Business Analysis Series

Part II – Competitive Landscape and Industry Structure

Imagine doing a case study pedagogy-based MBA, only that we consider real time business examples rather than studying what happened 25 years ago.

That is what investors deal with on an ongoing basis.

If you get your understanding and the subsequent thesis wrong, you don't just flunk the exam but you also lose a respectable amount of your own money. No wonder people fresh out of business schools get things wrong more often than not in investing, their degree and the MBA culture pushes them to sound as confident as possible without their bravado being backed by any meaningful insights. This is the perfect recipe for disaster when one gets down to investing, but then I digress.

One cannot understand the competitive position of a business without having the context of how the industry evolved into the current shape it is in, neither can one derive meaningful insights without being financially and economically numerate.

Things are the way there are for good reasons. The road less travelled is also less travelled for a reason.

Entrepreneurs with good business acumen manage to stay away from industry segments that are plagued by poor unit economics.

Before you get down to reading this note, please send some time on the "Assessing unit economics" note under the same Business Analysis series.

For a start it is good to understand how things are and hypothesize why things are the way they are before one becomes forward looking. What completes this analysis is to go through corporate actions within the particular industry – who has entered the entered the industry and when, who has exited the industry and for what possible reasons, how has the product portfolio of the incumbents changed over the past 10 years, is the industry seeing convergence or divergence among the players.

It is much easier to understand things sequentially and systematically with real examples.

What follows next is not an all-encompassing exercise but the framework should provide a good enough start to think about businesses in a structured manner.

Market & Business Landscape

Arrive at numerate answers to these simple questions

1. **How do I want to define the market and the peer set?**
   a. If you are trying to build a view about the innerwear market, are you considering only innerwear or are you considering lounge wear too?
   b. If you are looking a cooling solutions market, do you consider both commercial and home cooling? Do you consider just Air Conditioners or do you want to include Air Coolers too?

2. **Once this definition is set, what are the homogeneous categories once can define within this market?**
   a. Men's wear, women's wear and kids wear are logical categories. So is the categorization of unorganized, economy, semi premium and premium.
   b. Commercial cooling and Home cooling are logical categories. So is the categorization based on technology like window AC, split AC, inverter AC and so on
   c. The ground rule here is that any categorization you choose to work with should be consistent with some form of customer segmentation. If the businesses are using a particular way of defining market segments, that should do the job for investors too
3. **What is a good estimate of the size of each of these categories and the market?**
   a. How big are each of these categories – men's wear, women's wear, kids wear? What is the approximate growth for each of these categories?
   b. Within the commercial and home cooling segments, what is the addressable market size in today's terms for each of the categories you have already defined? What are each of these categories growing at?
   c. You can either do this top down or bottom up. If you start with the overall market size number and use guesstimates to size each category it is top down. If you are able to get reasonably good estimates of each category and then sum them up to arrive at the overall market size, this is bottom up. In general bottom up should be the preferred method for investors, wherever feasible
4. **Who are the Top 5/10 leading players in the market and in each category?**
   a. Who are the Top 5 players in each of the segments? Who are the top 10 players in the market?
   b. What have each of these players been growing at? For listed companies this is readily available, for private players one will have to mine this information out from management interviews or industry publications

The output of this exercise should be on the following lines

Segment	Size (INR Cr)	Growth Rate	Leading Players
Segment 1	100	12%	Player 1, Player 2
Segment 2	200	8%	Player 2, Player 3
Segment 3	300	15%	Player 1, Player 2, Player 4
Segment 4	200	10%	Player 1, Player 3
Total	**800**	**11.6%**	

Player	Revenue	Growth Rate	Product Portfolio
1	350	12%	
2	250	10%	
3	100	12%	
4	100	15%	
Total	**800**		

You may not get details of all competitors all the time. As a thumb rule if you are able to cover 80% of the total market size, it is enough to derive insights that are reliable. It is not wise to start deriving insights when you can't even cover 50% of the market.

No rocket science so far, this is simple arithmetic and data gathering, isn't it? I have news for you, very few investors do this exercise in a structured manner. Most investors read a few reports and can summarize this information without having to note it down in a structured manner. But then, we are only at step 1. The analytical and computing power of the human mind should be harnessed to get insights, not spent in remembering data.

Do the structured work. Don't stop until you have gathered enough data points to start the next step.

My ability to make sense of business dynamics went up exponentially after I started to write formal research notes for myself in 2014. Once you pen things down, there is no place to hide after some years if things do not play out as expected. You learn only when you confront your mistakes.

Making notes on the Industry Structure

Some elementary questions –

- Is the industry structure consolidated or fragmented? Has there been any change in the trend over the past 10 years?
- How many players have entered the industry over the past 15 years? How have they fared?
- How many players have exited the industry over the past 15 years and for what reasons?
- What is the proportion of unorganized players in the market size? Is this increasing or decreasing with time?

- Is pricing for the market stable or fluctuating? What has been the trend over the past 10 years?
- What has been the M&A activity in the market?

Once you have gathered enough information to answer these questions, you will start to form an outline of the industry dynamics. As a thumb rule, stable industry structure can indicate that there are some entry barriers and that the industry is mature and efficient. If you have a new player entering every now and then trying to disrupt the status quo, you might not be able to take a long-term view towards the industry in the first place. Impending disruption is something that investors inherently dislike, how can you invest with a long-term horizon when there is a lot of flux in the industry structure?

Observe the most profitable listed businesses in India and you will observe some common trends – duopolies and monopolies are inherently profitable. Monopolies are rare unless they are formed due to Government intervention, in which regulatory interference is usually high.

Estimating and Evaluating Profit Pools

Next develop the value chain map which encompasses the suppliers and the customers of the industry

- What is the industry structure of the vendors to the industry?
- What is the industry structure of the customers to whom the industry sells?
  - Does the industry sell commoditized products to concentrated buying centres?
  - Does the industry sell differentiated products to distributed buying centres?
- On an average who is more profitable – the industry player, the vendor or the customer?
- Who sets the pricing in the value chain? Usually it is set by the industry that is closest to the end consumer
- Is pricing in the entire value chain stable or volatile? Does it respond to customer demand pattern changes or to supply pattern changes?

One of the more useful frameworks to use here is the Porter's Five Forces model. The only tweak investors need to make here is to quantify each observation to the extent possible.

Once you identify which leg of the value chain has the best profit pool, the power balance in the industry becomes clear. **This is not as simple as it sounds.**

Taking the example of the equity broking industry in India. Broking offers the highest profit pool within the entire value chain but that part of the value chain gets attacked the most. The other legs of the value chain like depository, registrar, exchanges do not get attacked that frequently. Some segments naturally gravitate towards a duopoly or an oligopoly.

Just look at the industry structure of the broking value chain –

Retail Brokers – Dime a dozen

Equity Exchanges – Duopoly

Depository – Duopoly

Registrar – Duopoly

When was the last time we saw a new equity exchange, depository or a registrar? On the other hand, a relatively new entrant like Zerodha has emerged as a dominant retail broker.

The best profit pool is the one that cannot be attacked easily and can be defended by incumbents while offering the possibility of a healthy growth rate.

In other words, profit pools with moats are more valuable than those without.

Having an approximate estimate of the profit pools in the value chain quantifies things to a good extent before we move to the next step. Just have the revenue, PAT and growth rate of each leg of the value chain handy.

Inferential Reasoning - Deriving Insights

Referring back to the table we built, one can start pondering over some questions

- Why isn't Player 3 focusing on Segment 3 which has the largest addressable size and also the highest growth rate?
- Has Player 4 consciously chosen to focus only on Segment 3 or is it that they started with that segment and haven't been proactive enough to get into the other segments?

To cite a few real-world examples, consider the Indian innerwear market –

The men's category has a size of around INR 11,000 Cr and grows at 7-9% p.a. in value terms. The women's category has a size of around INR 20,000 Cr and grows at around 12% p.a. in value terms. Men's category has more than 7 players who make annual revenue > 500 Cr each while the women's category has just 1 player who makes annual revenue > 500 Cr revenue from the category.

- Why is it that the larger and the faster growing innerwear segment has fewer large players?
- If the players see this and are still not focusing on that segment – is this because they cannot? Or is it that they do not want to?
- If leading players other than Page Industries have stayed away from focusing on the women's inner wear segment, what chance does a new age player like Zivame have of succeeding there?
- What makes the large players reluctant to address this larger market segment?

Next consider the plastic pipes market in the country. Finolex Industries and Supreme Industries were large players before Astral Poly became a large player.

- Why did these incumbents allow Astral Poly and Ashirwad Pipes to focus on and to dominate the cPVC market which offers higher margins than PVC pipes?
- Did they err in their assessment of how big the cPVC segment would grow or did they consciously choose not to focus on that market?
- Now that they have finally chosen to participate in the cPVC market, how has this been changing the industry dynamics?

We are already starting to ask some pertinent questions. Answers to questions like these is what causes an investor to have a "view" on a business and hence the stock.

What valuation the business trades at will only make sense once the context of the market size, industry dynamics, growth rates and profit pools are studied.

Price to Earnings, Price to Book, Enterprise Value to EBITDA – these are meaningful only within the right context. Ratio analysis can misguide if this point is not appreciated.

As stated earlier, this is not an exhaustive or an all-encompassing exercise, this is just a basic framework that can help avoid some elementary errors. There are multiple other perspectives that good investors consider before they make up their mind about the quality of a business or of a sector.

This analysis takes up almost 60% of the time I spend on the research process, especially when I look at an industry for the first time. Without this context, one cannot understand the strengths of a business, nor does one have the right context to be able to place and assess why the unit economics of the business are what they are.

Would like to conclude this note by encouraging you to think about these questions –

1. Why does the pharma sector have so many companies that have been able to scale to annual revenue > INR 2,500 Cr, most of them being profitable?
2. When was the last time you came across an IT Services company that makes losses?
3. How many paints companies do we have in India? Why are they so few in number?
4. What other industries can you think of where the industry structure is consolidated with just 3-4 years capturing 75%+ of the market?
5. Under what conditions do the big get bigger? Under what conditions do incumbents get disrupted?

The more one thinks, the better one can recognize patterns and come to the right conclusions. The best investors take one look at a balance sheet and can accurately guess which sector the business operates in.

Now that is wisdom and pattern recognition, not intelligence.

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The purpose of this publication is not to express views on the valuation of the business or the sector being discussed. Most of the content here is an exercise in inferential reasoning and the mental models involved in thinking about businesses in general. Effective learning calls for specific examples to drive home the core concepts and that precisely is the endeavour here.

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We sincerely suggest that you view this as a learning exercise and nothing more.

Please consult a qualified and registered investment professional before taking any investment decisions.