

Chapter 2: Analyzing a Company's Financial Statements & Operations

To analyze a company's operations a close look must be taken at the day to day operations as well as examining a company's financial history. Usually more emphasis is placed on financial ratio analysis. However, financial statements offer only figures. Many times more insight can be gained by simply walking through the company.

Overview

Competition acts to drive profit margins and the returns on investment down to a free market minimum level. In other words, competition translates into lower prices. Therefore, in the long run, the analysis of profit margins (which is a component of return on equity) will depend upon the analysis of a firm's competitive position as well as the competitive position of the industry in which it operates.

Two factors determine the choice of a competitive strategy:

- (1) The long-term profit outlook for an industry
- (2) A firm's competitive position within its industry.

Both are important. A firm can be in a profitable industry and still do poorly because of a bad competitive strategy, or it may have a good competitive strategy and do poorly because the industry is mature.

In order to forecast the profit margin of a company, and its return on equity, one needs to review the basic competitive forces that exist in an industry and assess the strength of each. There are five basic competitive forces as put forward by Michael Porter in his book *Competitive strategy: Techniques for Analyzing industries and competitors*:¹

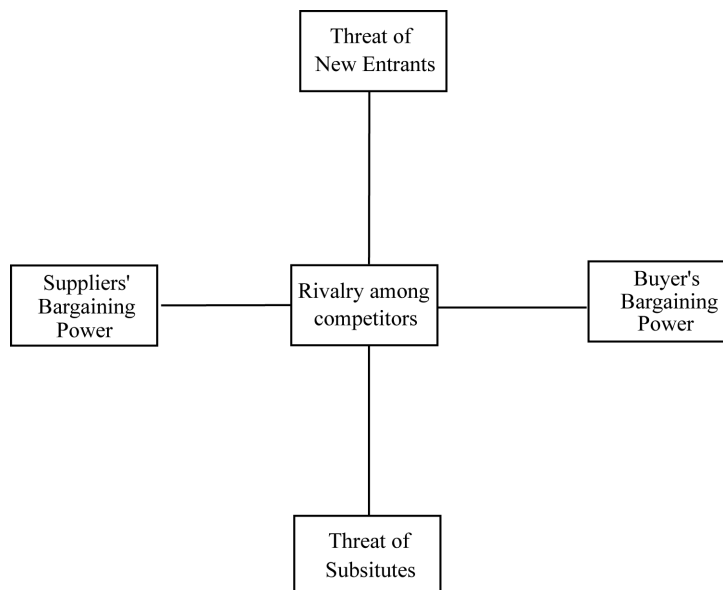
- (1) Ease of entry and exit
- (2) Rivalry between existing competitors
- (3) Pressure from substitute products

1. Porter, Michael E. 1980. *Competitive strategy: Techniques for analyzing industries and competitors*. New York: Free Press.

- (4) Bargaining power of buyers
- (5) Bargaining power of suppliers

These pressures are presented in Figure 2-1.

Figure 2-1: Five Basic Competitive Forces Facing a Company



First, with respect to ease of entry, the following factors affect the decision of a company to enter a given market: capital requirements, economies of scale, secure distribution channels, strong brand identification, high switching costs, government policy, proprietary product differences, expected retaliation, and absolute cost advantages.

Second, rivalry between existing competitors involves such variables as the number of competitors, the relative strength of the competitors, the industry growth potential, the amount of fixed costs needed, whether the products are perishable, product differences, large incremental additions, or diverse competitors such as foreign or small operators, the costs of switching, the informational complexity of the industry, and the high exit barriers. Exit and entry barriers often combine to determine the degree of competition in an industry.

Third, pressure from substitute products can devastate an industry. Sometimes an industry faces competition not only from within, but also from other industries. One needs to focus on substitute products and the minimum switching costs for potential customers, and high profit earning industries which can afford to reduce margins in order to broaden their market into the seller's market.

Fourth, with respect to their bargaining power, buyers can bargain for price cuts, better quality, and more service. Such actions by buyers tend to lower profit margins for sellers. The buyers' power depends on their bargaining lever-

age, their sensitivity to the price of the product being sold, and the relative availability of substitutes. These variables are: the volume of purchases by the buyer as a percentage of the seller's sales, the profitability of the buyer, the percentage of buyer cost that is represented by the product, buyer information, whether the buyer could duplicate the product from the seller, the product's impact upon the buyer's business, switching costs, and the seller's ability to influence the buyer.

Finally, the bargaining power of suppliers can reduce a firm's profit margins by raising costs or reducing quality. The conditions that give bargaining power to suppliers are: the relative size of suppliers versus buyers, the importance of the buyer to the seller, the switching costs, whether the supplier can penetrate the buyer's market, the degree of organization of the supplier, the supply of the supplier's product, and whether the government can control the supplies of certain products.

If economic forces are strong enough to create a competitive market, then they will place downward pressure on rates of return so as to equal the return to assets used plus a business risk premium. If an industry is earning above average returns, then capital will flow into it causing an expansion of supply and therefore placing downward pressure upon margins. If the industry is earning below average returns, then capital will exit and there will be upward pressure upon margins.

It is the degree of competition produced by these competitive forces that determines the ability of firms in an industry to generate attractive rates of return. If these five factors are favorable, then many firms can earn attractive returns; if they are unfavorable and lead to intense competition, then few firms can do well despite good management. Industry profitability is directly related to the industry structure and not the product which the industry sells.

Review of Financial Position

The degree of competition and the financial ratios are related to each other. A financial overview of the company in comparison to its industry can usually be done by looking at four different categories of ratios:

- Activity ratios
- Liquidity ratios
- Long term debt and solvency ratios
- Profitability ratios

These ratios should be compared to those of similar companies within the industry or SIC (Standard Industrial Classification) code.

These ratios are calculated by either averaging the figures for two different years, or taking only one year's figures. The difference between these two calculations can be seen in the table below.

Table 2-1: Example of Financial Ratio Differences for Two and One Year Averages

Ratio	Formula (2 Year Average)	Formula (1 Year)
Inventory turnover	$\frac{\text{Cost of goods sold}}{\text{Average Inventory for Two Years}}$ $\frac{3,164}{(668 + 578)/2} = 5.1$	$\frac{\text{Cost of goods sold}}{\text{Inventory}}$ $\frac{3,164}{668} = 4.7$

Formulas are taken from Table 2-2 on page 37, and Table 2-3 on page 38

When calculating all of these ratios, the resulting figures should be taken with “a grain of salt,” since these figures are simply a snap shot in time. The existing health of the operations of a company can be completely different from what the ratios may indicate. As they say “historical results may not be indicative of future returns.” Furthermore, accrual accounting tends to smooth these figures and their trends.

A sample company's balance sheet and income statement can be seen in Table 2-2 on page 37, and Table 2-3 on page 38, as a reference for discussion.

The company represented in Table 2-2 and Table 2-3 represents a chemical blending and distribution service business. This company has 23 employees and has had tax losses in recent years (notice that taxes were not paid in some years due to the tax loss carry). The owner has continued to increase his paid in capital (equity) over this time period and pays himself annual dividends.

Activity Ratios

Activity ratios evaluate the efficiency of output generated by the company assets (inventory, receivables, working capital, etc.). Generally, these ratios are broken down into short term (operating) activity ratios, and long term (investment) activity ratios. A summary of these formulas can be seen in Table 2-4.

General short term (operating) activity ratios measure inventory turnover, average number of days of inventory in stock, receivable turnover, average number of days receivables outstanding, and working capital turnover.

Table 2-2: Sample Balance Sheet

	19X9	%	19X8	%	19X7	%	19X6	%
Assets								
Current Assets								
Cash & Equivalents	\$ (37)	-2.4	\$ 1	0.1	\$ 0	0.0	\$ 0	0.0
Accounts Receivable	635	40.9	511	36.9	406	32.3	370	32.0
Inventory	668	43.0	578	41.8	545	43.4	507	43.8
Other Assets	53	3.4	35	2.5	26	2.1	26	2.2
Total Current Assets	\$1,319	84.9	\$1,125	81.3	\$977	77.8	\$903	78.0
Fixed Assets								
Building	133	8.6	136	9.8	138	11.0	141	12.2
Machinery & Equipment	672	43.3	645	46.6	634	50.5	597	51.6
Total Fixed Assets	805	51.8	781	56.5	772	61.5	738	63.7
Depreciation	(571)	36.8	(532)	38.5	(505)	40.2	(492)	42.5
Net Fixed Assets	234	15.1	249	18.0	267	21.3	246	21.2
Other Assets	0	0.0	9	0.7	12	1.0	9	0.8
Total Assets	\$1,553	100.0	\$1,383	100.0	\$1,256	100.0	\$1,158	100.0
Liabilities & Equity								
Current Liabilities								
Accounts Payable	\$425	27.4	\$330	23.9	\$423	33.7	\$259	22.4
Accrued Liabilities	40	2.6	362	26.2	65	5.2	0	0
Notes Payable (Current)	364	23.4	287	20.8	207	16.5	297	25.6
Current Long Term Debt	0	0.00	3	0.2	0	0.0	0	0.0
Capital Leases	0	0.0	6	0.4	0	0.0	0	0.0
Bank Overdraft	46	3.0	36	2.6	77	6.1	50	4.3
Other Current Liabilities	0	0.0	6	0.4	0	0.0	0	0.0
Total Current Liabilities	\$875	56.3	\$1,030	74.5	\$772	61.5	\$606	52.3
Long Term Debt	31	2.0	5	0.4	39	3.1	0	0
Note Payable-Stockholder	122	7.9	0	0.0	164	13.1	148	12.8
Contract Payable	12	0.8	0	0.0	0	0.0	0	0.0
Capital Lease Obligations	0	0.0	24	1.7	0	0.0	0	0.0
Total Liabilities	\$1,040	67.0	\$1,059	76.6	\$975	77.6	\$754	65.1
Stockholder's Equity	513	33.0	324	23.4	281	22.4	404	34.9
Total Equity & Liabilities	\$1,553	100.0	\$1,383	100.0	\$1,256	100.0	\$1,158	100.0
Working Capital	\$444	28.6	\$95	6.9	\$205	16.3	\$297	25.6
Debt Free Working Capital	\$808	52.0	\$385	27.8	\$412	32.8	\$594	51.3