

# **How to do fundamental analysis**

*from*

Penman, Financial Statement Analysis and Security Valuation, 2001.

## **Step 1: Economic and Market Analysis**

Structure of the Industry: competition and market dynamics

Products being produced: what the products do, technology, substitute products

Firm cost structure and revenue composition

Firm Strategy: what are the firm's stated objectives for future growth

Regulatory Environment

## **Step 2: Analysis of Financial Statements**

Balance sheet: Price to book value of equity; net market value of assets

Income statement: earnings, free cash flow, revenues, EVA

Cash flow statement: Operating, financing and investing

Other factors not included in the financial statements: industry and government publications

## **Step 3: Forecasting relevant payoffs**

What are the important 'value drivers'?

What are 'best guess' forecasts of the value drivers?

What factors could act to undermine the forecasts?

## **Step 4: Formulating a security value**

Specifying the approach to valuation

Applying the valuation model to the available data from steps 1-4

## **Step 5: Making a recommendation**

For an outside investor, recommend buy, sell or hold.

Stating qualifications to the forecast