

LM05 · EQUITY INVESTMENTS · LOS A–E

Company Analysis: Past and Present

CFA Level I · 2025 Curriculum · Analyzing what a company has done, and where it stands now

What This Module Covers

Company analysis starts with a **company research report**: a document combining financial analysis, industry context, valuation, and an investment recommendation. This reading builds the foundation — the *past and present* — so a subsequent reading can take on forecasting.

Core sequence: understand the business model → analyze revenue and pricing power → evaluate operating profitability and working capital → evaluate capital investments and capital structure.

Learning Outcome Statements

- a Describe the **elements that should be covered in a thorough company research report**.
- b Determine a company's **business model**.
- c Evaluate a company's **revenue and revenue drivers, including pricing power**.
- d Evaluate a company's **operating profitability and working capital** using key measures.
- e Evaluate a company's **capital investments and capital structure**.

FLOW OF COMPANY ANALYSIS: PAST & PRESENT



Understand → Measure → Assess returns vs. cost of capital

Exam Tip: The curriculum frames this reading as "past and present" — it deliberately excludes forecasting. Your job here is to diagnose the business as it stands, using historical and current data only.

LOS A · COMPANY RESEARCH REPORTS

The Company Research Report & Information Sources

A **company research report** examines a company's past and present financial statements, its industry and competitors, and forecasts its future financial statements. Reports conclude with a **valuation, an investment recommendation, and a discussion of investment risks.**

Initial vs. Subsequent Research Reports

Initial Research Report

Extensive; written for readers **not yet knowledgeable** about the company ("initiating coverage").

Subsequent Research Report

Shorter. Audience already familiar with the company — just needs the **update based on new information.**

Elements of an Initial Research Report

ELEMENT	WHAT IT INCLUDES
Front matter	Issuer name, buy/hold/sell recommendation, target buy/sell prices, legal disclosures
Rationales	The reasoning behind the recommendation
Company description	Including the <i>business model</i>
Industry overview	And the company's competitive positioning
Financial analysis & model	Past and pro-forma financial statements
Valuation	Analyst's estimate of intrinsic value
ESG factors	Environmental, social, governance considerations
Upside & downside risks	And their valuation impact

A subsequent report includes the front matter, updated recommendation & rationale, analysis of new information, and changes to valuation and risk factors.

Four General Types of Information Sources

1 · Directly from the company (Issuer)

Annual/interim filings, financial statements, MD&A, conference calls, analyst/investor days, press releases.

2 · Publicly available third-party info

Industry data, competitor filings, news, government statistics, trade publications.

3 · Proprietary third-party info

Subscription research, paid market data, commercial industry reports.

4 · Proprietary primary research

Analyst-performed or analyst-commissioned research (e.g., surveys, channel checks).

Exam Tip: The same four-source taxonomy is used throughout the reading — memorize it. "Proprietary third-party" is paid external research; "proprietary primary" is research *you* (the analyst) originate or commission.

LOS B · BUSINESS MODEL

Determining the Business Model

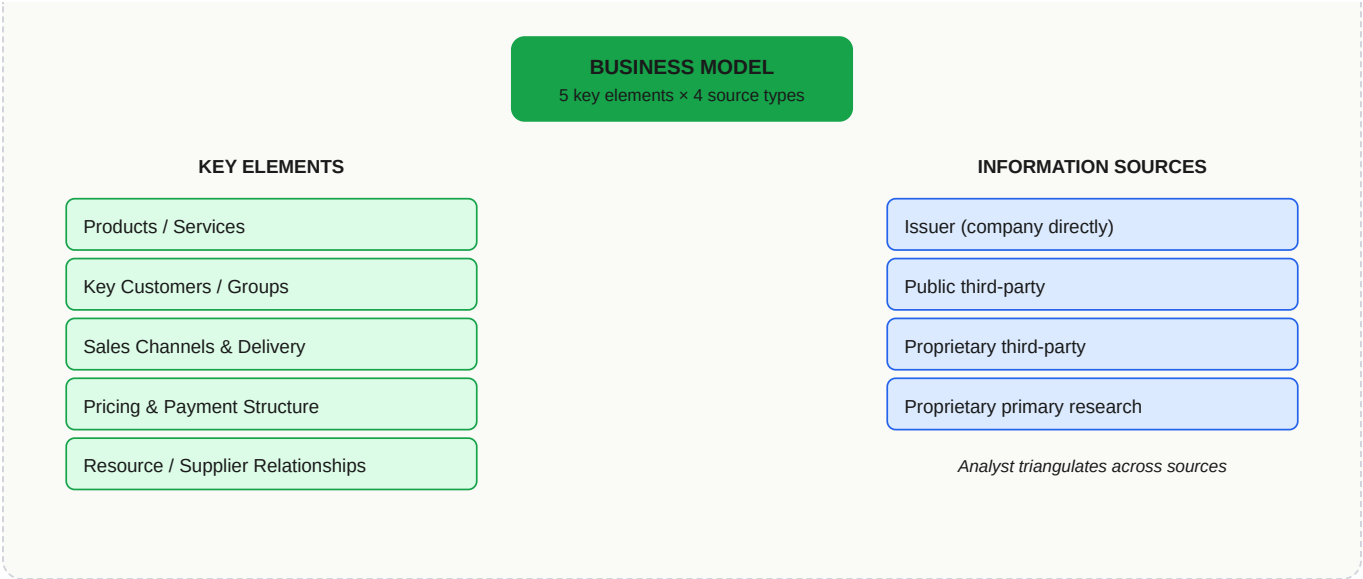
Step One in the company analysis framework is identifying the firm's business model. The business model:

- Identifies the **key drivers** of financial results and the firm's competitive position
- Highlights the **key areas that require further investigation**
- Allows the analyst to **set expectations** for future performance

Key Elements of a Business Model

BUSINESS MODEL ELEMENT	KEY QUESTIONS FOR ANALYSTS
Products and services	What is the firm selling?
Customers and key customer groups	To whom does the company sell?
Sales channels (incl. customer acquisition & delivery mechanisms)	How does the company reach current & potential customers, and how does it deliver products?
Pricing & payment structure	How much does the company charge, and how are prices and payment terms structured?
Resource, supplier and partner relationships	What does the company buy and rely on to operate effectively?

BUSINESS MODEL — FIVE QUESTIONS, FOUR INFORMATION SOURCES



Exam Tip: Don't confuse "business model" with "strategy" — the model describes *what and how* the business does things today; strategy is covered in the industry-analysis reading (Porter: cost leadership, differentiation, focus).

LOS C · REVENUE & REVENUE DRIVERS

Revenue Analysis: Drivers & Approaches

Revenue drivers are the *causative factors* explaining the level of, and changes in, revenue. The analyst asks:

- What are the drivers?
- How have they evolved over time?

Two Approaches to Identifying Revenue Drivers

Bottom-Up (micro)

Look **within the company**.

Price

Volume

Product line

Geography

Segments

Top-Down (macro)

Look at the **economy / industry**.

GDP growth

Market size

Market share

The two approaches are **often used together** — their combination helps surface inconsistencies in assumptions.

Worked Example — Warehouse Club (Bottom-Up)

Revenue decomposes into **Sales** and **Membership Fees**. Sales further breaks down by category and by driver:

CATEGORY	VOLUME SHARE	DRIVER TREE
Fresh food	13%	<i>For each: Number of Members × Price × Volume → then Sales per Store × Number of Stores</i>
Packaged food	40%	
Non-food	28%	
Other	19%	

Growth drivers: sales per store (or per sq. ft.) × number of stores. Switching costs (membership) reinforce revenue stability.

Exam Tip: Revenue decomposition is always *price* $\times$ *volume* at the lowest level. Bottom-up vs. top-down simply determines where you start — and a combined approach lets you cross-check.

LOS C · PRICING POWER

Pricing Power

Pricing power is a company's ability to **set prices and terms without affecting sales volume**. Revenues are limited by pricing power.

Pricing power is a function of two things: **market structure** and **competitive positioning within the market**.

The Pricing-Power Spectrum

Highly Competitive Markets (Low Pricing Power)

- Low barriers to entry
- Many substitutes available
- Little or no product differentiation
- Little or no brand loyalty
- Low or no switching costs

Examples: retail, oil & gas, fresh food, insurance, bank loans/deposits.

Firms are price takers. Long-run economic profit = zero (only a sustainable low-cost producer can maintain profit > 0). Commoditization describes the evolution toward this state.

Less Competitive Markets (Higher Pricing Power)

- High barriers to entry
- Few or no substitutes
- Greater product differentiation
- High customer loyalty
- High switching costs

Examples: branded consumer goods, patented pharmaceuticals.

*Types of higher pricing power: **value-based**, **cost-based**, **price discrimination**.*

How Analysts Infer Pricing Power

Study the **price trend versus the cost trend** — i.e. the behavior of margins over time.

- When **prices rise more than costs over time**, the company has demonstrably transferred cost increases to customers without losing sales.
- This transfer is **more likely** where *switching costs are high* or where the product has *no good substitutes*.
- Profit margins can therefore **indicate** pricing power.

Top-Down Angle: Market Size & Share

Market size = total revenue of all companies in the market.

Market share = company's revenue ÷ market size.

A top-down approach considers how external factors (market size, the company's share, GDP) affect revenue.

Exam Tip: "Pricing power" is not just about being able to raise prices — it is the ability to *set* prices and terms *without losing volume*. Volume sensitivity is the test.

QUIZ 1 · CHECKPOINT

Test Your Understanding: Reports, Business Model & Revenue

Q1. Which of the following is *least likely* to appear in an **initial** company research report but may be present in a subsequent one?

Q2. An analyst commissions an independent survey of retail shoppers to estimate demand for a retailer's new product line. This source is *best* described as:

Q3. Which of the following is *not* one of the key elements of a business model as described in the reading?

Q4. A pharmaceutical company holds a patent on a drug with no close substitutes and high switching costs for patients. Relative to a commodity producer, it will *most likely* have:

LOS D · OPERATING PROFITABILITY

Operating Profitability & Cost Behavior

Operating costs generate or are related to current-period revenue. They cover:

- Acquisition, production, sale, improvement, and delivery of goods and services
- Management of business activities
- Compliance with laws and regulations

Investing costs relate to acquisition and production of long-term assets; financing costs relate to debt and equity.

Two Ways to Categorize Operating Costs

By Behavior with Output

Variable costs (change with output): compensation, raw materials, merchandise.

Fixed costs (do not change with output, short-run): office supplies, many overhead items.

By Nature or Function

IFRS & US GAAP require companies to disclose costs by **either nature or function**. Function is the typical (and preferred) presentation on the income statement.

Functional buckets: Cost of Goods Sold · Sales & Marketing · General & Admin · Research & Development.

Operating Profit Formula & Operating Leverage

$$\text{Operating Profit} = [Q \times (P - VC)] - FC$$

- $(P - VC)$ = contribution margin per unit. Contribution margin *must be positive*.
- Quantity sold must be large enough to cover fixed costs.
- The larger the proportion of **fixed** costs, the more rapidly operating profits rise/fall with a change in quantity sold.

$$\mathbf{DOL} = \% \Delta \text{ Operating Profit} / \% \Delta \text{ Sales}$$

Practical limits of DOL: disclosure by *nature* is not required by IFRS/US GAAP, output volume is often not disclosed, and the split of VC vs. FC may vary across product lines. DOL is most useful when disclosure is typical for the industry.

Profitability Measures Built from a Functional Income Statement

LINE	COMPUTATION	COST-BEHAVIOR NOTE
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Revenue	—	—
(Cost of Goods Sold)	Revenue – COGS	Mostly <i>variable</i>
Gross Profit	Revenue – COGS	Good approximation of contribution margin
(Operating Expenses)	SG&A, R&D	Mostly <i>fixed</i>
EBITDA	Gross Profit – OpEx	—
(Depreciation & Amortization)	—	Fixed if straight-line
EBIT (Operating Profit)	EBITDA – D&A	—

Dividing each measure by revenue yields **gross margin**, **EBITDA margin**, and **EBIT (operating) margin**.

Economies of Scale vs. Scope

Economies of Scale

Cost per unit **decreases as output increases**.

Analyst check: compare size (revenues) to operating cost margin.

Economies of Scope

Cost per unit **decreases as the number of product lines increases**.

Analyst check: compare profitability of an integrated company with stand-alone peers.

Analyze Cost Trends Using Each Cost's Driver

COST	DRIVER	METRIC
Cost of Goods Sold	Revenue	Gross margin
Sales, G&A	Revenue	SG&A as % of revenue
Depreciation & Amortization	Gross Fixed Assets	Useful economic life = Gross FA / D&A
Industry-specific (e.g., warehouse club)	Stores opened	Cost per store opened

Exam Tip: Gross profit is usually a reasonable proxy for *total contribution margin* because COGS is mostly variable and most operating expenses (SG&A, R&D) plus D&A (if straight-line) are mostly fixed. Use gross margin to estimate

DOL when a clean VC/FC split isn't disclosed.

LOS D · WORKING CAPITAL

Working Capital Analysis

Working capital can be analyzed using **activity ratios**:

DOHDAYS OF INVENTORY ON
HAND**DSO**

DAYS SALES OUTSTANDING

DPODAYS PAYABLES
OUTSTANDING

Cash Conversion Cycle & Net Working Capital

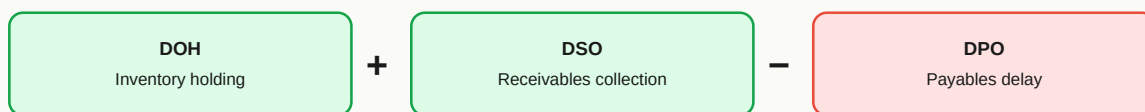
The primary measures of a company's working capital are:

- **Cash conversion cycle (CCC)** = $\text{DOH} + \text{DSO} - \text{DPO}$. A *short* CCC means the company requires *less external financing* to fund operations.
- **Ratio of net working capital to sales.**

Net working capital requirement refers to a minimum level of investment — in addition to capital investments — that *cannot* be distributed to investors.

Negative NWC is a source of financing. When NWC is negative, suppliers are effectively financing the company (e.g., retailers selling for cash while paying suppliers with a lag).

CASH CONVERSION CYCLE — MECHANICALLY



= Cash Conversion Cycle

Lower CCC → less external financing needed

Exam Tip: When evaluating working capital, compare a company's DOH, DSO, and DPO with its own history *and* with peers. A rising CCC with flat margins often signals the need for more financing.

QUIZ 2 · CHECKPOINT

Test Your Understanding: Operating Profit & Working Capital

Q5. The **degree of operating leverage** is most correctly defined as:

Q6. In a functional income statement, **gross profit** is often used by analysts as an approximation of:

Q7. A company observes that its unit production cost falls as it *adds new product lines* that share its existing distribution network. This is *best* described as:

Q8. A company has $\text{DOH} = 45$, $\text{DSO} = 30$, and $\text{DPO} = 60$. Its cash conversion cycle is:

LOS E · CAPITAL INVESTMENTS & CAPITAL STRUCTURE

Capital Investments & Capital Structure

Long-run aim: Return on capital invested must exceed cost of capital — that is what generates **economic profit**.

Analyst test : compare ROIC to WACC. A positive $ROIC - WACC$ spread creates value.

Uses and Sources of Capital

Drivers: Uses of Capital

- Cash on hand
- Net working capital (+)
- Capital expenditure (CapEx)
- Acquisitions
- Debt repayment
- Dividends & share repurchases

Drivers: Sources of Capital & Cost of Each

- Cash from operations (CFO) and...
- Net working capital (−)
- Debt issuance
- Equity issuance
- Asset disposals

Uses & sources interact with the cash conversion cycle — lower NWC frees capital; higher NWC absorbs it.

Capital Investments: CapEx vs. OpEx, Maintenance vs. Growth

CapEx vs. OpEx

Operating costs relate to *current-period* revenue.
Investing costs (CapEx) relate to *long-term* asset acquisition and production.

Maintenance vs. Growth CapEx

Maintenance: keeps current asset base productive; historical depreciation is usually the starting point.
Growth: expands the asset base; requires understanding management's business and revenue growth strategy.

*Note: distinguishing maintenance from growth CapEx becomes crucial in the **forecasting** reading; here the analyst is recognizing the distinction in the past/present data.*

Capital Structure & Financial Risk

Risk: debt finance increases financial risk. Two measures:

$$\mathbf{DFL} = \% \Delta \text{ Net Income} / \% \Delta \text{ Operating Income}$$

$$\mathbf{Interest Coverage} = \text{EBIT} / \text{Interest Expense}$$

Evaluating capital structure involves determining whether the **opportunities exceed the risks**. DFL **increases** when a company adds fixed interest expense by borrowing. A company with very little debt will have **DFL $\approx$ 1.0**.

ROIC (an after-tax, capital-structure-independent return) measures **unlevered** returns. These unlevered returns are then modified by **financial leverage** to produce **levered** returns — i.e., return on equity (ROE).

THE VALUE-CREATION CONDITION

VALUE CREATED

$$\mathbf{ROIC > WACC}$$

Economic profit is positive
Capital deployment adds to intrinsic value
CapEx and acquisitions earn above their cost

VALUE DESTROYED

$$\mathbf{ROIC < WACC}$$

Economic profit is negative
Growth destroys value
Shrink capital, return cash, or restructure

Reading the Cash Flow Statement — Tying It Together

The uses/sources framework makes the cash flow statement interpretable:

- *Debt issuance < increase in cash, no equity issued* → internally funded growth.
- *Returns to shareholders and CAPEX similar; no acquisitions* → capital being returned while the existing asset base is maintained/grown organically.
- *Positive ROIC – WACC spread with DFL $\approx$ 1.0* → an unlevered, value-creating profile.

Exam Tip: The exam-ready synthesis: *Uses of capital* (CapEx, acquisitions, NWC+, dividends, debt repay) must be funded by *Sources* (CFO, debt/equity issuance, disposals, NWC–). Assess whether ROIC exceeds WACC — and use DFL and interest coverage to size the financial risk that comes with the chosen capital structure.

QUIZ 3 · CHECKPOINT

Test Your Understanding: Capital & Leverage

Q9. According to the reading, the *ideal* measure of industry and company profitability — used to judge whether capital is being deployed productively — is:

Q10. A firm financed almost entirely with equity will have a degree of financial leverage (DFL) that is:

Q11. Which of the following is *least likely* classified as a **use** of capital in the reading's framework?

MODULE COMPLETE

Your Scorecard

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LM05 Key Takeaways — Exam-Ready Cheat Sheet

Research Reports & Information Sources

- 1 **Initial reports** are extensive (for unfamiliar readers). **Subsequent reports** focus on new information and changes to valuation/risks.
- 2 **4 information sources:** (1) issuer directly, (2) public third-party, (3) proprietary third-party, (4) proprietary primary research.

Business Model & Revenue

- 3 **5 business-model elements:** products/services, customers, sales channels (w/ delivery), pricing & payment, supplier/partner relationships.
- 4 **Revenue drivers:** bottom-up (price, volume, segment, geography) or top-down (market size, share, GDP). Combine both to cross-check.
- 5 **Pricing power** = set prices/terms without affecting volumes. Function of market structure + competitive position. Commoditization (low barriers, substitutes, no differentiation) → zero long-run economic profit.

Operating Profit & Working Capital

- 6 **Operating profit** = $[Q \times (P - VC)] - FC$. Contribution margin per unit = $P - VC$ and must be positive.
- 7 **DOL** = $\% \Delta \text{Operating Profit} / \% \Delta \text{Sales}$. Rises with fixed-cost share. Limited by non-standard VC/FC disclosure.

- 8 **Functional income statement:** Revenue → Gross Profit ($\approx$ contribution margin) → EBITDA → EBIT. Divide each by revenue for margins.
- 9 **Scale** = lower unit cost with more output of the same line. **Scope** = lower unit cost with more product lines.
- 10 **CCC** = DOH + DSO – DPO. Short CCC → less external financing needed. Negative NWC → suppliers finance operations.

Capital Investments & Capital Structure

- 11 **Value creation test: ROIC > WACC.** ROIC is unlevered and capital-structure independent. Leverage converts unlevered returns to ROE.
- 12 **Uses:** cash, +NWC, CapEx, acquisitions, debt repay, dividends/buybacks. **Sources:** CFO, –NWC, debt/equity issuance, asset disposals.
- 13 **CapEx split:** maintenance (protect existing asset base) vs. growth (expand it).
- 14 **DFL** = $\% \Delta \text{Net Income} / \% \Delta \text{Operating Income}$. Rises with debt. **Interest coverage** = EBIT / Interest. Low-debt firm → $\text{DFL} \approx 1.0$.

Last-Minute Exam Checklist

5 business-model elements: product, customer, channel, pricing, supplier

4 info sources: issuer, public 3P, proprietary 3P, proprietary primary

Pricing power ↑: barriers, differentiation, switching costs, no substitutes, brand loyalty

Operating formula: Op Profit = $[Q \times (P - VC)] - FC$; Gross Profit $\approx$ contribution margin

DOL = $\% \Delta \text{Op Profit} / \% \Delta \text{Sales}$ · **DFL** = $\% \Delta \text{NI} / \% \Delta \text{Op Income}$

CCC = DOH + DSO – DPO · Negative NWC → suppliers finance the firm

Value test: ROIC vs. WACC · **ROIC unlevered**, ROE is ROIC × financial leverage effect