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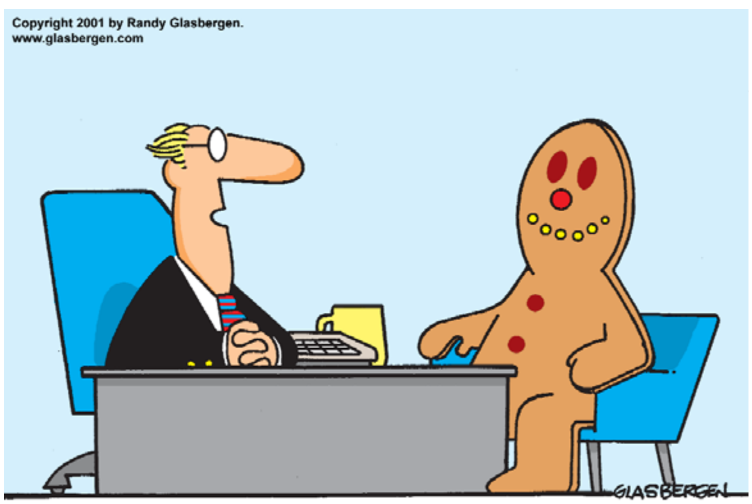
Corporate Finance Insights

Sometimes Assets are Liabilities

Through the Fall I had been traveling around a little, teaching some business valuation classes for the American Institute of CPA's. It's a fun assignment. I've met a lot of good people and it is fun talking about something that is so interesting.

On my last trip I noticed a trend that carried over from other presentations that I've made for business executives. People in business understand the connection between profitability and corporate value. Higher profits mean greater value, all else equal. The more difficult issue tends to be the effect that asset management has on corporate value.



"The economy is crumby. You're an expert on crumbs. Talk to me."

A lot of this has to do with our training from college. Back in our first finance classes we were often taught from an asset-based perspective (instead of cash flow-based). So when we learned about the current ratio (current assets divided by current liabilities), we were told, "The higher the better." So if a company had a lot of accounts receivable and inventory relative to its accounts payable and accrued liabilities, our professors told us it had a "strong working capital position." And if a company had a lot of assets relative to its liabilities we were told it had a "strong balance sheet."

Math for fun and profit

But what if we look at the balance sheet in a different way? How about if we call the asset side of the balance sheet the "investment necessary to generate operating profits"? Then we can compare the "investment" to profits. Now it's beginning to sound a lot like return on investment, which is closer to the heart of valuation. While I'm not a proponent of using only return on assets ("ROA") to judge corporate performance (there are better measures, but that's a subject for another newsletter), let's take a look at how the math breaks down on ROA:

Corporate Value Partners, Inc.

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- Assisting with the acquisition or sale of a business, business unit or product line;
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- Preparing business valuations;
- Assisting creditors in corporate bankruptcies;
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ROA =

Profit/Sales *Profitability* **X** **Sales/Assets** *Asset Utilization*

The formula above shows that return on assets is a function of profitability and asset utilization (which is an indicator of asset management). The formula also shows that if a company can operate with fewer assets and still generate the same profitability, its value-creation performance improves. This makes sense.

Details, details...

So instead of signifying a "strong working capital position," a relatively high current ratio should raise a lot of questions. What's causing the high ratio - accounts receivable, inventories or some other issue? For accounts receivable: Are customers stretching us out? If so, which customers are stretching us out? Should we be concerned with customer bankruptcy risk? What can we do to speed-up collection efforts? For inventories: Is it an operational issue, or more demanding customer-service requirements that is causing an increase in inventory? If operational, is it temporary or likely to be long term? What sort of steps can be taken to correct the operational issues? If customer-related, which customer(s)? Do we run the risk of being stuck with obsolete inventory? Are the inventory requirements so tough that they raise questions about the overall value of the customer relationship? If so, what can we do to improve the customer relationship and improve our ability to create value? Details tell the story.

If you're looking at buying a company, and the seller is touting its "strong working capital position," or "strong balance sheet," you might want to consider what that means for the business and its ability to create value. Instead of being a strength it could actually signal a weakness that the company needs to carry a lot of investment to generate operating profit.

Clean Air Conservancy

I was recently nominated to the Board of Trustees for the Clean Air Conservancy. Please take a look at the web site http://www.cleanairconservancy.org. The Clean Air Conservancy's mission is:

"The Clean Air Conservancy is a non-partisan, non-profit organization dedicated to continuously improving our shared environment by retiring marketable emission-reduction credits. Our goal is to participate in developing local, regional, national and global pollution markets in ways that can produce cleaner air and help slow the pace of global climate change. As an active market participant, the CAC is dedicated to improving the effectiveness and efficiency of existing and developing markets."

Please contact Ronald DiMattia at Corporate Value Partners at (440) 333-1910 or ron@corporatevaluepartners.com with any questions or to discover how CVP can help you get the most out of your assets.

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