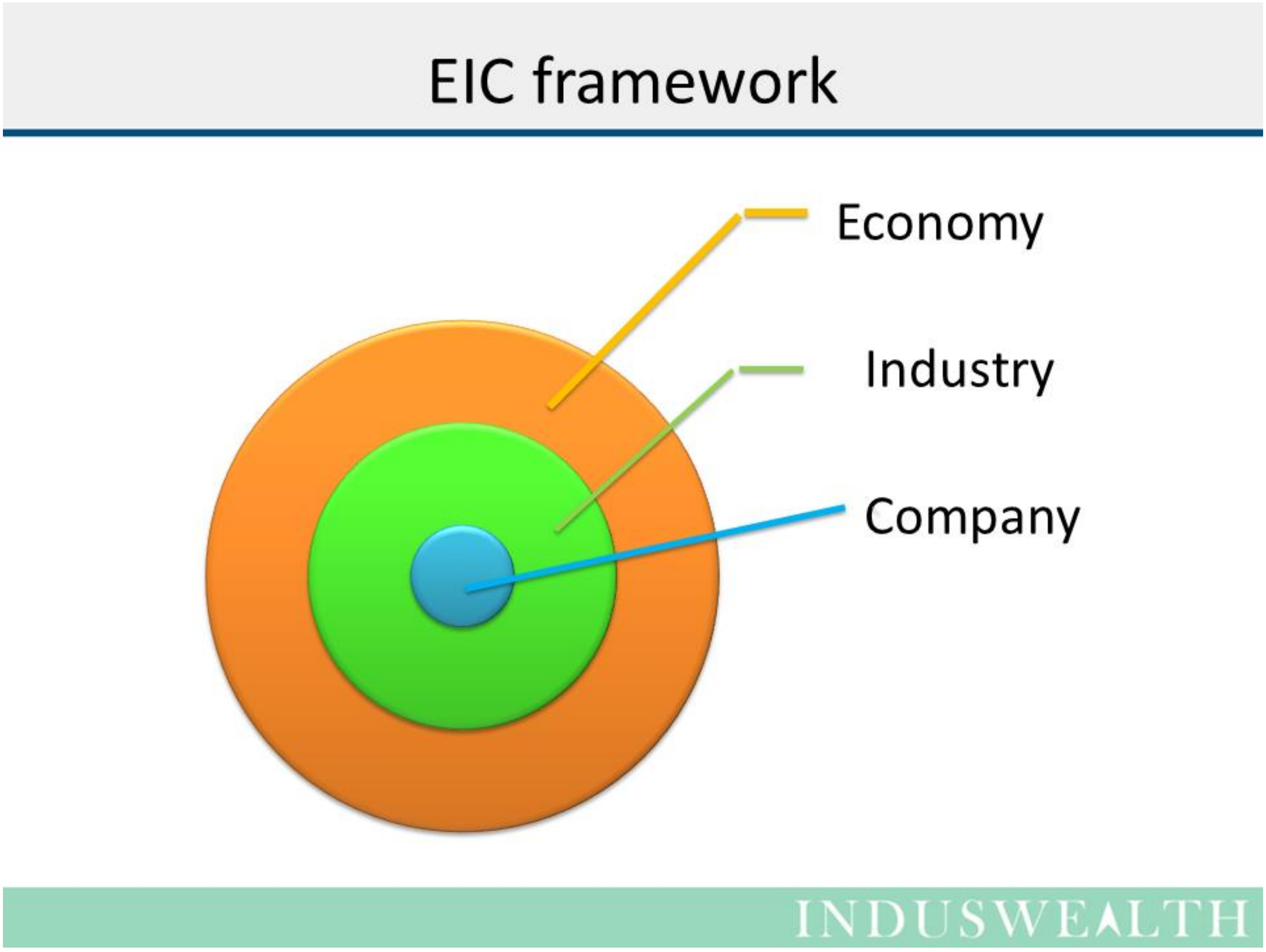
Frameworks for valuation of a company

So far we have established that an entity is valuable only if it has an ability to generate profits. And we have agreed that future is fraught with uncertainty, but evaluation of the future prospects is the key for valuation. Let now look at a few tools that will help us objectively analyse the future prospects of a company.

We will be looking at 3 frameworks for analysing a company. Pl note that these are not the only frameworks and each of these frameworks will give a lens into understanding the business from its perspective. It useful to remember that multiple perspectives are possible for the same subject. Some frameworks may not completely agree with each other and there are times when they can contradict each other.

EIC framework: Economy, Industry, Company framework. This is basically a top down approach where we start by evaluating the overall business, political, legal, social, and economic environment in which the firm is operating.



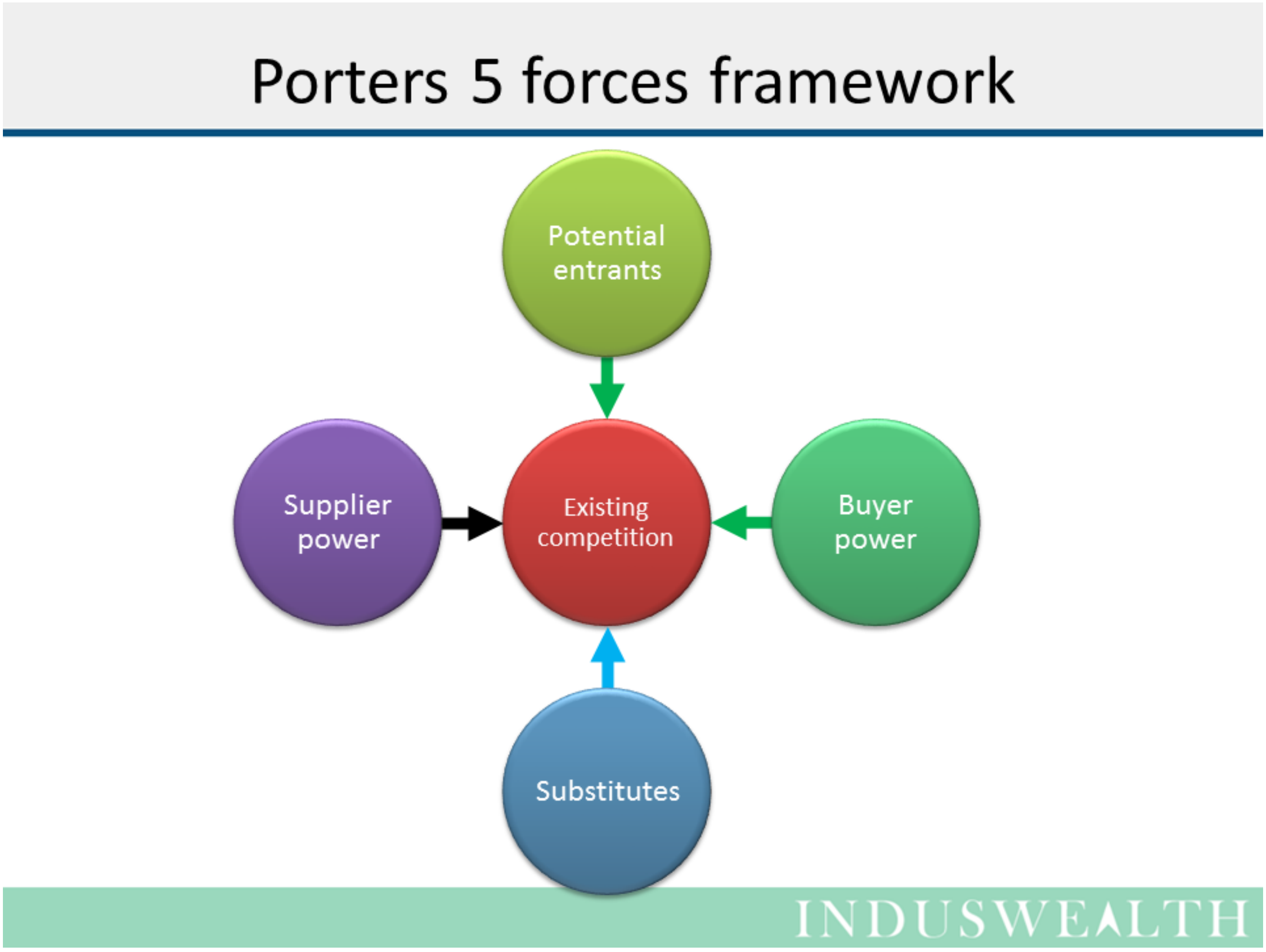
- This helps understand if the overall environment is favourable for the company to do well. For example a growing economy augurs well for a firm building infrastructure. A politically conservative government may pose some challenges to liquor or gambling business. Legal and/or regulatory overdrive can pose challenges for getting environmental clearances.

- Then we look at the environment in the industry that company is operating in – for instance technology, availability of infrastructure, clarity of laws governing that industry, incentives available for the industry participants, supplier and customer economics, firm in relation to its competition etc.,
- We finally look at the specifics of the firm – the geography, quality of its assets, operations, and management etc.,

For example let's look assume we are trying to analyse companies like Vardhman textiles or Ambika cotton mills. We can look at the Indian economy that is growing at a about 8% per annum. People are spending significant to make sure they dress smart and the average number of clothes in the wardrobes are on the rise. If we look at the textile industry the general economics is good, the levels of debt are reasonable. We can now look to understand the geography of the firms and quality of assets – Vardhaman and Ambika are doing well over a period of time with prudent management. One can consider these to be reasonable companies to buy.

Porter's 5 forces framework:

Porter's framework can be considered as a more in-depth analysis for the industry the company operates and companies interaction with external entities.

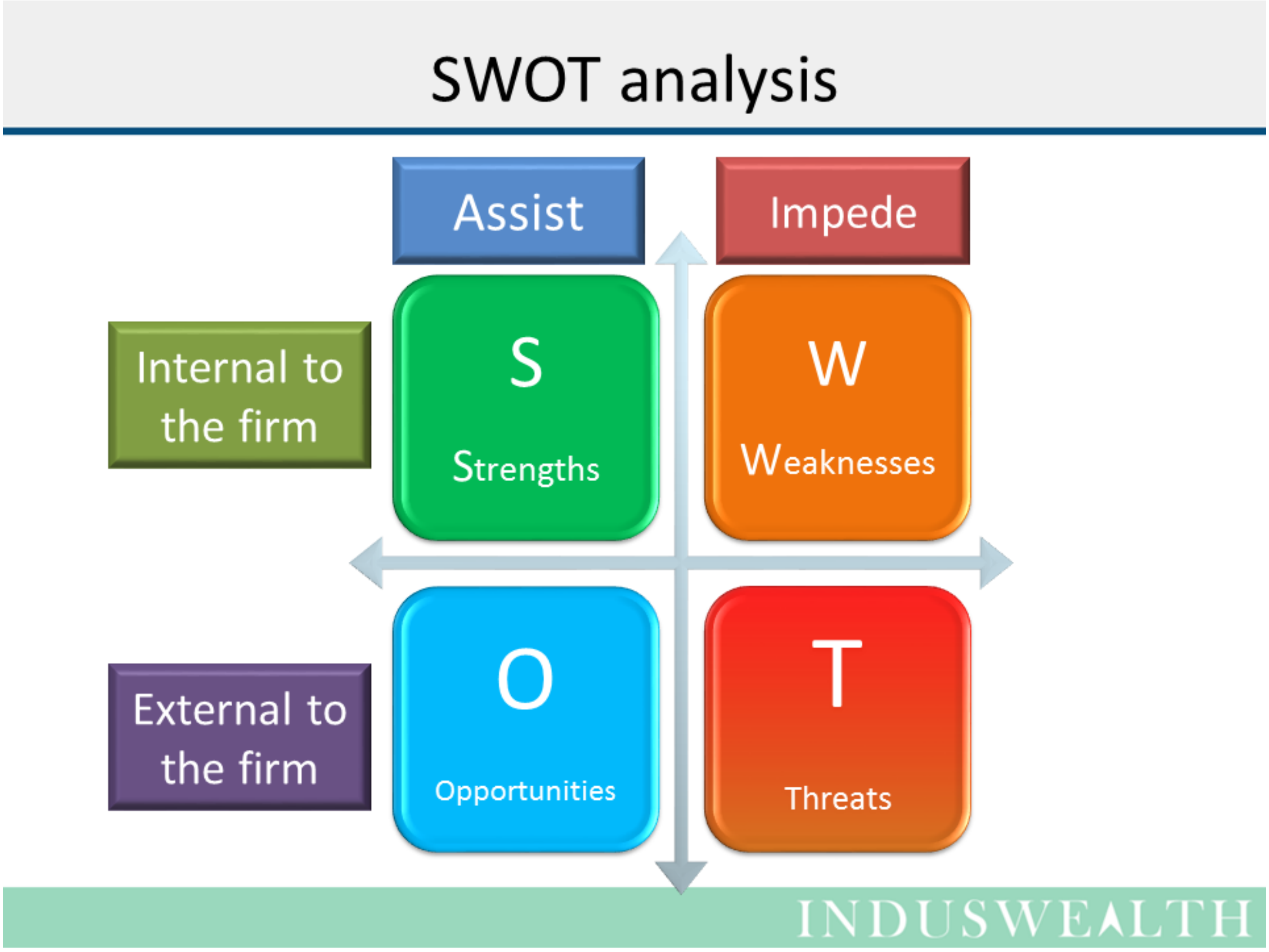


- Competition: This is a review of the competitive framework of the industry. We look at things like – margin erosion due to competition, effectiveness of competition's response to changes in strategies, nature of competition – local vs global, exit barriers (cost of closing a business) etc.,

- Buyer power: Here we are looking to see if the company is operating in a buyer's market (if the customers are in a position to significantly influence the future of the firm). Some of the key factors reviewed are - Percentage of the business coming from the top 20% of the customers, ease with which the customers can switch to rival products (customer lock-in and cost of changing), price sensitivity of customers etc.,
- Supplier power: Here we are looking to see if the company is operating in a market where suppliers can significantly influence the future of the frim. Some of the key factors reviewed are – number of suppliers, percentage of the inputs represented by top 20% of the suppliers, ability of the firm to switch suppliers, pricing power of the suppliers etc.,
- Potential entrants: Here we are looking at the ease with which new entrants can come into the industry. Entry barriers like – specialist knowledge/technology, economics of scale, time and cost to make a successful market entry etc.,
- Substitutes: Here we are looking to understand how quickly can substitutes come into the market and take away the current business. Here we look at cost of change, rate of technology for the customers etc.,

Lets say one is looking to analyse Pharma companies like Ajanta Pharma, Suven Life sciences or Aurobindo pharma. Though there are lots of players in the industry, as the populations is increasing and readiness to spend on health care is increase – people are buying more so the opportunity is fairly good. Supplier to these companies are supplies generic chemicals and have limited leverage over these companies. Buyers especially for the exporters who are selling to large institutions have a bit of a challenge – firms with ability to demonstrate quality are able to charge a good premium. Regulation (like approvals from FDA etc) is a challenge for new firms to make an entry. Substitutes like alternate medical practices etc will take long time to be established and followed. So the companies mentioned could be reasonably expected to do well as long as the management is continuing to run them prudently as they have been doing over the last few years.

SWOT analysis: SWOT analysis can be considered as more in-depth analysis of the company.



- Strengths are characteristics of the firm that can give it an advantage. For instance, technical superiority, scale of business etc.
- Weaknesses are characteristics of the firm that result it to be in a disadvantages position. Shortage of skilled associates, poor work culture etc.
- Opportunities – external elements that could favour the firm. Good infrastructure, access to ports etc.
- Threats – external elements that could inhibit the firm. Political or social disturbance, Entry of a large competition with deep pockets etc.

➢ Strengths and Weakness are internal to the firm. Opportunities and threats are external to the firm.
➢ Strengths and opportunities assist the firm in achieving its goals. Weaknesses and threats impede the firm from achieving its objectives.

If we look at IT& ITES firms like HCL technologies , ELCERX, Mindtree, Zensar. Their strengths are their understanding of their clients business and ability to provide solutions to them. Weakness would be the large set of employees who are not familiar with the latest technologies and business trends. Opportunities would be to cater to increasing demand from clients who need to be data driven, and more agile. Threats would be chances of price war as the large players in the industry are trying retain their position and may cut prices. Overall these firms mentioned here are nimble enough to respond to changing needs, and are not too big to be burdened significantly as the other large players in the industry are. There is a good chance that by prudent management they can leverage on the opportunities and manage the threats and have a decent chance to deliver reasonable growth in profits.

These frameworks provide a structured approach to evaluate future prospects of the firm. We need to remember frameworks assist in looking at multiple dimensions but the success of the analysis is based on how well one understands the dynamics of the industry, firm, relevance of the underlying assumptions, and quality of the analysis.
