Financial Ratios

Participant Handout

Financial Ratios Guide

Ratio analysis

Financial ratios are relationships based on a company's financial information and they can serve as useful tools to evaluate a company's investment potential

Analysis of these ratios is a technique of evaluating financial statements like the income statement, cash flow and balance sheet to form an opinion about the various aspects of the organization like profitability, liquidity, efficiency, etc.

Analysts compare the ratios with similar firms in the industry or analyze the company's trend over time.

Categories of financial ratios

Profitability ratios:

Gauge a company's ability to earn profits.

Examples:
Gross Margin
Net Margin
Return on Equity

Liquidity ratios:

Measures the ability of a company to meet its short-term debt obligations

Examples:
Current Ratio
Quick Ratio

Valuation Ratios:

Measures the relationship between the company's market value against metrics from the financial statements

Help assess the value of an investment

Examples
Price to Earnings
Price to Book
Price to Sales

Efficiency ratios:

Evaluate how effectively a company utilizes its assets to produce income

Examples:
Inventory Turnover
Day Sales Outstanding,
Asset Turnover

Leverage ratios:

Gauge of how much a company's operations or assets are financed by deb

Examples:
Debt Ratio
Debt to Equity

Profitability Ratios

	Details
Net Profit Margin	Measures how much net income/profit is generated as a percentage of revenues/sales received. $$\text{Net Profit Margin} = \frac{\text{Net Income}}{\text{Revenue}} \times 100$$ General guideline: 5% (low) 10% (average) 20% ≥ (high) Varies by industry & other factors
Return on Equity (ROE)	Measures how much net income a company generates per dollar of invested capital. $$\text{ROE} = \frac{\text{Net Income}}{\text{Avg. Shareholder Equity}} \times 100$$ General guideline: 0% - 10% poor 10% - 20% average ROE >20% excellent Best to benchmark with industry average

Efficiency Ratios

	Details
Inventory Turnover Ratio	Measures the efficiency at which a company can convert its inventory purchases into revenue $$\text{Inventory Turnover} = \frac{\text{Cost of Goods Sold (COGS)}}{\text{Avg. Inventory}}$$ General guideline: **Between 5 and 10** Good for most industries
Asset Turnover Ratio	Measures efficiency with which a company uses its assets to generate revenue. $$\text{Asset Turnover} = \frac{\text{Revenue}}{\text{Avg. Assets}}$$ General guideline: **Higher ratio means the company is more efficient at generating revenue from assets**

Liquidity

	Details
Current Ratio (working capital ratio)	Measures a company's capacity to pay off all its short-term obligations due within the next twelve months. $$\text{Current Ratio} = \frac{\text{Current Assets}}{\text{Current Liabilities}}$$ General guideline: 1.2x to 2x Generally, for most industries
Quick Ratio (acid test ratio)	Measures a company's ability to meet its short-term obligations with its most liquid assets. $$\text{Quick Ratio} = \frac{\text{Current Assets} - \text{Inventory}}{\text{Current Liabilities}}$$ General guideline: 1.0x or Greater (higher quick ratio is better)

Leverage

	Details
Debt Ratio	Measures the amount of leverage used by a company in terms of total debt to total assets. $\text{Debt Ratio} = \frac{\text{Total Debt}}{\text{Total Assets}}$ General guideline: 0.3x to 0.6x Varies by industry & other factors
Debt to Equity Ratio (D/E)	Measure of financial leverage representing the proportion of financing that came from creditors (debt) versus shareholders (equity). $D/E = \frac{\text{Total Debt}}{\text{Avg. Shareholder Equity}}$ General guideline: 1.0x to 1.5x Varies by industry and other factors but risky when higher than 2.0x

Valuation

	Details
Price to Earnings (P/E) Ratio	A valuation multiple representing the amount that investors are currently willing to pay for a dollar of the company's net profit. $P/E = \frac{\text{Market Stock Price}}{\text{Earnings Per Share}}$ General guideline: Preferably low compared to competitors / industry average
Price to Book (P/B) Ratio	A valuation multiple that measures the market capitalization of a company relative to its book value. $P/B = \frac{\text{Market Stock Price}}{\text{Book Value Per Share}}$ General guideline: P/B < 1: Undervalued and favored P/B 1- 3: Fairly valued P/B < 3: Overvalued

IMPORTANT INFORMATION

The information has been drawn from sources believed to be reliable and was updated as of October 16th, 2024.

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