

Key ratios

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Why key ratios?

Introduction

Key ratios are used to improve and simplify the analysis and evaluation of a company's business. A key ratio is to be seen as one of many yardsticks of the company. It enables one looking through the financial information to easily get an opinion on the company's status. Key ratios are to be looked upon as a *complement* not a substitute for other financial and non-financial information. In the next sections I will point out the importance of using key ratios in financial reporting and especially describe the ones used in our business: property management.

The role of key ratios

Financial reports include a lot of numerical information in terms of income statement, balance sheet, notes, etc. This information doesn't really tell much about a company's capacity. The result has been affected by appropriations, which in itself isn't a measure of good performance or consumption. Also, an absolute figure doesn't give you an opinion without being set in relation to other figures. This relation can give you a clue as to how well or bad the company's doing. Key ratios are used for internal control and comparison as well as external benchmarks. Key ratios are one of the most important tools when comparing different companies within the same line of business. Important business partners, such as credit-giving banks, use key ratios when evaluating which company to give credit. Suppliers also want to know the risk of a company not being able to pay its bills and so on.

Key ratios in operative management

Operative management – the property

In the operative business in property management we use key ratios on different operative levels. The lowest common denominator is the property. Its income and costs over time tell us the development on this specific property. In relation to other properties it doesn't tell us much. Are we efficient enough in our management of this specific property? The key ratio *sek/m²* or

euro/m2 is commonly used in property management and enables a comparison between two or more properties no matter how large or small they are. Below is a review and a brief discussion of various income and costs included in a property's operating result.

Residential income related to the property's residential area presented in *euro/m2* give us a sense of the rent level in the Municipal Housing Corporation as well as how good we are in charging rent based on utility value whenever measures are taken to raise the standard. *Commercial income* related to the property's commercial area presented in *euro/m2* describes the status of the commercial area, an area in the basement or a premium-level shopping area. The *level of vacancy* or even better, the *level of occupancy* is another key ratio related to the company's income. A level of occupancy of 100% means no vacancies and therefore no losses in terms of vacancy rent. You can distinguish between a level of occupancy related to *area* or an *economical level of occupancy*. The latter is more useful as it describes the loss in percent of income whenever a vacancy occurs. Any vacant area doesn't have the same income value and therefore is a bit misleading to use when comparing.

The key *euro/m2* ratio is used for all types of income and costs. When comparing the cost of water, heating and electricity you also want to know the *consumption/m2* and *cost/consumption*. In this case, it's not enough to simply present the key ratio of cost but you also need to present the consumption statistics. Consumption can be presented in kWh or m³ depending on the type of cost. Does the cost depend on high or low rates and/or high or low consumption? The suppliers act more or less under monopoly, which gives you little room for negotiating the price. That leaves us the only option of affecting consumption. High costs and negative effect on the environment is a result of high consumption. Therefore everyone benefits from efficient management of keeping consumption at a low level.

You can distinguish between two types of maintenance: *running maintenance* which can be emergency in nature, and *planned maintenance*. A combination of extensive knowledge of the property's status (continuity in management) as well as technically well built, well planned maintenance provides a good basis for preventing unexpected surprises in terms of high running maintenance costs. Planned maintenance which besides annual changes of white goods, etc., also includes changes of windows, renovation of roof and balconies. The latter type of maintenance isn't performed annually but is carried out in accordance with the property's technical life cycle. The cost/m² for planned maintenance can therefore fluctuate over the years.

The costs of *lease-bound maintenance* are also allowed to fluctuate over the years. The company's costs to renovate premises are affected by the conditions of tenancy and duration of the contracts. Whilst expenses arise when housing tenants move, they remain more stable and even-keeled over a period of years. This latter cost can also be measured by the key ratios *cost per tenant movement* and *the turnover rate in tenant movements (%)*. The latter is the total number of movements among the tenants during a period divided by the total amount of apartments a property holds.

Operative management – portfolio of properties

In property management on an operating level, which has been described in the previous sections, key ratios such as cost/m² and consumption/m² are simple and useful tools to compare different properties. Doing so makes it possible to find where to apply improvement and efficiency efforts. Key ratios that are useful on a more aggregated level with a portfolio of properties, in a city or a whole region for instance, are *rate of operating surplus* and *direct yield*. These key ratios can, of course, also be used for a specific property. The rate of operating surplus is measured in percent (%) and tells us the surplus out of every euro that is put in the company, ie, the operating surplus divided by the total income. A rate of operating surplus > 50% is desirable. Direct yield measures the property's operating surplus by the market value. If the property shows a low direct yield, this may due to:

1. Low operating surplus due to relatively high costs
2. High market valuation due to a “boom” in the real-estate market with great demand
3. A combination of 1 and 2

The above is meant to demonstrate how important it is not to depend on only a single key ratio, but a combination of key ratios when evaluating the efficiency of a company's management. Where a property is situated and the attractiveness of the city itself is reflected in the market value. This means that the value isn't only affected by the property's operating income and costs, but also by the market situation. This can be shown via the *market value/m²*.

Direct yield is a wide spread and useful key ratio and can be measured on different levels of results and compared to book value as well as market value. In conjunction with acquisition, the price is set by a desired direct yield. A higher direct yield is required when buying properties in less attractive cities, which reflects the higher risk. The same is required when buying a

commercial property, which is more volatile, ie, more sensitive to market changes than a housing property. When it comes to project management, direct yield is also used when deciding whether to start the project or not. The expected rise in income and/or reduction in costs due to the project is compared with the cost of the investment.

Key ratios - company level

The level of direct yield is decided by the top management and reflects the owner(s) willingness to engage in risk, the company's borrowing requirement and overall financial situation. The actual and expected rate of interest is affected not only by the financial strategy of the company but in large part by developments on the financial markets around the world.

Measure of solvency

Solvency is about the company's financial strength. It shows how well the company can handle temporary setbacks or losses many years in a row. The company's equity is negatively affected by losses. A commonly used key ratio for showing solvency is *adjusted equity compared to total capital*. Adjusted equity includes the equity part of untaxed reserves (in Sweden 72%). This measure is an instant glimpse of the books on the closing day and is therefore static. It says more about historical fact than the future. How good is the company's margin, according to the result, to deal with financial costs? This can be measured by the *interest coverage ratio*. This key ratio is measured by the result - before financial costs - but after financial income compared to financial costs and reflects how well the company covers its interest costs.

Example 1:	
Total equity	250
Untaxed reserves	10
Total capital	1,000
<i>Solvency</i>	25.7 %

Example 2:	
Operating result	250
Financial income	30
Financial costs	- 150
<i>Interest coverage ratio</i>	1.9

Measure of liquidity

Liquidity is about the company's ability to pay their bills in the short run. The company always has to keep a reserve of liquid assets. The size of this reserve has to be balanced between the risk of not being able to pay the bills and the cost of keeping a reserve with low or no interest. Large cash flows, in and out, have to be planned via a cash budget. A more static view of the liquidity is to compare different assets. *Cash-to-current-liabilities ratio* is current assets except inventories compared to short term liabilities. A good rule of thumb is a ratio of 100% or 1.0. *Current ratio* is total current assets including the inventories compared to the short term liabilities. Here's the rule of thumb: 200% or 2.0. Cash-to-current-liabilities ratio is more liquid than current ratio. When evaluating a company's solvency, *credit information* is another good tip. This shows possible records of non-payment of debt.

Other key ratios

There are of course other ways of evaluating a company, its departments and regions. These key ratios deal more with how it's organized. I want to mention the key ratio *number of apartments (and commercial area) compared to the number of caretakers, property managers and lessors*. The status of the properties and where they are situated plays a role, but a good measure to keep in mind is 800 -1,000 apartments per property manager. You can also measure the result compared to the number of employees.

Closing

Much focus is put on financial information and key ratios. Profitability is essential for the company's survival and using key ratios is one of many tools for taking control of the company's business. In this essay I have tried to give you some examples of the key ratios that we use in our business: property management. Statistics Sweden publish financial statistics on a yearly basis where key ratios are used to compare different companies within the same line of business. REPAB is another publisher in Sweden that offers all kinds of books covering key ratios, cost objectives, etc. on property management.

Sources

Sigurd Hansson *Företags- och räkenskapsanalys*, Studentlitteratur, Lund 1986

Jan Thomasson, Olov Larson, Lennart Rohlin, *Den nya affärsredovisningen*, Liber Stockholm 1986

Sven-Erik Johansson, *Företagets lönsamhet, finansiering och tillväxt*, Studentlitteratur Lund 1983

Questions

1. Why use key ratios in financial analysis?
2. Give some examples of key ratios used to compare one specific property to another.
3. What is considered when deciding the company's direct yield?
4. What is the difference between using the solvency ratio compared to the interest coverage ratio?
5. What does a cash-to-current-liabilities ratio of 0.8 tell us?