Part 1: FRAMEWORK

Chapter 01:

A Framework for Business Analysis and Valuation Using Financial Statements

Discussion Questions

1. ***Qian, who has just completed his first finance course, is unsure whether he should take a course in business analysis and valuation using financial statements, because he believes that financial analysis adds little value, given the efficiency of capital markets. Explain to Qian when financial analysis can add value, even if capital markets are efficient.***

The efficient market hypothesis states that security prices reflect all available information, as if such information could be costlessly digested and translated immediately into demands for buys or sells. The efficient market hypothesis implies that there is no further need for analysis involving a search for mispriced securities.

However, if all investors adopted this attitude, no equity analysis would be conducted, mispricing would go uncorrected, and markets would no longer be efficient. This is why there must be just enough mispricing to provide incentives for the investment of resources in security analysis.

Even in an extremely efficient market, where information is fully impounded in prices within minutes of its revelation (i.e., where mispricing exists only for minutes), John can get rewards with strong financial analysis skills:

1. John can interpret the newly announced financial data *faster* than others and trade on it within minutes; and
2. Financial analysis helps John to understand the firm better, placing him in a better position to interpret other news *more accurately* as it arrives.

Markets may be not efficient under certain circumstances. Mispricing of securities may exist days or even months after the public revelation of a financial statement when the following three conditions are satisfied:

1. relative to investors, managers have superior information on their firms’ business strategies and operation;
2. managers’ incentives are not perfectly aligned with all shareholders’ interests; and
3. accounting rules and auditing are imperfect.

When these conditions are met in reality, John could get profit by using trading strategies designed to exploit any systematic ways in which the publicly available data are ignored or discounted in the price-setting process.

Capital in market efficiency is not relevant in some areas. John can get benefits by using financial analysis skills in those areas. For example, he can assess how much value can be created through the acquisition of a target company, estimate the share price of a company considering initial public offering, and predict the likelihood of a firm's future financial distress.

2. Accounting statements rarely report financial performance without error. List three types of errors that can arise in financial reporting.

Three types of potential errors in financial reporting include:

1. error introduced by rigidity in accounting rules;
2. random forecast errors; and
3. systematic reporting choices made by corporate managers to achieve specific objectives.

Accounting Rules. Uniform accounting standards may introduce errors because they restrict management discretion of accounting choice, limiting the opportunity for managers' superior knowledge to be represented through accounting choice. For example, SFAS No. 2 requires firms to expense all research and development expenditures when they are occurred. Note that some research expenditures have future economic value (thus, to be capitalised) while others do not (thus, to be expensed). SFAS No. 2 does not allow managers, who know the firm better than outsiders, to distinguish between the two types of expenditures. Uniform accounting rules may restrict managers' discretion, forgo the opportunity to portray the economic reality of firm better and, thus, result in errors.

Forecast Errors. Random forecast errors may arise because managers cannot predict future consequences of current transactions perfectly. For example, when a firm sells products on credit, managers make an estimate of the proportion of receivables that will not be collected (allowance for doubtful accounts). Because managers do not have perfect foresight, actual defaults are likely to be different from estimated customer defaults, leading to a forecast error.

Managers' Accounting Choices. Managers may introduce errors into financial reporting through their own accounting decisions. Managers have many incentives to exercise their accounting discretion to achieve certain objectives, leading to systematic influences on their firms' reporting. For example, many top managers receive bonus compensation if they exceed certain prespecified profit targets. This provides motivation for managers to choose accounting policies and estimates to maximise their expected compensation.

3. Joe Smith argues that 'learning how to do business analysis and valuation using financial statements is not very useful, unless you are interested in becoming a financial analyst'. Comment.

Business analysis and valuation skills are useful not only for financial analysts but also for corporate managers and loan officers. Business analysis and valuation skills help corporate managers in several ways. First, by using business analysis for equity security valuation, corporate managers can assess whether the firm is properly valued by investors. With superior information on a firm's strategies, corporate managers can perform their own equity security analysis and compare their estimated 'fundamental value' of the firm with the current market price of share. If the firm is not properly valued by outside investors, corporate managers can help investors to understand the firm's business strategy, accounting policies, and expected future performance, thereby ensuring that the share price is not seriously undervalued.

Second, using business analysis for mergers and acquisitions, corporate managers (acquiring management) can identify a potential takeover target and assess how much value can be created through acquisition. Using business analysis, target management can also examine whether the acquirer's offer is a reasonable one.

Loan officers can also benefit from business analysis, using it to assess the borrowing firm's liquidity, solvency, and business risks. Business analysis techniques help loan officers to predict the likelihood of a borrowing firm's financial distress. Commercial bankers with business analysis skills can examine whether or not to extend a loan to the borrowing firm, how the loan should be structured, and how it should be priced.

4. Four steps for business analysis are discussed in this chapter (strategy analysis, accounting analysis, financial analysis, and prospective analysis). As a financial analyst, explain why each of these steps is a critical part of your job, and how they relate to one another.

Managers have better information on a firm's strategies relative to the information that outside financial analysts have. Superior financial analysts attempt to discover 'inside information' from analysing financial statements. The four steps for business analysis help outside analysts to gain valuable insights about the firm's current performance and future prospects.

1. Business strategy analysis is an essential first step because it enables the analysts to frame the subsequent accounting, financial, and prospective analysis better. For example, identifying the key success factors and key business risks allows the identification of key accounting policies. Assessment of a firm's competitive strategy facilitates evaluating whether current profitability is sustainable. Finally, business strategy analysis enables the analysts to make sound assumptions in forecasting a firm's future performance.

2. Accounting analysis enables the analysts to ‘undo’ any accounting distortion by recasting a firm’s accounting numbers. Sound accounting analysis improves the reliability of conclusions from financial analysis.
3. The goal of financial analysis is to use financial data to evaluate the performance of a firm. The outcome from financial analysis is incorporated into prospective analysis, the next step in financial statement analysis.
4. Prospective analysis synthesises the insights from business strategy analysis, accounting analysis, and financial analysis in order to make predictions about a firm’s future.

5 Your brother, who works in a bank, has recommended to you that you purchase shares in an organisation, on the basis of the following information, which he has heard discussed around the office:

- ***Total assets have increased by 33 per cent.***
- ***Revenue has increased by 12 per cent.***
- ***Profit after tax has decreased by 4 per cent.***
- ***The dividend per share is 23c.***
- ***The current share price is $8.50, whereas 12 months ago it was $7.50.***

Would you invest in this organisation? What information encourages you to do so, and what reasons might you have for hesitating? What additional information would you like before making this decision, and where might you find that information?

There is not enough information provided to make the decision to invest in this organisation. The information provided can be classified as either ‘encouraging’ you to invest, or causing you to ‘hesitate’. Both types of information lead you to want more information before making a decision.

Information that encourages you to invest is the increase in revenues, and the increase in total assets, both of which point to a growing organisation. This is supported by the fact that the share price has increased compared to last year.

Information that encourages you to hesitate is the decrease in profit, and the low dividend (the yield, or dividend as a percentage of share price, is 2.7%).

Additional questions that you might ask are:

- How reliable is the information provided by your brother? You might seek to verify information that has been ‘passed around the office’.
- Why have the organisation’s expenses increased at a faster rate than revenues, which must be the case if the profit has fallen but revenues have increased?
- How was the increase in assets financed?
- What was the previous dividend? Its change from the previous level indicates management’s confidence in the future of the organisation. What are the dividends of comparable firms?

- What has been the general movement in share prices in the economy and in the industry? What industry does this organisation belong to?
- What has been the performance of comparable organisations?

There are many more questions that could be asked. These are just the starting point, based on the information provided.

The sources of the answers to these (and other) questions are the organisation's annual report, the stock exchange on which the organisation is listed, the organisation's website, and commercial providers of financial information.

Part 2: BUSINESS ANALYSIS AND VALUATION TOOLS

Chapter 02:
Strategy Analysis

Discussion Questions

1. Julie, an accounting major, states, 'Strategy analysis seems to be an unnecessary detour in doing financial statement analysis. Why can't we just get straight to the accounting issues?' Explain to Julie why she may be wrong.

Strategy analysis enables the analyst to understand the underlying economics of the firm and the industry in which the firm competes. There are a number of benefits to developing this knowledge before performing any financial statement analysis.

1. *Strategy understanding* provides a context for evaluating a firm's choice of accounting policies and hence the information reflected in its financial statements. For example, accounting policies (such as revenue recognition and cost capitalisation) can differ across firms either because of differences in business economics or because of differences in management's financial reporting incentives. Only by understanding differences in firms' business strategies is it possible to assess how much to rely on a firm's accounting information.

2. *Strategy analysis* highlights the firm's profit drivers and major areas of risk. An analyst can then use this information to evaluate current firm performance and to assess the firm's likelihood of maintaining or changing this performance based on its business strategy.

3. *Strategy analysis* also makes it possible to understand a firm's financial policies and whether they make sense. As discussed later in the book, the firm's business economics is an important driver of its capital structure and dividend policy decisions.

In summary, understanding a firm's business, the factors that are critical to the success of that business, and its key risks is critical to effective financial statement analysis.

2. What are the critical drivers of industry profitability?

Rivalry Among Existing Firms. The greater the degree of competition among firms in an industry, the lower average profitability is likely to be. The factors that influence existing firm rivalry are industry growth rate, concentration and balance of competitors, degree of differentiation and switching costs, scale/learning economies and the ratio of fixed to variable costs, and excess capacity and exit barriers.

Threat of New Entrants. The threat of new entry can force firms to set prices to keep industry profits low. The threat of new entry can be mitigated by economies of scale, first mover advantages to incumbents, greater access to channels of distribution and existing customer relationships, and legal barriers to entry.

Threat of Substitute Products. The threat of substitute products can force firms to set lower prices, reducing industry profitability. The importance of substitutes will depend on the price sensitivity of buyers and the degree of substitutability among the products.

Bargaining Power of Buyers. The greater the bargaining power of buyers, the lower the industry's profitability. Bargaining power of buyers will be determined by the buyers' price sensitivity and their importance to the individual firm. As the volume of purchases of a single buyer increases, its bargaining power with the supplier increases.

Bargaining Power of Suppliers. The greater the bargaining power of suppliers, the lower the industry's profitability. Suppliers' bargaining ability increases as the number of suppliers declines when there are few substitutes available.

3. ***One of the fastest growing industries in the last twenty years is the memory chip industry, which supplies memory chips for personal computers and other electronic devices. Yet the average profitability for this industry has been very low. Using the industry analysis framework, list all the potential factors that might explain this apparent contradiction.***

Concentration and Balance of Competitors. The concentration of the memory chip market is relatively low. There are many players that compete on a global basis, none of which has a dominant share of the market. Due to this high degree of fragmentation, price wars are frequent as individual firms lower prices to gain market share.

Degree of Differentiation and Switching Costs. In general, memory chips are a commodity product characterised by little product differentiation. While some product differentiation occurs as chip makers squeeze more memory on a single chip or design specific memory chips to meet manufacturers' specific power and/or size requirements, these differences are typically short-lived and have not significantly reduced the level of competition within the industry. Furthermore, because memory chips are typically interchangeable, switching costs for users of memory chips (computer assemblers and computer owners) encouraging buyers to look for the lowest price for memory chips.

Scale/Learning Economies and the Ratio of Fixed to Variable Costs. Scale and learning economies are both important to the memory chip market. Memory chip production requires significant investment in 'clean' production environments. Consequently, it is less expensive to build larger manufacturing facilities than to build additional ones to satisfy additional demand. Moreover, the yield of acceptable chips goes up as employees learn the intricacies of the extremely complicated and sensitive manufacturing process. Finally, while investments in memory chip manufacturing plants are typically very high, the variable costs of materials and labor are relatively low, providing an incentive for manufacturers to reduce prices to fully utilise their plant's capacity.

Excess Capacity. Historically, memory chip plants tend to be built in waves, so that several plants will open at about the same time. Consequently, the industry is characterised by periods of significant excess capacity where manufacturers will cut prices to use their productive capacity (see above).

Threat of Substitute Products. There are several alternatives to memory chips including other information storage media (e.g., hard drives and disk drives) and memory management software that 'creates' additional memory through more efficient use of computer system resources.

Price Sensitivity. There are two main groups of buyers: computer manufacturers and computer owners. Faced with an undifferentiated product and low switching costs, buyers are very price sensitive.

All the above factors cause returns for memory chip manufacturers to be relatively low.

4. Rate the leisure and hospitality industry and the mining industry as high, medium, or low on the following dimensions of industry structure.

Mining firms historically have had relatively high rates of return, whereas hospitality and leisure firms have had relatively low returns. The following analysis reveals why.

	Hospitality and Leisure Industry	**Mining Industry**
Rivalry	*High*	*Low*
	Firms compete fiercely for market share. The affluence of the economy has increased access to this market for many consumers, encouraging a rapid increase in the number of firms.	Firms specialise in mining in a particular geographic area or areas, limiting rivalry. Demand and prices have been strong, with the result that the total market has grown and rivalry has not been high.
Threat of	*High*	*Medium*

New Entrants	Entry to this industry is often low cost, and it is not affected by much regulation. There is little advantage to a first mover, giving new entrants an equal chance with more established providers. Attempts have been made to reward loyalty, as a disincentive to new entrants.	Entry into the lumber industry requires access to mining leases, and capital.
Threat of Substitute Products	*High* There are many substitute product and services in this market.	*Low* Exploration is protected by leases, giving mining companies a monopoly in that region. .
Bargaining Power of Buyers	*Low* Historically, consumers have had little buying power.	*High* Many buyers are very large, including international companies and countries.
Bargaining Power of Suppliers	*Low* There are few suppliers, and most of them are not well organised.	*Not applicable.* Supplies of timber for lumber are limited. Owners of timberland can sell to any lumber mill.

5. Joe argues, 'Your analysis of the five forces that affect industry profitability is incomplete. For example, in the banking industry, I can think of at least three other factors that are also important--namely, government regulation, demographic trends, and cultural factors'. His classmate Jun disagrees and says, 'These three factors are important only to the extent that they influence one of the five forces'. Explain how, if at all, the three factors discussed by Joe affect the five forces in the banking industry.

Government regulation, demographic trends, and cultural factors will each impact the analysis of the banking industry. While these may be important, they can each be recast using the five forces framework to provide a deeper understanding of the industry. The power of the five forces framework is its ability to incorporate industry-specific characteristics into analysis for any industry. To see how government regulation, demographic trends, and cultural factors are important in the banking industry, we can apply the five forces framework as follows:

Rivalry Among Existing Firms. Government regulation has played a central role in promoting, maintaining, and limiting competition among banks. Banks are regulated at the federal and state levels. In the past, these regulations restricted banks from operating across state lines or even within different regions of the same state, and from paying market rates on deposits. The government also regulates the riskiness of a bank's portfolio in an effort to prevent banks from competing for new customers by taking on too many high-risk investments, loans, or other financial instruments. These regulations have limited the degree of competition among banks. However, recent deregulation of the industry has allowed banks to expand into new geographic areas and to pay market rates on deposits, increasing the level of competition.

Threat of New Entrants. Government regulations at both the federal and state levels have limited the entry of new players into the banking industry. New banks must meet the requirements set by regulators before they can begin operation. However, as noted above, deregulation of some aspects of banking has made it easier for out-of-state banks to enter new markets. Further, it appears to be relatively easy for non-banking companies to successfully set up financial services units (e.g., AT&T, GE, and General Motors). Finally, as consumers have become more comfortable with technology, 'Internet banks' have formed. These 'banks' provide the same services as traditional banks, but with a very different cost structure.

Threat of Substitute Products. The primary functions of banks are lending money and providing a place to invest money. Thrifts, credit unions, brokerage houses, mortgage companies, and the financing arms of companies, such as GMAC, provide potential substitutes for these functions. Government regulation of these entities varies dramatically, affecting how similar their products are to those of banks. In addition, with the expansion of IRA and 401(k) retirement savings accounts, consumers have been become increasingly familiar with non-bank options for investing money. As another example, some brokerage houses provide money market accounts that function as checking accounts. As a result, the threat of substitutes for bank services has grown over time.

Bargaining Power of Buyers. Business and consumer buyers of credit have little direct bargaining power over banks and financial institutions. The decline in relationship banking towards a transactions approach, where consumers seek the lowest-cost lender for each new loan, probably also reduces the buying power of customers.

Bargaining Power of Suppliers. Depositors have historically had little bargaining power.

In summary, bank regulations have historically had a very important role in determining bank profitability by restricting competition. However, recent deregulation in the industry as well as the emergence of non-bank substitutes has increased competition in the industry.

6. Coca-Cola and Pepsi are both very profitable soft drinks. Inputs for these products include corn syrup, bottles/cans, and soft drink syrup. Coca-Cola and Pepsi produce the syrup themselves and purchase the other inputs. They then enter into exclusive contracts with independent bottlers to produce their products. Use the five forces framework and your knowledge of the soft drink industry to explain how Coca-Cola and Pepsi are able to retain most of the profits in this industry.

While consumers perceive an intensely competitive relationship between Coke and Pepsi, these major players in the soft drink industry have structured their businesses to retain most of the profits in the industry by concentrating operations in its least competitive segments. Coke and Pepsi have segmented the soft drink industry into two industries—production of soft drink syrup and manufacturing/distribution of the soft drinks at the retail level. Moreover, they have chosen to operate primarily in the production of soft drink syrup, while leaving the independent bottlers with the more competitive segment of the industry.

Coca-Cola and Pepsi compete primarily on brand image rather than on price. They sell their syrup to independent bottlers who have exclusive contracts to distribute soft drinks and other company products within a specific geographic area. (While other syrup producers exist, they are typically regional and have very small shares of the market.) Given the large number of competing forms of containers for soft drinks (glass bottles, plastic bottles, aluminum cans, etc.), it is difficult for bottlers to earn any more than a normal return on their investment. Consequently, Coke and Pepsi can write exclusive contracts with bottlers prohibiting them from simultaneously bottling for a competitor. It is also difficult for independent bottlers to switch from Coke to Pepsi products, since there is likely to be an existing Pepsi bottler in the same geographic area. Consequently, independent bottlers have little bargaining power and Coke and Pepsi are able to charge them relatively high prices for syrup.

The threat of new entrants at the syrup level is restricted by limited access to adequate distribution channels and by the valuable brand names that have been created by both Coke and Pepsi. While soda syrup is relatively inexpensive and easy to make, a new syrup producer would have difficulty finding a distributor that could get its products to retail stores and placed in desirable shelf space. The high levels of advertising by Coke and Pepsi have created highly valued, universally recognised brands, which would be difficult for a potential competitor to replicate.

The main ingredients of syrup are sugar and flavouring, and the markets for these inputs are generally competitive. As a result, Coke and Pepsi exert considerable influence over their suppliers. For example, in the 1980s when corn syrup became a less-expensive sweetener than cane sugar, Coke and Pepsi switched to corn syrup. Thus, Coke and Pepsi are able to retain profits rather than pay them out to their suppliers.

The production and distribution of soft drinks at the retail level is likely to be less profitable than is syrup production for several reasons. First, despite tremendous amounts of advertising designed to create differentiated products, many people view sodas as being relatively similar and switching costs for consumers are very low, which makes it difficult to price one soft drink significantly higher than another. Second, there are a great number of substitutes for soft drinks, such as water, milk, juice, athletic drinks, etc., which consumers could switch to if the price of soda were to increase. Third, because of low switching costs, consumers can be price sensitive and also exercise relative bargaining power over independent bottlers. Finally, as discussed before, the structure of the relationship between Coke and Pepsi and the independent bottlers gives Coke and Pepsi greater bargaining power over the bottlers, further limiting the ability of independent bottlers to keep a larger share of their profits.

7. In the early 1980s and 1990s, many airline companies started frequent flier programs as a way to differentiate themselves in response to excess capacity in the industry. Many industry analysts, however, believe that this move had only mixed success. Use the competitive advantage concepts to explain why.

Initially, frequent flier programs had only limited success in creating differentiation among airlines. Airlines tried to bundle frequent flier mileage programs with regular airline transportation to increase customer loyalty and to create a differentiated product. Furthermore, the airlines anticipated that the programs would fill seats that would otherwise have been empty and would, so they believed, have had a low marginal cost. However, because the costs of implementing a program were low, there were very few barriers to other airlines starting their own frequent flier programs. Before long, every airline had a frequent flier program with roughly the same requirements for earning free air travel. Simply having a frequent flier program no longer differentiated airlines.

More recently, airlines have had some success in differentiating frequent flier programs by creating additional ways to earn frequent flier mileage and increasing the number of destinations covered. Airlines have developed ‘tie-ins’ with credit card companies, car rental companies, hotels, etc. to allow members of a particular frequent flier program more ways to earn frequent flier mileage. They have also reached agreements with foreign airlines so that frequent flier mileage can be redeemed for travel to locations not served by the carrier. Finally, the programs have provided additional services for their best customers, including special lines for check-in and better flight upgrade opportunities. As a result of these efforts, airline programs have been somewhat successful in increasing customer loyalty.

8. *What are the ways that an organisation can create barriers to entry to deter competition in its business? What factors determine whether these barriers are likely to be enduring?*

Barriers to entry allow a firm to earn profits while at the same time preventing other firms from entering the market. The primary sources of barriers to entry include economies of scale, absolute costs advantages, product differentiation advantages and government restrictions on entry of competitors. Firms can create these barriers through a variety of means.

1. A firm can engineer and design its products, processes and services to create economies of scale. Because of economies of scale, larger plants can produce goods at a lower cost that smaller plants. Hence, a firm considering entering the existing firm's market must be able to take advantage of the same scale economies or be forced to charge a higher price for its products and services.

2. Cost leaders have absolute cost advantages over rivals. Through the development of superior production techniques, investment in research and development, accumulation of greater operating experience or special access to raw materials, or exclusive contracts with distributors or suppliers, cost leaders operate at a lower cost than any potential new entrants to the market.

3. A firm can engineer and design its products, processes and services to create economies of scale. Because of economies of scale, larger plants can produce goods at a lower cost that smaller plants. Hence, a firm considering entering the existing firm's market must be able to take advantage of the same scale economies or be forced to charge a higher price for its products and services.

4. Differentiation of the firm's products and services may also help create barriers to entry for other firms. Firms often spend considerable resources to differentiate their products or services. Soft drink makers, for example, invest in advertising designed to differentiate their products from other products in the market. Other competitors that would like to enter the market will be forced to make similar investments in any new products.

5. Firms often try to persuade governments to impose entry restrictions through patents, regulations and licenses. AT&T fought with the government for many years to prevent other providers of long distance telephone service from entering the market. Similarly, the local Bell operating companies have lobbied the federal government to write laws to make it difficult for other firms to provide local phone service.

Several factors influence how long specific barriers to entry are effective at preventing the entry of competitors into an industry.

- Economies of scale depend on the size and growth of the market. If a market is growing quickly, a competitor could build a larger plant capable of producing at a cost lower than the incumbent. If a market is flat, there may not be enough demand to support additional production at the efficient scale, which forces new entrants to have higher costs.

- Absolute cost advantages depend on competitors' difficulty in designing better processes. Some processes receive legal protection from patents. Entrants must either wait for the patent to expire or bear the expense of trying to invest around the patent. Similarly, differentiation advantages last only so long as a firm continues to invest in differentiation and it is difficult for other firms to replicate the same differentiated product or service.
- Incumbent firms and potential entrants can both lobby the government. If potential entrants launch intensive lobbying and public interest campaigns, laws, regulations, and rules can change to ease entry into a once-protected industry. Several recent examples in the U.S. are deregulation of the airline, trucking, banking, and telecommunications industries.

9. Explain why you agree or disagree with each of the following statements:

a. It's better to be a differentiator than a cost leader, since you can then charge premium prices.

Disagree. While it is true that differentiators can charge higher prices compared to cost leaders, both strategies can be equally profitable. Differentiation is expensive to develop and maintain. It often requires significant company investment in research and development, engineering, training and marketing. Consequently, it is more expensive for companies to provide goods and services under a differentiated strategy. Thus, profitability of a firm using the differentiated strategy depends on being able to produce differentiated products or services at a cost lower than the premium price. On the other hand, the cost leadership strategy can be very profitable for companies. A cost leader will often be able to maintain larger margins and higher turnover than its nearest competitors. If a company's competitors have higher costs but match the cost leader's prices, the competitors will be forced to have lower margins. Competitors that choose to keep prices higher and maintain margins will lose market share. Hence, being a cost leader can be just as profitable as being a differentiator.

b. It's more profitable to be in a high-technology than a low- technology industry.

Disagree. There are highly profitable firms in both high technology and low technology industries. The argument presumes that high technology always creates barriers to entry. However, high technology is not always an effective entry barrier and can be associated with high levels of competition among existing firms, high threat of new entrants, substitute products and high bargaining power of buyers and/or sellers. For example, the personal computer industry is a high-technology business, yet is highly competitive. There are very low costs of entering the industry, little product differentiation in terms of quality, and two very powerful suppliers (Microsoft and Intel). Consequently, firms in the PC business typically struggle to earn a normal return on their capital. In contrast, Wal-Mart is a cost leader in a very low-tech industry, and is one of the most profitable companies in the US.

c. The reason why industries with large investments have high barriers to entry is because it is costly to raise capital.

Disagree. The cost of raising capital is generally related to risk of the project rather than the size of the project. As long as the risks of the project are understood, the costs of raising the necessary capital will be fairly priced. However, large investments can act as high entry barriers in several other ways. First, where large investments are necessary to achieve scale economies, if additional capacity will not be fully used, it may make it unprofitable for entrants to invest in new plant. Second, a new firm may be at an initial cost disadvantage as it begins to learn how to use the new assets in the most efficient manner. Third, existing firms may have excess capacity in reserve that they could use to flood the market if potential competitors attempt to enter the market.

10. There are very few companies that are able to be both cost leaders and differentiators. Why? Can you think of a company that has been successful at both?

Cost leadership and differentiation strategies typically require a different set of core competencies and a different value chain structure. Cost leadership depends on the firm's ability to capture economies of scale, scope, and learning in its operations. These economies are complemented by efficient production, simpler design, lower input costs, and more efficient organisational structures. Together, these core competencies allow the firm to be the low cost producer in the market. On the other hand, differentiation tends to be expensive. Firms differentiate their products and services through superior quality, variety, service, delivery, timing, image, appearance, or reputation. Firms achieve this differentiation through investment in research and development, engineering, training, or marketing. Thus, it is the rare firm that can provide differentiated products at the lowest cost. Companies that attempt to implement both strategies often do neither well, and as a result suffer in the marketplace. Differentiation exerts upward pressure on firm costs, while one of the easiest sources of cost reduction is reducing product or service complexity, which leads to less differentiation.

Home Depot, a lumber, hardware and home improvement company, is one example of a company that has been successful as both a cost leader and a differentiator. Home Depot operates hardware and lumber superstores that focus on do-it-yourself home improvement. While they stock tens of thousands of top quality items in each store, advertise extensively, and provide expert advice and service for customers (by employing a highly-skilled and well-trained workforce that is knowledgeable about their products and home improvement), they are also able to provide low prices through aggressive purchasing and warehouse stores.

11. Many consultants are advising diversified companies in emerging markets such as India, Korea, Mexico and Turkey to adopt corporate strategies proven to be of value in advanced economies like the US and the UK. What are the pros and cons of this advice?

Corporate strategy involves making choices regarding the scope of a firm's business activities. As the chapter discusses, firm scope is a function of transaction costs in the market place. If the transaction costs in the market are high, internalising some of these activities inside a firm will be optimal. Transaction costs are a function of the degree to which intermediary institutions are developed. Emerging markets such as India, Korea, and Mexico have less developed market institutions compared to advanced markets such as the US and the UK. As a result, transaction costs in these economies are likely to be higher, leading to a different set of optimal firm scope choices. Therefore, replicating the strategic choices of advanced market companies in these economies will not be optimal.