**Corporate Banking - Updates**

**Ratios**

Ratio Analysis is a widely used tool of financial analysis. It is defined as the systematic use of ratios to interpret the financial statements so that the strengths and weaknesses of a firm as well as its historical performance and current financial position can be determined. It should be noted that computing ratios does not add any information not already inherent in the financial statements. The ratios however reveal the relationship in a more meaningful way so as to enable one to draw cogent conclusions from them. It also facilitates intra and inter- firm comparisons. Therefore, the rationale of ratio analysis lies in the fact that it makes related information comparable. A single figure by itself has no meaning, but when expressed in terms of a related figure, it yields significant inferences.

Some of the important ratios useful to bankers are presented below.

**Net Working Capital (NWC):**

NWC represents the excess of Current Assets over Current Liabilities. A firm should have adequate NWC for meeting the claims of creditors and meeting its day - to - day needs.

The term Current Assets refers to assets which in the normal course of business get converted into cash over a short period, usually not exceeding one year. Current Liabilities are those liabilities which are required to be paid in a short period, normally a year.

**Current Ratio**

Current Ratio: $\frac{Current Assets}{Current Liabilities}$

Although there is no hard and fast rule, conventionally, a current ratio of 2:1 is considered satisfactory.

**Acid Test/Quick Ratio:**

Acid Test Ratio = $\frac{Quick Assets}{Current Liabilties}$

Quick Assets includes:

* Cash and bank balances
* Short term marketable securities
* Debtors/receivables

Generally, an acid test ratio of 1:1 is considered satisfactory as a firm can meet its current claims.

**Debt Equity Ratio:**

The relationship between borrowed funds and owner’s capital is a popular measure of long term financial solvency of a firm. The relationship between outsiders’ claims and owners’ capital can be shown in different ways and, accordingly, there are variants of the Debt-Equity ratio. One approach is to express the D/E ratio in terms of the relative proportion of long term debt and shareholders’ equity.

Debt Equity Ratio = $\frac{Long term Debt}{Shareholders^{'}Equity}$ (i)

The debt considered here is exclusive of current liabilities. The shareholders’ equity includes:

* Equity and preference share capital
* Accumulated profits (retained earnings) excluding fictitious assets like accumulated losses, etc. The shareholders’ equity so defined is equal to Net Worth. This ratio can also be called as Debt to Net Worth ratio.

Debt Equity Ratio = $\frac{Total Debt}{Shareholders^{'}Equity}$ (ii)

The difference between (i) and (ii) is essentially in respect of the treatment of current liabilities. The D/E ratio indicates the margin of safety to the creditors. It is not unusual to find firms having a D/E ratio of 2:1 or even 3:1.

**Gross Profit Margin:**

Gross Profit Margin = $\frac{Gross Profits}{Sales }\*100$

**Net Profit Margin:**

Operating Profit = $\frac{Earning Before Interest and Taxes (EBIT)}{Sales}$

Net Profit Ratio = $\frac{Earnings after Interest and Taxes (EAT)}{Sales}$

A high net profit margin would ensure adequate returns to the owners as well as enable a firm to withstand adverse economic conditions.

**Return on Ordinary Shareholders’ Equity (Net Worth):**

Return on Equity Funds = $\frac{Net Profit after Taxes-Preference Dividend}{Average Ordinary Shareholders^{'}Equity or Net Worth}$

**Turnover Ratio:**

Some of the turnover ratios are:

* Inventory Turnover Ratio
* Debtors Turnover Ratio
* Creditors Turnover Ratio

Inventory Turnover Ratio = $ \frac{Cost of goods sold }{Average inventory}$

Cost of goods sold = opening stock + manufacturing cost (including purchases) – closing stock (inventory)

Debtors Turnover Ratio = $\frac{Net credit sales}{Average Debtors}$

The ratio measures how rapidly debts are collected. A high ratio is indicative of shorter time lag between credit sales and cash collections. A low ratio indicates that debts are not being collected rapidly.

Creditors Turnover Ratio = $\frac{Net credit purchases}{Average Creditors}$

Where, Net credit purchases = Gross Credit purchases less returns to suppliers

 Average creditors = Average of creditors outstanding at the

 beginning of the year end of the year.

A low credit turnover ratio reflects liberal credit terms granted by suppliers, while a high ratio shoes that accounts are to be settled rapidly.

**Book Value per Share (BPS)**

BPS =$\frac{Ordinary Shareholders’ Equity}{Number of equity Shares outstanding}$

**Earnings per share (EPS)**

EPS is generally considered to be the single most important variable in determining a share's price. It is also a major component used to calculate the price-to-earnings valuation ratio.

EPS = $\frac{Net Profit after tax – preference share dividend paid, if any}{Number of ordinary shares outstanding}$

EPS has some limitations inasmuch as an increasing EPS may be due to profits being retained in the business with the number of ordinary (equity) shares outstanding remaining the same. It also does not reveal the amount of dividends paid to the owners. Nevertheless, the EPS is a widely used ratio and lends itself to be compared with the EPS of other similarly placed firms and comparison with the industry average.

**Price to Earnings Ratio (P/E Ratio)**

The P/E ratio examines the relationship between the stock price and the company’s earnings.

**P/E ratio =**$ \frac{Market Price per Share (MPS)}{Earnings per Share (EPS}$

For example, a company with a share price of Rs. 140 and an EPS of 7 would have a P/E of 20 (140 / 7 = 20).

The P/E gives you an idea of what the market is willing to pay for the company’s earnings. The higher the P/E, the more the market is willing to pay for the company’s earnings. Generally, a high ratio with an increasing EPS indicates good future prospects.

**Market Price Per Share (MPS)**

P/E ratio = $\frac{MPS}{EPS}$

Therefore, MPS = $P/E ratio \*EPS$

**Dividend per share (DPS)**

The sum of declared dividends for every ordinary share issued. It is given by the formula:

**DPS =** $\frac{Dividend paid to ordinary shareholders}{Number of ordinary shares outstanding}$

Dividends are a form of profit distribution to the shareholders. Having a growing dividend per share can be a sign that the company's management believes that the growth can be sustained.

**Earnings Yield**

The earnings per share for the most recent 12-month period divided by the current market price per share. The earnings yield (which is the inverse of the P/E ratio) shows the percentage of each Re. invested in the stock that was earned by the company.

**Earnings Yield =** $\frac{EPS}{MPS}$ **\* 100**

**An increase in the numerator will bring about a corresponding increase in the denominator.**

**Generally, a low yield along with an increasing EPS trend indicates that the investors consider the future prospects of the firm in terms of sales growth and profits as good.**

**Dividend Payment Ratio**

The percentage of earnings paid to shareholders as dividend.

Calculated as: $\frac{Dividend per share}{EPS}$

A reduction in dividends paid is looked poorly upon by investors, and the stock price usually depreciates as investors seek other dividend-paying stocks.

A stable dividend payout ratio indicates a solid dividend policy by the company's Board of Directors.

**Market Capitalization**

The total market value of all of a company's outstanding shares. Market capitalization is calculated by multiplying a company's shares outstanding by the current market price of one share. The investment community uses this figure to determine a company's size, as opposed to sales or total asset figures. It is frequently referred to as "market cap."

If a company has 35 million shares outstanding, each with a market value of Rs.100, the company's market capitalization is Rs. 3.5 billion (35,000,000 x Rs. 100 per share).

**Swap Ratio**

The ratio in which an acquiring company will offer its own shares in exchange for the target company's shares during a merger or acquisition. To calculate the swap ratio, companies analyze financial ratios such as book value, earnings per share, profits after tax and dividends paid, as well as other factors, such as the reasons for the merger or acquisition.

For example, if a company offers a swap ratio of 1:1.5, it will provide one share of its own company for every 1.5 shares of the company being acquired.