

Financial Overview Report

Client Group: Gary's Furniture Pty Ltd

Date: March 2010

The Financial Overview Report provides analysis on financial performance for the last period and seeks to provide management with feedback regarding financial management of the business. Management should also consider addressing observations in this report when sharing financial information with their bank.

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The purpose of this report is to identify opportunities for clients to enhance their financial management of the business and to provide some understanding of banking process. Pearl makes no commitment with regard to the business having ability or otherwise to secure funding through this analysis. This report is not intended to be used in part of in full for the application of funding.

This report primarily focuses on the trends evident between the last 2 years of statutory financials.

1 Executive Summary

The following key observations are made:

- 1) Gary's Furniture is a profitable business with a sound business model
- 2) However the business is wasting cash, with increases in Account Receivable and Inventory requiring the bank to continually seek increases to current bank facilities.
- 3) Volume is detrimental to cash flow as the company needs more cash to fund the working capital cycle than the company generates in Gross Margin (GM% is 31% and WC% is 41%).
- 4) The requirement for bank support, and the consequential interest costs, could be significantly reduced through the implementation of tighter debt collection and inventory management processes. Without immediate action is it envisaged that Gary's Furniture's bank, who has been funding the increases in Accounts Receivable and Inventory, will not continue to support the business for this purpose.

2 Performance Analysis

	2007	2008	2009	YOY trend	Comments
P & L					
Revenue Growth %		11.11	20.00	●	Strong revenue growth
Gross Profit %	28.89	30.00	31.00	●	Increasing Margin
Operating Expenses %	20.76	19.29	20.00	▲	Expenses remaining flat
EBITDA	2,560,000	3,750,010	4,620,000	●	EBITDA strong
Profitability %	8.13	10.71	11.00	●	EBIT should ideally exceed 5% which it does
Effect Interest %	7.03	9.41	8.71	▲	
Net Profit %	3.67	4.73	4.96	●	Strong profitability
Working Capital					
Days Receivable	50.00	70.00	75.00	●	Negative trend - is this a process problem?
Days Inventory	148.03	154.00	180.00	●	Stock levels high - review obsolescence and appropriateness of buying processes
Days Payable	69.90	60.02	70.00	●	Opportunity to improve Gross profit by paying earlier for discount?
Working Capital %	28.92	37.20	41.34	●	Negative trend
Gross Profit % - Working Capital %	<u>-0.03</u>	<u>-7.20</u>	<u>-10.34</u>	●	Negative cashflow with volume being detrimental to cash
Asset Utilisation					
Activity	1.90	1.63	1.56	●	Flat
Results					
Net Cash after Operations \$		-1,091,510	-895,443	●	Negative cash position being funded by increased debt
Return on Net Assets %	15.41	17.42	17.2	●	Business should be aiming for >20%
Return on Equity %	19.74	22.04	21.74	●	Business should be aiming for >25%
Change in Net Debt		-3,258,560	-3,260,073	●	Negative Cash flow predominantly funding increased debtors and inventory
Debt to Equity	1.84	1.87	1.8	●	Acceptable (ie less than 2)
Bank Measures					
Current Ratio	2.21	1.88	1.79	●	Acceptable
Interest Cover	3.39	3.22	3.39	●	Acceptable
Equity / Total Assets	27.98	29.36	29.57	●	Appropriate level (ie >25%)

3 Marginal Cash



This chart depicts the production of cash as Gross Margin, less the cash required to fund the working capital of the business (Working Capital %) and the Operating Expenses (Operating Expenses %).

Where Working Capital % exceeds Gross Margin %, the working capital (Accounts Receivable, Inventory and Accounts Payable) takes more cash from the business than the business is producing. This is an indicator of negative cash flow and the business cannot fix this problem by increasing sales volume. Fundamental changes need to be made to either increase Gross margin or reduce the working capital requirements of the business.

Where Working Capital % + Operating Expense % exceed Gross Margin, and the cost structure of Operating Expenses is largely variable, then the business will also struggle to produce cash without change to the financial structuring of the business.

Gary's Furniture faces considerable cash problems currently, all due to the current working capital structure. Without immediate action to rectify this the business will lose the support of its bank, who is currently funding the cash shortfall.

4 The Power of One

Business management have available to them 7 key financial levers that can be used to improve the cash result of the business. The following table identifies the cash benefit to the business by making small change to these levers.

Lever	Action	Change to Cash Flow
Sales Volume Growth	Increase by 1%	- \$123,502
Price Change %	Increase by 1%	\$187,733
COGS %	Decrease by 1%	\$406,714
Operating Expense	Decrease by 1%	\$276,509
Accounts Receivable Days	Decrease by 1 Day	\$118,369
Inventory Days	Decrease by 1 Day	\$81,674
Accounts Payable Days	Increase by 1 Day	\$81,674

This demonstrates that management can make material improvement to cash performance with small changes. It is also evident that increasing sales volume alone will not improve the cash position of the business as sales volume growth actually makes the cash position of the business worse, not better.

5 Sustainable Growth Cycle



6 Glossary

Term	Description	Calculation
Revenue Growth %	Revenue increase / decrease from previous year as a percentage	$(\text{Current Period Annualized Revenue} - \text{Previous Period Annualized Revenue}) / \text{Previous Period Annualized Revenue} \times 100$
Gross Profit %	Gross Profit produced as a percentage of Revenue.	$\text{COGS} / \text{Revenue} \times 100$
Operating Expense %	Operating Expenses as a percentage of Revenue.	$\text{Operating Expenses} / \text{Revenue} \times 100$
EBITDA	Earnings before Interest, Tax, Depreciation and Amortisation. Often used by banks as a proxy for cash retained by the business from which debt servicing can be undertaken.	Gross Profit – Operating Expense (including Interest, Amortisation and Depreciation) - Tax
Profitability %	Earnings before Interest and Tax as a percentage of sales. Banks are ideally looking for a result >5%.	$\text{EBIT} / \text{Revenue} \times 100$
Effective Interest %	The interest rate applied to the average borrowings to produce the total interest expensed by the business.	$\text{Annualized Interest} / (\text{Previous Borrowed Funds} + \text{Current Borrowed Funds})/2 \times 100$
Net Profit %	Net profit (after tax) as a percentage of sales.	$\text{Net Profit} / \text{Revenue} \times 100$
Days Receivable	The average time taken by customers to pay debts owing to the business. Business should be continuously focusing on reducing this measure.	$\text{Accounts Receivable} / \text{Revenue} \times \text{Number of Days Current Period}$
Days Inventory	The average time that a stock item is held by the business before it is sold. Business should be continually focussing on reducing this measure.	$\text{Inventory} / \text{COGS} \times \text{Number of Days Current Period}$
Days Payable	The average time that it takes for the business to pay its trade creditors. Business should maximise their suppliers willingness to provide this form of funding for the business, but not at the expense of COGS – ie if the supplier is applying a margin to allow longer trading terms than this could be an expensing form of funding.	$\text{Accounts Payable} / \text{COGS} \times \text{Number of Days Current Period}$

Working Capital %	The working capital balances of the business as a percentage of Revenue. The percentage result can be used to understand the cents required by the balance sheet to fund working capital for every \$1 of sales. To produce cash the business should strive to reduce this.	$\frac{[(\text{Acc Receivable} + \text{Inventory} - \text{Acc Payable}) / \text{Revenue} \times 100] \times \text{Number of Days Current Period}}{365}$
Gross Profit % - Working Capital %	Shows the theoretical amount of cash left from operating and is used by banks as an indicator for cash shortage. If a business has a Gross Profit % of 25% and a working capital % of 35%, then for every \$1 of sales, the business retains 25c in Gross profit but needs 35c to fund the working capital in the balance sheet (receivables, inventory and payables). Hence in this instance the business is using 10c more than it produces, and is going backwards in cash.	Gross Profit % - Working Capital %
Asset Turnover	Asset Turnover measures the relationship between Net Operating Assets and Revenue. Asset Turnover is a critical measure of operating performance focusing on balance sheet efficiency.	Revenue/Net Operating Assets (see below)
Net Operating Assets	The Assets purchased using sources of Debt and Equity funding, less the external sources of funding being trade and other creditors.	Current Assets + Non Curr Assets - Current Liabs (Excluding Short Term Debt) - Non Curr Liabs (Excluding Long Term Debt)
Net Cash after Operations	The remaining cash of the business after trading, movements in current assets and liabilities and taxation. It is from this balance that a bank is then paid its interest dues and any principal reductions.	Tales into account payments to creditors and receipt from debtors, movement in inventory and payment of Taxation.
Return on Net Assets %	The return derived by management from the investment of Debt + Equity (ie all funding sources made available).	EBIT / Net Operating Assets x 100
Return on Equity %	The return produced as a percentage of the Equity provided. This measure does not take into account bank commitments other than interest.	Net Profit / Equity x 100

Change in Net Debt	A measure of cash flow. Positive cash flow results in debt reduction and negative cash flow results in increases in debt.	(Previous Short Term Debt + Previous Long Term Debt - Previous Cash at Bank) - (Current Short Term Debt + Current Long Term Debt - Current Cash at Bank)
Debt to Equity	How much Debt the business holds relative to the amount invested by shareholders. Banks do not like to lend more than twice as much as equity contributions.	(Short Term Debt + Long Term Debt) / Equity
Current Ratio	An indicator of business solvency, a business should, if required to do so, be able to liquidate all current assets to meet all of its current liabilities. Banks like to see an excess position and hence prefer a Current Ratio > 1.5x – ie Current Assets 1.5x current liabilities.	Current Assets / Current Liabs
Interest Cover	How many times will the business be able to pay its interest from EBIT produced? A bank seeks a minimum of 1.5x.	EBIT / Interest
Equity / Total Assets	Equity to Total Assets measures the contribution of owners/shareholders in the form of shareholder capital funds and retained earnings. This measure is an important Bank measure and is often known as Capital Adequacy and should not be less than 25%.	Equity/Total Assets x 100