Fundamental Analysis

E-I-C Framework

Learning Objectives

- After completing this chapter student should be able to:
  - Explain what is fundamental analysis and why is it done.
  - Understand the importance of economic analysis in investment management
  - Explain why industry analysis is important and its classification.

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Introduction

- Fundamental analysis is the method of finding out the future price of a stock which an investor wishes to buy.
- It relates to the examination of
  - Intrinsic worth of company
  - Background of company's performance
  - Background of industry's performance to which company belongs
  - General socio – political scenario of the country

Objectives of Fundamental Analysis

- Attempts to identify the under priced and over priced securities so that appropriate decisions can be made
- Helps to take long term decisions
- To beat the market

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Intrinsic value

- It is the investment value and investment value of a security is the present value of all future cash payments to be made on the security.
- Cash payments like
  - Dividends
  - Interest
  - Liquidation proceeds, etc
- Determined using estimates of all major factors like
  - GNP of economy
  - Industry sales
  - Firm sales & expenses
  - Capitalization rates

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Fundamental analysis framework

- Fundamental analysis comprises of
  - Economic analysis
  - Industry analysis
  - Company analysis
- Basically uses two types of approach
  - Top – down approach
  - Bottom – up approach

Economic Analysis

- It is important to predict the course of National economy because it affects:
    - Corporate profits
    - Investor attitudes and expectations
    - Security prices
- The investor makes an analysis of the economy to determine the investment strategy.

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- Strategic considerations in economic analysis are as follows:
  - Involves a study of economic trends in the economy like growth rate of GNP, employment, price level, aggregate corporate profits, etc.
  - Study of economic policies of the govt.
  - Study of relationship between economic trends and policies and stability of such relationships
  - Study of world economic trends and their impact

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Economic Forces

- Population
- Performance of agriculture
- Technological development
- Natural resources
- Role of government
- Business conditions
- Political stability
- Balance of trade

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Economic forecasting

- It is a technique to find out the future return of an investment
- Techniques
  - Short term vs. long term
- Techniques of short – term forecasting
  - Surveys
  - Barometric or indicator approach
  - Money & stock prices
  - Econometric model building
  - Opportunistic model building

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Potential usefulness of Economic Forecasts

- Helps to forecast the economy much before the stock prices forecast it
- Helps to develop an economic series that lead the economy

International Economic Factors

- Exchange rates
- Exports – Imports
- Disposable Income, Demographic factors and demand

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Exercise

- What economic factors would you be most interested in forecasting if you were an analyst investigating major consumer durable – goods sales for next year?

INDUSTRY ANALYSIS

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Introduction

- Industry can be defined as "a group of productive or profit – making enterprises or organizations that have a similar technological structure of production ad that produce or supply technically substitutable goods, services, or sources of income".
- Purpose of industrial analysis is to seek industries that are expected to grow faster than the real rate of GNP.

Industry classification

- According to SIC, which covers the entire field of economic activity and defines industries in accordance with the composition and structure of the economy, subdivisions are as follows:

Industrial division		Major groups
A	Agriculture, forestry & fishing	01 - 09
B	Mining	10 – 14
C	Construction	15 – 17
D	Manufacturing	20 – 39
E	Transportation, communications, electric, gas & sanitary services	40 – 49

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Industrial division		Major groups
F	Wholesale trade – durable goods	50 – 51
G	Retail trade	52 – 59
H	Finance, insurance and real estate	60 – 67
I	Services,	70 – 89
J	Public administration	91 – 97
K	Non classifiable establishments	99

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Industrial classification contd...

- According to business cycle:
  - Growth industries
  - Cyclical industries
  - Defensive industries
  - Cyclical – growth industries

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Industry analysis should focus on

- Sensitivity of Industry to Business cycles.
- Profit Potential of Industry
  - Porter Analysis
- Structure and characteristics of Industry
  - Structure of industry and nature of competition
  - Nature and prospects of demand
  - Cost, efficiency and profitability
  - Technology and research

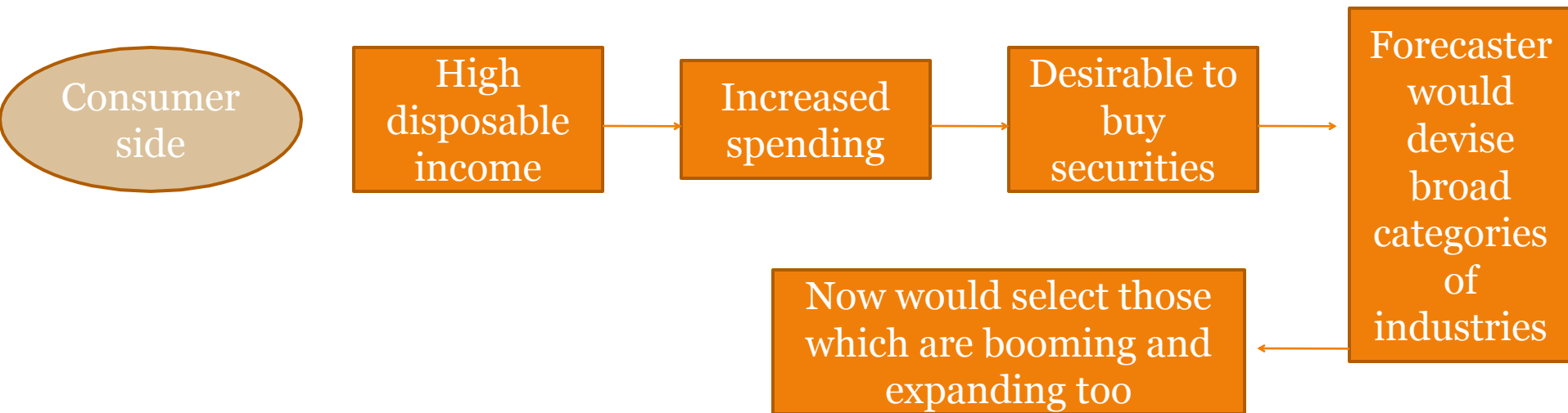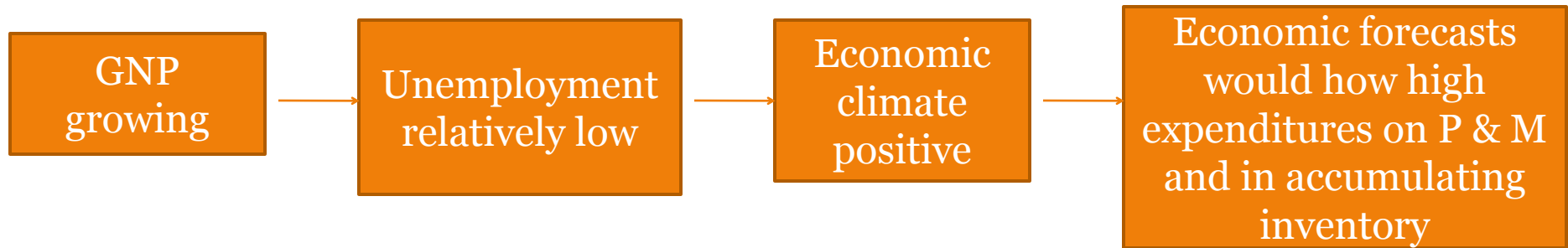**Never think "Can I" , Always proceed with " I Can" attitude**

Industry life cycle

- Helpful for investors to assess the growth potential of different companies in industry.
- Stages are as given below:
  - Pioneering stage
  - Expansion stage
  - Stabilization stage
  - Decline stage
- Limitations to analysis:
  - Only a generalization
  - May not apply to some industries

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Key characteristics in an Industry Analysis

- Past sales and earnings performance
- Permanence
- Attitude of govt. towards industry
- Labor conditions
- Competitive conditions
- Industry share prices
- Demand of the product
- Management
- Future prospects

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Economy and industry analysis

GNP growing → Unemployment relatively low → Economic climate positive → Economic forecasts would how high expenditures on P & M and in accumulating inventory

Consumer side → High disposable income → Increased spending → Desirable to buy securities → Forecaster would devise broad categories of industries → Now would select those which are booming and expanding too

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Exercise

- If you were told that the housing industry was going to have a good year, what other industries do you think would be positively affected either concurrently with this event or shortly thereafter? Explain your answer.

- Do SWOT analysis of any industry of your choice.

- Which stage of the industrial life cycle is the most attractive from an investment point of view?