



Exploring financial ratios

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Introduction

Overview of financial ratios

Profitability

Liquidity

Debt

Investment



Profitability ratios

Use of profitability ratios

To assess a business' ability to generate earnings compared to its commitments



To determine the efficiency of management in using shareholders' investments

Cash generation is an indispensable key performance indicator

Revenue
is vanity

Profit
is sanity

Cash
is reality

Key ratios

Ratio	Interpretation
Gross profit margin $= \frac{\text{Gross profit}}{\text{Turnover}}$	<ul style="list-style-type: none">• measures the efficiency of a company after deducting its direct cost, or cost of goods sold
Net profit margin $= \frac{\text{Net profit}}{\text{Turnover}}$	<ul style="list-style-type: none">• measures how profitable the company is relative to its sales, after taking into account all cost of goods sold, overheads, interest and tax

Observations

Profit margins higher than the industry average implies that the business can maintain a healthy profit as long as it keeps its overhead costs in check.

Relatively lower profit margins indicate that the business is under-pricing or the operating costs of the business are too high when compared to the industry average.

Key ratios

Ratio

Interpretation

$$\text{EBITDA margin} = \frac{\text{EBITDA}}{\text{Turnover}}$$

- measures how much earnings the company is generating before taxes, interests, depreciation, and amortization in relation to company turnover
- the EBITDA margin is a true measure of Management's efficiency, regardless of shareholders' funding strategy

$$\text{Return on equity} = \frac{\text{Net income}}{\text{Shareholders' equity}}$$

- measures how well the company uses shareholders' investments to generate profits
- higher ROE implies more success in using shareholders' investment to generate profits

Key ratios

Ratio

Interpretation

$$\text{Return on assets} = \frac{\text{Net income}}{\text{Total assets}}$$

- measures how efficiently the company's assets are generating income
- interest expenses are sometimes added back to net income to ignore the costs of funding the assets in question

$$\text{ROCE} = \frac{\text{Earnings before Interest and Tax}}{\text{Working capital}}$$

- measures a company's profitability and the efficiency with which its capital is being employed
 - a higher ROCE indicates more efficient use of capital
 - if ROCE is lower than the company's capital cost, the company is not employing its capital effectively and is not generating shareholder value
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Liquidity ratios

Use of liquidity ratios

To measure a company's ability to pay debt obligations

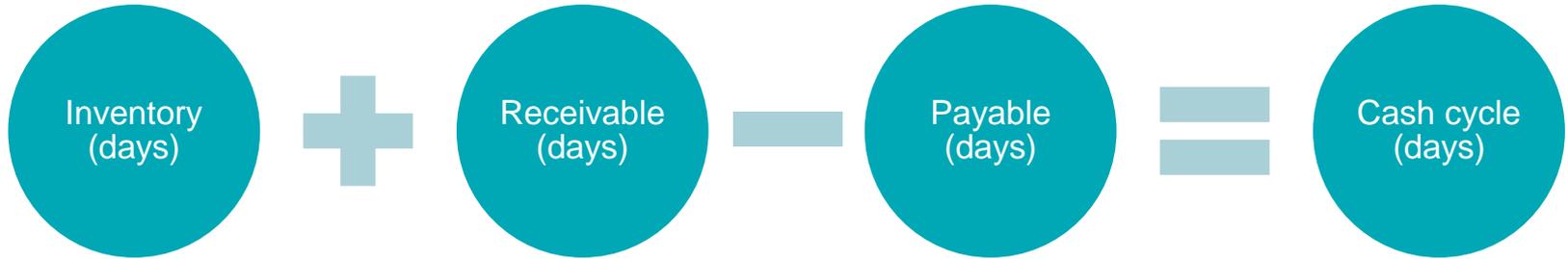


To evaluate going concern issues

Key ratios - liquidity

Ratio	Interpretation
<p>Working capital surplus/(deficiency) = Current assets – Current liabilities</p>	<ul style="list-style-type: none">• measures the business' ability to pay its short-term obligations
<p>EBITDA conversion = $\frac{\text{Operating cash flow}}{\text{EBITDA}}$</p>	<ul style="list-style-type: none">• assesses the efficiency of the company to turn the EBITDA into cash• a low ratio indicates a potential working capital issue (e.g. clients paying late or a high level of inventory)

Working capital cycle



Inventory (days)	$\frac{\text{Inventory}}{\text{Cost of sales}} * 365$
Receivable (days)	$\frac{\text{Net credit sales}}{\text{Average accounts receivable}} * 365$
Payable (days)	$\frac{\text{Total supplier purchases}}{\text{Average accounts payable}} * 365$



Debt ratios

Use of liquidity ratios

To determine the overall level of financial risk a company and its shareholders face



To quantify the firm's ability to repay long-term debt

Key ratios - debt

Ratio

Interpretation

$$\text{Debt to equity} = \frac{\text{Debt}}{\text{Equity}}$$

- measures how much debt a company is using to finance its assets relative to the amount of value represented in shareholders' equity
- measures the proportion of the company's balance sheet that is financed by suppliers, lenders, creditors and obligors versus what the shareholders have committed

$$\text{Gearing} = \frac{\text{Interest bearing debt} - \text{Cash}}{\text{Equity} + \text{Interest bearing debt} - \text{Cash}}$$

- measures the entity's financial leverage
 - a high gearing ratio typically indicates a high degree of leverage, and vice-versa
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Key ratios - debt

Ratio

Interpretation

$$\text{Interest cover} = \frac{\text{EBITDA}}{\text{Interest expense}}$$

- measures how many times over a company could pay its current interest payment with its available earnings
- considered as the margin of safety for a company to meet unforeseeable future hardships

$$\text{Debt service cover} = \frac{\text{EBITDA}}{\text{Capital repayment} + \text{Finance lease repayment obligations} + \text{interest expense}}$$

- measures how well a company is able to pay its entire debt service.
- debt service cover ratio (DSCR) refers to current debt obligations, meaning any interest, principal, sinking-fund and lease payments that are due in the coming year



Investment ratios

Use of liquidity ratios

To estimate the attractiveness of a potential or existing investment and get an idea of its valuation



To assess the performance of a company per individual share

Key ratios - investment

Ratio

Interpretation

Dividend payout ratio = $\frac{\text{Dividends}}{\text{Net profit}}$

- measures the percentage of earnings paid to shareholders in dividends

Price – Earnings ratio
= $\frac{\text{Market value/share}}{\text{Earnings per share}}$

- measures its current share price relative to its per-share earnings

Key ratios - investment

Ratio

$$\text{Dividend yield} = \frac{\text{Annual dividends per share}}{\text{Price per share}}$$

Interpretation

- measures the return for every euro invested in an equity position
- if a company pays high dividends to shareholders, it could be an indication of undervaluation, while cases of no dividends being paid may indicate overvaluation of shares

Key ratios for a sample of companies listed on MSE

Name	Market Cap. (€'000)	EPS (€)	P/E ratio	Gross Dividend Yield (%)	NAV/ share (€)	Price/ NAV (€)
GO plc	359,652	0.18	19.51	4.76	0.97	3.67
Simonds Farsons Cisk plc	289,500	0.40	23.89	1.17	4.23	2.28
PG plc	162,000	0.07	22.06	-	0.26	5.81
Malita Investments plc	111,229	0.04	17.47	4.79	0.75	1.00
MaltaPost plc	78,284	0.06	37.13	2.98	0.60	3.46
Malta Properties Company plc	51,364	0.03	20.28	-	0.36	1.42

Key ratios - investment

Ratio

Interpretation

Beta

- measures the volatility or systemic risk of a given security/portfolio of securities against the market as a whole
- found through the application of regression analysis
- represent the likeliness of a security's returns to vary as swings in the market occur. It is calculated by dividing the covariance of a securities' returns by the variance of the benchmark market returns – over a given period

Price volatility for a sample of companies listed on MSE

Name	Closing Price as at 01/11/17	Low – 2017 (€)	High – 2017 (€)
GO plc	3.55	3.26	3.60
Simonds Farsons Cisk plc	9.65	7.00	9.65
PG plc	1.50	1.00	1.50
Malita Investments plc	0.75	0.70	0.86
MaltaPost plc	2.08	1.90	2.08
Malta Properties Company plc	0.51	0.50	0.60

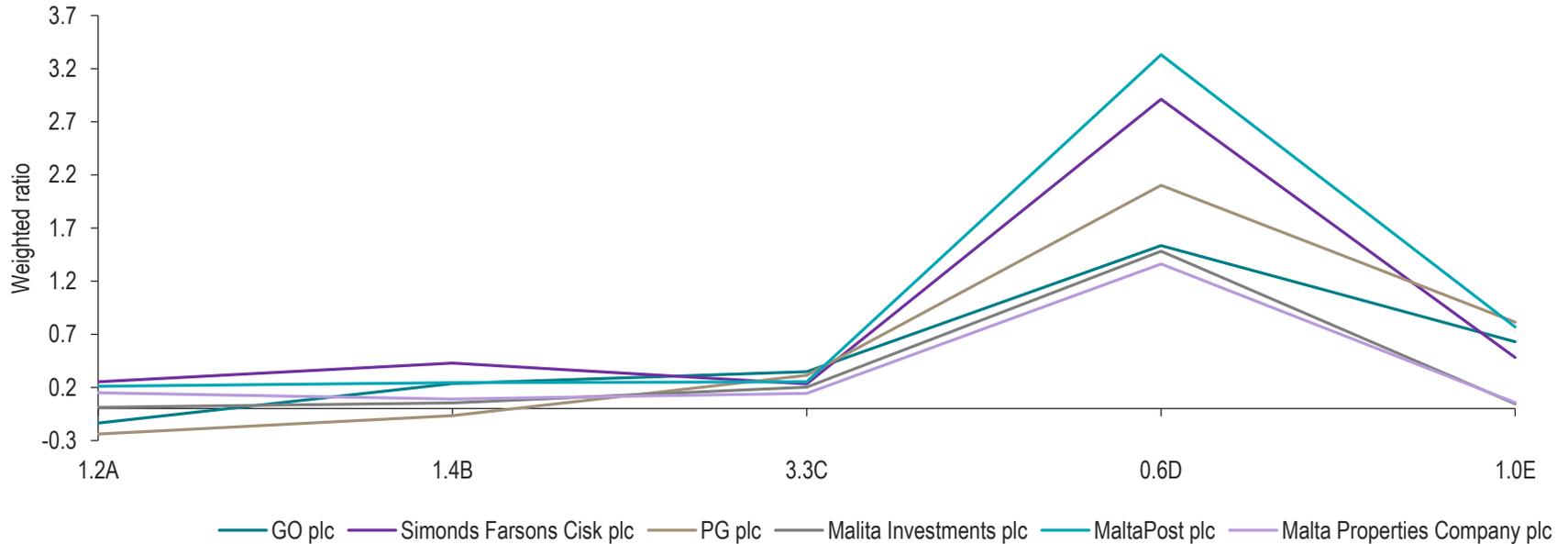
Working capital cycle



A	$\frac{\text{Working capital}}{\text{Total assets}}$
B	$\frac{\text{Retained earnings}}{\text{Total assets}}$
C	$\frac{\text{EBIT}}{\text{Total assets}}$
D	$\frac{\text{Market value of equity}}{\text{Total liabilities}}$
E	$\frac{\text{Sales}}{\text{Total assets}}$

Range	Indication
$Z < 1.8$	Company is “likely” to experience financial distress
$1.8 \leq Z < 3$	Company is “probably safe” from financial distress
$Z \geq 3$	Company is “safe” from financial distress

Altman's ratios for a sample of companies listed on MSE



Altman Z-score for a sample of companies listed on MSE

Name	Z-score
GO plc	2.6
Simonds Farsons Cisk plc	4.3
PG plc	2.9
Malita Investments plc	1.8
MaltaPost plc	4.8
Malta Properties Company plc	1.8

Limitations to Altman Z-Score

Results for the Z-score need to be interpreted with great care.

- Not immune to false accounting practices
- New companies with little or no earnings will always score poorly
- Z-score does not address the issue of cash flows directly
- Values swing from one period to another when a company records one-time write-offs



Limitations to using ratios

Limitations of financial ratios



Thank you

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