

KPIs explained.

Terminology from the accounting and finance world and what it means.

Operating Cash Flow Conversion

$$= \text{Operating cash flow} / \text{EBITDA}$$

Efficiency Ratio, measures a company's ability to convert its operating profits into operating cash flow. A "good" free cash flow conversion rate would typically be around or above 100%, indicating efficient working capital management. In contrast, "bad" FCF conversion would be well below 100% – and can be particularly concerning if there has been a distinct pattern showing deterioration in cash flow quality year-over-year.



Free Cash Flow (FCF)

$$= \text{Operating Cash Flow} \text{ less } \text{Capital Expenditure and Corporation Tax}$$



Dividend payout ratio

$$= \text{Dividends} / \text{Net income}$$



Current Ratio

$$= \text{Current assets} / \text{Current liabilities}$$

Financial Strength Ratio, indicates how well a company can pay its short-term obligations with its current assets.



Free Cash Flow Conversion

$$= \text{Free Cash Flow} / \text{EBITDA}$$

Liquidity ratio, measures a company's ability to generate cash flow for financing activities (i.e. debt repayments) and will be a function of operating cash conversion and the level of capital investment required for operations. A high conversion rate will indicate a stronger position to service debt, financing or dividend payments.



Return on Equity (ROE)

$$= \text{Net income} / \text{Shareholders' equity}$$

Efficiency Ratio, shows how effectively a company utilises its equity to generate a profit.



Quick Ratio (Acid-test ratio)

$$= (\text{Current assets} - \text{Inventory}) / \text{Current liabilities}$$

Indicates the company's ability to instantly use its near-cash assets (assets that can be converted quickly to cash) to pay down its current liabilities.



Debt to Equity Ratio

$$= \text{Total debt} / \text{Total equity}$$

Financial leverage ratio that can be helpful when attempting to understand a company's economic health. Highlights a company's dependence on borrowed funds and its ability to meet those financial obligations.



Operating Cash Flow (OCF)

$$= \text{EBITDA} \text{ +/- } \text{movements in working capital}$$



Return on Assets (ROA)

$$= \text{Net income} / \text{Average total assets}$$



Return on Invested Capital (ROIC)

$$= \text{EBIT} (1 - \text{tax}) / (\text{Long term debt} + \text{Equity} - \text{Cash})$$

Profitability ratio, measures the percentage return that a company earns on investment capital.



Inventory Turnover

$$= \text{Cost of goods sold} / \text{Average Inventory}$$

Rate at which inventory is sold, used or replaced in a given period. A low ratio indicates weak sales and/ or a sign of overstocking, whilst a higher ratio indicates strong sales. In some cases a very high ratio could however indicate insufficient stock is held to support demand.



Days Sales Outstanding (DSO, Countback)

The Countback Method estimates the number of days it takes a business to collect its accounts receivable. It requires a monthly comparison of accounts receivable and sales on credit, followed by the addition of the number of days for each month. The average is based on the total value of sales and receivables, so will be weighted towards the timings seen across the larger customers. A good metric to track to ensure days are in line with expected credit terms, anything outside of expectations may suggest weaknesses around collectability/credit control.



Accounts Receivable Turnover

$$= \text{Net credit sales} / \text{Average accounts receivable}$$

Efficiency ratio, reflecting the number of times a company collects its average debtor balance over a given period. A higher ratio indicates prompt collections are being made and thus a strong credit control environment, a lower ratio indicates slower collections which may indicate credit control weaknesses.



Days Inventory Outstanding (DIO, Countback)

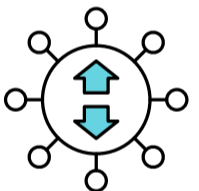
The Countback Method is a technique for estimating the number of days of stock purchases that remain in stock ("Inventory") at a given point in time or, or how many days of sales cover. A low metric may indicate a company is holding too little stock and losing revenue. A high metric may indicate a company is holding too much stock and is losing financing opportunity. However, key considerations will be the lead time of bringing Stock in and/ or any restrictions or delays in the supply chain (i.e. logistics, shortages).



Operating Cash Flow Ratio

$$= \text{Operating cash flow} / \text{Current liabilities}$$

Liquidity ratio, identifies the extent to which a company's (short term) liabilities are covered by the cash flows generated by operations. A ratio of less than 1 indicates a short term liquidity problem. A ratio greater than 1 indicates the company can cover its short term liabilities - the higher the ratio the stronger the financial health.



Gross Profit Margin

$$= (\text{Revenue} - \text{Cost of goods sold}) / \text{Revenue}$$

Profit generated by a company after subtracting its cost of goods sold, typically presented as a ratio to its revenues. In other words this considers any costs directly incurred in selling its product or services, such as material costs in a manufacturing business. A key influence on this margin is the optimisation of product/ service pricing, the management of which can increase overall sales and thus gross profit margin, as there will typically be no commensurate increase in direct costs.



Days Payable Outstanding (DPO, Countback)

Similar to the sales counterpart above, the Countback Method is a technique for estimating the number of days it takes a business to pay its suppliers. It requires a monthly comparison of accounts payable and purchases on credit (direct and indirect costs), followed by the addition of the number of days for each month. This a good metric to track to ensure days are in line with expected payment terms and can indicate both opportunities and issues.



Accounts Payable Turnover

$$= \text{Purchases} / \text{Average accounts payable}$$

Liquidity ratio, reflecting the number of times a company pays its average creditors over a given period. This metric indicates how quickly a company is paying its suppliers and thus is a good measure of short term liquidity.



Total Asset Turnover

$$= \text{Revenue} / \text{Average total assets}$$

A measure of how efficiently a company uses its asset base to generate sales. A high ratio indicates a company operating more efficiently as compared to a low ratio. Ratios can vary significantly by industry however should be comparable across companies in similar industries.



Net Profit Margin

$$= \text{Net income} / \text{Revenue}$$

Profit generated by a company after subtracting all of its costs, typically presented as a ratio to its revenues.

