COLLEGE OF ACCOUNTING

FINANCIAL MANAGEMENT | ADVANCED

Video Transcription: Analysing Company Performance

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Welcome, my name is James. In this video we are going to explore the concept of analysing company performance. Whether it is in the board exam or in the boardroom, as a financial expert you may be required to answer the question: "How is my company doing?", or "Tell us what is going wrong?", or "Should we buy this company?"

These questions leave many students and professionals thinking: "What do I do?", "What should I look for?", "What should I talk about?", or "Where do I start?"

The answer is seemingly as simple as the question itself - every organisation should create value. For a company, that value is determined by growth in shareholder wealth. But how do we measure this wealth creation (other than looking at the share price)? The answer lies in the accounting equation.

Every organisation operates in exactly the same way. When an organisation is established, it needs funding. We acquire this funding from people willing to put up funds as equity (i.e. they become shareholders), as well as those willing to lend the organisation money (i.e. provide us with debt finance, which we typically call liabilities). As management of the organisation, we have some influence over the financing we obtain by making good financing decisions. Each of these sources of finance (equity and liabilities) are provided at a cost – the required rate of return demanded by the equity and debt financiers respectively. Based on the proportion of equity and debt financing, as well as the respective costs of those forms of capital, we can calculate the weighted average cost of capital, or WACC. This WACC is the amount of return required to be made by the organisation to compensate our financiers. Bear in mind that WACC is calculated based on permanent sources of finance; therefore, we should really define these liabilities as long-term or interest-bearing liabilities.

So, how does management go about making this return? Well, first we have to make good investment decisions. We do this by purchasing an appropriate amount of assets. But perhaps we need to be more specific and distinguish between fixed assets and working capital, and perhaps go a step further to define working capital as net working capital. It consitutes both accounts payable, which are used to support our inventory, and accounts receivable in the working capital cycle.

Next, we need to take those assets and make good operating decisions. This means we have to spend more money investing in fixed costs that provide us with capacity to perform our operations. For example, we need to pay salaries to our staff. Then we need to continue to spend more money making products or providing services – in other words, incurring variable costs to do what the organisation does in normal operations. Only once we have provided those goods or services to customers may we get revenue from those customers. We hope that the revenue we make is enough to cover the variable costs incurred to generate a contribution that is large enough to exceed the fixed costs we incurred, to leave us with a profit. Of course, profit means nothing if it does not turn into cash – I can spend cash; I cannot spend profit.

Once I have my cash profits, I can either reinvest this in the organisation as equity, or use it to pay back debt, equity, or pay dividends. This completes what I like to call “the circle of cife”. As management, we get finance in from outside parties at a WACC; we use that money to invest in the right mix of fixed assets and net working capital; and we use those assets and other costs of capacity to generate cash profits.

So let us now revisit the original question: “How do I analyse the performance of a company or any other organisation?” Well, the first thing we can do is take a high-level look at performance. The debt and equity funders want WACC as a required rate of return. They have provided their money to management, who have used that money to invest in assets (in this case fixed assets and net working capital) to generate a return (in this case an after tax return, but before interest). Hence the concept of return on investment should be a good proxy for determining whether management have satisfied the required rate of return of our debt and equity funders. Of course, to create value, we really need to generate a return on investment in excess of WACC – only then have we added value to our financiers.

The next step in analysing company performance would be to take both the return (EBIAT) and the net investment (FA and NWC) and analyse these components in more detail. Let us start with return or profitability:

As we have seen, our EBIAT is made up of a number of line items. Presented as a variable costing statement, it is easy to perform some form of cost-volume-profit exercise like break-even. Whether the business is making a profit or making a loss, it is important to understand our break-even point to assess our business risk. A tool like CVP can be used in some form of sensitivity analysis to determine which variables are particularly important.

Next we can assess each of the cost line items to determine if any of the costs have moved significantly. We may do this on a line-for-line basis, or we may choose to first analyse some high-level ratios such as gross margin, contribution margin, operating margin or net margin. Where there are changes in any of these high level ratios, we know there is something more to investigate to determine why that ratio has moved. For example, if we compare our current year contribution margin ratio to prior year, and this margin remains constant at 25%, but our operating margin declines from 15% to 12%, we should be able to identify that there is likely to have been some change in our fixed costs, and therefore we start looking in more detail at those fixed costs that have moved significantly.

Once we have assessed the costs, we will want to look at our revenue. This is the major contributor to our profitability. Revenue can be broken down into three components:

1. Volume of sales;

2. The price of our goods sold, and

3. The mix of products sold.

To create value, we need to generate return on investment in excess of WACC, and therefore we need to generate sufficient revenue to cover costs and leave enough return based on the investments to generate a strong ROI. To do this, we really need to grow our revenue at a rate of at least inflation. We can analyse revenue growth by looking at a number of factors like growth relative to inflation, growth relative to competitors, growth in market share, growth in volume versus increase in price, and growth of each product (i.e. looking for changes in product mix).

Now, let us move our attention to our assets. Because our assets consist of both FA and NWC and the nature of these assets differ, we can analyse each separately. We can analyse our NWC using ratios such as days inventory, days receivables, and days payables and look for changes therein. Similarly, we can look at how productive our fixed assets have been by looking at ratios such as total asset turnover – or how much revenue has been generated given the value of our assets. We may also look at more practical numbers like the level of capacity utilisation – practical capacity versus normal capacity versus what we have actually utilised in the current period.

Lastly, we can analyse how our operating decisions turn into cash by looking at ratios like quality of earnings – a measure of operating cash relative to earnings. Similarly, we can assess our influence on financing decisions by calculating ratios such as debt to equity, interest cover and dividend payout ratios.

Ultimately, if we choose the best mix of debt and equity at the lowest costs; invest those in the right mix of FA and NWC; utilise our FA to maximum efficiency (or capacity); manage our net working capital effectively to minimise our working capital cycle; are efficient when incurring costs; generate maximum revenue using the right price and mix of products to maximise volume; and effectively turn our returns into cash, we have the best possible chance of maximising value.

Now, I said every company or organisation operates in exactly the same way. But, we know that a retailer is very different from a mining company. This difference does not matter. What will matter is the amount of time you spend analysing specific areas. A retailer will have a large amount of working capital, but very few fixed assets. A mine on the other hand will have a lot of fixed assets and relatively little working capital. This simply means you will spend more time analysing the most important aspects of that particular business.

Our analysis will largely be driven by the information presented to us. Therefore, if we have two years' worth of actual data, we may perform an analysis using the aforementioned ratios comparing the prior year to current year. If we were given budget and actual information for the past year we may need to perform similar ratios, but understanding we are comparing information for the same year (but merely what we planned to have happen versus what actually happened). Your choice of figures to compare and ratios to calculate will be driven by the information presented to you, but with the right understanding and approach you will know where to start, where to look, how much time to spend on specific areas, and ultimately provide the most valuable insight in answering that question, "How do we analyse company performance?"