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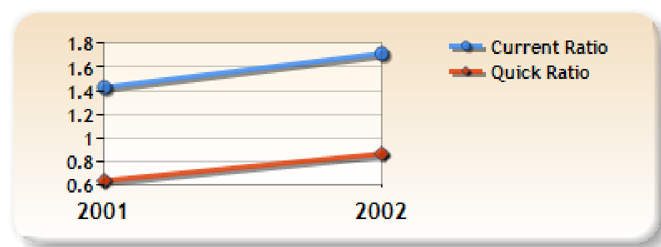
Ratios: Mystic Motors (Pty) Ltd

	2001	2002

LIQUIDITY



	2001	2002
Current Ratio	1.43	1.72
Quick Ratio	0.64	0.87
GAP	0.79	0.85

GREEN **RATIO COMMENTARY**

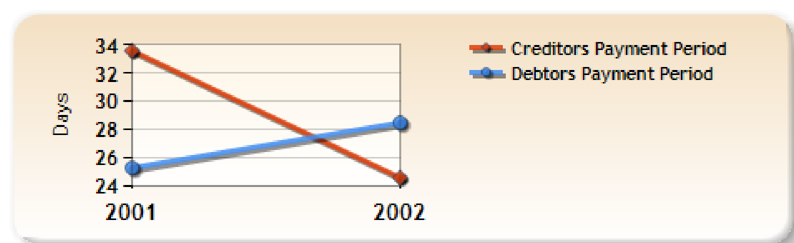
The trends show an increase in the Current Ratio as well as the Quick Ratio over the period of review resulting in a relatively constant gap between the two ratios. As the gap between these two ratios can only be caused by inventory (stock), it implies that the inventory holding is in line with the other current assets.

As the gap between the Current and Quick Ratio is relatively constant, it indicates that the level of inventory in relation to the other current assets has also remained constant. In other words, the inventory remains the same percentage of the total current assets in the current year as it was in previous years. As inventory is the slowest of all current assets to convert into cash, this implies that even with increasing levels of liquidity, there is not likely to be an increased burden of additional inventory slowing down this cash conversion process.

The business is managing to increase the level of liquidity without an increase in inventory (in relation to other current assets). The cash conversion process is therefore not slowed down by increasing inventory and implies that the operating cash flows of the business should be fairly manageable.

Questions for Client

1. The liquidity is increasing in the 20 - 30% range. This should not pose too much of a problem if the growth of the business is in the same range. If the business is growing by far less than 20% (i.e. turnover growth), it is clear that the liquidity is growing a lot faster than the turnover. IS there a reason for this?
2. If inventory is not causing the increase in liquidity, what is? You will need to look at both Debtors and Creditors Days (see below) to check the cause of the increased liquidity. If the reason is a large reduction in Creditors this may need to be investigated.



	2001	2002
Creditors Payment Period	33.6 Days	24.6 Days
Debtors Payment Period	25.3 Days	28.5 Days
GAP	8.29	-3.94

AMBER **DEBTOR CREDITOR COMMENTARY**

The gap between the Debtors Days and Creditors Days is first reducing and then increasing, with Creditors Days initially being higher than Debtors Days.

This initial gap can be considered as a POSITIVE gap as the business is paying creditors only after receiving money from their debtors. Therefore, the business has "Free Money" as "Money In" is longer than "Money Out".

However, the trend has deteriorated, and the positive gap has converted to a NEGATIVE gap. In the current year, the Debtors Days are now higher than the Creditors Days indicating that the business is now paying first and then collecting later. This is an unhealthy trend as now the "Money In" is shorter than the "Money Out" which creates a negative effect on operating cash flows. It does also mean, however, that the liquidity of the business is improving as current assets (debtors) are growing faster than current liabilities (creditors).

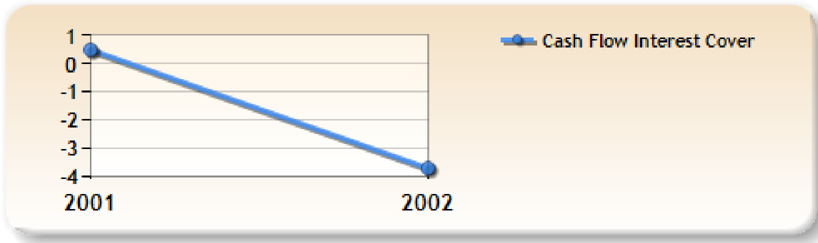
While liquidity is improving as a result of these trends, the speed of conversion of current assets into cash is reducing and the business should attempt to reverse this negative gap into the future.

Questions for the Client

1. What is the cause for the trend to move from a positive to a negative gap?
2. Does the business have any plans to improve their working capital management regarding debtors and creditors or are there conditions prevailing which will cause this trend to continue into the future?

CASH FLOW

	2001	2002
Cash Flow Interest Cover	0.5 Times	-3.7 Times



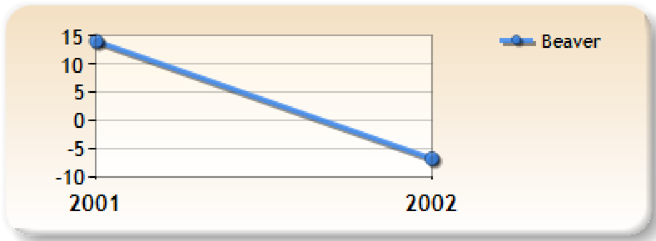
RED **CASH FLOW INTEREST COVER COMMENTARY**

The trend over the period of review is reducing and currently the Cash Flow Interest Cover is negative. This indicates that the business is unable to cover its interest costs with its operating cash flow.

While it is not totally unusual for businesses to have insufficient cash flows to pay interest in one particular year, it can become a big problem if this occurs over an extended period of time. In this case, the previous years were positive, so it has only become a problem this year. However, you do need to understand why the operating cash flows have reduced over the period.

Questions for the client

1. Check the Cash Flow Statement to determine why the cash flows are so weak at present. A possible reason could be investment in working capital, or the business suffering losses over the last financial period. It could also be caused by an increase in interest costs. What are they doing to turn these negative cash flows positive in the future?



Beaver	14.13	-6.69

RED **BEAVER COMMENTARY**

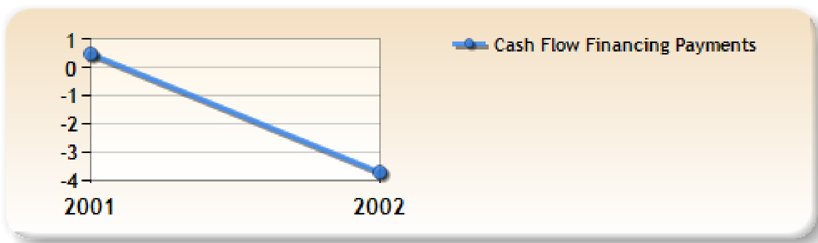
As the Net Operating Cash Flows have moved from positive to negative, the reducing trend shows an increase in the number of years it will take the business to repay its total interest bearing debt out of its net operating cash flow. However, this is academic as a current negative net operating cash flow means that the business is not ever able to repay the interest bearing debt.

Please note that this is an indicator only and takes into account the ability of the business to repay long term debt, which is not theoretically repayable. Any portion of long term debt that is repayable over the next 12 months will be placed into Current Liabilities (Current Portion of Long Term Debt), so while an amount is under long term, it is not repayable. However, research has revealed that the probability of business failure is strong where this ratio exceeds 10 years, which is the case in this scenario. It shows that the business is not ever able to repay all its interest bearing debt (short and long term).

The other concern is that over the period of review, the ability to repay is getting weaker as the negative operating cash flow deteriorates.

Questions for the client

1. When do the owners believe that the operating cash flows will again become positive? A negative cash flow can be managed for relatively short periods of time, but as the cash flows remain negative over a number of years, this seriously impacts on the ability of the business to service and repay its debts.
2. Have you been provided with a Cash Flow Forecast? If so, ensure that the cash flows will improve over the next 12 months. If not, you need to be provided with one so you can check for an improvement next year.
3. Why is the ability to repay debt from cash flows deteriorating? Is it due to increased debt or inability to generate operating cash flows, or a combination of both?
4. What strategies do the directors have in place to reverse this negative trend and bring the ratio to below 10 years?



CashFlowFP	0.50 Times	-3.70 Times

RED **CASH FLOW FINANCING PAYMENTS COVER COMMENTARY**

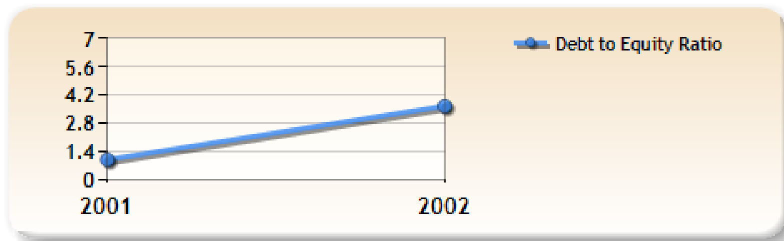
The cover has reduced over the period under review and is currently negative. This means that the business is unable to cover its short term obligations (excluding trade creditors) from the operating cash flow.

The purpose of this ratio is to determine the ability of the business to cover not only its interest (including finance charges and lease obligations), but also the current portion of its long term debt and the dividends paid during the year. As this requirement is substantially more than just interest, any cover in excess of 1 would be acceptable. However, in this case the cover is negative, which is a cause for concern.

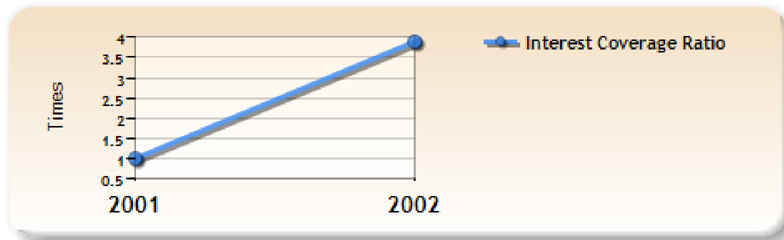
Questions for the client

1. Why is the business finding it more and more difficult to cover their short term obligations from operating cash flow?
2. What are they doing to try to turn this around in the forthcoming year?

GEARING



Debt to Equity Ratio	1.01	3.66



Interest Coverage Ratio	1.0 Times	3.9 Times
Interest to Interest Bearing Debt		4.07 %
Sustainable Growth Rate		45.34 %
Projected Growth Rate		26.00 %

AMBER **GEARING COMMENTARY**

The Debt to Equity Ratio is increasing, which results in the business being a higher risk asset to the bank than in previous years. This indicates that as the business is growing, it is funding the growth with proportionately more external than internal funding. This increases the risk profile of the business as the balance sheet weakens as a result of lower solvency.

While this increase in gearing can be favourable to the owners of the business (improves ROE and is relatively cheaper than equity financing), the bank does not share in these benefits, but shares the increased risk through the continued (or increased) lending to the business. If the trends show that the business is sustainable at this level of debt, the additional risk to the bank should be offset by either an increase in the cost of borrowing to the business, or additional security to lower the risk to more acceptable levels.

The Interest Cover is increasing, and is currently 3.90 times, which is acceptable. However, the Interest / Interest Bearing Debt is 4.07, which is a cause for concern, as this is below the current market rate. This indicates that the interest in the Income Statement is not in proportion to the level of debt (it is only 4.07 of the total interest bearing debt). Thus the business must have brought in a portion of their debt late in the year. It is therefore only paying interest on a much shorter period but will attract a full 12 months of interest next year. This indicates that the cover is actually lower than 3.90 times.

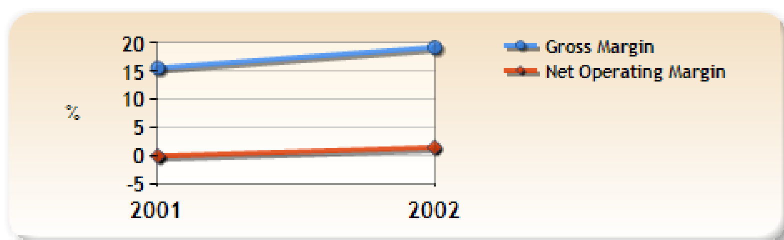
With regard to the foreseeable future, the Sustainable Growth Rate (SGR) is higher than the Projected Growth Rate (PGR). This shows that the business is planning to grow within its sustainable rate and is generating sufficient retained earnings to support this level of projected growth. As a result, less debt in relation to equity will be needed to fund the growth and the level of Debt/Equity should therefore reduce over the next 12 months providing some relief.

While the business appears to be able to service the increasing debt on the Balance Sheet, the interest cost next year could increase quite substantially because of the fact that the debt will now be on the Balance Sheet for an entire year. With Interest Cover of 3.90 times, the situation is not critical, but care needs to be taken to ensure the business will be able to cover the increased interest. This might need a concerted effort to improve the profitability over the next twelve months.

Questions for the client

1. The current profit retention in the business is sufficient for the current levels of growth, and the interest cover is acceptable. However, the prospect of interest costs being much higher next year is a cause for concern. If the business grows by a lot more than their projections, it could well lead to an overtrading situation. Is there a possibility that this could happen? If so, they will need to commit to increased retention of profits to support the increased growth.
2. Assuming the business can find ways of improving their sustainability, are they willing to offer additional security to offset the additional risk to the bank as a result of the increased gearing?

PROFITABILITY



Gross Margin	15.60 %	19.27 %
Net Operating Margin	-0.02 %	1.51 %

AMBER **MARGIN COMMENTARY**

The business is trading profitably, and the net operating margin is increasing rapidly over the period in question. However, the current margin is still very low.

As every business is different, it is extremely difficult to determine what the ideal margin of the business should be. In this respect, therefore, the NOI% as a number is not always relevant. What is relevant is the sustainable growth of the business. This means that the business should not be using debt financing to the extent that the ability to service the debt becomes impaired. The use of internal financing through retained earnings (profit) is therefore imperative for sustainable growth. This requires at least, a constant profit margin.

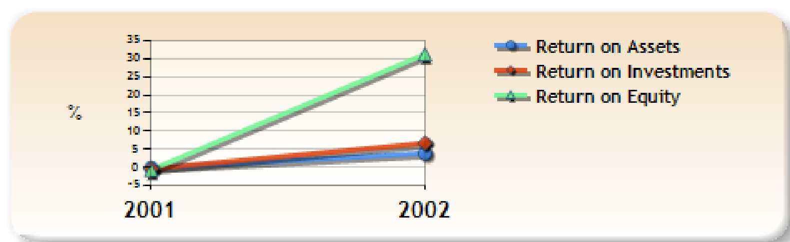
A business cannot be expected to have increasing margins over time. Once it has reached its ideal margin based on its competitors, it needs to maintain the margin and increase profitability through growth. In this case the NOI margin is increasing substantially which means it might not yet be at its ideal margin and there is further room for improvement. As the current margin is still very low, it is questionable as to whether such a low margin is the ideal for this business. However, the increase in profit margin is certainly positive in terms of future growth.

The gap between the Gross Margin and the NOI Margin is increasing which means that the operating expenditure in relation to their turnover is increasing. The NOI Margin has been calculated by taking out (as much as possible) all items of income or expenditure which are not operational as well as items which are extraordinary. Thus the operating costs are growing faster than the turnover of the business. Fortunately the Gross Margin is increasing at a faster rate than the Net Margin, which will obviously contribute to the rise in net profit.

A problem could develop in the future if the Gross margin stabilises and the Operating Costs continue to increase in relation to the turnover.

Questions for the client

1. As we lend to the future, you should go through the itemised income statement and compare the expenses from last year to the current year. Look for any abnormal change in the expenditure patterns. If an expense is abnormally larger or smaller than the previous year, you need to determine whether this change is going to continue in the future or whether it is, in fact, abnormal. If it is abnormal (i.e. will not continue next year), the expense should be adjusted to what is normal and the net margin re-calculated. You might need an explanation of potentially abnormal expenses from the business.
2. What is the reason for the increased gross margin and to what extent is it sustainable? Does the business have a target margin in mind?
3. Is this business a high turnover, low margin business? Is the current margin sufficient for them to retain profits to sustain their future growth? Will they be able to continue improving their net margin going forward?



Return on Assets	-0.10 %	3.92 %
Return on Investment	-0.30 %	6.70 %
Return on Equity	-0.61 %	31.20 %

GREEN **RETURN COMMENTARY**

It is pleasing to see that all the return ratios are positive and have increased over the period of review.

The gaps in these trends should be considered as they provide an indication of how the external financing (gearing) has improved the returns to the business.

Firstly, the only difference in the Return on Assets and Return on Capital Employed (according to the formulae for these ratios) is Current Liabilities. In other words, if the business had zero Current Liabilities, the GAP between these two ratios would be zero. Therefore the GAP, which is currently 2.78% indicates the benefit the business has received from utilising Current Liabilities as form of external financing. Thus the Short Term Gearing of the business has generated an extra 2.78% in returns. Thus using Current Liabilities as a form of funding has geared up the ROA to a higher ROCE. Please note that ROCE is identical to Return on Investment (ROI) - the terms are used interchangeably.

Secondly, the only difference in the Return on Capital Employed (or ROI) and the Return on Equity (also based on the formulae for these ratios) is Long Term Liabilities. In other words, if the business had zero Long Term Liabilities, the GAP between these two ratios would be zero. This means that the GAP between these two ratios can only be caused by long term external funding. Again, there has been a gearing mechanism which has improved the ROCE of 6.70% to a higher ROE of 31.20%. The use of long term financing has thus improved the return to the shareholders by 24.50%.

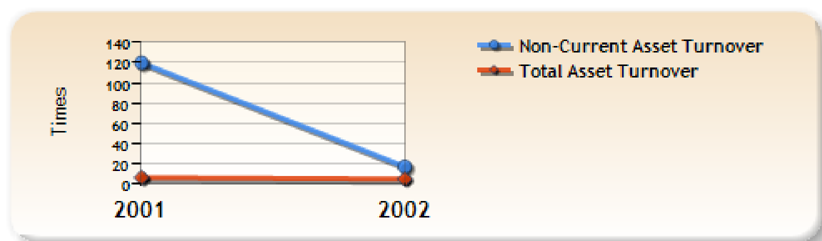
As the first GAP relates to short term gearing and the second GAP relates to long term gearing, the GAP between ROA and ROE would be the benefit of the TOTAL GEARING. In this case, the business has geared up a ROA of 3.92% to a ROE of 31.20%. This is the reward to the shareholders for taking the risk of borrowing funds to finance their business operations.

As the returns are all positive and the trends are increasing, there is no major concern regarding these ratios at present.

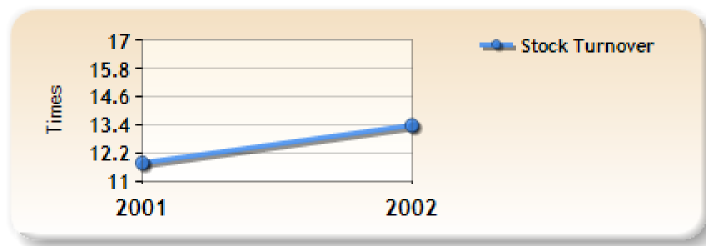
Questions for the Client

1. There are no questions necessary regarding the Return Ratios.

ACTIVITY



Non-Current Asset Turnover	120.1 Times	16.9 Times
Total Asset Turnover	6.1 Times	4.7 Times
Stock Turnover	11.8 Times	13.4 Times



AMBER **ACTIVITY COMMENTARY**

While the Total Asset Turnover (TATO) ratio has remained relatively constant over the period of review, the Fixed Asset (non-current) Turnover Ratio (FATO) has reduced, and the Stock Turnover Ratio has increased.

These ratios are important as they consider the relationship between the turnover of the business and the assets utilised in creating this turnover. The turnover should be increasing faster than the assets, which shows that the activity of the business is improving and the assets have been better utilised. Although the non-current (fixed) assets are increasing at a faster rate than turnover, the turnover is growing faster than the inventory. As these assets can affect the operating cash flows of the business negatively, it is pleasing to see them being utilised more efficiently in the business.

The decrease in the FATO trend is a cause for concern. This can be caused by underutilisation of the non-current assets, or a result of an acquisition of new assets over the current period. This can be a positive signal as it shows that the business is creating capacity for future growth. However, you need to determine which assets have increased (check the Balance Sheet) and satisfy yourself that these assets will contribute to future growth. Alternatively, if the downward trend is the result of a drop in turnover, this could indicate a slowing down of the business which will require further investigation.

Questions for the client

1. If the downward trend in FATO is a result of the acquisition of new assets and not a decrease in turnover, there is no major problem with the activity of the business. However, if the cause for the trend is a reduction in turnover, you need to understand the reason for the drop, and how the business intends to get back to higher levels of turnover in the future.