Financial Analysis Fundamentals

Virginia Institute of Finance and Management

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.

Peer & Industry Benchmarking

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What Is Best Practice Financial Analysis

1. **Gather**

   Get multiple years of historical financial statements (i.e., income statement, balance sheet, and cash flow statement).

2. **Calculate**

   Calculate financial ratios that provide a broad range of perspectives on the business (e.g., liquidity ratios, profitability ratios, and solvency ratios).

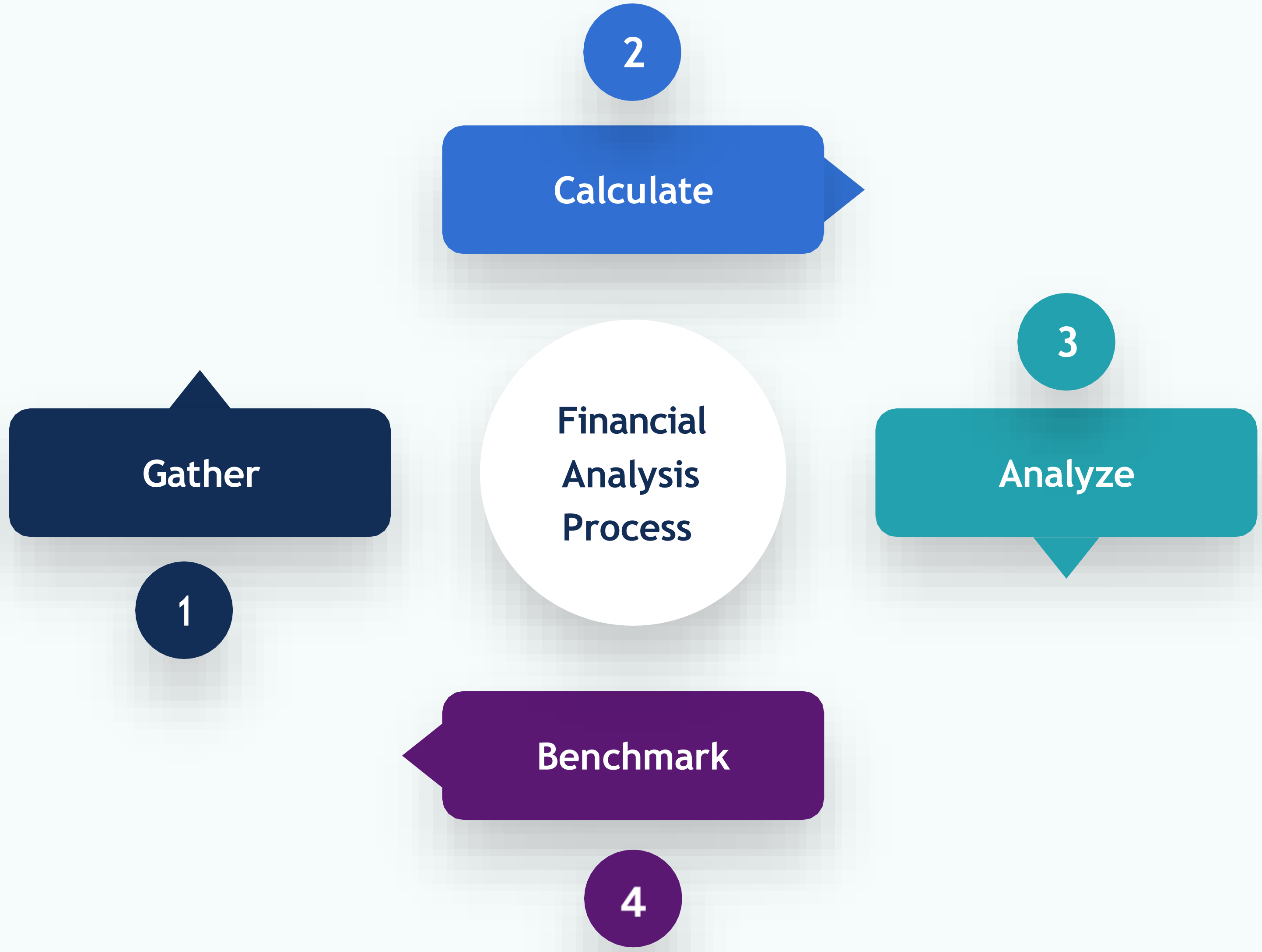
3. **Analyze**

   Interpret the calculated ratios and uncover trends and stories (e.g., a declining profitability ratio may indicate inefficiencies).

4. **Benchmark**

   Benchmark with an appropriate peer group or industry averages (e.g., evaluate how the company fares in relation to its competitors or industry).

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.

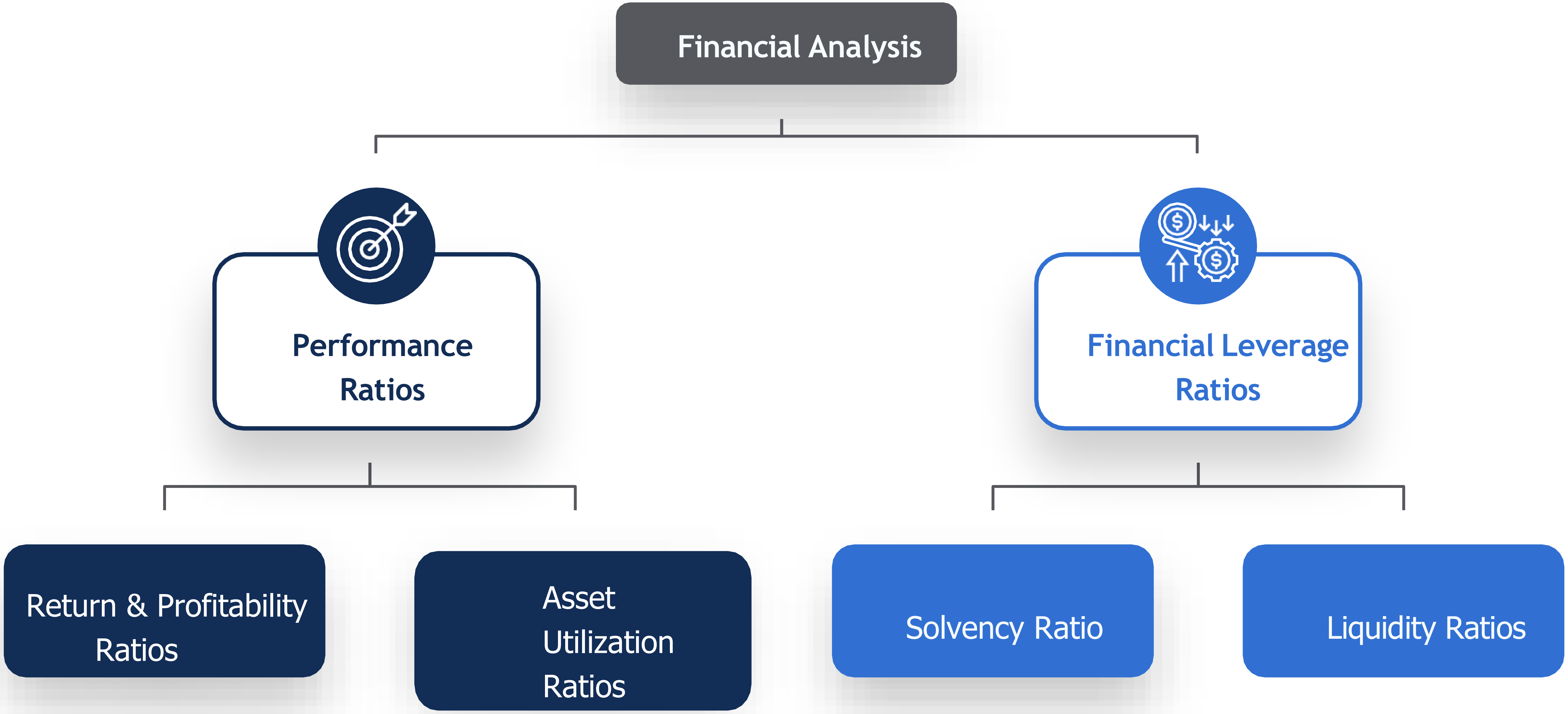
Make your calculations in Excel transparent so that you can trace from financial statements to ratios.

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

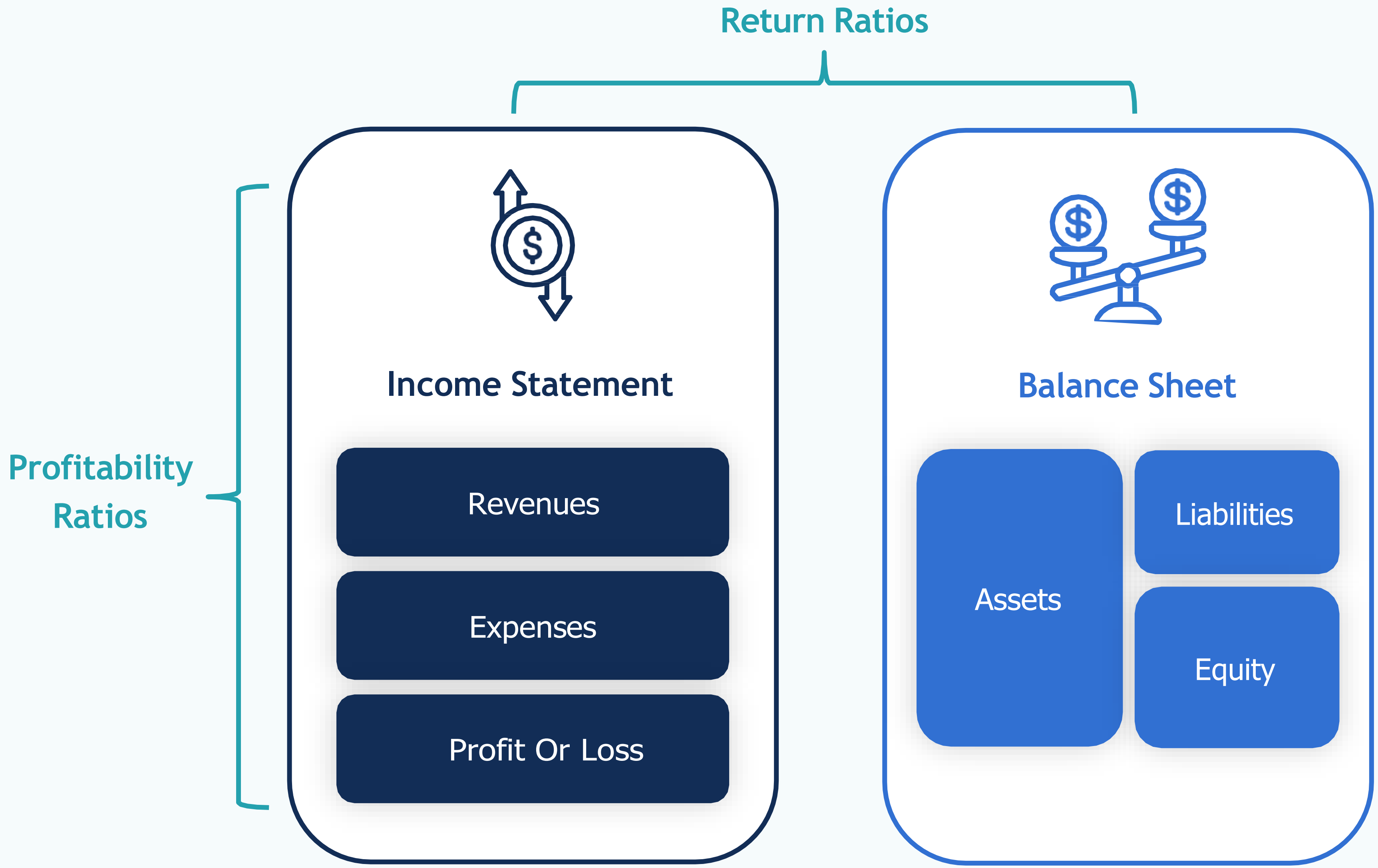
Balance Sheet

- Assets
- Liabilities
- Equity

Statement of Cash Flows

- Operating
- Investing
- Financing

Quick Recap of the Three Financial Statements



What Is Benchmarking

Financial ratios are valuable tools for assessing a company’s performance, but their true significance lies in the context they provide.

Benchmarking

allows us to **compare a company's ratios against those of its peers.**

Peer Group

Benchmarking against a small peer group provides a **focused comparison** among direct competitors.

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Industry

Benchmarking against the industry provides a **broader context,** capturing industry trends and performance expectations..

Combination

Both approaches are often used in combination to gain a **comprehensive understanding of performance.**

Industry Benchmarking

Industry benchmarks are **derived from aggregating data from a diverse set** of companies in the sector.

Companies **gain a sense of their position within the industry** and understand how their performance compares.

helps identify overall industry trends, challenges, and opportunities.

Considers companies of different **sizes, market positions, and operational models.**

Valuable for strategic decision-making (setting long-term goals, identifying areas for growth).

Industry Benchmarking

Peer Group Benchmarking

Peer Group Benchmarking

Compares companies that are **similar in size, market position, and operational characteristics.**

uncovers specific strategies, weaknesses, and competitive advantages **within a specific market segment.**

Benchmarking against a small peer group **allows for a more granular analysis and comparison.**

Peer groups are **made of direct competitors** of companies operating within the same industry niche.

It is a focused view of **how a company is performing relative to its closest competitors.**

Picking Peer Group for Benchmarking

Picking peers is the most important part of a peer group analysis and **where you should spend the bulk of your time.**

Similar Risks Factors

- You want to identify firms with **similar risk factors**

No Peers

If there are no peers, **you can look outside of the firm's sector.**

Closest Peers

- Here benchmarking should be determined **based on the closest comps.**

Peer Group Benchmarking Checklist

We select peer companies by looking at several key **business and finance characteristics.**

Business Characteristics

- Industry/Sector
- Geography
- Product/Services
- Customers
- Distributions
- Network

Finance Characteristics

- Size
- Growth
- Season
- Cycles
- Profits