**CASE STUDY ON FINANCIAL PERFORMANCE ANALYSIS.**

The following information refers to the period 1 January 2019 to 31 December 2020

*S plc*

*Income Statements (in £000)*

*2020 2019*

|  |  |  |
| --- | --- | --- |
| Sales revenues | 25,500 | 17,250 |
| Cost of sales | (14,800) | (10,350) |
| Gross profit | 10,700 | 6,900 |
| Administrative expenses | (3,300) | (1,850) |
| Selling & Distribution costs | (1,500) | (1,450) |
| Operating profit | 5,900 | 3,600 |
| Finance costs (Interest) | (650) | (100) |
| Profit before tax | 5,250 | 3,500 |
| Tax payable | (2,250) | (1,000) |
| Profit after tax (SHAREHOLDERS’ PROFITS) | 3,000 | 2,500 |
| Dividends | (750) | (1,500) |
| Retained profit for the year | 2250 | 1000 |

*S plc*

*Summarised position statements (in £000)*

*2020. 2019*

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| --- | --- | --- |
| **Non-current assets** | 15,700 | 5,400 |
| **Current assets** |  |  |
| Inventory | 3,600 | 3,200 |
| Receivables | 1,200 | 2,000 |
| Bank & Cash | 3,200 | 2,000 |
|  | 8,000 | 7,200 |
| **Total assets** | 23,700 | 12,600 |
|  |  |  |
| **Equity** |  |  |
| Share capital (20 pence ordinary shares) | 4,000 | 4,000 |
| Share premium | 1,000 | 1,000 |
| Retained profits | 4,500 | 2,250 |
| Shareholders’ funds | 9,500 | 7,250 |
| **Non-current liabilities** |  |  |
| Long term loan (2030) | 9,000 | 2,000 |
| **Current liabilities** | 5,200 | 3,350 |
| **Total equity and liabilities** | 23,700 | 12,600 |

Additional Information**:**

* Share capital consists of 20 million shares
* Market price stands currently at 81p per share, compared to 60p a year ago.

**Required: Using the information in the question, comment on the financial performance of S plc for the year ended 31 December 2020.**

**Please note:**

**This report is longer than what is required for your first assignment of !000 words. The explanation provided is more than what is required to respond to your assignment.**

**Use your *knowledge* and use your *imagination* as much as possible and make straight forward comments / analysis that directly relate to the ratios used.**

**ANALYSE, THINK, RESEARCH!!!**

**Report on the financial performance of S plc**

**Introduction**

There are several broad aspects of financial performance of S plc that can be observed in the financial statements/information provided. These are:

* There is a large increase in investment in non-current (productive) assets from £5.4m in 2019 to £15.7m in 2020.
* This is mainly financed by a long-term loan of £7m in 2020. The financial analysis will examine the effect of this on its gearing levels and interest cover and consequently the financial risks to business and its shareholders.
* Share price has risen from 60p in 2019 to 81p in 2020 – positive performance on the stock market giving ordinary shareholders a capital gain of 21p per share over one year but there is a cut in the dividends paid to them in 2020.

The financial analysis will cover the areas of profitability, liquidity, working capital management or efficiency, capital structure management and its stock market performance.

However, this analysis is applied to its most recent performance and may or may not have any direct relevance to how S plc will perform in the future. Besides the analysis uses summarised financial statements and this information may hide a more complex story of partial success offset by partial failures.

**Profitability**

A company’s financial performance is also about *profits and profitability since* without profits, investors would not be willing to invest.

Profit gives investors a “*return*” on their investment and it also provides a vital internal source of finance (i.e. retained profits) to fund future expansion of the business. Profitability is how management’s performance is *judged*.

However, *profit* is not cash. Companies can be profitable – but still run out of cash and go out of business. Companies can be unprofitable/making losses, but still be *liquid*. This is important for the short term. In the medium-to-longer term, companies need to be *both* liquid *and* profitable to survive and grow.

A company’s profitability is usually assessed through the use of a range of different *financial ratios*.

Two profitability ratios as related to *sales* are:

1. *Gross profit (margin) ratio*.

2. Ne*t profit (margin) ratio*. (Profit before or after tax to sales ratio).

*Gross profit ratio* = Gross profit / Sales x 100

The gross profit ratio reflects the company’s “pricing strategy\*”.

A low ratio signals that the company is going for high sales volumes with low prices; a higher margin suggests a strategy of lower sales volumes with higher prices. Generally, we would expect this ratio to be *quite stable* over time.

*Net Profit ratio =* Profit before interest and tax (PBIT) or operating profit / Sales x 100

This ratio looks at the company’s ability to run its basic business at a profit – before considering interest and *corporation* *tax*.

It looks at how much such profit is generated on every £1 of sales. In conjunction with the Gross Profit ratio, the Net Profit ratio looks at how well the company is *controlling its costs/expenses (operating costs – i.e. admin costs, selling costs and distribution costs).* It can indicate the *competitive pressures* that the company is operating under.

Two profitability ratios as related to *capital employed* are:

1. *ROCE* = PBIT or operating profit / Total capital employed (i.e. shareholders’ funds and borrowed capital) x 100

2. *ROE* = PAT / Shareholders’ funds x 100

The *ROCE* looks at the overall profitability of the company and is seen as a key “management performance” ratio: Management’s ability to generate profits, before considering tax and financing costs (interest expense).

The *ROE* is, perhaps, the *least important* of the profitability measures, mainly because the “Shareholders Funds” figure has little real *economic meaning* – as the SOFP excludes most intangible asset values.

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| --- | --- | --- | --- |
| **Ratio** | **Formula** | **Ratios for 2020** | **Ratios for 2019** |
| Gross profit ratio | Gross profit / Sales x 100 | £10.7m / £25.5m x 100 = 41.96% | £6.9m / £17.25m x 100 = 40% |
| Net profit ratio | Operating profit / Sales x 100 | £5.9m / £25.5m x 100 = 23.14% | £3.6m / £17.25m x100 = 20.87% |
| Admin costs to sales ratio | Admin costs / Sales x 100 | £3.3m / £25.5m x 100 = 12.94% | £1.85m / £17.25m x 100 = 10.72% |
| S & D costs to sales ratio | S & D costs / Sales x 100 | £1.5m / £25.5m x 100 = 5.89% | £1.45m / £17.25m x 100 = 8.41% |
| ROCE | Operating profit / Total capital employed x 100 | £5.9m / £9.5m + £9m] x 100 = 31.89% | £3.6m / £[7.25 + 2]m x 100 = 38.92% |
| ROE | PAT / Shareholders’ funds x 100 | £3m / £9.5m x 100 = 31.58% | £2.5m / £7.25m x 100 = 34.48% |

Commentary on profitability ratios:

*Gross profit ratio*: There is a small increase in the GP ratio. This may be due an increase in selling prices or a decrease in purchase costs or both in 2020.

*Net profit ratio:* An increase here appears to show better management of operating expenses. The analysis of the operating expenses/costs ratios will provide better insight into this.

*Administration costs to sales ratio*: There is an increase in administration costs and shows either a lack of lack of control of admin costs or is this due to expansion as shown by the increased investment in productive non-current assets. Detailed analysis of the summarised administration costs is required to conclude on this.

*Selling & Distribution costs to sales ratio*: A decrease in this ratio indicates possible improved management of S & D costs

*ROCE*: Though net profit has increased in 2020 this is not reflected by the *ROCE*. The decrease in the ROCE in 2020 is mainly due to an increase in capital employed resulting from increased long term borrowing of £7m in 2020.

*ROE*: The decrease in the *ROE* may not be a reliable indicator for shareholders as the shareholders’ funds in the SOFP are at book values. They exclude intangible asset values.

*Conclusion*: The higher net profit ratio in 2020 is mainly due better management (savings) of S & D costs though also affected by an increase in administration costs. The new investment in non-current assets in 2020 has reduced the ROCE. This may be expected to rise in the future as sales and profits increase on account of the increased investment in productive non-current assets in 2020.

**Liquidity:**

This looks at the company’s ability to pay for its expenses and current liabilities (such as payables, loan repayments, corporation tax, accrued expenses etc) as and when they fall due.

There are 2 liquidity ratios – the *current ratio* and the *quick (or acid test) ratio* that are used to asses liquidity.

*Current ratio* measures the current assets in relation to current liabilities. It is the amount of current assets available to pay the short-term liabilities/debts of the business. The benchmark (or norm or standard) for this can vary considerably and a commonly quoted norm is 2:1.

*Quick ratio* measures the liquid assets in relation to the current liabilities. The benchmark for this can also vary considerably and a commonly quoted norm is 1:1.

The difference between the two liquidity ratios is one of timing. The current ratio looks at liquidity and cash flow issues further ahead than the quick ratio. The quick ratio is more an immediate measure of liquidity – hence the reason why it is referred to as the acid test ratio.

It is more important to look at the *trends in the liquidity ratios over time* than comparing against the norms (or the standard ratios).

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| --- | --- | --- | --- |
| Ratio | Formula | Ratios for 2020 | Ratios for 2019 |
| Current ratio  Norm 2:1 | Current assets / Current liabilities | £8m / £5.2m = 1.54 or 1.54:1 or 1.54 times | £7.2m / £3.35m = 2.15 or 2.15:1 or 2.15 X |
| Quick or acid test ratio  Norm 1:1 | Current assets – Inventory/Current liabilities | £ (8 – 3.6) m / £5.2m = 0.85 or 0.85:1 or 0.85X | £ (7.2 – 3.2) m / £3.35m = 1.19 or 1.19: 1 or 1.91X |

Commentary on liquidity ratios:

*Current ratio*: This is lower in 2020 when compared to the 2019 ratio also against the norm – the trend may indicate problems with liquidity / cash flow in 2020.

Quick ratio: This appears to be adequate since it is closer to the norm even though this has decreased in line with the current ratio. This is a better ratio than the current ratio to rely on as an immediate measure of liquidity.

Conclusion: Does not require management attention since the quick ratio (which is more reliable and important for immediate liquidity) shows a trend around the norm for both years.

**Efficiency / Working capital management**

There are 3 Working Capital Day ratios and these are:

*Inventory days*......the shorter, the better.

*Receivable days*.......the shorter, the better.

*Payable days*......the longer, the better.... (within reason)

Working capital investment is *necessary*, but it is a *non-productive investment*. So, companies do not want to over invest in working capital than what they really need as this may be wasteful. Similarly, an under investment in working capital may be disruptive to business operations.

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| Ratio | Formula | Ratios for 2020 | Ratios for 2019 |
| Inventory holding ratio | Closing inventory / Cost of sales x 365 days | £3.6m / £14.8m x 365  = 88.78 = 89 days | £3.2m / £10.35m x 365 = 112.85 = 113 days |
| Receivables ratio | Receivables / Sales x 365 days | £1.2m / £25.5m x 365  = 17.18 = 17 days | £2m / £17.25m x 365  = 42.32 = 42 days |

Commentary on Efficiency / Working capital management ratios:

*Inventory holding ratio*: This has improved in 2020 and shows better management of inventory. Industry inventory holding ratio may show how effectively and efficiently S plc has managed its inventory

*Receivables ratio*: This too has improved in 2020. Shows better management of receivables in 2020. However, it is assumed that these do not exceed the credit period allowed by S plc on credit sales.

Conclusion: Both ratios do not require any management attention. Both inventory holding and receivables days show trends of improvement in 2020. There is no information available to ascertain the payables ratio (lacking information).

**Capital structure**

There are two ratios to assess capital structure: *Gearing ratio and interest cover*

Capital structure ratios measures how a company is financed by a combination of equity (shareholders’ funds) and debt. Debt finance has a fixed return (interest expense) compared to equity which has a variable return (dividends). While interest is an expense which must be paid, dividends are at the discretion of the company’s directors and so are avoidable. Debt finance is not only cheaper than equity finance it is also tax efficient (reduces taxation).

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*Gearing ratio* = Borrowed capital / Total capital x 100

The terms “gearing” or “leverage” refers to the amount of debt (or loan) financing used by the company. This is important since *Increased debt/gearing = Increased risk.*

If a company *defaults* on its debt *interest*, or debt *capital repayments*, then the company is likely to go out of business**.** *The* *more* the company has borrowed, *the more* interest it has to pay, *the more* loans it will have to repay and so *the greater* *the risk/chance* of default. This risk is termed: *Financial risk*.

What can be good about gearing and why? Borrowed capital is low risk / low cost and tax efficient capital.

It’s called “gearing” because the use of debt finance can be used to *MAGNIFY* the impact of a *change in sales* on the *change* *in* the company’s *profits after tax and interest.*

The *higher* the gearing, (i.e. the more debt the company has), the *more* *interest* it has to pay, and the *greater* is the magnification effect of a change in revenues on the company’s after-tax profits.

If gearing more than 50% then the company is high geared. The disadvantages are the following:

* May have difficulty in meeting its commitment to pay interest if profits are low or a loss is made.
* May find it difficult to borrow more in future since it already has a high amount of fixed return finance.

*Interest cover* = Operating profit (or PBIT) /interest

An *equally important* measure of the financial risk exposure caused by high gearing is the interest cover. The *lower* this ratio is, the *higher* the risk of default on interest payments

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| --- | --- | --- | --- |
| Ratio | Formula | Ratios for 2020 | Ratios for 2019 |
| Gearing ratio | Borrowed capital / Total capital x 100 | £9m / £ (9.5 + 9) m x 100 = 48.65% | £2m / £ (7.25 + 2) m x 100 = 21.62% |
| Interest cover | Operating profit (or PBIT) / interest | £5.9m / £0.65m = 9. 076  = 9.08 times | £3.6m / £0.1m  = 36 times |

Commentary on capital structure management ratios.

Gearing has increased from 21.62% in 2019 to 48.65% in 2020. This is a substantial increase (more than twice). The increased borrowing in 2020 of £7m (£2m in 2019 to £9m in 2020) is to support investment in productive non-current assets for expansion.

Interest cover has consequently deteriorated from 36 times in 2019 to only 9.08 times due to the increase in finance costs (interest) in 2020 but is not critical.

Conclusion: A gearing ratio of 48.65% is close to 50%. If gearing increases to more than 50% then S plc would be high geared. It may then have difficulty in meeting its commitment to pay interest in debt if profits are low or a loss is made in future.

In addition, S plc may find it difficult to borrow more in future since it already has a high amount of fixed return finance currently. However, if the current interest cover of 9.08 times can be maintained in the future then its long-term profitability and liquidity may not be at risk.

**Stock market performance / Investor’s ratios**

The following ratios are relevant: *EPS, DPS, Dividend cover, Dividend yield and the* *PER*. In addition, *share price* movements over time provides an overview of S plc’s stock market performance for investors.

*EPS* (Earnings per share) - Indicates how much profit is generated for the shareholders for *each ordinary share* in issue.The EPS ratio looks at the company’s profitability purely from the *shareholder’s viewpoint*, after tax and interest payments.

What we look for here is *year-by-year growth* in this EPS figure i.e. the *trend over time*.

*DPS (Dividends per share)*– Indicates how much of the EPS is paid out in the form dividends per ordinary share in issue

*Dividend cover ratio* - This works in much the same way as the Interest Cover ratio by indicating *how many times* the dividends are *covered* by the earnings after tax and interest. The *higher* the dividend cover, the *lower* the risk that future dividends will *fall below* the current dividend level.

*Dividend yield* **-** An investment in shares is made to get a“*return*” (to make a profit), in *TWO* ways. One way is through the profits the company gives back to shareholders in the form of “dividends” and this measured by the dividend yield. The other way is to be able to sell the shares for a higher price than you paid to buy them, and so make a “*capital gain”.*

*Price-earnings ratio (or PER)* **-** This shows the share price as a “*multiple*” of

the *after-tax* profits per share or its EPS. The PER can be seen as an indication of *stock market’s view* of the *company’s future* GROWTH prospects (reflected by its investment in productive non-current assets) and the ability of the management team. The *higher* this multiple or PER, the *better*. But, in another sense, the more “*expensive*” the shares.

When comparing the PERs of companies in the *same area of business*, the company with the *higher* PER is seen by the stock market to have the *better* management team and *better* future growth prospects. (however, looking at the *trend over time* of a company’s PER is *meaningless*.)

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| --- | --- | --- | --- |
| Ratios | Formula | Ratios for 2020 | Ratios for 2019 |
| EPS (Earnings per share) | PAT / Number of ordinary shares x100 | £3m / 20m shares x100 = 15p | £2.5m / 20m shares x 100 = 12.5p |
| DPS (Dividends per share) | Total dividends / Number of ordinary shares | £0.75m / 20m shares x100 = 3.75p | £1.5 m / 20 m shares x 100 = 7.5p |
| Dividend cover ratio | Profit after tax / Dividends Paid | £3m / £0.75m = 4 times  Or EPS / DPS  = 15p / 3.75p = 4 times | £2.5m / £1.5m  = 1.67 times  Or EPS / DPS = 12.5p / 7.5p =1.67 times |
| Dividend yield | DPS / Market price x 100 | 3.75p / 81p x 100  = 4.62 % | 7.5p / 60p x 100 = 12.5% |
| Price-earnings ratio or PER | Market price/EPS | 81p / 15p = 5.4 times | 60/12.5 = 4.8 time |

Commentary on stock market ratios

*EPS* - This shows an increase from 12.5p to 15p resulting from an increase in profits.

*DPS* - This has been cut in 2020 (to half of the previous year) even though EPS has increased. The result is a higher profit retention for the year.

*Dividend cover ratio* - The increase in 2020 is mainly due to the cut in dividends.

*Dividend yield* - Decrease in the dividend yield is mainly due the cut in the DPS in 2020

*Price-earnings ratio (or PER)* – this shows an increase in 2020 and shows the stock market’s confidence in S plc’s management and its growth prospects in the future.

*Share price* – This has seen an increase from 60p in 2019 to 81p in 2020; this captures the investment and growth potential of S plc

Conclusion: DPS is lower in 2020 but this is despite profits increasing in 2020. The cut in dividends has also reduced the dividend yield in 2020. Income investors who rely on dividend income may prefer to sell their shares and invest in companies that offer better dividend yields. The increase in the PER, dividend cover and the share price may be welcome news to non-income investors who prefer capital gains to dividend income. They are advised to hold on to their shares as the prospects of share price and capital gains rises result from higher earnings on account of its organic growth.

Summary and recommendations:

The large investment in productive non-current assets in 2020 supports the organic or internal growth prospects of S plc. The £7m long term bank loan closely matches the increase in non-current assets which explains the dramatic increase in the gearing ratio and the consequent fall in the interest cover. Although the current ratio of 1.5:1 is on the low side of acceptability the quick ratio of 0.85:1 suggests no real immediate cash flow/liquidity problems.

The overall performance of S plc has deteriorated (as measured by its ROCE) from 38.92% to 31.89%. The fall in the ROCE is largely the effect of increased investment in new non-current assets in 2020. The returns from this new investment may be greater next year as the expansion begins and more profits are reported. It may also be that the integration of the new business requires time (and expense) before it delivers its full potential.

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**Some general advice when undertaking Financial Statement Analysis**

**1.Always think carefully about *which* you** **ratios you select,**

**.....explain the *purpose* of each one,**

**.....explain how each is *calculated*,**

***.....*explain why you have *chosen* each one,**

**.....and – MOST IMPORTANT OF ALL – what** **does each ratio “tell” you....what are its *implications*.**

**2. Never look at *individual* ratios, always** **try to look at the *trend* over the last** **few years.**

**3. Don’t forget to look at, and compare,** ***growth rates*.**

**4. *Never* simply state that a particular ratio is “going up” or is “falling” .....** **instead always:**

**Try and find out *why* the ratio is** **changing – what’s the *cause* of the**

**change – do some research!**

**What is the *significance* of the change –** **is it “good news” or “bad news” or** **what? Think about it!**

**5. Use graphs and charts and “pie** **diagrams” if they help *illustrate* and** ***explain* your analysis.**

**Remember, you’re trying to tell a *story* about what has been happening to the**

**company.**

**Use your *knowledge* and use your *imagination* as much as possible.....**

**ANALYSE, THINK, RESEARCH!!!**