**EXERCISE N. X FINANCIAL ANALYIS**

**The following two income statements and statements of financial position are of two companies operating in the beverage industry. Both companies are based in Europe and prepare their financial statements in US$ under International Financial Reporting Standards.**

**Required: Using ratios and Common Size Analysis Techniques compare and contrast the two companies profitability, liquidity, efficiency, investment potential etc.**

**N.B. Ignore VAT in your calculations of DSO and DPO.**

|  |  |  |  |
| --- | --- | --- | --- |
| **Income statement** | 31.12.2014 | | 31.03.2014 |
|  | US$ millions |  | US$ millions |
|  | Company A |  | Company B |
| Sales | 47,063 |  | 22,311 |
| Cost of sales | (18,756) |  | (4,711) |
| Gross profit | 28,307 |  | 17,600 |
| Operating expenses | (12,999) |  | (13,358) |
| Other income (expense) | (197) |  |  |
| Operating profit | 15,111 |  | 4,242 |
| Finance income (expense) | (1,319) |  | (645) |
| Share of results of Associated Cos | 9 |  | 1,226 |
| Pre-tax profit | 13,801 |  | 4,823 |
| Income tax | (2,499) |  | (1,173) |
| Net profit | 11,302 |  | 3,650 |

**Profitability ratios**

|  |  |  |
| --- | --- | --- |
|  | Company A | Company B |
| Gross Margin % | 28,307/47,063x100%  60% | 17,600/22,311x100%  79% |
| Operating Margin % | 15,111/47,063x100%  32% | 4,242/22,311x100%  19% |
| Net Profit Margin % | 11,302/47,063x100%  24% | 3,650/22,311x100%  16% |
| Return on Capital Employed (ROCE) % | (15,111+9)/(54,257+43,630)x100%  15% | (4,242+1,226)/(27,482+12,528)x100%  14% |
| Return on Equity (ROE) % | 11,302/54,257x100%  21% | 3,650/27,482x100%  13% |

|  |  |  |  |
| --- | --- | --- | --- |
| **Statement of financial position** | |  |  |
|  | US$ millions |  | US$ millions |
|  | Company A |  | Company B |
| **Non-current assets** |  |  |  |
| Goodwill | 70,758 |  | 18,497 |
| Intangible assets | 29,923 |  | 8,532 |
| Property Plant & Equipment | 20,263 |  | 9,065 |
| Investments | 228 |  | 11,390 |
| Deferred taxes | 1,058 |  | 115 |
| Other | 1,779 |  | 767 |
|  | 124,009 |  | 48,366 |
| **Current assets** |  |  |  |
| Inventories | 2,974 |  | 1,168 |
| Trade receivables | 3,363 |  | 1,821 |
| Other current assets+101 | 3,746 |  | 315 |
| Cash | 8,357 |  | 2,081 |
|  | 18,440 |  | 5,385 |
| **Total assets** | **142,449** |  | **53,751** |
|  |  |  |  |
| **Current liabilities** |  |  |  |
| Short-term Borrowings | 7,492 |  | 4,519 |
| Trade payables | 10,913 |  | 3,847 |
| Income taxes | 629 |  | 1,106 |
| Provisions | 165 |  | 450 |
| Other current liabilities | 8,009 |  | 78 |
|  | 27,208 |  | 10,000 |
| **Non-current liabilities** |  |  |  |
| Long-Term Borrowings | 43,630 |  | 12,528 |
| Provisions | 634 |  | 433 |
| Pensions and employee benefits | 3,050 |  |  |
| Other | 13,771 |  | 3,308 |
|  | 61,085 |  | 16,269 |
| **Shareholder's equity** | 54,257 |  | 27,482 |
| Total Equity and liabilities | **142,550** |  | **53,751** |
|  |  |  |  |
|  |  |  |  |
|  |  |  |  |

**Liquidity ratios**

|  |  |  |
| --- | --- | --- |
|  | Company A | Company B |
| Current ratio | 18,440/27,208  0,68 | 5,385/10,000  0,54 |
| Quick ratio | (18,440-2,974)/27,208  0,57 | (5,385-1,168)/10,000  0,42 |

**Efficiency ratios**

|  |  |  |
| --- | --- | --- |
| Asset Turnover | 47,063/124,009  0,38 | 22,311/48,366  0,46 |
| Inventory holding period (DOI) | 2,974/18,756x365  58 days | 1,168/4,711x 365  90 days |
| Trade receivables collection period (DSO) | 3,363/47,063x365  26 days | 1,821/22,311x365  30 days |
| Trade payable payment period (DPO) | 10,913/18,756x365  212 days | 3,847/4,711x365  298 days |

**Investment ratios**

|  |  |  |
| --- | --- | --- |
| Debt/equity ratio (Gearing) | 43,630/54,257  0,80 | 12,258/27,482  0,46 |
| Interest cover | (15,111+9)/1,319  11,5 times | (4,242+1,226)/645  8,5 times |
| Earnings per share (EPS) | 11,302/1,634  6.92 | 3,650/1,597  2.29 |
| Price/Earnings ratio (P/E) | 113.95/6.92  16 | 31.01/2.29  14 |
| Dividend yield | 3.52/113.95x100  3.1% | 1.05/31.01x100%  3.4% |

**Other ratios**

|  |  |  |
| --- | --- | --- |
|  | Company A | Company B |
| Effective tax rate | 2,499/13,801x100  18% | 1,173/4,823x100  24% |
| Intangibles as a % of total assets | (70,758+29,923)/124,009x100  71% | (18,497+8,532)/48,366x100  50% |
| Intangibles as a % of Equity | (70,758+29,923)/54,257x100  186% | (18,497+8,532)/27,482x100  98% |
| Shareholders equity as a % of market capitalization | 54,257/186,194x100  29% | 27,482/49,523x100  55% |

**Comment on the comparative profitability, liquidity, efficiency and investment potential of the two companies:**

**Profitability**

Although Company B has a higher **Gross Margin** (79% vs 60%) it has much higher operating expenses and, consequently, has a much lower **Operating Margin** (19% vs 32%). Company B’s **Net Profit Margin** is also lower due to a higher **Effective Tax Rate** (24% vs 18%). Both companies have similar **Returns On Capital Employed** (15% and 14%) but Company A has a **Return On Equity** of 21% compared to Company B’s 13%.

**Liquidity**

Company A has both a slightly higher **Current Ratio** and **Quick Ratio** than Company B. The ratios for both Companies, however, are less than 1. Both Companies have high **Days Payable Outstanding** ratios (Company A 212 days, Company B 298 days). However, **Days Sales Outstanding** for both companies is very low (Company A 26 days, Company B 30 days). This seems to indicate that both companies are financing themselves with their suppliers.

**Efficiency**

Both companies have similar **Asset Turnover** ratios (Company A 0.38, Company B 0.46) due to significant amounts of Goodwill and Intangible assets as a result of acquisitions. Company A’s **Inventory Turnover** is 6.3 times a year compared to Company B’s 4 times, indicating that Company A is more efficient at managing its inventory.

**Investment**

Company A is the more highly **Geared** at 0.80 compared to Company B 0.46 but it has an **Interest Cover** of 11.5 times interest expense which would appear to be quite healthy. Both companies have a **Dividend Yield** of just over 3%. Company A is more expensive, trading on a **Price/Earnings** ratio of 16 compared to Company B’s 14.

**Other ratios**

Both companies have obviously made acquisitions as they have significants amounts of **goodwill and intangible assets**. For Company A these represent 71% of **Total Assets** and 186% of **Shareholders Equity**. For Company B the correspending amounts are 50% and 98%. Company A therefore is more exposed to any loss in value or impairment of these assets. However, Company A’s **Market Capitalization** is more than 3 times **Shareholders Equity** compared to Company B’s 2 times.

**Which Company would you prefer to invest in?**

Overall, based on this single year’s data, Company A would be appear to be the more attractive option on account of its ROE, Liquity and Efficiency ratios. This is also supported by the stock market’s valuation of the company.

**What additional information would be useful in order to make a more informed decision?**

Additional useful information would include 3-5 year trend information, analysts reports, future prospects and forecast by management, details of commitements and contingencies and any other risk exposures. Information on other competitors.