

Ratio analysis assignment

Business



Financial Statement Analysis Project ??? “ Guess, Inc. ” and “ The Gap ” FI 504 ??? Accounting and Finance: Managerial Use and Analysis October 13, 2008 I. Liquidity Ratios Liquidity shows the degree to which an asset or security can be bought or sold in the market without affecting the asset’s price. Liquidity is characterized by a high level of trading activity. Also it the ability to convert an asset to cash quickly, known as “ marketability. ” For an investor it is safer to invest in liquid asset then illiquid ones because it is easier to get his money out of the investment.

Current ratio measures a company’s ability to pay short-term obligations. Both companies are able to pay back their short-term liabilities (debt and payables) with its short-term assets (cash, inventory, receivables). The higher the current ratio, the more capable the company is of paying its obligations. Both companies’ ratios are above one, which means they can pay off their obligations. It shows the companies are financially healthy. Current ratio of Guess, Inc. was lower than Current ratio of The Gap during four years from 2004 to 2007, but is was stable.

The Gap’s current ratio decreased slightly, it means its liquidity needs further investigation. Investors and managers use the relationship among sales, accounts receivable, and cash collections to evaluate the companies’ liquidity. The Receivables Turnover ratio is an activity ratio, measuring how efficiently a firm uses its assets. A high ratio implies either that a company operates on a cash basis, or that its extension of credit and collection of accounts receivable is efficient.

A low ratio implies the company should re-assess its credit policies in order to ensure the timely collection of imparted credit that is not earning interest for the firm. Average collection period should be consistent with corporate credit policy. The increase in Average Collection Period of Guess, Inc. and The Gap may suggest a decline in financial health of customers. Analysis of inventory is a result of Inventory Turnover ratio and Days in Inventory. Having too much inventory on hand costs the company money in storage costs, interest costs, and costs associated with the shifts in fashion.

But having too little inventory on hand results in lost sales. The calculation shows that The Gap turns its inventory more frequently than Guess, Inc. Consequently, the average time an item spends in The Gap stores is shorter. This suggests that The Gap is more efficient than Guess, Inc. in its inventory management. Comparing the two companies' liquidity results with Industry Average's, it should be mentioned that both companies were pretty liquid during the year of 2007. Most of the figures are either higher or on the same level as Industry Average. II. Solvency Ratios.

Long-term creditors and stockholders are interested in a company's long run solvency its ability to pay interest as it comes due and to repay the balance of a debt due at its maturity. Solvency ratios measure the ability of the enterprise to survive over a long period of time. Guess, Inc. ' s Debt-to-Total Assets ratio of 50% means that the company's creditors provided \$0.50 of every dollar invested in Guess, Inc. ' s assets. This ratio exceeds The Gap's ratio of 40%. The higher the ratio, the lower the equity " buffer" available to creditors, if the company becomes insolvent.

Thus, from creditors' point of view, a high ratio of debt to total assets is undesirable. Guess, Inc.'s solvency appears lower than that of The Gap. Other measures can also be useful in assessing solvency. One of them is the Times Interest Earned (Interest Coverage) ratio, which provides an indication of a company's ability to meet interest payments as they come due. Guess, Inc.'s Times Interest Earned ratio declined from 27.1 times in 2006 to 22.2 in 2007. Guess, Inc.'s high Debt-to-Total Assets ratio, combined with its interest coverage ratio of 22.2 times, should be of obvious concern to the company's creditors and investors. Another measure of solvency that uses cash figures is the Cash Debt Coverage ratio. This ratio indicates a company's ability to repay its liabilities from cash generated from operations, that is, without having to liquidate productivity assets such as property, plants, and equipment. A general rule of thumb is that a cash debt coverage ratio below 2.0 times is a cause for additional investigation. Guess Inc.'s Cash Debt Coverage ratio of 0.38 times is two-thirds as strong as The Gap's.

The high value of Cash Debt Coverage ratio suggests the company is solvent; that is, it will meet its obligations in the long term. Free Cash Flow is intended to indicate the cash-generating capability of the company. Significant Free Cash Flow indicates greater potential to finance new investment and pay additional dividends. The Gap generated Free Cash Flow of \$413 million, which is available for the acquisition of new assets, the retirement of stock or debt, or the payment of additional dividends. Long-term creditors consider a high Free Cash Flow amount an indication of solvency. Guess, Inc.'s Free Cash Flow for 2007 was only \$49 million. This

lack of Free Cash Flow calls into question Guess? ' s ability to pay its long-term obligations as they come due. Talking about the Industry Average and companies' figures of 2007 regarding solvency, both companies stayed within the normal frames; therefore, neither Guess, Inc. , nor The Gap showed any huge differences with the Industry Average, which usually might result in investors' further investigation. III. Profitability Ratios Profitability Ratios measure the income or operating success of a company for a given period of time.

Both companies' Gross Profit Rates declined in 2007. It might have several causes. Guess, Inc. and The Gap were forced to pay higher prices to their suppliers, without being able to pass these costs on to their customers. Profit Margin ratio measures the percentage of each dollar of sales that results in net income. Profit Margin ratio measures the extent by which selling price covers all expenses (including cost of goods sold.) Guess, Inc. ' s Profit Margin Ratio decreased in 2007 almost twice. The Gap's ratio also decreased, but not so dramatically.

Thus, their Profit Margin ratios don't suggest exceptional profitability. An overall measure of profitability is the Return-on-Assets (ROA). This ratio indicates the amount of net income generated by each dollar invested in assets. Thus, the higher the ROA, the more profitable the company. The Gap's 2007 Return-on-Assets was better than that of Guess, Inc. , but its 2006 return was less than Guess, Inc. ' s. Asset Turnover indicates how efficiently a company uses its assets ??? that is, how many dollars of sales a company generates for each dollar invested in assets.

Asset Turnover ratios tell that for each dollar invested in assets, Guess, Inc. generated sales of \$1.2 and The Gap \$1.9 in 2007. The Gap was more successful in generating sales per dollar invested in assets. Another ratio that measures profitability from the common stockholders' viewpoint is Return-on-Equity (ROE). It shows how many dollars of net income a company earned for each dollar invested by common stockholders. From 2006 to 2007, Guess, Inc.'s return on common shareholders' equity decreased more than 10%. The Gap's ROE also decreased more than 5% during the same period.

The declining ROE shows weak earning performance from common stockholders' perspective. For evaluation of the company's relative earnings performance from the perspective of shareholder, we can compare Earnings Per Share (EPS) of a company over time. But the comparison of EPS across companies is not meaningful because of the wide variations in the numbers of shares of outstanding stock among companies. Guess, Inc.'s EPS increased from \$1.33 in 2006 to \$1.98 in 2007. The higher measure suggests improved performance. The Gap's EPS on the contrary decreased from \$1.32 in 2006 to \$1.18 in 2007.

The market value of a company's stock changes based on investors' expectations about a company's future earnings per share. In order to make a meaningful comparison of market values and earnings across firms, investor calculate price-earnings (P-E) ratio. The P-E ratio reflects investor's assessment of a company's future earnings. The ratio of price to earnings will be higher, if investors think that earnings will increase substantially in the future and, therefore, are willing pay more per share of stock. Guess, Inc.

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's and The Gap's P-E were high in 2007, that shows the investors believe companies' earnings will be strong.

Comparing Guess, Inc. 's and The Gap's profitability levels with that of the Industry Average, we can see that both companies showed higher figures in almost every ratio, which tells us that the companies are more profitable than the majority of others belonging to the same industry. If we were considering investing in one of the two companies, we would choose the Gap for several reasons. First of all, The Gap shows higher current ratios, and its average time an item spends in the Gap's stores is shorter. These two facts make us believe that The Gap is more liquid and efficient than Guess, Inc. Secondly, Guess, Inc. 's solvency appears lower than that of the Gap's, which reflects the ability of the company to survive over a long period of time. Besides, The Gap's amount of Free Cash Flow is almost nine times higher than Guess, Inc. 's. Thirdly, even though The Gap's EPS decreased between the years of 2006 and 2007, when Guess, Inc.'s increased, as a whole, The Gap was more successful in generating sales per dollar invested in assets. All those factors make us, investors, believe in The Gap more than in Guess, Inc. But as customers, we love both of the apparel stores and consider them one of the most popular brand names in the United States.

Ratio Analysis Report Two Public Company Ratios for the four years ended Dec. 31, 2007, 2006, 2005, 2004 Guess? , Inc. (NYSE: GES) Gap Inc. , The (NYSE: GPS) GESGPSGESGPSGESGPSGESGPSIndustry: Apparel Stores 2007 Year End 31-Dec-07Year End 31-Dec-07Year End 31-Dec-06Year End 31-Dec-06Year End 31-Dec-05Year End 31-Dec-05Year End 31-Dec-04Year End 31-Dec-04 I. Liquidity Ratios 1. Current ratio 22. 222. 71. 92. 822. 62. 1 2.

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Current Cash Debt Coverage ratio 0.520. 880. 550. 590. 850. 740. 750. 670.
 7 3. Accounts Receivable Turnover 9. 710. 411. 0211. 813. 712. 616. 817.
 310. 1 4.

Average Collection Period (Average Age of Receivables) 37. 53533. 130. 926.
 528. 821. 621. 134. 2 5. Inventory Turnover 4. 55. 94. 65. 85. 45. 65. 55. 34.
 2 6. Days in Inventory (Average Age of Inventory) 8061. 879. 362. 967. 565.
 166. 468. 882 II. Solvency Ratios 1. Debt-to-Total Assets ratio 0. 50. 40. 50.
 40. 50. 50. 50. 60. 3 2. Times Interest Earned (Interest Coverage) ratio 22.
 233. 127. 141. 515. 612. 29. 98. 229. 1 3. Cash Debt Coverage ratio 0. 380.
 60. 370. 370. 540. 360. 470. 711. 1 4. Free Cash Flow 4941388772100. 51,
 099491, 820517 III.

Profitability Ratios 1. Gross Profit Rate 41. 00%35. 50%43. 80%36. 70%40.
 70%39. 20%37. 60%37. 60%45. 20% 2. Profit Margin Ratio 5. 80%4. 90%10.
 40%6. 90%6. 30%7. 10%4. 10%6. 50%5. 10% 3. Return-on-Assets (ROA) 9.
 00%9. 10%14. 70%12. 60%9. 30%11. 40%7. 00%9. 60%7. 60% 4. Asset
 Turnover 1. 21. 91. 41. 81. 51. 61. 71. 51. 1 5. Return-on-Equity (ROE) 18.
 00%15. 00%28. 60%20. 50%20. 40%23. 30%13. 40%22. 20%16. 10% 6.
 Earnings per Share 1. 981. 181. 331. 320. 651. 340. 331. 151. 11 7. Price-
 Earnings (p/e) ratio 36. 820. 813. 1149. 516. 41820. 115. 5 I. Liquidity Ratios

Liquidity shows the degree to which an asset or security can be bought or sold in the market without affecting the asset's price. Liquidity is characterized by a high level of trading activity. Also it the ability to convert an asset to cash quickly, known as "marketability." For an investor it is safer to invest in liquid asset then illiquid ones because it is easier to get his

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Debt-to-Total Assets ratio | 0. 5 | 0. 4 | 0. 5 | 0. 4 | 0. 5 | 0. 5 | 0. 5 | 0. 6 | 0. 3
 | |???? 2. Times Interest Earned (Interest Coverage) ratio | 22. 2 | 33. 1 | 27.
 1 | 41. 5 | 15. 6 | 12. 2 | 9. 9 | 8. 2 | 29. 1 | |???? 3. Cash Debt Coverage ratio
 | 0. 38 | 0. 6 | 0. 37 | 0. 37 | 0. 54 | 0. 36 | 0. 47 | 0. 71 | 1. 1 | |???? 4. Free
 Cash Flow | 49 | 413 | 88 | 772 | 100. 5 | 1, 099 | 49 | 1, 820 | 517 | |?? ?? ??
 |?? |?? |?? |?? |?? |?? |?? | | III. Profitability Ratios |?? |?? |?? |?? |?? |?? |?? |??
 |?? | |???? 1. Gross Profit Rate | 41. 00% | 35. 50% | 43. 80% | 36. 70% | 40.
 70% | 39. 20% | 37. 60% | 37. 60% | 45. 20% | |???? 2.

Profit Margin Ratio?? | 5. 80% | 4. 90% | 10. 40% | 6. 90% | 6. 30% | 7. 10% |
 4. 10% | 6. 50% | 5. 10% | |???? 3. Return-on-Assets (ROA) | 9. 00% | 9. 10% |
 14. 70% | 12. 60% | 9. 30% | 11. 40% | 7. 00% | 9. 60% | 7. 60% | |???? 4.
 Asset Turnover | 1. 2 | 1. 9 | 1. 4 | 1. 8 | 1. 5 | 1. 6 | 1. 7 | 1. 5 | 1. 1 | |???? 5.
 Return-on-Equity (ROE) | 18. 00% | 15. 00% | 28. 60% | 20. 50% | 20. 40% |
 23. 30% | 13. 40% | 22. 20% | 16. 10% | |???? 6. Earnings per Share | 1. 98 |
 1. 18 | 1. 33 | 1. 32 | 0. 65 | 1. 34 | 0. 33 | 1. 15 | 1. 11 | |???? 7. Price-
 Earnings (p/e) ratio | 36. 8 | 20. 8 | 13. 1 | 14 | 9. 5 | 16. 4 | 18 | 20. 1 | 15. 5 |
 |