

Intro to ratios

Ratios are essential to making sense out of financial numbers. For example, assume that a hypothetical XYZ company sells for \$100 per share. Is that a high price or a low price? There's no way to answer without more information. Investors typically will compare the share price to the company earnings per share, to get a "P/E ratio." If XYZ earned \$1 per share, that's a P/E of 100, and many investors would consider that pretty expensive. But if XYZ earned \$20 per share, that pushes the P/E down to 5, which would be remarkably cheap. Historically, most large-capitalization companies have had P/E ratios in the teens.

For analysis of a company's financial health, instead of its stock price, financial analysts use other ratios. These are derived using numbers made available through each company's financial statements. The ratios need to be reviewed over time, in order to determine trends in financial health, and they should be compared to other companies in the same industry.

Activity ratios

Inventory turnover, the cost of goods sold divided by average inventory value. High turnover rate is usually a good sign, but it may indicate that the inventory is too lean and the firm is unable to meet demand.

Receivables turnover, the net revenue divided by the average accounts receivable. Again, a high receivables ratio is healthy, but it might mean that the company's credit terms are too tight, so it is missing out on sales.

Payables turnover, the total purchases divided by average payables. A low payables rate suggests that the company is having trouble paying its bills, or it might just mean it is taking advantage of generous supplier credit terms.

Asset turnover, the net revenue divided by average total assets. Low asset turnover suggests inefficiency or the presence of a capital-intensive environment.

Liquidity ratios

Current ratio, current assets divided by current liabilities. A high current ratio suggests that bills can be paid promptly; there is no risk of a cash squeeze.

Quick ratio, cash and short-term marketable securities plus accounts receivable divided by liabilities. This ratio excludes inventory being held for sale, which may be a substantial portion of a company's assets.

Cash ratio, drop the accounts receivable from the quick ratio. This is the most conservative liquidity ratio.

Solvency ratios

Debt-to-assets, total liabilities divided by total assets. A high number indicates more leverage, which can increase reward as well as risk.

Debt to capital, total debt divided by total debt plus shareholder's equity. A high ratio here again shows leverage, which may restrict growth opportunities.

Debt to equity, total debt divided by total shareholder's equity. A ratio of 1.0 shows an equal amount of debt and equity. High debt levels can make weathering economic storms problematic.

Interest coverage ratio, earnings before interest and taxes divided by interest payments. This ratio is more important during economic downturns.

Profitability ratios

Gross profit margin, gross income divided by net revenue. This figure varies widely among industries.

Operating profit margin, operating income divided by revenue. Operating expenses include those items that can't be attributed to a single product.

Net profit margin, the net income divided by the net revenue. This is where sales are turned into earnings for the shareholders.

Return on equity, the net income divided by the total shareholder's equity. This measure takes into account the amount of debt that the firm is using to finance its operations.

As you can see, when you get into it, financial analysis is complicated. If you'd rather not do it alone, turn to our investment professionals for help.

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