

Investing in athletic shoes with Mac, Aisha, and Reggie

Part 4: How debt ratio and industry structure help you pick stocks

Mac and Aisha have been thinking about whether to invest in Nike stock. Earlier, while researching Nike, Mac noticed the company recently reported that its long-term corporate debt was over \$419.4 million.* Wow, he thought, that's a lot of money! Mac remembers that companies have to pay interest on the money they borrow, and eventually have to pay that money back. He thinks this may be a problem for Nike, and asks Reggie about it.

Why do companies have debt?

Reggie starts by reviewing why companies have debt. First, companies need to increase their sales and earnings over time because that helps the price of their stocks go up. How can a company make its sales and earnings grow? One way is to bring out new products, or improve the products it's already making.

But companies need money beyond what they're already earning from selling their products to begin designing and making new or improved products. Companies can raise extra money by selling more stock to the public, borrowing money from banks in the form of loans, or borrowing money from investors by selling bonds. If a company takes on debt for a good purpose—like increasing its sales and earnings—debt can be good.

Debt can be good if companies use the borrowed money to increase their sales and earnings.

Can all companies "handle" the same amount of debt?

Reggie tells his friends that companies with publicly traded stock vary widely in size. The amount of debt a company has is relative to other things like the size of the company and the amount of money it makes selling its products.

He asks Aisha and Mac to compare AT&T, which recently reported long-term corporate debt totaling more than \$55 billion, with Nike (remember that Nike's long-term debt was about \$419.4 million). It's clear that AT&T has a lot more debt than Nike, but Reggie says AT&T made more than \$63 billion in sales in 2006—a lot more than Nike's 2006 sales of \$11.9 billion. Also, AT&T recently reported it had \$270.6 billion of assets, compared with Nike's assets of \$10.2 billion.

How to figure in these factors

A tool called the debt ratio helps investors decide whether the amount of debt a company has is OK for a company of its size. To find a company's debt ratio (sometimes called the debt-to-equity ratio), divide the company's long-term debt by the total shareholders' equity.

Here's an example of how to calculate the debt ratio for both companies:

Find shareholders' equity (Nike's Web site lists shareholders' equity at \$6,848 million);

Find long-term debt (Nike lists it as \$419.4 million);

Divide the debt by the equity. This gives us a debt ratio.

	Equity (millions)	Long-term Debt (millions)	Debt Ratio (approx.)
Nike	6,848	419.4	6.12%
AT&T	115,540	55.000	47.6%

What do Nike's 6% and AT&T's 48% debt ratios mean? It's hard to make general statements because there are so many factors involved, and because different investors think different things. But AT&T's debt ratio of 48% is certainly on the high side. Many investors would be feel that's too much debt for the company—and they would be reluctant to invest in its stock.

On the other hand, many investors would be more comfortable with a company having a debt ratio of 6%, as Nike does. They might feel that Nike would not have a major problem paying interest on that amount of debt, and eventually paying back the money it borrowed.

"The debt ratio is an important tool, but it's not the only thing investors should take into account," Reggie says.

Non-numerical tools for analyzing stocks

So far, Aisha and Mac have learned to analyze a company using methods based on numbers and mathematical calculations—the PE ratio, the debt ratio, the dividend yield, and the net profit margin.

Reggie tells his friends that there are other more conceptual tools—abstract ways of thinking that can't always be expressed in numbers—many people also use to decide whether to invest in a company's stock.

Five factors that describe an industry

One of these conceptual tools is a list of five factors developed by Professor Michael E. Porter. By examining each factor and putting all the conclusions together, investors can analyze an industry as a whole and how a company fits within that industry. An investor can use the results of this analysis to decide whether or not to invest in a company in that industry. Of course, the way the factors fit together will be different for different industries.

Professor Porter's factors are:

- The possibility that new companies will enter the industry (barriers to entry).
- The threat that a company's customers will substitute products (buy something else).
- The amount of bargaining power a company's customers have (can customers force the company to lower its prices?).
- Whether the company's suppliers have bargaining power (can suppliers force the company to pay more for the things it needs to make its products?).
- Whether the rivalry between a company's existing competitors is intense or relatively mild.

The debt ratio helps investors decide if a company has too much debt for its size.

Let's look at how each of these factors affects the athletic shoe industry.

Are new athletic shoe competitors likely to appear?

Reggie asks Aisha and Mac to consider whether it would be easy for a new company to start making and selling athletic shoes, possibly taking sales and earnings away from Nike.

Aisha and Mac list the things a new athletic shoe company would have to do:

- *Design a stylish shoe that serves a specific purpose (a soccer shoe is very different from a marathon runner's shoe);*
- *Build a factory where the shoe will be made;*
- *Hire and train the workers who will make the shoe;*
- *Buy materials to make the shoes—leather, cloth, and plastic;*
- *Buy machines to make the shoes;*
- *Advertise the shoe so customers will know it's out there—and want to buy it;*
- *Find a way to sell the shoe to the public;*
- *Repeat these steps for a number of other shoes, since it's not likely that a company would want to make and sell just one shoe.*

Putting all these factors together, an investor might conclude that there are significant barriers to entry in the athletic shoe industry. It seems possible that a new shoe company could come along and start selling shoes, but it would probably take a lot of money and might be difficult.

This favors Nike stock as an investment. If it were too easy for a new company to come into the industry, a company probably would do that, possibly taking some sales and earnings from Nike.

Can customers find substitutes for athletic shoes?

Porter's second factor is whether customers could substitute—use other products instead of the products the industry makes. Many of Nike's customers are athletes on school, college, or professional teams and use shoes specially developed for their sports. These athletes could not easily substitute another kind of shoe for their specialized athletic shoes.

Aisha and Mac realize that this is favorable to the shoe industry as a whole since these customers are a kind of "captive market."



Do athletic shoe customers have a lot of bargaining power?

The third factor in Porter's list concerns the bargaining power that industry customers may have. Look at the number of customers who buy the industry's products and the importance of each sale in relation to the industry's total sales.

In today's marketplace for shoes, there are many customers and each pair of shoes is a very small percentage of its overall sales. This is favorable to companies in the industry, because no one customer can pressure a company to drop its prices. If the shoe industry had only a few big customers, and if the money each customer spent was a large percentage of the industry's total sales, things would be different.

Do athletic shoe industry suppliers have a lot of bargaining power?

The next factor is the bargaining power of industry suppliers—the companies from which Nike and other companies buy the things like leather and other raw materials needed to make their shoes. Are there a large number of companies that sell raw materials to Nike and other athletic shoe manufacturers? Are sales to the shoe industry a big part of those companies' total sales?

Reggie asks his friends to look into this factor more, since they don't know too much about this part of Nike's business. But he suggests that what Nike buys is considered commodities. Suppliers of commodities to other companies that make finished products sometimes have very low bargaining power. If that's the case here, this factor would be favorable to manufacturers of athletic shoes.

How intense is competition in the athletic shoe industry?

If industry competition is intense or fierce, companies fight each other hard for sales. They're likely to spend more money on advertising and on their sales force, cut prices to sell more products, and the like. All this may cause them to take in less money in sales and to report lower earnings. If competition within an industry is fierce, that's unfavorable for a company in the industry.

In other industries where competition is less vigorous, companies generally don't fight as hard to take sales away from their competitors, saving money on expenses like advertising and sales, and making more money by avoiding price cuts. Mild competition is generally favorable for companies within an industry.

Aisha and Mac think that competition in the shoe industry is fairly intense. After all, there are several other shoe companies trying to take sales from Nike, and each company in the industry seems to spend a lot on advertising and marketing. This is a somewhat unfavorable factor for Nike.

Adding up the factors for the athletic shoe industry

Aisha and Mac look at all the factors put together and conclude that the athletic shoe industry is a fairly good industry to be in. They decided that the first four factors were favorable to the industry. The only unfavorable factor related to the nature of

competition in the athletic shoe industry, and that was only somewhat unfavorable.

Reggie tells his friends that this is an important step, but it's only one step. "After you decide that an industry is an overall favorable investment, look closely at a specific company, or several companies, within that industry," he advises.

Reggie also asks Aisha and Mac to research each factor to see if their initial conclusions are correct. The "bottom line" of this five-factor analysis could change if they change their minds on one or more of the factors. He also reminds them that it's important to remember that the way the factors fit together can change over time.

For more information, see:

Part 1: How to find information about stocks

Part 2: What dividends and capital tell you about a company

Part 3: Understanding the price-to-earnings ratio

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