Standard

| TOP-DOWN |

Walking the fundamental analysis talk

"Stress test" an investment case

LAST WEEK WE EXAMINED the two types of analysis available to investors: technical and fundamental. Over the next two weeks we'll examine fundamental analysis in more detail and provide some guidelines for how novice investors can walk the fundamental analysis talk.

Fundamental analysis combines an in-depth look at the economic environment, industry and the company itself to forecast future earnings growth and – from that – determine what the company's share price should be.

There are, broadly, two main fundamental analysis schools: top-down and bottom-up. The top-down approach involves beginning with a broad overview and working down to a specific stock pick; bottom-up starts the analysis process by selecting companies that look as though they might be attractive investments from specific ratios and then delving into their intricacies more thoroughly.

It's important to remember that both approaches have the same ultimate goal: to select a share that will be a profitable investment by determining a company's "intrinsic" or real value. This week we pick apart the mechanics of top-down fundamental analysis.

First, let's define exactly what top-down analysis is. The top-down approach to analysing a company involves looking at, first, the broad macroeconomic, social and political environment in which it operates. The investigation is then narrowed to look at the industry-specific factors that affect a company's future performance. Lastly, top-down analysis will then zero in on specific companies and, given this important background information, determine their values.

Top-down analysis has two key benefits. First, it ensures that an investor includes all relevant information in a consistent manner; second, no company operates in a vacuum, and macroeconomic and industry conditions are important inputs into its performance.

A top-down analysis can also incorporate useful alternative assumptions to "stress test" an investment case. For example, a top-down investor may look at how changes in interest rates or exchange rates will affect a company's performance and hence its future profitability and share price.

Richard Seddon, head of Online Share Trading at the Standard, says that researchers do some of that analysis for investors (available on the website www.securities.co.za), but individuals need to understand and agree about it before accepting that view. ¤

The first step

Macroeconomic investigation

THE FIRST STEP in top-down analysis is undertaking a macroeconomic investigation. That's done for two reasons: first, a company's growth prospects are, ultimately, reliant on the economy in which it operates; second, share price performance is generally tied to economic fundamentals, as most companies generally perform well when the economy is doing the same.

The macroeconomic evaluation should first look at the global situation, as South Africa's economy is affected by international developments and a number of JSE-listed companies have international operations. There's a great deal of information available in newspapers, magazines and on the Internet and from the research departments of banks and stockbrokers.

Standard Bank produces a number of economic reports that will fill in some of the details that laymen can't. Its offering includes "Manufacturing Unpacked" (which looks at the health of the manufacturing sector), "Taking Stock" (which examines the retail sector), "Motor Alert", "PPI Alert", "CPI Alert", a monthly "Market Forecast", a "Quarterly Employment Survey", the "Commodity Monitor", "MPC Alert and many others. All are available to Online Share Trading Clients at no cost.

The top-down investor should then move on to a more detailed investigation of SA's economy. There are seven key inter-related

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variables that investors should consider when constructing their economic viewpoint: gross domestic product growth, unemployment, inflation, exchange rates, the balance of payments (BoP), the current account deficit and interest rates.

GDP is, simply, the total income earned by SA. GDP growth statistics published by Statistics SA, the Government arm responsible for compiling the country's statistics, show how fast the economy is growing. Intuitively, investors know that strong economic growth is good for companies and that recessions or full-blown depressions cause share prices to decline, all other things being equal.

Unemployment figures are published by StatsSA and show trends in sectoral employment. For investors those numbers show that SA publishes both consumer (CPI) and producer price inflation (PPI) figures monthly. CPI (or CPI excluding the effect of mortgages (CPIX)) shows what inflation consumers experience, while PPI tracks inflation at the factory gate.

Inflation is important for investors, as excessive inflation undermines consumer-spending power (prices increase) and so can cause economic stagnation. However, deflation (negative inflation) can also hurt the economy, as it encourages consumers to postpone spending (as they wait for cheaper prices).

The exchange rate is the fourth important economic variable and affects the broad economy and companies in a number of ways. First, changes in the exchange rate will alter how much SA companies export or import, because it changes the cost in rand terms. If the exchange rate strengthens (as it did between 2002 and 2005), exporters will find that their product becomes more expensive in international terms, which can result in a

→ ANNUAL GDP GROWTH

Annualised percentage change in the seasonally adjusted quarterly value, constant 2000 prices

Source: Statistics SA

volume (and profitability) decline.

Investors need to be conscious of the effect that exchange rates have on the companies in which they're invested. Rand hedge shares (such as mining companies, international luxury goods retailer Richemont and Sasol) earn foreign currency revenues, so rand depreciation will increase rand income and cause the rand share price to increase. In addition, even SA companies can have their revenue tied to foreign currencies if they have offshore subsidiaries, such as Steinhoff (furniture manufacturer) or Bidvest (a diversified industrial company).

BoP is simply the scoreboard that reflects a country's international monetary transactions for a specific time period. It includes the trade balance (the difference between imports and exports), foreign investment by local players and inward investment by foreigners.

All trades by both the private and public sectors are recorded to show how much money flows in and out of the country. The BoP affects the exchange rate through supply and demand: the rand appreciates when there's more money coming into than leaving SA.

A current account deficit occurs when a country imports more goods and services than it exports. It affects the exchange rate through demand and supply.

Interest rates have a significant effect on share markets. In very broad terms, share prices improve when interest rates fall and decline when interest rates increase. There are two reasons for that: the "intrinsic value" estimate will increase as interest rates (and the linked discount rate) fall and underlying company profitability will improve if interest payments reduce.

The success of a top-down investment model hinges on the quality of information available and the consistency with which the investor drills down into it. Standard Bank has professionals who do that on a daily basis and produce regular reports that will provide and interpret that information for you. ¤

Picking winners

Industry analysis important

TOP-DOWN FUNDAMENTAL investors believe they increase their chances of picking winning shares by finding winning industries. While the individual company is important, the industry in which it operates is likely to exert a profound influence on its share price, as sector share prices tend to move in tandem. Consequently, investors should look just as carefully at the industry framework in which a company operates as the company itself.

Most industries can either be categorised as defensive or cyclical. Defensive industries are those that sell goods that people consume irrespective of the state of the economy, such as basic foodstuffs or pharmaceuticals. Their performance tends to be relatively steady in bad times, but earnings won't usually increase proportionately with an upswing in the economic cycle. In general, people don't eat more when they have more disposable income – though they may buy more luxury items to complement the basket of basic foodstuffs.

The profitability of cyclical industries is closely tied to a particular economic cycle. For example, the profitability of mining shares is dependent on the commodity cycle (or the change in international commodity prices), while apparel and furniture retailers' prospects are tied to the economic cycle and specifically to consumer spending. That's generally because the demand for goods sold by cyclical industries changes with these underlying cycles: cyclical industries are those whose fortunes change with the rise and fall of the economy.

To start with, investors can ask seven key questions to select industries for further examination:

- Does the industry show a long-term growth trend and is that likely to continue?
- How big is the industry and how important is it to the economy? Smaller industries with higher growth potential are structurally more attractive to investors than large, mature industries with more limited growth prospects.

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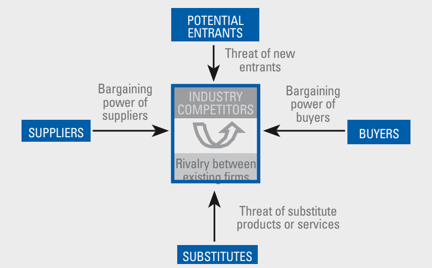
- Are the industry's goods or services in demand? It's essential to determine whether society will continue to buy a company's offering and that it won't be replaced by new technology in the short to medium term. For example, a long-term investment in a company that produced gramophones would have been severely compromised by the advent of the CD player.
- What does its growth rely on? Investors need to determine if there's a strong underlying trend driving industry growth or whether it risks losing its relevance to its consumers.
- Is the industry a potential target for Government action? Legal intervention can change a company's long-term growth profile significantly – just look at the effect of tobacco litigation and the rise of stringent anti-smoking legislation and curbs on advertising have had on the growth profile of the tobacco industry in the developed world.
- Is the industry dependent on another sector? Where that's the case, investors will also need to investigate the prospects for the supporting industry.
- Which companies are the leading players in an industry and how are relative market shares likely to change in future? Once an investor has established that he can pick either the established industry leaders – the conservative choice – or look at industry innovators that may show a higher future growth path.

PORTER'S "FIVE FORCES" THAT DRIVE INDUSTRY COMPETITION



Source: M E Porter: Competitive Strategy: techniques for analysing industries and competitors, The Free Press, New York, 1980

The interaction between industry players – which will affect relative market share and future profitability – can be assessed using Porter's Five Forces analysis. Porter's framework identifies the five factors that will determine an industry's future profitability.

The first force is the threat of new entrants. If an industry has low barriers to entry (that is that new competitors can set up shop easily, as the requirements for capital or skills investment are relatively small), competition will increase in future. That in turn hurts profitability, as margins contract. The threat of new entrants can be reduced by factors such as high barriers to entry or large economies of scale (which means that higher volumes can be produced at lower cost).

Second, Porter highlights the threat of substitute products. The greater the threat of substitute products, the more intense is industry competition, which reduces overall sector profitability.

The third force is the bargaining power of buyers. Competition will increase if consumers can demand reduced prices or higher quality goods at the same price, at the expense of industry profitability.

Fourth, does the bargaining power of suppliers affect industry profitability? If there are a few industry suppliers those companies will have greater bargaining powers and the ability to increase the price they demand for their goods.

The last competitive force is the rivalry between existing industry players. Increased rivalry will increase competition, which will ultimately hurt margins if players compete for customers on the basis of price. ¤

Creating an edge

IN THE TOP-DOWN fundamental analysis framework an investor will narrow the focus of his investigation from an industry perspective to looking at individual companies as the final step to making a stock pick.

The first step is to examine an industry's current business and competitive environment.

The second component of company analysis is assessing the capability of the management team to both execute the current business plan and adapt it to changing market conditions. Pertinent questions include: Has management delivered on past promises; what is management's track record; and how talented is the management team?

The last step is financial analysis, which strips down the company's financial statements. Standard Bank's analysts research many of the JSE's listed companies and provide the answers to those questions, as well as earnings' forecasts and valuations, in their reports. They're available at www.securities.co.za to all clients of Online Share Trading. ¤

QUIZ

EACH WEEK we'll publish three questions related to the week's content. At the end of the 12 weeks Online Share Trading will give R10 000 worth of Satrix shares in an online account to the reader who has correctly answered each week's questions.

To take part in the draw just answer the following questions and submit your answers either online to SBquizz@finweek.co.za or by fax to (011) 884-0851.

1. What is the term applied to the style of fundamental analysis that looks first at macroeconomic variables, then at the industry and finally at the individual shares?
2. What economic model, developed by Michael Porter, looks at the factors that cause competition for companies?
3. What are CPI and CPIX in South Africa? ¤

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