Corporate Financial Health Check – The 5-Minute Analysis

If one had merely few minutes to perform a swift, preliminary corporate health check, then a decomposition of a firm´s Return on Equity (RoE) may be considered, followed by one of its Return on Assets (RoA) and its Cash Conversion Cycle (CCC). This may be accompanied by a review of selected liquidity ratios, next to an assessment of a firm´s solvency and whether its growth momentum is actually sustainable.

RoE (net income / equity) measures the profitability of funds provided by shareholders. Whereby the in-/decrease of a firm´s RoE does not reveal much, unless broken down into net margin, asset turnover and leverage. – An increase in a firm´s net margin is a positive sign. As is - most of times - an increase in asset turnover, indicating the efficient employment of assets. Whereby a cross-check of recent capital expenditure may be useful, as sustained under-investments would candidly also result in a (questionable, though) higher asset turnover. Finally, an increase in leverage would point towards a firm´s financial risk profile having gone up. This is not of concern, as long as higher leverage reduced a firm´s average cost of capital. However, excessive leverage, despite enhancing a firm´s RoE, can result in dangerously volatile performance patterns, which tend to become painfully visible in economic downturns. – Therefore, decomposing a firm´s RoE is essential to understand its origins, its drivers. – Whilst RoE can serve as a benchmark vis-à-vis industry peers, more relevant, though, is whether RoE (as an absolute figure) exceeds the opportunity costs for shareholders: the cost of equity for similarly risky investment propositions. - Hence, RoE exclusively reflects the perspective of a shareholder.

RoA (EBIT / total assets) measures the viability of a firm´s going concern and can be decomposed into gross margin and – once again – asset turnover. Hence, RoA assesses a firm´s performance from the perspective of its management, which is entrusted assets with the mandate to optimally operate them, regardless how they are funded: This performance is reflected in Earnings before Interest and Taxes (EBIT), the last line in the income statement prior to a firm´s capital structure being taken into account (i.e. interest expenses, the next line down in the income statement). – Whilst RoA can also be used as a benchmark vis-a-vis industry peers, its absolute figure is more relevant: For a firm´s operations being viable, RoA must - as an absolute minimum – exceed the least expensive source of funding: a firm´s cost of debt. - Whilst a firm´s average cost of capital would be the more appropriate (and precise) threshold to beat, calculating that is a cumbersome exercise (and would exceed the purpose of a 5-minute check).

Each component of the decomposed CCC (expressed in days) and respective trends provide insight into a firm´s ability to convert input components into cash. Focused on the flows of working capital, CCC illustrates the volume of cash bound, and for how long. A CCC´s decomposition into days payable, days of inventory turnover, days receivable as well as cash and liquidity held indicates funding requirements of a firm´s working capital and related processes (e.g. cost of goods sold and overhead).

Liquidity measures, such as the current, quick and cash ratio help to determine a debtor´s ability to meet current obligations. Next to working capital, focus is on all short-term assets and liabilities. – Whilst some argue that a firm´s current ratio should exceed 1 (a questionable stance, as entirely dependent on a firm´s industry sector and its bargaining power within), this strategy´s trade-off is that such coverage requires funding: Apart from the fact that funding via (non-interest bearing) payables is cheaper than (interest bearing) debt. Hence, if such can be implemented, an aggressive treasury and liquidity strategy may rather pursue a current ratio of less than 1.

When assessing a firm´s solvency, one may also review refunding requirements of medium- and long-term liabilities. Hence, an understanding of the degree of diversification of a firm´s funding base may be helpful as well as the state and liquidity of relevant private and public capital markets.

Finally, a firm´s ability to support its growth momentum via organic funding may also be assessed: Not least, as the implementation of a growth strategy by foremost outside (debt) funding could already have reached its limits. Whether that is already the case, will also be determined by a firm´s credit and credit rating policy as well as lenders´ perception (e.g. in comparison to industry peers).

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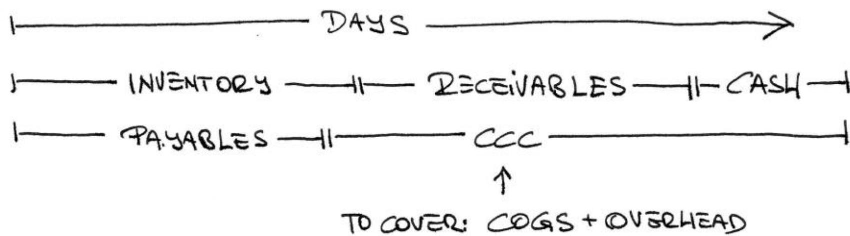
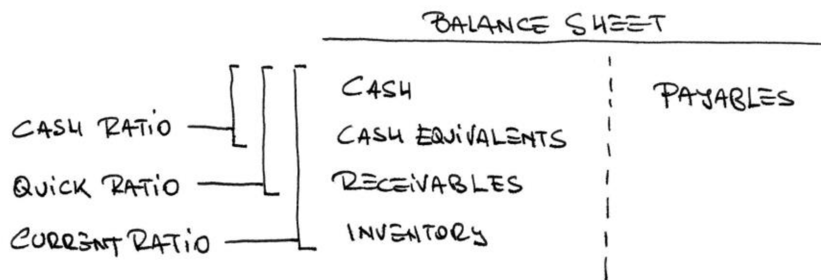
$$RoE = \frac{NI}{E} = \frac{NI}{REV} \times \frac{REV}{TA} \times \frac{TA}{E} > CoE$$

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

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

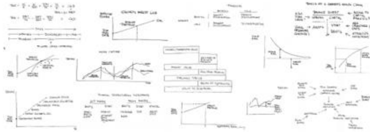




$$\text{ORGANIC GROWTH POTENTIAL} = RoE \times \text{RETENTION RATE}$$

$$\text{RETENTION RATE} = (1 - \text{DIVIDEND PAYOUT RATIO})$$

For more concepts click on:



Corporate Finance Concepts

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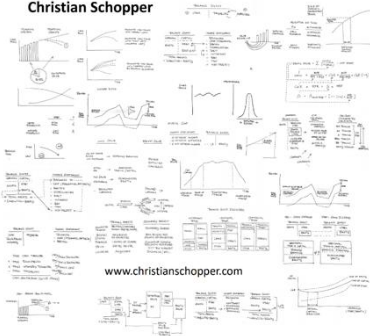

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