WHITE PAPER

TEXAS SECURITY BANK

ANALYZING BUSINESS PERFORMANCE

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Executive Summary

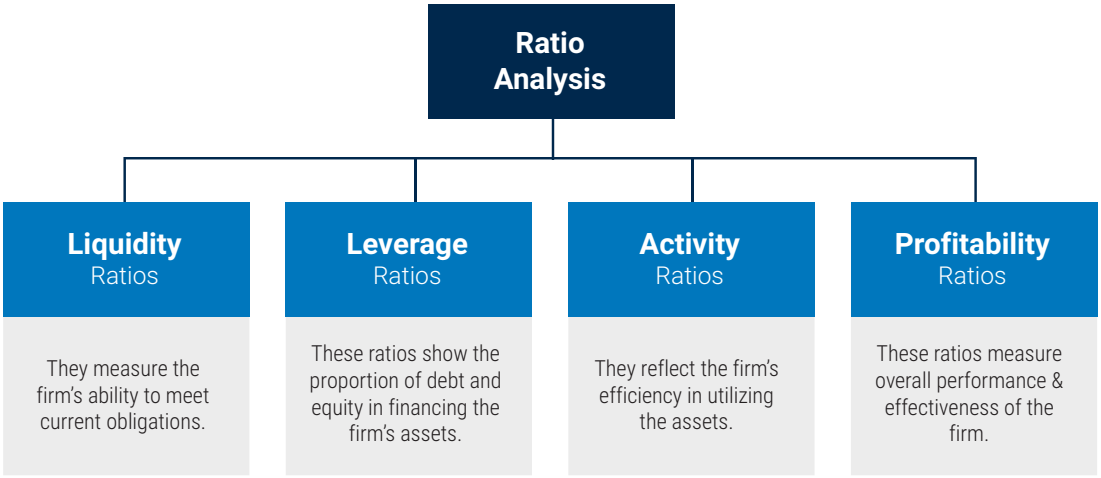
You work tirelessly to grow your business by focusing on generating revenue, managing expenses, recruiting talent, putting out fires, and everything in between. But do you really know how well your business is performing?

Many business owners determine if they've had a successful year only when they close the books and look at net income. Sometimes they do it simply by checking the account balance. This type of management significantly limits a company's potential at best, and at worst sounds the alarm when it's too late to adapt and change.

There is a better way to measure your company's performance on an ongoing basis. Ratio analysis and benchmarking are two disciplines that will help you monitor your company's daily performance and compare your company to the best-in-class. Knowing which aspects of the business to prioritize at any given time and which aspects generate the greatest return will help you control your company's destiny.

Ratio Analysis

Ratio analysis includes four groups of key indicators that can help you determine if what you're doing is actually producing the results you want.



1. Liquidity Ratios

These measure your ability to repay short-term debt and meet unexpected cash needs, helping you gauge how nimble your company is at any given time. Liquidity is powerful in its ability to make the company flexible and able to seize short-term opportunities before they are gone. Primary liquidity ratios include:

- **Current Ratio:** Also known as the Working Capital Ratio, this measures your ability to pay current obligations using current assets. Current Ratio = Current Assets/Current Liabilities.
- **Quick Ratio:** This provides the same purpose as the Current Ratio but excludes less-liquid assets such as inventory. Quick Ratio = Quick Assets/Current Liabilities, with Quick Assets being highly liquid assets like cash, marketable securities, and accounts receivable.
- **Net Working Capital:** This determines if your company can meet its current obligations with current assets (similar to Current Ratio) while showing how much excess or deficiency exists. Net Working Capital = Current Assets – Current Liabilities.

2. Leverage/Solvency Ratios

These help you compare your company's debt levels with its assets, equity, and earnings to evaluate whether your business can stay afloat in the long-term by paying its long-term debt and interest on the debt. Leverage, or lack thereof, is an indicator of the overall health of a company. It reveals if your company has a prudent capital stack to scale, make acquisitions or capital investments, secure senior debt or equity, and weather downturns. Primary leverage/solvency ratios include:

- **Balance Sheet Leverage Ratio:** Also known as Debt to Equity (Net Worth) Ratio, this evaluates the capital structure of your company. The Balance Sheet Leverage Ratio = Total Liabilities/Total Equity. A more specific and telling ratio is Debt to Tangible Net Worth = Total Liabilities/Tangible Net Worth.
- **Debt Service Coverage Ratio:** This ratio examines your EBITDA (Earnings before Interest, Taxes, Depreciation and Amortization) against your debt principal and interest. When using this ratio, make sure you compare relative EBITDA and debt service periods, such as six months of each.
- **Cash Flow Leverage Ratio:** Also known as Debt to EBITDA Ratio, this evaluates a company's debt level compared to earnings by revealing estimated time to repay all or certain debt. Cash Flow Leverage = Total Debt/EBITDA. You can also compare Funded Debt/EBITDA or Senior Debt/EBITDA.

3. Management Efficiency (Activity) Ratios

These evaluate how well your company uses its assets and liabilities to generate sales and maximize profits. They are more dynamic in that they incorporate line items from the balance sheet and income statement to measure productivity and efficiency. If you have ever wondered why cash flow seems tighter than in previous periods, the answer will be revealed in one or more of following ratios:

Accounts Receivable Turnover and Days Sales Outstanding

These two ratios measure the efficiency of extending credit (that's what you are really doing) and collecting.

- **Accounts Receivable Turnover:** This measures the average number of times in a year your company collects receivables. The higher the number, the better. Accounts Receivable Turnover = Sales/Average Accounts Receivable.
- **Days Sales Outstanding:** This measures the average number of days it takes your company to collect receivables. The lower the number, the better. Days Sales Outstanding = 365 Days/Accounts Receivable Turnover.

Inventory Turnover and Days Inventory Outstanding

These two ratios measure the efficiency of your company's inventory management.

- **Inventory Turnover:** This measures the average number of times in a year your company sells and replaces inventory. The higher the number, the better. Inventory Turnover = COGS/Average Inventory.
- **Days Inventory Outstanding:** This measures the average number of days from inventory purchase to sale of the inventory. The lower the number, the better. Days Inventory Outstanding = 365 Days/Inventory Turnover.

Accounts Payable Turnover and Days Payable Outstanding

These two ratios measure the frequency of paying a company's obligations (payables). It's important to consider the health of your relationship with vendors when determining how long to stretch payables. In most cases, you can find a balance between enhancing your cash flow by paying on terms and paying in a time frame that maintains a positive relationship with your vendors.

- **Accounts Payable Turnover:** This measures the average number of times in a year your company pays its accounts payable. The lower the number, the better for cash flow purposes. Accounts Payable Turnover = COGS/Average Accounts Payable.
- **Days Payable Outstanding:** This measures the average number of days spent before paying obligations to suppliers. The higher the number, the better for cash flow purposes. Days Payable Outstanding = 365 Days/Payable Turnover.

Operating Cycle and Cash Flow Conversion Cycle

The cash conversion cycle is a metric used to gauge the effectiveness of a company's management and overall health. These calculations measure how fast a company can convert cash on hand into inventory and accounts payable, through sales and accounts receivable, and then back into cash.

- **Operating Cycle:** This measures the average number of days it takes a company to complete one operating cycle. The shorter the cycle, the better. Operating Cycle= Days Inventory Outstanding + Days Sales Outstanding.
- **Cash Flow Conversion Cycle:** This measures the average number of days spent before paying obligations to suppliers. The fewer days, the better. Cash Flow Conversion Cycle = Operating Cycle – Days Payable Outstanding.

Cash Impacts of Working Capital Components

Keep in mind the following equations when considering the cash impact of your different working capital components:

- **Change in Days Sales Outstanding x 1 Average Day's Sales =**
  $ Cash Impact of Change in Days Sales Outstanding
- **Change in Days Inventory Outstanding x 1 Average Day's COGS =**
  $ Cash Impact of Change in Days Inventory Outstanding
- **Change in Days Payable Outstanding x 1 Average Day's COGS =**
  $ Cash Impact of Change in Days Payable Outstanding

The result of these equations doesn't directly equate to profit, but a positive cash impact can lead to increased profits as the company will have additional free cash flow to reduce debt or to invest in assets that produce return.

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4. Profitability Ratios

Profitability Ratios demonstrate how well a company can generate profits from its operations. As you work to improve the fundamentals of your business through consistent and disciplined monitoring of liquidity, leverage, and management efficiency ratios, you'll want to see how these efforts translate into profit. By setting a baseline of one or more of the ratios below, you can periodically compare them going forward to see the impact of your efforts on profitability:

Return on Assets and Return on Equity

These two ratios measure how profitable your company is relative to total assets and total equity.

- **Return on Assets:** This measures how well management is employing the company's assets to make a profit. The higher, the better. Return on Assets = Net Income/Average Total Assets.
- **Return on Equity:** This measures how much your shareholders earned for their investment in the company. The higher, the better. It's important to use this ratio in conjunction with Balance Sheet Leverage. Return on Equity = Net Income/Average Shareholder's Equity

Earnings Per Share and Price to Earnings Ratio

Earnings Per Share indicate how much an investor is willing to pay per dollar of earnings. In other words, it is an indicator of investor's expectations for the stock. This is the most widely used investment valuation ratio.

- **Earnings Per Share:** This measures the net income earned per share of stock. Earnings Per Share = Net Income (less preferred dividends)/Average Shares Outstanding.
- **Price to Earnings Ratio:** Price to Earnings Ratio = Stock Price per Share/Earning Per Share

Benchmarking

The first step in analyzing your ratios should be to compare them over different points or periods of time. Are they trending in a positive or negative manner? Either way, action is called for. Answer the question of why they are trending in that direction and either do more or less of what is driving the results.

After analyzing your baseline and trends, compare your company to others within your industry. This can be an uplifting or humbling experience but knowing where you stand is vital to success. Ratios are usually only comparable across companies in the same industry. An acceptable ratio in one industry may be viewed as high risk in another; therefore, it is of limited benefit to compare the ratios of two randomly-selected companies.

Benchmarking against companies in your industry will provide a baseline for each ratio and the ability to compare your company to the top performers. Industry benchmarking can also be a very useful tool for budgeting and goal setting.

Conclusion

Financial statements can be a source of confusion or anxiety for a business owner, but they don't need to be. Think of them as the data behind a dashboard for your company's health and performance. Selecting a few of the discussed ratios to serve as your initial gauges will help you monitor your company. As your comfort and confidence in calculating and monitoring these gauges rises, add more to the dashboard. In a short period of time, you'll have a significantly better feel for what drives your company's success and what is potentially weighing it down. After you do that, research your industry to see how you compare with the best of the best. Benchmarking will help you set attainable targets as you strive towards your goals.