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Rational Investing with Ratios

Implementing Ratios with Enterprise Value and Behavioral Finance

Yannick Coulon

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ISBN 978-3-030-34264-7 ISBN 978-3-030-34265-4 (eBook)
<https://doi.org/10.1007/978-3-030-34265-4>

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This Palgrave Pivot imprint is published by the registered company Springer Nature Switzerland AG.

The registered company address is: Gewerbestrasse 11, 6330 Cham, Switzerland

PREFACE

WHY DO YOU NEED THIS BOOK?

This book adds value to any discussion on the importance and implementation of ratios.

A financial ratio establishes a proportional relationship between accounting and market data. If a ratio is isolated and applied incorrectly, it is seen as a number without great significance. However, when well integrated into a global company vision, ratios become powerful indicators that can outline relevant information and identify warning signs. Ratios help us better understand business ventures, especially their strengths and weaknesses.

The purpose of this book goes beyond merely listing possible ratios; it aims to explain the concept and logic behind each key ratio. Didactics is key to this project, and each ratio family is illustrated with numerous graphs and practical cases. This information is therefore particularly useful for bankers, entrepreneurs, investors, managers, and obviously, students.

Ratios are applicable worldwide, and the book is not US or Europe centric; readers can come from international contexts and backgrounds.

RATIO QUALITY AND LIMITATIONS

Ratios help establish the financial diagnosis of a company, but they are limited by the quality and availability of key information. In other words, ratios will not turn lead into gold! As a result, the book puts emphasis on ratios incorporating market data, whenever they are available and reliable.

ACCURACY OR TREND

The absolute level and precision of a ratio is interesting. However, the trend observed is the most reliable and fundamental piece of information, as it demonstrates whether a situation is deteriorating, stabilizing or improving.

COMPARISONS HAVE LIMITATIONS

A comparison is not always appropriate but in the practice of finance, it is a fundamental step if well applied. It helps users to detect deviations from the past or deviations from competing companies within the same sector.

RATIOS ARE A BEGINNING, NOT AN END UNTO THEMSELVES

A financial diagnosis is only one aspect of a global company analysis. Its strategic positioning, competitive advantages, corporate sustainability and human capital add value to the financial vision.

RATIOS ARE NUMEROUS

The list of ratios mentioned in the book is not exhaustive or academic. The inclusion of countless ratios does not allow for a concise and coherent financial analysis, and therefore the book retains the ones that are considered relevant, essential and complementary.

RATIOS FOR FAMILY BUSINESSES AND CORPORATIONS

Many simple and more challenging educational cases are used for illustrating each ratio family. The ratios will differ depending on the given context, such as a family business or a listed company. These complementary visions are outlined.

ENTERPRISE VALUE (EV)

Much attention is given to the concept of enterprise value, and the reader will find a detailed description of enterprise value in the first section. Numerous ratios illustrate the importance of this reference value for debt,

economic performance and valuation. The concepts of capital employed, non-core assets or surplus cash are also addressed, given that they play a key role in EV calculation. Very few current textbooks treat these metrics in such great detail.

A TOUCH OF BEHAVIORAL FINANCE

Ratios become useless if the financial decision is emotional or irrational, and thus this book addresses a few aspects of behavioral finance. The principles of an investment thesis are outlined.

THE NARRATIVE THREAD

The book starts with a short review of financial statements and cash flows (see Sects. 1.1 and 1.2). However, the goal is not to lecture on accounting principles, as there are already numerous books of high-quality that cover this topic on the market.

The emphasis is then placed on operating assets, capital employed and enterprise value (see Sect. 1.3). These are essential metrics that will be extensively used in Chaps. 5 and 6.

The core of this book is found in Chaps. 2, 3, 4, and 5, which deal with ratios in the following order:

- Efficiency, liquidity and solvency ratios are outlined first since poor cash management will be rapidly fatal for a company (see Chaps. 2 and 3).
- Debt and profitability ratios follow suit in Chaps. 4 and 5 with a clear divide between non-listed (i.e., accounting ratios) and listed companies (i.e., market-related ratios).
- Chapter 6 brings the full set of ratios into perspective with two case studies: One case deals with a small private company, and the other deals with three giant retail companies, namely Alibaba, Amazon and Walmart.

Chapter 7 starts with a discussion on the benefits of using an investment thesis. This disciplined and rational approach can be an efficient tool to combat behavioral biases. Possible investment theses for Alibaba, Amazon and Walmart are presented thereafter. The key behavioral biases are then introduced and conclude the chapter.

Some of the contents are straightforward, while some are more complex and concise. In any case, the book aims to be informative, practical and clear, rather than to pursue an academic dimension. The book concentrates on the essential, and it strives to make complex equations understandable.

Please enjoy the book, and do not hesitate to send feedback.

Brest, Brittany, France

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ACKNOWLEDGMENTS

A special thank you goes to Tula Weis, Senior Editor and Lucy Kidwell, Assistant Editor at Palgrave Macmillan and G. Nirmal Kumar from SPI Global for their active support.

Thank you to Sarah W. PhD from Cambridge Proofreading LLC and Elaine L. from Scribbr for improving my English writing style.

I salute my former colleagues at Iomega Corp, Srinivasa Nageswar, Joël Broc and my former colleagues at UBS Global Asset Management, Martin Thommen, Olivier Groeflin, Steffen Glos for the great years we have had together and from whom I had learned so much. Un grand merci à Monsieur Stéphane Derville de Maxima mais aussi à Messieurs Dai Shen, Luc Pontet, Gurvan Branellec et Jean Moussavou de BBS. Je salue aussi mes deux enfants, Samantha et Fabian.

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