



David Lithwick
and
Enrico Codogno



a monthly
column devoted
to answering
questions relating
to Competitive
Intelligence

Dear CIC: I have been deferring to our finance department to assess our competitor's financial statements, but recently have been told that they no longer have the time to do this. Can you recommend one technique to assess financial data? **Financially Curious**

Dear Financially Curious

Financial ratios are easy to do and understand. Essentially there are four basic attributes that are commonly analyzed using financial ratios: "liquidity," "leverage," "turnover," and "profitability." So, we will define these terms in addition to explaining the ratios.

1. LIQUIDITY

Liquidity is used to determine the competitor's ability to pay bills from day to day. (If a competitor owes \$2 million and only has \$200,000 in the bank and little money coming in, it really doesn't matter how good the competitor's prospects are in the long term. They may not last.)

Current Ratio is calculated by dividing current assets (assets that are cash or will be converted into cash in the next 12 months) by current liabilities (amounts owed in the next 12 months). So, if the ratio is < 1 , chances are, the competitor isn't doing well – they can't pay back the money they owe with cash on hand and will have to start selling long-term assets, or look at refinancing, to pay their short-term bills.

Quick Ratio is just like Current Ratio, except that inventory isn't counted as a current asset. Sometimes, inventories are either worthless or very hard to get rid of in real life (e.g., \$400,000 worth of 1990s computers, would be hard to get rid of). Because of the unreliability of inventory values, a lot of people use Quick Ratio instead of Current Ratio to determine liquidity.

2. LEVERAGE

Leverage is used to describe the competitor's current ability to pay its long-term debt. (Generally, the more leveraged the competitor, the more "upside potential" and "downside potential" they have.)

Debt Ratio takes the total assets less the total equity (i.e., the total debt), and divides it by the total assets. The ratio tells you what percentage of the competitor is financed by debt. For example, a competitor using 28% debt will be more leveraged than a competitor using 10% debt.

Times Interest Earned Ratio divides earnings (before interest and tax) by the interest paid that year to get a good idea of what percentage of the competitor's earnings is being used to finance debt. For example, an earned ratio of 1.4 signifies that a significant amount of the money earned this year is going straight to the interest expense that the competitor is carrying. Hence, by seeing how much earnings are going back to the competitor and how much are going to their creditors, you can get a fairly good idea of how leveraged your competitor is.

3. TURNOVER

Turnover ratios provide insights into how well the competitor is managing their inventory levels, accounts receivables, etc.

Inventory Turnover Ratio

Inventory turnover is key in high tech industries, where inventory becomes obsolete very quickly. It also gives an indication as to the competency of management: If, e.g., they're making too much inventory, they're probably not running their company properly.

By dividing the "cost of goods sold" line item by the inventory line item, you get an inventory multiple. For example, if a competitor has \$5 million worth of inventory, and their cost of goods sold was \$50 million, they have an inventory multiple of 10. This means that, every year, they "turn over" inventory 10 times. By dividing the number of days in the year by this number, you get the number of days the average piece of inventory sits on the shelf: $365/10 = 36$, so the average piece of inventory is on the shelf a little longer than a month.

Receivables Turnover Ratio

Receivables turnover gives an idea of how reliable the competitor's customers are with payments.

By dividing sales by accounts receivable, you get a multiple similar to one in inventory turnover. By dividing the number of days in the year by this number, you get an idea of how long your competitor's average receivable lasts. For example, if their sales were \$5 million for the year, and they had accounts receivable of \$500,000, their average accounts receivable age would be $365/(5,000,000/500,000)$, or 36.5 days. This means that the average customer pays the competitor 36.5 days after they've purchased the item.

4. PROFITABILITY

Profit Margin

This ratio is calculated by dividing net income by sales. If a competitor's net income after taxes was \$30 million, but they generated \$300 million in sales, their profit margin is 10%. If you figure out your competition's profit margin, you will be able to see whether they're making more or less money than you for selling the same amount of product.

Return on Equity

Shows how much a competitor is making per dollar invested by shareholders. The easiest way to calculate ROE is dividing net income by total equity. If shareholders can make a higher return on equity elsewhere, the competitor may be in trouble: They may decide that some other competitor is a better investment for them and pull out their funds.

CI Corner is written by David Lithwick and Enrico Codogno. David is a senior partner at Market Alert and can be reached at (416) 932-9820 or david@marketalert.ca.

Enrico Codogno is with the Customer Foresight Group, Limited and can be reached at (416) 651-0143 or enrico@customerforesight.com. Email your questions and they will make sure you get the answers you need.