Analyzing Business Models

*(Kindly note, we have provided a bonus example of **Asian Paints Ltd** along with some key performance indicators of all the three companies towards the end of this document)*

Investing in a Business: When you invest in a stock, you become a part-owner of the business. Would you ever put money in a business that you don't understand? Understanding businesses thoroughly and investing in only those businesses that you understand is the cornerstone of value investing.

Analysis of Business Models: When we study a company, we start by analyzing its business model and the industry structure. A company's business model is a description of how a company operates within an industry/ economy and creates value for its shareholders. Porter's Five Forces is a very powerful framework that can help you analyze a company's business model and the overall industry dynamics.

Porter's Five Forces- Basics: Firms in an industry compete for profits. Competition is not limited to direct competitors alone. Factors such as potential new entrants, customers, suppliers and substitute products also impact an industry's profitability. An analysis of Porter's Five Forces gives us a solid understanding of a company's business model, the industry structure and the long term profitability.

Porter's Five Forces- Benefits:

- ✓ Helps analyze a company's business in the context of the industry in which it operates
- ✓ Helps filter away short term market trends and understand root factors that affect long term profitability of firms in an industry
- ✓ Helps understand why some sectors command premium valuations while others do not

Porter's Five Forces:

1. **Threat of New Entrants:** The barriers to entry determine how likely it is that new firms will enter the market. The threat of new entrants determines how long high profitability in an industry can last. If a company is making high profits, this will attract other firms into the market, ultimately driving profits lower. Factors such as high fixed costs, distribution network, network effects, use of patented technologies, brand loyalty, government regulations, etc. tell us how easy it is for new firms to enter the market.

2. **Bargaining Power of Customers:** The bargaining power between a firm and its customers can affect the company's profit margins. In particular, if buyers are concentrated (i.e. a small number of buyers), they are likely to have considerable bargaining power. Other factors include how easy it is for buyers to switch suppliers, whether buyers are price sensitive, whether they can afford not to buy temporarily, and how dependent the firm is on individual customers.

3. **Bargaining Power of Suppliers:** The bargaining power between a firm and its suppliers also significantly impacts the company's profitability. The concept is similar to the analysis of the bargaining power of customers; the difference is that the company is a customer of its inputs. If there are a small number of suppliers, then they will hold considerable bargaining power. Also important is how easy it is for the firm to switch inputs and suppliers; the harder it is to so, the more bargaining power the supplier has.

4. **Threat of Substitutes:** A company faces competition from not just other firms in the same industry but also firms from other industries that have products that offer the same benefits as the company's products. The threat of substitute products determines whether profit margins can remain high over long periods of time. The more likely a customer is to switch to a substitute product, the lower the company has to keep its prices (and thus profit margins) to attract the customer. If profit margins are low, it is more difficult for a company to withstand external shocks; e.g. a rise in the price of its inputs.

5. **Competitive Rivalry:** Competitive rivalry looks at the way in which companies compete with each other within the industry. If companies compete heavily on price, this is likely to keep profit margins low; this occurs primarily when the companies' products are very similar. Competitive rivalry is low if there is differentiation between products and brand loyalty is significant. Competitive rivalry is also low if exit barriers are low and vice versa.

Applying Porter's Five Forces: We have selected two companies, Arvind Ltd and Nestle India Ltd, due to their distinctly different profiling as per Porter's Five Forces model. The analysis is performed as of June 2013. Many of the facts come from company websites, annual reports, data providers, etc.

Arvind Ltd

- World's fourth largest denim manufacturer.
- India's largest denim exporter.
- Annual capacity: 110 m metres of denim and over 72 m metres of shirting fabric.
- Vertical integration in garments, strong brand franchise and a wide distribution network in branded apparels has placed the company in a strong position in domestic as well as global markets.
- Well-known in-house brands like Flying Machine, Excalibur, Newport University and Ruggers.
- Licensed brands such as Geoffrey Beene, Cherokee, Elle, US Polo Association, Arrow, Izod, Energie, and Gant.
- Master franchisee of Tommy Hilfiger through a joint venture (JV).
- Business-to-business clients include brands such as Miss Sixty, Diesel, Gap and Zara for denim.

Despite having a leadership position in the denim industry, company has failed to create value for shareholders. Once a large cap stock, Arvind Ltd was part of the BSE-Sensex from 1996 to 1998. However, company has consistently lost value and today is a mid cap stock. Porter's

analysis helps understand how the adverse dynamics of the textile industry have impacted the company's long term profitability.

Arvind Ltd - Porter's Five Forces

1. **Threat of New Entrants - Very high**

- Denim is a highly commoditised product and does not require a lot of capital investment. It is easy for any new player to enter the market and take away market share from existing players.

- Even in apparel retailing, threat of new entrants is high on account of numerous Indian and global brands entering the market across all price points.

2. **Bargaining Power of Customers - High**

- Given that there are several players in the denim space starting from those vending unbranded, low priced ones and going up to higher priced branded ones, the bargaining power of customers is especially high in the mid-market segment, where Arvind operates.

3. **Bargaining Power of Suppliers - High**

- Cotton and power costs put together comprise nearly 40% of Arvind's manufacturing expenses. The volatility in the prices of cotton due to shortage in global markets has made the bargaining power of suppliers very high. Also, the bargaining power of the foreign licensee companies is very high.

4. **Threat of Substitutes - Very High**

- Most other fabrics can act as substitute for denim.
- Demand for denim tends to move as per fashion trends in global markets.

5. **Competitive Rivalry - High**

- There exists a huge unorganized market for both denim and shirting in India.
- In each of the product segments, there exist other players that compete in both the premium end space as well as in the economy space.
- An apparel manufacturer without strong brand recall amongst customers and a strong retail franchise has very little pricing power.

Nestle India Ltd

- Indian arm of Swiss MNC Nestle S.A.
- Largest food company in India.
- Third largest FMCG company in India.
- Leader in branded processed foods.
- Commands a large market share in products such as instant coffee, weaning foods, instant foods, milk products.

Nestle India has been among the best shareholder wealth creators with over 2300% returns in 18 years (19% CAGR). Low capex model with excellent return on capital. For nearly two decades, Nestle has paid out on average 76 out of every 100 rupees of net profits as dividends to shareholders. How has the company managed to do this? Porter's Analysis provides some useful insights...

Nestle India - Porter's Five Forces

1. Threat of New Entrants - Low

- Although launching a product is relatively easier, making it a success is based on establishing its brand presence.
- The brand equity is built over a period of time through promotions that develop a brand recall and a robust distribution network to ensure availability.
- Nestle with its 100 years presence and powerful brands, enjoys a definitive advantage over entrants.

2. Bargaining Power of Customers - Moderate

- In mass segments where volumes play a major role, customers enjoy bargaining power.
- Customers also benefit in well penetrated and mature product categories that are relatively more price sensitive.
- Barring instant noodles, majority of the company's products are in the premium categories.
- As such, the bargaining power of customers is moderate.

3. Bargaining Power of Suppliers - Low

- Since there are no major suppliers of inputs, they do not have considerable clout and hence have low bargaining power.

4. Threat of Substitutes - Low

- Most of the food products do have readily available substitutes but it is difficult to rid people of their deep rooted habits.
- Those who prefer coffee over tea or instant noodles over any other snack will seldom give up their preferences.
- Threat of substitutes, therefore, is low for company's products.

5. Competitive Rivalry - Low

- The competitive rivalry is low in all product categories such as noodles, chocolates and milk & milk products.
- This is borne by the company's dominant market share in most of the categories it is present in.
- In instant noodles, it enjoys a market share of about 80%.
- Nestle is also the market leader in other categories like baby food, instant coffee and milk products.
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Bonus Example:

Asian Paints Ltd

- Founded in 1942, market leader in paints since 1968.
- India's largest paint company and Asia's third largest.
- Nearly 4 times the size (in terms of FY13 sales and net profits) of its biggest competitor in India.
- Manufactures a wide range of paints for decorative and industrial use.
- Operates in 17 countries, has 24 paint manufacturing facilities and services consumers in over 65 countries.
- Driven by its strong consumer-focus and innovative strategies, it has several strong brands and has consistently pioneered new concepts in the industry.

Asian Paints ranks among leading shareholder wealth creators with over 3300% returns over 18 years (22% CAGR).It was included in Forbes Asia's 'Fab 50' list of Companies in Asia Pacific in 2011 and 2012. It has a low capex model with excellent return on capital. Over last 12 years, Asian Paints has paid out on average 45 out of every 100 rupees of net profits as dividends to shareholders. How has the company managed to do? Porter's Analysis provides some useful insights...

Asian Paints - Porter's Five Forces

1. Threat of New Entrants - Moderate

- Since there are no major regulatory hurdles and relatively low fixed costs, starting the business is easy.
- However, scale, reach and brand are major barriers to entry.
- Also, there is some element of technology involved in industrial paint segment which may act as a barrier.

2. Bargaining Power of Customers - Low

- Asian Paints is the largest player in the decorative segment. Since individuals are typical customers here, they lack bargaining power.
- However, in the industrial segment, the customers have high bargaining power since they buy in bulk.
- The company has strong presence in the decorative segment. Hence, bargaining power of customers could be deemed as low.

3. Bargaining Power of Suppliers - High

- Major raw material inputs include crude-based derivatives and certain solvents.
- Crude prices move based on global demand-supply dynamics.
- Availability of titanium dioxide is also scarce.
- Hence, bargaining power of suppliers is high.

4. Threat of Substitutes - Low

- The use of limestone as a substitute is limited to rural markets.
- In urban markets there is no real substitute to paint.
- As such, the threat a substitutes is virtually absent.

5. Competitive Rivalry - Moderate

- There is stiff competition in organized market since there are many players.
- Advertising and distribution are the key to attract customers as there is minimal product differentiation.
- Asian Paints has certain advantages because it is the largest player and also has the biggest distribution network.

- But margins are not very lucrative and hence, the competitive rivalry can be termed as moderate.

Key Performance Indicators- 10 years

Arvind Ltd.

(Consolidated)	Mar-04	Mar-05	Mar-06	Mar-07	Mar-08	Mar-09	Mar-10	Mar-11	Mar-12	Mar-13
Net Profit margin (%)	5.3	5.5	3.8	5.7	0.7	-4.0	1.6	4.0	8.7	4.6
Return on Equity (%)	9.8	10.1	6.3	9.2	1.5	-9.6	4.9	12.8	27.9	13.4
Dividend Payout ratio (%)	0.0	17.2	25.5	0.0	0.0	0.0	0.0	0.0	5.8	17.1
Total Debt to Equity ratio (times)	1.5	1.6	1.4	1.6	1.7	2.3	1.8	1.6	1.2	1.2

Nestle India Ltd.

(Standalone)	Dec-03	Dec-04	Dec-05	Dec-06	Dec-07	Dec-08	Dec-09	Dec-10	Dec-11	Dec-12
Net Profit margin (%)	11.5	10.6	11.7	10.7	11.3	11.9	12.5	12.8	12.5	12.4
Return on Equity (%)	84.3	77.0	91.9	84.8	102.5	119.8	124.2	114.0	90.3	69.5
Dividend Payout ratio (%)	73.3	93.8	77.9	78.0	76.9	76.7	71.4	57.1	48.6	43.8
Total Debt to Equity ratio (times)	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.8	0.6

Asian Paints Ltd.

(Consolidated)	Mar-04	Mar-05	Mar-06	Mar-07	Mar-08	Mar-09	Mar-10	Mar-11	Mar-12	Mar-13
Net Profit margin (%)	5.5	6.2	6.1	6.9	8.7	6.9	12.4	10.1	9.4	9.2
Return on Equity (%)	28.7	33.0	34.7	39.8	48.6	38.4	60.7	45.2	41.4	37.8
Dividend Payout ratio (%)	56.3	52.3	56.5	44.4	39.9	42.2	31.0	36.4	38.8	39.6
Total Debt to Equity ratio (times)	0.3	0.4	0.4	0.4	0.3	0.3	0.1	0.1	0.1	0.1

Data Source: Ace Equity

Important note: The financial ratios shown above will be explained in Module 2

Conclusion: Understanding businesses is fundamental to value investing. Porter's five forces is a powerful framework to analyze business models & industry structures. The five forces are: Threat of New Entrants, Bargaining Power of Customers, Bargaining Power of Suppliers, Threat of Substitutes, and Competitive Rivalry. How companies rank on the five forces impacts long term profitability and shareholder returns.

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