Suggested Results on case study 1 on Ratio analysis

A. *Liquidity ratios*

Because Dry Supply at 15/07/2017 has about $1.80 of current assets for every rupee of current debt, it should be able to continue to handle its current liabilities and take advantage of trade discounts. An examination of Dry Supply's balance sheets shows that although current liabilities decreased, current assets remained somewhat level. This situation reduced the company's need for short-term borrowings to support its current asset base, thus increasing its current ratio at 15/07/2017. Using the narrower measure of the quick ratio at 1.2x, Dry Supply should be able to cover current liabilities with cash, marketable securities and accounts receivable – all of which usually can be converted to cash more quickly than inventory. Both of these ratios, as well as the rupee amount of working capital, have improved over the three-year period. (If there is any issue in receivables or inventory please mention here)

B. *Leverage ratios*

Among the leverage ratios, the debt to net worth ratio is 1.9x and probably appropriate for a wholesale business that must carry high levels of accounts receivable and inventory. Tangible leverage is the same 1.9x since Dry Supply does not have any intangible assets to be subtracted from net worth for this ratio. Both ratios have shown steady improvement over the three-year period.

The decreasing tangible leverage (debt to tangible net worth) ratio suggests that Dry Supply's net worth (consisting primarily of retained earnings) has been sufficient to fund its balance sheet growth in the same or in better proportions over the three-year period. This could have resulted from a conscious management decision to use the company's leverage less aggressively. Dry Supply's increasing net profits for fiscal years 2015 to 2017, together with its dividend policy (a dividend payout ratio of zero), appears to support this conclusion.

Further, with subordinated debt included as net worth, leverage drops to 0.7x at 15/07/2017, continuing a decreasing trend (improving) since 15/07/2015. This value presents much less risk to all creditors, including a bank. A key question is what are management's plans for maintaining this level of owner's funds loaned to the business?

C. *Profitability ratios*

As measured by net profit margin, return on assets and return on equity ratios, Dry Supply was very profitable in 2017. Specifically, net profit margin was 4.4 percent, return on assets was 14.8 percent and return on equity was 42.6 percent. All three measures showed improvement over the three-year period, attributable to improvement in gross margin and operating margin. The profit margin improvement may indicate a lack of competition, improved sales mix, good expense control, or some combination of all three. The return on assets improvement is due to limited growth of assets compared to improved profits.

What is the profitability outlook in the coming years, and how will this affect the company? Can the improvements noted over the last three years be expected to continue?

D. *Efficiency ratios*

Essentially, Dry Supply depends on inventory sales to repay short-term debt. Inventory sales result in accounts receivable, which then need to be collected. The accounts receivable turnover of 45 days indicates the company sells to customers capable, for the most part, of paying on time, and that Dry Supply has adequate collection practices. This statement is further supported by the study of the aged listings of Accounts Receivables which shows that problem or delinquent accounts are small and pose little risk (what about concentration?)

. This ratio has been stable over the three-year period.

Inventory turnover is 39 days and has improved slightly over the three-year period. Is this trend traceable to good management and control of inventory? In any case, a 39-day holding period does not seem high for a wholesale business. Altogether, it takes approximately 84 days (accounts receivable 45 days plus inventory 39 days) for inventory to convert to cash in order to repay current liabilities, including suppliers, then purchase inventory and start the cycle over again. Accounts payable turnover is 18 days. It appears that the company is paying on time and maintaining a good relationship with its trade creditors. However, due to the closure of business of one of the suppliers, the supplier credit facility has been reduced.

E. ***Coverage ratios***

The interest coverage ratio for 2017 indicates Dry Supply is generating about Rs.4.60 of pretax profit (before interest expense) needed to pay each rupee of interest expense. The fixed charge ratio is similar with about Rs.4.30 of earnings before interest and deprecation available to cover debt service. Both ratios have been at a high level and fairly steady over the three-year period, because the company does not carry long-term debt. Additionally, since Dry Supply does not pay dividends, Ramchandra wants to determine if this is the company's plan for the future. At this point, Ramchandra believes that Dry Supply has plenty of capacity to cover interest expense on additional debt, should current profit levels continue.

General comments on ratios

Ramchandra's questions reinforce the point that management's actions or inaction (whether responding to the competition, industry conditions or the economy) drives the numbers, which in turn helps to determine the ratios.