CORPORATE ANALYSIS

Liquidity

A firm must be in a position to meet its short term financial commitments and obligations once they become due. This is generally referred to as a firm´s liquidity.

These commitments and obligations may arise from a firm´s indebtedness (meeting principle and interest payments of, for example, bank loans or bonds), payments to shareholders (dividends), but also relate to payments in regards to the firm´s production process, including payments to its suppliers of raw material, goods and services, not least to its personnel, but also of taxes or fees, as there may be.

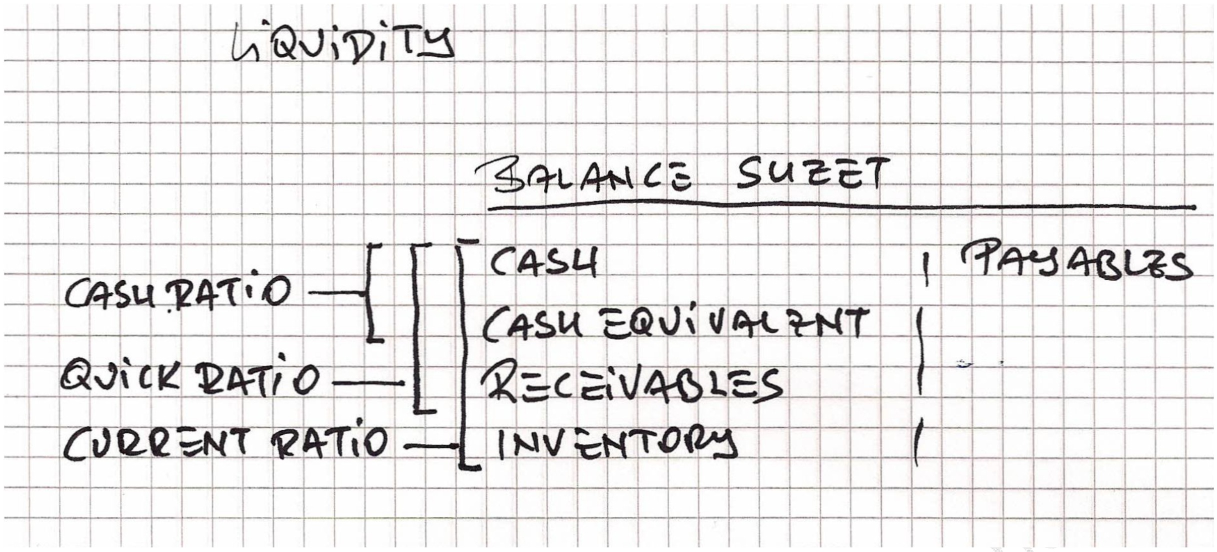
For this purpose, firms require to have access to sufficient liquidity, either by holding an adequately large cash position or – if this were not the case – having access to cash, for example by the sale of liquid assets (e.g. securities or receivables) or by drawing cash from a credit line provided by one of the firm´s house banks.

Financial analysts at commercial banks and credit rating agencies have developed a broad set of parameters and ratios to assess a firm´s financial health as far as its liquidity is concerned. Among them, the most relevant are Current Ratio, Quick Ratio and Cash Ratio.

The Current Ratio addresses the relationship of a firm´s current assets vis-à-vis its current liabilities. Current assets are such which a firm intends to hold for a short period of time only, such as cash, cash equivalents, securities, receivables and inventory. Current liabilities include payables as well as short term debt. According to the concept of the Current Ratio, a firm should hold sufficient liquid, current assets to be in a position to cover its current liabilities, whereby literature often concludes that the Current Ratio should exceed 1 – alas: current assets should exceed current liabilities. - However, this view ignores that there are various means for a firm to ensure a sufficient level of liquidity, next to just holding sufficient liquid assets. Further, as far as any ratio is concerned, also the Current Ratio has to be either seen in a relative, peer-to-peer context (rather than serving as an absolute benchmark) or to be assessed along a trend which may be stable, improving or deteriorating.

The Quick Ratio excludes the firm´s inventory from the current assets and this reduced position is then divided by its current liabilities: In most cases inventory - composed of raw material, semi-finished and finished goods - is regarded as being less liquid than cash or receivables. Whilst in many instances true, one could argue that it actually depends upon the type of inventory: Commodities, such as oil or timber could be converted into cash fairly easily and fast, maybe within days. On the other hand, the same process may definitely take considerably longer if specialty machinery components or similar were involved.

Finally, the Cash Ratio also excludes - next to the inventory - also receivables from current assets. As a matter of fact, receivables - depending upon size and quality – can commonly fairly easily be sold, often within a matter of days. And, there are actually firms whose liquidity management heavily relies on factoring, whereby receivables are sold to factoring specialists on a continuous basis. These financial institutions immediately pay in cash for a certain percentage of the claims, often around eighty or even ninety percent (depending upon the quality of its customers), with the remainder split between the factor and the firm. - Despite all that, receivables do not have the liquidity quality of cash or equivalents. - The Cash Ratio is therefore defined as the firm´s cash position plus highly liquid securities (also referred to as cash equivalent) divided by the firm´s current liabilities.


LIQUIDITY
BALANCE SHEET
CASH RATIO
QUICK RATIO
CURRENT RATIO
CASH
CASH EQUIVALENT
RECEIVABLES
INVENTORY
PAYABLES