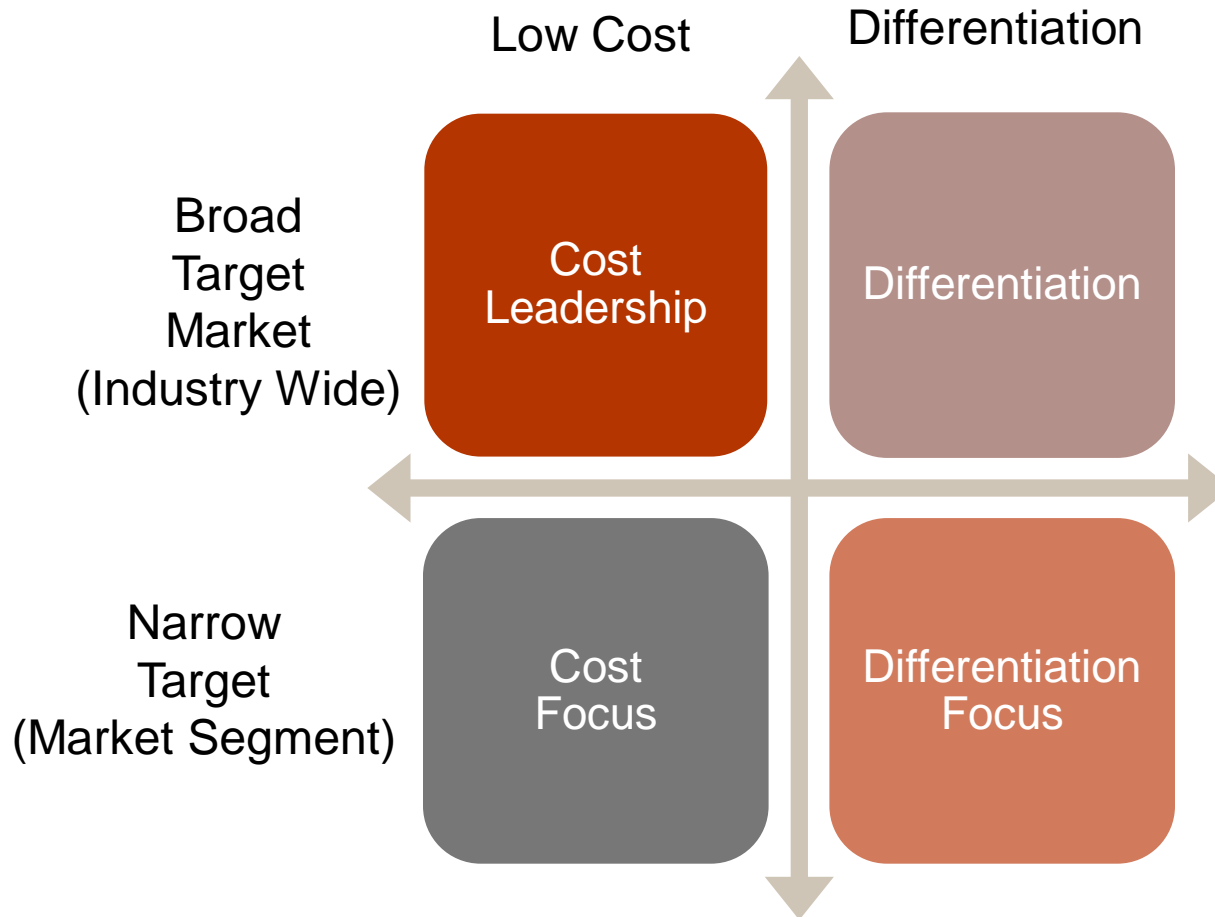
Understand if:

- the company has resources and capabilities to put in place its strategies;
- strategies fit into the industry environment

SOURCES OF COMPETITIVE ADVANTAGE



UNDERSTANDING THE BUSINESS: COMPETITIVE ANALYSIS



CORPORATE SOCIAL RESPONSIBILITY

- Companies are increasingly accepting responsibilities that extend well beyond the immediate interest of shareholders:
 - For ethical reasons
 - For reasons of self-interest
 - Sustainability (it is in both society's and the firm's interests to sustain the ecosystem)
 - Reputation (CSR enhances the firm's reputation with consumers and third parties)
 - License to operate (firms need the approval and support of the constituencies on which they depend)

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Industry Overview

STRATEGIC MANAGEMENT AND INDUSTRY ANALYSIS

INTRODUCTION

Company analysis is the analysis of an individual company, and it requires understanding a company's industry and identifying its peers.

- An **industry** is a group of companies offering similar products and/or services, whereas a **sector** is a group of related industries.
- A **principal business activity** is a source from which a company derives a majority of its revenues and/or earnings.
- A **peer group** is a group of companies that are engaged in similar business activities, and whose economics and valuation are influenced by closely-related factors.

INTRODUCTION

Industry Analysis should provide a picture of where the industry is going and how the subject company fits in.

Relevant Questions for Industry Analysis

- What are the prospects for growth?
- What are the industry's dominant economic traits?
- What competitive forces are at work in the industry and how strong are they?
- Which companies are in the strongest/weakest competitive positions?
- What key factors will determine competitive success or failure?
- How attractive is the industry in terms of its prospects for above-average profitability?
- How large is the industry?
- How much M&A activity is occurring?
- Is it a regulated industry?
- Who are the consumers? Is that base growing?
- ...

THE PROFITABILITY OF US INDUSTRIES, 2000-2010

SIGNIFICANTLY VARIABILITY PER INDUSTRY

Industry	Median ROE 2000-10(%)	Leading companies
Tobacco	33.5	Philip Morris Int., Altria, Reynolds American
Household and personal products	27.8	Procter & Gamble, Kimberly-Clark, Colgate- Palmolive
Motor vehicles and parts	4.4	GM, Ford, Johnson Controls
Entertainment	3.9	Time Warner, Walt Disney, News Corporation
Airlines	-11.3	AMR, UAL, Delta Airlines

Source: Data from Fortune 1000 by industry.

See Grant & Jordan 2e Table 2.1 for a more detailed list of US industries.

HOW CAN WE ACCOUNT FOR THESE DIFFERENCES IN INDUSTRY PROFITABILITY?

- Is it all down to luck?
- Some industries are in decline, others are growing fast?
- The basic premise that underlies industry analysis is that the level of industry profitability is neither random nor entirely the result of industry-specific influences, it is determined by the **industry's underlying economic characteristics**

INDUSTRY STRUCTURE

STEPS FOR INDUSTRY ANALYSIS

Typical steps in industry analysis (Porter, 2008):

Define the relevant industry:

- What products are in it? Which ones are part of another distinct industry?
- What is the geographic scope of competition?

Identify the participants and segment them into groups, if appropriate:

Who are the

- buyers?
- suppliers?
- competitors?
- substitutes?
- potential entrants?

Assess the underlying drivers of each competitive force to determine which forces are strong and which are weak and why.

STEPS FOR INDUSTRY ANALYSIS

Typical steps in industry analysis (Porter, 2008):

Determine overall industry structure, and test the analysis for consistency:

- *Why* is the level of profitability what it is?
- Which are the *controlling* forces for profitability?
- Is the industry analysis consistent with actual long-run profitability?
- Are more-profitable players better positioned in the relation to the five forces?

Analyze recent and likely future changes in each force, both positive and negative.

Identify aspects of industry structure that might be influenced by competitors, by new entrants, or by the company.

APPROACHES TO IDENTIFYING SIMILAR COMPANIES

Products and/or services supplied

- Similar products and/or services
- Industry and sector classification
- A company's principal business activity

Business-cycle sensitivities

- **Cyclical companies** have profits correlated with the overall economy
- **Noncyclical companies'** performance is independent of the economy

Statistical similarities

- Groups based on correlations of security returns
- Based on historical returns, but relationship may not continue in the future
- May associate firms based on chance or may exclude important relationships

IDENTIFYING PEER GROUPS

Examine classification systems



Review subject company's annual report



Review company's competitors' annual reports



Confirm comparability with potential peers

INDUSTRY OVERVIEW & COMPETITIVE POSITIONING: STRUCTURE

Bottom-up approach

Aggregates individual company forecasts to industry forecasts

...may be aggregated to macroeconomic forecasts

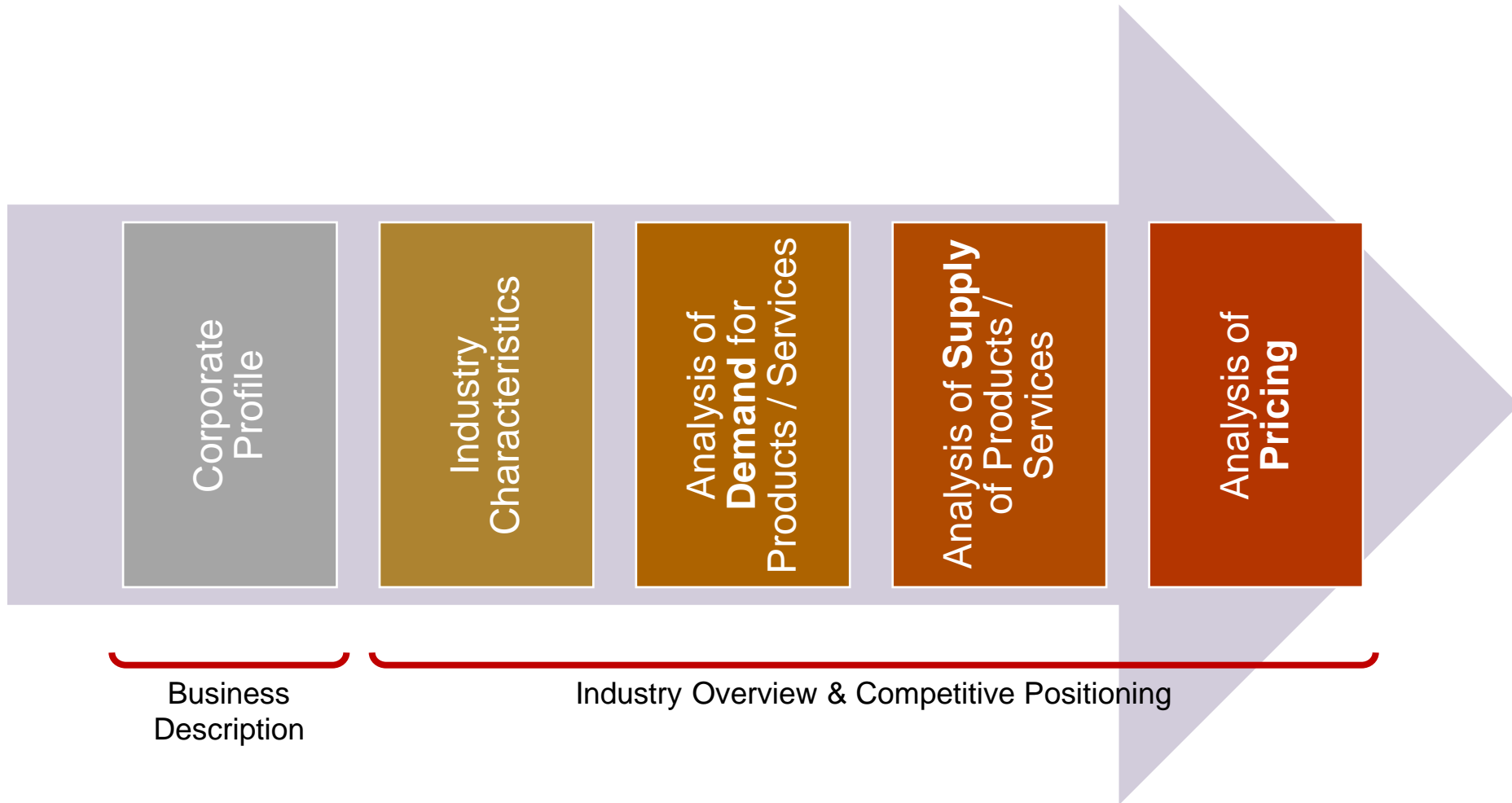
Top-down approach

Starts with macroeconomic forecasts

Moves to industry forecasts

...and then to individual company and asset forecasts

INDUSTRY OVERVIEW & COMPETITIVE POSITIONING: STRUCTURE



INDUSTRY OVERVIEW & COMPETITIVE POSITIONING: STRUCTURE

Industry Characteristics

- Stage in its **life cycle**
- **Business-cycle** sensitivity or economic characteristics
- Typical **product life cycles** in the industry (short and marked by technological obsolescence or long, such as pharmaceuticals protected by patents)
- Brand **loyalty**, customer **switching costs**, and intensity of **competition**
- **Entry and exit barriers**
- Industry supplier considerations (concentration of sources, ability to switch suppliers or enter suppliers' business)

INDUSTRY OVERVIEW & COMPETITIVE POSITIONING: STRUCTURE

Industry Characteristics

- Number of companies in the industry and whether it is, as determined by **market shares**, fragmented or concentrated
- Opportunity to **differentiate** product/service and relative product/service price, cost, and quality advantages/disadvantages
- **Technology** used
- Government **regulation**
- State and history of **labor relations**
- Other industry problems/opportunities

INDUSTRY OVERVIEW & COMPETITIVE POSITIONING: STRUCTURE



Supply

- Sources (concentration, competition, and substitutes)
- Industry capacity Outlook – short, medium, and long term
- Company's capacity and cost structure
- Import/export considerations

- Sources of demand
- Product differentiation
- Past record, sensitivities, and correlations with social, demographic, economic, and other variables
- Outlook – short, medium, and long term, including new product and business opportunities



Demand

PEST ANALYSIS

How macro-environmental factors might impact a business organization:

<p>Political</p> <p>Changes in government economic policy, e.g. taxation, government spending, monetary policy</p> <p>Changes in legal requirements e.g. employment law, health and safety legislation, licensing practices, environmental regulations, competition policy</p> <p>Changes in the government ownership e.g. nationalization, privatization, de-regulation</p>	<p>Economic</p> <p>Changes in the level of economic activity, e.g. growth rates, rates of unemployment, inflation</p> <p>Changes in wage rates and income distribution</p> <p>Changes in exchange rates</p>
<p>Social</p> <p>Changes in demographics e.g. the size of the population, the age distribution with the population</p> <p>Changing attitudes e.g. work/life balance, concern for the environment, ethical standards</p> <p>Changes in social structure e.g. socio-economic groupings, social mobility</p>	<p>Technological</p> <p>Development of new products and processes</p> <p>Automation</p> <p>Developments in information and communication technologies</p> <p>Developments in the natural sciences</p>

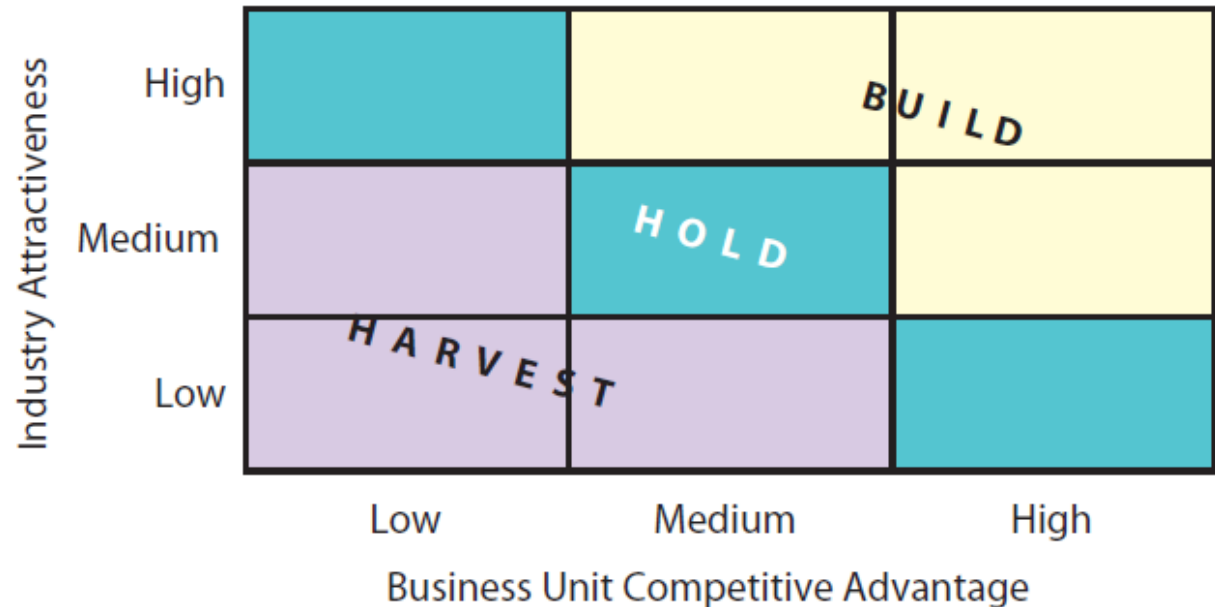
THE GE/MCKINSEY PORTFOLIO (NINE-BOX) PLANNING MATRIX

Industry Attractiveness

- Market growth rate
- Market size
- Industry profitability
- Industry rivalry
- Global opportunities
- Macroeconomic factors (PEST)

Business Unit Strength

- Market share
- Growth in the market
- Brand equity
- Distribution channels access
- Production capacity
- Profit margins relative to competitors

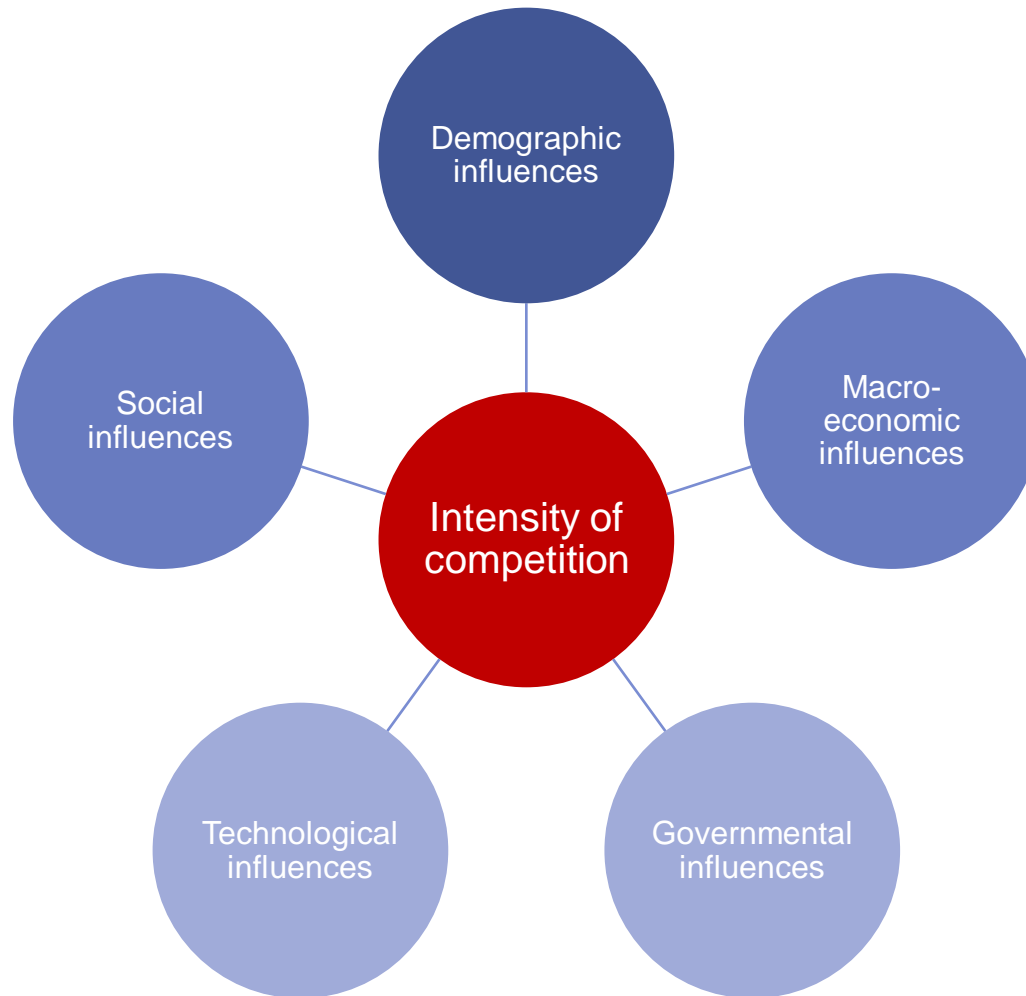


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Competitive Positioning

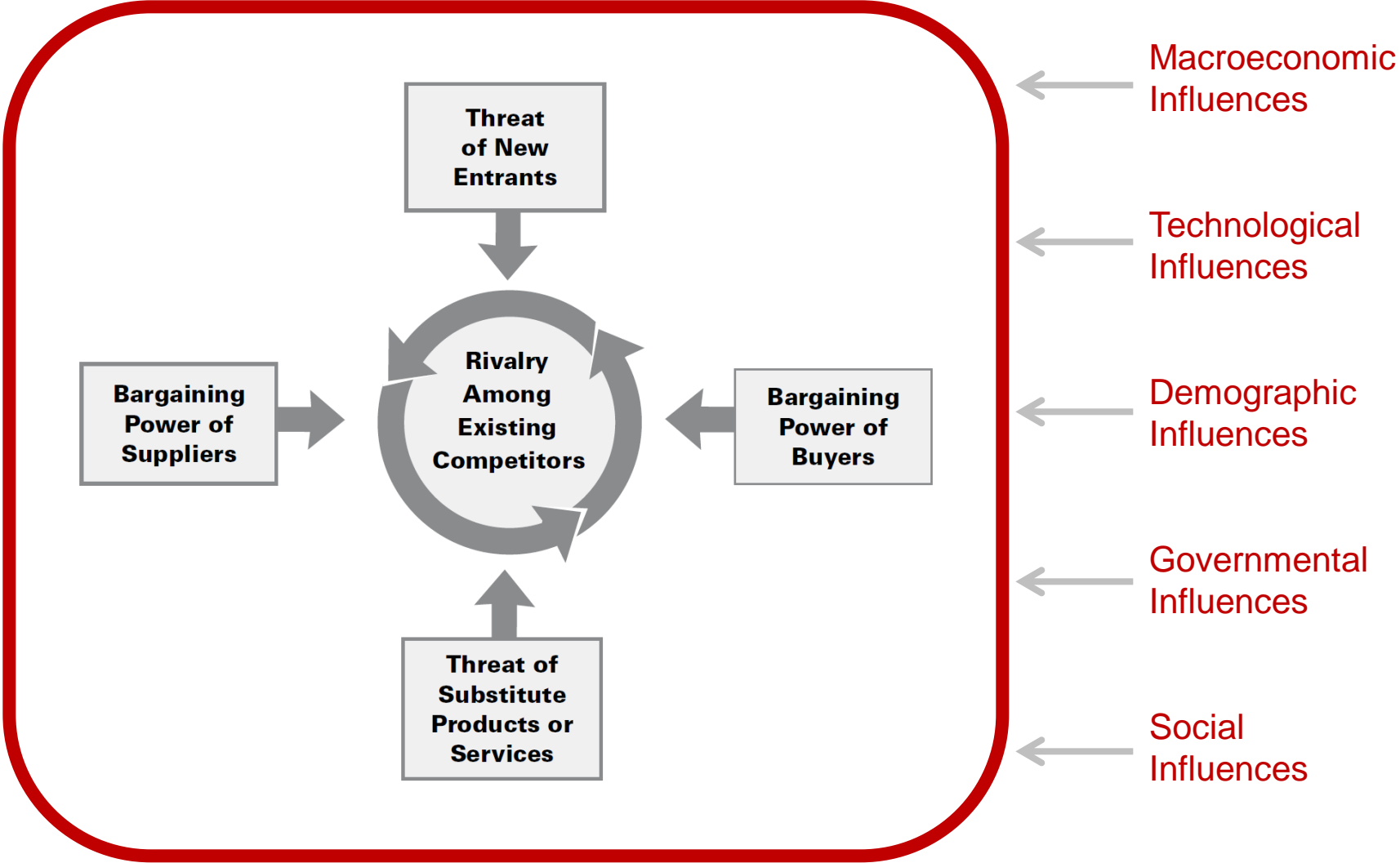
STRATEGIC MANAGEMENT AND INDUSTRY ANALYSIS

FRAMEWORK FOR INDUSTRY ANALYSIS

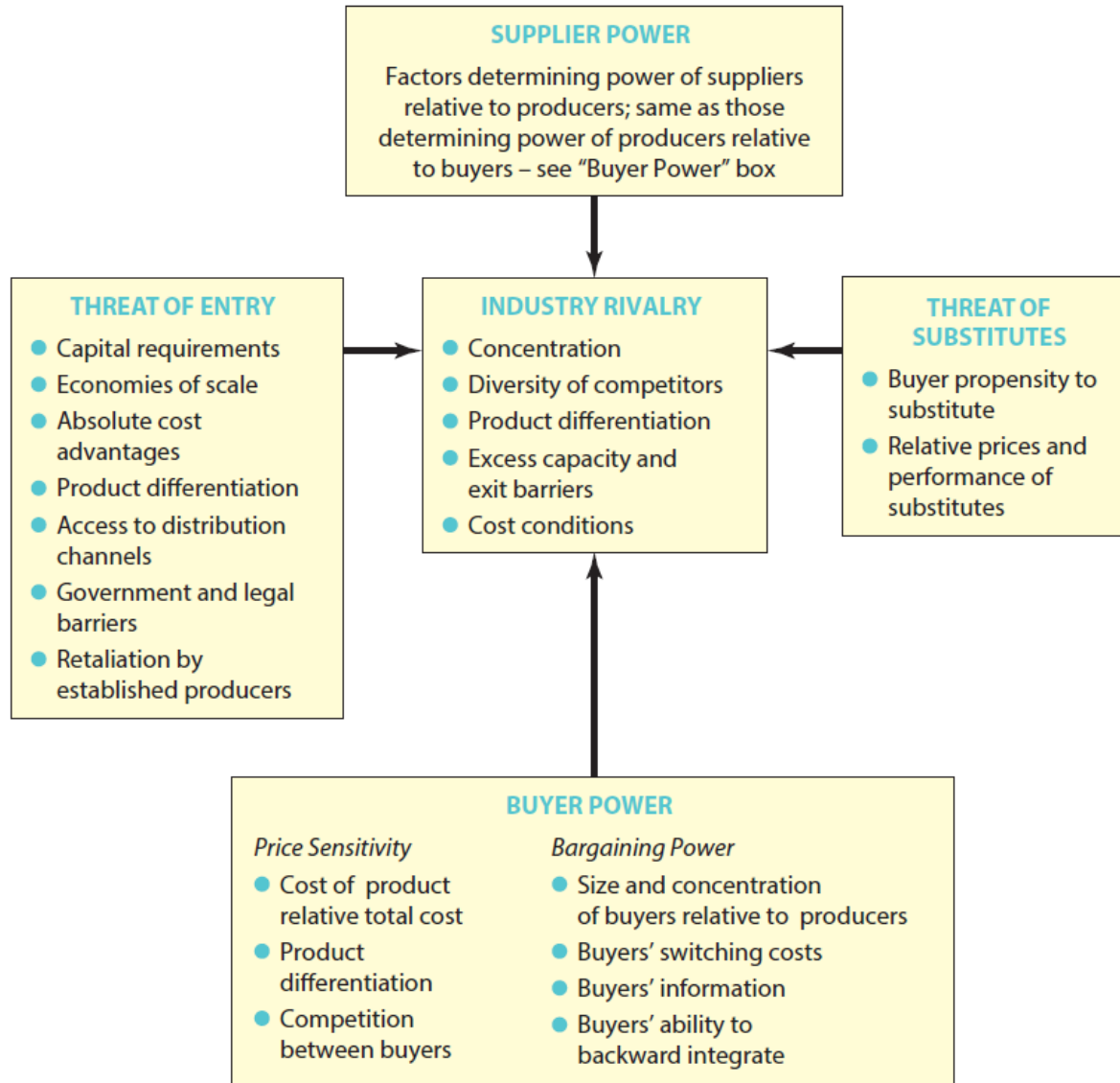


STRATEGIC ANALYSIS AND COMPETITIVE POSITIONING

Porter's "Five Forces" Framework



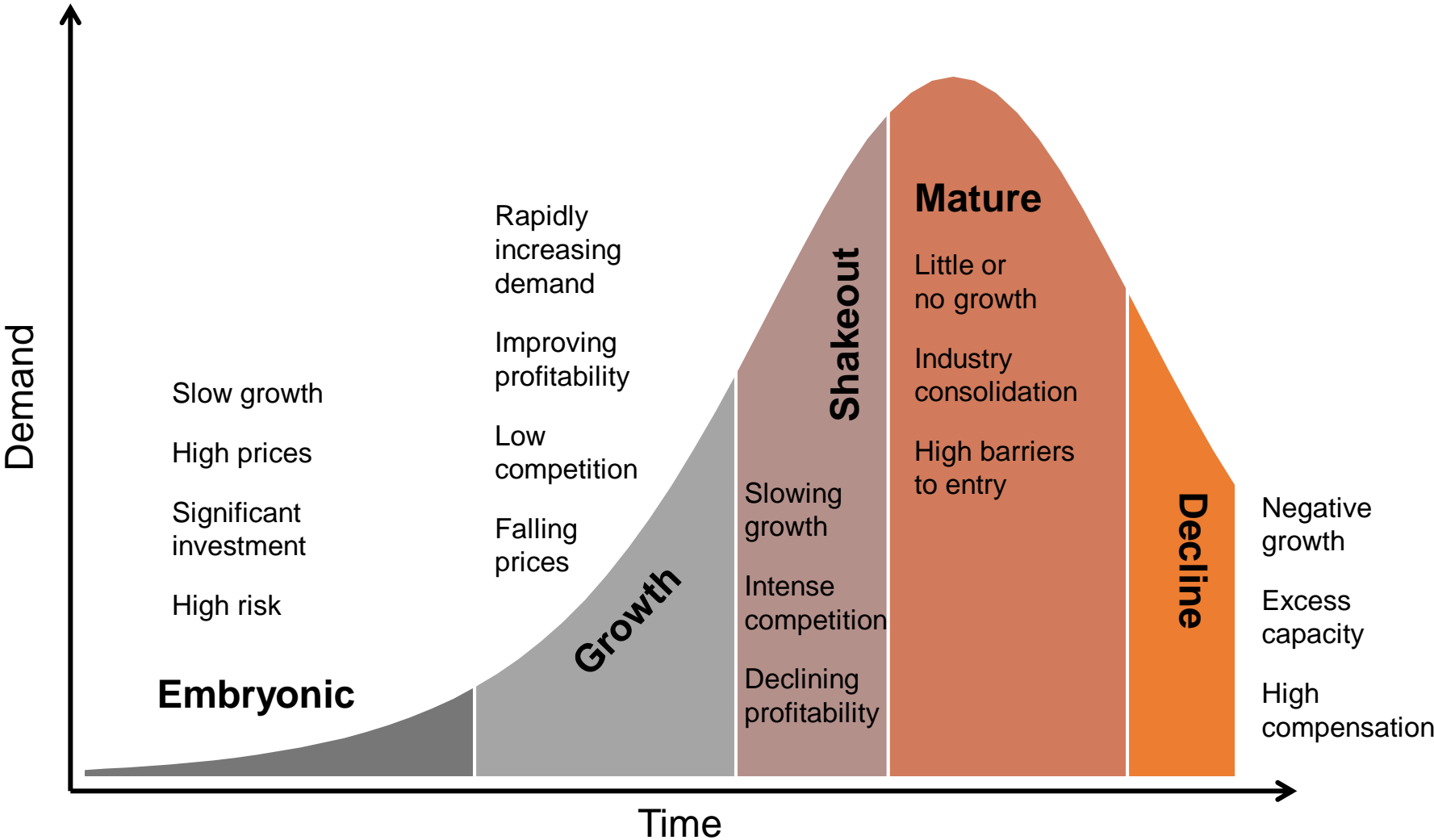
STRATEGIC ANALYSIS AND COMPETITIVE POSITIONING



FACTORS AFFECTING PRICING POWER AND PRICE COMPETITION

- **Barriers to entry** are obstacles or hurdles that limit or restrict the entry of new competitors in the market
 - These barriers keep or discourage new entrants, hence reducing competition
- **Industry concentration** is the degree to which some companies may dominate the industry in terms of market share.
 - Generally, the more concentrated an industry, the less competitive it is
- **Industry capacity** is the maximum amount of a good or service that can be supplied in a given time period
 - The more limited the capacity, the greater the companies' pricing power
- **Market share stability** is the degree to which market shares change over time
 - The more stable the market shares, the less competitive the industry

INDUSTRY LIFE CYCLE



APPLYING THE LIFE-CYCLE CONCEPT

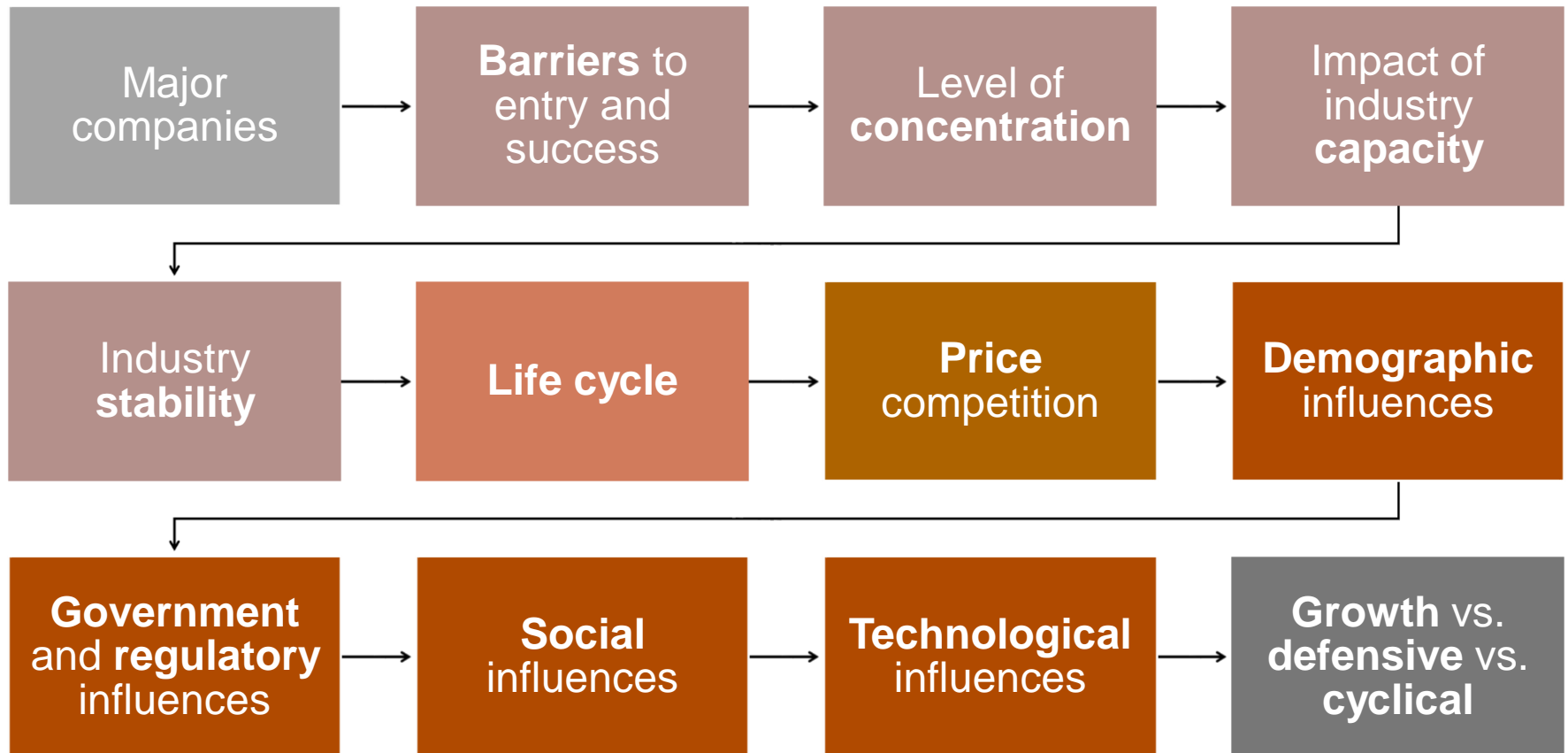
Using the life-cycle model

- Newer industries tend to be more **competitive** than mature industries
- **Growth** companies tend to reinvest in **new products and services**, and **mature** companies tend to focus on **internal efficiencies**
- **Mature** companies are generally more focused on **extending successful product lines**

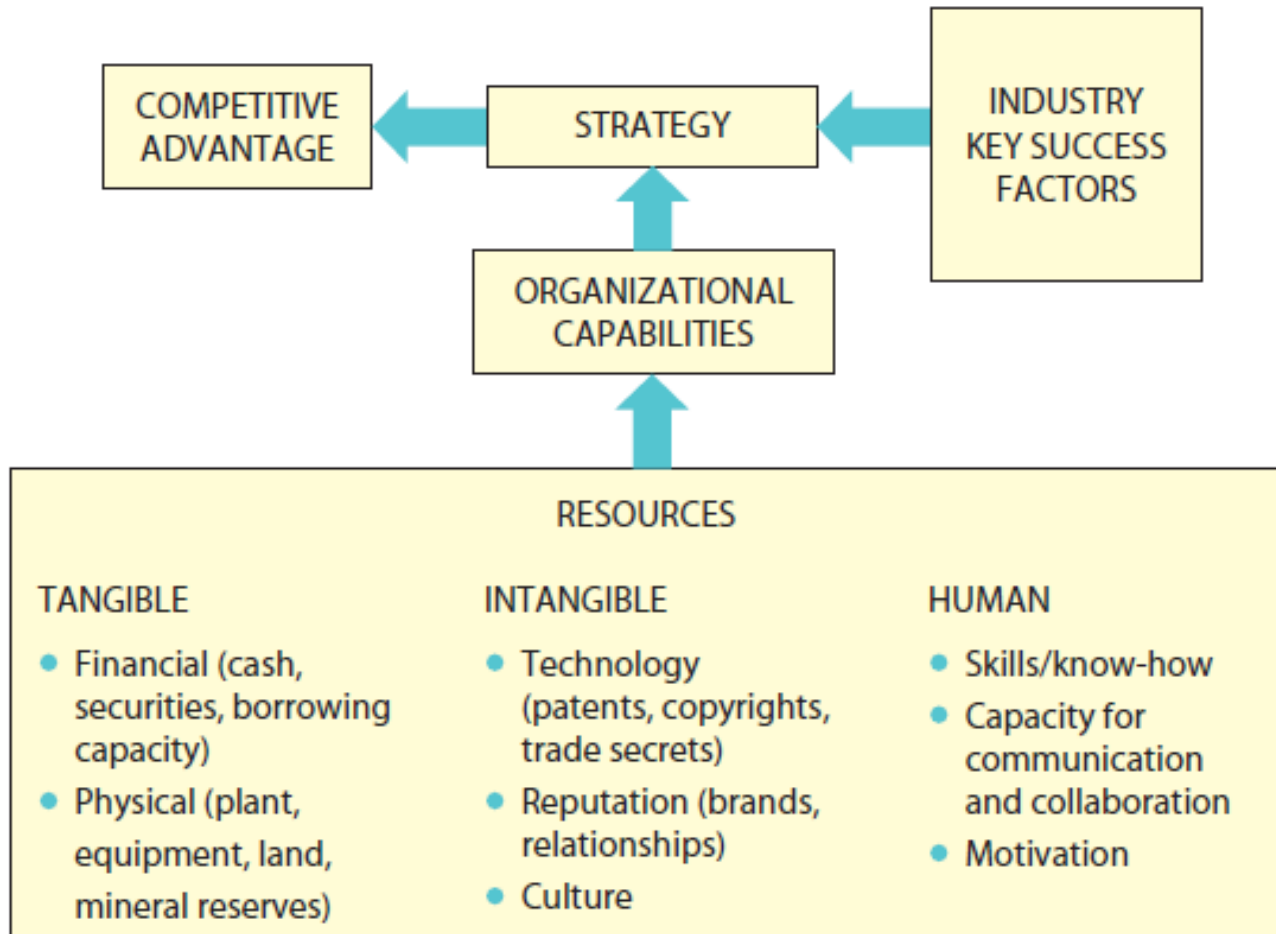
Limitations to the life-cycle model

- Changes may **disrupt the cycle**: technological change, regulatory changes, social changes, and demographic shifts.
- **Not all** companies in an industry **have the same performance**

CHARACTERISTICS OF INDUSTRIES



THE LINKS AMONG RESOURCES, CAPABILITIES AND COMPETITIVE ADVANTAGE



IDENTIFYING RESOURCES

RESOURCE		CHARACTERISTICS	INDICATORS
Tangible Resources	Financial	Borrowing capacity Internal funds generation	Debt/Equity ratio Credit rating Net cash flow
	Physical	Plant and equipment: Size, location, technology flexibility. Land and buildings Raw materials	Market value of fixed assets. Scale of plants Alternative uses for fixed assets
Intangible Resources	Technology	Patent, copyrights, know-how, R&D facilities Technical and scientific employees	Number of patents owned Royalty income R&D expenditure R&D staff
	Reputation	Brands, customer loyalty, company reputation (with suppliers, customers, government)	Brand equity Customer retention Supplier loyalty
Human Resources		Training, experience, adaptability, commitment and loyalty of employees	Employee qualifications, Pay rates, turnover

ELEMENTS OF A COMPANY ANALYSIS



Company profile (overview of the company)

Relevant industry characteristics

Demand for the company's products and services

Supply of products and services, includes analysis of costs

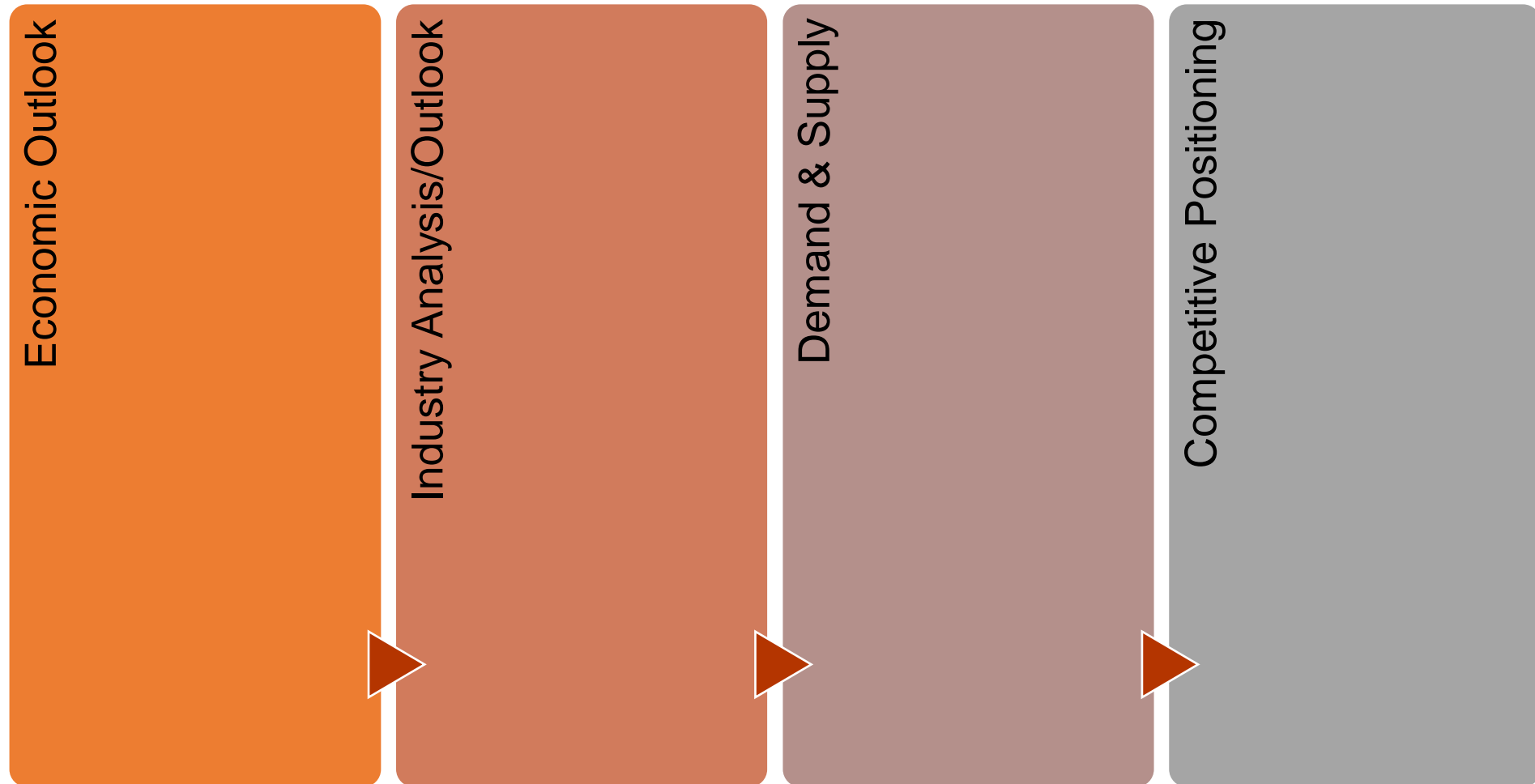
Company's pricing environment: degree of price competition

Financial ratio analysis: over time and compared with competitors

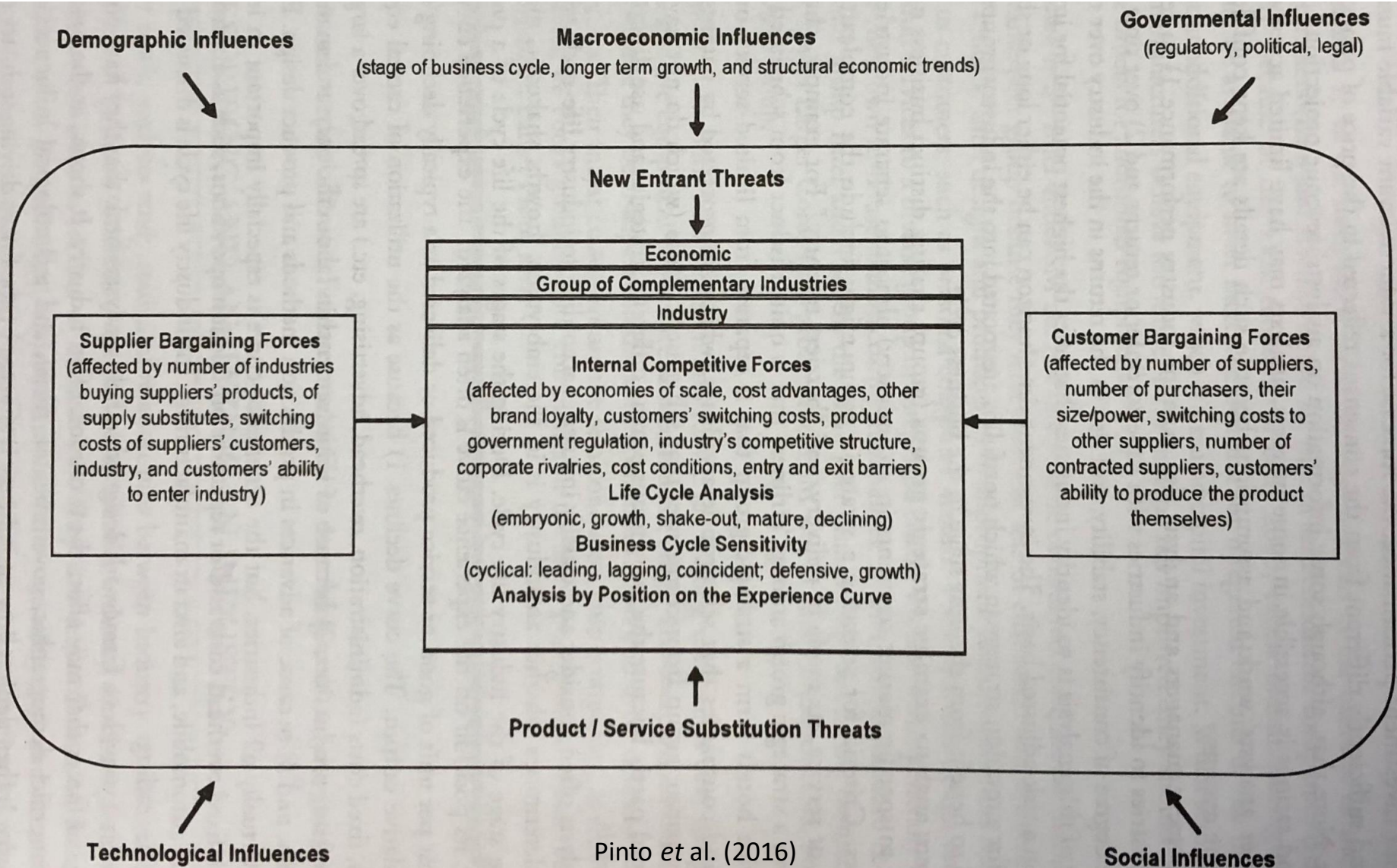
ANOTHER LOOK TO THE INDUSTRY STRUCTURE AND COMPETITIVE POSITIONING

Industry
Overview &
Competitive
Positioning
(IO&CP)

Top-Down Approach



FRAMEWORK FOR AN INDUSTRY ANALYSIS



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Example: Airline Industry

STRATEGIC MANAGEMENT AND INDUSTRY ANALYSIS

EXAMPLE: AIRLINE INDUSTRY

Luxury Airlines

- Virgin Atlantic
- Qatar Airways
- Emirates
- Singapore Airlines
- Etihad Airways
- ...

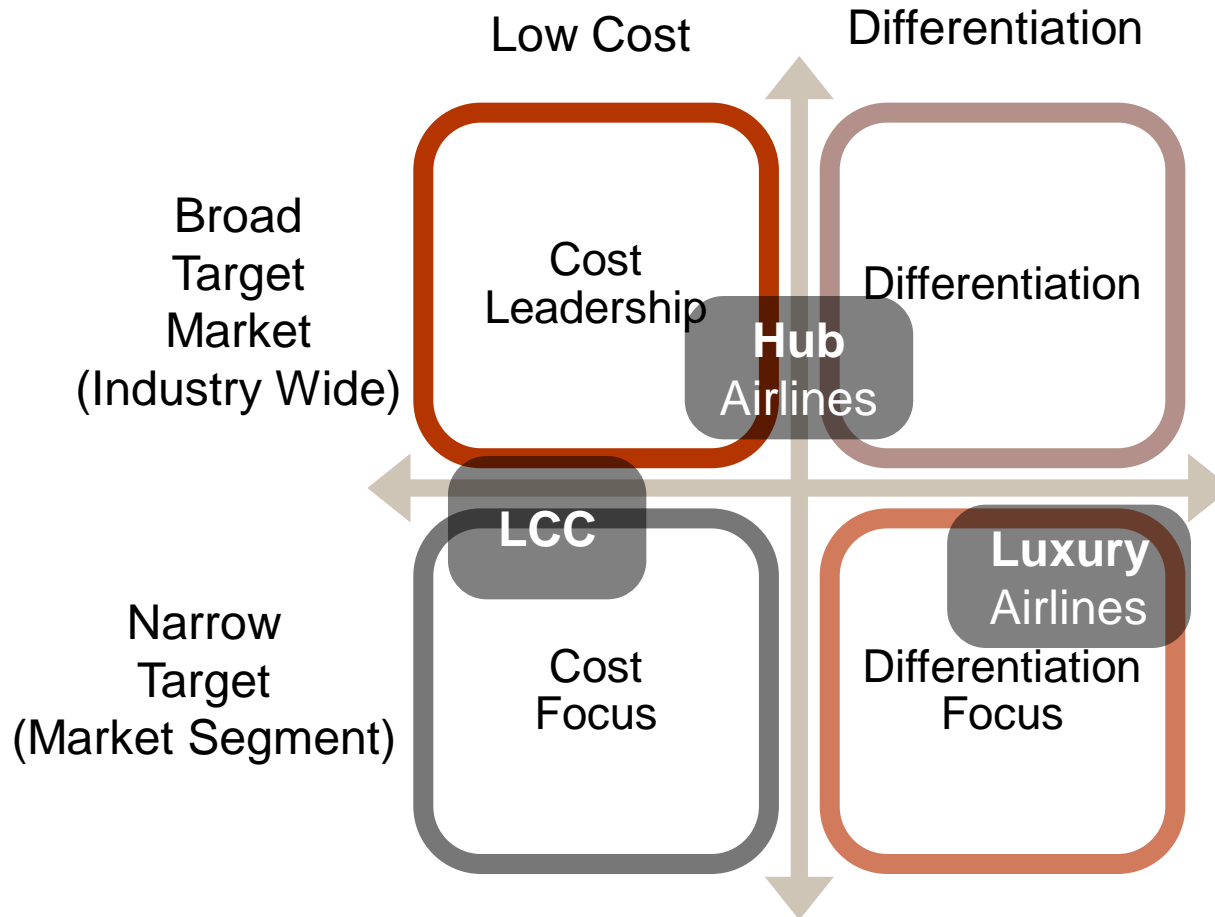
Hub Airlines

- Lufthansa
- United Airlines
- British Airways
- Swissair
- Air France+KLM
- CopaAirlines
- LOT
- Iberia →
- TAP Air Portugal →
- ...

Low-Cost Carriers

- Ryanair
- EasyJet
- WizzAir
- JetBlue
- Norwegian
- Transavia
- AirAsia
- Germanwings [Eurowings]
- Vueling
- Air Berlin [?]
- ...

EXAMPLE: AIRLINE INDUSTRY



EXAMPLE: AIRLINE INDUSTRY

Drivers of Profitability

Revenues

Passenger Yield	RPK (Traffic)	ASK (Capacity)	PLF (Used Capacity)	Ancillary
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Main Costs

Fuel	Labor Costs	Fees & Charges
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Yield = passenger revenue \div RPK

(demand) RPK = number of paying passengers \times total distance travelled

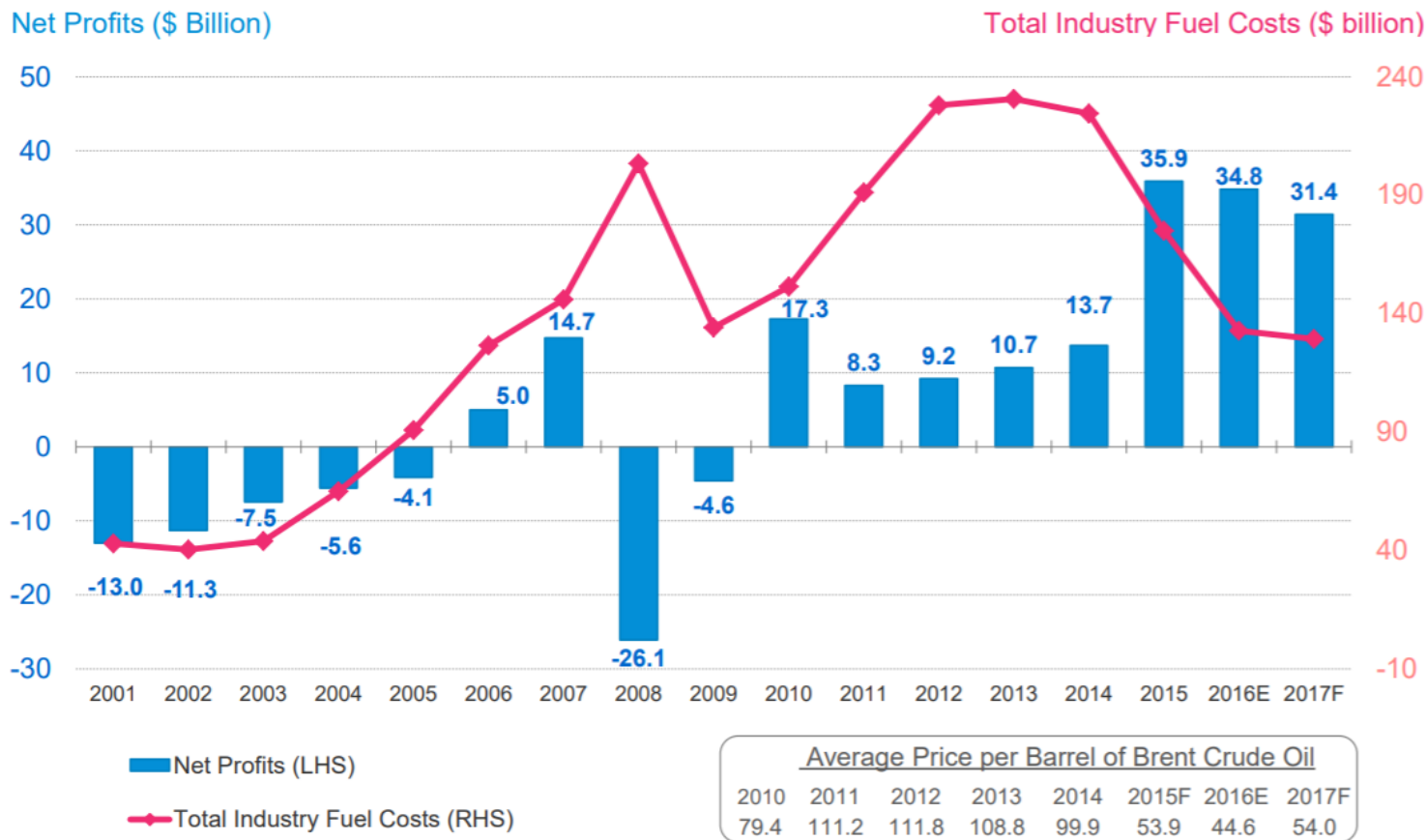
(supply) ASK = seats available \times distance flown

PLF = RPK \div ASK

Hedging strategies?

EXAMPLE: AIRLINE INDUSTRY

Industry Fuel Costs and Net Profits



Source: Industry Economics Performance - Forecast Table (IATA Economics)

Updated: 06/2017 Next Update: 12/2017

EXAMPLE: AIRLINE INDUSTRY

Fuel Impact on Operating Costs

Year	% of Operating Costs	Average Price per Barrel of Crude (US\$)	Break-even Price per Barrel (US\$)	Total Fuel Cost
2004	17.3%	US\$38.3	US\$34.7	US\$65 billion
2005	22.0%	US\$54.5	US\$52.0	US\$91 billion
2006	27.2%	US\$65.1	US\$68.1	US\$127 billion
2007	28.6%	US\$73.0	US\$81.7	US\$146 billion
2008	35.7%	US\$99.0	US\$83.3	US\$203 billion
2009	28.2%	US\$62.0	US\$59.1	US\$134 billion
2010	26.9%	US\$79.4	US\$89.8	US\$151 billion
2011	29.8%	US\$111.2	US\$116.1	US\$191 billion
2012	32.3%	US\$111.8	US\$117.1	US\$228 billion
2013	32.0%	US\$108.8	US\$114.8	US\$231 billion
2014	29.3%	US\$99.9	US\$107.4	US\$224 billion
2015	24.3%	US\$53.9	US\$72.5	US\$175 billion
2016E	18.8%	US\$44.6	US\$61.7	US\$133 billion
2017F	17.4%	US\$54.0	US\$68.7	US\$129 billion

Source: Industry Economics Performance - Forecast Table (IATA Economics)

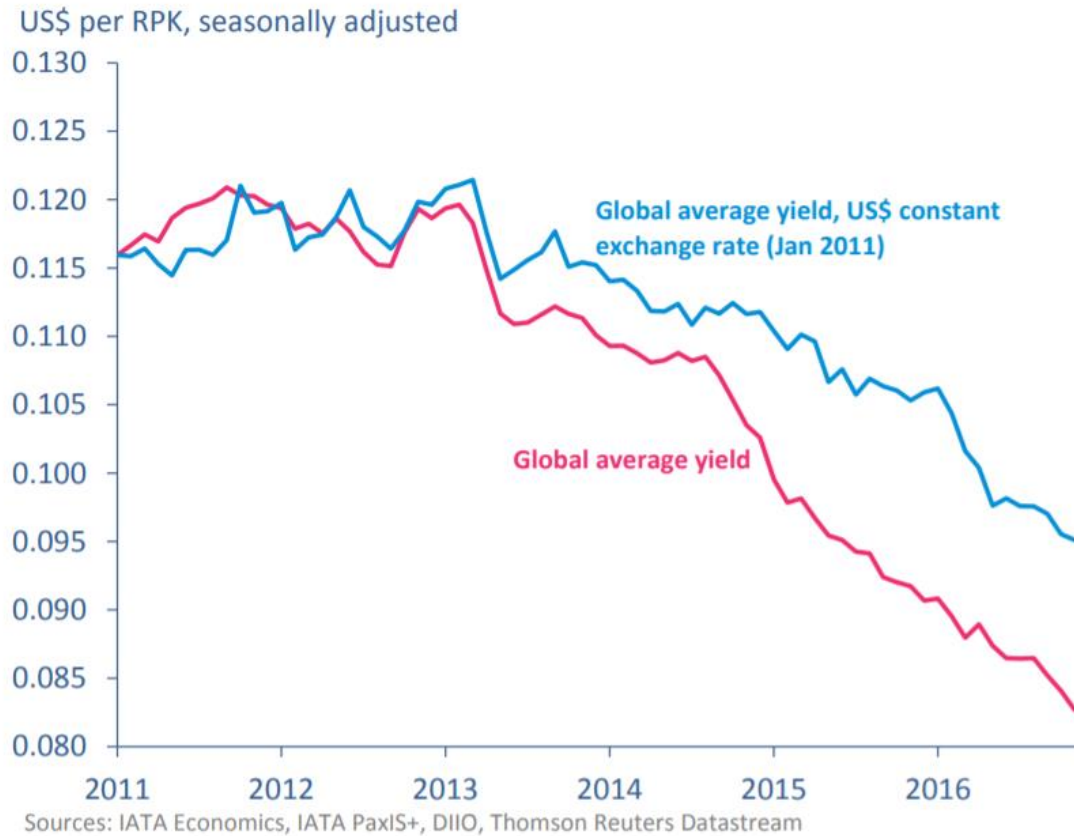
Margin of +US\$14.7 p/ barrel

Updated: 06/2017 Next Update: 12/2017

EXAMPLE: AIRLINE INDUSTRY

Yields and premium revenues

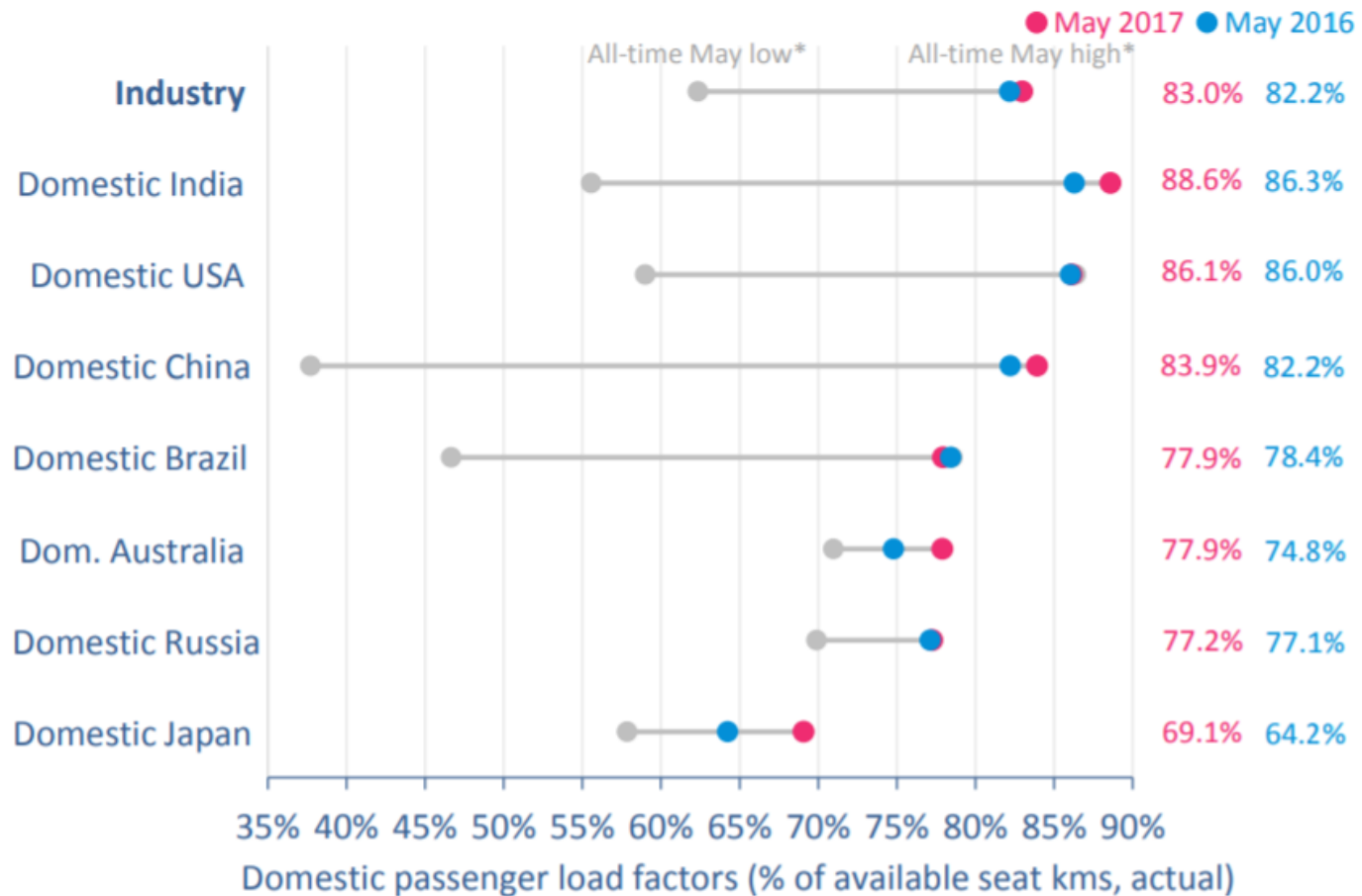
Downward pressure on underlying industry yields continues



Passenger yield is the **average fare paid per kilometer (mile)**

EXAMPLE: AIRLINE INDUSTRY

Chart 7 – Domestic passenger load factors



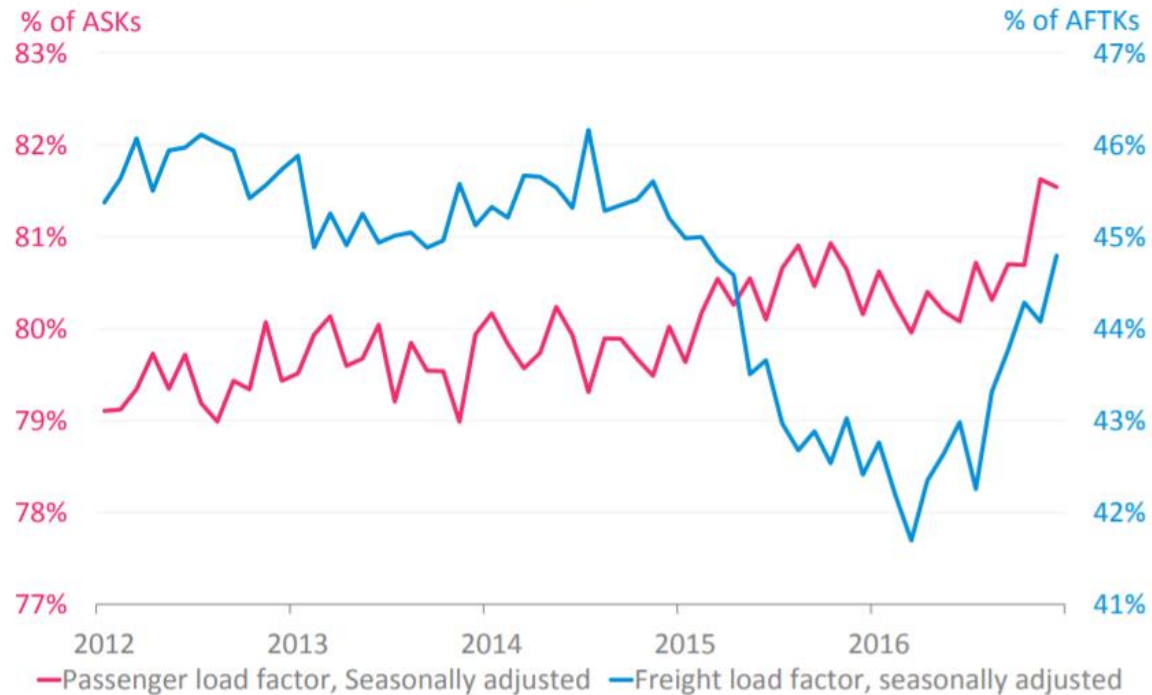
Sources: IATA Economics, IATA Monthly Statistics

*Data from 1990 onwards

EXAMPLE: AIRLINE INDUSTRY

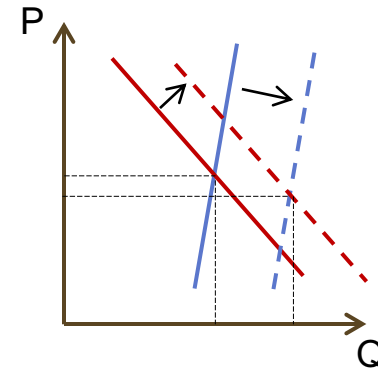
Load factor performance remains strong

Load Factors - Passenger and Freight



Source: IATA Monthly Statistics

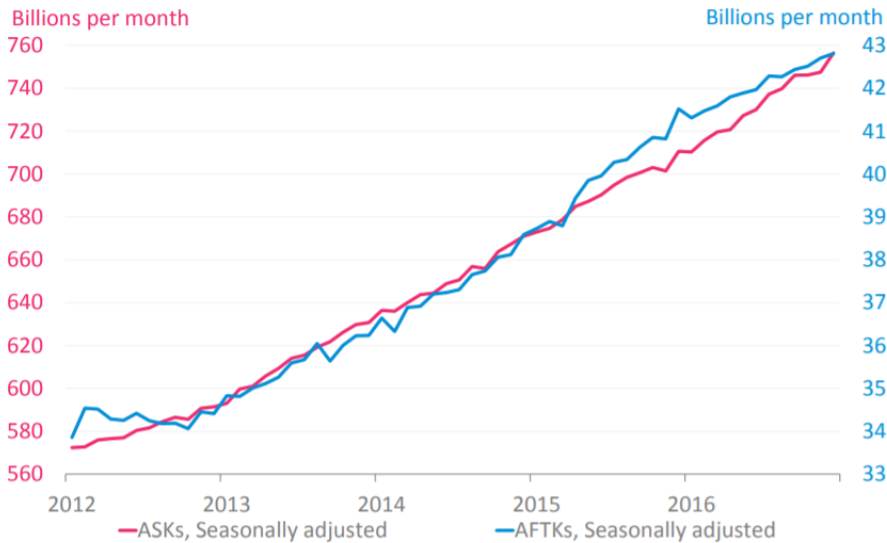
EXAMPLE: AIRLINE INDUSTRY



Capacity

Passenger capacity steps up into the year-end

Air Passenger and Air Freight Capacity

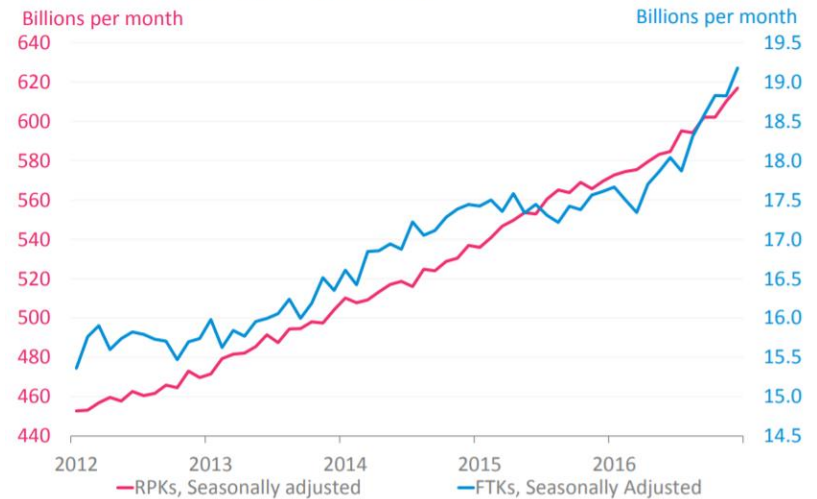


Source: IATA Monthly Statistics

Demand

Passenger & freight traffic end 2016 on a solid footing

Air Passenger and Air Freight Volumes



Source: IATA Monthly Statistics

EXAMPLE: AIRLINE INDUSTRY

Financial Results

Should use
EBITDAR

System-wide global commercial airlines	EBIT margin, % revenues							Net profit, \$ billion						
	2011	2012	2013	2014	2015	2016	2017 F	2011	2012	2013	2014	2015	2016	2017 F
Global	3.1%	2.6%	3.5%	4.6%	8.5%	8.8%	7.5%	8.3	9.2	10.7	13.7	35.9	34.8	31.4
Regions														
North America	3.0%	3.4%	6.8%	11.0%	14.8%	13.2%	11.6%	1.7	2.3	7.4	11.1	21.7	16.5	15.4
Europe	0.8%	0.7%	2.0%	2.0%	5.4%	6.1%	5.2%	0.3	0.4	1.0	1.9	7.4	8.6	7.4
Asia-Pacific	6.6%	4.7%	2.9%	2.0%	8.0%	10.0%	8.3%	5.0	5.8	2.3	0.3	7.3	8.1	7.4
Middle East	3.1%	3.0%	0.9%	2.4%	3.6%	2.0%	0.8%	1.0	1.0	0.3	1.1	2.1	1.1	0.4
Latin America	2.0%	1.5%	2.2%	2.1%	1.5%	4.2%	4.7%	0.2	-0.2	0.2	0.0	-1.6	0.6	0.8
Africa	0.6%	-0.4%	-0.5%	-2.4%	-4.3%	2.0%	1.7%	0.0	-0.1	-0.5	-0.8	-1.0	-0.1	-0.1

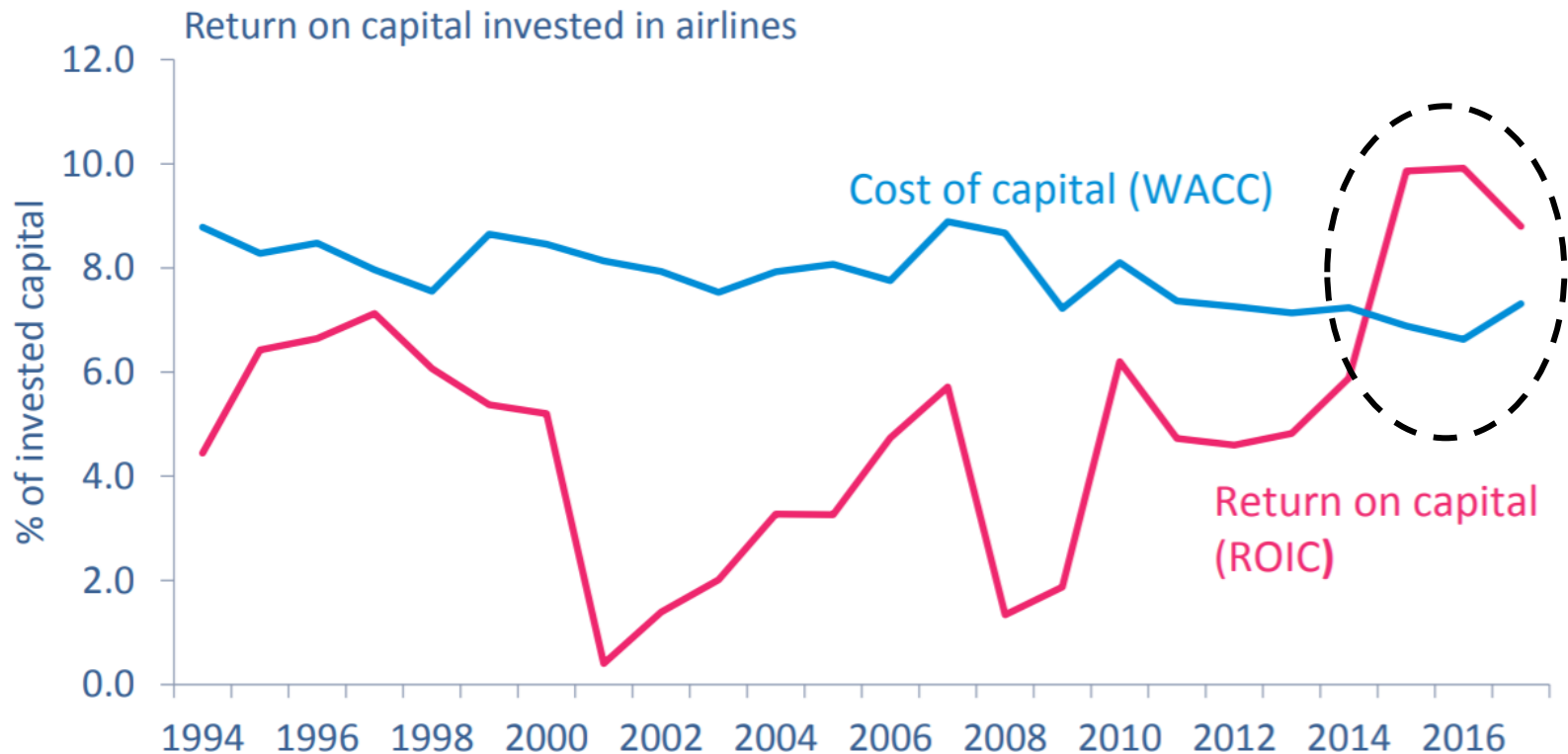
Data sources: ICAO revised data 2010-15. IATA estimates for regions in 2011-16. IATA forecast for 2017.

Note: Bankruptcy reorganization and large non-cash costs are excluded.

Updated: 06/2017 Next Update: 12/2017

EXAMPLE: AIRLINE INDUSTRY

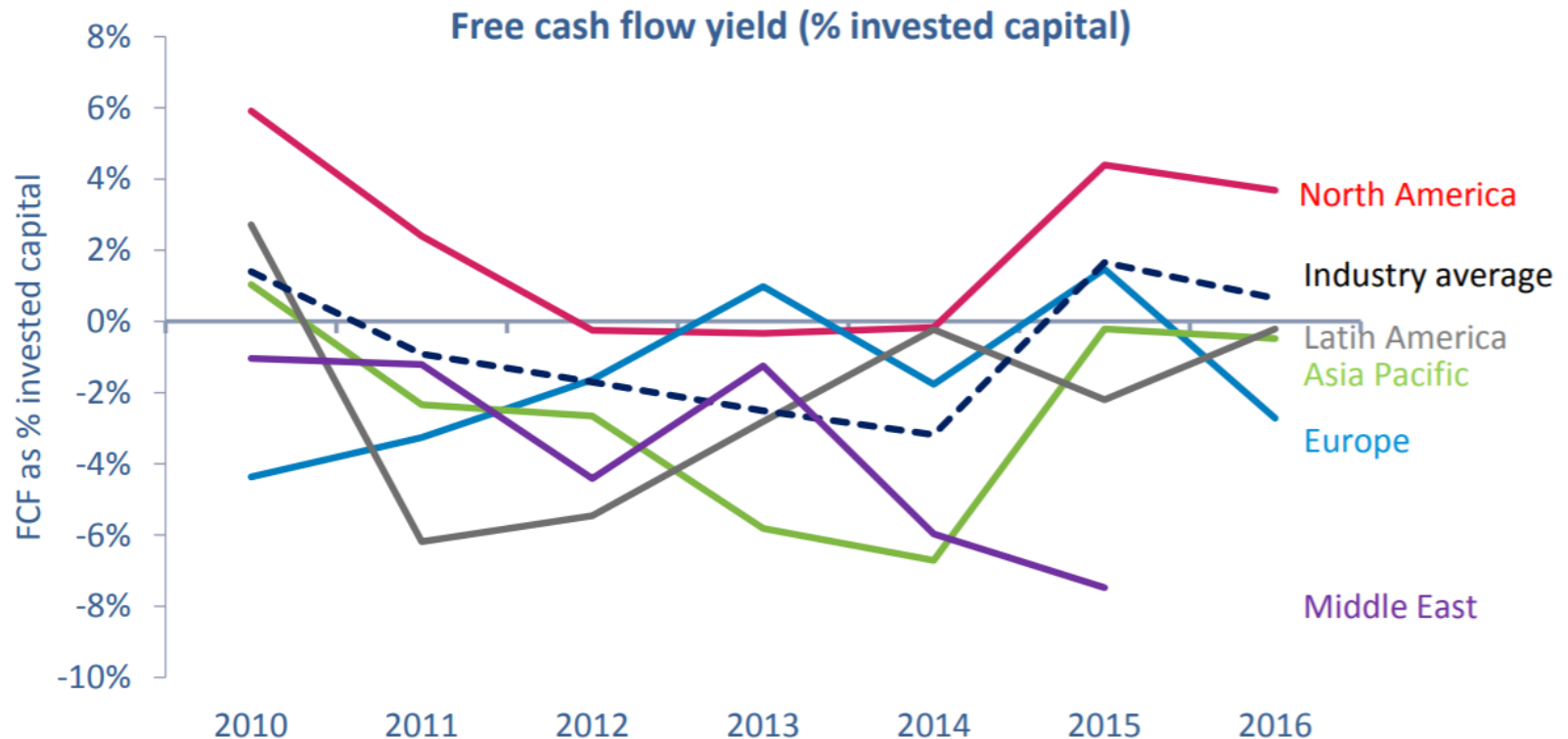
Return on capital lower but still good in 2017



Source: IATA Economic Performance of the Airline Industry, Mid-year 2017 report

EXAMPLE: AIRLINE INDUSTRY

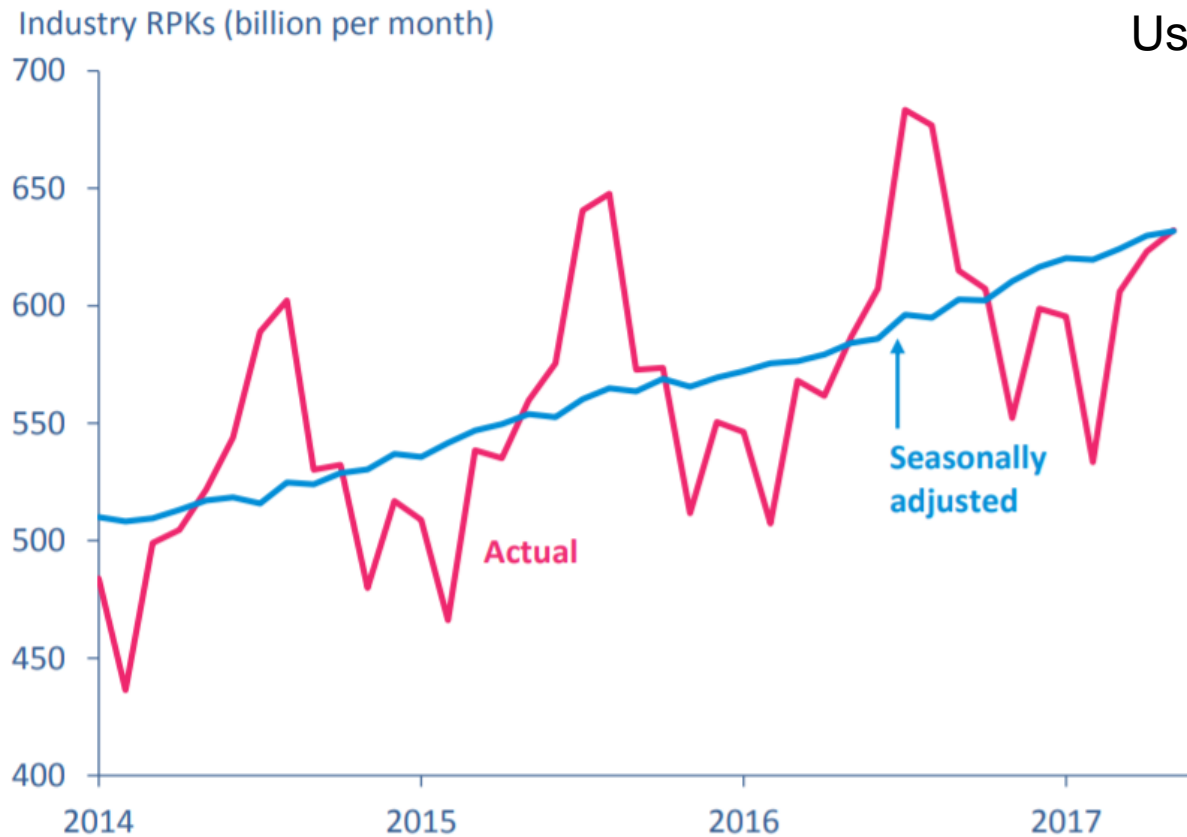
2016 free cash flow good but more divergent



Source: IATA Economics using data from The Airline Analyst

EXAMPLE: AIRLINE INDUSTRY

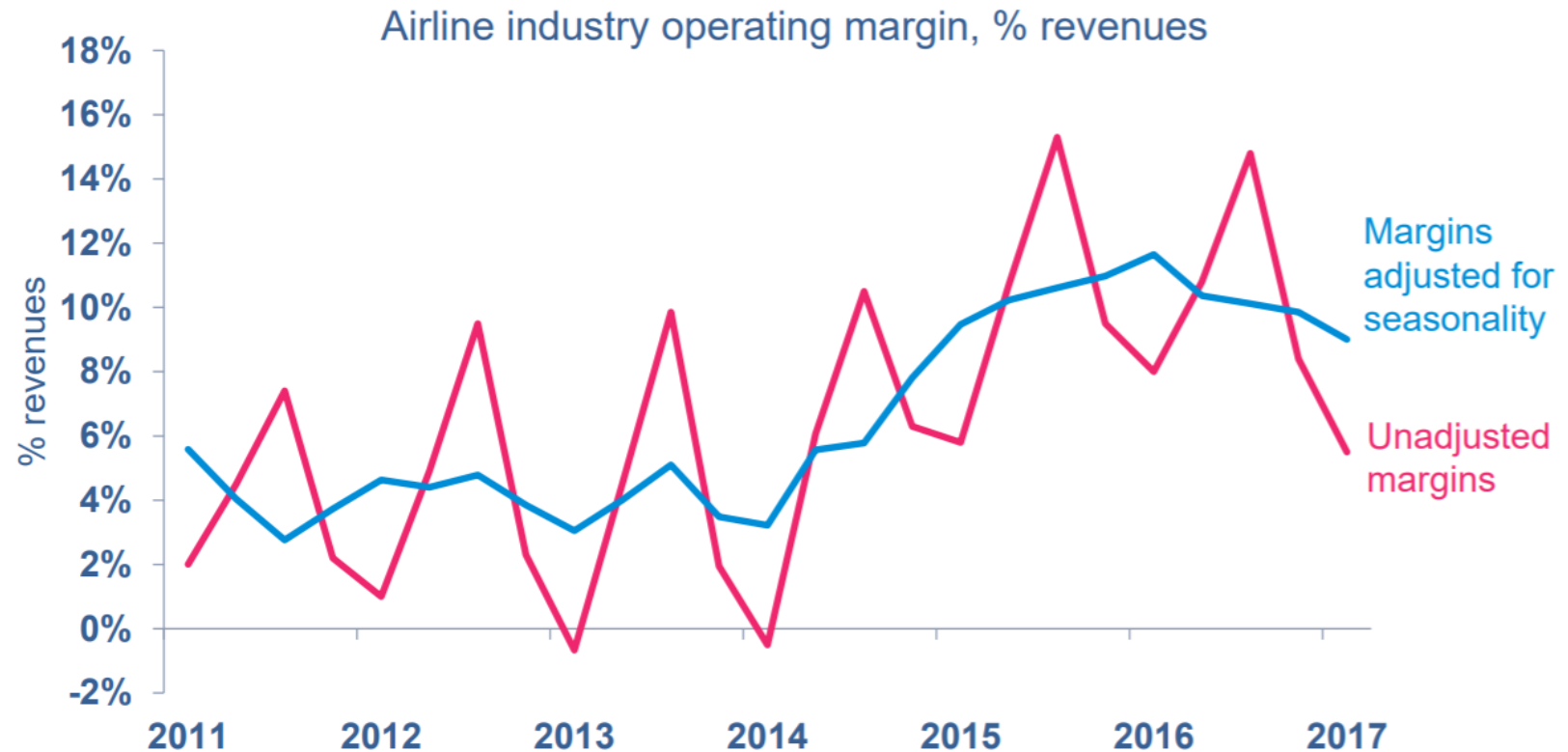
Chart 1 – Air passenger volumes



Sources: IATA Economics, IATA Monthly Statistics

EXAMPLE: AIRLINE INDUSTRY

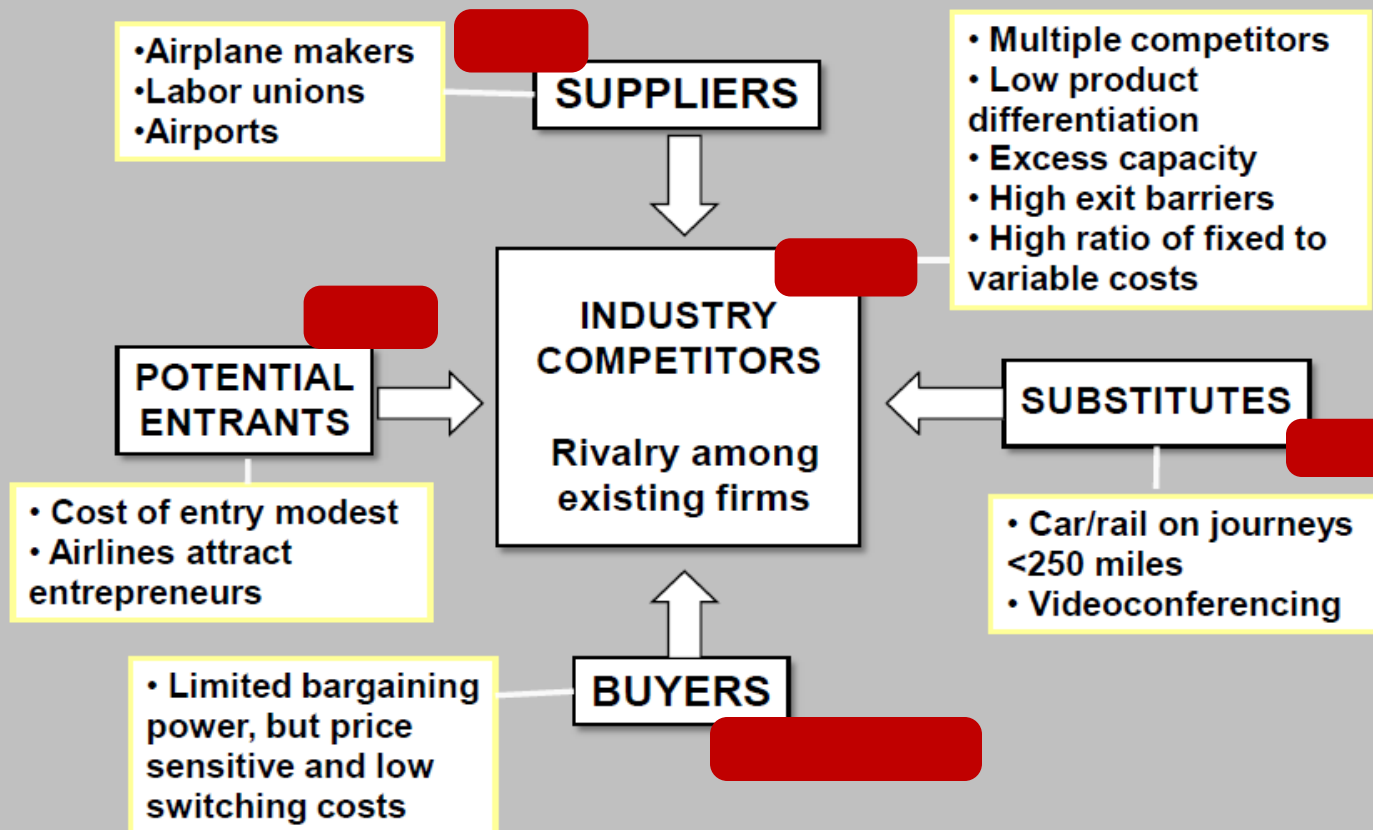
Operating margins still high but declining



Source: IATA Economics using data from The Airline Analyst and airline releases

EXAMPLE: AIRLINE INDUSTRY

Five Forces of Competition Framework: Applied to US Airline Industry



INDUSTRY OVERVIEW FOR THE AIRLINE INDUSTRY

Industry
Overview &
Competitive
Positioning
(IO&CP)

Top-Down Approach

Economic Outlook

Global GDP

European GDP
or Asian
or LATAM, etc

GDP in the
countries where
the company
operates

Oil Prices / Jet fuel

Interest rates

Exchange rates

Industry Analysis/Outlook

World Travel
Growth

Ancillary Revenue

Passenger Yield

PLF

Regulations

Trends: M&A

Trends: LCC

Demand & Supply

Demand:

Trends

Purchasing power

RPK

Supply:

Competitors

Industry capacity

ASK

Fuel Cost/ASK

Labor Cost/ASK

Competitive Positioning

Sources of
competitive
advantage

Porter's Five
Forces

SWOT Analysis

Quality vs Price
matrix

Comparisson of
EBITDAR m,
ROE / ROIC
etc