

# Assess a Company Before Buying Its Stocks



**Carmen Lee** is currently the Head of OCBC Investment Research, a unit of OCBC Group. OCBC Investment Research specialises in equity-related research products. Carmen has more than 15 years of equity investment experiences working with American, European and Asian stock broking firms.

**Carmen is one of the top Earnings-Estimators awarded by StarMine in 2006.**

 **OCBC Investment Research**

[www.ocbcresearch.com](http://www.ocbcresearch.com)

## Assessing a company before buying its stocks, what to look out for:

In the present hot and rising global equity market, sometimes fundamental theories and caution are thrown out of the window as market participants look to ride the rally. While participating in a rising market as the momentum builds up is often used as an investment strategy, for long-term investors looking at identifying and investing in quality stocks, it pays to look realistically at the sustainability of the earnings streams of the invested company.

*With so many listed stocks, what are the key factors to look out for before investing in a company?*

At the core of long-term investment strategies is to an understanding of the **company's business model**. Is it **sustainable**? This is crucial and a look back at the Internet bubble of 2000-2001 should provide some recent indications. Then, investors were carried along by the rising global wave for Internet services and companies. Excessive valuations were accepted as the norm

as market expectations were of potentially stronger earnings from these companies. Irrational exuberance was often cited, but market participants generally ignored these early warnings. However, within a short span of time, interest in these stocks quickly dried up as earnings and merger & acquisition (M&A) deals evaporated just as speedily as the Internet's bubble exploded. However, those companies that survived have gone on to make good gains. For example, Yahoo!, an Internet stock is still around today while many failed and were forced to transform their business models or were acquired.

Sustainability of the business model also ensures that earnings streams are more assured. A good example is conglomerate Keppel Corporation. When oil prices were low, interest in Keppel Corporation was almost non-existence and the performance of its stocks was lacklustre, hovering at around S\$1 to S\$2 from 2000 to 2002 (adjusted for stock split). However, this conglomerate remained profitable during the whole period with its earnings supported by several core sectors including marine and property. All these changed dramatically about two years ago. The strong surge in oil prices together with renewed buying

interest in properties, both regional and domestic, have created two strong pillars of earnings growth for the group. This was spectacularly reflected in its share price which moved up 180% in the last 2 years to current level of S\$15.00. This is a group that has successfully ridden out the cyclical trends in its core businesses, with a sustainable business model, which in turn gives its earnings momentum to ride the present uptrend.

**Assessment of the environment** that the company operates in is the next step. Generally, a top-down approach will include an evaluation of the macro-economic factors, the industry specific factors and the company specific factors. Macro-economic indicators are readily available from renowned government agencies, newspapers, magazines and numerous reputable websites. Industry specific factors can also be similarly gathered from these same sources. Research reports from brokers also provide a good in-depth analysis of industry trends and drivers.



One of the key assessment points is what the main growth drivers are in a specific industry. **Where are the growth factors coming from? What are the long term sustainable growth trends? What are the key risk factors?**

At this juncture, a **SWOT (Strength, Weakness, Opportunity and Threat)** analysis is a useful tool to fairly assess the key merits and weaknesses. This is a fairly tedious process of listing down the main arguments for the four main categories, but is necessary and useful to give a balanced view of the company's prospects and risks. While some concentrate on only the key investment merits, assessing risks is just as crucial as it warns of the perils ahead and serves to heighten one's awareness of the key red flags to watch out for. Some risks are more significant than others and these warrant a higher weightage.

**Corporate transparency** and the **credibility and track record** of the management team are also essential factors. Timely release of corporate developments be it positive or negative, is indicative of a management's commitment to corporate transparency. A steady flow of corporate updates also serve to keep investors in touch with the developments within the company.

Once the above is carried out, it is time to **rank the companies within the industry**. Typically, at both extremes are the leaders and laggards. The leaders tend to be bigger and are generally the price-setters. These are also usually among the first to benefit from the industry uptrend. For the first wave of buying interest into a growing or recovering industry trend, investors generally tend to focus on the leaders first. Then, interest will spill over to the second-tier beneficiaries, mainly the smaller-to-mid capitalisation companies, that is, those that provide supporting services and products. Finally, towards the later part of the cycle, the laggards then come into play. These are further down the line, but essentially also beneficiaries, albeit of a smaller scale, of the uptrend.

Secondly, once you have ascertained the long-term sustainability of the earnings model, then it is time to look at the **target company's valuations** and compared these against its peers, both locally and globally. This gives an indication of the valuations parameters. For example, if the target company is offering similar earnings growth of 15%, and all things being equal, but it is trading at 12x earnings versus the average of 15x for its peers, this is indicative of a possible re-rating upwards. Similarly, the reverse is true. While this is simplistic and is just one indicator, other useful valuation parameters should be similarly applied to gain a better understanding of relative performances.

Once you have identified a fundamentally sound company, it pays to **monitor** its stock price for a period of time before buying the stock. Investing is fairly long term in nature, and contrary to popular belief of quick gains, it pays to look at **price trends**. Identifying price support and resistance levels is helpful in indicating price entry and exit levels. It pays to be patient to buy on price dips and sell into price strength. In some situations, investors are keen to buy, but reluctant to sell and in the end, missed out on capital gains. A good exit strategy or price level is as critical as identifying a good company to invest in.



**Do You Have Any Questions For Us Regarding Investment Issues?**

Write in to us and we would answer your queries. Please send all questions to [letters@the-executive.com.sg](mailto:letters@the-executive.com.sg)