Corporate Financial Health Check - Principles

When assessing a corporate´s financial health and sustainability, focus should be on its profitability, operating efficiency, its state of liquidity and solvency. Ideally, such checks also help to determine whether the underlying business and operations will create shareholder value long-term.

There are numerous ways to determine the momentum of current value creation as well as its future potential for both, a corporate itself as well as its shareholders. To start with, from a strategic point of view, a firm´s positioning within its market segment and vis-à-vis its competitors is key: Most commonly, this is assessed qualitatively. Michael Porter, among others, has undertaken groundbreaking research in this regards. His 5-forces model helps evaluating a firm´s current position as well as developing sustainable business strategies.

However, value maximization may not be a firm´s only goal: As investors increasingly focus on themes such as ESG (environmental, social, governance matters), long-term sustainability becomes ever more relevant. Whereby some of the oldest firms in Asia or Europe, having been around for centuries, indicate that the fundament of sustainability is actually found in a corporate´s culture: The ability to reinvent itself, swiftly adapt to a changing environment as well as spot and grab opportunities.

Hence, next to more common drivers of value creation (e.g. revenues, costs, investments), also qualitative value-enhancing parameters (e.g. customer loyalty and satisfaction, product quality) are relevant components of a solid, profound corporate strategy: Thereby, corporate objectives are linked with specific employee activities which are supported by management. A range of tools such as balanced scorecards can help in monitoring, correcting and designing incentives.

A company may be deemed fundamentally "healthy" if it creates value medium- and long-term. Implicitly, this should also be reflected in value accretion for shareholders, not least by generating free cash flows, with returns of committed capital higher than its respective costs. – Whereby shareholder value creation may not immediately translate into a firm´s stock price increasing: Long-term, this should be the case, though, as ultimately the stock price can be regarded as a reasonably accurate interpretation by the market. - Nevertheless, by times, stocks can be under- or overvalued: Not least due to an overhang of supply or demand of shares, an industry having come into or going out of fashion, or merely by some - even irrational - psychological phenomena.

As a matter of fact, though, it is a key responsibility of corporate management to have a clear understanding of investor concerns and motives, such as whether shareholders prefer stable dividends or rather expect an increase in a firm´s stock price. – This does not only underline the importance of investor relations, but may also justify transactions with the aim of unlocking value, such as all kinds of restructurings, spin-offs or the re-levering of a balance sheet.

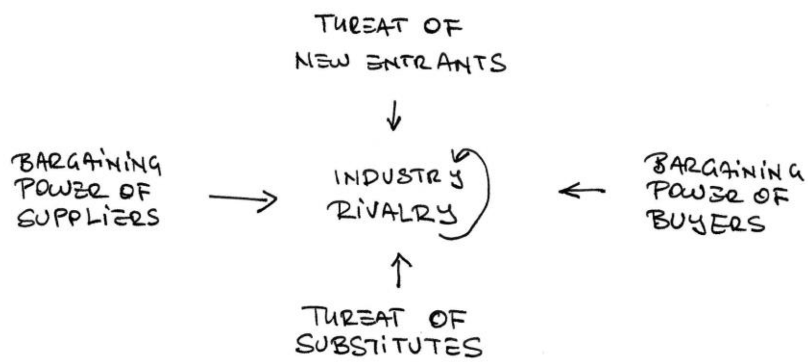
Shareholder value creation can be measured by parameters such as (disclosed) economic profit or the generation of Economic Value Added (EVA). Whereby, most likeminded approaches in this context are based on forward-looking financial parameters, such as future expected cash flows: However, for outsiders, such as retail investors, lacking access to crucial data and information, such methodologies are difficult, often even impossible to apply.

A reasonably swift financial health check should ideally provide a momentary snapshot and answer the following questions:

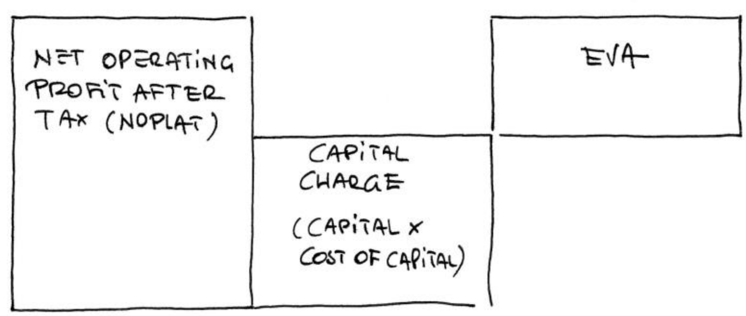
- Is the company an attractive investment for shareholders?
- Shall the firm´s business and operations be continued?
- Are creditors reasonably safe?
- Is the firm sufficiently liquid?
- Does the firm have access to additional liquidity and funding, if needed?

Of course, there are plenty additional aspects one may want to investigate, such as: The sustainability of a firm´s dividend policy, its ability to fund further growth, or whether a firm´s cost of capital could be optimized, and how. - However, the outcomes of a brief 5-minute analysis (see following sections) should already provide first, valuable insights.

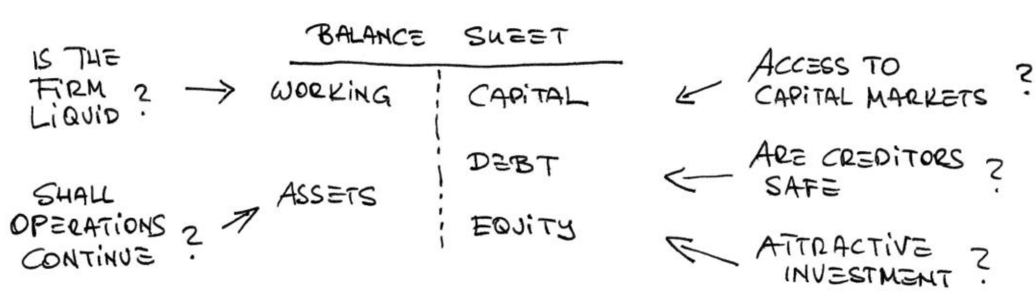
PORTER'S FIVE FORCES FRAMEWORK



ECONOMIC VALUE ADDED (EVA)



CORPORATE HEALTH CHECK – BASICS



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