

Financial Analysis Fundamentals



Learning Objectives



Undertake a comprehensive financial analysis using wide range of ratios



Use ratios to analyze the income statement and profitability.



Look at ratios to analyze operating assets and asset utilization.



Analyze capital structure with ratios.



Recommend how a business can improve operations, capital structure, and asset utilization.

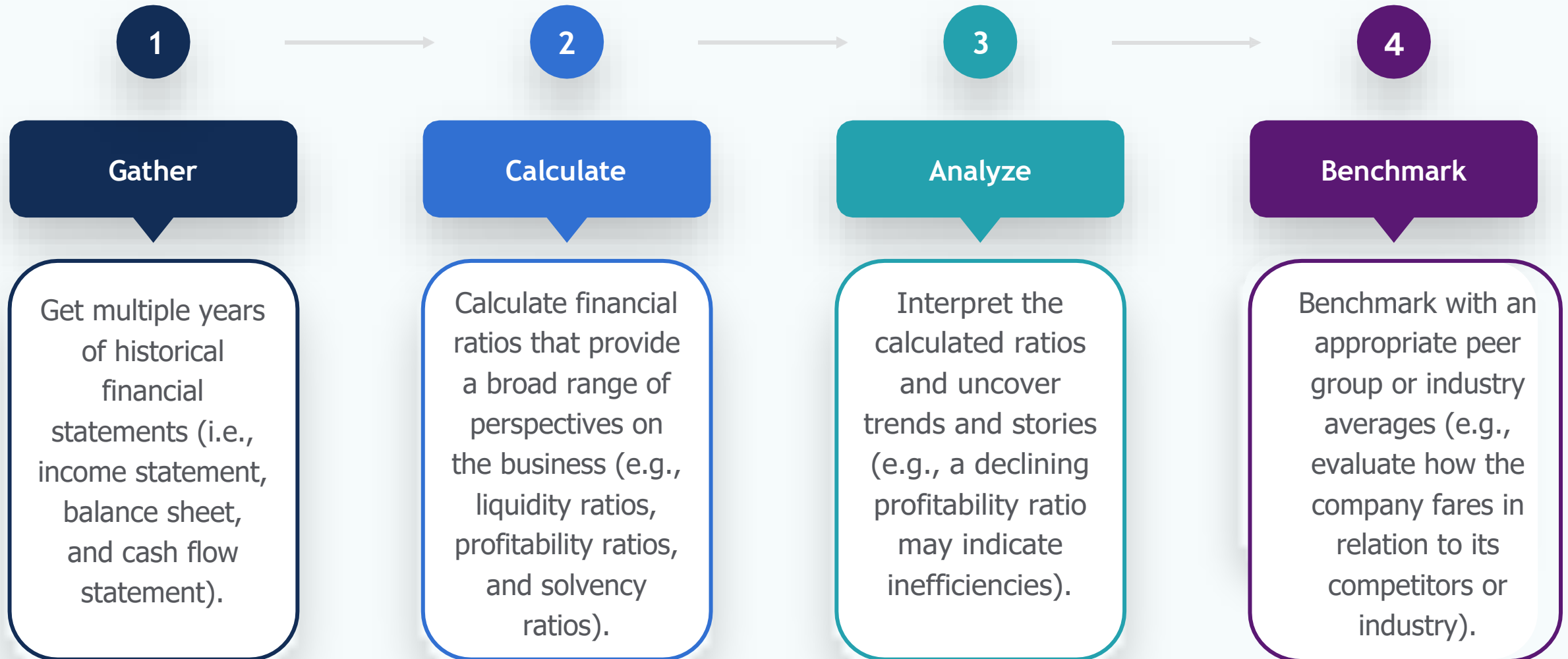


Use the DuPont Pyramid of ratios to get a more comprehensive view of a business.

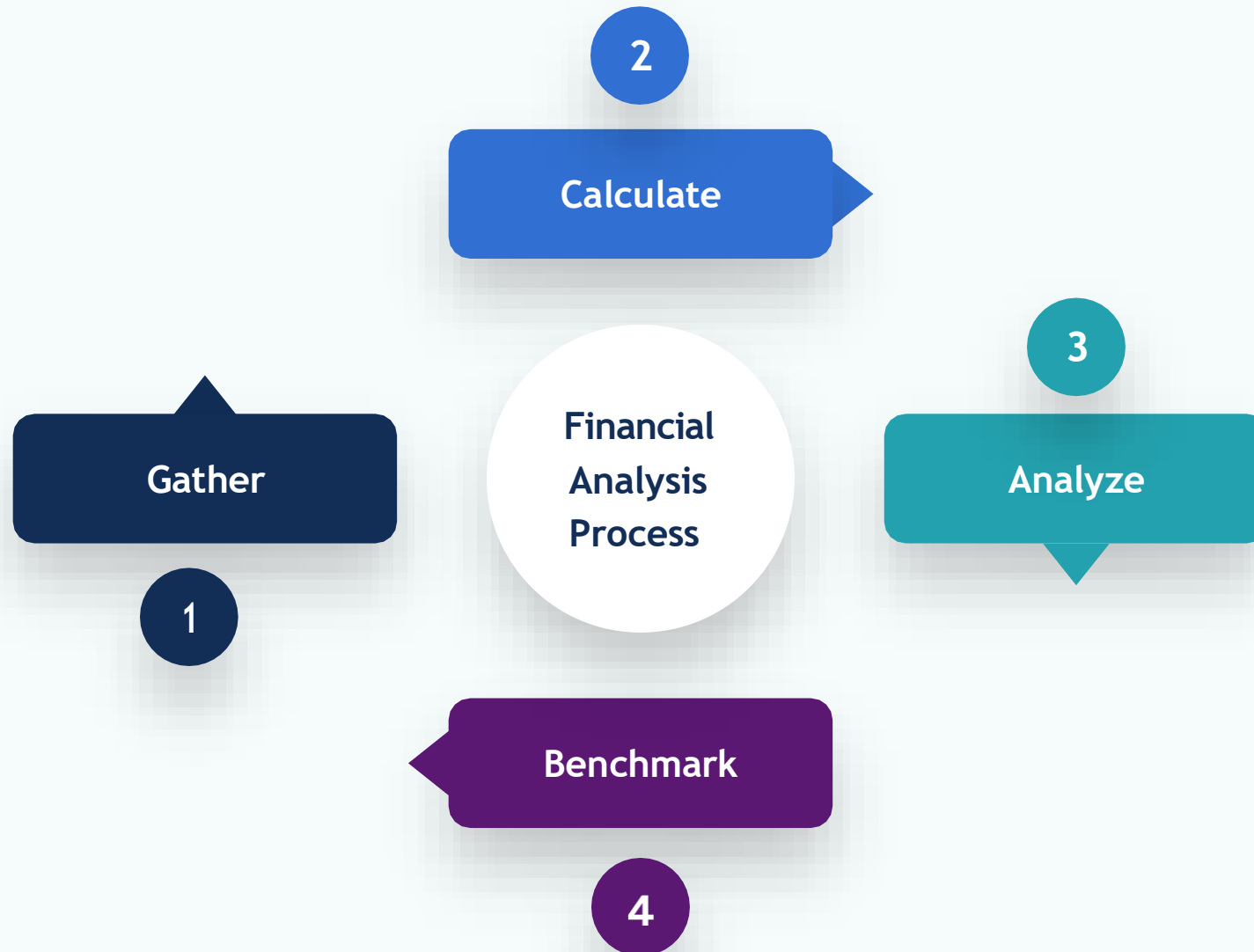
Leverage Analysis



What Is Best Practice Financial Analysis



What Is Best Practice Financial Analysis



Critical Tips for Effective Financial Analysis



- Gather a minimum of five years of historical financial performance to better identify trends over time.



Make your calculations in Excel transparent so that you can trace from financial statements to ratios.



Need to identify an appropriate peer group, which is broader in scope, as it is rare to find two companies that are exactly similar.

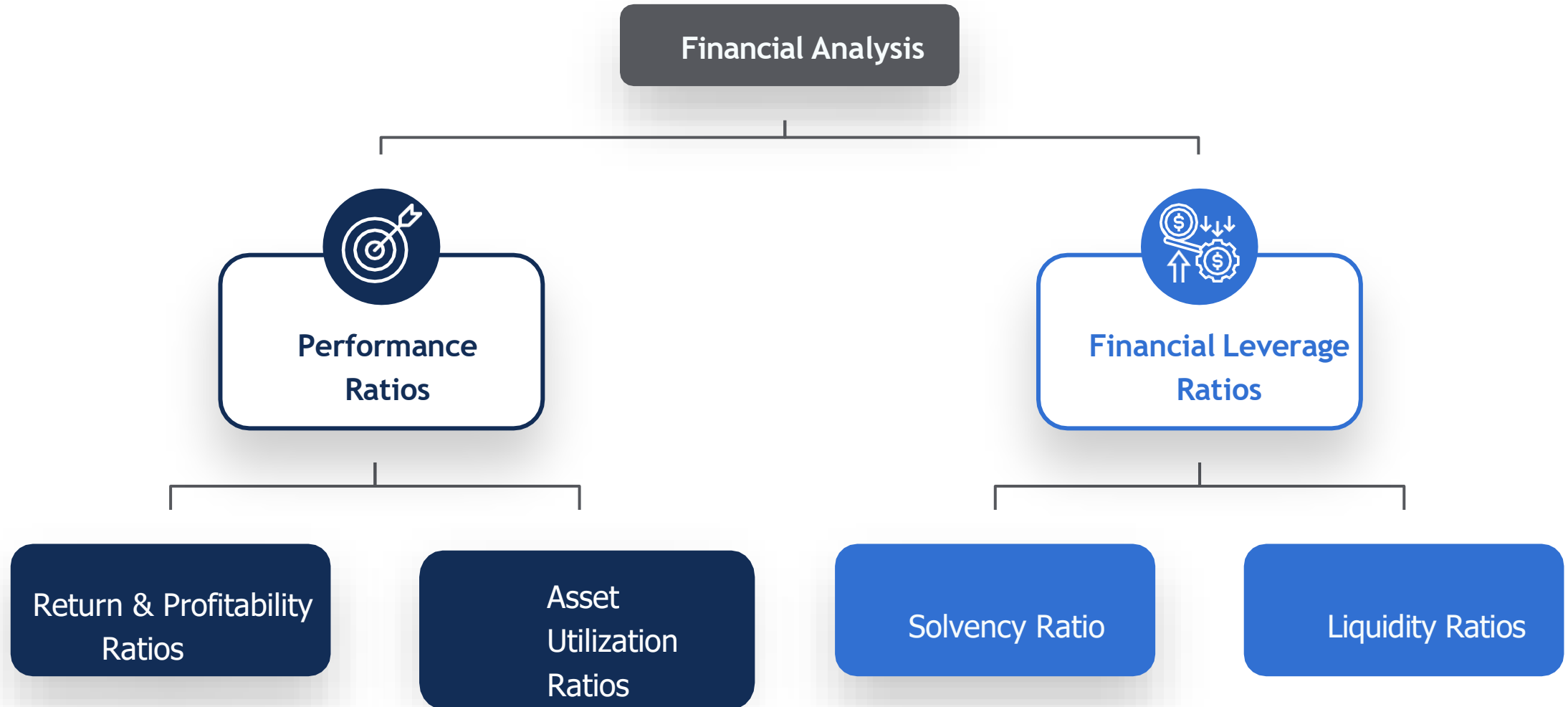


Keep adjustments of ratios to a minimum, as there is more room for error to creep in.



Averages are typically more academically sound, but in practice, virtually everyone uses closing balances.

Financial Analysis Ratio Categories



Quick Recap of the Three Financial Statements

Let's do a quick Recap of the three financial statements.



Income Statement

Revenues

Expenses

Profit Or loss



Balance Sheet

Assets

Liabilities

Equity



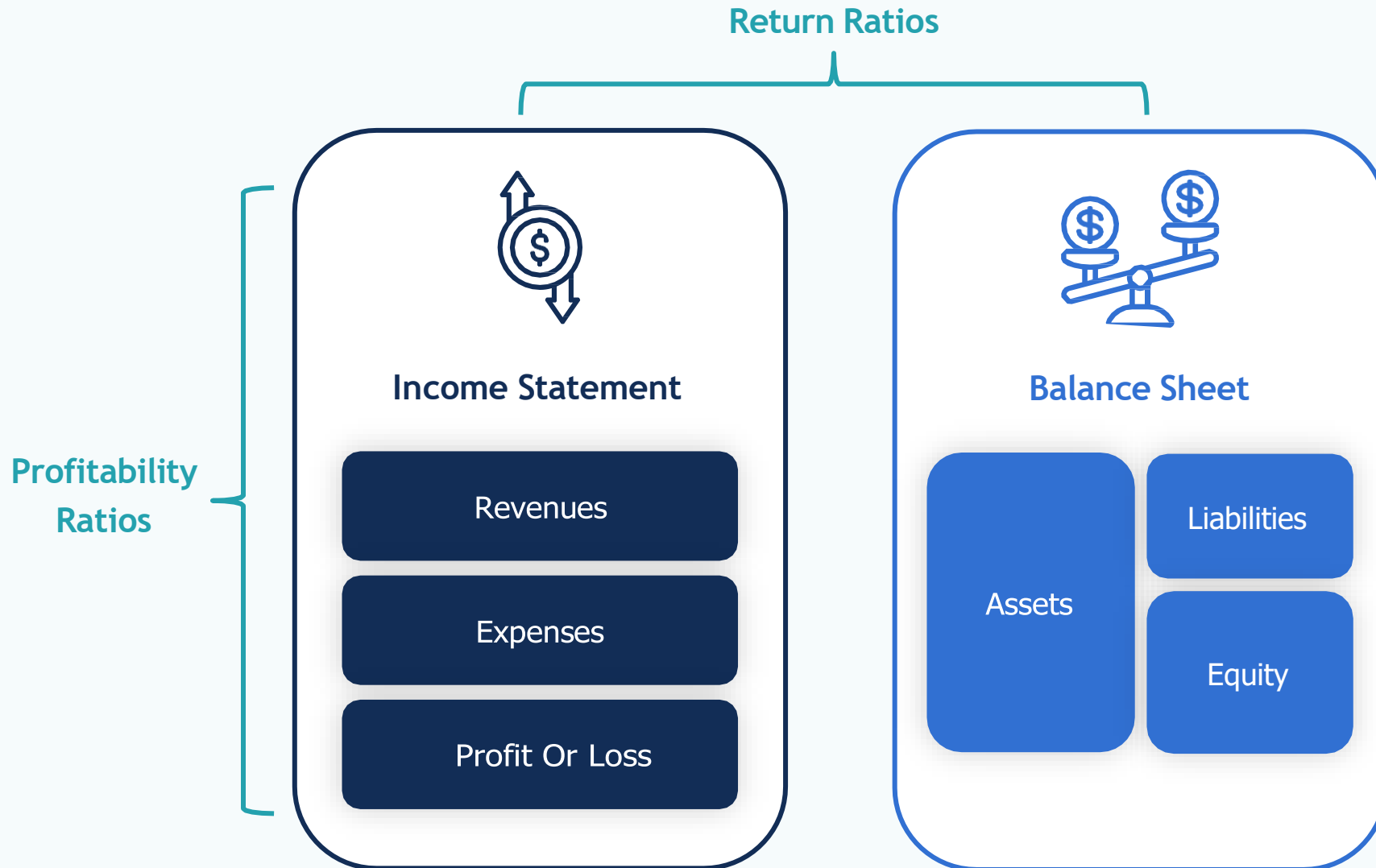
Statement of Cash Flows

Operating

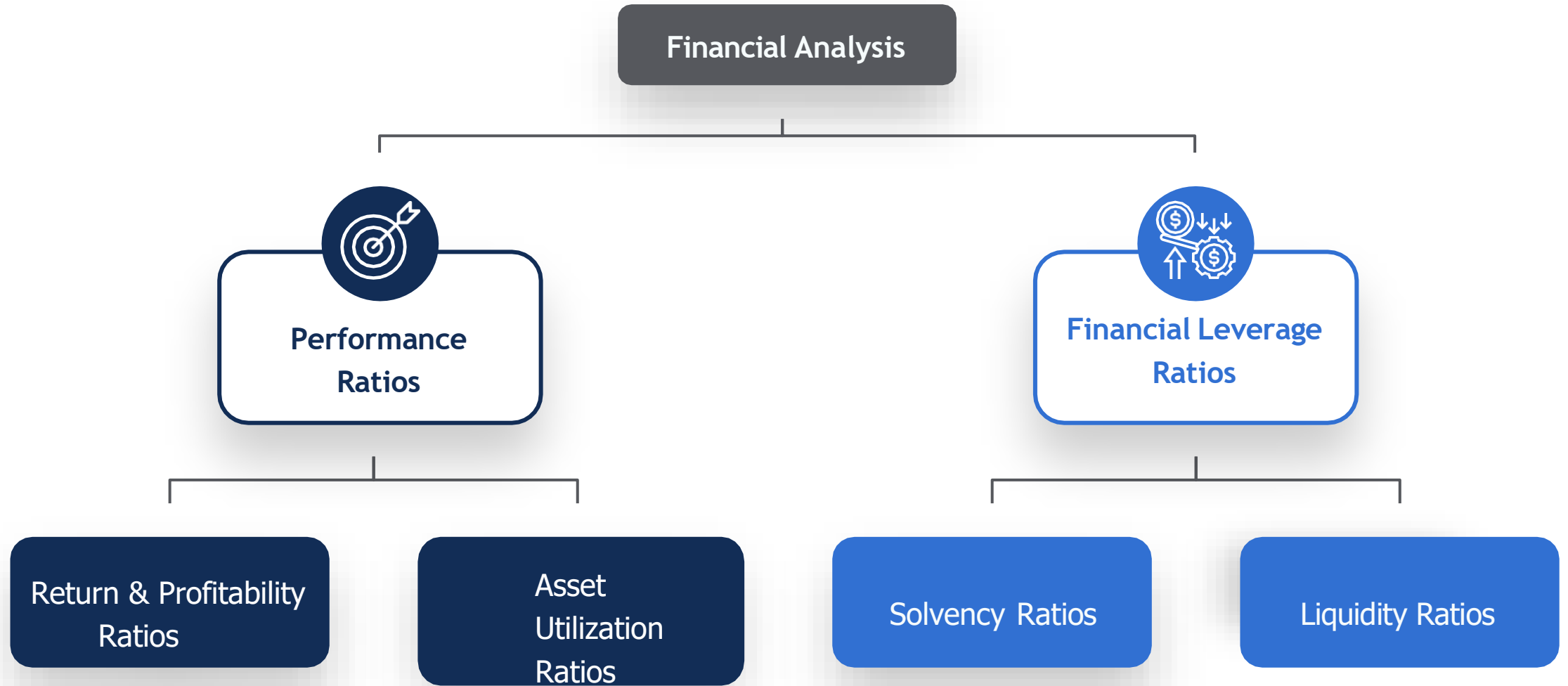
Investing

Financing

Quick Recap of the Three Financial Statements



Introduction to Financial Leverage Ratios



Introduction to Financial Leverage Ratios



Solvency ratios

Focus on Company **long-term financial health** and its ability to meet long-term obligations.

Liquidity Ratios

Liquidity ratios assess the company's **short-term cash position** and its ability to handle immediate financial needs and obligations..

What Is Leverage

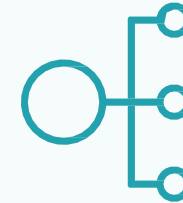
The Amount of **interest-bearing debt funding** a business relative to its **equity funding**.



A company loads the catapult with **its own funds**, While the **debt funding** acts as the extra tension mechanism.



Financial leverage empowers a company to **propel its growth and profitability** to new heights.



This combination of resources enables a company to catapult ahead. (**expansion, investment, and market presence.**)

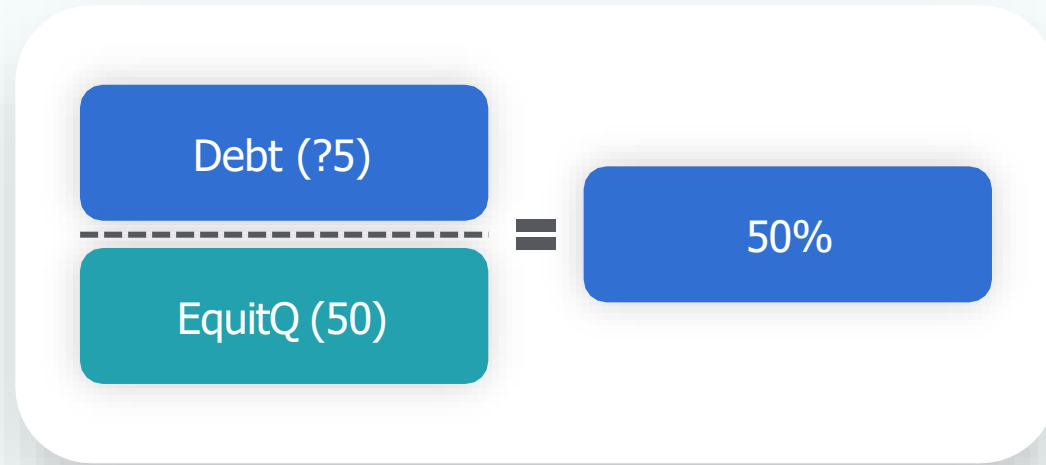
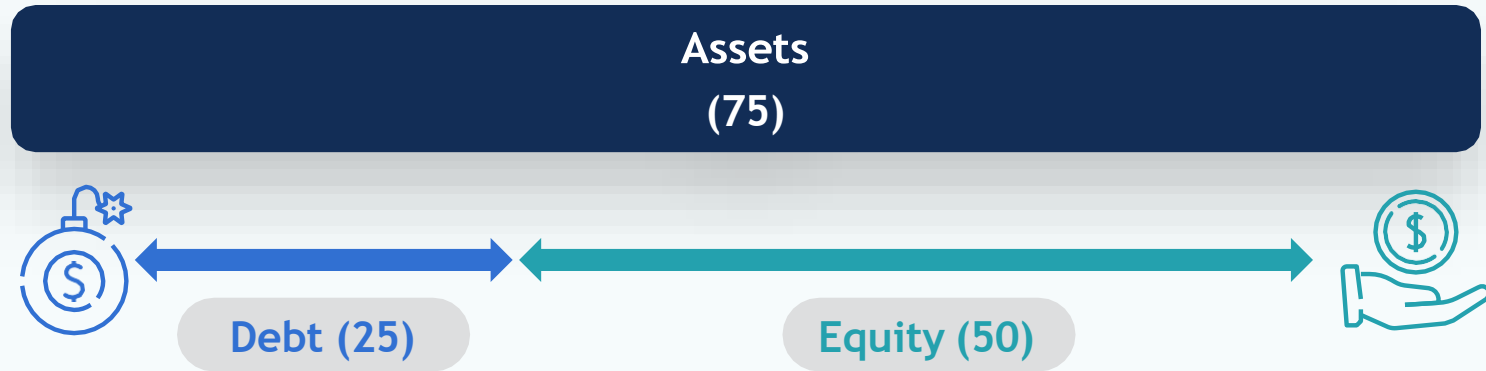
What Is Leverage

Financial leverage increases when a company takes on more debt financing relative to its equity financing.

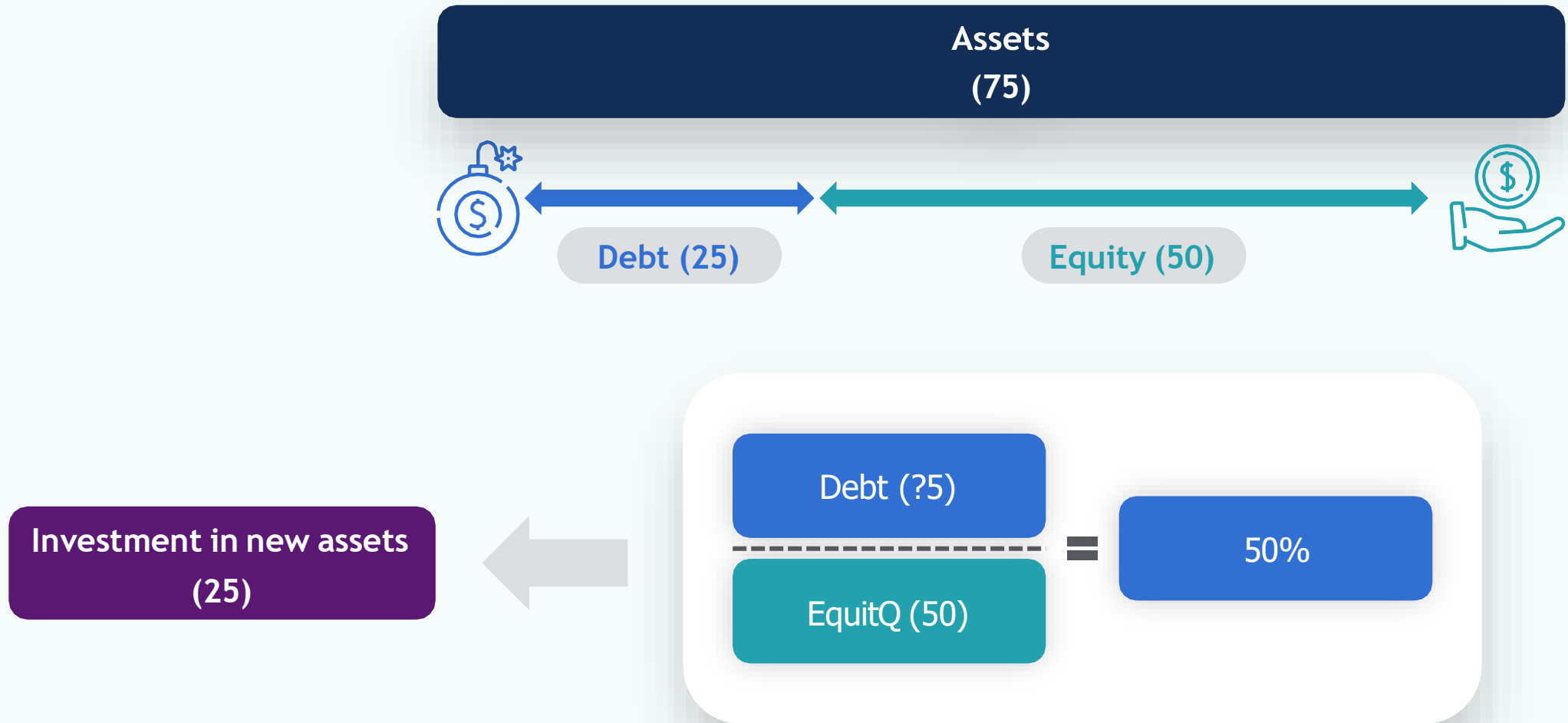
Another name for 'financial leverage' is 'financial



Example of Low Leverage



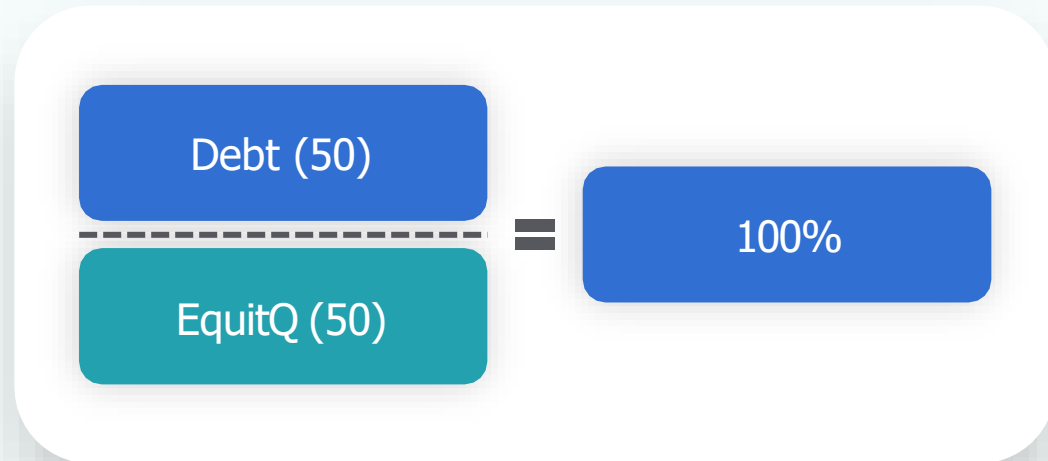
Example of Low Leverage



Example of Low Leverage



increased its financial leverage or financial gearing.



Why Increase Debt Rather Than Equity

Here are several reasons why a company may choose to increase debt rather than equity:.



Retaining Ownership Control

By relying more on debt financing, a company can **raise funds without diluting the ownership stake** of existing shareholders.



Cost of Capital

Depending on the prevailing interest rates and market conditions, debt financing can be **cheaper than issuing additional equity**.



Flexibility

Debt financing allows a company to **maintain flexibility in capital structure as it has a defined repayment schedule**, providing a company with a clear timeline.



Timing and Availability

Debt financing may be **more readily available and quicker to secure** compared to equity financing, which often involves more extensive processes..



Tax Advantage

Interest payments on debt are **typically tax-deductible**, while dividends paid to equity shareholders are not..

The Sweet Spot - Optimal Leverage

The optimal financial leverage for a company is the level of debt or borrowed funds that strikes a balance between **maximizing potential returns and minimizing financial risks.**



Risk Tolerance

Be aware of a company's risk tolerance and its ability to handle debt obligations.



Industry & Business Characteristics

Understand the specific dynamics of the industry in which the company operates.



Cash Flow & Profitability

Analyze a company's cash flow generation capacity and profitability.



Growth Opportunities

Consider the company's growth prospects, investment plans, and capital requirements.



Interest Rates & Market Conditions

Evaluate prevailing interest rates and overall market conditions.



Shareholder Expectations

Understand the expectations of shareholders, such as dividend payments and capital appreciation.

The Sweet Spot - Optimal Leverage



Risk
Tolerance



Industry & Business
Characteristics



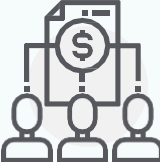
Growth
Opportunities



Cash Flow &
Profitability



Interest Rates &
Market Conditions



Shareholder
Expectations

- ▶ Financial leverage **varies** » and requires
- ▶ Must also understand **company goals, performance, and risk appetite.**
- ▶ **Striking the right balance is crucial** to ensure growth and success.

Total Assets and Total Liabilities to Equity Ratios

Assets to Equity

Total Assets

Total Stockholders
Equity

Total Liabilities



Measures how much of the asset base is funded by equity and indirectly by debt..



Leverage Ratios

Usually, leverage ratios **are quoted as a multiple** rather than as a percent.



Example:

Asset to Equity = 2.5x (not 250%)



Generally, the **smaller** the number, the **better**.



There is typically an **optimal capital structure based on industry**.

Debt to Equity and to Tangible Net Worth Ratios

Debt to Equity

Interest Bearing
Liabilities

Total Stockholders
Equity



Allows us to precisely compare a company's debt financing to equity financing.

.

Debt to Tangible Net Worth

Interest Bearing
Liabilities Liabilities

Stockholders
Equity

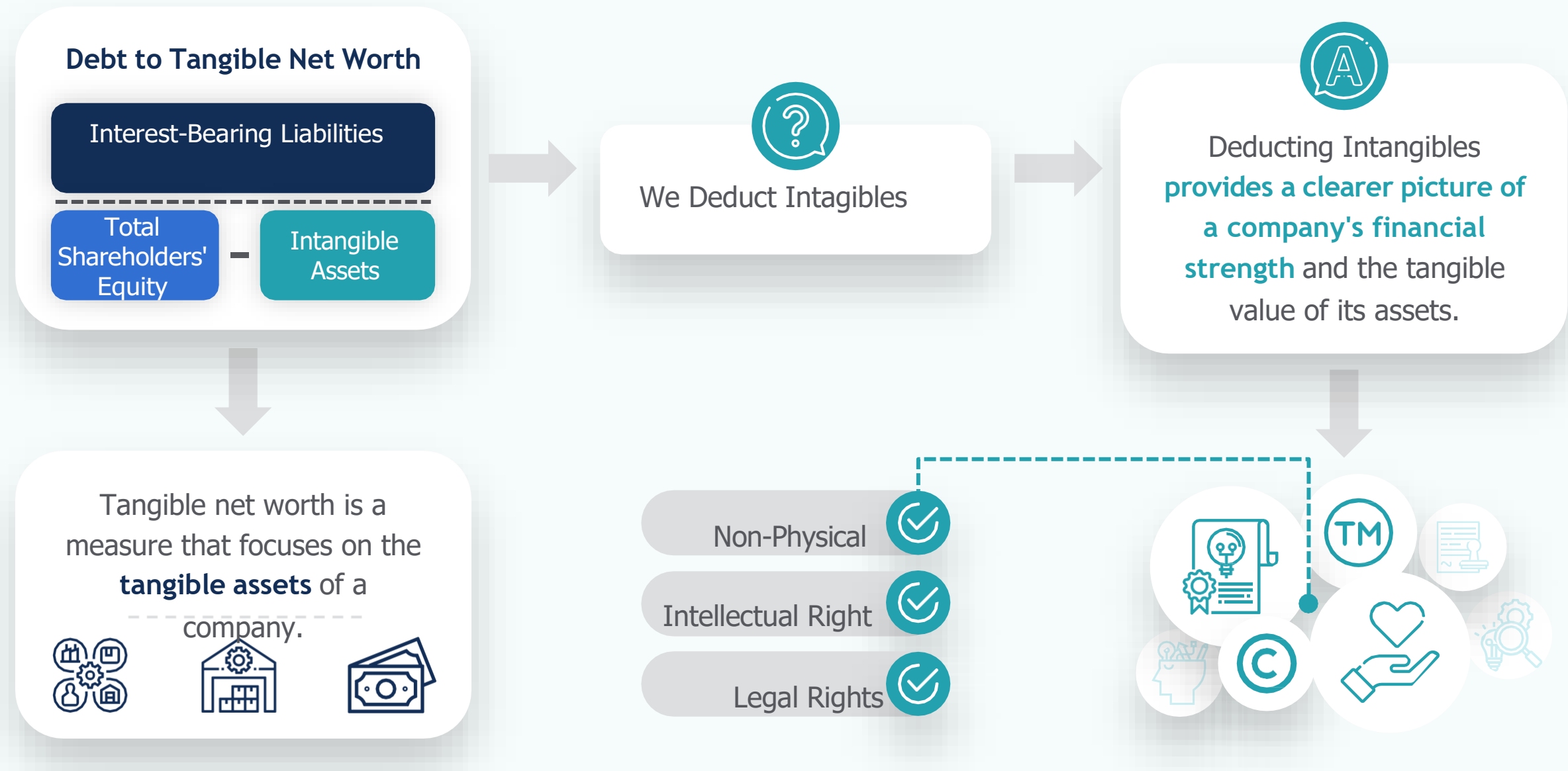
—

Intangible
Assets



Regarded as a more conservative measure of a company's financial state.

Debt to Equity and to Tangible Net Worth Ratios



Debt and Net Debt to EBITDA Ratios

Debt to EBITDA

Interest Bearing
Debt

EBITDA



Shows how much actual cash flow a company earns to cover its debt and other liabilities.

Net Debt to EBITDA

Interest
Bearing

Cash

EBITDA



Shows how long a company would need to operate at its current level to pay off all its debt.



(Net) Debt to EBITDA Ratios



A **high** Debt-to-EBITDA ratio may indicate **higher financial risk**.



A **lower ratio** suggests **lower risk and better debt repayment** capacity.



Here are both very popular with **M&A professionals** who typically **use EBITDA multiples** to value businesses.