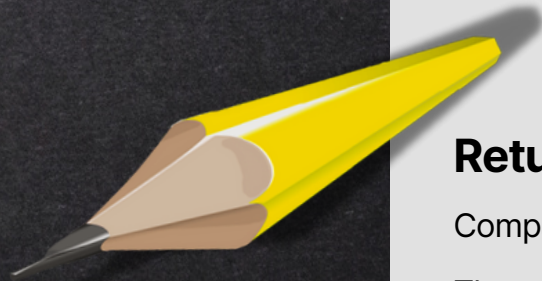


Return on investment (ROI) =

$$\frac{\text{net profit}}{\text{cost of investment}} \times 100$$



$$\frac{(\$60,000 \times 10) - \$300,000}{\$300,000} \times 100$$

= 100%

What is it?

Return on investment (ROI) measures the **amount of return on an investment relative to the investment's cost**.

Why measure it?

ROI is a popular metric because of its versatility and simplicity.

ROI can be measured on share investment, business investment, marketing and so on. Investors can weigh different investments' ROI's and decide which ones to invest in.

ROI shouldn't be the only factor for deciding best investment. You should look at length of time each investment takes, risks, social and other effects as well.

Return on investment (ROI) in practice

Company 'A' wants to replace a machine with a new one that will improve efficiency.

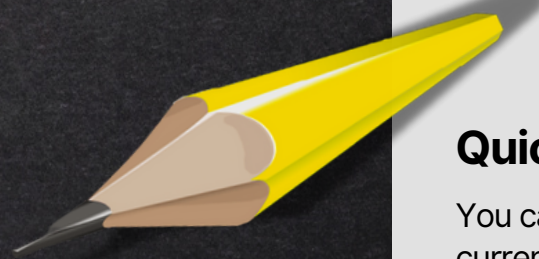
The estimated cost of replacement is \$300,000. Improved efficiency will save \$60,000 per year. Estimated life of this machine is 10 years.

ROI is 100% in this case.



Quick ratio / acid-test ratio =

$$\frac{\text{liquid current assets (cash + accounts receivable + short term investment)}}{\text{current liabilities}}$$



$$\frac{\$70,000 + \$100,000 + \$160,000 + \$35,000 + \$20,000 + \$10,000}{\$200,000} = 1.65$$

What is it?

Quick ratio **measures the ability to meet short term financial obligations with assets that can be quickly converted into cash.** This ratio provides a more conservative assessment of liquidity than current ratio, as it ignores illiquid assets such as inventory.

Why measure it?

Quick ratio shows if your company is able to meet current financial liabilities. Using this ratio you can see how dependent your current ratio is on the illiquid assets such as inventory.

The lower your quick ratio is compared to current ratio, the more dependent you are on inventory. But like current ratio, there are some industries that just rely more on inventories than the others.

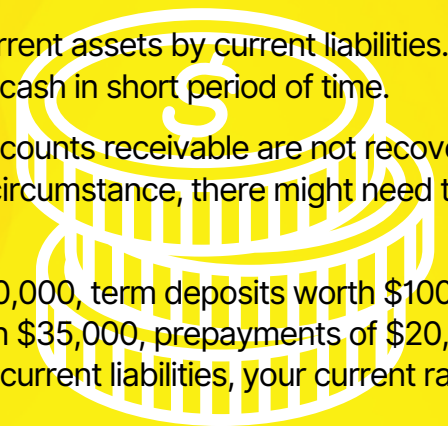
Generally, lenders recommend >1 for quick ratio.

Quick ratio / acid-test ratio in practice

You can calculate quick ratio by dividing liquid current assets by current liabilities. Liquid current assets are assets that can be turned into cash in short period of time.

In some industries such as construction, some accounts receivable are not recoverable for a long time - until project is complete. In that circumstance, there might need to be adjustments to calculation of quick ratio.

Assuming you had current assets of - cash of \$70,000, term deposits worth \$100,000, accounts receivable of \$160,000, inventory worth \$35,000, prepayments of \$20,000, deferred tax assets of \$10,000 and \$200,000 as current liabilities, your current ratio is 1.98 and your quick ratio is 1.65.



Debt service coverage ratio (DSCR) =

$$\frac{\text{EBITDA (net income + taxes, interest + depreciation + amortisation)}}{\text{annual debt payments}}$$

$$\frac{\$140,000 + \$60,000 + \$20,000 + \$40,000 + \$5,000}{\$150,000} = 1.77$$

What is it?

Debt service coverage ratio (DSCR) **compares a business's level of cash flow to its debt obligations**. It indicates how many times you can pay your required debt payments in a year.

Why measure it?

DSCR is one of the most important metrics when it comes to getting a business loan because it shows if your business can pay back the loan in full or not.

In this ratio, lenders look for a minimum DSCR of 1.0 and an increasing trend, especially if the DSCR is low. Obviously, the higher the ratio the better as it warrants if your business slows down or loses some clients, you can still pay the debts.

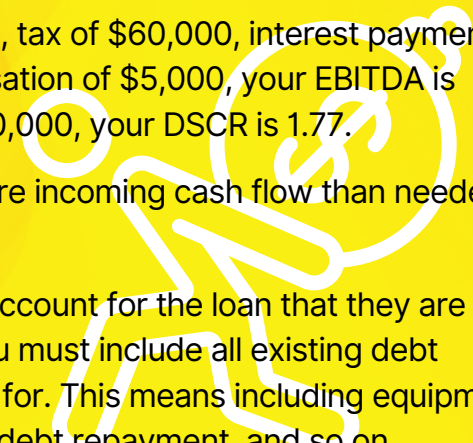
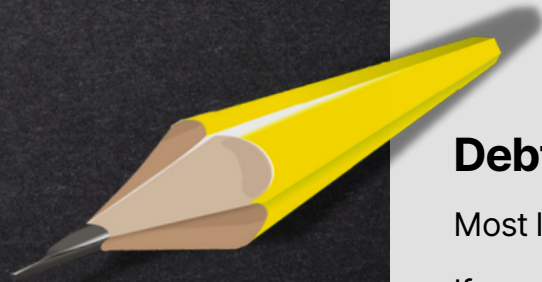
Debt service coverage ratio (DSCR) in practice

Most lenders calculate DSCR by dividing EBITDA by annual debt payments.

If your business had a net income of \$140,000, tax of \$60,000, interest payments of \$20,000, depreciation of \$40,000 and amortisation of \$5,000, your EBITDA is \$265,000. If your annual debt payment is \$150,000, your DSCR is 1.77.

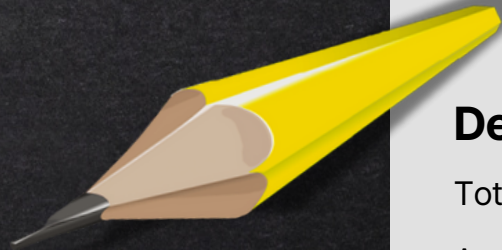
DSCR of 1.77 means the business has 77% more incoming cash flow than needed to cover debt payments each year.

One of the most common mistakes is to only account for the loan that they are applying for. For DSCR calculation to work, you must include all existing debt payments as well as the loan you are applying for. This means including equipment leasing, business credit card repayment, ATO debt repayment, and so on.



Debt to equity ratio (D/E) =

$$\frac{\text{total liabilities}}{\text{total equity}}$$



$$\frac{\$200,000 + \$1,200,000}{\$2,400,000} = 0.58$$

What is it?

Debt to equity ratio (D/E) **compares a company's total debt to total equity, representing percentage of company financing that comes from creditors and investors.** Higher ratio implies more creditor financing used than investor financing.

Why measure it?

Debt to equity ratio is a simple yet effective way of seeing how a business is funding its assets. Lenders and investors check this ratio to assess financial risk of an organisation. High ratio increases the likelihood that the business defaults and is liquidated as a result. It also means that investors don't have as much skin in the game as the creditors do and could suggest the investors don't want to fund the business operations because it isn't performing well.

Lenders generally look for a maximum ratio of 1, meaning that investors and creditors have an equal stake in the business assets.

Debt to equity ratio (D/E) in practice

Total liabilities divided by total equity gives you debt to equity ratio.

Assume a company has \$200,000 lines of credit and a \$1,200,000 mortgage on its property. Shareholders of the company have invested \$2,400,000. Debt to equity ratio is 0.58.

