

RATIOS DO TELL STORIES: THE CASE OF FINANCIAL STORY TELLING

Academic Research and Knowledge Centre of AAE wrote this case solely to provide material for class discussion. The authors do not intend to illustrate either effective or ineffective handling of a managerial situation. The authors may have disguised certain names and other identifying information to protect confidentiality.

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Version: 2024-04-15

Sunny always loved listening to her grandparents' stories, and she often wondered why stories were so captivating. She noticed how stories could explain complicated things in a fun way, introducing characters and events that kept her hooked. They made her curious and she was eager to find out what happens next, leaving a lasting impression.

Now in her final year of college, Sunny wanted to work in finance domain as a financial analyst. She was a good student and understood the basics of finance well. She knew that understanding financial information was crucial for understanding how businesses work.

During a class, Sunny's professor emphasized the significance of ratio analysis in simplifying complex business aspects. Ratio analysis, he explained, provides a straightforward representation of key business characteristics, making it easier to comprehend. Intrigued by its simplicity and practicality, Sunny became eager to explore the realm of ratio analysis further, seeing its potential application in the financial landscape.

The Good news

At 8:00 AM, Sunny received an email notification—a job interview call from a top finance firm for the position of financial analyst, the dream opportunity she had been eagerly awaiting. Excitement surged through her as she envisioned landing the job she coveted.

However, as the initial thrill settled, anxiety crept in. Thoughts raced through her mind: How should she prepare for the interview? Taking a logical approach, Sunny began to strategize. She quickly drafted a list of key topics to study: financial statement analysis and reporting, financial modelling, and industry analysis.

Interaction with Mentor

Sunny decided to seek guidance from her mentor, an esteemed banker from a renowned Public Sector bank in India, who had transitioned into a financial literacy advocate, helping students carve successful careers in finance. With a unique blend of industry experience and academic expertise, Sunny believed her mentor could provide valuable insights into the interview process.



Sunny:

"May I come in, sir?"

Professor:

"Of course, Sunny. How are you doing?"

Sunny:

"Thank you, Sir. I'm doing well. I wanted to discuss something important with you regarding an interview I've been called for."

Professor:

"Absolutely, come on in."

Sunny:

"Sir, can analysing a company's assets, liabilities, and financial ratios often provide insights into the sector to which the company belongs?"

Professor:

"Absolutely, Sunny. Examining a company's assets, liabilities, and financial ratios can indeed offer valuable clues about its industry sector. Different sectors have distinct financial characteristics shaped by their business models, revenue streams, and operating environments. Here's how we can approach identifying a company's sector based on these factors:

Asset Composition: Different sectors have different asset compositions. For instance, manufacturing companies often invest heavily in property, plant, and equipment (PP&E), while technology firms might have more intangible assets like intellectual property and patents.

Liability Structure: Similarly, the types of liabilities a company holds can vary by sector. Financial institutions typically carry high levels of debt related to their lending activities, while service-oriented businesses may focus more on accounts payable and accrued expenses.

Financial Ratios: Certain financial ratios can also hint at a company's sector. For instance:

Profit Margin: High profit margins are common in technology or pharmaceutical companies, whereas lower margins are typical in retail or manufacturing.

Asset Turnover: Retail or consumer goods companies often have high asset turnover ratios, while industries with high capital intensity, like utilities or telecommunications, might have lower ratios.

Debt-to-Equity Ratio: Sectors like utilities or real estate investment trusts (REITs) may have high debt-to-equity ratios, while technology or healthcare sectors might have lower ratios.

By analysing these factors together and considering the broader economic context, we can often make informed judgments about a company's sector. However, it's crucial to remember that there can be exceptions and overlap, so additional research and context are usually necessary for accurate classification."

Sunny:

"Could you provide a specific example to illustrate this?"

Professor:

"Of course, let's consider two hypothetical companies:

Company A:

Asset Composition: Company A invests heavily in property, plant, and equipment (PP&E) and holds significant inventory.

Liability Structure: It carries moderate debt levels, mainly in long-term debt and accounts payable.

Financial Ratios: Company A's profit margin is moderate, with a high asset turnover ratio and moderate ROA and ROE.

Based on these characteristics, Company A likely belongs to the manufacturing sector, given the typical profiles seen in manufacturing companies.

Company B:

Asset Composition: Company B's assets are primarily intangible, such as intellectual property and patents, with minimal physical investments.

Liability Structure: It has low debt levels and relies more on equity financing.

Financial Ratios: Company B boasts a high profit margin due to its asset-light model, with moderate asset turnover and high ROA and ROE.

Given these traits, Company B is likely in the technology or software sector, typical of companies with intellectual property-based business models.

By analysing the asset composition, liability structure, and financial ratios of these hypothetical companies, we can infer their likely sectors. These examples are simplified, but in real-world analysis, we'd consider additional factors and context for more accurate determinations."

During their hour-long interaction, the mentor elaborated on the industry's expectations, emphasizing the importance of possessing industry insights and applying academic knowledge in real-world scenarios. He highlighted how financial literacy could help identify industry trends and discussed the significance of different ratios across various industries.

The Interview Day

As the interview day dawned, Sunny arrived at the venue with a mix of excitement and nerves. As she settled into her seat, the interviewer began with opening remarks, expressing gratitude for the interest in the financial analyst position within the Wealth and Asset Division of the Investment Bank.

"You're here today to showcase your skills in financial analysis," the interviewer began. "You'll be provided with financial information for a set of 10 companies (see Exhibit 1), each belonging to different sectors. Your task is to identify the sectors based on the financial data provided and answer a series of questions within the allotted time of 90 minutes."

With a sense of determination, Sunny prepared herself to tackle the challenge ahead, eager to demonstrate her analytical prowess and secure the coveted position.

Financial story telling task

The interviewer emphasized the use of intuition and common sense to identify the unique characteristics of the listed companies and to group them accordingly. Subsequently, observations were requested on the following questions:

1. How can you analyse the provided data on the structure of assets, liabilities, and financial ratios for the listed companies? Can you break down the key components and characteristics?
2. Could you comment on the asset structure, liability structure, and financial ratios of each company individually?
3. How would you classify the given companies based on the financial data provided?
4. Based on the financial data analysis and characteristics observed, can you identify potential sectors to which each company may belong?

Exhibit 1: Asset, Liability and Financial Ratios of Selected Companies
(10 years average from March 2014- March 2023)

('Rs in Cr)

	A1	B2	C3	D4	E5	F6	G7	H8	I9	J10
Liabilities										
Equity Share Capital	25.40	30.27	110.38	613.36	70.27	87.54	111.92	282.87	233.44	527.51
Reserves	2750.65	9157.22	19515.25	6465.96	3843.69	24728.21	4042.10	77898.28	38690.78	145434.81
Borrowings	60.23	85.40	34789.64	739.00	3255.12	92472.92	3903.50	3297.26	7114.48	1111126.93
Other Liabilities	881.54	3748.20	23425.64	686.05	2369.95	86219.51	2543.89	26890.88	14914.56	62407.63
Total Liabilities	3717.83	12995.47	77840.91	8504.37	9539.03	203508.17	10601.40	108369.29	60953.26	1319496.87
Assets										
Net Block	795.02	1258.63	30644.73	4872.87	5529.42	2365.00	7140.63	15268.25	18522.15	4718.20
Capital Work in Progress	146.73	389.88	11077.57	428.79	459.13	58.93	262.04	1565.79	2078.04	0.00
Investments	73.38	4268.95	2390.91	39.63	537.07	82501.79	1538.72	25861.25	7100.37	299031.69
Other Assets	334.20	2454.64	14842.43	975.09	976.79	114103.12	837.74	25436.05	9316.13	922602.46
Receivables	659.59	1417.52	12616.09	33.61	1069.45	1874.64	295.59	29002.23	7839.00	0.00
Inventory	727.09	1356.26	3399.46	1549.15	446.18	0.00	92.84	16.53	7312.32	0.00
Cash & Bank	981.83	1849.59	2869.73	605.25	520.99	2604.70	433.84	11219.19	8785.24	93144.52
Total Assets	3717.83	12995.47	77840.91	8504.37	9539.03	203508.17	10601.40	108369.29	60953.26	1319496.87
Financial Ratios										
Sales Growth	22.71%	7.71%	17.75%	28.53%	16.54%	36.04%	14.37%	12.06%	13.64%	16.91%
PBT Growth	27.45%	18.50%	35.19%	34.57%	71.60%	22.23%	-67.19%	9.68%	20.61%	18.70%
Net Profit Growth	29.03%	17.66%	35.35%	37.34%	94.94%	21.48%	-98.22%	9.42%	25.14%	20.28%
Dividend Growth	105.85%	36.22%	11.44%	0.00%	30.97%	26.26%	0.00%	45.04%	51.51%	39.79%
Operating Cash Flow Growth	35.86%	39.85%	146.24%	37.86%	18.66%	-91.84%	-28.08%	12.94%	19.06%	-220.73%
Free Cash Flow Growth	56.04%	-98.80%	1348.72%	40.52%	-124.84%	-142.24%	55.79%	12.97%	32.68%	-222.76%
Operating Margin	16.67%	15.66%	8.05%	7.98%	12.43%	39.35%	13.22%	27.48%	27.62%	64.77%
PBT Margin	14.90%	15.31%	2.47%	6.44%	5.82%	22.17%	-3.50%	27.92%	18.65%	32.96%
Net Margin	10.38%	11.00%	2.13%	4.45%	3.98%	16.08%	-4.75%	21.15%	15.75%	22.82%
Debtor Days	60.64	46.76	96.95	0.64	40.86	17.54	28.64	75.14	90.49	0.00
Inventory Turnover	6.18	8.26	17.80	12.30	22.61	0.00	43.28	11260.90	4.30	0.00
Fixed Asset Turnover	5.11	8.98	2.79	4.06	1.68	15.74	0.57	9.35	1.73	20.21
Debt/Equity	0.01	0.01	1.63	0.30	0.84	3.37	1.16	0.04	0.20	7.93
Debt/Assets	0.01	0.01	0.41	0.17	0.34	0.41	0.37	0.03	0.12	0.84
Interest Coverage (Times)	140.24	404.95	1.57	22.56	3.06	2.30	1.28	408.42	29.97	1.66
Return on Equity	15.29%	13.56%	5.56%	14.80%	8.92%	21.67%	-4.06%	37.56%	13.19%	16.43%
Return on Capital Employed	21.88%	18.95%	7.43%	18.53%	11.55%	12.59%	4.02%	48.13%	13.65%	6.78%
Free Cash Flow (Rs Cr)	-345.06	334.90	4647.65	164.77	127.95	-18773.95	-167.01	27734.13	4825.97	-5327.57

Source: Created by the authors of the case, based on the data available in the website <https://ticker.finology.in/company> accessed on 02.04.2024