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| Illinois Institute of Technology |
| MSF 506 Financial Statement Analysis |
|  |
| Project Report |

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# Overview

Best Buy was founded in 1996, headquarter in Richfield, Minnesota. Best Buy is a service provider of technology products, services, and solutions. The company operates through two segments Domestic and International. The company’s Domestic and International have offerings in six categories, such as consumer electronics, computing and mobile phones, entertainment, appliances, services and other. It is traded on NYSE as BBY. Best Buy competes primarily with Amazon, Walmart, Target, and Costco.

**All the amount presented in the report are in $ millions expect the share price.**

# **Assessment of Financial Distress**

## **Altman Z-score Calculations**

* Formulae used
  + Z=1.2\*X1 + 1.4\*X2 + 3.3\*X3 + 0.6\*X4 + 1.0\*X5

where

X1 = Working Capital / Total Assets

X2 = Retained Earnings / Total Assets

X3 = EBIT / Total Assets

X4 = Market Value of Equity / Book Value of Equity

X5 = Sales / Total Assets

| **Fiscal Year** | **2016** | **2015** |
| --- | --- | --- |
| X1 | 0.22 | 0.24 |
| X2 | 0.31 | 0.27 |
| X3 | 0.10 | 0.10 |
| X4 | 5.22 | 7.68 |
| X5 | 2.92 | 2.65 |
| Altman Z Score | 7.08 | 8.25 |

* Please refer to “[Altman Z Score calculation](#_Altman_Z_Score)” attachment for complete detailed calculation

## **Comment on the significance of the Altman Z-scores**

The Altman Z – Score is used to determine the probability whether Best Buy will be a firm to file for bankruptcy in a short period of time (within 2 years). The Altman Z – Scores for Best Buy for Fiscal Years 2016 and 2015 are 7.08 and 8.25 respectively. These scores clearly indicate that Best buy is unlikely to file for bankruptcy in the next two year since it has very strong financial position. The Altman Z score of the company is 7.08 for year 2016 which is 2.3 times higher (approximately) than the minimum safety zone (2.99). However, the Altman Z Score for Fiscal Year 2016 is slightly lesser than the previous year’s score. The possible reasons for this fall can be the Market Value of Equity in turn the Common Stock prices (20.65% fall) on the last working day of Fiscal Years.

# **Analysis of Historical Operating Performance (GAAP Basis)**

## **Year-to-Year Trend Analysis**

| **Fiscal Year** | **2016** | **2015** | **$ Change** | **% Change** |
| --- | --- | --- | --- | --- |
| Net Revenue | 39,528.00 | 40,339.00 | -811.00 | -2.01 |
| Gross Profit | 9,191.00 | 9,047.00 | 144.00 | 1.59 |
| Operating Income | 1,375.00 | 1,450.00 | -75.00 | -5.17 |
| EBIT | 1,390.00 | 1,477.00 | -87.00 | -5.89 |
| Interest expense | 80.00 | 90.00 | -10.00 | -11.11 |
| Net earnings from continuing operations | 807.00 | 1,246.00 | -439.00 | -35.23 |
| Net earnings attributable to Best Buy Co., Inc. shareholders | 897.00 | 1,233.00 | -336.00 | -27.25 |
| EBITDA | 2,248.00 | 2,156.00 | 92.00 | 4.27 |

* Please refer to “[Year-to-Year Trend Analysis calculation](#_Altman_Z_Score)” and “[EBIT & EBITDA calculation](#_EBIT_&_EBITDA)” attachment for complete detailed calculation

## **Profitability Ratios**

| **Fiscal Year** | **2016** | **2015** | |
| --- | --- | --- | --- |
| Gross Profit | 9,191.00 | 9,047.00 | |
| Net Revenue | 39,528.00 | 40,339.00 | |
| **Gross Margin** | **23.25%** | **22.43%** | |
|  | | |
| Operating Income | 1,375.00 | 1,450.00 | |
| Net Revenue | 39,528.00 | 40,339.00 | |
| **Operating Margin** | **3.48%** | **3.59%** | |
|  | | |
| EBIT | 1,390.00 | 1,477.00 | |
| Net Revenue | 39,528.00 | 40,339.00 | |
| **EBIT Margin** | **3.52%** | **3.66%** | |
|  | | |
| EBIT | 1,390.00 | 1,477.00 | |
| Interest expense | 80.00 | 90.00 | |
| **Interest Coverage Ratio** | **17.38X** | **16.41X** | |
|  | | |
| Net Earnings | 897.00 | 1,233.00 | |
| Net Revenue | 39,528.00 | 40,339.00 | |
| **Net Margin** | **2.27%** | **3.06%** | |
|  | | |
| EBITDA | 2,248.00 | 2,156.00 | |
| Net Revenue | 39,528.00 | 40,339.00 | |
| **EBITDA Margin** | **5.69%** | **5.34%** | |

* Please refer to “[Profitability Ratios calculation](#_Profitability_Ratios_calculation)” attachment for complete detailed calculation

## **Comment on Financial Performance**

### **Consolidated Overview:**

The sales of the Best buy in 2016 fiscal year declined by $811 million compared to last year, approximately decline of 2.01% with Foreign currency fluctuations and negative effect of closure of Canada Stores being the drivers for decline. Due to Canadian brand consolidation, there was closure of 66 Future shop stores in Canada and conversion of the remaining 65 Future Shop stores into the Best Buy brand. Despite the decline in revenues, gross profit soared by 1.59% because of the litigation proceeds related to cathode ray tube (CRT) and liquid crystal display (LCD) and recognition of $148 million of periodic profit sharing benefit from externally managed service plan portfolio. As the restructuring charges increased in 2016 to $198 million compared to $5 million in 2015 which dramatically impacted the operating income by negative 5.17% but was offset by litigation settlement related to CRT / LCD. The company’s interest expense dropped to $80 million from $90 million because of lower fixed rate as the company in year 2016 swapped $750 million floating debt to fixed rate. The net earnings from continuing operations was $807 million in 2016, decline of 35.23% compared to 1,233 million in 2015 mainly due to company incurred restructure charges due to Canadian brand consolidation plan. These restructure charges comprises of lease exit costs, a tradename impairment, property and equipment impairments, inventory write-downs and employee termination benefits. Thus, earnings declined due to the major changes in Canada (International segment).

### **Business Segment Overview:**

Best Buy report revenue through six categories such as consumer electronics, computing and mobile phones, entertainment, appliances, services and other. The major revenue income is recorded from Best Buy’s consumer electronics and computing and mobile phones segments.

* + **Consumer Electronics:**

The key component of consumer electronics segment are home theatre, home automation, digital imagining, health and fitness and portable audio. Best Buy’s consumer electronics segment reported sales gain of 4.7% in 2016 compared to 3.7% in 2015 in domestic segment. The growth in sales was primarily due to strong increase in sales of Ultra-HD large screen television and the expansion of home theater design called Magnolia Design Center within Best Buy stores. However, the sales gain was offset due to side effects of Canadian brand consolidation like closure of 66 stores in Canada and increased promotional activity in Canada and negative foreign currency impact from International segment. The operating income of $1,585 million in 2016, a 10.3 % increase, compared to $1,437 million in 2015 due to higher revenue and $75 million in CRT / LCD litigations settlements proceeds received in fiscal 2016, which were offset by operating loss of $210 million in 2016 in international segment due to decrease in revenue and restructure charges as a part of Canadian brand consolidation which was partially offset by lower SG&A expense.

* + **Computing and Mobile Phones:**

The key components of Computing and Mobile Phones are computing and peripherals, networking, tablets, mobile phones (including related mobile network carrier commissions), wearables (including smartwatches) and e-readers. Best Buy’s computing and Mobile Phones segment reported decline because of the ongoing industry decline in tablets.

* + **Entertainment:**

The key components of Entertainment are gaming hardware and software, movies, music, technology toys and other software. Decline in demand of the music and movies because of increase in online music and movie streaming and decline in gaming hardware are the main driving reasons for declined Sales.

* + **Appliances:**

The key components of Appliances are major appliances (for example, refrigeration, dishwashers, ovens, laundry, etc.) and small appliances (for example, coffee makers, blenders, etc.). The Appliances segment reported increase in sales growth because of the expansion of the Pacific Kitchen & Home store within Best Buy stores which helped in selling more number of appliances.

* + **Services:**

The key components of Services are consultation, design, delivery, installation, set-up, protection plans, repair, technical support and educational classes. The decline was majorly due to lower repair revenue from extended protection plan claims.

# **Financial Position (GAAP Basis) and ROE (DuPont) Analysis**

## **Return on Equity Analysis**

### **Return on Equity (ROE) calculation for 2016 and 2015 using the 3-step DuPont model**

* Formulae used

or

| **Fiscal Year** | **2016** | **2015** | **% Change** |
| --- | --- | --- | --- |
| **Profitability** | | | |
| Net Earnings | 897.00 | 1,233.00 | -27.25 |
| Net Revenue | 39,528.00 | 40,339.00 | -2.01 |
| **Net Margin** | **2.27** | **3.06** | **-0.79** |
|  | | | |
| **Long Term Activity** | | | |
| Net Revenue | 39,528.00 | 40,339.00 | -2.01 |
| Average Total Assets | 14,382.00 | 14,617.50 | -1.61 |
| **Total Asset Turnover** | **2.75** | **2.76** | **-0.01** |
|  | | | |
| Solvency | | | |
| Average Total Assets | 14,382.00 | 14,617.50 | -1.61 |
| Average Total Equity | 4,689.00 | 4,494.50 | 4.33 |
| **Financial Leverage** | **3.07** | **3.25** | **-0.18** |
|  | | | |
| **Return on Equity (%)** | **19.13** | **27.43** | **-8.30** |

### **Comment on Return on Equity (ROE)**

The return on equity shows the declining trend (decline of 8.30%) from 2015 to 2016. The major factor which contributed highest in declining trend is Profitability factor (Net Profit Margin). The Net Profit Margin shows decline of 0.79% approximately from 2015 to 2016 because of disruptive impact of Canadian brand Consolidation Company reported high restructure charges as compared with last year which impacted the net income margin.

## **Liquidity Position Analysis**

* Formulae used

**Quantitative Measure of Liquidity (Ratios)**

| **Fiscal Year** | **2016** | **2015** |
| --- | --- | --- |
| Current Assets | 9,886.00 | 11,472.00 |
| Current Liabilities | 6,925.00 | 7,777.00 |
| **Current Ratio** | **1.43** | **1.48** |
|  |  |  |
| Cash and cash equivalents | 1,976.00 | 2,432.00 |
| Receivables, net | 1,162.00 | 1,280.00 |
| Current Liabilities | 6,925.00 | 7,777.00 |
| **Quick Ratio** | **0.45** | **0.48** |
|  |  |  |
| Cash and cash equivalents | 1,976.00 | 2,432.00 |
| Current Liabilities | 6,925.00 | 7,777.00 |
| **Cash Ratio** | **0.29** | **0.31** |
|  |  |  |
| Operating Cash Flow | 1,322.00 | 1,935.00 |
| Current Liabilities | 6,925.00 | 7,777.00 |
| **Cash Flow Ratio** | **0.19** | **0.25** |

* Cash and cash equivalents totaled at 1,976 million in 2016
* Current Ratio of 1.43x in 2016 and 1.48X in 2015 (above the benchmark of 1). The company have positive working capital of $2,961 million. The Current Ratio declined due to decrease in Cash Balance and increase in Current Liabilities because 2016 Notes was due in fiscal year 2017
* The Cash Flow Ratio for 2016 and 2015 are 0.19X and 0.25X which are below the industry expert benchmark of 0.40X. The reason for downside of Cash Flow Ratio is because of the declining cash from Operating activity. The declining in cash from Operating activity is due to maintaining large inventory for the holiday season and in addition, super bowl moved to first quarter of fiscal year 2017.

**Short-Term Activity Ratios**

| **Fiscal Year** | **2016** | **2015** |
| --- | --- | --- |
| Cost of Goods Sold | 30,334.00 | 31,292.00 |
| Average Inventory | 5,112.50 | 5,275.00 |
| **Inventory Turnover** | **5.93** | **5.93** |
| **Inventory Days** | **61.52** | **61.53** |
|  |  |  |
| Net Revenue | 39,528.00 | 40,339.00 |
| Average Accounts Receivables | 1,221.00 | 1,294.00 |
| **Receivables Turnover** | **32.37** | **31.17** |
| **Receivables Days** | **11.27** | **11.71** |
|  |  |  |
| Cost of Goods Sold | 30,334.00 | 31,292.00 |
| Average Accounts Payables | 4,740.00 | 5,076.00 |
| **Payables Turnover** | **6.40** | **6.16** |
| **Payables Days** | **57.04** | **59.21** |

**Cash Conversion Cycle**

| **Fiscal Year** | **2016** | **2015** |
| --- | --- | --- |
| Inventory Days | 61.52 | 61.53 |
| Add: Receivables Days | 11.27 | 11.71 |
| **Operating Cycle** | **72.79** | **73.24** |
| Less: Payables Days | 57.04 | 59.21 |
| **Cash Conversion Cycle Days** | **15.76** | **14.03** |

* Cash conversion cycle slightly increased by 1.73 days in 2016 over 2015. Best Buy was holding up the inventory due to the holiday season and Super Bowl shifted to first quarter of the year.
* **U.S. revolving credit facilities**

At January 30, 2016 and January 31, 2015 there was no borrowings outstanding under the five-year facility agreement. $1.25 billion was available under the five-year senior unsecured credit facility agreement.

* **Long-term Credit Rating**

|  |  |  |  |
| --- | --- | --- | --- |
| **Rating Agency** | **2016 Rating** | **2015 Rating** | **Outlook** |
| Standard and Poor's | BB+ | BB | Stable |
| Moody's | Baa1 | Baa2 | Stable |
| Fitch | BBB- | BB | Stable |

In fiscal 2016, Rating Services (Standard and Poor’s, Moody’s and Fitch) upgraded Best Buy’s long-term credit rating with “Stable” outlook. This upgrade will positively impact the perception of Best Buy's credit risk, access to capital markets, borrowing costs, vendor terms and lease terms.

* The company does have any securities filed under Shelf registration.

## **Capital Structure & Enterprise Value**

### **Capital Structure**

| **Fiscal Year** | **2016** | **2015** |
| --- | --- | --- |
| Debt-to-Total Capital | 28.37% | 24.39% |
| Total Debt-to-EBITDA | 0.77X | 0.75X |

* Please refer to “[Financial Leverage Ratios calculation](#_Financial_Leverage_Ratios)” attachment for complete detailed calculation
* The total debt- to-capital ratio for year 2016 and 2015 are 28.37% and 24.39% respectively, which indicates the company’s leverage position as healthy by maintaining total debt-to-total capital ratio at or below 60%
* The lower the total debt-to-EBITDA ratio is better it is. The Best Buy’s continues to solidify its investment credit rating by maintaining its debt to EBITDA at or below 3.5x. The company has .77x debt-to-EBITDA in 2016.

### **Enterprise Value**

* Formulae used

| **Fiscal Year** | **2016** | **2015** |
| --- | --- | --- |
| Common Stock issued (in millions) | 324.00 | 352.00 |
| Common Stock Price (as on last working day of fiscal) | 27.93 | 35.20 |
| **Market Value of Equity** | **9,049.32** | **12,390.40** |
|  |  |  |
| Total Interest bearing Debt | 1,734.00 | 1,613.00 |
| Debt Trading Value | 0.96 | 0.96 |
| **Market Value of Debt** | **1,664.64** | **1,548.48** |
|  |  |  |
| **Enterprise Value** | **10,713.96** | **13,938.88** |
|  |  |  |
| **Total Debt-to-Enterprise Value** | **15.54%** | **11.11%** |

* The enterprise value of Best Buy in 2016 is $ 10,713 million compared to 13,938.88 million in 2015. The reason for the decline is company repurchased 33 million common stock shares in 2016. The company also increased its debt market value from $1,548.48 to $1,664.64 in 2016, as a part of its financing activities for general corporate purpose and repurchase of common stock. The increase in debt value drove the total-debt-to-enterprise value to 15.54% in 2016 from 11.11% in 2015. Although, total debt-to-enterprise value has increased, but the overall company’s capital structure is healthy and stable.

## **Depreciation Ratios**

### **Average Total Life Span of Property, Plant & Equipment**

* Formulae used

| **Fiscal Year** | **2016** | **2015** |
| --- | --- | --- |
| Total Property & Equipment | 8,107.00 | 7,660.00 |
| Depreciation & Amortization of definite-lived intangible assets | 657.00 | 656.00 |
| **Average Depreciable life of Property and Equipment** | **12.34** | **11.68** |

### **Average Age of Property, Plant & Equipment**

* Formulae used

| **Fiscal Year** | **2016** | **2015** |
| --- | --- | --- |
| Accumulated Depreciation | 5,761.00 | 5,365.00 |
| Depreciation & Amortization of definite-lived intangible assets | 657.00 | 656.00 |
| **Average Age of Property and Equipment** | **8.77** | **8.18** |

### **Comment on Average Total Life Span and Age of Property, Plant & Equipment**

Average total life span is the measurement of expecting years in use of property, plant, and equipment of a company. The Best Buy has the total life span of Property and Equipment is 12.34 and its current average age of Property and Equipment is 8.77. The number indicates that Best Buy’s fixed assets are currently near to their life cycles. Thus, at the end of 8.77 years company will have to change the existing Property and Equipment at the cost of $ 8,107 million.

# **3-Year Financial forecast – Management Case**

## **Income Statement Forecast**

* Formulae used

| **Fiscal Year** | **Base Year Data** | **Forecast Years** | | | **Assumptions** |
| --- | --- | --- | --- | --- | --- |
| **2016** | **2017** | **2018** | **2019** |
| Revenue Growth | 0.00 | 2.30 | 3.10 | 3.50 | Revenue growth of 2.3%, 3.1%, and 3.5% projected for 2017, 2018, and 2019, respectively |
| **Net Revenue** | **39,528.00** | **40,437.14** | **41,690.70** | **43,149.87** |
| Gross Margin Growth | 0.00 | 0.22 | 0.22 | 0.22 | Gross margin is forecasted to improve 22 basis points each year, using the gross margin in 2016 as the base year |
| **Gross Margin** | **23.25** | **23.47** | **23.69** | **23.91** |
| **Gross Profit** | **9,191.00** | **9,490.60** | **9,876.53** | **10,317.13** |
| **Cost of Goods Sold** | **30,337.00** | **30,946.55** | **31,814.17** | **32,832.74** |  |
| SGA 3 Years average for 2014, 2015 & 2016 | 19.35 | 19.35 | 19.35 | 19.35 | Selling, general, and administrative expense, as a percentage of revenues, for each forecast period will be based on the 3-year historical average |
| **Selling, general and administrative expenses** | **7,618.00** | **7,824.59** | **8,067.15** | **8,349.50** |  |
| Restructuring charges | 198.00 | 30.00 | 25.00 | 20.00 | Restructure charges are expected to be $30.0 million in 2017, $25.0 million in 2018, and $20.0 million in 2019 (all non-cash) |
| **Operating Income** | **1,375.00** | **1,636.01** | **1,784.38** | **1,947.63** |  |
| Interest expense growth | 0.00 | 2.40 | 2.40 | 2.40 | Interest expense is projected to increase 2.4% each forecast period, using interest expense in 2016 as the base year |
| **Interest expense** | **-80.00** | **-81.92** | **-83.89** | **-85.90** |  |
| Total Other Income (Expense) | 15.00 | 14.00 | 18.00 | 12.00 | Investment income is forecasted to be $14.0 million in 2017, $18.0 million in 2018, and $12.0 million in 2019 |
| **EBT** | **1,310.00** | **1,568.09** | **1,718.49** | **1,873.73** |  |
| Income tax expense | 503.00 | 627.24 | 687.40 | 749.49 | Assume taxes on (pre-tax) earnings of 40.0% for all forecast periods |
| **Net earnings from continuing operations** | **807.00** | **940.85** | **1,031.09** | **1,124.24** |  |

## **Statement of Free Cash Flows Forecast**

| **Fiscal Year** | **Base Year Data** | **Forecast Years** | | | **Assumptions** |
| --- | --- | --- | --- | --- | --- |
| **2016** | **2017** | **2018** | **2019** |
| **Operating Income** | **1,372.00** | **1,636.01** | **1,784.38** | **1,947.63** |  |
| Add: Total Other Income (Expense) | 15.00 | 14.00 | 18.00 | 12.00 |  |
| **EBIT** | **1,387.00** | **1,650.01** | **1,802.38** | **1,959.63** |  |
| Depreciation Growth % | 0.00 | 2.70 | 2.70 | 2.70 | Depreciation expense is forecasted to increase 2.7% each forecast period, using 2016 as the base year in computations (ignore for income statement) |
| **Add: Depreciation & Amortization** | **657.00** | **674.74** | **692.96** | **711.67** |
| **Add: Restructuring charges** | **201.00** | **30.00** | **25.00** | **20.00** |  |
| **EBITDA** | **2,248.00** | **2,354.75** | **2,520.33** | **2,691.30** |  |

| **Fiscal Year** | **Forecast Years** | | | **Assumptions** |
| --- | --- | --- | --- | --- |
| **2017** | **2018** | **2019** |
| **EBITDA** | **2,354.75** | **2,520.33** | **2,691.30** |  |
| Capital Expenditure | 675.00 | 550.00 | 575.00 | The Company is projecting capital expenditures of $675.0 million in 2017, $550.0 million in 2018, and $575.0 million in 2019. Assume maintenance capital expenditures for each period is 35% of each of the above totals |
| Maintenance Capex % | 35.00 | 35.00 | 35.00 |
| **Maintenance Capex Amount** | **236.25** | **192.50** | **201.25** |
| Dividend Payment % | 2.00 | 2.00 | 2.00 | Management will be paying dividends on common stock of 2.0% on net earnings in each forecast period (if earnings are negative, no dividends will be paid) |
| **Dividend Payment** | **18.82** | **20.62** | **22.48** |
| **Free Cash Flows** | **2,099.68** | **2,307.21** | **2,467.57** |  |

## **Fixed Charge Coverage Ratio Forecast**

* Formulae used
  + Fixed Charge Coverage Ratio =

| **Fiscal Year** | **Forecast Years** | | | **Assumptions** |
| --- | --- | --- | --- | --- |
| **2017** | **2018** | **2019** |
| **EBITDA** | **2,354.75** | **2,520.33** | **2,691.30** |  |
| Principal debt repayments | 350.00 | 0.00 | 517.00 | Assume scheduled principal debt repayments (includes capital lease obligations) as follows: 2017 - $350.0 million, 2018 - $0.0, 2019 - $517.0 million; |
| Interest expense | 81.92 | 83.89 | 85.90 |  |
| Lease Rent Expense | 813.00 | 708.00 | 572.00 | Management projects lease rent expense of $813 million, $708 million, and $572 million in 2017, 2018, and 2019, respectively. (Note: These amounts are included in selling, general and administrative expense above; however, use information for part C.) |
| Maintenance Capex | 236.25 | 192.50 | 201.25 |
| Dividend Payment | 18.82 | 20.62 | 22.48 |  |
| EBITDA + Lease Rent | 3,167.75 | 3,228.33 | 3,263.30 |  |
| Principal Payment + Interest Exp. + Maintenance Capex + Dividends + Rent | 1,499.99 | 1,005.01 | 1,398.63 |  |
| **Fixed Charge Coverage Ratio** | **2.11** | **3.21** | **2.33** |  |

## **Comment on 3-Year Financial Forecast – Management Case**

### **3-Year Income Statement Forecast:**

The Net Revenue shows the increasing trend in the coming years. The increase in Revenue (may be the after the Canadian brand consolidation) will have positive impact on the sales of Best Buy. The Restructuring Charges are dramatically declining during forecasting tenor, resulting the Operating Income to accelerate in the coming years. The slight increase in Interest Expense every forecasting year is offset by increasing Investment Income for 2017 and 2018. Thus, consistent Sales growth and improving Gross Margin improves the forecasted Net Earnings in the coming years.

### **3-Year Statement of Free Cash Flows:**

Statement of Free Cash Flows shows an upward trend during forecasting tenor. It indicates Best Buy’s ability to generate the positive cash flows after paying Company’s Capital Expenditure and Dividend Payment. The positive cash flows show healthy financial leverage. In future, Company can further utilize the remaining positive cash flow to expand the presence in International segment or it may increase the amount of dividend payment to investors which will positively impact the company.

### **3-Year Fixed Charge Coverage:**

The Fixed Charge Coverage Ratio exceeds the benchmark of 1X in all 3 years. Overall, it shows that company would be able to cover its Fixed Cost from the cash flows generated. Total Fixed Cost is highest in year 2017 followed by year 2019 which includes a large amount of principal payments coming due. In year 2018, we see big improvement in Fixed Charge Coverage Ratio due to $0 Principal Payment expected due the following year.

# **3-Year Financial forecast – Student Case**

## **Current state of the consumer electronics and appliance industry**

Global Consumer Electronics market is classified into consumer electronic device, wearable device, and smart home device. The consumer electronics and appliance industry revenue remained flat sequentially, but year over year it posted a marginal decline of 2.3%. The CTA Index of Consumer Technology Expectations (ICTE), which measures consumer expectations about technology spending measures US economy ICTE dropped nine points in June to 171.3 .The fall in sentiment towards the overall economy was likely due to the global uncertainty amid the Brexit vote in United Kingdom and Presidential election in U.S. Comparatively, the European market will decline with CARC of -0.8% and the Asia-Pacific market will grow with a CAGR of 2.3% respectively, over the same period, to reach respective values of $55.6bn and $84.0bn in 2019. The consumer electronics sector is projected to accelerate and reach to US$ 2,976.1 billion by 2020, reflecting a CAGR of 15.4% during the forecast period, 2015 – 2020(Source: prnewswire.com).

## **Financial Forecast Variables**

| **Fiscal Year** | **2017** | **2018** | **2019** |
| --- | --- | --- | --- |
| Revenue Growth % | 3.2 | 2.95 | 1.04 |
| Gross Margin Growth (basis) | 0.33 | 0.33 | 0.33 |
| SGA Growth (%) | 20.0 | 20.0 | 20.0 |
| Interest Expense Growth (%) | 1 | 3.2 | 3.2 |
|  | | | |
| Restructuring Charges ($) | 30 | 25 | 12 |
| Total other income (expense) ($) | 14 | 18 | 12 |
| Income Tax (%) | 40 | 40 | 40 |
| Depreciation Growth (%) | 2.7 | 2.7 | 2.7 |
| Capital Expenditure ($) | 675 | 550 | 575 |
| Maintenance Capex (%) | 35 | 35 | 35 |
| Dividend Payment (%) | 2 | 2 | 2 |

## **Income Statement Forecast**

* Formulae used

| **Fiscal Year** | **Base Year Data** | **Forecast Years** | | | **Assumptions** |
| --- | --- | --- | --- | --- | --- |
| **2016** | **2017** | **2018** | **2019** |
| Revenue Growth | 0.00 | 3.20 | 2.95 | 1.04 | Revenue growth of 3.2%, 2.95%, and 1.04% projected for 2017, 2018, and 2019, respectively |
| **Net Revenue** | **39,528.00** | **40,792.90** | **41,996.29** | **42,433.05** |
| Gross Margin Growth | 0.00 | 0.33 | 0.33 | 0.33 | Gross margin is forecasted to improve 33 basis points each year, using the gross margin in 2016 as the base year |
| **Gross Margin** | **23.25** | **23.58** | **23.91** | **24.24** |
| **Gross Profit** | **9,191.00** | **9,618.96** | **10,041.31** | **10,285.77** |
| **Cost of Goods Sold** | **30,337.00** | **31,173.93** | **31,954.97** | **32,147.28** |  |
| SGA 3 Years average for 2014, 2015 & 2016 | 19.35 | 20.00 | 20.00 | 20.00 | Selling, general and administration expense will increase to 20.0 % because of the additional Marketing expenses due to entrance of small competitor in 2017 |
| **Selling, general and administrative expenses** | **7,618.00** | **8,158.58** | **8,399.26** | **8,486.61** |  |
| Restructuring charges | 198.00 | 30.00 | 25.00 | 12.00 | Restructure charges are expected to be $30.0 million in 2017, $25.0 million in 2018, and $12.0 million in 2019 (all non-cash) |
| **Operating Income** | **1,375.00** | **1,430.39** | **1,617.05** | **1,787.16** |  |
| Interest expense growth | 0.00 | 1.00 | 3.20 | 3.20 | Interest expense for 2017 is expected to increase by 1%, 3.2% for 2018 and 2019 |
| **Interest expense** | **-80.00** | **-80.80** | **-83.39** | **-86.05** |  |
| Total Other Income (Expense) | 15.00 | 14.00 | 18.00 | 12.00 | Investment income is forecasted to be $14.0 million in 2017, $18.0 million in 2018, and $12.0 million in 2019 |
| **EBT** | **1,310.00** | **1,363.59** | **1,551.67** | **1,713.11** |  |
| Income tax expense | 503.00 | 545.43 | 620.67 | 685.24 | Assume taxes on (pre-tax) earnings of 40.0% for all forecast periods |
| **Net earnings from continuing operations** | **807.00** | **818.15** | **931.00** | **1,027.86** |  |

## **Statement of Free Cash Flows Forecast**

| **Fiscal Year** | **Base Year Data** | **Forecast Years** | | | **Assumptions** |
| --- | --- | --- | --- | --- | --- |
| **2016** | **2017** | **2018** | **2019** |
| **Operating Income** | **1,375.00** | **1,636.01** | **1,784.38** | **1,947.63** |  |
| Add: Total Other Income (Expense) | 15.00 | 14.00 | 18.00 | 12.00 |  |
| **EBIT** | **1,390.00** | **1,650.01** | **1,802.38** | **1,959.63** |  |
| Depreciation Growth % | 0.00 | 2.70 | 2.70 | 2.70 | Depreciation expense is forecasted to increase 2.7% each forecast period, using 2016 as the base year in computations (ignore for income statement) |
| **Add: Depreciation & Amortization** | **657.00** | **674.74** | **692.96** | **711.67** |
| **Add: Restructuring charges** | **201.00** | **30.00** | **25.00** | **20.00** |  |
| **EBITDA** | **2,248.00** | **2,354.75** | **2,520.33** | **2,691.30** |  |

| **Fiscal Year** | **Forecast Years** | | | **Assumptions** |
| --- | --- | --- | --- | --- |
| **2017** | **2018** | **2019** |
| **EBITDA** | **2,354.75** | **2,520.33** | **2,691.30** |  |
| Capital Expenditure | 675.00 | 550.00 | 575.00 | The Company is projecting capital expenditures of $675.0 million in 2017, $550.0 million in 2018, and $575.0 million in 2019. Assume maintenance capital expenditures for each period is 35% of each of the above totals |
| Maintenance Capex % | 35.00 | 35.00 | 35.00 |
| **Maintenance Capex Amount** | **236.25** | **192.50** | **201.25** |
| Dividend Payment % | 2.00 | 2.00 | 2.00 | Management will be paying dividends on common stock of 2.0% on net earnings in each forecast period (if earnings are negative, no dividends will be paid) |
| **Dividend Payment** | **18.82** | **20.62** | **22.48** |
| **Free Cash Flows** | **2,099.68** | **2,307.21** | **2,467.57** |  |

## **Comment on 3-Year Financial Forecast**

### **Financial Forecast Assumptions for years 2017, 2018 and 2019**

In 2016 Best Buy did the structure changes towards Canadian Brand Consolidation which might boost the revenue for the company in 2017, 2018 and 2019. In addition, there, economists forecasted that in 2017 economy would recover which may result in growth of revenues. Considering these factors revenue for 2017 will grow at 3.2%, however in 2017 there is entrance of new small competitor in domestic segment which might affect the revenue and decline to 2.95% in 2018. In year 2019, it is forecasted that economy might face some downfall which will negatively affect the Best Buy revenue growth and declined to 1.04%. Best Buy inventory management is assumed to be the most efficient in the industry which indicates that gross profit margin would rise but during year 2018 and 2019 there is an expected increase in appliance and computer cost which would lower down the gross profit margin. Gross profit margin forecasted for each year is 33 basis point, using gross margin in 2016 as base year. Assumed that selling, general and administration expense will increase to 20.0 % because of the additional Marketing expenses due to entrance of small competitor in 2017. Interest expense will increase by 1% in 2017, however for 2018 and 2019 interest will be rise to 3.2% because the company will have higher average use of the revolving credit facility to fund the higher purchase costs. As given, Investment income and other, restructure charges and income tax percentage is assumed to be same as management case.

### **3-Year Income Statement Forecast**

The Income statement shows the increasing trend in all the forecasted year. The sales growth is at declining rate because in 2019, economic recession is expected. Operating income improves because there were no major changes in restructure charges in year 2017, 2018 and 2019. Interest expense rising each year which is slightly offset by investment income received each year.

### **3-Year Statement of Free Cash Flows**

Stronger EBITDA in all 3 forecasted years drives the improving free cash flow to the firm. As the company is maintaining the free cash flows even after paying capex and dividends company may utilize its cash for building strong brand presence as there is threat of entrance of new competitors or Best Buy could increase the dividend payments to investors which might help increase in the confidence and building the positive goodwill for the company.

# **Adjusted Financial Analysis (Non-GAAP)**

## **Adjusted Income Statement**

| **Fiscal Year** | **Actual 2016** | **Adjusted 2016** | **Actual 2015** | **Adjusted 2015** |
| --- | --- | --- | --- | --- |
| **Net Sales / Revenue** | **39,528.00** | **39,528.00** | **40,339.00** | **40,339.00** |
| **Cost of Goods Sold** | **30,334.00** | **30,334.00** | **31,292.00** | **31,292.00** |
| Restructuring charges — cost of goods sold | 3.00 |  | 0.00 |  |
| **Gross Profit** | **9,191.00** | **9,194.00** | **9,047.00** | **9,047.00** |
| Selling, general and administrative expenses | 7,618.00 | 7,618.00 | 7,592.00 | 7,592.00 |
| Restructuring charges | 198.00 |  | 5.00 |  |
| **Operating Income** | **1,375.00** | **1,576.00** | **1,450.00** | **1,455.00** |
| Other income (expense) |  |  |  |  |
| Gain on sale of investments | 2.00 |  | 13.00 |  |
| Investment income and other | 13.00 |  | 14.00 |  |
| **Total Other Income (Expense)** | **15.00** |  | **27.00** |  |
| Interest expense | - 80.00 | - 80.00 | - 90.00 | - 90.00 |
| **Earnings from continuing operations before income tax expense** | **1,310.00** | **1,496.00** | **1,387.00** | **1,365.00** |
| Income tax expense | 503.00 | 568.48 | 141.00 | 518.7 |
| **Net earnings from continuing operations** | **807.00** | **928.00** | **1,246.00** | **863.04** |
| Gain (loss) from discontinued operations | 90.00 |  | -11.00 |  |
| **Net earnings including noncontrolling interests** | **897.00** | **928.00** | **1,235.00** | **863.04** |
| Net (earnings) loss from discontinued operations attributable to noncontrolling |  |  |  |  |
| interests |  |  | -2.00 |  |
| **Net earnings attributable to Best Buy Co., Inc. shareholders** | **897.00** | **928.00** | **1,233.00** | **863.04** |

## **Rationalization for Normalized Earnings**

* We have not considered the restructuring charges under cost of goods sold and selling & Administration expense because in 2016 there was permanent closure of 66 Future shop stores and conversion of 65 Future shops to the Best Buy brand due to which company incurred restructure charges. These expenses were towards organization restructuring which is a one-time expense.
* We have chosen not to include ‘Other (income) and expense, net’ into the analysis even though it is a recurring account but it is a non-cash expense and it doesn’t hold any economic value. Thus, it is removed while the earnings are normalized.
* The provision is provided on the ‘Income from continuing operations before income taxes at 38% as mentioned.
* Interest expense are included in the analysis since they are not interest on capital leases.
* Income from discontinued operations and income from non-controlling interest is not included while normalizing the income statement even though they are a recurring item, it doesn’t truly reflect the Net Income of the company.

## **ROE & ROA**

### **Adjusted ROE & ROA**

* Formulae used

|  |  |
| --- | --- |
| **Fiscal Year** | **Adjusted 2016** |
| Net Income | 928.00 |
| Average Shareholder's Equity | 4,689.00 |
| **Return on Equity** | **19.79%** |
|  | |
| Net Income | 928.00 |
| Average Total Assets | 14,382.00 |
| **Return on Assets** | **6.45%** |

### **Actual ROE & ROA**

* Formulae used

|  |  |
| --- | --- |
| **Fiscal Year** | **Actual 2016** |
| Net Income | 897.00 |
| Average Shareholder's Equity | 4,689.00 |
| **Return on Equity** | **19.13%** |
|  | |
| Net Income | 897.00 |
| Average Total Assets | 14,382.00 |
| **Return on Assets** | **6.24%** |

* The ROE and ROA both increased slightly by 0.66% and 0.22% respectively when calculated with the normalized net earnings. The major reason for this the ‘other income is not taken into consideration. The other income even though it is a recurring item it is excluded from the normalized earnings because it is a non-cash item. These expenses are generated in the accounting process but they do not have any real economic value. Therefore, it is eliminated thus increasing the Net Income which increase the company’s ROA and ROE.

## **Sustainable Cash Flow**

|  |  |  |
| --- | --- | --- |
| **Fiscal Year** | **2016** | **2015** |
| **Reported Operating Cash Flows** | **1,322.00** | **1,935.00** |
| Add: Special Income tax expense | 6.00 |  |
| Add: Additional pension plan contribution | 12.00 |  |
| Add: Settlement of Pending lawsuit | 5.20 |  |
| Less: Proceeds from Sales of accounts receivables |  | -15.00 |
| Add: Restructuring Charges |  | 75.00 |
| Add: Inventory increased in order to launch new product line |  | 22.00 |
| **Sustainable Operating Cash flows** | **1,345.20** | **2,017.00** |

# **Attachments**

## **Working Capital calculation**

* Formulae used
  + Working Capital ($) = Current Assets ($) – Current Liabilities ($)

| **Fiscal Year** | **2016** | **2015** |
| --- | --- | --- |
| Current Assets | 9,886.00 | 11,472.00 |
| Current Liabilities | 6,925.00 | 7,777.00 |
| **Working Capital** | **2,961.00** | **3,695.00** |

## **EBIT & EBITDA calculations**

| **Fiscal Year** | **2016** | **2015** |
| --- | --- | --- |
| **Operating Income** | **1,375.00** | **1,450.00** |
| Other income (expense) | 0.00 | 0.00 |
| Gain on sale of investments | 2.00 | 13.00 |
| Investment income and other | 13.00 | 14.00 |
| **EBIT** | **1,390.00** | **1,477.00** |
| Add: Depreciation & Amortization | 657.00 | 656.00 |
| Restructuring charges | 201.00 | 23.00 |
| **EBITDA** | **2,248.00** | **2,156.00** |

## **Market Value of Equity calculation**

* Formulae used
  + Market Value of Equity ($) = Balance Common Stock – Price ($)

| **Fiscal Year** | **2016** | **2015** |
| --- | --- | --- |
| Balance Common Stock (as on Fiscal Year End) | 324.00 | 352.00 |
| Common Stock Prices (as on Fiscal Year End) | 27.93 | 35.20 |
| **Market Value of Equity** | **9,049.32** | **12,390.40** |

* Common Stock Prices (as on Fiscal Year End) are taken from Yahoo! Finance
* Balance Common Stock quantity (as on Fiscal Year End) are extracted from Consolidated Statements of Changes in Shareholders' Equity

## **Altman Z Score calculation**

| **Fiscal Year** | **2016** | **2015** |
| --- | --- | --- |
| Working Capital | 2,961.00 | 3,695.00 |
| Total Assets | 13,519.00 | 15,245.00 |
| **X1 (Working Capital / Total Assets)** | **0.22** | **0.24** |
| **1.2 \* X1** | **0.26** | **0.29** |
|  | | |
| Retained Earnings | 4,130.00 | 4,141.00 |
| Total Assets | 13,519.00 | 15,245.00 |
| **X2 (Retained Earnings / Total Assets)** | **0.31** | **0.27** |
| **1.4 \* X2** | **0.43** | **0.38** |
|  |  |  |
| EBIT | 1,390.00 | 1,477.00 |
| Total Assets | 13,519.00 | 15,245.00 |
| **X3 (EBIT / Total Assets)** | **0.10** | **0.10** |
| **3.3 \* X3** | **0.34** | **0.32** |
|  | | |
| Market Value of Equity | 9,049.32 | 12,390.40 |
| Book Value of Debt | 1,734.00 | 1,613.00 |
| **X4 (Market Value of Equity / Book Value of Debt)** | **5.22** | **7.68** |
| **0.6 \* X4** | **3.13** | **4.61** |
|  | | |
| Sales | 39,528.00 | 40,339.00 |
| Total Assets | 13,519.00 | 15,245.00 |
| **X5 (Sales / Total Assets)** | **2.92** | **2.65** |
| **1.0 \* X5** | **2.92** | **2.65** |

* Working Capital calculation is explained in "[Working Capital calculation](#_Working_Capital_calculation)" attachment
* EBIT calculation is explained in "[EBIT & EBITDA calculations](#_EBIT_&_EBITDA)" attachment
* Market Value of Equity calculation is explained in "[Market Value of Equity calculation](#_Market_Value_of)" attachment

## **Year-to-Year Trend Analysis calculation**

| **Fiscal Year** | **2016** | **2015** | **$ Change** | **% Change** |
| --- | --- | --- | --- | --- |
| **Net Revenue** | **39,528.00** | **40,339.00** | **-811.00** | **-2.01** |
| Cost of Goods Sold | 30,334.00 | 31,292.00 | -958.00 | -3.06 |
| Restructuring charges — cost of goods sold | 3.00 | 0.00 | 3.00 |  |
| **Gross Profit** | **9,191.00** | **9,047.00** | **144.00** | **1.59** |
| Selling, general and administrative expenses | 7,618.00 | 7,592.00 | 26.00 | 0.34 |
| Restructuring charges | 198.00 | 5.00 | 193.00 | 3,860.00 |
| **Operating Income** | **1,375.00** | **1,450.00** | **-75.00** | **-5.17** |
| Other income (expense) |  |  |  |  |
| Gain on sale of investments | 2.00 | 13.00 | -11.00 | -84.62 |
| Investment income and other | 13.00 | 14.00 | -1.00 | -7.14 |
| **EBIT** | **1,390.00** | **1,477.00** | **-87.00** | **-5.89** |
| Interest expense | 80.00 | 90.00 | -10.00 | -11.11 |
| **Net earnings from continuing operations** | **807.00** | **1,246.00** | **-439.00** | **-35.23** |
| **Net earnings attributable to Best Buy Co., Inc. shareholders** | **897.00** | **1,233.00** | **-336.00** | **-27.25** |

* EBIT & EBITDA calculations are explained in "[EBIT & EBITDA calculations](#_EBIT_&_EBITDA)" attachment

## **Profitability Ratios calculation**

* Formulae used

| **Fiscal Year** | **2016** | **2015** |
| --- | --- | --- |
| Gross Profit | 9,191.00 | 9,047.00 |
| Net Revenue | 39,528.00 | 40,339.00 |
| **Gross Margin** | **23.25%** | **22.43%** |
|  | | |
| Operating Income | 1,375.00 | 1,450.00 |
| Net Revenue | 39,528.00 | 40,339.00 |
| **Operating Margin** | **3.48%** | **3.59%** |
|  | | |
| EBIT | 1,390.00 | 1,477.00 |
| Net Revenue | 39,528.00 | 40,339.00 |
| **EBIT Margin** | **3.52%** | **3.66%** |
|  | | |
| EBIT | 1,390.00 | 1,477.00 |
| Interest expense | 80.00 | 90.00 |
| **Interest Coverage Ratio** | **17.38X** | **16.41X** |
|  | | |
| Net Earnings | 897.00 | 1,233.00 |
| Net Revenue | 39,528.00 | 40,339.00 |
| **Net Margin** | **2.27%** | **3.06%** |
|  | | |
| EBITDA | 2,248.00 | 2,156.00 |
| Net Revenue | 39,528.00 | 40,339.00 |
| **EBITDA Margin** | **5.69%** | **5.34%** |

## **Financial Leverage Ratios calculation**

* Formulae used

| **Fiscal Year** | **2016** | **2015** |
| --- | --- | --- |
| Total Interest bearing Debt | 1,734.00 | 1,613.00 |
| Total Shareholder's Equity | 4,378.00 | 5,000.00 |
| Total Capital | 6,112.00 | 6,613.00 |
| **Debt-to-Total Capital** | **28.37%** | **24.39%** |
|  | | |
| Total Interest bearing Debt | 1,734.00 | 1,613.00 |
| Total Shareholder's Equity | 4,378.00 | 5,000.00 |
| **Debt-to-Book Equity** | **39.61%** | **32.26%** |
|  | | |
| Total Interest bearing Debt | 1,734.00 | 1,613.00 |
| Market Value of Equity | 9,049.32 | 12,390.40 |
| **(Book) Debt-to-Market Equity** | **19.16%** | **13.02%** |
|  | | |
| Average Total Assets | 14,382.00 | 14,617.50 |
| Average Total Equity | 4,689.00 | 4,494.50 |
| **Financial Leverage** | **3.07X** | **3.25X** |
|  | | |
| Total Interest bearing Debt | 1,734.00 | 1,613.00 |
| EBITDA | 2,248.00 | 2,156.00 |
| **Total Debt-to-EBITDA** | **0.77X** | **0.75X** |