TOPIC 8: UNDERSTANDING THE 3 PRE-DEFINED INDUSTRIES

Pharmaceutical and Biotechnology: What This Industry Is About

Definition as per Industry Classification Benchmark (ICB)

Pharmaceutical: Companies engaged in research into and development of biological substances for the purposes of drug discovery and diagnostic development, and which derive the majority of their revenue from either the sale or licensing of these drugs and diagnostic tools.

Biotechnology: Manufacturers of prescription or over-the-counter drugs, such as aspirin, cold remedies and birth control pills. Includes vaccine producers but excludes vitamin producers, which are classified under Food Products.

Examples: Pfizer, GlaxoSmithKline, Merck, Takeda

How to Analyse This Industry

This industry is more complicated than others and requires a student to do a significant amount of external reading. The following are areas to look out for as a student proceeds with the business and financial analysis.

- **Revenue Growth:** This is driven by releases of new drugs and the expiration of patents on existing drugs. When a patent expires, other companies can "copy and produce" the same drug at a cheaper price – this is known as the generic drugs industry. The expiration of a patent will lead to a drop in revenue as the company must lower its prices so as to compete with the manufacturers of generic drugs.
- **% of R&D to Sales:** A company invests in its future by entering into R&D for new drugs. It is very expensive to develop new drugs and can easily take more than 10 years. There is a trend of companies lowering drug development risk by acquiring promising biotechnology start-ups instead.
- **% of Marketing Costs to Sales:** It is costly to advertise and convince the public that a drug is useful. Marketing spend for pharmaceutical companies tend to be high and must be closely watched.
- **Government intervention:** There is a trend of how governments intervene and either (a) demand price reductions for certain drugs or even (b) neutralize the patent on a drug and allow generics to be made.
- **Consolidation and Tax Inversion:** This is the latest way for pharmaceutical companies to grow and to reduce their tax liabilities at the same time.
- **Litigation:** A common issue within the industry, especially when certain drugs lead to fatal outcomes.

How to Bench-Mark within This Industry

- **Similar product mix:** Understand the product mix of your target company and select an appropriate comparator. Some pharmaceutical companies derive the majority of their income from sale of drugs while others may derive a much lower proportion.
  For example, Eli Lilly has most of its revenues from drugs while for Bayer, drugs constitute a minority of its revenues.
- **Similar scale:** Scale is a big advantage within the pharmaceutical industry due to how it allows for better economies of scale in R&D, clinical trials and marketing expenses.
- **Similar accounting standards:** Be mindful of the challenges when selecting a UK company alongside a US one. This will lead to difficulties in comparing their results and adjustments may have to be made.

Airlines: What This Industry Is About

Definition as per Industry Classification Benchmark (ICB)

Airlines: Companies providing primarily passenger air transport. Excludes airports, which are classified under Transportation Services.

Examples: Singapore Airlines, Emirates Airlines (this is an unlisted company), AirAsia, EasyJet

How to Analyse This Industry

This industry has a variety of unique factors, where management decisions define the performance of the company. We will explore a few in the following section:

- **Risk Management:**

Airlines often choose to hedge the cost of fuel, which is a large part of their expenses. There has been a recent fall in oil prices, but companies like SIA which are significantly more conservative hedged over 85% of their fuel costs at significantly higher prices, and are therefore less competitive than other airlines like Emirates. The fact that these prices were locked in at higher rates impacts their ability to reduce prices, remove fuel taxes, and generate a high profit margin.

- **Capital Decisions:**

Airlines with newer fleets tend to do better in terms of fuel consumption, but face significantly higher depreciation. The capital policy therefore creates differences in performance of different airlines.

Similarly, newer planes may make previously unprofitable routes profitable again (like the latest Dreamliner 787).

- **Environmental Legislation:**

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As countries impose carbon taxes on airlines, this significantly reduces their profitability, and makes certain routes less viable. Be sure to explore the impact on the company and its strategy.

- **Consider the Intangibles**

People often rank airlines by the quality of its service. This is intricately linked with its financial performance. Other possible factors include the quality of inflight entertainment systems, food, the availability of WiFi (Emirates recently launched a WiFi service on board all A380s which offers a free 10mb and US$1 for subsequent 500mbs of WiFi).

- **Load Factor**

A ratio unique to the industry, this ratio affects net profit margin. A large amount of the airline expenses are fixed. An airplane that carries 1 person incurs probably 95% of the cost that an airplane carrying 300 people might. As such, how full these planes are will affect the profitability of the airline, and determine how airlines carry out their promotions to ensure that these planes are filled. Examine the success of which by looking at the trend of load factors.

How to Bench-Mark within This Industry

- **Similar product mix:** Understand the product mix of your target company and select an appropriate comparator. You should not compare SIA with China Eastern for example, or a budget airline with a full-fledged airline.
- **Similar scale:** An airline that flies predominantly domestic routes will have very different performance from an airline that flies predominantly international routes. Select your comparator well.
- **Similar accounting standards:** Be mindful of the challenges when selecting a UK company alongside a US one. This will lead to difficulties in comparing their results and adjustments may have to be made.

Telecommunications: What This Industry Is About

Definition as per Industry Classification Benchmark (ICB)

Fixed Line Telecommunications: Providers of fixed-line telephone services, including regional and long-distance. Includes companies that primarily provides telephone services through the internet. Excludes companies whose **primary** business is Internet access, which are classified under Internet.

Mobile Line Telecommunications: Providers of mobile telephone services, including cellular, satellite and paging services. Includes wireless tower companies that own, operate and lease mobile site towers to multiple wireless service providers.

Examples: Vodacom, Orange, SingTel, StarHub

How to Analyse This Industry

- **Product Mix**

Many of the telecom companies are no longer merely fixed or mobile line companies. They often offer Pay-TV, Internet packages and sell handsets together with their lines. Be sure to examine the strategy that defines their bundles and if they can be easily replicated by their competitors.

- **Saturation and Growth**

The telecom markets in many countries are usually highly saturated. As such, how is the company generating growth? If not, can the companies learn from other successful ones in other countries (like SingTel)?

- **Legislation**

The market is oligopolistic, but legislation is often enacted to ensure that these companies stay competitive. Be sure to examine the legislations and how they affect the telecom companies. In particular, consider if they undermine monopoly powers and the effects on the company.

- **Market Share**

This is crucial. When examining two companies operating in the same countries, and providing vastly similar services, the changes in market share is a good indicator of the success of the company. Do look at why the shares changed the way they did, and the link between this and financial performance.

How to Bench-Mark within This Industry

- **Similar geographical concentration:** You should generally compare telecom companies concentrated in the same regions. It makes it easier to critique, than to compare say Orange in France and Vodacom in Australia.
- **Conglomerates:** Many telecom companies are large conglomerates. Vodacom for example has operations in numerous countries. Are you able to compare Vodacom with another company that may have similar scale? If not, you may need to consider selecting a telecom company that is more geographically concentrated.
- **Similar accounting standards:** Be mindful of the challenges when selecting a UK company alongside a US one. This will lead to difficulties in comparing their results and adjustments may have to be made.

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