Impact of Qualitative Fundamental Analysis on Intrinsic Value of a Share

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It takes a lot of thought process and hard work to research into a company's fundamentals to determine what the intrinsic or latent value of a share should be. This intrinsic value provides a direct link to investor's action. As a prelude to this, the analyst must understand the role of fundamental analysis which involves on one hand quantitative analysis that can be done with numbers and statistics and are easier to this paper is a conceptual one which deals with the study of qualitative factors in evaluating the worth of a company for investing in securities.

Keywords: Fundamental Analysis, Qualitative Analysis, Investment Decisions, Intrinsic Value

Contribution to the Body of Knowledge
A successful investor should study not just the quantitative aspects of his portfolio but also the qualitative aspects. This paper would help investors in evaluating the worth of a company for investing in securities. The paper will also help investors find out what are the main characteristics of winning companies, according to the main fundamentals.

1. Introduction

Equity Investments are an investment that requires the active involvement of the investors to give results in the long run. Even if an investor appoints a manager to look after their portfolio it is advised to be equally involved in the investment decision that they take. Many investors are not professionally equipped to take these investment decisions and hence require guidance.

The primary purpose of an investor while investing in the stock market is gain. He needs to decide the timeline for his investment i.e. if he's investing for a short term (1 year or so) or if he's in it for the long haul. A speculative investment is one where an investor invests into a company for a short period of time. However, when an investor holds it for a fairly long period of time there is an inherent expectation that he would receive some return on this investment. And hence, he would want to invest in those companies that give him higher returns in the long run. The process of deciding where to invest (i.e. Investment Decision) and how long to invest in that company depends on various analyses which conducted by the investor.

The method of calculating the future price of a stock that one wishes to buy is called Fundamental analysis. One can conduct fundamental analysis by analyzing two factors: Qualitative factors and Quantitative factors. Basically, it is an approach to determine this "what ought to be" price of the security under scrutiny.

The quantitative analysis involves a thorough analysis of the broad economic forces in which a company operates. It also includes the analysis of the industry that company is a part of and the particularly the internal working of the company by analyzing its financial statements. Thus, fundamental analysis is the method for forecasting the future behavior of investments.

The performance of the economy that a company is a part of also dictates what the performance of a company will be. This is because a company is an integral part of the industrial and business sector of the said economy. If the economy is in recession phase or stagnation phase, with other things being the same that is, ceteris paribus, the performance of companies within that economy will also be bad. There will however be certain exceptions to this.

On the other hand, if the economy is thriving, with increase in incomes and the demand is good, then the companies within that economy will prosperous. However, as in the earlier case in this case as well there will be some exceptions.
Figure 1 given below showcases this interlinking of a company's performance in view of the industry and economy it belongs two.

An economy is the condition of a country or region in terms of the supply of money in the region, which is the quantity of production and consumption of the goods and services produced in the region. An economy analysis would hence, encompass the calculation of the Gross Domestic Product, Economic Growth of the region, the level of exports and imports, levels of industrial production etc. of the region under study. As discussed earlier the economy plays an important role in the performance of any company.

An industry consists of hundreds of companies and they may be producing similar products, yet their level of diversification, operational profit and efficiency differ from each other. Within the industry companies risk and return profile vary. Sometimes, the difference may be marginal or wide. Now, the investor has to choose the best performing company among the group for his investment purpose. Take for instance if he has selected Information Technology Industry, he has to select from companies like Infosys, TCS, Wipro, Cognizant, Hexaware, Mahindra Satyam, Tech Mahindra, Oracle Fin, Rolta, Polaris, Mind tree etc. For this the investor has to integrate a large amount information related to the company and evaluate the present and future values of the stock. The ability of the investor to gather and analyze this information from the complex web of relationships and inter-relationships among the related variables determines the valuation process. Industrial Analysis would encompass the various aspects that an investor researches to forecast the relative position of the company under scrutiny against other players in the said industry.

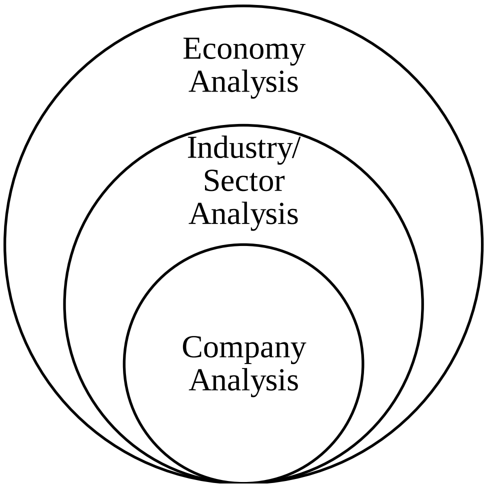

Figure 1

Evaluating the financial performance of a company on the basis of the qualitative and quantitative factors related to it is called company analysis. Company analysis is similar to industry analysis as the investor integrates the information related to the company in a similar fashion as the industry analysis.

Qualitative factors are non-quantifiable factors that represent certain aspects of a company's business. Integrating such information in the evaluation of stock price can be quite difficult. At the same time they cannot be ignored. The management factor is a qualitative factor, which is difficult to measure, yet it exerts tremendous influence on the profitability of the company or even the existence of the company. Satyam Computers is an example for the collapse of a company because of mismanagement of funds. Quantifiable factors are measurable factors like earnings, sales, cost of production etc., which directly affect the revenue of the company. Figure 2 given below showcases the various Qualitative and Quantitative Factors.

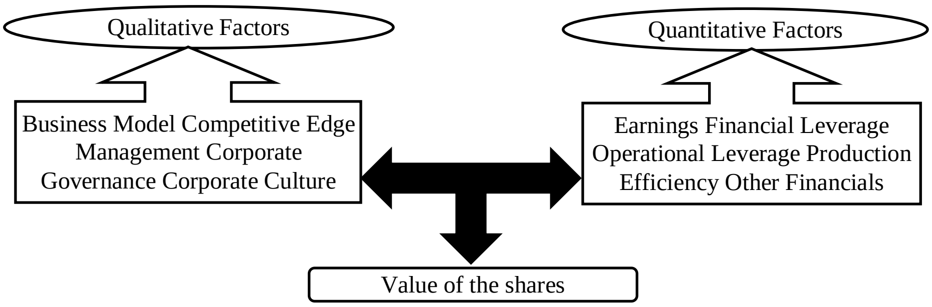

Figure 2

Objectives

1. This paper aims to study the qualitative factors in evaluating the worth of a company for investing in securities.
2. Another objective of the research is to collect all relevant information so that it provides a better picture to know that how a company proposes and grow its business in the best possible manner while rewarding its shareholders. Thus the study was made to find out what are the main characteristics of winning companies, according to the main qualitative fundamentals.

2. Literature Review

Various studies are been made, which revealed the value of fundamental study on the developed equity markets: F. Shostak [7], Moube A. and Jannach M. [13]. But when it comes to similar studies when the study is practically implemented to emerging market equities question the time and energy invested to carry out analysis prior to investing in any of the companies, especially when there is a limited investing time frame of less than 1 year.

Khan and Zuberi (1999) who is considered as bed-rock of security analyzing investment, plays an extremely crucial role to analysts. According to him, fundamental analysis is top-ranking and one of the key methods in analyzing investment. It can be said, this can be a fairly solid base, on which we can make investing decisions effectively. There are approximately 90% investors using fundamental analysis. Warrant Edward Buffett, who made most of money from investment; he is an excellent example of successful people of fundamental analysis. His analysis focused on the easiness of the business, the stability of its functioning history, the attractiveness of its long term prospects, the quality of management, and the firm's capacity to create value (Banchuenvijit, 2008)

Another study by Mussio I. and Sosa M. [13] indicates that the companies with high integrity, better corporate governance and high and good credit ratings were the top performers during the financial crisis. On the other hand, it was seen that low returns, poor corporate governance and ratings, and higher risks were offered by the companies that tried to be flexible and bendable and have been retrenching off employees during the crisis.

From past many years, probably for the last 80 years, fundamental analysis has been used in determining core value that is the true value which the price of a particular venture is heading towards over a longer period of time. This analysis is a constantly developing science, as evidenced by emergence of newer and newer valuation methods (BOROWSKI 2014, p. 10).Among the most famous advocates of fundamental analysis, in addition to GRAHAM and DODD, we should mention investors such as Warren E. BUFFETT (see: GRAHAM et al. 2009, 2003), Peter LYNCH (see: LYNCH, ROTHCHILD 2000, 2012; LYNCH 2012) and Philip A. FISHER (see: FISHER 2015). BUFFET alone became an inspiration for a large number of writers with his policy of security and investment policy-making (see: CALANDRO 2009; CUNNINGHAM 2001, 2003; HAGSTROM 2009; HAGSTROM et al. 2014).

Whenever one has to make long-term predictions of values of future phenomena, fundamental analysis is taken into considerations which are based on historical data and a set of other factors which may affect, to a certain extent the level of demand and supply (KRZYWDA 2010, p. 55). It too be noted that both measurable and non-measurable features (quantitative and qualitative factors) are counted and incorporated in the study. According to DAMODARAN (2012, p. 6), the main purpose and final result of its application is determining the object's true value, the so-called fundamental (intrinsic) value where Black's Law Dictionary defines Intrinsic value of a thing as its true, inbuilt , and indispensible value, not depending upon accident, place, or person, but the same everywhere and to everyone. (http:// thelawdictionary.org/intrinsic-value/)

3. Analysis and Discussions

Qualitative analysis helps us look beyond the facts and figures given in the quantitative analysis towards the functioning of the company that the investor wishes to invest in. As discussed earlier, qualitative analysis includes the "soft" analysis of the company viz. the Ownership Pattern and the management team of the organisation, the business model that the company follows, the governance of the company, the competitive analysis of the company (i.e. its competitive edge) and the culture of the organisation. All these factors contribute to each other and hence form an interlinked chain as shown in Figure 3.

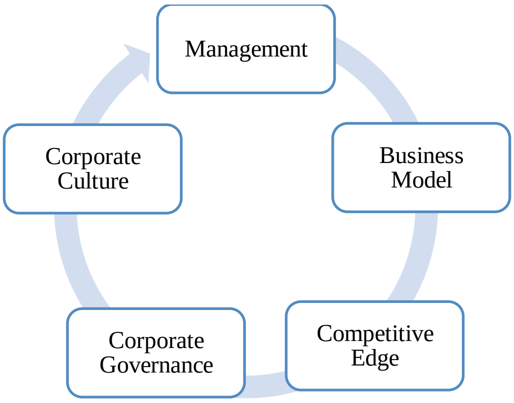

Figure 3

We shall now discuss each of these factors in detail and see how they impact the investors' investment decision.

Management

By management we mean the ownership pattern of the organisation and the C-suite or top management of the company.

Ownership Pattern: The number of shares that are owned by the promoter of the company indicates the confidence that the promoters have in the company's future. Therefore, a company where the promoter hold a sizeable quantum of shares bolsters the investors' faith in the company. Further, it is important to note the percentage of institutional holding of an organisation also enriches the confidence in the company. Let us take the example of Wipro to understand the impact of Ownership Patter. In the latest stock exchange filing of Wipro dated 31 March 2017, the reported promoter holding is 73.34%. This indicates the conviction and sincerity of the promoters as the share of promoter holding is considerably large. A promotional holding that is greater than 35% is considered to offer a certain level of safety to the retail investors. During the same time period the institutional holding in the Company (that is, the sum of FII and DIIs) was 15.29 %. An Institutional holding of this size indicates that even seasoned investors have confidence in the company. However, this also brings about a high level of volatility in the stock price as institutions buy and sell larger quantum of stocks than retail participants.

C-Suite Analysis: The C-suite stands for all the top management employees of the organization. These include the CEO and the heads of all the departments of the company. The top management of an organization is responsible for all the policy level decisions of the organization and hence their business acumen plays an important role in the functioning of the organization. Hence, before investing in an organization it is important to understand in detail about the organizations C-suite. This information can be collected by reading up on these people. In today's digital age information on these people can be easily gathered via various search engines. Try to read up on any interviews and such that the individuals have given. One can also look into the social media profiles of the individuals reading through their tweets (via Twitter), LinkedIn Profiles and Facebook pages can help us understand in detail about the approach that these individuals have. Past history with regards to where they have worked earlier and how they have risen in the ranks of the organization will also help you understand them better.

Annual Reports: Studying the annual reports especially the columns such as Directors' Message, Future Plans etc. give investors an idea about the direction in which the C-Suite of the company plan to take it.

Thus, these three things together make up the management analysis of the Qualitative analysis. This will be able to help the investor in understanding how reliable the organization can be.

Business Model

The business model of a company is basically how it makes money. Business models can be simple or complex. Even before making financial analysis an investor should know: What exactly does the company do? The business model clearly explains it. The business model provides a description of the company's operations and the revenue generation avenues, the expenses it incurs, the structure of the organization, and its sales and marketing strategy. An analysis of the company's business model should result in bolstering the belief of the investor that the company is poised for success. By not understanding the business of the company you are investing in can act as a huge liability as you may not be able to decipher whether the business decisions taken by the company are sound or not. Business models provide a pan-industry lens that helps us in understanding how a company is being managed and the resulting stock market total return. To analyze the business model of the organization the investor needs to understand whether they know how the company works, whether you have the personal knowledge of the particular field of business. A simple and straight forward business model is a better investment than a complicated one which you don't understand. For example knowing Tata Motors is in the automobile sector is not enough for an investor. Tata Motors produces truck, buses and cars. Thus, it caters to the automobile needs of a large segment and the business model ensures certain amount of safety for returns.

Competitive Edge

An industry is composed of a number of individual companies. Let us take the example of the Information Technology (IT) Industry. In the IT industry there are a large number of number of companies however, certain companies such as TCS, Infosys, Wipro etc., control the major market share. This is also the case in all industries, certain companies are able to rise to a position of eminence and dominance. Large companies are able to withstand the competition and are successful. The market-leader position once obtained is seldom lost by the companies. Their ability to handle the competition and create a sizeable market share is proved over time. The competitive edge of a company is what helps it gain this mileage over other companies in that industry. This competitive edge of the company is further reflected in the sales of the company and a surge in the market share. So, what separates these companies from their peers? What is so distinctive about these companies who have outperformed the other companies in their sectors? This factor is the Competitive Edge that the company has over others. Thus, Competitive Edge is that unique aspect of a company that sets it apart from others. The factors that can be the Competitive Edge of the company can be "Price Premium" or "Cost Efficiency". Price premium can be achieved by creating innovative products that are of high quality. Apple Inc. is an example of a Mobile Phone manufacturing company creating a Competitive Edge through the Price Premium route. Cost Efficiency can be achieved by creating economies of scale and scalable products. Oppo Mobiles is an example of a Mobile Phone manufacturing company creating a Competitive Edge through the Cost Efficiency route.

Corporate Governance

An important aspect that determines a company's future is how accountable and transparent it is with regard to its dealings with the laws and regulations of their place of business. This adherence to accountability and transparency is called Corporate Governance. A company that has in place a sound system of processes and practices to ensure good governance has a level of fairness in its dealings to meet the aspirations of the stakeholders and society. The stakeholders in a company are all those individuals or sections that are affected by it. Hence, it includes everyone ranging from the board of directors, management, and shareholders to customers, employees and the society at large. The aforementioned systems and practices are defined in the company's charter and bylaws, along with corporate laws and regulations set by the government. Further, good corporate governance also ensures that the organization does not get involved in any activities that are either illegal and/ or unethical. Good corporate governance enhances the trust investors have in a company. As a result of good corporate governance, the company will not get embroiled in any practices that will hinder the company's image in the mind of the shareholder. Financial transparency and clear disbursal of information is a key factor in maintaining good corporate governance.

Corporate Culture

Corporate culture can be defined as a collection of beliefs, value systems, and processes that are followed by a company. It is the culture of the company that makes it unique from its peers. This set of values and goals helps a company to define how they will do business and what their business is about. A strong corporate culture helps the employees to withstand an ever changing marketplace and hence also enables it to have strong financial results. An important aspect of a good corporate culture is that it values its employees, customers, and owners. It also encourages leadership and pro-activeness from everyone in the company that results in a good performance. A measure of a good corporate culture is whether the company's culture customizes itself to the changing needs of its customers. Thus, as the company is able to modify and adapt itself to the customer's needs they are able to show a sustained performance. Another factor that is influenced by the corporate culture is the employee morale and engagement levels. A sound corporate culture would nurture employees and ensure high morale and engagement levels. Thus, the employees are highly motivated to work hard and achieve the targeted goals and also have a lot of faith in the company which is reflected in the customers as well as the investors.

4. Conclusions

A company may have sound financial track record, but an inefficient management, poor business model, lack of corporate governance, and various other parameters will not help the company to move forward. In fact, the financial indicators would take a downturn in such a situation.

Therefore, we can conclude that along with the analysis of financial statistics we must also analyse the qualitative information. The data driven financial analysis needs to be supplemented with an understanding of the qualitative features of a company which is human-judgement driven. The qualitative analysis includes the analysis of the company's present state, the business it is involved in, and projections of the future and the quality and competence of its management.

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