NISM XV: Short Notes

This will help you pass. Best of luck!

Introduction to the Research Analyst Profession

Who is a Research Analyst? A Research Analyst helps clients make informed investment decisions by conducting research and analysis. The role involves a comprehensive study of companies, evaluating their past performance, analyzing future prospects, and making buy, hold, or sell recommendations based on this analysis.

Types of Research Analysts:

- **Sell-Side Analysts:** Publish research reports on securities for a broad client base, with specific recommendations.
- **Buy-Side Analysts:** Create research and recommendations for internal use by money managers like mutual funds, pension funds, or hedge funds.
- **Independent Analysts:** Work for separate research firms and sell their research to clients on a subscription basis.

Primary Responsibilities of a Research Analyst:

- **Understanding the Economy:** Analyzing macro-economic factors, fiscal and monetary policies, global factors, and their impact on the market.
- **Understanding Industries & Companies:** Evaluating businesses based on their strategy, products, financial health, and competitive landscape.

Important Qualities of a Research Analyst:

- Strong numerical and data analysis skills.
- Clarity on financial concepts.
- Ability to read and comprehend financial statements.
- Attention to detail and keen questioning abilities.
- Excellent written and verbal communication skills.

Securities Market & Financial Instruments

Structure of the Securities Market: The market is broadly divided into two segments:

- **Primary Market:** Where new securities are issued for the first time through methods like Initial Public Offerings (IPOs), Rights Issues, or Private Placements.

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- **Secondary Market:** Where existing securities are traded among investors. This includes regulated stock exchanges (like NSE, BSE) and Over-the-Counter (OTC) markets.

Key Financial Instruments:

- **Equity Shares:** Represent ownership (a share) in a public company and are a primary source of long-term financing.
- **Debentures/Bonds:** A form of loan issued by governments and companies to raise capital, paying a fixed interest rate to investors.
- **Mutual Funds:** A professionally managed investment vehicle that pools money from many investors to purchase a diversified portfolio of stocks, bonds, or other securities.
- **Derivatives (Futures & Options):**
    - **Futures:** A contract obligating the buyer to purchase an asset or the seller to sell an asset at a predetermined future date and price.
    - **Options:** Gives the buyer the right, but not the obligation, to buy (Call Option) or sell (Put Option) an underlying asset at a set price on or before a specific date.
- **REITs/InvITs:** Investment trusts that pool investor funds to invest in revenue-generating real estate (REITs) or infrastructure projects (InvITs).
- **Depository Receipts (ADRs/GDRs):** Certificates issued by a bank that represent shares in a foreign company, allowing them to be traded on a local stock exchange.

Key Terminologies in Equity and Debt Markets

Equity Market Terminology:

- **Face Value:** The nominal value of a security as stated by the issuer on the certificate.
- **Book Value:** The value of a share according to the company's balance sheet accounts.
- **Market Value:** The current price at which a stock is trading in the market, determined by supply and demand.
- **Intrinsic Value:** The "true" value of a company's stock based on fundamental analysis of its finances and business, independent of its market price.
- **Market Capitalization (Market Cap):** The total market value of a company's outstanding shares. It is calculated as:
    - *Market Cap = Market Price per share x Number of Outstanding Shares*.
- **Enterprise Value (EV):** A comprehensive measure of a company's total value. The formula is:
    - *EV = Market Cap + Total Debt - Cash & Cash Equivalents*.
- **Earnings Per Share (EPS):** The portion of a company's profit allocated to each outstanding share of common stock.
    - *EPS = Net Profit / Number of Outstanding Shares*.
- **Price to Earnings Ratio (P/E Ratio):** A valuation ratio that compares a company's share price to its earnings per share.
    - *P/E Ratio = Market Price per share / Earnings per Share*.

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Debt Market Terminology:

- **Coupon Rate:** The annual interest paid by the issuer relative to the bond's face value.
- **Yield to Maturity (YTM):** The total return an investor can expect to receive if they hold the bond until it matures. It accounts for all future coupon payments plus the principal repayment.
- **Duration:** A measure of a bond's price sensitivity to changes in interest rates. Bonds with higher duration are more sensitive to rate changes.

Fundamental vs. Technical Analysis

Two Core Approaches to Research:

1. Fundamental Analysis

- **Focus:** Long-term investing.
- **Premise:** The long-term value of a stock is driven by the company's financial performance and returns. A stock has an "intrinsic" or "fair" value, and profit opportunities arise when the market price diverges significantly from this value.
- **Methodology:** Involves a comprehensive study of the company's business, management, financial health, and the economic and industry conditions it operates in. This is often called the **"Top-Down" approach**:
    1. **Economic Analysis:** Evaluate the overall state of the economy (GDP growth, inflation, interest rates).
    2. **Industry Analysis:** Understand the specific industry's dynamics, growth potential, and competitive intensity.
    3. **Company Analysis:** Analyze the specific company's business model, competitive advantages, and financial statements to determine its fair value.

2. Technical Analysis

- **Focus:** Short-term trading.
- **Premise:** All relevant information (fundamentals, economic factors, market sentiment) is already reflected in a stock's price and trading volume.
- **Methodology:** Forecating the direction of prices by studying patterns in historical market data, primarily price and volume. "Chartists" use trends, support and resistance levels, and other patterns to predict future stock price movements.

Key Differences: | Feature | Fundamental Analysis | Technical Analysis | | :--- | :--- | :--- | | **Goal** | Determine intrinsic value | Predict price movements | | **Time Horizon** | Long-term | Short-term | | **Tools** | Financial statements, economic data, industry reports | Charts, price patterns, trading volume | | **Approach** | "What" to buy | "When" to buy |

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Economic and Industry Analysis

Economic Analysis Economic analysis forms the first step in the top-down approach, helping to understand the external business environment.

Key Macroeconomic Variables to Track:

- **National Income (GDP):** Measures the overall health and growth of the economy.
- **Inflation (CPI/WPI):** The rate at which the general level of prices for goods and services is rising, which erodes purchasing power.
- **Interest Rates:** Set by the central bank (RBI) through monetary policy, affecting borrowing costs for companies and consumers.
- **Fiscal Policy:** The government's policies on taxation and public spending, which can stimulate or slow down economic activity.
- **Foreign Investment (FDI/FPI):** Inflows of capital from abroad that can impact currency exchange rates and market liquidity.

PESTLE Analysis Framework A framework for analyzing the broad macro-environmental factors that can impact an industry.

- **P**olitical: Government stability, tax policy, trade regulations.
- **E**conomic: GDP growth, inflation, interest rates, employment rates.
- **S**ocio-Cultural: Demographics, consumer lifestyles, cultural norms.
- **T**echnological: R&D activity, automation, technological disruption.
- **L**egal: Labor laws, consumer protection, copyright laws.
- **E**nvironmental: Climate, environmental policies, pollution regulations.

Industry Analysis Frameworks

Once the economic landscape is assessed, the focus narrows to the specific industry.

Michael Porter's Five Forces Model A model to analyze the competitive intensity and therefore attractiveness of an industry.

1. **Threat of New Entrants:** How easy or difficult it is for new competitors to enter the market.
2. **Bargaining Power of Buyers:** How much power customers have to drive down prices.
3. **Bargaining Power of Suppliers:** How much power suppliers of raw materials or components have to increase their prices.
4. **Threat of Substitute Products:** The likelihood of customers finding a different way of doing what your product does.

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5. **Industry Rivalry:** The intensity of competition among existing players in the market.

Business Life Cycle Industries typically evolve through several stages:

- **Pioneering Stage:** A new industry emerges with high uncertainty and risk.
- **Growth Stage:** Rapid growth in sales and profits as the product gains acceptance.
- **Maturity Stage:** Growth slows down, competition intensifies, and the focus shifts to efficiency and market share.
- **Declining Stage:** The industry shrinks due to obsolescence, changing consumer preferences, or new technology.

Boston Consulting Group (BCG) Matrix A framework to classify business units based on market growth rate and relative market share.

- **Stars:** High Growth, High Share. Require significant investment to fuel their growth.
- **Cash Cows:** Low Growth, High Share. Generate more cash than they consume; profits can be used to fund Stars.
- **Question Marks:** High Growth, Low Share. Uncertain potential; may become Stars or Dogs.
- **Dogs:** Low Growth, Low Share. Generate low profits and are often divested.

Company Analysis - Qualitative Aspects

This stage involves a deep dive into the specific company.

Understanding the Business Model An analyst must first understand how the company creates, delivers, and captures value. This includes its products, customers, efficiency of operations, and unique parameters for evaluation (e.g., footfalls for retail, Net Interest Margin for banks).

Competitive Advantage What makes the company different and better than its competitors? This could be:

- Product differentiation or unique features.
- Cost leadership driven by operational efficiency.
- Strong brand loyalty and pricing power.
- Superior execution and distribution networks.

SWOT Analysis Framework A strategic tool for documenting a company's internal and external positioning.

- **S**trengths (Internal): Internal capabilities that give the company an advantage (e.g., strong finances, valuable patents, low costs).

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- **W**eaknesses (Internal): Internal factors that place the company at a disadvantage (e.g., high debt, weak brand, high customer concentration).
- **O**pportunities (External): Favorable external factors the company can exploit for growth (e.g., new markets, technological shifts, favorable regulations).
- **T**hreats (External): Unfavorable external factors that could harm the business (e.g., new competitors, economic downturns, changing regulations).

Evaluating Management Quality & Corporate Governance

- **Management Competency:** Assessing the experience, track record, and vision of the top management (CEO, CFO, etc.).
- **Corporate Governance:** The system of rules and processes by which a company is directed and controlled. Good governance ensures that the interests of all stakeholders (shareholders, employees, customers) are balanced. Key areas to check include the independence of the board, rights of minority shareholders, and transparency in disclosures.

Company Analysis - The Financial Statements

Financial statement analysis is crucial for understanding a company's performance and position quantitatively.

1. The Balance Sheet Provides a snapshot of the company's financial position at a single point in time. It follows the fundamental accounting equation:

- ***Assets = Liabilities + Shareholder's Equity***
- **Assets:** What the company owns (e.g., cash, inventory, property, equipment). Classified as *Current Assets* (convertible to cash within one year) and *Non-Current Assets* (long-term).
- **Liabilities:** What the company owes (e.g., loans, accounts payable). Classified as *Current Liabilities* (due within one year) and *Non-Current Liabilities* (long-term).
- **Shareholder's Equity:** The residual interest in the assets of the company after deducting liabilities. It represents the capital invested by shareholders plus retained earnings.

2. The Profit and Loss (P&L) Statement Also called the Income Statement, it summarizes a company's revenues, expenses, and profits over a period of time (e.g., a quarter or a year).

- **Revenue (Sales):** The money earned from selling goods and services.
- **Cost of Goods Sold (COGS):** Direct costs attributable to the production of goods sold.
- **Gross Profit:** Revenue - COGS.
- **Operating Expenses:** Costs not directly related to production (e.g., salaries, marketing, R&D).

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- **EBITDA:** Earnings Before Interest, Tax, Depreciation, and Amortization. A key measure of operating profitability.
- **EBIT (Operating Profit):** Earnings Before Interest and Tax.
- **Net Profit (PAT):** The final profit after all expenses, interest, and taxes have been deducted.

3. The Cash Flow Statement Tracks the movement of cash into and out of the company over a period, categorizing it into three activities:

- **Cash Flow from Operations (CFO):** Cash generated from the principal revenue-producing activities.
- **Cash Flow from Investing (CFI):** Cash used for or generated from the purchase and sale of long-term assets.
- **Cash Flow from Financing (CFF):** Cash flows resulting from debt, equity, and dividend payments.

Financial Ratios & Valuation

Ratios are used to interpret financial data and make comparisons across companies and over time.

Key Financial Ratios:

- **Profitability Ratios:**
  - **Return on Equity (ROE):** Measures how effectively management is using shareholders' capital to generate profits. *ROE = Net Profit / Shareholder's Equity*.
  - **Return on Capital Employed (ROCE):** Measures the return generated from all capital invested (both equity and debt). *ROCE = EBIT / (Total Assets - Current Liabilities)*.
- **Leverage Ratios:**
  - **Debt-to-Equity (D/E) Ratio:** Indicates the proportion of debt and equity used to finance assets. *D/E Ratio = Total Debt / Shareholder's Equity*.
- **Liquidity Ratios:**
  - **Current Ratio:** Measures a company's ability to pay short-term obligations. *Current Ratio = Current Assets / Current Liabilities*.
- **Efficiency Ratios:**
  - **Asset Turnover:** Indicates how efficiently a company is using its assets to generate sales. *Asset Turnover = Revenue / Total Assets*.

Valuation Approaches: The goal of valuation is to determine a company's intrinsic value.

1. **Discounted Cash Flow (DCF) Valuation:** Values a company based on the present value of its expected future cash flows.

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2. **Relative Valuation:** Values a company by comparing it to what similar companies are worth in the market. This involves using multiples like:
    - Price-to-Earnings (P/E) Ratio.
    - Enterprise Value-to-EBITDA (EV/EBITDA) Ratio.
    - Price-to-Book (P/B) Ratio.

Capital Asset Pricing Model (CAPM) A model used to determine the expected return on an asset, which is a key input (cost of equity) for DCF valuation.

- ***Expected Return = Risk-Free Rate + Beta * (Market Return - Risk-Free Rate)***
    - **Beta:** Measures a stock's volatility relative to the overall market.

Risk, Return, and Regulations

Risk in Investment Risk is the uncertainty or potential for loss in an investment. Key types include:

- **Market Risk:** Risk of losses due to factors that affect the overall financial market.
- **Inflation Risk:** The risk that inflation will undermine the real-world returns on an investment.
- **Interest Rate Risk:** The risk that a change in interest rates will negatively affect a bond's price.
- **Credit Risk (or Default Risk):** The risk that a bond issuer will be unable to make its promised interest payments or principal repayment.
- **Liquidity Risk:** The risk that an investment cannot be bought or sold quickly enough to prevent or minimize a loss.

Risk-Adjusted Return It's important to evaluate returns in the context of the risk taken. A common measure is:

- **Sharpe Ratio:** Measures the return earned on an investment above the risk-free rate (e.g., a government bond) per unit of total risk (standard deviation).
    - *Sharpe Ratio = (Portfolio Return – Risk-Free Rate) / Standard Deviation of Portfolio*.
    - A higher Sharpe Ratio indicates a better risk-adjusted return.

Key Regulations (SEBI) The Securities and Exchange Board of India (SEBI) is the primary regulator for India's securities market.

- **SEBI (Prohibition of Insider Trading) Regulations:** Prohibits trading by "insiders" (e.g., connected persons) who possess Unpublished Price Sensitive Information (UPSI).

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- **SEBI (Prohibition of Fraudulent and Unfair Trade Practices) Regulations:** Prohibits any act, expression, or omission intended to induce another person to trade in securities, thereby preventing market manipulation.
- **SEBI (Research Analyst) Regulations, 2014:** Aims to manage conflicts of interest and ensure that research analysts provide independent and unbiased opinions. It mandates disclosures of any conflicts of interest and establishes a code of conduct for analysts covering honesty, diligence, and confidentiality.

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