UNCONVENTIONAL RATIOS FOR UNDERSTANDING **CONVENTIONAL** BUSINESS

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INTRODUCTION

In today's dynamic economic landscape, businesses face various challenges that can lead to financial instability. To navigate these uncertainties effectively, it's crucial to have robust tools for early crisis detection. One such tool is the analysis of key financial ratios. These ratios serve as vital indicators, offering insights into a company's financial health and potential vulnerabilities. In this article, we'll delve into the significance of key financial ratios in spotting crises, empowering readers with essential knowledge to safeguard their financial interests.

- **CFO TO EBITDA**
- **CONTINGENT LIABILITIES AS PERCENTAGE OF NET WORTH**
- **CASH CONVERSION CYCLE**
- **RETENTION RATE**
- **GROWTH RATIOS**
- **LOANS AND ADVANCES TO RELATED PARTIES AS A PERCENTAGE OF NET WORTH**
- **THE DEBT-SERVICE COVERAGE RATIO (DSCR)**

CFO TO EBITDA

The cash flow to EBITDA ratio is a valuable metric that assesses the amount of cash flow a company generates compared to its EBITDA. Lower CFO to EBITDA ratio indicate

- Potential Liquidity Issues
- Underlying Operational Challenges
- Strategic Concerns

$$\textbf{Cash Flow to EBITDA ratio} = \frac{\textbf{Operating Cash Flow}}{\textbf{EBITDA}}$$

Example: In present year RCB Corp has

Operating cash flow - Rs. 12.51 Crore

EBITDA - Rs. 15. 05 Crore

$$\text{Cash Flow to EBITDA ratio} = \frac{\text{Rs. 12.51 Crore}}{\text{Rs. 15. 05 Crore}} = 83\%$$

This Indicate the company was able to convert **83%** of its EBITDA into cash flow.

CONTINGENT LIABILITIES AS PERCENTAGE OF NET WORTH

A contingent liability is a liability that may occur depending on the outcome of an uncertain future event. It is a potential liability that may occur in the future, such as pending lawsuits or honoring product warranties. It adversely impact a company’s assets and net profitability.

Large contingent liabilities might suggest that a company’s capital commitments will rise significantly and lead to a deteriorating financial position.

CASH CONVERSION CYCLE

The cash conversion cycle represents the duration required by a company to convert investments in production and sales into cash or working capital

<u>Higher cash conversion days will indicate</u>

- Inefficient Working Capital Management
- Slow Inventory Turnover
- Delayed Accounts Receivable Collection

Cash Conversion Cycle = **Days Inventory Outstanding** **+** **Days Receivable Outstanding** **-** **Days Payables Outstanding**

Example: CSK Limited has:

Inventory outstanding : 15.02 days

+

Sales Outstanding : 9.88 days

-

Payable Outstanding : 14.50 days

CCC : 10.40 days

RETENTION RATE

The portion of consumers who remain customers for an entire reporting period. This will help us refine our strategies and optimize our efforts toward.

<u>Lower customer retention rate will indicate</u>

- Customer Dissatisfaction
- Poor Customer Experience
- Lack of Value Proposition
- Competitive Pressure
- Marketing or Communication Issues
- Operational Challenge

(Number of Customers at the Start of a Period
Customers Lost in a Given Period) /
(Number of Customers at the Start of a Period)
=
(Customer Retention Rate)

Example: Ram Limited

Customers at the Start is 300

Customers Lost is
then its Retention Rate will be 80%

(300-60)/300

GROWTH RATIOS

Growth ratios are financial metrics used to evaluate the rate at which a business is expanding or growing over a specific period. These ratios provide insights into various aspects of growth, including revenue, earnings, and shareholder equity. This ratio help in crisis detection by

- Identify sudden declines in growth rates
- Monitor negative trends in key metrics.
- Assess cash flow constraints

<u>Revenue Growth Rate</u>

Current Period Revenue - Previous Period Revenue) / Previous Period Revenue * 100%

<u>Earnings Growth Rate</u>

Current Period Earnings - Previous Period Earnings) / Previous Period Earnings * 100%

<u>Asset Growth Rate</u>

(Current Period Total Assets - Previous Period Total Assets) / Previous Period Total Assets * 100%

<u>Production Growth Rate:</u>

(Current Period Production - Previous Period Production) / Previous Period Production * 100%

LOANS AND ADVANCES TO RELATED PARTIES AS A PERCENTAGE OF NET WORTH:

This ratio measures the extent to which a company has extended loans or provided advances to its related parties relative to its net worth. Related parties typically include affiliates, subsidiaries, directors, officers, and entities under common control.

A higher ratio indicates a larger exposure to related parties, which may raise concerns about potential conflicts of interest, corporate governance issues, or financial risk. Conversely, a lower ratio suggests a lower level of exposure and potentially less risk.

Loans and Advances to Related Parties as a Percent age of Net Worth=Loans and Advances to Related Parties/ Net Worth)×100%

Example:

if a company has provided Rs 5,00,000 in loans and advances to related parties and its net worth is Rs. 20,00,000, the ratio would be Loans and Advances to Related Parties as a Percent age of Net Worth

= (5,00,000 / 20,00,000) × 100% = 25%

THE DEBT-SERVICE COVERAGE RATIO (DSCR)

DSCR measures a firm's available cash flow to pay current debt obligations. The DSCR shows investors and lenders whether a company has enough income to pay its debts. The ratio is calculated by dividing net operating income by debt service, including principal and interest. It helps in:

1. Analysing company's borrowing capacity
2. Monitoring their own financial health

Lower DSCR ratio will indicate

- Increased Financial Risk
- Liquidity Issues
- Operating Performance Decline

DSCR =EBITDA/Total Debt Service

Example:

Let's say a company has an annual operating income of $500,000 and its annual debt payments amount to $300,000.DSCR is 1.67 which indicates that the company generates 1.67 times more operating income than its total debt payments. This means the company has sufficient income to cover its debt obligations, which is typically considered a healthy ratio.

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