Company Performance and Financial Analysis

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(This document was written as a supplement to a text book on Strategy.)

Measuring the Performance of the Organization

When reviewing the internal resources and capacity of the organization, the first thing that comes to mind is: What is our current performance? Strategy is about setting a direction that leads to a high performance organization. The manager invests in many types of resources in order to generate performance. However, the concept of organizational performance is complex and it stretches beyond a single measure such as market share or return on investment. High performance companies need measurements that evaluate the whole organization. Traditional measures focus on financial metrics which only tell us part of the story. Multiple measures are the ideal solution for measuring performance.

An umbrella measure for performance may very well be sheer survival. Sears Canada and Hudson Bay department stores still exist, whereas Eaton's and Simpson's do not. The list of the top 500 US and Canadian companies has changed dramatically in the last two decades. Many names have been deleted and many names have been added. We cannot help but be impressed by 100 year old oil companies, given the nature of the business. Economists talk about creative destruction as a model for understanding the comings and goings in the industry. Examples of survivors include: The Hudson Bay Company (Can.), 300 years; R. Twining and Company Ltd. (UK), 301 years; IBM (US), 96 years; Canadian Pacific Railway (Can.), 126 years. Although survival does not provide us with the details of performance that we need to grow and develop a business strategy, it does provide us with an inkling that the organization must be doing something right.

Financial Measures of Performance

Financial measures are readily available from the accounting statements of a company and are the most popular metrics of performance. Financial data and ratios are most often compared to industry or competitors' ratios. In certain industries, such as retailing, the financial ratios from the accounting

statements are augmented by industry specific ratios such as sales per square foot, sales per employee, and sales per employee hour. In the airline industry, the industry specific metrics include various costs per seat mile (food, salaries and benefits, fuel, landing fees, maintenance, etc.). Accounting year end data are a snapshot of the financial situation on one day (year end), and therefore an analysis of data over a period of time must be undertaken in order to begin understanding trends and changes in performance metrics. It should be kept in mind that financial data are available for publicly traded companies, but rarely for privately owned companies, so comparisons may not be available in an industry where the majority of companies are privately owned. However, every now and then, various government studies may publish financial ratios for an industry.

Longitudinal Analysis of Financial Data (Discovering Trends and Traps):

The following data should be graphed and analyzed over a period of time. Other metrics may be added, depending on the specific situation and the industry.

- Revenue (examine both sales units and sales dollars)
- Gross margins
- Net margins
- Net income
- Expenses
- Debt

The best way to visualize changes in financial performance is to convert the profit and loss statement and the balance sheet to common size statements. Convert the profit and loss statement using net revenue (sales) as 100% and calculate the percentage of each number. In the balance sheet, use total assets as 100% and calculate the other numbers as a percentage. This format makes it easy to spot trends and changes over time.

Note: In examining revenue, it's important to separate unit sales from $$ sales. An examination of the two can help identify whether sales growth/reduction is due to changes in demand (units) or changes in price ($$).

Source: Knud B. Jensen, *Business Strategy: A Primer.*

Understanding Financials

Business is complex. Strategy is partly a distillation process to get to the key issues that will drive a company forward. Part of this process is to understand the financial situation of a company. Business insights "*require understanding the building blocks of money making.*" (Ram Charan, *What the CEO Wants to Know*, Crown Business, 2001). We need to understand if the company is making money, and how. The business model usually provides this information. Charan suggests three key metrics as the nucleus of starting to understand the financials of a company:

1. Cash
2. Return on assets
3. Growth

Cash

Cash is important, not only for small companies, but equally so for large firms. General Motors and Chrysler both filed for bankruptcy when they ran out of cash. Many start-ups have gone out of business for lack of cash. Blackberry is still an ongoing concern, mainly because they had $2 billion on the balance sheet when things started to go badly, enabling them to keep going despite losses. Jeffrey D. Sherman, writing primarily for small and medium size businesses, states: *Cash is at the centre of all business activity. You need cash to start and expand the business, and cash to run it, and you need to generate cash from business activity. The business is successful if the excess of the cash it generates over the cash it consumes is a sufficient*

reward for the effort and risks taken in starting and running the business. (*Cash Management Toolkit*, The Canadian Institute of Chartered Accountants, 2010). Cash enables a company to have a future.

You want to know not only where the cash has come from and where it was spent, but also where future cash will come from. The current downturn in the price of oil has brought the importance of cash into focus for oil companies, leading to massive asset sales, dividend cuts, and a reduction in future capital investments (CAPEX). Many oil companies have issued shares in order to raise cash and survive the downturn. Cash impacts both strategy and execution.

Return on Assets

This is the return on invested capital. Capital is sourced from shareholders and/or banks and investors. Capital is invested in various assets that enable the company to grow and prosper. The profit made is measured as the return on the acquired assets (ROA). Margins and turnover are the variables in ROA. Gross margin, also called gross profit, is a key metric, as is net margin, also called net profit, for ROA.

Growth (past, present, and future growth)

For many companies, growth is essential. Growth is what provides increased value for owners and shareholders. Past performance (the last three to five years) is often, but not always, a good indicator of the position of the company. The three metrics to be graphed and analyzed are revenues, gross profit, and net profit (CAGR is the best measure). Growth should be profitable. To some extent, strategy is about finding and executing profitable growth for a company. Opportunity identification is part of the process.

There are only two ways a company can grow; organic growth, or by acquisition (for further insight, see Roger Martin, *There are still only two ways to compete*, Harvard Business Review, April 21, 2015). Ram Charan suggests the following questions must be answered in order to gain the

insight needed to develop a growth strategy. A modified version is as follows:

1. What were the company's revenues in the last 3 – 5 years (CAGR)?
2. Are the company's revenues growing or declining?
3. What was the gross profit in the last three to five years?
4. How does the gross margin compare to your competitors?
5. How has your asset turnover performed in the last 3 – 5 years?
6. How has the return on assets performed in the last 3 – 5 years?
7. Is the cash position increasing or decreasing?
8. Is your market share increasing or decreasing?

The answers to these questions, and subsequent conclusions and implications, will provide a good overview of the company's situation.

The Three Financial Statements

The financial analysis must answer the key questions: What is the financial health of the company at present? What are the strategic implications of the financial situation? Once the financial situation is understood, strategy and execution can flow from this knowledge. The three statements that provide the basic information are the balance sheet, the income statement, and the cash flow statement (cases usually supply the balance sheet and the income statement, but the cash flow statement may have to be calculated).

The Balance Sheet

The balance sheet provides a snapshot of what the company owns (assets) and what it owes (liabilities) on a given day. The difference between the two is the owners' equity or the shareholders' equity. The basic accounting equation tying the three together is:

Assets – Liabilities = Owners' Equity

This equation always balances.

What should we look for?

1. Net Working Capital (current assets minus current liabilities)

2. Inventory – change over time

3. Leverage – What % of money invested is debt? High leverage may change both risk and returns.

The Income Statement (Profit and Loss Statement)

This statement demonstrates the amount of money made or lost over a period of time, usually 12 months. The accounting equation is:

Revenue – Expenses = Net Income (Profit)

What should we look for?

1. Gross margin over time

2. Net margin over time

3. EBITDA over time

4. Expenses – changes over time, anomalies

What are the conclusions and implications here?

Cash Flow Statement

This statement shows the cash generated and spent by the business. The accounting equation is:

Net income – Net Operating Activities – Net Investments (Divestitures – CAPEX) – Net Financing = Cash Change in Period

What should we look for?

1. The various activities

2. The total change in cash

3. Can we pay the bills and invest in growth?

What are the conclusions and implications here?

The cash flow statement is the most important for future growth because it signals money available to support growth; for example, increasing capabilities by hiring, or by investing in technology or other assets such as machines, facilities, etc.

Making Sense of the Financial Statements

The raw data as presented in the financial statements is the start of developing insight into the wellbeing of the company. Revenue, profits,

margins, costs, debt, and free cash flow should be graphed in order to understand the historical context.

Ratios allow a second level of analysis and provide further insight, and there are numerous ratios that can be generated. The most important ones are clustered as follows:

Profitability Ratios

Return on Assets:
A key ratio outlining how well the company is using the assets it has.
(*net income/total assets*)

Return on Equity
This is the owner's return on investment and is a valuable benchmark for the owner/shareholder. It is often used to compare alternative investments.
(*net income/owner's equity*)

Gross Profit Margin
This ratio demonstrates the amount available for covering operating expenses and profit.
(*sales-cost of goods sold/sales*)

Net Profit Margin
After tax profit (the bottom line).
(*profit after tax/sales*)

Earnings Before Interest and Taxes (EBIT)
This is often used for intercompany comparisons, since it doesn't include the impact of how the company is financed.
(*EBIT/sales*)

Operating Ratios
These ratios measure the efficiency of the company.

Asset Turnover (Velocity)
Demonstrates how efficient the company is in using the assets at its disposal.
(*sales/total assets*)
Efficiency is governed by many variables.

Liquidity Ratios
These ratios measure the company's ability to meet its obligations.

Current Ratio
This is the most important ratio, often used by banks as a benchmark.
(*current assets/current liabilities*)
The ratio should be higher than one.

Working Capital
Demonstrates the internal funds available.
(*current assets – current liabilities*)

Leverage Ratios
Informs how the company is using debt.

Debt to Equity
Measures the extent to which the company is using debt to increase profits.
It is often compared to industry norms.
(*total debt/owner's equity*)

These are the key ratios that should be used to analyze the firm's health. There are numerous other ratios, both accounting and industry based, that can be used to refine the analysis.

Caveats for the Analyst

1. Accounting statements in SMEs are often created for the tax efficiency of the owner.

2. Researchers have suggested that some SMEs create artificial profits under $500,000 in order to take advantage of the low small business tax.

3. Hedging of commodity prices in the oil and gas industry, as well in the gold and metal industry, often creates unsustainable profits, or sometimes losses.

4. Management has discretions; for example, how to book sales.

5. Currency volatility often influences profits or losses, as well as costs.

6. Accounting is an annual event and the statements are for one point in time.

7. It has often been shown that public companies have a short term bias.

8. Intangible assets are often difficult to value; for example, a good reputation or a well known brand.

Future Expectations as a Metric

For publicly listed companies, the stock price is probably a good measure of shareholders' sentiment regarding a company's future performance. It is also a good measure of the ability of a company to attract new capital. There is a large number of metrics used to evaluate stock performance, such as price/earning ratio. The most important metric from an analytic perspective is the dividend payout ratio (*dividend per share/earnings per share*) and the actual dividends paid out. This influences the free cash flow available. A

dividend cut is often used in poor times to save cash and lower external capital requirements.

Questions

Following are some of the questions a ratio analysis will enable you to answer:

1. Can the company pay its bills?
2. Does the company have the capacity to raise capital?
3. Do the financials provide a competitive advantage? How?
4. What are the implications of the financials for future strategy and for the execution of strategy?
5. How does the company perform compared to its competitors?
6. What is increasing – revenue, debt, costs, etc.? What is decreasing? What are the implications?
7. Is the company in a healthy or unhealthy position? Implications?
8. What are the spreads – revenue/costs, revenue/EBIT, revenue/debt?
9. Outstanding trends in data?

You must translate the ratios into prose!

Cash Flow (Working Capital) Shortage

Cash flow is one of the most important issues for small and medium businesses, yet owner/managers often pay little attention to it. The budgeting process is frequently seen as having little value, especially when compared to going out and getting revenue. Although both are important, cash budgeting is essential for the start-up where cash is a precarious resource. Bankers and lenders are very interested in the cash position, present and future.

If you are running short on cash, the process is simple on the surface. Identify the problem: Why is my cash flow poor or declining? Develop a strategy to remedy the problem. Execute the strategy. It's simple to say, but more difficult in practice, especially for the owner/entrepreneur who has enough on his/her plate just getting a business off the ground. A cash flow forecast, usually monthly, is essential even if it's a rough one; you have to demonstrate you can meet your obligations. This means viability for the entrepreneur and sound management for the lender or investor. Free cash flow is especially important for new capital investment for growth that is to be internally financed. Even if financing is external, cash flow will be part of the evaluation process.

Identifying issues in poor cash flow can be simple. For example, a distributor found himself in a cash flow crunch. It was discovered that the collection of accounts had been lax and mismanaged. A lot of cash was sitting in the customers' hands and the average account was being collected in 120-150 days. The strategy was simple - manage the accounts payable more efficiently. An aggressive collection process was executed and this solved the cash flow problem. The financial statement analysis surfaced the problem. However, often the solution is not as simple. There are many variables impacting on cash flow and a more detailed analysis is required. This means appraising the cash conversion cycle. Examining sales, margins, costs, expenses, inventory, debt, assets, taxes, and profits is necessary since they all impact the cash flow. For example, inventory is a great consumer of cash and dead inventory is just cash sitting there. Expenses can spike and drain cash. If a company is involved in international trade, especially with the US, a change in currency such as a rising Canadian dollar, will put pressure on cash flow. Many cash flow decisions involve trade-offs. Tighten credit and you may lose customers. A large inventory improves service, but consumes cash. Moving to a larger facility means increased expenses, but maybe improved and more productive processes.

Basically, cash flow management means working two levers, cash inflow and cash outflow, and the larger the company, the more complex the process. Keep in mind that cash flow issues occur for growing companies, for slow-growth or no-growth companies, and for companies in decline. Many entrepreneurs consider cash flow budgeting a nuisance, but it's as essential to growth as the revenue forecast.

A Quick Cash Flow Checklist

Here is a brief list for checking cash flow. Evaluate the variances and look at the present and future position:

> Collecting receivables
> Inventory
> Debt/interest
> Sales/margins/pricing
> Foreign exchange
> Acquisitions/investments
> Expenses/hires

> List what can be liquidated (sold for cash).

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