Chapter 10B: Advanced Investing – Understanding Business

This lesson covers the key success factors for a business and elements of a business plan and financial statements. This can be useful both for stock investors who want to understand the businesses they invest in, and for those who are or plan to be self-employed or set up their own business.

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A successful business plan should provide a satisfactory answer to the question: is there demand for the product that is or will be provided, and does the business have the capacity to successfully meet this demand?

While each business is different, here are 5 fundamental areas that are critical for any enterprise:

1. **MARKET**: is there and will there be in future sufficient demand for this product? For existing products, what is the current level of demand and what factors are likely to influence it in future, for example demographic trends, social habits, technological changes, etc. How will prices be affected by these trends? For new products, do they meet a fundamental need and will they be able to reach consumers?

2. **COMPETITION**: is the company in a good position to meet the demand? Does it have some competitive advantage vis-à-vis existing or potential rivals, for example through superior technology, strong management, established brands or distribution channels, unique access to raw materials, etc.? It's hard to be a leader in all areas, but all of these aspects are important and you need to have advantage in at least some of them. This means you need to know who the main competitors are and understand their strengths and weaknesses vis-à-vis your own company.

3. **MANAGEMENT & HUMAN RESOURCES**: people are the key success factors in any enterprise. This does not necessarily mean a visionary CEO, though they can be useful too, but it does mean: (a) a capable and dedicated management team pursuing the long-term interests of the firm, (b) qualified technicians, engineers and researchers; and (c) a skilled and motivated workforce. Many companies talk about the importance of human resources, but you should check what happens on the ground: for example, does management compensation reward long-term performance, how high is staff turnover, does the company provide good career prospects and invest in training and continuing education, etc.

4. **PRODUCTION & TECHNOLOGY**: does the company have the capacity to produce the goods or deliver the services targeted? For existing products and technologies, this is easier to assess but should not be taken for granted: check whether the company and its employees have a track record in making this product, and whether they use state-of-the-art technology? For new products or technologies, have there been successful trials or similar experiments? You may want to seek expert guidance to assess the likelihood of success and prepare plans for various contingencies.

5. **FINANCE**: does the company have sufficient capital to undertake the investments needed and carry out its business plan? The investment needs should take into account not only fixed assets like land, buildings, and

equipment, but also working capital, i.e., the need to carry inventories and extend payment terms to buyers. Investment needs also include intangible assets like research and development or brand building, which can take a long time to bear fruit. Investment capital can be provided in form of equity and debt: while equity is long-term capital that assumes the risk of the business, debt needs to be repaid. But adding debt can relieve the financing burden on shareholders and generate tax benefits.

You may be surprised to find finance at the end of this list. All 5 factors are critically important. Finance may not be the primordial success factor, as no amount of financial wizardry can make up for weak demand or uncompetitive products. But a good financing plan adds stability and resilience, while a badly conceived financing plan can scupper an otherwise successful business!

This brings us to the financial statements of a company. Underneath are the key elements of a profit and loss (also called income) statement and balance sheet of a company and what they mean:

I. PROFIT AND LOSS or INCOME STATEMENT: a statement listing the total revenues and costs of a business over a period of time (typically a quarter or year), leading to its net income or profit as the difference. It mainly consists of:

- **Revenue/Sales**: income generated from the sale of goods and services by the firm, before any expenses. Sales can be before or after sales or value added tax.
- **Cost of Goods Sold (COGS)**: direct costs of producing the goods or services sold, including materials and labor used for production. COGS excludes indirect expenses such as marketing and management
- **Gross Profit**: difference between revenue and COGS. It must be sufficient to cover general and overhead expenses and leave a net profit (bottom line) for the company

REVENUE – COST OF GOODS SOLD = GROSS PROFIT

- **General & Administrative (G&A)**: general or overhead expenses needed for running the company and which cannot be readily attributed to a particular product or division; includes things like office rent, HR departments, management salaries, etc.
- **Depreciation**: decrease in the value of a capital asset due to wear and tear. In accounting, a capital good is recorded at its purchase price; every year, its value diminishes by a factor depending on the expected life of the asset; this depreciation is charged as a cost (though not a cash outflow) in the income statement and a corresponding reduction in the asset value in the balance sheet
- **Finance charges**: interest expenses incurred by the company. Businesses can also generate interest income if they invest in savings accounts or fixed-income securities; net finance charges are the difference between interest costs and revenues
- **Extraordinary items**: gains or losses from events that are unusual or infrequent, for example from sale of a division
- **Tax**: income tax due by the business, generally a percentage of pre-tax profits, though there are many detailed tax rules including special rates, exemptions, allowances, etc.
- **Net income**: profit after tax or the bottom line! It's the money the company earned over the period and that belongs to its shareholders.

GROSS PROFIT – G&A – DEPRECIATION – FINANCE CHARGES – TAX = NET INCOME

Net income can be allocated for two purposes

- **Dividends:** the part of net income that is distributed to shareholders
- **Retained earnings**: the balance kept in the company and added to shareholders' equity; it is available for future use in investments, acquisitions, etc.

NET INCOME = DIVIDEND + RETAINED EARNINGS

II. BALANCE SHEET: a statement listing the total assets (what it owns) and liabilities (what it owes) of a business at a particular point of time, leading to its net worth or shareholders' equity as the difference. The fundamental equation is:

ASSETS – LIABILITIES = NET WORTH (SHAREHOLDERS' EQUITY)

Assets consist of:

- **Fixed assets**: assets with a long life expectancy and planned for long-term use, such as land, buildings, and equipment. Assets are generally valued at their historical purchase price minus accumulated depreciation. This can differ substantially from current market or replacement value, for example when the equipment becomes obsolete because new and better methods of production appear
- **Intangible assets**: non-physical assets, for example intellectual property rights like patents, copyrights or trademarks
- **Current assets**: assets that are expected to be turned into cash over the next 12 months, such as inventories and receivables; receivables are amounts due by customers for products sold or services rendered that have not yet been paid

Liabilities consist of:

- **Current liabilities**: debts that are due to be paid over the next 12 months, including trade payables or maturing financial debt; payables are amounts due to vendors or suppliers of goods and services that have not yet been paid
- **Long-term debt**: debt that is due in more than 12 months' time, typically bank loans or long-term bonds; note that the portion of long-term debt maturing within the next 12 months is counted as short-term debt and included in current liabilities

Shareholders' equity or **net worth** is shown underneath liabilities on the same side of the balance sheet: it is the difference between the assets owned by the firm and the debt if owes. It consists of the share capital initially contributed by shareholders plus retained earnings that have been added over time.

Assets and liabilities are tied to the **investment** and **working capital cycle** of the business. Investment means acquiring long-lasting goods like factories or machinery that are expected to generate long-term benefits for the firm. It is generally financed by a mix of long-term debt and equity. Current assets and liabilities are tied to the working capital cycle: a typical business buys and stores raw materials for production or trading, paying on credit; transforms the raw materials and sells the finished goods against receivables; ships the goods, collects the accounts receivable, pays the accounts payable, and replenishes its inventory, thus continuing the cycle.

There are many ratios and indicators that financial analysts calculate based on the income statement and balance sheet of a company. Here are some of the more widely used:

- **Net profit margin**: net profits divided by revenues: measures the profitability of sales
- **Return on equity**: net profit divided by shareholders' equity: measures the return earned by shareholders on the equity capital they invest in the firm
- **Current ratio:** current assets divided by current liabilities: measures the ability of the firm to meets its short-term payment obligations

- **Debt/equity ratio**: total liabilities divided by shareholders' equity: measures the financial leverage or risk of the company
- **Cash flow:** net profit earned by the company after adding back non-cash charges such as depreciation: measures the actual cash earned by the company

You may leave in-depth financial analysis to experts, but the above figures can provide valuable insights. The main question is: are numbers indicative of a sound business performance and financial condition? It is important to ascertain not only whether profit margins are positive and financial ratios solid, but compare them (as far as possible) to industry peers and the company's past performance. Low or negative profits, weak cash flows, and high indebtedness are all warning signs—especially when they show a deteriorating trend or underperform other firms in the industry.

You should avoid drawing conclusions based on quarterly performance or a one-off balance sheet; but you should investigate any issues thrown up and ask relevant questions.

None of this is strictly necessary for successful investing, especially if you diversify widely and invest through mutual funds. But it is important for a general understanding of business and can help you hold your own in discussions, whether with investment professionals, colleagues at work, or business associates and partners.