LM06 · EQUITY INVESTMENTS · LOS A

Industry and Competitive Analysis

CFA Level I · 2025 Curriculum · LOS a–e

What is an industry?

A group of companies with the **same business models, product markets, and factor markets** — facing the **same supply and demand opportunities and risks**.

Industry and competitive analysis is a *macro approach* to analyzing what drives industry size, profits, and market share — and to determining a company's position within its industry.

Why it matters: Industry is the #1 driver of sustainable economic profit

Competition tends to drive company profitability toward an **industry base rate** over time. Within a given industry, differences in profitability result from **business model, competitive strategy, size,** and **execution** — variation around the industry's median.

- **Industry** is the most important factor in the *sustainability* of economic profits (ROIC − WACC).
- **Company-specific effects** are much larger for low-performing firms than for high performers — there is no floor or ceiling on how bad one company can do.

Aim of Industry & Competitive Analysis

1. Estimate base rate

Industry's base rate of profitability & its drivers

2. Forward-looking view

Opinion on potential structural changes

3. Firm vs. base rate

Strengths/weaknesses vs. industry norm

The 5 Steps of Industry & Competitive Analysis

1. **Define the industry**, often using third-party classification systems (GICS, ICB, TRBC).
2. **Survey the industry** — size, growth rate, profitability, and market share trends.
3. **Analyze industry structure** using a framework such as Porter's Five Forces.

4. **Examine external influences** — political, economic, social, technological, legal, environmental (PESTLE).
5. **Analyze competitive strategies** and each company's competitive advantages.

Exam Tip: Remember: industry sets the *base rate*; company-specific factors explain variation around it. Industry factors **limit** what companies can earn, but company-specific factors are usually more to blame when firms *underperform*.

LOS B · INDUSTRY CLASSIFICATION METHODS

How do we group companies into industries?

The simple definition

Companies that **sell similar products or services** — usually from the customer's perspective.

The problems: Do we include substitutes? What about companies in multiple industries? Geography?

Third-Party Commercial Classification Schemes

Modern commercial classifications are **global, demand-approach based, and updated frequently**. The three main providers:

GICS

Global Industry Classification Standard

Tiers: sectors → industry groups → industries → sub-industries

ICB

Industry Classification Benchmark

Tiers: industries → supersectors → sectors → subsectors

TRBC

The Refinitiv Business Classification

Tiers: economic sectors → business sectors → industry groups → industries → activities

Earlier government-agency methods were country-specific and grouped by production characteristics rather than by demand.

Four Limitations of Third-Party Classification Schemes

LIMITATION	EXAMPLE
1. Business-model variations / substitutes Groupings may include firms with different models or that sell substitutes	Application Software: *Shopify* (e-commerce payment processing) vs. *Check Point* (security software)
2. Multi-product companies Classified by principal activity, but other segments may dominate profits	*Amazon* — classified Consumer Discretionary, but most profits come from AWS
3. Geography Some industries don't compete	*Health care* companies often do not compete across borders

globally	
4. Changes in groupings Disrupt comparability of prior-period industry statistics	*Fintech payment processors* — Information Technology or Financial Sector?

Alternative Grouping Methods

By Geography

Country of incorporation; groups such as developed, emerging, frontier

By Business Cycle Sensitivity

Cyclical: consumer discretionary, energy, financials, industrials, technology, materials
Defensive / non-cyclical: consumer staples, health care, telecom, utilities

By Statistical Similarity

Clustering analysis on financial or return characteristics

By ESG Characteristics

Personnel diversity, green production methods, etc.

□ **Exam Tip:** A **cyclical** company's earnings are highly dependent on the stage of the business cycle; a **defensive** company produces goods and services for which demand is relatively stable over the cycle.

LOS B · TOP-LEVEL CLASSIFICATION

The 11 Common Sectors

The top level of all three commercial classification systems (**GICS, ICB, TRBC**) consists of **11 common sectors or industries**. Different providers use slightly different names, but the categories map to the same areas of the economy.

1. Energy
Oil, gas, energy equipment & services

2. Materials
Basic materials — chemicals, metals, mining

3. Industrials
Capital goods, transportation, commercial services

4. Consumer Discretionary
Cyclical consumer goods & services (autos, retail, leisure)

5. Consumer Staples
Non-cyclical — food, beverage, household products

6. Health Care
Pharma, biotech, equipment, services

7. Financials
Banks, insurance, capital markets

8. Information Technology
Software, hardware, semiconductors

9. Communication Services
Telecommunications services & media

10. Utilities
Electric, gas, water utilities

11. Real Estate
REITs and real estate management

Cyclical vs. Defensive Groupings

Highly Cyclical Sectors

Earnings sensitive to the business cycle.

- Consumer Discretionary
- Energy
- Financials
- Industrials
- Technology
- Materials

Defensive Sectors

Demand relatively stable across the cycle.

- Consumer Staples
- Health Care
- Communication Services
- Utilities

Why updates matter

Providers update their groupings periodically to reflect natural business changes over time. This can **disrupt the continuity of industry-level statistics** — analysts may need to revise historical data to be consistent with current groupings, or choose different classification tiers and subjectively adjust groupings for their specific need.

> □ **Exam Tip:** You don't need to memorize every sub-industry — but be able to recognize the 11 top-level sectors and tell cyclical from defensive groupings.

LOS C · INDUSTRY SURVEY (PART 1)

Industry Size & Growth Characteristics

Industry Size

Size = total annual sales of the product from a product or customer perspective.

This is *not* the same as the total sales of every constituent company. Example: in **Retail**, Amazon's industry size is Amazon's *retail sales* — not AWS revenue, which belongs to a different industry.

When significant sales come from private or unincorporated businesses, industry size is typically approximated using **government economic indicators or third-party data**.

Industry Growth Rate

- **Annual growth** — year-over-year for each year
- **Compound annual growth rate (CAGR)** — for multi-year periods
- Useful to **break down growth into contributions from volume vs. price/mix**
- Historical growth patterns characterize the industry by *magnitude* and *sensitivity to the business cycle*

Limitations: correlations across industries rise in severe downturns; life cycle can impact growth.

The Style Box — Characterizing Industry Growth

SENSITIVITY × MAGNITUDE

MAGNITUDE (growth rate)

SENSITIVITY (to cycle)	MATURE Full saturation; growth in line with economy or declining	GROWTH Not yet saturated; idiosyncratic drivers separate from GDP
DEFENSIVE	**Utilities** Defensive + Mature	**Biotech** Defensive + Growth
CYCLICAL	**Crude oil** Cyclical + Mature	**Fintech** Cyclical + Growth

Growth drivers: business model · discretionary vs. essential · interest-rate exposure · subscription?

> **Exam Tip:** Growth industries = meaningful growth potential remaining (often new technology). Mature industries = industry growth rates in line with the general economy or declining.

LOS C · INDUSTRY SURVEY (PART 2)

Industry Profitability & Market Share

Best Measure of Profitability: ROIC

Return on Invested Capital — after-tax operating profits per dollar of invested capital.

- Measures **after-tax operating profits**
- Is **not distorted by capital structure**
- Data is **not readily available** for private firms — use public comparables
- Use **time series** to assess trends; **percentiles / quartiles** to assess distribution

Market Share & Its Trend

$$MarketShare = Company's AnnualRevenue \div IndustrySize$$

The **trend** in a company's market share over time signals whether customers view its products favorably. Distinguish between **organic growth** and growth **from acquisition**.

An industry with many small firms may be highly competitive; **consolidation typically decreases competition**.

Herfindahl–Hirschman Index (HHI)

$$HHI = \Sigma(marketshare_i)^2 - expressedinbasis - point - styleunits$$

Square the market share of each firm in the market, then sum. Higher HHI → higher concentration.

10,000	2,500+	1,500 – 2,500	< 1,500
MONOPOLY · (100^2)	HIGH CONCENTRATION	MODERATE CONCENTRATION	LOW CONCENTRATION

*Regulatory tripwire: an acquisition that causes an HHI increase of **200+** may face a regulatory challenge.*

□ **Exam Tip:** ROIC > WACC = economic profit. ROIC is the gold-standard profitability measure *because* it is agnostic to capital structure — apples-to-apples across firms.

QUIZ 1 · CHECKPOINT

Test Yourself: Classification, Sectors & Survey

Q1. The 5 steps of industry and competitive analysis are, in order:

Q2. Which of the following is *least likely* a limitation of third-party industry classification schemes?

Q3. Which sector is *most likely* classified as defensive rather than cyclical?

Q4. The best measure of industry profitability is:

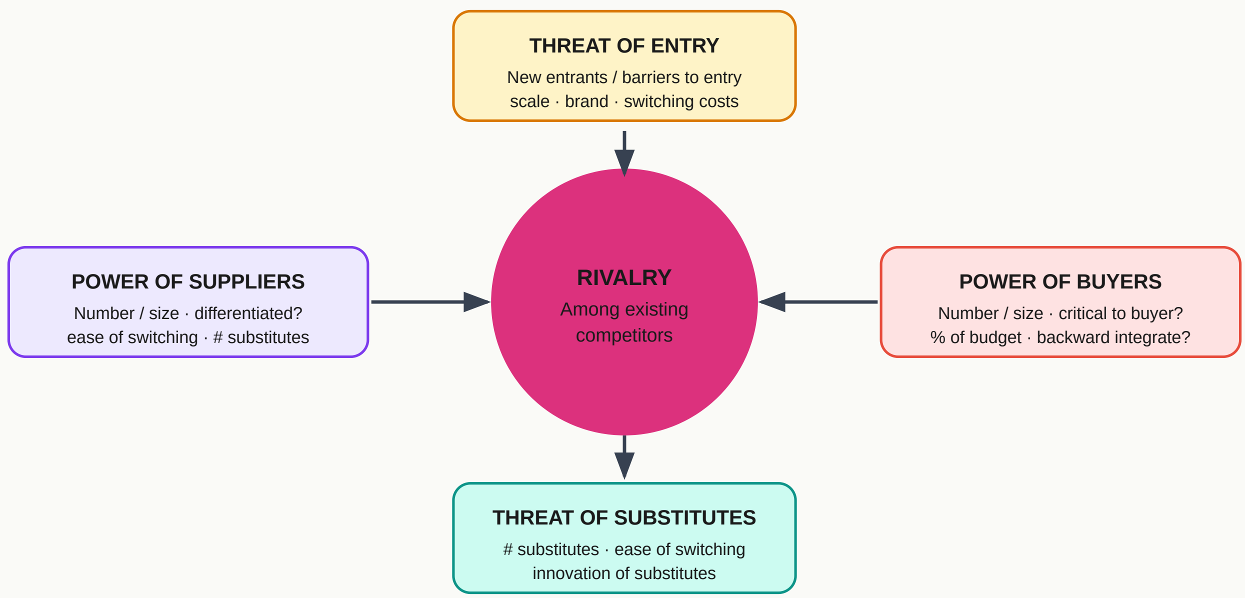
Q5. Industry A has four firms with market shares of 40%, 30%, 20%, and 10%. Its HHI is closest to:

LOS D · INDUSTRY STRUCTURE

Porter's Five Forces

Porter's Five Forces is a commonly used framework for assessing **industry structure** — it helps determine an industry's **long-run profitability**. If some or all of the forces are strong, firms will likely earn zero or close to zero economic profits.

THE FIVE COMPETITIVE FORCES



Each force in detail

1. Rivalry Among Existing Competitors

Driven by history, number/concentration of firms, slow growth, undifferentiated products, high fixed costs, and barriers to exit.

2. Threat of New Entrants

High when barriers to entry are low. Barriers include economies of scale, economies of scope, network effects, customer loyalty, switching costs, preferential access, and government policies.

3. Threat of Substitutes

Substitutes raise demand elasticity and cap pricing. Look at the number of substitutes, ease of switching, and the innovation of substitutes.

4. Bargaining Power of Buyers (Customers)

Higher when buyers are fewer/larger, products are not critical to them, product is a large % of customer budget, or customers can backward-integrate.

5. Bargaining Power of Suppliers

Higher when suppliers are few and their products scarce or highly differentiated. Look at number/size, differentiation, ease of switching, and the number of substitutes for the input.

 Exam Tip: Strong forces → more competition → economic profits driven toward zero. Weak forces → room for sustainable economic profits. The exact wording to remember: *rivalry*, *threat of new entrants*, *threat of substitutes*, *bargaining power of buyers*, *bargaining power of suppliers*.

LOS D · EXTERNAL INFLUENCES

PESTLE Analysis

PESTLE examines the **external factors** that may affect an industry — complementing Porter's Five Forces, which looks at internal structure.

P **Political** — Fiscal policy · Monetary policy · Regulation · Government purchasing

E **Economic** — GDP trends · Inflation · Interest rates · Cycle

S **Social** — Demographics · How people work, play, and spend their leisure time · Spending patterns

T **Technological** — Sustaining innovation (improvements that don't fundamentally change a product) vs. disruptive innovation (new markets or new value in existing markets)

L **Legal** — Laws & regulations that alter an industry's business practices

E **Environmental** — Low-carbon transition risk · Sustainability concerns · Climate impact

Sustaining vs. Disruptive Technology

Sustaining Innovation

Improvements in a product over time that do *not* fundamentally change its nature. Incumbents usually benefit.

Disruptive Innovation

Creates a new market, or enters an existing market and creates value in a new way. Can make existing products redundant and dramatically reshape the industry.

□ **Exam Tip:** Mnemonic: **P-E-S-T-L-E** — Political, Economic, Social, Technological, Legal, Environmental. The exam may present it as "external factors affecting industry profitability" — match to PESTLE letters.

QUIZ 2 · CHECKPOINT

Test Yourself: Porter & PESTLE

Q6. Porter's Five Forces are best described as:

Q7. Which factor *most likely* increases the bargaining power of buyers?

Q8. A government increasing corporate tax rates and tightening regulations on carbon emissions *most likely* illustrates:

Q9. A new technology that creates a brand-new market and makes existing products redundant is *best* described as:

LOS E · COMPETITIVE STRATEGY & POSITION

Competitive Strategy & Position

An effective strategy is evidenced by a **track record of economic profit**. But how do we assess it on a **forward-looking** basis? Porter says answer three questions.

Three Questions to Evaluate a Strategy

1. Does it create a **defense against the five industry forces**?
2. Does it **benefit from, or at least not clash with, external industry forces** identified in PESTLE?
3. Does the company have the **resources and capabilities** to make it work?

Porter's Three Generic Strategies

COST LEADERSHIP

Become the **lowest-cost producer**, offer the lowest prices, and generate enough volume to make a superior return.

Can be used defensively to protect share, or offensively to gain share.

DIFFERENTIATION

Offer products/services that are **distinctive in type, quality, or delivery**. The cost of differentiation must be less than the price premium customers will pay — and that premium should be sustainable.

FOCUS

Target a **specific customer group** or niche. Can combine elements of cost leadership and differentiation — built on a strong understanding of the group's needs.

⚠ Strategy 4: "Stuck in the Middle"

Porter argues a firm must **choose one** of the three generic strategies to compete effectively. A firm that fails to commit — trying a little of everything — ends up **stuck in the middle** and tends to earn poor returns.

Market Structure & Pricing Power

Highly Competitive / Price-Taker

Little product differentiation · many substitutes · few/no barriers to entry · low brand loyalty · low switching costs.

Returns tend toward the cost of capital (zero economic profit) unless you're a sustainable low-cost producer.

Less Competitive (Monopoly, Oligopoly, Monopolistic Competition)

Greater product differentiation · few/no substitutes · high barriers to entry · high customer loyalty · high switching costs.

Commoditization describes industries evolving toward this state.

Meaningful pricing power — cost increases can be passed on without losing sales.

Industry Growth Stage & Strategy

Analysts broadly classify industries as **growth** or **mature**. Growth industries have considerable growth potential remaining (often technology-driven); mature industries' growth is in line with the general economy or is declining. The life-cycle stage influences which competitive strategy is most viable and what base rate of profitability to expect.

□ **Exam Tip:** "Stuck in the middle" is the classic wrong-answer trap. A firm must *commit* to cost leadership, differentiation, *or* focus — mixing them without a clear edge destroys economic profit.

QUIZ 3 · CHECKPOINT

Test Yourself: Competitive Strategy

Q10. Porter's three generic competitive strategies are:

Q11. A firm that tries to mix cost leadership and differentiation without committing to either is *best* described as:

Q12. Which market structure is *most likely* associated with meaningful pricing power?

Q13. When evaluating a firm's competitive strategy on a forward-looking basis, an analyst should ask all of the following *except*:

MODULE COMPLETE

Your Scorecard

0 / 13

LM06 Key Takeaways — Exam-Ready Cheat Sheet

The 5 Steps

1. **Define → Survey → Porter → PESTLE → Competitive Strategy.** Industry is the most important factor in the *sustainability* of economic profits.

Classification

2. **Third-party schemes:** GICS, ICB, TRBC — global, demand-approach, updated frequently. 4 limitations: business-model/substitutes, multi-product, geography, grouping changes.

3. **11 sectors:** Energy · Materials · Industrials · Consumer Discretionary · Consumer Staples · Health Care · Financials · IT · Communication Services · Utilities · Real Estate.

Survey

4. **Size** = total annual sales of the product. **Growth** characterized by magnitude & cycle sensitivity (style box). **Profitability** best measured by **ROIC** (after-tax, capital-structure agnostic).

5. **Market share** = company revenue / industry size. **HHI** = Σ (share)^2: <1,500 low · 1,500–2,500 moderate · 2,500+ high · 10,000 monopoly. Acquisition +200 HHI = regulatory challenge.

Porter's Five Forces

6 **Rivalry** · **Threat of new entrants** · **Threat of substitutes** · **Bargaining power of buyers** · **Bargaining power of suppliers**. Strong forces → zero economic profit.

PESTLE

7 **P**olitical · **E**conomic · **S**ocial · **T**echnological · **L**egal · **E**nvironmental. Sustaining vs. disruptive innovation under T.

Competitive Strategy

8 Three evaluation questions: (1) defense vs. five forces, (2) alignment with PESTLE, (3) resources & capabilities.

9 Three strategies: **Cost Leadership**, **Differentiation**, **Focus**. Failing to commit = *"Stuck in the middle."*

⚡ Last-Minute Exam Checklist

Classification schemes: GICS, ICB, TRBC — 11 top-level sectors

Industry profitability: ROIC (after-tax, capital-structure agnostic)

HHI thresholds: <1,500 low · 1,500–2,500 moderate · 2,500+ high · +200 on M&A = regulatory scrutiny

Porter's Five Forces: rivalry, entry, substitutes, buyer power, supplier power

PESTLE: Political · Economic · Social · Technological · Legal · Environmental

Generic strategies: cost leadership · differentiation · focus — never "stuck in the middle"

Aim of analysis: estimate base rate · forward-looking structural view · firm vs. base rate

Step 1 of 12