

Financial Analysis

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In visiting with our clients, we are often asked what is the difference between how you analyze a stock versus a bond. From a big picture vantage point we often reply that fundamental financial analysis for both stocks and bonds is essentially the same, up to the point where you decide if you want earnings (stocks) or cash flow (bonds). While this is true in a general sense, like most anything in life, there's more to it than that. Lets look at both the similarities and the differences.

Financial analysis can be broken down into three very broad categories: 1) Economic, 2) Industry, and 3) Company. Economic analysis, of course, deals with the economy, interest rates and other domestic and international big-picture items that affect the investment environment as a whole. Industry research identifies general industry trends, competition among companies, and generally looks at overall industry conditions and compares and contrasts where each specific company fits within this industry profile.

The similarities and differences in stock and bond analysis show up at the company research level. The broad areas are:

Stocks & Bonds

Activity Analysis, Working Capital Analysis, Capital Spending Analysis

Stocks

Profitability Analysis, Operating Leverage Ratios, Earnings Expectations

Bonds

Long Term Debt & Solvency Analysis, Cash Flow & Interest Coverage Ratios, Financial & Debt Leverage Ratios

We typically track in excess of 50 financial ratios. Space here doesn't permit a monograph on financial statement analysis, but I want to give you a flavor for some of the important ratios we follow.

Activity Analysis

Activity analysis deals with operating efficiency, both production related and financial related. On the production side, things like inventory turnover ($\text{Cost of Goods Sold} / \text{Average Inventory}$) and accounts receivable turnover ($\text{Sales} / \text{Average Accounts Receivable}$) are analyzed. Financial related analysis includes ratios like the operating cycle days in inventory ($365 / \text{Inventory}$

Turnover) minus days receivables outstanding ($365 / \text{Receivables Turnover}$), and the cash-cycle which is the operating cycle minus days payable outstanding ($365 / \text{Accounts Payable Turnover}$). The cash cycle measures the number of days it takes a company to convert inventory to cash. If you are a business owner this is an important concept.

Profitability Analysis

This area includes things like the gross margin ($\text{Gross Profit} / \text{Sales}$), management efficiency ($\text{Gross Profit} / \text{Selling, General and Administrative Expense}$), and net income margin ($\text{Net Income} / \text{Sales}$). It also includes return on assets ($\text{Net Income} / \text{Average Total Assets}$) and return on equity ($\text{Pre-tax Income} / \text{Average Equity}$). Within the stock arena, earnings expectations are a major emphasis as management tries ever-harder to please Wall Street on a quarterly basis.

Cash Flow & Interest Coverage Ratios

On the bond side we follow things like EBITDA coverage ($\text{Earnings Before Interest, Taxes, Depreciation \& Amortization} / \text{Interest Expense}$), EBITDA margin ($\text{EBITDA} / \text{Sales}$), and free cash flow coverage [$(\text{EBITDA} - \text{Capital Expenditures}) / \text{Interest Expense}$.]

Financial & Debt Leverage

In this area we follow ratios like the leverage ratio ($\text{Total Debt} / \text{EBITDA}$), the number of years required to pay off debt ($\text{Total Debt} / \text{Free Cash Flow}$, with Free Cash Flow defined as EBITDA minus Capital Expenditures), and the financial leverage effect ($\text{EBIT, or Earnings Before Interest and Taxes} / \text{Net Income}$).

If you study financial statement analysis carefully you will discover that, in fact, almost all ratios have a place in both stock and bond analysis, it's just that the emphasis is different between equity and fixed income security analysis. In a sense, all roads lead to the same place - do we purchase this security (or sell it) or not. At the end of the day it is true that earnings and earnings expectations drive stock prices and cash flow coverage of interest and debt leverage drive bond prices.