

Financial Analysis: A User Approach

Chapter 1

Financial Analysis is the use of financial and other information to form judgments leading to decisions.

Examples of Decisions:

- Continue or discontinue its main operation or part of its business
- Make or purchase certain materials in the manufacture of its product
- Acquire or rent/lease certain machineries and equipments in the production of its goods
- Issue stocks or negotiate for a bank loan to increase its working capital
- Make decisions regarding investing or lending capital

Our focus:

- Credit decisions
- Equity investments decisions (including M&A)

Basic Process:

1. Identify purpose of analysis
2. Understand and document an overview of the company
3. Perform quantitative financial analysis
4. Perform detailed accounting analysis
5. Summarize and document the overview, quantitative, and accounting analysis
6. Present a recommendation based on your work

Step 1 – Identify the Purpose of Your Analysis

- The purpose will dictate the components and depth of your analysis
- Financial and other information will be the focus of your work regardless of your purpose
- Example – Lending Decision

Step 2 – Company Overview

Two components:

- Industry Analysis
- Business Strategy

Industry Analysis

- Identify Industry for Subject Company
- Industry Classification Systems
 - Standard Industrial Classification (SIC) codes
 - North American Industry Classification System (NAICS) codes
 - Other systems:
 - Fortune 500
 - Standard & Poor's
 - Many other proprietary systems
- Challenges in Assigning a Company to an Industry
 - Emerging Industries
 - Differential Growth of Business Segments
 - Large, Complex, Consolidated Businesses

- Example – Seagate Technology (STX)
 - SIC Code – 3572
 - Manufacturing (3)
 - Industrial Machinery and Equipment (35)
 - Computers and Office Equipment (357)
 - Computer Storage Devices (3572)
 - NAICS Code – 334112
 - Manufacturing (33)
 - Computer and Electronic Product Manufacturing (334)
 - Computer and Peripheral Equipment Manufacturing (3341)
 - Computer and Peripheral Equipment Manufacturing (33411)
 - Computer Storage Device Manufacturing (334112)
 - Other Industry Companies
 - Western Digital
 - Iomega
 - Quantum
 - Sandisk
 - EMC

Sources of Industry Analysis

- Analysts Reports (Investext)
- Hoovers

Business Strategy

Factors That Describe Business Strategy

- Cost Leadership
 - Potential economies of scale
 - Efficient production methods
 - Low input prices (vertical integration for example)
- Product Differentiation
 - Commodity vs. Specialty
 - Availability of substitute goods
- Core Competencies
 - Typically industry specific

Example – Seagate

SWOT Analysis

| Seagate Technology, SWOT Analysis | |
|---------------------------------------|---|
| Strengths | Weaknesses |
| Market Leadership | Single Business Line |
| Increased Revenues | Dependence on Small Number of Suppliers |
| Balanced Revenues Across Geographies | |
| Opportunities | Threats |
| Growing Demand for HDDs | Highly Competitive Market |
| Increasing Sales of PCs | Volatile Market |
| NBC Chooses Seagate for 2008 Olympics | Rapid Changes in Technology |

Step 3 – Quantitative Financial Analysis

Basic input – company financial statements

Techniques:

- Standardization
 - Common size financial statements
 - Ratio analysis
- Trend Analysis
- Cross Sectional Analysis

Step 4 – Detailed Accounting Analysis

Examining Financial Information to Determine

- Accounting Policy Choices (Footnote #1)
- Management's Discussion and Analysis (MD&A)
- Recurring vs. Nonrecurring Items
- Off-Balance Sheet Obligations
- Earnings Management
 - Discretionary
 - Non-Discretionary

Step 5 – Comprehensive Analysis

- Summary of the Previous Analysis
- Red Flags
- Green Flags
- Executive Summary

Step 6 – Financial Analysis Decision

- Driven by the Purpose