Corporate Financial Health Check – The 5-Minute Analysis

If one had just several minutes to perform a preliminary corporate health check, then a decomposition of the firm´s Return on Equity (RoE) may be considered, as well as its Return on Assets (RoA) and its Cash Conversion Cycle (CCC). This may be accompanied by determining some selected liquidity ratios, next to an assessment of the firm´s solvency and whether recent and anticipated future growth momentum could be funded organically.

RoE (net income / equity) measures the profitability of funds shareholders provide. However, a firm merely reporting an increase in its RoE does not reveal much, unless it is broken down into a firm´s net margin, asset turnover and leverage. – An increase in the firm´s net margin is undoubtedly positive, as is – in most cases - an increase in asset turnover. Latter indicates how efficiently assets are employed. It may be useful, though, to check a firm´s level of capital expenditures, too: Recent underinvestment would candidly enough also result in an (undesirable, however) higher asset turnover. Finally, an increase in the firm´s leverage would indicate an increase in its financial risk profile. This is not necessarily of concern, if additional leverage improved the firm´s capital structure, resulting in reduced average cost of capital. Excess leverage, though (despite driving up RoE) can make a firm dangerously volatile, with that becoming painfully visible during an economic downturn. – Therefore, decomposing a firm´s RoE is essential to understand its relevant 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 cost for a shareholder: The relative cost of equity for a similarly risky investment proposition. - Hence, RoE exclusively reflects a shareholder´s perspective.

RoA (EBIT / total assets) measures the viability of a firm´s going concern and can be decomposed into a firm´s gross margin and – once again – asset turnover. RoA focuses on the perspective of a firm´s management, which is entrusted assets and mandated to optimally operate them, regardless how these are funded: This performance is reflected in Earnings before Interest and Taxes (EBIT), the last line in the income statement before a firm´s capital structure is taken into account (i.e. interest expenses, the next line down in the income statement). – Whilst RoA can also be used as a benchmark against industry peers, its absolute figure is even more relevant: For a firm´s operation being viable, RoA has (as an absolute minimum) to exceed the least expensive source of funding: The cost of debt. Whilst applying the average cost of capital as threshold would be more appropriate (and precise), its calculation is actually cumbersome (and would exceed the purpose of a 5-minute check).

The components of the CCC (each expressed in days) and their respective trends provide a useful insight into the firm´s ability to convert input components into cash. With a focus on the major components of working capital, the measure indicates the amount of cash bound, and for how long. Based on its decomposition into days payable, days of inventory turnover, days receivable as well as cash and liquidity held, the CCC provides guidance for funding requirements of a firm´s working capital and related processes (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. Next to working capital, focus is on all short-term assets and liabilities. – Whilst a few argue a firm´s current ratio better exceed 1 (which is questionable, as dependent on the industry sector as well as on the bargaining power of certain players), the trade-off in this strategy is that such overhang also requires funding. And that is certainly more expensive by the means of (interest bearing) debt than (non-interest bearing) payables. Therefore, provided such can be implemented, an aggressive treasury and liquidity strategy may rather pursue 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 and liquidity of the capital markets may be helpful.

Finally, a firm´s ability to support its growth momentum by means of organic funding should also be assessed: Not least, as the implementation of a growth strategy by foremost relying on outside (debt) funding may already have reached its limits, depending on a firm´s credit policy as well as perception by lenders (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

TO COVER: COGS + OVERHEAD

BALANCE SHEET

CASH RATIO	CASH	PAYABLES
	CASH EQUIVALENTS	
QUICK RATIO	RECEIVABLES	
CURRENT RATIO	INVENTORY	

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

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

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