5 key ratios every investor must look at gauge health of a company

Ratios are the relative measures of financial statements. There are different facets of the income statement and the balance sheet which, when combined, can give interesting insights into the performance and health of the company in question. Ratios are always relative as opposed to profit and sales numbers that are absolute in nature. Ratios can be from within a single financial statement or from different financial statements. For example, the net profit margin and the operating margins are examples of

ratios that are purely derived from the income statement. At the same time the current ratio and the debt/equity ratio are entirely derived from the balance sheet. However, ratios like the asset turnover ratio and the return on equity (ROE) or return on capital employed (ROCE) entail data points from the income statement and also from the balance sheet. It is this ability to cross breed parameters from different financial statements that make ratios so powerful.

Ratios are not just used by investors for buying or selling a stock. On the other hand, these ratios are used by credit rating agencies, company CFOs, competitors, bond investors, potential acquirers and the regulator to study trends in the company. Ratios are more often than not, a good starting point to identify potential winners of the future as well as potential problem areas in a company. Let us look at 5 such critical ratios that give a quick idea of the health of a company.

CURRENT RATIO AND QUICK RATIO

It is said that the really solid good companies manage their working capital efficiently and the current ratio is all about how the working capital dxc of the company is managed. Every manufacturing company needs a positive working capital. That means your short term liabilities must be funded with short term assets to avoid putting your long term assets under pressure. The current ratio is, therefore, a basic measure of solvency. Lenders generally want to see a 2:1 current ratio or better, although very high current ratio is not a very encouraging sign.

Current Ratio = Current assets (cash, receivables, and inventory) / current liabilities.

However, the problem with the current ratio is that it includes inventories as assets and quite often such inventories may not have a ready secondary market. That is where the quick ratio comes in handy. The quick ratio is the current ratio with inventory removed. The quick ratio tells you if you have enough readily available funds to cover short-term obligations. It should be at least 1:1 for manufacturing companies to give comfort.

CURRENT ASSETS TURNOVER RATIO

Let us understand this ratio a little better as it is different from the current ratio. The current ratio just looks at the current assets and the current liabilities. The Current Assets Turnover Ratio tells you how quickly the company is collecting on receivables. It's also industry specific, but it should be as low as possible. If it jumps up, you could have a serious liquidity issue. Normally, this ratio is seen as a percentage of sales and the lower it is the better for the health of the company.

One can also extent the above argument of receivables to inventories too and focus on how quickly the inventory is turned around. Here also the ratio is compared with annual sales to get a relative picture. Think of inventory as frozen cash, so you would like to churn it as many times as possible. The ideal rate varies by industry, but you must look at the trend and also benchmark with the industry.

RETURN ON EQUITY AND THE RETURN ON CAPITAL EMPLOYED

This ratio lets you know if you're using your assets efficiently and rewarding your stake holders adequately. While ROE only looks at equity shareholders, the ROCE looks at providers of equity and debt capital. A higher ROE and ROCE is better. Typically, manufacturing companies that are capital intensive have lower levels of ROE and ROCE whereas service companies are better at these ratios. Here again, the trend over the last few quarters and the benchmarking with the industry matters a lot more.

OPERATING CASH FLOW RATIO

When you sell goods you give credit and create debtors as assets in your balance sheet. Similarly, when you buy inventories you get credit and create creditors as liabilities. This is part of the core working capital management of the company. The operating cash flow ratio tells you quickly about the volume of cash you are generating compared with the amount you will have to lay out. This basically shows you if the cash flows generated are good enough to pay your creditors on time and enjoy a good credit standing. The operating cash flows are normally compared with the current liabilities.

NET PROFIT MARGINS

It is the bottom line and measures how your profits after tax stack up against the total sales generated. The net profit margin or the NPM is the ratio of the net profits to the sales and here again the trend is important. A positive trend is always favourable and above-industry averages are always welcome.

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