CHAPTER 37

INTRODUCTION TO INDUSTRY AND COMPANY ANALYSIS

1. (A) **Educational curriculum and the relative demand for various products.**

Explanation

If technological changes result in changes in the set of skills required of workers, this is likely to lead to changes in educational curriculum (and possibly delivery). Such changes often result in the production and demand for new or different products.

(Study Session 12, Module 37.2, LOS 37.j)

Related Material

SchweserNotes - Book 3

2. (C) **its product is differentiated.**

Explanation

Firms offering products that are differentiated in terms of quality and features are more likely to have pricing power than firms that produce undifferentiated (commodity-like) products. High market share does not necessarily imply pricing power; for example, if four firms each have 25% market share, none of them are likely to have significant pricing power. High exit costs can create overcapacity in an industry and result in a high degree of price competition as firms try to maintain production volume during a period of reduced demand.

(Study Session 12, Module 37.2, LOS 37.h)

Related Material

SchweserNotes - Book 3

3. (A) **Apparel.**

Explanation

Apparel is classified as consumer discretionary, tobacco as consumer staples, and internet services as technology.

Related Material

SchweserNotes - Book 3

4. (B) **Growth.**

Explanation

A growth industry is typically characterized by above-normal expansion in sales and profits independent of the business cycle.

(Study Session 12, Module 37.1, LOS 37.c)

Related Material

SchweserNotes - Book 3

5. (C) Automobile.

Explanation

The automobile industry is cyclical because demand for new autos fluctuates with the business cycle. The confectionery industry tends to be non-cyclical and defensive because demand for candy tends to be stable through the business cycle. The pharmaceutical industry is non-cyclical because demand for medicines is independent of the business cycle.

(Study Session 12, Module 37.2, LOS 37.k)

Related Material

SchweserNotes - Book 3

6. (C) business cycle sensitivity.

Explanation

A peer group should consist of firms that are alike in their principal lines of business, along with other similarities such as cost structures and access to capital. Firms can be similar in business cycle sensitivity but dissimilar in terms of their business activities (e.g., a firm in the home building industry and a firm in the heavy equipment manufacturing industry).

(Study Session 12, Module 37.1, LOS 37.e)

Related Material

SchweserNotes - Book 3

7. (A) decline stage.

Explanation

The decline stage of the industry life cycle is often characterized by declining prices as substitute products or global competition emerge, or as a result of decreasing demand due to societal changes.

(Study Session 12, Module 37.2, LOS 37.i)

Related Material

SchweserNotes - Book 3

8. (A) low barriers to entry, low concentration, and high unused capacity.

Explanation

Low barriers to entry increase competition as more firms can enter the business. Industries that are fragmented and have unused capacity tend to be highly competitive as they fight for market share and attempt to utilize excess manufacturing resources.

(Study Session 12, Module 37.1, LOS 37.f)

Related Material

SchweserNotes - Book 3

9. (C) defensive industries.

Explanation

Food, beverage, and utility companies provide basic necessities of life and are considered to be defensive industries. In a recession, the demand for their products will not fall as much as for some of the other industry groups.

(Study Session 12, Module 37.1, LOS 37.d)

Related Material

SchweserNotes - Book 3

10. (A) consumer discretionary.

Explanation

Automobiles and apparel are classified as consumer discretionary; banking is classified as financial services; and heavy machinery is classified as industrials. Based on revenues, a majority of the firm's sales (55%) are derived from the consumer discretionary sector.

Related Material

SchweserNotes - Book 3

11. (A) principal business activities.

Explanation

Commercial providers of industry classification systems such as the GICS classify firms according to principal business activity, such as Consumer Staples, Financial Services, or Health Care.

(Study Session 12, Module 37.1, LOS 37.b)

Related Material

SchweserNotes - Book 3

12. (B) Investment capital is available at low cost.

Explanation

Readily available capital tends to make entry into an industry easier. If an industry is composed of the same firms over a long period of time, barriers to entry are likely high. Economies of scale are a barrier to entry because existing firms are likely to be producing at a lower cost per unit than a new competitor can achieve.

(Study Session 12, Module 37.2, LOS 37.h)

Related Material

SchweserNotes - Book 3

13. (A) high concentration.

Explanation

High return on invested capital and high pricing power are associated with high industry concentration (i.e., small number of firms), high barriers to entry, and low industry capacity.

For Further Reference:

(Study Session 12, Module 37.2, LOS 37.h)

CFA® Program Curriculum, Volume 4, page 324

Related Material

SchweserNotes - Book 3

14. (B) demographic influences.

Explanation

Among the external influences that affect industries, "demographic factors" refers to those that are related to the size and composition of the population.

(Study Session 12, Module 37.2, LOS 37.j)

Related Material

SchweserNotes - Book 3

15. (B) slopes downward.

Explanation

The experience curve, which shows the cost per unit relative to output, slopes downward because of increases in productivity and economies of scale, especially in industries with high fixed costs.

(Study Session 12, Module 37.1, LOS 37.f)

Related Material

SchweserNotes - Book 3

16. (A) Cyclical Cyclical

Explanation

Asset management firms are classified in the financial services industry group. Apparel manufacturers are classified in the consumer discretionary industry group. Financial services and consumer discretionary are cyclical industry groups.

(Study Session 12, Module 37.1, LOS 37.c)

Related Material

SchweserNotes - Book 3

17. (A) **produces a differentiated product with high switching costs.**

Explanation

The threat of competition from substitute products is likely to be low for a firm that produces a differentiated product with high switching costs. Unused capacity and low industry concentration (a fragmented market) tend to intensify rivalry among industry competitors but are not directly related to the threat of substitutes.

(Study Session 12, Module 37.1, LOS 37.g)

Related Material

SchweserNotes - Book 3

18. (C) **Only one of these statements is accurate.**

Explanation

The first statement is accurate. When analyzing an industry, an analyst should use different approaches and scenarios when estimating industry variables. The second statement is inaccurate. Comparing one's own forecasts with those of other analysts can be useful for confirming the soundness of the analysis and for identifying industries that are potentially overvalued or undervalued by the consensus view.

(Study Session 12, Module 37.1, LOS 37.f)

Related Material

SchweserNotes - Book 3

19. (C) **product innovation.**

Explanation

Frequent introductions of new products and innovations tend to make firms' market shares within an industry less stable. High barriers to entry into the industry and high switching costs for customers to change to a competing product both contribute to market share stability.

(Study Session 12, Module 37.2, LOS 37.h)

Related Material

SchweserNotes - Book 3

20. (B) **the firm produces luxury items.**

Explanation

Producers of luxury items tend to have cyclical earnings because consumers typically decrease their purchases of these items during economic recessions. The earnings of firms with high percentages of variable costs are not as likely to be cyclical as those of firms with high percentages of fixed costs (i.e., high operating leverage). A growth industry has demand that is strong enough that earnings remain relatively unaffected by the business cycle.

(Study Session 12, Module 37.1, LOS 37.c)

Related Material

SchweserNotes - Book 3

21. (B) principal business activity.

Explanation

Commercial providers such as Standard and Poor's and MSCI Barra classify companies according to their principal business activity and the products and services they provide.

(Study Session 12, Module 37.1, LOS 37.b)

Related Material

SchweserNotes - Book 3

22. (C) with similar business activities and competitive factors.

Explanation

An analyst should form peer groups of companies that have similar business activities, drivers of demand and costs, and access to capital. Companies in the same industry or sector and companies at the same stage of the industry life cycle are not necessarily comparable for equity valuation purposes.

(Study Session 12, Module 37.1, LOS 37.e)

Related Material

SchweserNotes - Book 3

23. (A) Defensive.

Explanation

A defensive industry is typically characterized by stable performance during both expansions and contractions of the business cycle.

(Study Session 12, Module 37.1, LOS 37.c)

Related Material

SchweserNotes - Book 3

24. (B) cumulative output and cost per unit.

Explanation

The industry experience curve shows cost per unit relative to cumulative output. Cost per unit typically decreases over time due to higher utilization rates for fixed capital, improvements in the efficiency of labor, and better product design and manufacturing methods.

(Study Session 12, Module 37.1, LOS 37.f)

Related Material

SchweserNotes - Book 3

25. (A) **high concentration, under capacity, and high market share stability.**

Explanation

Firms in highly concentrated industries are more likely to have pricing power than firms in fragmented industries. Firms in industries with tight capacity constraints are more likely to have pricing power than firms in industries with excess capacity. High market share stability is indicative of pricing power because competition is likely less intensive.

(Study Session 12, Module 37.2, LOS 37.h)

Related Material

SchweserNotes - Book 3

26. (B) **Switching costs include the time needed to learn to use a competitor's product.**

Explanation

Switching costs include the time and expense of learning to use a competitor's product and tend to be higher for specialized or differentiated products. High switching costs contribute to market share stability and pricing power.

(Study Session 12, Module 37.2, LOS 37.h)

Related Material

SchweserNotes - Book 3

27. (A) **Competitive strategy.**

Explanation

Company analysis involves examining a specific firm's financial condition, products and services, and competitive strategy (cost leadership or differentiation). Industry analysis should include examining competitive forces such as the threat of entry and the power of buyers.

(Study Session 12, Module 37.2, LOS 37.1)

Related Material

SchweserNotes - Book 3

28. (B) **Cost leadership strategy.**

Explanation

Michael Porter identified two competitive strategies: cost leadership and product or service differentiation. A firm that uses a cost leadership or low-cost strategy seeks to have low production costs that will enable it to offer lower prices than its competitors to protect or gain market share. A product or service differentiation strategy seeks to gain a price premium for its products by making them distinctive to the consumer.

(Study Session 12, Module 37.2, LOS 37.1)

Related Material

SchweserNotes - Book 3

29. (A) Telecommunications.

Explanation

Both technology and housing firms tend to be quite cyclical, that is, their profits are very sensitive to changes in overall growth. The profits of telecommunications firms, on the other hand, are less economically sensitive.

For Further Reference:

(Study Session 12, Module 37.1, LOS 37.c)

CFA® Program Curriculum, Volume 4, page 309

Related Material

SchweserNotes - Book 3

30. (C) levels of capacity.

Explanation

Low capacity is associated with pricing power because it increases the likelihood that supply in the short run will be less than demand at current prices. Low barriers to entry and low industry concentration (a fragmented market) typically suggest firms have little pricing power.

(Study Session 12, Module 37.2, LOS 37.h)

Related Material

SchweserNotes - Book 3

31. (B) rivalry among existing competitors and power of buyers.

Explanation

Porter's five competitive forces are: (1) rivalry among existing competitors; (2) threat of entry; (3) threat of substitutes; (4) power of buyers; (5) power of suppliers.

(Study Session 12, Module 37.1, LOS 37.g)

Related Material

SchweserNotes - Book 3

32. (A) Shakeout.

Explanation

The shakeout industry life-cycle stage is characterized by slowing (but still positive) growth, intense competition, and declining profitability, as demand begins to approach market saturation. In contrast, the decline industry stage is characterized by negative growth. The lack of brand loyalty among customers suggests the industry has not yet reached the mature stage.

For Further Reference:

(Study Session 12, Module 37.2, LOS 37.i)

CFA® Program Curriculum, Volume 4, page 332

Related Material

Schweser Notes - Book 3

33. (C) **Underweight the industry.**

Explanation

A cyclical industry is one that is expected to outperform during an expansion and underperform in a contraction. The industry rotation strategy for a cyclical industry is to overweight during an expansion and underweight during a contraction. This does not imply that a manager will rotate entirely out of a cyclical industry.

(Study Session 12, Module 37.1, LOS 37.a)

Related Material

SchweserNotes - Book 3

34. (B) **Consumer staples.**

Explanation

The consumer staples industry is best classified as non-cyclical and defensive. Energy and technology are best classified as cyclical industries.

For Further Reference:

(Study Session 12, Module 37.2, LOS 37.k)

CFA® Program Curriculum, Volume 4, page 343

CFA® Program Curriculum, Volume 4, page 343

Related Material

SchweserNotes - Book 3

35. (C) **Pricing power.**

Explanation

Industry analysis provides a framework for an analyst to understand a firm in relation to its competitive environment, which determines how much pricing power a firm has. Competitive strategy and financial performance are aspects of company analysis.

(Study Session 12, Module 37.1, LOS 37.a)

Related Material

SchweserNotes - Book 3

36. (B) **High barriers to entry and low power of buyers.**

Explanation

High barriers to entry (low threat of entry) and low power of buyers both increase the potential for economic profits within an industry. The five forces that shape industry competition are rivalry among existing competitors, threat of entry, threat of substitutes, power of buyers, and power of suppliers. The stronger any of these forces are within an industry, the less potential that industry has to generate (or continue to earn) economic profits.

(Study Session 12, Module 37.1, LOS 37.g)

Related Material

SchweserNotes - Book 3

37. (B) **The growth stage is typically characterized by decreasing prices.**

Explanation

Prices tend to decrease in the growth stage as firms begin to realize economies of scale in production. The stages of the industry life cycle, in order, are embryonic, growth, shakeout, mature, and decline. Industry growth is slow during the embryonic stage as firms develop products and attempt to gain customer acceptance.

(Study Session 12, Module 37.2, LOS 37.i)

Related Material

SchweserNotes - Book 3

38. (B) **Market research.**

Explanation

A firm that follows a product or service differentiation strategy needs to emphasize market research to identify needs for which customers are willing to pay a premium. Market share and operating efficiency are more of a focus for firms that pursue a low-cost strategy.

(Study Session 12, Module 37.2, LOS 37.l)

Related Material

SchweserNotes - Book 3

39. (A) **Confections.**

Explanation

Technological influences are relatively important in the pharmaceuticals and oil services industries, but they are generally not a significant influence in the confections industry.

(Study Session 12, Module 37.2, LOS 37.k)

Related Material

SchweserNotes - Book 3

40. (A) **Shakeout Stage.**

Explanation

The typical industry life cycle stages in chronological order are embryonic, growth, shakeout, mature, and decline.

(Study Session 12, Module 37.1, LOS 37.f)

Related Material

SchweserNotes - Book 3

41 (B) **sensitivity to business cycles.**

Explanation

Auto manufacturing and home building are both cyclical industries. An industry classification system based on business cycle sensitivity would be the most likely to group firms from these industries together. While these industries are both affected by some macro forces, they are also each affected by forces specific to their products and would not necessarily be grouped together in a classification system based on returns correlations.

(Study Session 12, Module 37.1, LOS 37.b)

Related Material

SchweserNotes - Book 3

42. (B) **examine firms' annual reports to see if they identify competitors.**

Explanation

Annual reports are a good source of information when identifying peer groups because companies may identify their key competitors. It is often appropriate to include a company in more than one peer group. An analyst forming peer groups can use commercially available industry classification systems to identify which companies are in the same industry.

(Study Session 12, Module 37.1, LOS 37.e)

Related Material

SchweserNotes - Book 3

43. (C) **Mature.**

Explanation

The mature stage exhibits little or no growth, industry consolidation, and high barriers to entry. Kidwell has noted that the industry is growing, but slowly (replacement demand and population gains). Furthermore, the firms have efficient cost structures and strong brand loyalty; both of which are high barriers to entry.

The decline stage exhibits negative growth, excess capacity, and high competition. Kidwell has observed positive, slow growth and a lack of price wars. Both of these observations are contrary to what would be expected in the decline stage.

The shakeout stage exhibits slowing growth, intense competition, and declining profitability. Kidwell has observed that growth is stable, the firms have achieved efficient cost structures, and price wars are uncommon. Hence, growth is not slowing, competition must not be intense because there are price wars (these occur when competition is intense), and profitability is likely stable given the efficient cost structures.

(Study Session 12, Module 37.2, LOS 37.i)

Related Material

SchweserNotes - Book 3

44. (B) Utilities.

Explanation

Non-cyclical industries are those for which demand is not highly sensitive to business cycles, such as utilities, health care, and food and beverages. Housing and autos are examples of cyclical industries.

(Study Session 12, Module 37.1, LOS 37.c)

Related Material

SchweserNotes - Book 3