

Q2 ? Is the company's business model understandable? How does it make money?

Objective:

This is the core question regarding the company's business. If the company's business model is not understood, any investment in the same is tantamount to speculation. For instance, in Q#1, it may turn out that the company is in the business of life insurance. However, if the investor does not understand how money is made in life insurance, all plans to invest in the company need to be abandoned.

What to look for:

- The key question here is – Can you describe the company's business(es) in your own words?
- Is it a product company or service company?
- Is it a domestic company or global company?
- Does it have a monoline or diversified business? If diversified, what is the business mix?
- Is the business secular or cyclical?
- Who are its major customers? When it comes to customers, there are 3 types of businesses: (1) B2C (business-to-consumer), (2) B2B (business-to-business) and (3) B2G (business-to-government). B2C companies tend to have higher bargaining power with their customers, which is progressively lower for B2B and B2G.

Understanding the business model also involves a thorough understanding of the company's value chain. A value chain is a set of activities that an organization carries out to create value for its customers. For companies that produce goods, a value chain comprises the steps that involve bringing a product from conception to distribution, and everything in between – such as: (1) Procuring raw materials, (2) Manufacturing functions, and (3) Marketing activities. For a service company, the Value Chain is likely to involve: (1) Marketing, (2) Service delivery and (3) Customer Relationship Management.

Having said that the Value Chain for every single company will be unique and needs to be well understood.

Value chain analysis also helps determine how exactly the company makes money. For instance, for a primary steel company –

- It may have captive mines for iron ore and coal.
- Both iron and coal are put into a blast furnace and melted to produce what is called molten iron or hot metal.
- Blowing oxygen through the hot metal lowers the carbon content of the alloy and changes it into steel.
- The steel is then converted into various forms – bars, rods, coils, etc.
- The same may be sold direct to users or through the company's distributors.

Value gets added at each of the above steps.

Data/information sources to understand the company's business:

- Reading up of industry material available online.
- Interacting with industry associations.
- Discussion with the Investor Relations team of the company.

