Key Financial Metrics and Ratios

- **Problem:** How do you *evaluate* different companies?
- Why is one company **more highly valued** by the market than others?
- Could be many factors, but one approach is to **look at the numbers**
- **Key Tool:** Financial Metrics and Ratios

Key Financial Metrics and Ratios

- **Purpose:** These numbers answer questions like…
- How much **equity** is required to generate a certain amount of **after-tax profit** (Net Income)?
- How much in **assets** is required to generate a certain amount of **after-tax profit** (Net Income)?
- How much **total capital** is required to do this?

Key Financial Metrics and Ratios

- And…
- How **dependent** is a company on its assets?
- How **liquid** is the company? Can it meet its obligations?
- How **quickly** does it sell all its Inventory, pay its outstanding invoices, and collect its receivables?

Key Financial Metrics and Ratios

- **Return on Equity (ROE)** = Net Income / Average Shareholders' Equity

- **Return on Assets (ROA)** = Net Income / Average Assets

- **Return on Invested Capital (ROIC)** = NOPAT / (Total Debt + Equity + Other Long-Term Funding Sources)

Key Financial Metrics and Ratios

- **Return on Equity (ROE):** How efficiently is a company using its equity to generate after-tax profits?

- **Return on Assets (ROA)**: How well is a company using its assets / how dependent is it on them?

- **Return on Invested Capital (ROIC):** How well is a company using ALL its capital, or how much capital is required to grow its business?

Key Financial Metrics and Ratios

- **Asset Turnover Ratio** = Revenue / Average Assets
- **Current Ratio** = Current Assets / Current Liabilities
- **Inventory Turnover** = COGS / Average Inventory
- **Receivables Turnover** = Revenue / Average AR
- **Payables Turnover** = COGS / Average AP (*)

Key Financial Metrics and Ratios

- Let's look at the *interpretation* of these metrics and ratios in Excel…

- **My Question to You:** Think about which company *you* think should be most highly valued based on the #s

- **At the End:** I'll reveal the "punch line"

The Punch Line:

- At the time of the analysis, here were the *actual* valuation multiples:

- ***Wal-Mart***: P / E multiple of 16x

- ***Amazon***: P / E multiple of 456x! (Not a typo)

- ***Salesforce***: Not meaningful – *negative* Net Income

Why?

- Because the market was valuing all these companies based on different criteria…

- ***Wal-Mart***: Established, mature, slower-growth company – use of capital, margins, inventory management

- ***Amazon and Salesforce***: Higher-growth companies, all about reinvestment and expansion at the expense of poor margins and financial metrics

Moral of the Story:

- **Key Metrics and Ratios:** Only useful in certain contexts

- **Best When:** Comparing companies of *similar* sizes, growth rates, margins, and industries

- **Less Useful:** For high-growth companies that don’t care as much about capital management