CORPORATE ANALYSIS

RoA: The Management Perspective

Return on Assets (RoA) is an appropriate measure to assess whether there is value created in management further running the firm´s operations.

The SWOT analysis, the Porter Model or similar approaches are all helpful in assessing the strategic positioning and strength of a firm. They help specifying internal and external factors that contribute favorably or unfavorably in achieving an overall firm objective. - From a Corporate Finance perspective, the fundamental issue is: When and under which circumstances should management halt operations and possibly shut them down.

A firm´s management is entrusted with assets and it is its job to generate revenues, cash flows and ultimately profits. To start with, management´s operational basis comprises all assets provided. From a Corporate Finance point of view this is the active, left side of the balance sheet. One should note, though, that numerous non-financial assets are actually not accounted for in a balance sheet, such as the quality of staff, good standing, image or customer relations. – In any case, assets have to be funded, the means and instruments of which are to be found on the passive, right side of the balance sheet. However, for the time being, we will ignore funding as well as isolate the Chief Financial Officer (CFO) from the management team: We just want to focus on those functions within the management board which are directly linked to production, operations or delivering a service.

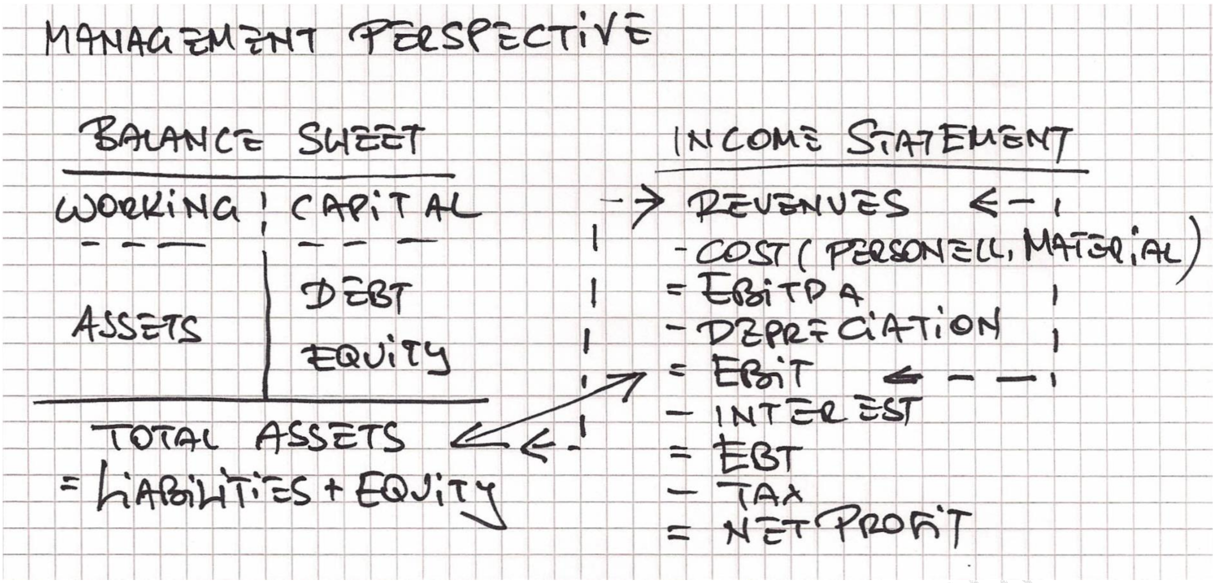
Taking a closer look at the income statement, then Earnings before Interest and Taxes (EBIT) seems a good indicator for measuring operational performance: EBIT represents the last line in the income statement, before dealing with funding (interest payments or income) and taxes. Hence, this is the last line in the income statement which focuses on management performance from a Corporate Finance point of view, before the CFO comes in.

Therefore, putting entrusted assets and EBIT in perspective appears to appropriately define management performance, at least from a Corporate Finance point of view. And it also reflects management´s unique perspective on running a business: Therefore, RoA (EBIT / total assets) seems to be a most relevant ratio to assess the feasibility of an operation.

However, also RoA has to be put in a perspective. Of course, trends in RoA overtime provide some insight. – But more relevant is the definition of a benchmark which has to be met to signal to management and investors upon whether to continue with operations or not.

The ultimate benchmark in this regards are the funding costs of the firm, of its assets and operations. In reality, though, calculating a firm´s cost of capital can at times be a quite cumbersome task. In the context of a quick corporate health check a reasonable short cut is considering a firm´s average Cost of Debt (CoD): Dividing the firm´s interest expense by interesting bearing short- and long-term liabilities.

This approach is already fair enough, at least for a start: Assuming that the most basic balance sheet funding structure just comprises equity and debt and with CoD always being lower than cost of equity, a basic rule may be formulated: For management to continue operations medium- / long-term, RoA has to meet or exceed the firm´s CoD. Of course, there could be years when this benchmark may not be met. However, if RoA undershoots CoD long-term, then the viability of a firm´s operations should certainly be in question.


MANAGEMENT PERSPECTIVE
BALANCE SHEET
WORKING | CAPITAL
ASSETS
DEBT
EQUITY
TOTAL ASSETS
= LIABILITIES + EQUITY
INCOME STATEMENT
REVENUES
- COST (PERSONELL, MATERIAL)
= EBITDA
- DEPRECIATION
= EBIT
- INTEREST
= EBT
- TAX
= NET PROFIT

.