CORPORATE ANALYSIS

Corporate Financial Health Check – The 5-Minute Company Analysis

If you had merely five minutes to do a swift corporate financial health check, then you may consider doing the following: A decomposition of the Return on Equity (RoE), a decomposition of the Return on Assets (RoA), run a quick cash conversion cycle (CCC) and some selected liquidity ratios, swiftly assess the firm´s solvency and finally whether growth was supported organically.

RoE (net income / equity) measures a firm´s profitability for the funds shareholders have committed. However, a firm simply reporting an increase in its RoE does not necessarily reveal much, unless it is decomposed: RoE can be broken down into a firm´s net margin, asset turnover and leverage. – Now, an increase in the firm´s net margin is certainly positive, as is – in most cases - an increase in the asset turnover. Latter is an indication for how efficient a firm employs its assets. Nevertheless, in that regards one may also investigate whether the firm has recently undertaken sufficient capital expenditures. If not, then recent underinvestment would candidly enough also result in a higher asset turnover. Finally, an increase in the firm´s leverage would indicate that its financial risk profile has increased. This is not necessarily bad, if additional leverage was used to improve the firm´s capital structure in that overall cost of capital were reduced. However, excess leverage – despite driving up RoE – can at times dangerously expose a firm, which may become painfully visible during an economic downturn. – Therefore, decomposing a firm´s RoE is essential in understanding its drivers: Where an increase or decrease originated from. – On the one hand, RoE can be used as a benchmark against industry peers. In regards to RoE as an absolute figure, it has to exceed the opportunity cost for a shareholder, the relative cost of equity for a similarly risky investment proposition. Hence, RoE deals entirely with the shareholder perspective.

The same principle approach is valid in assessing a firm´s RoA (EBIT / total assets). RoA can be decomposed into a firm´s gross margin and – again – asset turnover. RoA focuses on the perspective of the management which is entrusted in optimally operating a firm´s assets, regardless from its capital structure: And EBIT is actually the last line in the income statement before dealing with the firm´s capital structure, reflected by the firm´s interest expense. – Also RoA can be used as a benchmark against industry peers. However, as an absolute figure it has – as a minimum – to exceed the least expensive source of funding: The cost of debt. Certainly, the average cost of capital may be more appropriate as a threshold. However, this component may at times be cumbersome to calculate (and at this point in time we purely focus on a quick health check).

The components of the CCC – expressed in days - and their respective trends provide a useful insight into the firm´s ability to convert a variety of input components into cash. Focus is thereby on the major working capital components. At the same time this measure provides an indication about the amount of cash bound and for how long. The CCC can be decomposed into its components of days payable, inventory turnover, days receivable as well as cash and liquidity held. - The CCC also indicates the requirements for a firm´s working capital and process funding (especially in regards to cost of goods sold and overhead).

Liquidity ratios, such as the current, quick and cash ratio are useful to determine a debtor´s ability to meet current debt obligations. Focus is again on the working capital. – Whilst many texts argue that a current ratio better be larger than 1 (which is questionable, as largely dependent on the industry sector as well as on the bargaining power of certain players), the trade-off in such a strategy is that those current assets exceeding current liabilities have to be funded. And such funding through, for example: loans, is commonly more expensive than through, for example: payables. Therefore, provided this can be implemented, a treasurer may actually rather aim for a current ratio of less than 1.

In regards to a firm´s solvency, one may not overlook possible refunding requirements of medium- and long-term liabilities. A quick assessment of how well diversified the firm´s funding base is as well as the state of the capital markets may be helpful.

Finally, the firm´s ability to organically support its growth momentum should be assessed. This is useful, as supporting a growth strategy foremost with outside (debt) funding may already have reached its leverage limits, especially when benchmarked against industry peers.

$$RoE = \frac{NI}{E} = \frac{NI}{REV} \times \frac{REV}{TA} \times \frac{TA}{E} > CoE$$

$$CoE = RFR + \beta \times MRP$$

$$RoA = \frac{EBIT}{TA} = \frac{EBIT}{REV} \times \frac{REV}{TA} > CoD$$

DAYS →

|— INVENTORY —||— RECEIVABLES —||— CASH —|

|— PAYABLES —||———— CCC ————|

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TO COVER: COGS + OVERHEAD

LIQUIDITY

BALANCE SHEET

CASH RATIO	CASH	PAYABLES
	CASH EQUIVALENT	
QUICK RATIO	RECEIVABLES	
CURRENT RATIO	INVENTORY	

ORGANIC GROWTH POTENTIAL = RoE × RETENTION RATE

RETENTION RATE = (1 − DIVI PAYOUT RATIO)