

The Value of Financial Ratios in the Retail Industry in Evaluating Financial Strength

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ABSTRACT

This study looks at two categories of retailers to find differences in averages in financial ratios. The first group of retailers has adopted a successful online model that allows consumers to purchase products through websites. The other group of retailers utilizes a traditional brick and mortar model. There's a comparison between the two groups, with averages calculated to determine which ratios are most valuable to retailers in understanding risk of financial distress and bankruptcy. Operating profit margin, ROE, ROC, cash ratio, and quick ratio are the key ratios.

INTRODUCTION

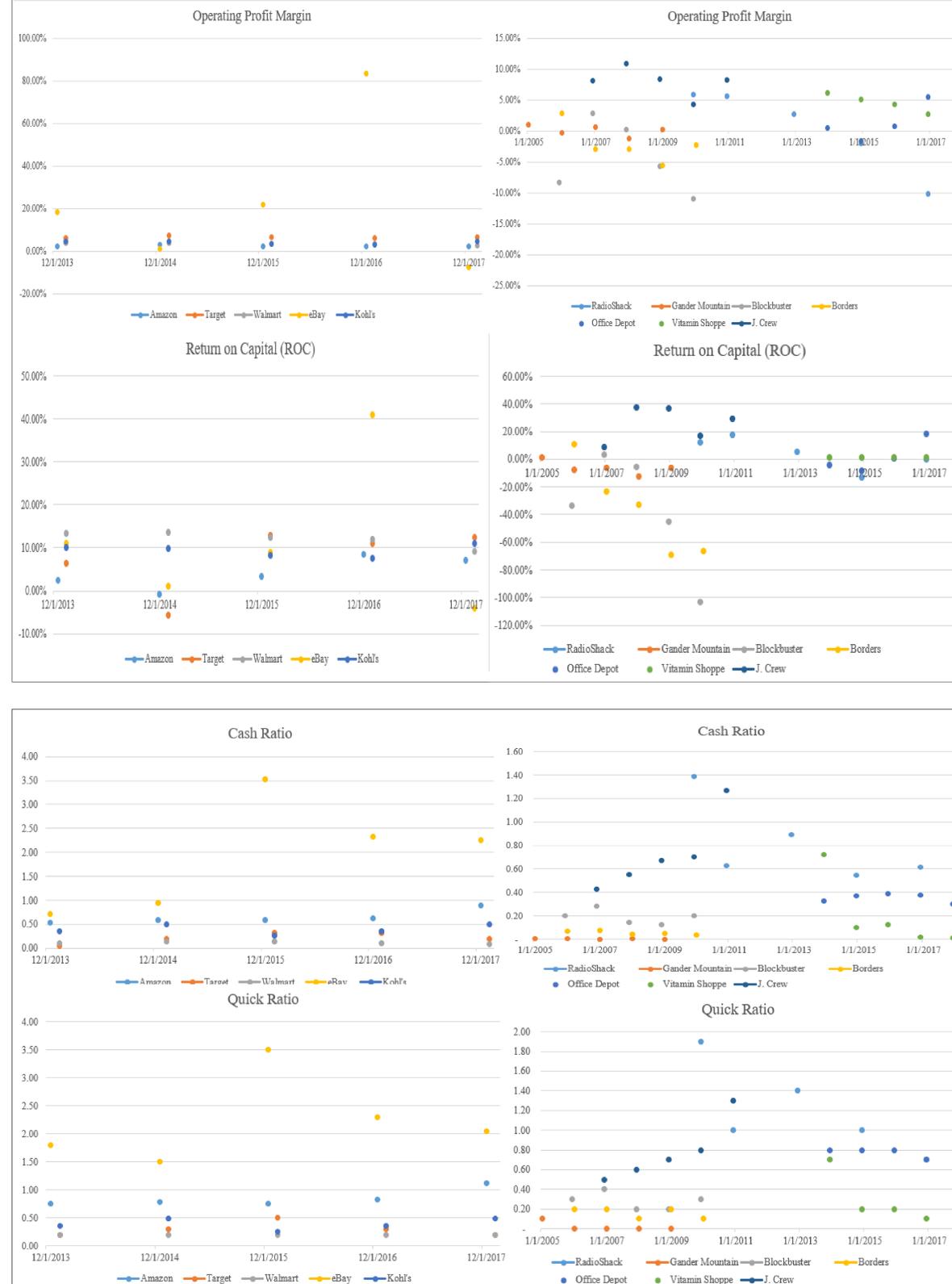
This study analyzes sixteen financial ratios in profitability, efficiency, leverage, and liquidity for five dominant online retailers and seven financially distressed retailers. Five years of data is collected for each company, allowing for trends to be understood and noted.

This project examines the question: which financial ratios are the strongest indicators of bankruptcy, when comparing dominant online retailers to brick and mortar retailers?

METHODOLOGY

Financial ratios were collected for five retailers that have adopted a successful online selling platform and seven bankruptcy-protected retailers. Five years of data for each company was collected from financial statements from Yahoo Finance, The Wall Street Journal, Nasdaq.com and Morningstar.com. All companies in the study were or currently are publicly traded. The five retailers that have adopted successful websites include: Amazon, Target, Walmart, eBay, and Kohl's. Since all five e-commerce giants have successfully adopted an online model, every company is still in business in 2019 and growing in total revenue, resulting in recent data being available to analyze. The seven bankruptcy-protected companies analyzed include: RadioShack, Gander Mountain, Blockbuster, Borders, Office Depot, Vitamin Shoppe, and J. Crew. Each one of these companies carried debt and was extremely leveraged. Data for both groups was collected from the most recent available records.

RESULTS



CONCLUSIONS

The profitability measures proved to be effective indicators of financial distress, as the successful brick and click retailers averaged an 8% operating profit margin, whereas the brick and mortar retailers averaged a 0.04% operating profit margin. Operating profit margin measures how much profit a company makes on a dollar of sales. Return on equity and return on capital also proved to have large differences in averages, as the differences for the two groups for ROE reached 8.2%. The differences in averages for ROC was 15.4%. This signifies that the online retailers are much more profitable and generate larger earnings relative to expenses. With such large differences in mean, retailers should value completing these ratios to understand financial strength.

Both the cash and quick ratios have large disparities in averages. The cash ratio, measuring the company's ability to use its most liquid assets to cover its current liabilities, has a difference of 0.33 between the two groups. The quick ratio is similar to the cash ratio in that it measures the ability of a firm to cover its current liabilities. However, it includes accounts receivable in the calculation. When comparing the two groups, the difference in quick ratios averages 0.3. This signifies that firms that are able to more effectively cover their current liabilities have stronger financial posture.

The financial ratios that are the strongest indicators of bankruptcy are profitability and liquidity measures, which include: operating profit margin, return on equity, return on cash, cash ratio, and quick ratio. Retailers can use this information to focus on these key performance metrics. Although understanding a company's financial strength includes a complete analysis of all financial ratios, the biggest differentiators of successful vs. bankrupt retailers were found.

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