Business Analysis Series

Part III – Putting it all together

My preferred approach to most things is to analyse to a respectable level of depth, then come back up for abstraction and summary. Take a deep dive, come back for a breath of fresh air, get a fresh sense of perspective, and then decide how to evaluate.

Battles are won due to the tactical acumen of generals who observe from a distance and analyse the situation dispassionately before deciding when and where to strike. It is difficult to extricate yourself from a situation and to view the same from a higher level of abstraction. This is a skill to be learnt over time if one wants to succeed at investing.

In my early years of investing I made the mistake of getting involved in a business to such an extent that I was zoning out and losing perspective. Just because one has put in a lot of effort does not mean that it is something worth investing into. The sunk cost fallacy gets to us in many ways.

The best way of ensuring you do not fall in love with a business is to always have a comparative framework handy, for the most part business analysis is an exercise in relativity. Unless you know what a bad business looks like, you cannot explain why something is a good business.

If you cannot articulate the why of what you do, you cannot have high conviction.

It is extremely important that we do the ground work of understanding a business and then take a step back to place the relative strength/attractiveness of the business by comparing it to the other businesses you understand well.

With this context, this note is one of the many ways of putting it all together.

Assuming we have diligently done what was suggested in Part I and Part II of the Business Analysis series, this note is all about taking a step back and understanding the nature of the business we are dealing with. By this time, we should have a good idea of –

- Long term growth rate of the business and the sector
- Time series data about the unit economics of the business and the sector
- Value chain that the business operates in
- Products, customer segments and other logical criteria which enable the managements to choose what to compete at
- Competitive landscape with market sizing data
- Understanding of where the profit pools lie in the value chain
- Entry and burn rate of competition, industry structure changes if applicable
- Some idea of the competitive strengths of each player in the industry

The next step is to ask ourselves some very basic questions that can help us benchmark the qualitative attractiveness of the business/sector. We still haven't gotten to the valuation at all, this is still an exercise in business analysis.

While Part I and Part II of the series called for a lot of reading and data gathering, this part is all about putting together what we know so far into a coherent framework. Part III is all about thinking, taking stock, and evaluating what else we will need to have a view about the business/sector in place.

The following are pretty basic questions but therein lies the simplicity, unless one gets the basics right it is difficult to do well in investing over the long term

1. Can the business deliver a growth higher than nominal GDP growth rate over the next 5-10 years? Why do you believe so?
2. Is the demand pattern for the business/sector consistent or volatile? Do you have any reason to believe the future will be different from the past in this regard?
3. Is the business driven off capacity creation or capacity utilization? For e.g. within the auto ancillary segment, engine components are capacity creation while battery/tyres are capacity utilization driven.
4. What is the annuity component of the business? Can this increase over the next few years and to what extent?
5. Does the specific business grow at a pace equal to the industry growth rate or at a different rate? How many such outliers do we have in the industry and for what reasons?
6. What is the extent of product/service differentiation across players in the industry? How much importance is given to intangibles like reputation, brand value when customers make their buying decision?
7. Is the industry segment in general characterized by buyers who value reliability and are loyal? Or are the buyers always in search for a better deal? How easy is it for customers to switch to competition?
8.
9.
10.

This list of questions is endless and the exercise starts looking too complicated.

We are better off organizing our thoughts into logical silos till the thought pattern gets ingrained to such an extent that we can do this exercise without it feeling like too much work.

I find it useful to structure this exercise as follows. Please note that this builds off some well-known frameworks that are used in the investing world across public markets, VC and PE investing.

We need not reinvent the wheel and come up with original frameworks, just pick and choose a combination of frameworks that can address most perspectives consistently enough.

Moat Analysis

Borrowed from Pat Dorsey's framework from "The Little Book that builds wealth". A rather light reading that explains the concepts in a very simple manner without unnecessary jargon.

My experience has been that there is no shortage of knowledge/frameworks in the investing world, almost every famous investor has one that is popular. The key is to choose something that completes your style of work and adds rigour to the analysis you do. I like to do back breaking number crunching work and have that captured in a structured format. Once you force yourself to follow a process, the chances of making silly errors drops down to a negligible percentage.

Moving onto the framework to assess the strength of a moat

	Sector/Company 1	**Sector/Company 2**	**Sector/Company 3**
1) Intangible Assets			
Brands/Quality/Technology	Strong	Strong	Strong
Patents & Trademarks	No	No	No
Regulatory Protection	No	No	No
2) Switching Costs	No	No	No
3) Network Effect	No	No	No
4) Cost advantage			
Distribution	Yes	Yes	Yes
Location	No	No	Yes
Access to raw materials	No	No	No
Relative Scale	No	No	No

Please do some focused reading on each of the terms used to be absolutely clear on what they mean. Once this is done, investing reduces to a comparative exercise across sectors and companies. This way you can pick and choose the best 20 businesses from the 50-60 businesses you track; consistency of evaluation is the key.

Business/Industry Characteristics

	Sector/Company 1	**Sector/Company 2**	**Sector/Company 3**
Risk of technology obsolescence	Low	Low	Low
Threat of substitutes	Low	Medium	Low
Extent of pricing competition	Medium	Medium	High
Reliance on a few suppliers	No	No	No
Threat of concentrated buyers	Emerging	Yes	No
Threat of new entrants	Medium	Low	Medium

Industry Structure	Oligopoly (U)	Duopoly (O)	Oligopoly (U)
10 Year Growth Rate (%)	8%	10%	12%
Demand Pattern	Steady	Volatile	Volatile
Average ROCE (%)	22%	28%	18%
Capex or Utilization driven	Capex	Both	Capex
Annuity Component	High	Low	High

This organizes some of the questions listed above into a tabular format that is much easier to comprehend and evaluate. Over time, you can add more parameters to this exercise.

As a rule, we should try to aim for the simplest visualization so that we utilize our mental capacity to drive insights, rather than waste mental capacity in remembering data points. There is no substitute to doing structured research work, even if one is not in the business of writing research reports.

The Operating Manager Perspective

I am reproducing the following content from one of my posts on valuepickr forum on the topic of Business Quality. I have found this an extremely useful construct to separate oneself from the average investor who does not appreciate the operating perspectives of running and scaling a business.

There are some real time examples in here which should make the utility of this exercise very evident.

One of the disconnects I see in a lot of investment management professionals & investors is the inability to wear the Operating Manager and P&L hat and view the business.

Assume the stock picker in me is I and the P&L manager in me is O

Exhibit 1

I - Does the business have pricing power?

O - Is the salesman of the company treated with respect or is he just an order taker? Who wears the pants in the OEM - distributor relationship?

In HDFC AMC when the TER cut came in and there were questions, I intuitively knew the answer since I was a P&L manager in the investment management industry. Any day the fund house (AMC) commands more respect than the advisor (wealth manager/distributor). Forced me to look deeper into the AMC expenses and that is where I saw that a good chunk of the expenses was discretionary in nature. The answer was then very apparent

Exhibit 2

I - Who among the midcap IT companies can grow faster over the medium term?

O - Which among the midcap IT companies has invested the most into their sales team?

Starting with the perspective of I in an industry like IT is fairly useless. I have posted about this in the Persistent Systems thread about why I wouldn't buy the stock even when it appears cheap. Instead, when I started thinking with the perspective of O, the answer to me was clear that I just need to figure out who

has the most motivated & high performing sales team. 2-3 calls were all it took to conclude that L&T Infotech had a higher quality sales team and hence the growth prospects there were clearly higher.

The above two were clear cases where I had an edge since I have worked as a P&L manager in both the industries.

Exhibit 3

I - What are the advertising spends of the company? Is the company investing enough into building a brand?

O - Is building a brand as simple as doing advert spends? Does the category even respond to advert spends? If the product has an associated service/installation component, is ASP the right approach or would channel loyalty programs work better? Adverts when done right can create tremendous operating leverage, when done wrong it is just a waste of resources

Hence, when an APL Apollo talks of doing a 50 Cr advert spend every year, the investor in me might feel good but the operating manager in me gets worked up because I begin to doubt the effectiveness of the spends.

Exhibit 4

I - Does the business have a moat or not?

O - How important was the operating situation or the context that led to the existence of a moat? Would APL Apollo have done this well if they had even one single serious competitor? Would Astral have done well had Finolex Industries decided to focus on CPVC when Astral and Ashirwad Pipes were just about picking up steam?

Implication of this answer is very high. It means that sometimes moats emerging is more due to the specific situation than due to any great capability or execution by the management. Moats do exist but they aren't necessarily created proactively all the time, sometimes they just emerge.

What exactly am I saying here?

Always keep toggling between the perspectives of I and O.

O understands way better than I ever will what it takes to scale a business, I understands valuation way better than O ever will

There are many other logical silos to consider, this is by no means an exhaustive exercise.

The output of this exercise should be to see the business/sector for what it is and not get carried away by the narratives. It should be to provide a consistent and logical basis for comparing businesses within a sector, as well as to compare businesses across sectors. Else the human mind is subject to availability bias and we end up buying businesses that are decent, but a few years down the line we realize that the next business would have been a better buy than the one we bought.

Errors of omission lead to opportunity loss while errors of commission lead to real loss.

My experience has been that by forcing myself to mandatorily look at 80% of the industry players in any sector, one can minimize errors of commission caused by availability bias.

Once we do this exercise for a few sectors and 20-25 businesses, we can start to appreciate why certain businesses/sectors are viewed favourably by the market more often than not.

These businesses/sectors are characterized by

- Steady demand patterns which reduces volatility of business performance
- Leading competitive position coupled with durable moats which can defend profit pools
- Consolidated Industry structure
- Healthy unit economics that stand the test of time
- Long growth runway
- Predictable range of outcomes for the investor

No wonder some of the most consistent wealth creators in India have emerged from a few sectors. There is a very clear method to the madness, contrary to what the average retail investor experiences.

In my opinion one should get into aspects of valuation only after getting a hang of how to go about business analysis. When you think you have done enough, go one level deeper. Add more perspectives to the analysis and one might discover that the current level of analysis is shallow, though respectable. Hope the three-part business analysis series helps in this regard.

Happy reading and brooding over business quality.

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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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