CFA LEARNING OUTCOMES DECODED

In our series *Learning Outcomes Decoded* we break down a single Learning Outcome Statement (LOS) from the CFA level 1 curriculum. This article is written by Dave Kaczorowski, CFA. Dave is the Content Manager of the CFA team at The Princeton Review and teacher of the live online review sessions. He is a professor of finance at the University of San Francisco.

EQUITY INVESTMENTS:
INTRODUCTION TO INDUSTRY AND COMPANY ANALYSIS

LOS: Describe the principles of strategic analysis of an industry

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This LOS is grouped with three others in the reading that cover industry analysis, barriers to entry and industry concentration, and company lifecycle. The main body of this LOS is Porter's Five Forces, a popular framework for determining the competitive position of a company. The curriculum suggests that exam questions test this LOS in combination with the connected LOSes rather than as a standalone concept.

Strategic analysis

Strategic analysis is the evaluation of a company's corporate strategy in the context of its competitive environment. The analysis varies widely based on the structural attributes of the industry where the company operates. An attractive return on capital may be a very different number in a mature and highly competitive industry compared with one with high differentiation or high barriers to entry. An analyst should understand not only the current state of the industry but also how it could change in the future.

Porter's Five Forces

The Porter's Five Forces framework suggests that the success of a company is determined by its relationships with five different groups with whom it does business. The main question addressed by the framework is how the situation can be expected to change in the event of a price increase, either by the subject company or by the partner. One way to remember how the parts fit together is to regard the company's place in the value chain by looking forward, backward, or sideways:

Bargaining power of customers (forward)—Participants who buy from the subject company.

- Price elasticity—What will customers do if the company raises prices? Are they likely to swallow the increase or look for another way to fill their needs? Switching cost is a factor, as is the number of customers in the market.

Bargaining power of suppliers (backward)—Participants who sell to the subject company.

- Price elasticity—This approaches elasticity from the other side, with the subject company as a customer. Can the company find the same products elsewhere if the supplier raises prices, or is it stuck with the increase? Switching costs and customer concentration are issues here as well.

Rivalry (sideways)—Competitors who share the market with the subject company.

- Market share dynamics—If the subject company raises prices, how likely are competitors to do the same? If the competitors keep their prices low, can they take customers away? If a competitor raises or lowers prices, how will customers react and how should the subject company respond?

Threat of substitutes (sideways)—Vendors who offer something else that fills the same need.

- How similar are the subject company's products to those of other industries? Are the substitute products more cost effective? Switching costs for the customer are involved here as well.

Threat of new entrants (sideways)—Competitors that may exist in the market in the future.

- Barriers to entry—How easy/difficult is entry into the market by a new or adjacent company? New entrants are more inclined to enter a market with high prices/profit margins.

Other LOSes in the text list factors that impact these dynamics such as industry concentration, capacity, price competition, market share stability, and life cycle stage. Like the rest of the framework, the focus of the analysis is how these factors impact the ability of the company to raise its prices over time.

CORPORATE ISSUERS:
INTRODUCTION TO CORPORATE GOVERNANCE AND OTHER ESG CONSIDERATIONS

LOS: Describe a company's stakeholder groups and compare their interests

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PRACTICE QUESTION

An equity analyst is following two industries with the following characteristics:

> **Cement:** The industry has a large number of competitors with similar products. Sales are highly sensitive to the business cycle. Regulatory influence is minimal.
>
> **Pharmaceuticals:** The industry is growing fast and projected to continue to do so. The industry only has a small number of competitors. The technology behind the product is patent protected, and products have unique features.

The analyst will *least likely* conclude that compared with the cement industry, the pharmaceutical industry has:

A. High economic profits

B. Low customer bargaining power

C. Intense rivalry

C is correct. A high-growth industry is less likely to be highly competitive since all companies are delivering results and are unlikely to try to steal market share. Both answer choices A and B are hallmarks of companies with high growth, highly barriers to entry, and high differentiation.