BOOST YOUR FINANCIAL PERFORMANCE ANALYSIS AND LOOK BEYOND THE COVID-19 CRISIS

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INTRODUCTION

Small and medium-sized enterprises (SMEs) have always faced particular challenges because of their size: competition, cash flow management, credit control, financing, the need to adapt to fluctuating market demand and technological change, capacity constraints, etc. But these challenges have intensified with the global Covid-19 crisis, impacting all economies and businesses in the world.

This ebook offers insights and concrete suggestions to SMEs on how to use financial performance analysis to face the challenges and opportunities that lie ahead.

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#ANALYSE² PERFORM

1 WHY ANALYSE FINANCIAL PERFORMANCE

Analysing financial performance is like performing maintenance on your car: it enables you to catch problems before they happen, and make sure everything is in good working order.

THE REASONS WHY YOU SHOULD ANALYSE FINANCIAL PERFORMANCE

Analysing financial performance means measuring your company's overall financial health over a given period of time – its earning capacity, profitability, operational efficiency and solvency position. This allows you to compare it to similar companies across the same industry and to take informed decisions for your company's growth.

Staying on top of your financial affairs is especially important in today's Covid-induced climate of rapid change and uncertainty.

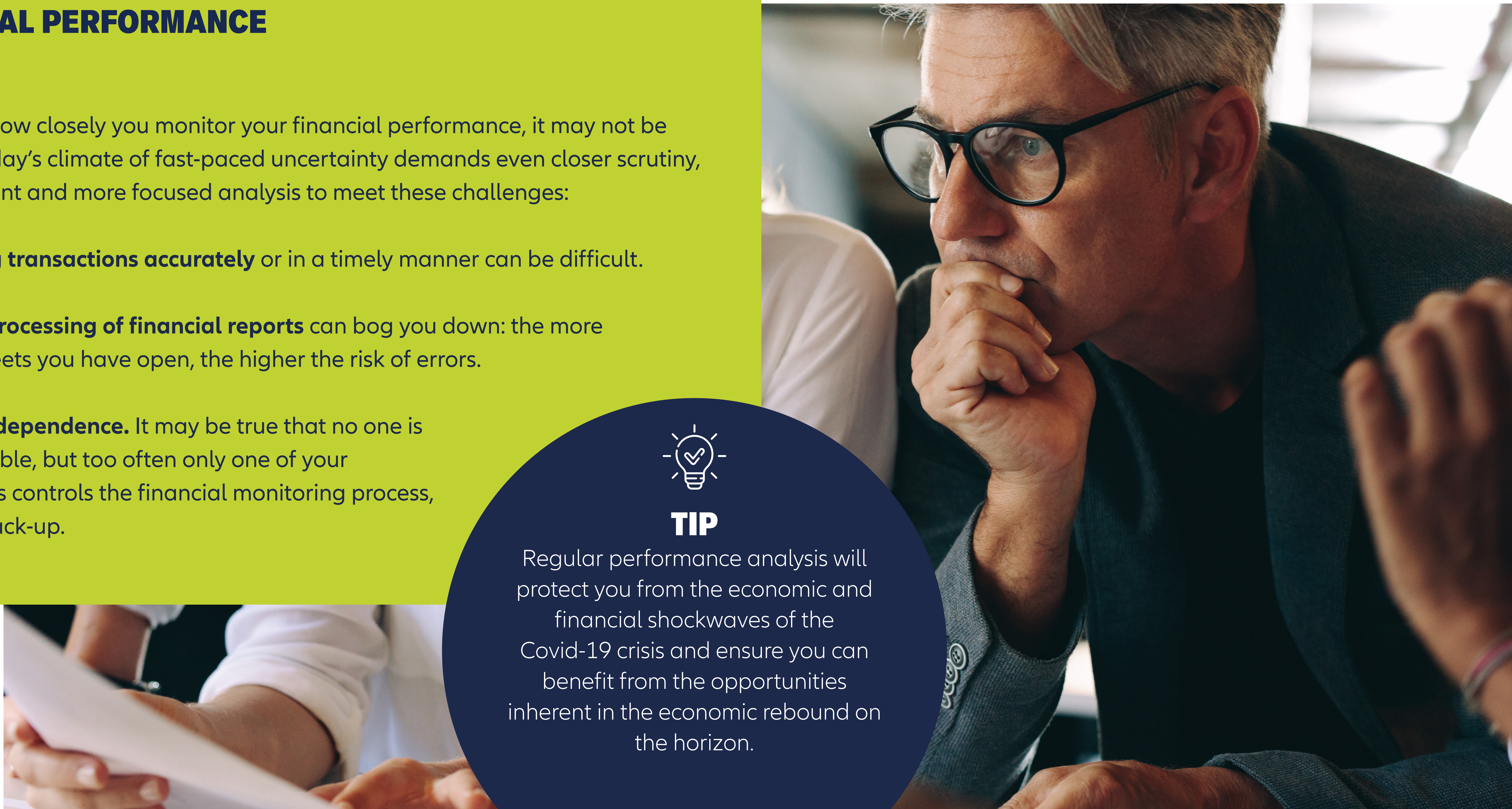
Dynamic financial monitoring – meaning done on a regular basis – can for example help you identify:

- **Payment delays,** which can adversely affect your cash flow.
- An unexpected **increase in demand on your working capital.**
- **Changes in cash flow** that could impact your operating plans.

THE MAIN DIFFICULTIES SMEs FACE WHEN ANALYSING FINANCIAL PERFORMANCE

No matter how closely you monitor your financial performance, it may not be enough. Today's climate of fast-paced uncertainty demands even closer scrutiny, more frequent and more focused analysis to meet these challenges:

- **Recording transactions accurately** or in a timely manner can be difficult.
- **Manual processing of financial reports** can bog you down: the more spreadsheets you have open, the higher the risk of errors.
- **Key man dependence.** It may be true that no one is irreplaceable, but too often only one of your employees controls the financial monitoring process, with no back-up.



TIP

Regular performance analysis will protect you from the economic and financial shockwaves of the Covid-19 crisis and ensure you can benefit from the opportunities inherent in the economic rebound on the horizon.

2 CHOOSING AND USING THE RELEVANT FINANCIAL PERFORMANCE RATIOS FOR YOUR BUSINESS

Financial performance ratios are an important way to establish a company's liquidity, leverage, growth, margins, profitability, rates of return, valuation, etc.

THE KEY FINANCIAL KPIs

Here are some key financial KPIs that can be useful to gain insight into your cash, profit and debt positions:

- **Revenue** is the income received from normal business operations and other business activities, such as sales.
- **EBITDA** (Earnings Before Interest, Taxes, Depreciation, and Amortisation) is a measure of a company's overall business profitability, showing earnings before accounting and financial deductions.
- **Gross profit margin** is the amount of revenue that remains after deducting the cost of sales.
- **Net profit margin** is the ratio showing how much of each euro in revenue collected by a company translates into profit.
- **Working capital** is the amount of liquid net assets available to fund your company's day-to-day operations, derived from the difference between your company's current assets (cash, accounts receivable, inventories) and its current liabilities, such as accounts payable.
- **Free cash flow** shows how much money a company is able to generate after paying for operations (salaries, supplies, etc...) but also its capital investments.
- **Leverage** is the amount of your company's debt being used to buy assets.

GET A SIMULATION OF YOUR BUSINESS LIQUIDITY

The Euler Hermes liquidity business calculator allows you to simulate your business liquidity and calculate how it may be influenced by external factors such as a drop in sales, payments delays, etc. Try it now!

TIP

Don't forget the Working Capital Requirement (WCR). It is a measure of the amount of liquidity that is trapped in the business at any time simply to maintain operations.

TIP

Create a cash flow statement and make projections. You'll be able to conduct a sound cash flow analysis and have a much greater awareness of likely opportunities and potential threats. Tracking your cash flow is essential to keep your business safe.

HOW TO COLLECT THE RELEVANT DATA FOR YOUR BUSINESS

Collecting relevant business data is a team effort. This data should be readily available and regularly analysed.

1. **Schedule regular reports** from your teams; not just operations but sales and marketing as well.
2. **Centralise the data** in one single file and make it easily accessible - for example, in the cloud or on a desktop digital dashboard.
3. **Analyse this data** to gauge past performance and make future predictions.

TIP

In an uncertain global economic environment, accounts receivable can represent more than a third of total business assets. Clear, concise timely intelligence improves control over accounts receivable portfolios to maximise opportunities. A variety of readily-available tools exist to facilitate data-collection.

3 ANALYSING FINANCIAL PERFORMANCE DEPENDING ON YOUR OBJECTIVES

All financial analysis is not created equal. You can adapt your monitoring to focus on your business objectives. Here are some examples.

OBJECTIVE A: OPTIMISE YOUR BUSINESS STRATEGY

You may have changed your business strategy as a result of the pandemic. Now how do you ensure your strategy keeps up with the events? By performing dynamic financial analysis on a regular basis:

- **Daily:** to manage cash flow and expenses. Remember: cash is king.
- **Monthly:** to evaluate performance and adjust targets for the immediate future.
- **Quarterly:** to evaluate seasonal performance and compare this to the same period a year ago.
- **Semi-annually:** to track and adjust longer-term performance and adjust KPIs as needed.
- **Annually:** to understand what changed since you set the year's goals, and why.

There are also extraordinary moments in the life of your company that require additional review:

- Creating internal growth, such as introducing new products, or adding new team members
- Creating external growth, such as buying a business or opening a new office.
- Seizing opportunities during an upturn in business, such as increased demand for your products or an acquisition that's too good to miss.

Judging risks associated with running your business can be difficult, and involves more than just generating numbers.

These are some of the performance indicators that can help you build for the future:

1. **Gross profit margin –** the amount of revenue that remains after deducting the cost of sales.
2. **Working capital -** the amount of liquid net assets available to fund your company's day-to-day operations.
3. **Current ratio -** determines whether your company has enough current assets to cover its current liabilities.
4. **Leverage -** shows how much of your debt is being used to buy assets.
5. **Return on equity -** analyses how effectively equity earns profits for investors.

OBJECTIVE B: MANAGE YOUR COMPANY AND ACHIEVE YOUR GOALS

Ongoing financial performance analysis helps you understand how your company should operate and compete in order to achieve your goals and objectives. It's a continual process:

- **Establish goals:** what do you want to achieve and in what time frame?
- **Create metrics to achieve your goals:** how will you measure your progress along the way?
- **Execute according to your metrics:** which of your company's resources must be deployed?
- **Analyse the figures:** what happened, why, and how can it be improved (or, in the case of a misstep, prevented)?

OBJECTIVE C: GROW YOUR COMPANY AND SEARCH FOR FINANCING

The Covid-19 vaccine is expected to supercharge global growth in H2 2021, with recovery anticipated by 2022.
Being optimistic about opportunities for business expansion can give you the extra energy you need to make it work, but double-check your ability to finance it.

- **Self-financing** can hamper your cash flow and limit your independence.
- **Banks are becoming less willing to lend money to SMEs** since recent regulatory changes have increased funding costs.
- Non-banking funding sources, such as **private and institutional investors**, are a growing option.
- **You need to be persuasive.** Prepare a detailed, transparent financial plan summarising your company's financial needs, resources, investments, and debt position.
- **Remember:** trade credit insurance can be leveraged to obtain funding facilities from banks.

GOOD TO KNOW

Our estimates show that bank financing currently makes up around 70% of external financing in for SMEs in Europe, 40% in the US.
Finance long-term needs with long-term resources, but keep in mind that eventually interest rates will rise!

FOCUS: FINANCIAL PERFORMANCE ANALYSIS IN 3 PARTICULAR MOMENTS IN THE LIFE OF A COMPANY

1. DECIDING TO EXPAND YOUR BUSINESS NEW OFFERING OR NEW MARKET

Every crisis creates opportunities, and the current health crisis is no exception. Consumer habits and business practices have changed dramatically in the past year, and for some companies the moment is right for expansion.

There are several key questions to ask yourself to determine how expansion will affect your future financial performance:

- What strategic objective will this expansion achieve?
- What is the cost of this expansion?
- What resources does it need in terms of finance, staff and production capabilities?
- How much more debt can your balance sheet carry?
- How much control do you want? The higher your leverage, the less control you have.

2. TAKING OVER A BUSINESS

An acquisition can be a quick way to expand, but is it really a good idea?
Ask yourself:

- What will this company do for me? Increase my market share? Cut costs by increased synergies? What are those synergies?
- How will this acquisition increase my sales and profits?
- How will I pay for this acquisition? What debt am I incurring? How will my own leverage increase? How much debt does the other company have?
- How difficult will integration be? Remember: this process can take more time to incorporate than you plan for, and this will put pressure on your working capital.

GOOD TO KNOW

Any increase in debt should be analysed **in relation to your company's present and future cash flow.** Even if your cash conversion cycle is the same, expansion adds more costs and puts more demands on your working capital. If you're selling 100 items now and want to sell 150 items, you need to increase your credit line by 50%.

FOCUS: FINANCIAL PERFORMANCE ANALYSIS IN 3 PARTICULAR MOMENTS IN THE LIFE OF A COMPANY

3. HOW TO PICK THE RIGHT BUSINESS PARTNERS AND CUSTOMERS THROUGH FINANCIAL PERFORMANCE ANALYSIS

You can only be as good as your counterparts: if they have difficulty paying, so will you. Some of the information listed below is publicly available online; a professional risk assessor can help obtain the rest. This is the information you'll want to review:

- **The financial situation:** operating cash flow and debt-to-income ratio, compared to their industry's average, will indicate their solvency in the short and medium term. Businesses with significantly weakened balance sheets and poor cash flows are a red flag.
- **The size:** a small company can be more risky and costly to manage in relation to the volume of business.
- **The reputation:** their bank, their business practices, and the background of the company's top managers.
- **The sector:** a solid partner will be aligned in terms of finances and performance with other companies in the same business. However, sector information can be difficult to collect and to analyse. network Check our global sector reports for insights and do not hesitate to get in touch with our local experts.

SIGNS OF CORPORATE DISTRESS:*

- Declining turnover,
- Weakened profitability,
- Declining capitalisation,
- Insufficient interest coverage ratio (can the company pay the interest on its debt?)

*(for European SMEs and MidCaps, according to a 2019 Euler Hermes study)

4 PREPARE FOR THE EMERGING OPPORTUNITIES LINKED TO BUSINESS MONITORING

Business monitoring is more complicated than it used to be. Your customers, investors and regulators want to know how you're behaving as a corporate citizen in addition to your bottom line. Fortunately, data and the tools to manage it can help you incorporate these new requirements for your performance analysis. Here's what you need to navigate.

HOW DIGITALISATION CAN HELP ANALYSE YOUR FINANCIAL PERFORMANCE

Digitalisation can provide 360-degree visibility with real-time "predictive prevention" assessments and help inform your decisions. Big Data, analytics, Robotic Process Automation (RPA), Artificial Intelligence (AI) virtual assistants all are useful tools with which to valorise data. They can help you:

- **Improve** the efficiency, consistency, and quality of your process.
- **Integrate** records and files into a digitalised form, eliminating duplication and redundancy.
- **Facilitate** information-sharing.

For example, you can use technology to put your company's KPIs at your fingertips:

- **Create an accounting dashboard** and set it to warn you when your top indicators exceed trigger levels.
- **Stay focused on your financial performance** in real-time to help you ward off impending problems and seize future opportunities, such as making an acquisition.

In addition, open digital systems can help you to collect and share non-financial data, such as ESG reporting – increasingly demanded by regulators, stakeholders and the general public.

TIP

Beware when presenting extra-financial information:

- Results linked to ESG matters should be traceable back your KPIs.
- Make sure your own governance in practice matches what your ESG report says in theory.

GOOD TO KNOW:

In June of 2020, we created our own ESG rating to gather Environmental, Social and Good Governance criteria to help the companies we serve analyse and evaluate the sustainable development and long-term issues deployed in their strategy.

INCORPORATING EXTRA-FINANCIAL DATA IN YOUR REPORTING

ESG covers Environmental, Social and Governance matters that can have an impact on your company's performance:

- **Environmental criteria** can include CO2 and greenhouse gas emissions, waste recycling, electricity consumption, environmental risk prevention, etc.
- **Social criteria** can include the quality of social dialogue within companies, the employment of disabled people, employee training, etc.
- **Governance criteria** can include the transparency of executive compensation, the fight against corruption, the number of women on boards of directors, etc.

ESG issues were not thought of before but they're now key considerations. Any company that doesn't take these into account is exposing itself to fail in the next ten years.

CONCLUSION: WHY THE CURRENT SITUATION MAKES FINANCIAL ANALYSIS EVEN MORE IMPORTANT

The Covid-19 crisis has introduced unexpected and unprecedented change on a daily basis everywhere in the world. And it's not over yet.

There is no guarantee that additional government measures to contain the virus won't be necessary in months to come. That could further restrict business activities and short-circuit the economic upturn anticipated this year.

Regular financial analysis provides insights and prepares you to guide your company through this landscape. It also helps you to anticipate and handle **one of the most common problems facing SMEs: late payments** – particularly problematic in the current context.

In some countries, state aid has allowed companies to momentarily maintain liquidity and avoid bankruptcy. As a result, when support measures end, many companies could face insolvency – including your partners. And they may not be able to pay their bills despite the economic upturn anticipated this year.

This can set off a domino effect that results in a string of bankruptcies throughout your business ecosystem.

In addition to keeping an eye on your company's finances with rigorous financial monitoring, you can further insulate yourself from this domino effect with **trade credit insurance.**

Trade credit insurers don't simply levy premiums and pay claims when debts turn bad. The end-to-end service offered by market-leading insurers, such as Euler Hermes, includes the services mentioned above (debt recovery and legal support).

Trade credit insurance compensates your company in the event of a bad debt and helps you avoid bad debt in the first place by providing comprehensive insight about the constantly changing risk environment, enabling you to identify vulnerable customers, de-risk your supply chains and protect your business from insolvencies

We hope you found this ebook useful.
Remember that Euler Hermes can advise you and help you make better-informed trade decisions.

Visit eulerhermes.ch to contact us or get more information.

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