Integrated Marketing Management
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Lecture – 06
Case Analysis 2

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Key Financial Ratios (cont'd)

Activity Ratios

1. Inventory turnover
2. Fixed assets turnover
3. Total assets turnover
4. Accounts receivable turnover
5. Average collection period

Liquidity ratios

1. Current ratio
2. Quick ratio
3. Inventory to net working capital

Other Ratios

1. Dividend yield on common stock
2. Price earnings ratio
3. Dividend payout ratio
4. Cash flow per share

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The third ratio with which we are interested is what is called the activity ratios. What is this activity ratios? This activity ratios refer to inventory turnover what does inventory turnover mean? It means when compared to industry averages an indication of whether the company has excess or inadequate inventory of finished goods. In an organization you should not be producing to stock you should an organizations aim should be to produce to sell not to keep on stocking the finished goods for an undesirable extent of time.

What is this undesirable extent of time? Many times if you look at a company like Toyota, this organization was the first in the in the world to bring in the concept of Just In Time inventory that is the JIT. The Japanese terminology for this is what is called the Kanban. What does this entail? It entailed that suppose you want to produce a car, if you look at the Toyota production line at the end of the day there would be nothing in the working in the inventory lineup that is nothing in working process inventory.

This whole assembly would start in the morning and at the end of the day you are engine for the car would be assembled through this production line. So, all this was done in such a wonderfully automated manner. You start producing this engine parts and assembling it one after the other from the morning at the end of the day the assembly line comes out with the finished engine. So, this was the way this just in time inventory used to be operated and still is in operation in most of these organizations especially the Toyota or the Honda and in our own case even the TVS.

The second ratio that we are going to look at is what is called the fixed assets turnover. What is this fixed assets turnover? It gives a measure of the sales productivity and utilization of the plant and equipment you put a lot of money into your fixed assets how is this being used, what is the type of turnover you are getting for this? So, this is calculated by the sales revenue divided by the fixed assets. So, find out what is the sales revenue for the period and divide it by the fixed assets you get this ratio of fixed assets turnover.

What is this see total assets turnover? In addition to this fixed assets. There might be so many other types of assets which an organization might be using. It gives a measure of the utilization of the firm's assets a ratio below the industry average in this indicates the company is not generating enough sales or business growth or business growth given the size of the assets investment. So, you might be a large industry and that large industries business growth that might be below average compared to the industry average.

Normally, a market growth rate of 10 percent and above with respect to any unit is considered to be good. Suppose, it falls below that 10 percent, then questions keep on getting asked why it is coming below this 10 percent. So, take any particular year. Suppose we were at 100 in the previous year you should be able to produce at least 110 that market growth rate where you are operating. If it is not able to accommodate these additional 10, then you are basically operating in a market where the growth rate is below average anything about this 10 percent is considered to be a good attractive market for an organization to operate.

The fourth ratio which you are getting is what is called the accounts receivables turnover. What is this accounts receivable turnover? It gives a measure of the average length of time it takes the firm to the sales made on credit. Suppose, you make all your sales only

on credit then it is disastrous for an organization. So, that credit fellow may not give that credit to talk to the organization. This is also happening in most of the cases not able to realize the credit.

Now, how do you overcome this type of a situation? You must put a ceiling on this collection period that is you must give what is the type of maximum period by which this credit has to be replenished by the person who has taken these sales. So, for example, if you looked at the types of accounts receivables for HMT watches many times it used to be the imagination why did this organization give this much credit to the buyers? Could it not have reduced this time? These were the questions which an observer would ask.

But, the organization will come or used to come with the answer that the business was in trying times, the competition was becoming very intense so, they had no other option other than to extend this credit time, but many times this get this could prove to be detrimental to an organization. In fact, it proved to be detrimental to HMT watches also.

Now, look at the competitor main competitor for HMT that is the Titan. If you look at titan it will not give you many times a credit beyond 1 month. So, if you live the goods within one month that money has to go to the organization. Suppose, you do not give that within a month then the second consignment of the goods from the company not going to come to you in other words they have a better control over the accounts receivables. The next ratio which you should look at with respect to activity is what is called the average collection period. If you are collection period keeps on increasing it affects the health of the organization.

So, you should put an outer limit beyond this we are not going to extend credit what does that mean? It means that your production line will not produce to stock. So, your production line you are operating in such a manner that whatever is the products the quantity of the products produced you are trying to realize the revenue in the minimum possible period, but depending on the organization an industry average collection period will also be there. Many times in the industry averages over between 1 to 3 months they say do not give more than 3 months period.

Suppose, you are forced to give more than 3 months because of the situation in which you are operating, then it can be a weakness on the part of the organization. That is one of the reasons why it is always mentioned keep on doing SWOT analysis, that is a

SWOT analysis is a continuous process. It is not that you did this month and I can keep quiet for a long period. No, it is a continuous process you keep on doing it this month next month how are we really in the marketplace.

Then, the next type of ratio that you are going to look at is what is called the liquidity ratios. What is this liquidity ratios? Three types of ratios are there with respect to liquidity. One is the current ratio current ratio is calculated by the current assets divided by the current liabilities that is CA divided by CL. What does it tell you? It gives you the extent to which the claims of the short term creditors are covered by the assets that are expected to be converted to cash in a very short notice.

So, you can suppose the were current assets creditor wants money you are in a position to service that asset these current assets in a very short period of time, you can tell him look take this money. In other words what does it tell you that is the organizations liquidity position is good. If the organizations liquidity position is good it is always healthy for the organization.

What is the next asset that is going to come into picture? It is the quick ratio. What is this quick ratio? You take the current assets reduce it by the inventory that is you will be holding some inventory divided by the current liabilities. It gives you the quick ratio. What does this quick ratio tell give you? It gives you the firm's ability to pay off short term obligations without relying on the sale of inventories.

So, there is an inventory with you, without having to bother on the sale of this particular inventory you can still service the current assets that you have taken. The last ratio is inventory to networking capital. How do you calculate this inventory to net working capital? It is inventory divided by current assets minus current liabilities. What does this give you? It gives you a measure of the extent to which the firms working capital is tied up in inventory.

In other words, as I mentioned throughout this particular lecture you do not produce normally to stock, you produce to sell that is your inventory holding should be minimum as far as possible. So, this is what most of these leading car companies like the Toyota or the Honda follow they do not want to produce to stock they would like to sell off. So, keep minimum inventory. So, many times when you book a Toyota car he will tell you

the waiting time is about 2 months or 3 months depending on the model that you are choosing.

Similarly, with respect to a Honda City car if you book it he is not going to deliver the Honda City car in one day or two days. Further this gets more complicated depending on the color that you want for the car. So, that particular color may not be available in stock. He will say sir it takes 6 to 8 weeks or 4 to 6 weeks or 3 to 5 weeks depending on the type of inventory which this particular organization holds.

So, this is normally the way organizations try to reduce inventory because if you reduce inventory what is going to happen you will have better working capital management. So, you need not keep on borrowing funds to service you are working capital. It becomes a chain reaction you pay interest on the working capital loan and you produce something that whatever they are producing is not selling in a market. So, again your inventory holding cost goes up your interest on the working capital also keeps growing all this impinges on the health of the organization.

So, in other words what is what are we trying to say in the whole process. The market forces make a high dent on a company's operatable profits or operating scenarios. So, this market forces keep on changing that is what is called the business landscape with respect to an organization keeps on changing this is called the dynamics of business environment.

And, in a organization there is always a team to look at this dynamics keep on observing what is happening to the market in which the company is operating. So, their job is from the morning to the evening is to keep on looking at how the business environment is changing. All this was given by a wonderful Indian who is now no more by name Sumitra Ghoshal who did this wonderful business landscape analysis he was from the London school of business.

So, he gave how to map this business environment with respect to an organization, how do you map it? So much on this liquidity ratios so, with respect to any organization you have to look at these four ratios. One is the profitability ratios, second is a leverage ratios, third is the liquidity ratios, fourth is the activity ratios. These four ratios you must and should look at. In addition you can also look at a few more ratios. What are these ratios? These are called other ratios. What are these other ratios? These other ratios refer

to dividend yield on common stock, price earnings ratio, dividend payout ratio and the cash flow per share.

So, there are four ratios which normally looked at other than these four types of ratios which I mentioned these are with respect to dividend yield on common stock. In other words what is this dividend yield trying to tell you? How much dividend you got on your common stock that is supposed you put 10 rupees in the share of the company you got a dividend of 2 rupees let us say. What does it tell you? Your 10 rupees investment into this organization has produced 20 percent return.

Now, you this may this is many times the questions which we you yourself will ask suppose somebody wants from you money to set up a business. You will always ask how much return am I going to get by investing in your business. Suppose, he says that you can expect an 8 percent return. You normally start thinking a business has it is ups and downs in other words a business always has a risky proposition associated with it.

Now, suppose I keep my money in the bank in a fixed deposit without taking much risk I can get this 8 percent return, why should I invest in this business and suppose in a particular year this business is not performing well then this 8 percent return will also not come it may be much less than 8 percent. So, these are the types of scenarios a business investor would be looking at. He will always look at why I should invest in this business, what is the type of return which I am going to get.

The second ratio that you are looking at is called the price earnings ratio. What is price earnings? Normally a share of 10 rupees when you are looking at with respect to the stock market it gives you a much higher this thing that is you many times start wondering with respect to an organization by how much is my share growing. Is the 10 rupee share at 10 rupees only or is a 20 rupees or 30 rupees?

In other words, this current market price per share divided by the after tax earnings per share gives you the price earnings ratio. It tells you the faster growing or less risky firms tend to have higher prices earning ratios than do slower growing or more risky firms. So, as an investor you might like to put your money in a less risky firm rather than a high risk firm. A dividend payout ratio tells how much of the percentage of profits is paid out by the company as dividends.

A company might like to keep a certain amount of money in its reserves. Why does it keep it in reserves? It may be to ward off a undesirable situation with respect to the company where its cash is coming under serious threat that is if an organization does not have cash then again you are going for borrowing.

Suppose you develop a good healthy reserves you do not have to go in for borrowing. So, take the example of Infosys. Its cash reserve position is in such a healthy state that even when it wants to acquire any other company it can do so from it is own reserves it does not have to borrow. Similar is the situation with respect to many Tata companies as well. So, this dividend payout ratio in a sense tells you how much of the profit after tax is paid out it is dividend and how much is going back to this reserves.

Then what is a fourth ratio that you are looking at? The fourth ratio is what is called the cash flow per share. What is cash flow per share giving going to give you? It is a measure of the discretionary funds over and above expenses available to the firm in a way it is also again pointing out to that type of reserves only. So, dividend payout ratio, cash flow per share gives you an indication of how much reserves you can an organization is keeping to ward off threats as and when it perceives.

So, how do you calculate this cash flow per share? It is calculated by after tax profits plus the depreciation divided by the number of common shares outstanding. All these formulas which I have just listed I have uploaded this in a pdf. This is also available to you in my case studies book. Kindly go through this pdf material. It will be very helpful for you to analyze an organization using these ratios. It will make you become a more informed person.

What do you mean by saying you become more informed person? You are not just talking through thin air you are talking with facts and figures with respect to the organization, and when you are talking with the rest with facts and figures with respect to the organization you are a much better informed person rather than a person who is talking through his hat saying oh this company is not good. Why do you say the company is not good? What is it that you have in your weapons armory to categorize this company as bad.

Suppose, this question were to be asked to him and he is not able to answer then it becomes a question mark. At the same breadth you are able to say prove the point why

this organization is going through troubled times and hence presents a risky investment through your facts and figures then you are in a better position to convince the investor ok.

So, in other words all these ratios will help you to analyze an organization much better and your case analysis should cover to the extent possible and to the extent relevant these ratios that is you must calculate these ratios with respect to the organization.

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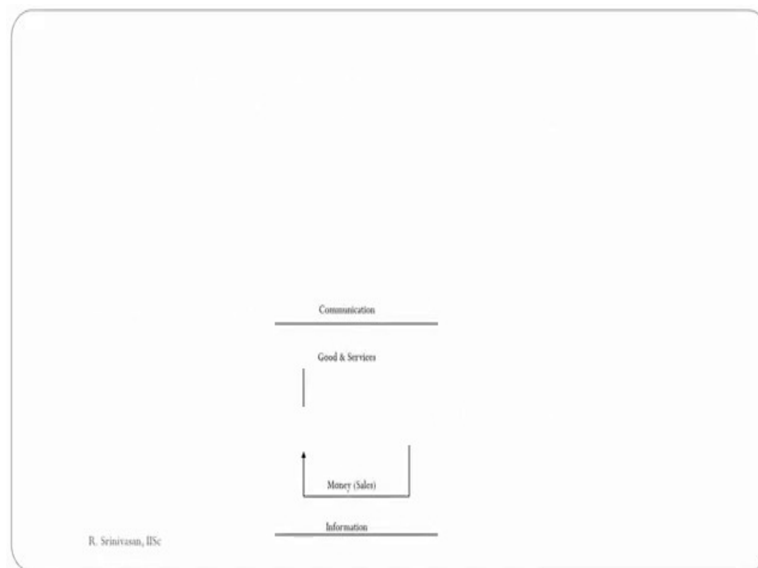

So, we will stop here we will continue in the next lecture the marketing environment.

Thank you.