

Questions to Ask Management

In a book “**Applied Equity Valuation**” by T. Daniel Coggin and Frank J. Fabozzi, there is an exhaustive sample interview outline that analysts and investors might find useful. At Amazon, see http://www.amazon.com/exec/obidos/tg/detail/-/1883249511/qid=1050580269/sr=1-2/ref=sr_1_2/104-5102841-8722341?v=glance&s=books

Company Background Information

Review some basic company history in order to have an understanding of how the company has evolved into its current form:

- When was the company founded?
- When did it go public?
- How/why has it evolved into the businesses in which it currently operates?
- How long has the current management team been in place?
- What are the management team's primary long-term goals?

Market and Competitive Overview

Gain an understanding of the market profile and competitive landscape in which the company operates. The analyst should try to gauge the attractiveness of the market, as well as the company's relative competitive position, and its ability to improve on this position:

- Approximate size of the market(s).
- Competitive advantages / disadvantages of size.
- Market growth.
- Historical cyclicalities.
- Position in the current economic cycle.
- Secular changes, if any, taking place that will affect the market profile going forward.
- Barriers to entry.
- Manufacturing capacity being added, and the impact on industry pricing structure.
- Fragmentation of the competitive landscape.
- Key industry competitors, ranked by strength.
- Market share breakdown among these industry participants.
- Market share shifts over the years, and the leading causes of these changes.
- Key differentiators (i.e., price, product quality, delivery times, technology, distribution).

Product Line Overview

The analyst wants to secure a solid understanding of the company's products, their competitive advantages, and their positioning in the marketplace. Special attention should be given to any product(s) that the company is particularly dependent upon, and the company's ability to maintain a competitive edge with respect to these products:

- Value added from a customer's perspective of the company's product line.
- Is any of the product line customized for customer specific applications?
- Product positioning in the market in terms of price, point, and quality.
- Where is the product in terms of its life cycle?
- How quickly do these cycles evolve?
- Proprietary aspects of the product line (i.e. patents, technology, trademarks, licenses, etc.)
- Products' drawbacks or competitive disadvantages.

- Risk of obsolescence.
- Company dependence on any single product or product line.
- Overall product mix profile in terms of revenue generation.
- How is this mix changing?
- How do operating margins differ within this mix?
- Level of resources put into research and development (R&D).
- Is R&D expensed or capitalized for accounting purposes?
- Company dependence on its ability to generate new and/or upgraded products.
- Ability to enter new markets.

Sales and Marketing

The analyst should try to understand how the sales and marketing functions are performed, and whether the company has gained any type of competitive advantage from these functions:

- Does the company have an internal sales force, or does it use independent representatives?
- Growth in sales force or number of independent representatives.
- How are the salespeople incentivized?
- Customer retention rates.
- Methodology for contacting new customers.
- Types of advertising used for marketing purposes.
- Ability to measure the impact of advertising on sales results.
- Significance of these costs in terms of the overall cost structure.
- Perceived competitive advantages/disadvantages of the company's sales and marketing efforts.

Distribution

The analyst should try to understand how the distribution functions are performed, and whether the company has gained any type of competitive advantage from these functions:

- Channels of distribution used.
- Percent of sales to Original Equipment Makers (OEMs), as opposed to the aftermarket.
- Percent of sales that are wholesale versus retail.
- How do margins differ by distribution channel?
- What changes are taking place industrywide in the way product is distributed?
- How is the company responding to these changes?
- Trends in distribution costs as a component of the overall cost structure.

Customer Overview

The analyst must gain an in-depth knowledge of the customer base, and an understanding of the company's strengths and weaknesses in regards to its customer base. This is determined by various factors such as the diversity of the customer base (diversification means less dependence on any one customer), the importance of the company's products to its customers (value added), and the financial health of the customer base:

- Composition of revenues by end market.
- By geography.

- By major customers.
- Diversity of the customer base.
- Does the company supply a dominant percentage of the customer's requirements?
- Price elasticity of customer purchasing decisions.
- Are sales done on a contractual basis?
- If so, how long do contracts typically last?
- Are they obtained through a competitive bidding process?
- Price escalators/deflators based upon changing factors such as volumes, raw materials, etc.
- Typical payment terms.
- What has the amount of bad debt writeoffs been?
- What is the current profitability / cash flow profile of the customer base?
- Customer capital spending plans relative to historical spending patterns.
- Does there appear to be pent up demand for the product(s)?
- How lean/full is the inventory pipeline?

Company Structure

The structure of the company's operations must be explored in order to gain an appreciation for the amount of operating leverage inherent in the business. This is important because the more operating leverage (fixed costs/total costs), the more profits will vary with changing volumes. It is also crucial to understand the relative cost advantages/disadvantages versus the competition. The analyst must determine whether the company is a low cost producer, and if not, then why not?

- Are the company's operations centralized or decentralized?
- To what degree is the company vertically integrated in its production processes?
- Level of capital intensity involved in running the business.
- Current capacity utilization.
- To what degree is the cost structure fixed versus variable?
- Components of costs of goods sold in percentage terms (i.e., raw materials, labor, overhead, etc.).
- Dependence on any one particular raw material supplier.
- Unionized labor force?
- Competitive advantage/disadvantage created by this.
- Geographic location of key production facilities, and reasons why.
- Is there a large need for capital to upgrade or expand facilities and equipment?
- How do the above factors affect the company's overall cost position relative to its competitors?

Earnings Model, Cash Flow, and Balance Sheet Discussion

The interview should provide the necessary guidance to build appropriate financial models. These models, which are helpful for valuation analysis, will also determine whether the profitability, cash flow, and balance sheet characteristics of the company can support its projected growth rate. These are all important variables which determine the ability to grow the value of an enterprise over the long-term, and they cannot be obtained from a static analysis of a company.

Earnings Model

It is critical to understand the relationship between sales growth and profitability. Ultimately the value the stock market places on the company will be derived from a company's secular profitability. The following issues should be reviewed:

- Assess the various components of revenue growth: volume, price, product mix changes, market share changes, acquisitions.
- Evaluate gross margins: trends in the components of COGS; incremental/decremental leverage on gross margins as volume changes; is COGS valued on a LIFO or FIFO basis?
- Any accounting methods considered too aggressive or too conservative?
- Evaluate selling, general, and administrative (SG&A) costs: Typically vary in line with changes in revenues? Ability to gain leverage on these costs as the company grows; How significantly can these costs be reduced as a percent of sales?
- Average interest rate on the company's outstanding debt.
- Recent or contemplated changes in capital structure that may change financing costs.
- Tax rate and any programs in place to try to reduce the tax burden?

Cash Flow

Even more important than the earnings model is the cash flow model. This model adjusts for the various accounting choices the company is able to make and exposes management's ability to efficiently run the enterprise. Whether a company is able to self-finance its growth or be forced to tap the capital markets, will be determined through analysis of the cash flow statement. The following issues should be reviewed:

- Trend in capital spending (CapEx) required over the next few years.
- Amount for replacement of the capital base versus growth.
- Compare to depreciation and amortization (D&A) levels.
- Any working capital required growth?
- If expected to generate free cash flow (FCF), what are the priorities for utilizing it (e.g., acquisitions, share repurchases, dividend payments, debt pay down)?
- If the company is in a negative FCF situation, how will it be financed (e.g., additional debt, stock offerings, etc.)?

Balance Sheet

Financial strength is critical to a company's ability to grow and compete. Financial flexibility as well as asset productivity (a sign of management ability) are important conclusions to draw from analysis of the balance sheet. The following issues should be reviewed:

- What is the company's optimal capital structure (debt/equity)?
- Does this differ significantly from the current capital structure?
- Strategy for bringing it in line.
- Discuss trends in asset productivity (e.g., receivables, inventory, and fixed asset turnover).
- Inventory levels versus expected revenue trends.
- Long-term liability funding issues (e.g., large debt maturity, post retirement obligations).

Review of Recent Trends

The analyst must assess current fundamentals. While the previous sections have helped the analyst gain insight into how the business is run and its long-term fundamentals, this part of the interview focuses on the short-term. While we are always looking to invest in businesses based on their longer term outlook, it would be foolish to overlook near term fluctuations. The following issues should be reviewed:

- Recent order rate trends.

- Backlog trends.
- Margins in this backlog versus typical margins in this type of operating environment.
- Customer indications that order levels may change significantly in the near future for any reason.
- Impact of seasonality.
- Potential acquisitions (it's not appropriate to ask for specific targets, but markets served, size, and valuation are appropriate discussion points).

Reviewing Management Focus/Issues

An important issue that must be resolved in the analyst's mind during the interview is whether this management team has a coherent strategy, and the ability to execute it properly. By this point of the interview, the analyst should be able to determine whether management's long-term goals that were discussed early on are feasible. Any outstanding concerns should be addressed at this point. There should also be a review of management performance measurement, and it is always a plus when management's financial incentives are aligned with shareholder's best interests. In the case of small companies, the analyst must determine whether management has the capability and depth to grow the company to the next level.

- Review the stated long-term goals and the outlook for achieving them.
- Review the greatest challenges being faced by this company near term and long-term.
- How will the management team address these challenges?
- Review the largest opportunities for growth.
- How will they be exploited?
- Key financial benchmarks used in managing the businesses (i.e., ROA, ROE, EPS growth , etc.)
- Do these benchmarks vary at different levels in the company, such as by division, by plant, etc.?
- Where are these benchmarks currently versus long-term targets and versus their competitors?
- How is meeting benchmarks tied into management compensation.
- Compare total compensation (including stock, options, etc.) with similar companies.
- Discuss level of insider equity ownership, and how this has changed over the past few years.
- Is the proper management team in place to take this company into the future, or are there voids which must be filled?
- Discuss employee turnover trends, and ability to recruit talented managers.

Miscellaneous Topics

This is a catch-all section where various questions can be asked to help the analyst make a decision at the margin.

- Review currency or foreign exchange issues that could potentially impact earnings.
- Review outstanding legal or environmental issues which could have a material impact.
- Are there any shareholders that hold a significant share of the company (10% or greater)?
- If so, have they held the shares a long time?
- What is their investment strategy?
- Which sell side analysts have the best understanding of the company and its philosophy?
- Which customers and suppliers would be worthwhile to speak with regarding their experience in doing business with this company? (This is a good way to obtain more objective insights on the company.)

- What are some up and coming companies in this business to become more familiar with? (The answer to this question can often provide solid leads for other investment opportunities.)
- Any other outstanding issues that have not been covered."