Company Research Template

Researching a company for selection into the portfolio is sometimes a difficult and frustrating task. Given that there are millions of market participants and the rewards for good selections are immense, one cannot expect to simply find a good stock easily.

If you think of nothing else, remember the importance of information asymmetries in the market. The only way to get an edge is by:

- Finding information that is not reflected in the market
- Interpreting available information in a contrarian fashion

Finding information no one else has is extremely difficult for large cap companies. With intense institutional interest and news coverage, insider information is probably the only guaranteed way to gain an edge on large cap stocks. This is, of course, illegal. The better approach for large cap stocks is to focus on a value proposition (i.e. the stock looks cheap—relative to its peers or its intrinsic value).

Small and mid cap stocks offer a better chance to find unincorporated information. The lack of liquidity and perceived risk in these investments leads to less institutional interest and news coverage. Therefore, you can understand a company much better than the market simply by reading through the right sources and talking to the right people. Finding these overlooked pieces of information is usually possible given an appropriate amount of effort. The key is to think about the sources that a typical Wall Street analyst would consider not worth his time or simply beneath him.

Despite the attractiveness of finding unincorporated information, developing a contrarian opinion on existing information is a more likely avenue for success. Why this works requires understanding how the market prices securities. The market prices securities by incorporating the value opinions of millions of market participants and creates a consensus price. The market weights each opinion according to its size, not its reflection of reality. The market then offers valuable opportunities to those who can recognize the temporary blindness of their peers. An efficient market should reflect all available information, but like any giant institution "turning in the right direction" is a slow process. Such lags offer tremendous possibilities for gains.

With this in mind, please turn to the next page for a step-by-step company research template. The aim of this template is not to be exhaustive, but to help guide your research. Please come and talk to existing managers about questions or concerns as they come up. Certainly, some of the steps will be more difficult for those without a Commerce background and this is where the managers can help.

Coming Up with Ideas

- Develop a manageable list of names (10) to consider
 - o Don't aim to consider just one stock initially
 - O You want to have multiple ideas in case you run into dead ends
 - o Better to switch than buy a bad company
- Sources for ideas:
 - o Business Press (Wall Street Journal, Financial Times, Barron's, etc.)
 - Yahoo! Finance (stock screener)
 - o Public Knowledge (what companies do you know something about)
 - o Interests (ex. who makes your tennis racquet)
 - o Random (e.g. advertisements, friends endorsements)
- Narrow down initial list
 - O Select the one stock you want to focus on initially
 - o Consider which company looks to be most attractive right now
 - Decision can be based on fundamental business or financials

Background Research on the Company

- Go to company's website and learn about its operations
 - Understand the business model
 - o Find out who are its competitors
- Go to competitors' websites and learn about their operations
 - O You can rule out many companies at this stage
 - O Don't consider second-tier players unless they have a specific focus or edge
- Read S&P Industry reports on industry
 - o Macro themes affecting the industry
 - o Industry competitive dynamic
 - o Think about how companies in this industry are different from each other
 - o Understand what metrics the market considers important
 - o Understand how the market thinks about this industry
 - o Financial characteristics of companies in this industry
- Look through company's SEC filings
 - o Last two 10-Ks (yearly reports), current year's 10-Qs (quarterly)
 - O See how company's presentation of itself compares to online description
 - Note major differences
 - o Understand business segments
 - o Focus on opportunities & risks (sections for both in the filing)
 - o Look at company's strategy going forward
 - o Understand financial statements
 - How it fits with financial characteristics of companies in this industry
 - How it reflects company's strategy
 - Write down items that look suspicious or don't make sense
 - Focus on company's economic earnings (exclude one-time gains/losses)
 - Try to understand as much as possible
 - See if you can find any trends

Background Research on the Company (continued)

- Media due diligence
 - o Look at news stories related to company
 - o WSJ, Bloomberg, Google, Lexis Nexis
- Read through equity research reports on company
 - o Initiation reports are especially helpful
 - o Focus not on the recommendation, but the information and data
 - Remember, research analysts are salesmen
 - They are important in influencing how the market thinks though
 - o Useful to benchmark your ideas against
 - Look at financial model and evaluate its validity
 - Take note of any other charts & projections
 - Look at their validity
 - Use as benchmark for your own ideas
- Understand company's operating strategy
 - Market focus
 - o Differentiation
 - o Relative cost position
 - o Evaluate the strategy—does it seem viable?
- Look at company's financing strategy
 - o Remember, a company survives only through proper financing
 - Equity holders get virtually nothing in bankruptcy
 - Brand names don't have tangibles values in bankruptcy
 - Repeated cash infusions can keep bad companies alive
 - o Debt vs. equity mix
 - How does it square with operating strategy?
 - WACC
 - Compare to competitors
 - Could it be improved? How?
 - o History of shareholder friendly actions (buybacks, dividends)
 - o Future strategy as far as cash infusions, debt issuances
 - Credit rating
 - Lots of debt is fine as long as it can be paid down
 - Judges ability of company to issue new debt in market and meet current obligations
 - o Debt
 - Rates of debt outstanding
 - Tied to credit rating
 - Interest expense calculation
 - Can signal how company will behave in future
 - Signal of the competence of management
 - Ex. If the management comes to market to issue new debt during interest rate peaks, you have to wonder about the company's viability
 - Maturity dates
 - (see above)

Background Research on the Company (continued)

- Covenants
 - If high-grade, you probably don't need to worry too much
 - If HY debt (< BBB-), explore covenants to see how they might affect company going forward
- Assignment
 - Entire company debt or specific subsidiaries
 - Credit-worthiness of company by segment
- Bank loans
 - Very important, but usually overlooked factors in financing strategy
 - Look at terms (\$ available, \$ already drawn, length of agreement, rate)
 - Covenants (see above)
- Corporate structure
 - Is it transparent and logical?
 - Be wary of too many subsidiaries and shell corporations
 - How stable is it (e.g. are spin-offs or acquisitions likely to happen?)
- o (this information is hard to find—Bloomberg is the best place to look)
- Dividend policy
 - o Yes/No
 - How common is it in the industry
 - o Compare yield to competitors
 - o Payout ratio
- Develop Porter's 5 Forces analysis for the company
 - o Threat of new entrants
 - o Supplier power
 - o Buyer power
 - o Threat of substitutes
 - Industry competition
 - o (focus on which ones matter—all 5 might not be relevant)
- Evaluate management team and corporate board
 - o Relationship between the two
 - o Prior history
 - o Look for connections (e.g. CEO went to Wharton w/ Chairman of Board)
 - Salary and compensation—how reasonable is it?
 - Incentive structure—is it tied to company's success?
 - Arms length transactions
- Management insider trades
 - o Frequency and direction
 - o % ownership
 - o Look at recent trades versus historical pattern (try to highlight irregularities)
- Establish the 4-5 items that are most important to consider with this stock
 - o All the above research should have gotten you to this point
 - If not, you need to reevaluate your initial research
 - o 4-5 items that will be the factors in moving the price
 - o These will be the items that you want to test in the next phase of analysis
 - O Ultimately, your opinion on these factors will end up being the thesis points

Background Research on the Company (continued)

- Have a handful of risk factors in mind
 - What prevents you from recommending this stock (as a short or long)
 - o See if these come up in the testing phase

Test Your Ideas

- VAR contacts (see VAR template below for more information)
 - o Stands for value-added research
 - Gain perspective beyond company's official filings and spin
 - Aim is to test out potential thesis points and gain perspective on the company
 - O What is value-added?
 - Important factors for the stock (hone in on 4-5 factors)
 - Focus on catalysts (what will happen now, not 10 years in the future)
 - Knowledge outside the financial press
 - Further understanding of company's underlying fundamentals
 - Company's job is to meet SEC requirements, not explain business model so that a layperson can understand it
 - Predictions for future performance of company
 - Perspective on qualitative/soft factors
 - Personal experiences with product/company
 - Grassroots consumer opinion
 - Store visits
 - Industry expertise
 - Information on competitors
 - Companies do not operate in a vacuum
 - Competitors often have a valuable perspective
 - Probing questions
 - Creativity
 - Contrarian opinions
 - Anything that cannot be seen in Manhattan
 - Market has very limited perspective being in NYC
 - Exploit this fact by bringing in different perspective
 - O What is not value-added?
 - Investor relations (unless you have a clarification question)
 - Research analysts (again, unless you have a clarification question)
 - Might be useful if they are willing to engage with you in conversation—don't count on it though
 - Information already priced into the stock
 - Difficult to gauge, but important to figure out
 - Ex. Take Coke. Everyone knows Coke is a great brand name. There is no need to make a VAR contact to establish this. However, what might be interesting is establishing a VAR contact to see how the recent pesticide scandal in India will affect its brand name in Asia.

Test Your Ideas (continued)

- Company employees (unless you don't understand the company's business model or are looking for a view on soft factors)
 - They can only say so much legally
 - They clearly are biased
 - Former company employees are a better bet
- Drawing conclusions from poor sample sizes
 - While you don't have to do a scientific study, realize that your best friend's opinion on Limited Jeans might not be accurate
 - Very important to try and get both sides of the story
 - o Avoid confirmation bias
- Highly speculative opinions
- O VAR sources:
 - Wonks/academics/think tank employees/PhDs/experts
 - Have a tremendous amount of knowledge on one subject
 - Could explain the entire commodity pricing cycle to you or at least provide good places to look
 - Have a valuable network of contacts
 - Committed to their ideas—not on commission
 - They can be quite influential
 - Not even considered by many analysts
 - Customers
 - Ultimately drive a company's success or failure
 - Ask specific questions or else you will get useless information
 - Former company employees
 - Have good, detached perspective on company
 - Can elucidate on soft factors
 - Distributors
 - Know how product/company is perceived on the ground
 - Less likely to offer corporate pitch
 - Can offer perspective of product/company vs. competitors
 - Suppliers
 - Know what are the integral parts of the company's product
 - Less likely to offer corporate pitch
 - Can offer perspective of product/company vs. competitors
 - Shareholder activists
 - Have been in communication with company
 - Specific agenda and vision for the company
 - Can drastically change a company very quickly
 - Might be difficult to contact
 - NGOs with specific focus on company/industry
 - Usually biased, but know a fair amount
 - Have experience seeing through corporate spin
 - Focus on one idea and know everything about it

Test Your Ideas (continued)

- Competitors/substitutes
 - Offer different perspective
 - Have insights into market dynamics
- Anyone else you think would have a good insight
 - Be creative
- Fundamental analysis
 - o Reevaluate the financial statements again with your increased knowledge base
 - O Consider if you still hold the same view as before
 - O See if your research has helped to explain what you didn't understand before
 - If not, decide whether it is pivotal enough to change your recommendation
 - o Evaluate:
 - Free cash flow
 - Debt/Equity
 - Balance Sheet:
 - Cash
 - Goodwill
 - Intangible Assets
 - PPE & Depreciation
 - Total Debt (LT & ST)
 - Income Statement
 - Recurring income from operations (compare it to net income)
 - Earnings growth
 - Statement of cash flows
 - Capital Expenditures
 - Investments
 - Other relevant cash flows
- Ratio analysis (analyze vs. competitors)
 - o Price/earnings (P/E-Trailing & Forward)
 - o Price/earnings growth (PEG)
 - o Price/book
 - o Debt/EBITDA
 - Interest Coverage
 - o Return on Equity
 - o Return on Assets
 - o DuPont analysis
 - o Profit margin
 - o Operating margin
 - o Enterprise Value/EBITDA
- Stock analysis
 - o Beta
 - o 52 week range
 - o Institutional ownership
 - Short % of float

Test Your Ideas (continued)

- Valuation
 - Build a DCF model for company
 - Incorporate knowledge learned from research
 - Incorporate analyst's expectations if reasonable
 - Consensus is better than one analyst
 - Make conservative assumptions
 - Project out 5 years
 - Develop a conservative terminal value
 - Sensitivity analysis
 - Worst case
 - Expected case
 - Best case
 - Make it legible and transparent for other people to look through
 - o Comps
 - EV/EBITDA multiple valuation
 - o Comparable transactions
 - o Other metrics
 - Refer back to industry report
 - Analyze vs. competitors
- Options market analysis
 - Look at ratio of puts to calls
 - Compare to historical level
 - O See where the puts and calls are trading
 - Compare to current stock price
 - o Convertible debt
 - Look at conversion prices

Recommendation

- Reevaluate the 4-5 factors you previously developed
 - o Decide whether they are all still relevant
 - drop & replace as needed
 - o Develop an opinion on all of them
 - o Rank by importance
 - o Decide how predictions will shape company
- Develop recommendation
 - O Use all your research to develop a recommendation
 - o Start with long or short decision
 - o Develop target price ranges given your research
 - More important to be directionally correct than exactly correct
 - Helps gauge potential return possible
 - o Develop time frame for recommendation
 - Useful for evaluating thesis points
- Consider risks to recommendation
- Condense research into memo and presentation for MII