

Financial Statement Information

- Used extensively by internal users
 - Management at various levels
 - Performance evaluation
 - Competitive analysis
 - Investment decisions
 - Valuation of targets
 - Current and future employees
 - Is this firm going to meet its payroll and will the stock options be worth anything?

Financial Statement Information

- Used primarily by external users
 - Financial intermediaries (analysts)
 - Stock recommendations
 - Lenders
 - Loan decisions
 - Monitoring
 - Investment bankers
 - Valuation for M&A and IPO
 - Top management performance evaluation

Financial Statement Information

- Financial statement analysis and business analysis applications
 - Focus is more than a mechanical analysis of financial statements.
 - Draw heavily on your understanding of finance, economics, marketing, and strategy.
 - Combine that understanding with financial statement information to diagnose problems and come up with solutions/recommendations

Financial Statement Information

What the course is NOT about

- Extreme details of financial reporting rules and financial statement preparation.
- T-accounts and journal entries.

Market Efficiency and the Role of Financial Statement Analysis

- Implications of stock market efficiency:
 - Many profit-maximizing, actively competing traders
 - Information almost freely available to all participants
 - Competition means that the full effects of new information on intrinsic values are reflected instantaneously in prices
 - Stock prices rapidly adjust to new information such that the new price promises only a normal rate of return to an investor
- If markets are efficient, then what's the use of "Fundamental Analysis" and Valuation?

Market Efficiency and the Role of Financial Statement Analysis

- Conflicting evidence on market efficiency
 - Markets are Efficient:
 - Market's reaction to news events is instantaneous.
 - Mutual funds have on average been unable to outperform broad indexes; in fact, generally under-performed.
 - Why publish “secrets” instead of making money yourself?.
 - Markets are Inefficient:
 - Growing evidence of “easy ways” to beat market.
 - Greater acceptance of “Behavioral Explanations” for stock market fluctuations.

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- **Business strategy** – A leadership plan to achieve a specific set of goals or objectives such as
 - Developing new products or services
 - Entering new markets
 - Increasing customer loyalty
 - Attracting new customers
 - Increasing sales

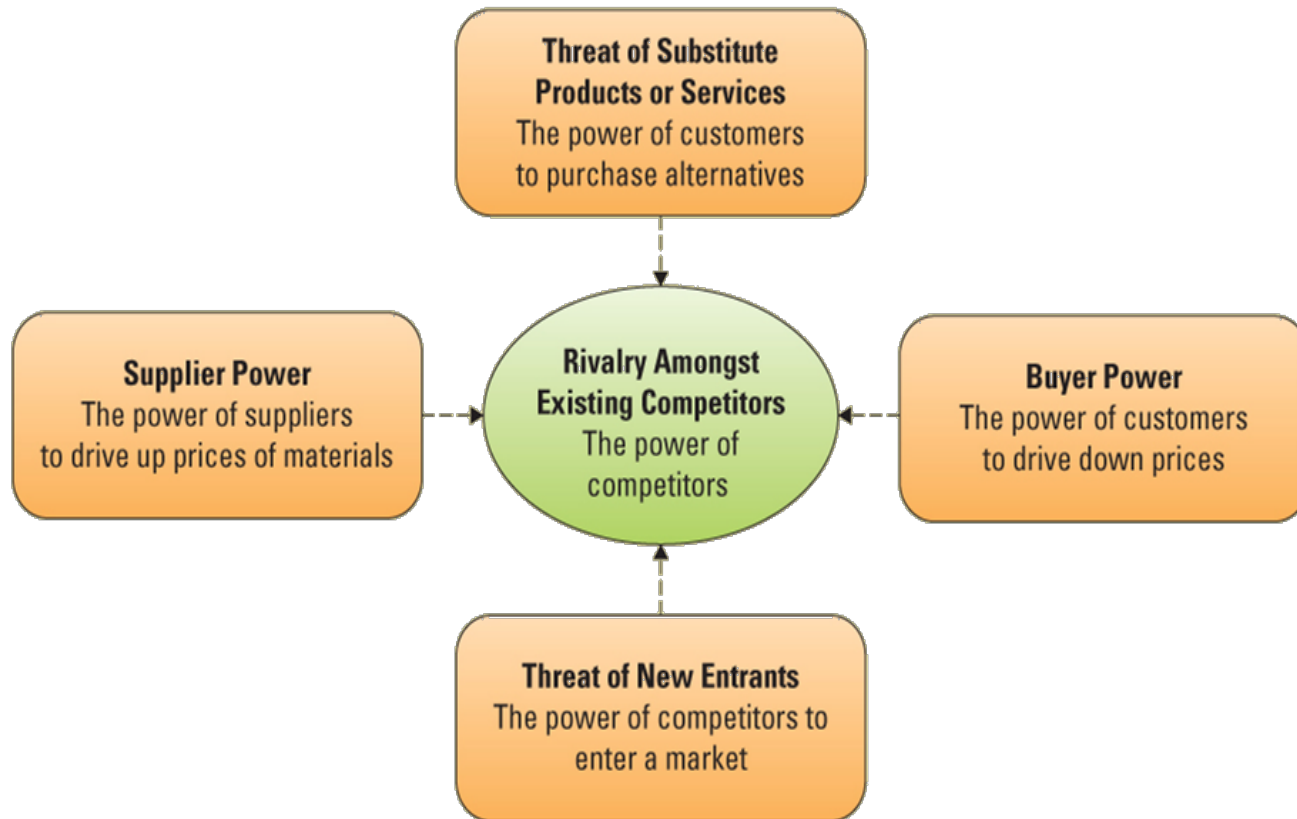
Identifying Competitive Advantages

- **Competitive advantage** – A product or service that an organization's customers place a greater value on than similar offerings from a competitor
- **First-mover advantage** – Occurs when an organization can significantly impact its market share by being first to market with a competitive advantage

Identifying Competitive Advantages

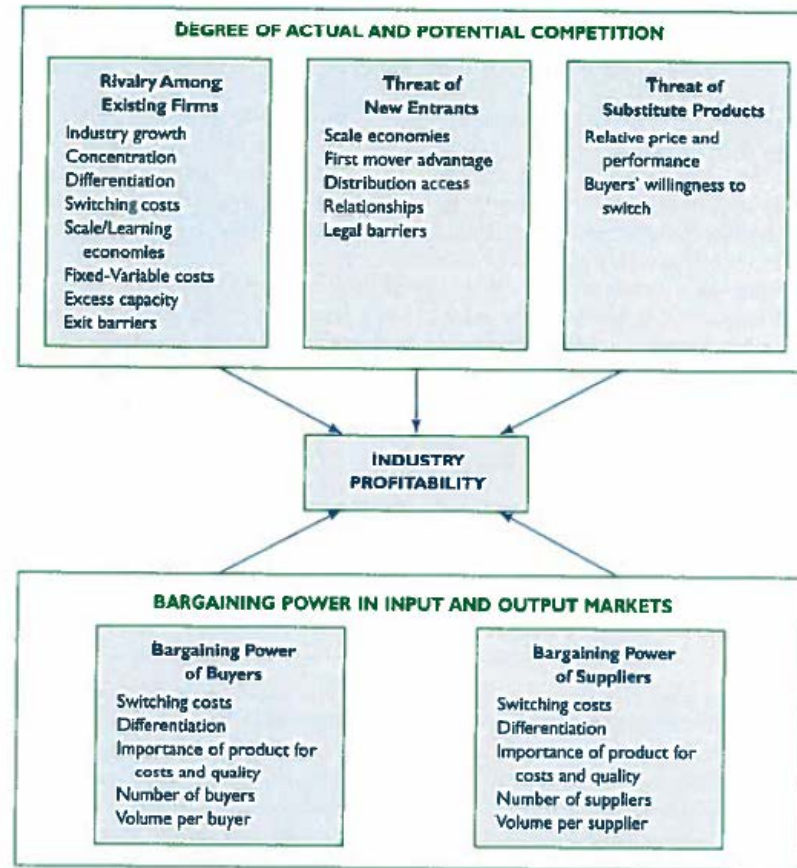
- **Competitive Intelligence** –The process of gathering information about the competitive environment to improve the company's ability to succeed
- **Competitive Intelligence analysis tools**
 - **Porter's Five Forces Model**
 - **Porter's Three Generic Strategies**
 - **Porter's Value Chain**

Porter's Five-Forces Model



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Figure 2-1 Industry Structure and Profitability



Competitive Advantage Analysis

- Best-made product
- Superior customer service
- Lower costs
- Superior manufacturing technology
- Shorter lead times
- Well-known brand name
- High value per cost

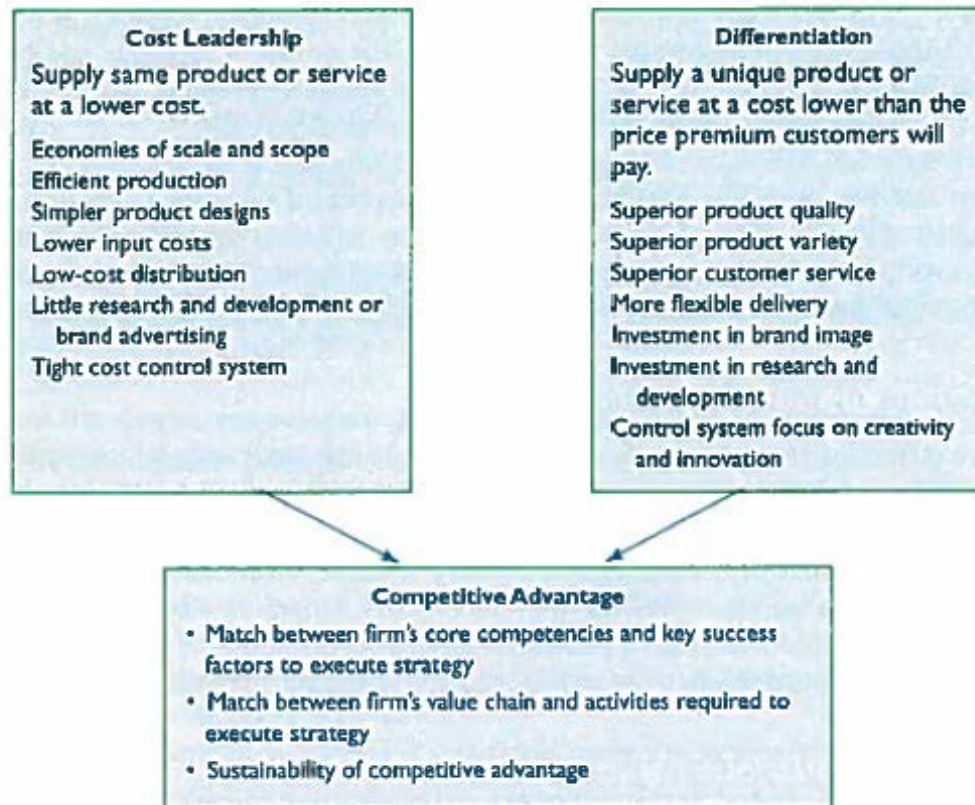
“CEO Speak” for Competitive Advantages

- **Intensification**: improving processes to serve current customers better: reengineer current processes, eliminate ineffective ops.
- **Extension**: using efficient existing processes to enter new markets to gain competitive advantage.
- **Augmentation**: expanding processes to provide additional services to current customers.
- **Conversion**: taking a process that the company performs well and performing it as a service to other companies.
- **Innovation**: applying existing processes that one performs well to create and deliver different goods or services.
- **Diversification**: creating new processes to deliver new goods or services

Competitive Advantage Strategies

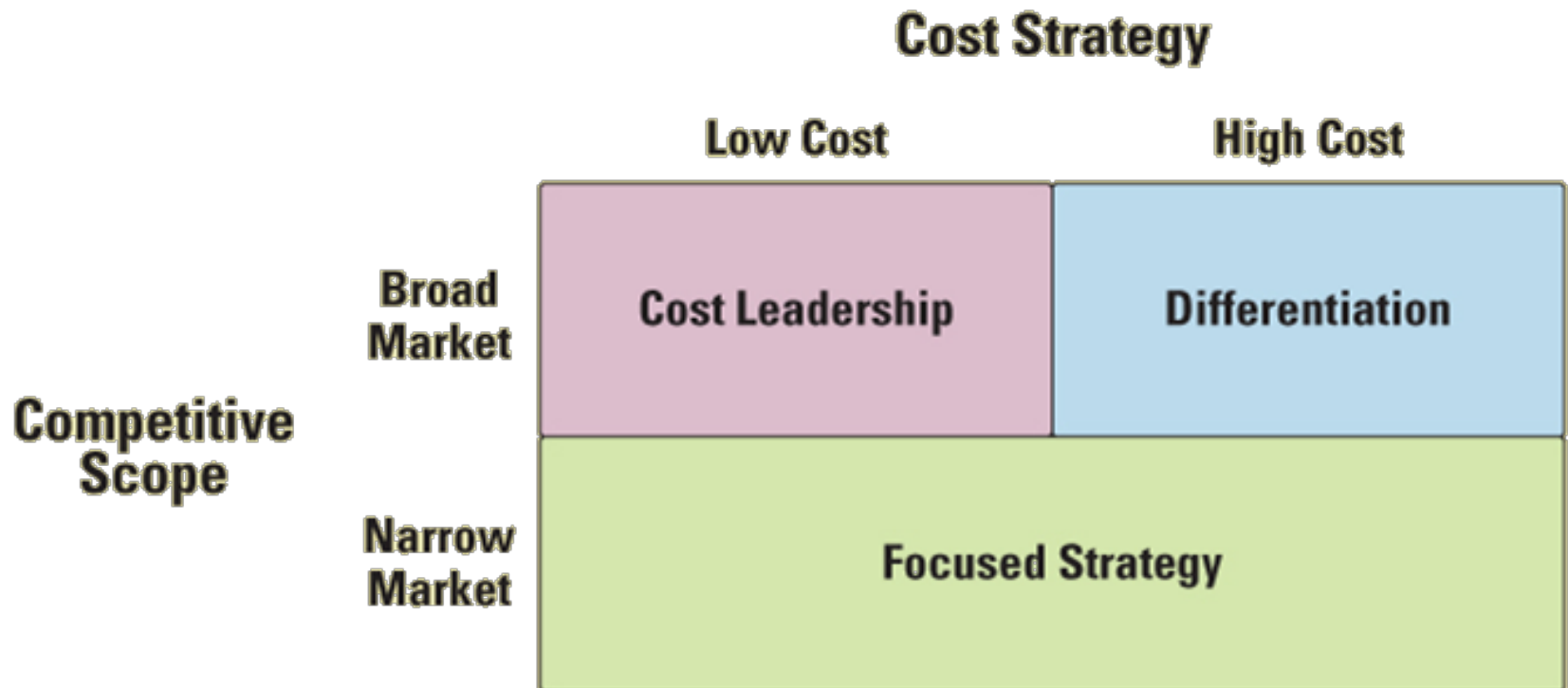
Figure 2-2

Strategies for Creating Competitive Advantage



PORTER'S THREE GENERIC STRATEGIES :

Choosing A Business Focus



Financial Statement Information

Information is available from

- Published annual reports
 - (1) Financial statements
 - (2) Notes to financial statements
 - (3) Letters to stockholders
 - (4) Auditor's report (Independent accountants)
 - (5) Management's discussion and analysis
- Reports filed with the government
 - e.g., Form 10-K, Form 10-Q and Form 8-K

Financial Statement Information

Information is available from

– Other sources

- (1) Newspapers (e.g., *Wall Street Journal*)
- (2) Periodicals (e.g. *Forbes*, *Fortune*)
- (3) Financial information organizations such as: Moody's, Standard & Poor's, Dun & Bradstreet, Inc., and Robert Morris Associates
- (4) Other business publications

Financial Statement Information

- Project 1 is performing a Five Forces and Competitive Advantage Analysis of Your Chosen company and Industry
 - First: Apply 5 Forces Analysis to INDUSTRY
 - Second: Classify the Industry (how value is created).
 - Third: Determine the “Key Success Factors” (Value Drivers) for the Industry
 - Fourth: Assess the extent to which your firm is managing/achieving these Value Drivers

Strategic Implications of Porter's Five Forces Model

- Industry industry is ***attractive*** when:
 - Rivalry is **moderate** or **low**
 - Entry barriers are **high**
 - Good substitutes **do not exist**
 - Suppliers and buyers are in a **weak bargaining position**

How Firms Should Cope with the Five Competitive Forces

- Craft a strategy that will:
 - **Insulate** firm from competitive forces
 - **Influence** competitive pressures in ways that will favor company
 - **Build** sustainable competitive advantage

Drivers of Change in an Industry

- Industries change because **forces** are **driving** industry participants to **alter their actions**
- **What are driving forces ?**
 - **Key underlying causes** of changing industry & conditions
- Analyzing Driving Forces
 - Identify forces likely to exert **greatest influence** over next 1-3 years – usually not more than **3-4** factors
 - Assess their **impact** – **difference** they make
 - Environmental scanning a pre-requisite
- Discussion: Importance and Applicability for:
 - Equity Analysts
 - Bankers
 - Management of the Firm

Common Types of Driving Forces

- Changes in long-term industry growth rate
- Changes in buyers of the product & how they use it
- Product innovation
- Technological change/process innovation
- Marketing innovation
- Entry or exit of major firms
- Diffusion of technical knowledge
- Changes in costs and efficiency

Common Types of Driving Forces

- Increasing globalization of industry
- Market shift from standardized to differentiated products
- New regulatory policies and/or government legislation
- Changing societal concerns, attitudes, and risk lifestyles
- Changes in the degree of uncertainty and business risk

Key Success Factors (KSFs) in an Industry

- ***What are industry KSFs?***
 - The competitive elements that ***every industry member*** must be competent at doing or concentrate on achieving in order to be competitive and financially successful in the marketplace
 - Specific strategy elements
 - Product attributes
 - Resources, Competencies & Competitive capabilities

Identifying Industry KSFs

- **KSF's** in an industry spell difference between
 - Profits and loss
 - Competitive success or failure
- Answers to three questions pinpoint **KSF's**
 - (1) On what basis do customers choose between competing brands or sellers?
 - (2) What must a seller do to be competitively successful – what resources and competitive capabilities does it need?
 - (3) What does it take for sellers to achieve a sustainable competitive advantage?
 - **KSFs** consist of **3-5** major determinants of financial & competitive success in an industry

Common Types of KSFs (6)

- Technology-related
 - Scientific research expertise; product innovation capability; expertise in a given technology; etc.
- Manufacturing-related
 - Low-cost production efficiency; low cost plant location; Quality of manufacture, low-cost product design & engineering, etc
- Distribution-related
 - Strong network of wholesaler distributors/dealers; ability to gain ample space on retail shelves; accurate filling of customer orders; short delivery times, etc.

Common Types of KSFs (6)

- Marketing-related
 - Customer service; merchandising skills; clever advertising; attractive styling or packaging, Guarantees & warranties
- Skills-related
 - Superior workforce talent; quality control know-how; design expertise; technological expertise, etc.
- Organizational capability
 - Superior information systems; ability to employ internet to conduct business; managerial expertise

Consistency between KSFs and Industry Classification

- Previous KSFs are Generic in Nature
 - Industries have developed their own specific language to describe these generic terms. You need to learn them.
 - Financial Institutions have developed a strategy of “relationship banking”.
 - Cross-Sell product and services across functional lines in order to generate more fee or service income.
 - Do you see any similarities in the current airline industry?

Recapping the Match between KSFs and Industry Classification from 5-Fs

