# DOMESTIC COMPANIES' PERFORMANCE ANALYSIS IN THE CONTEXT OF THE CURRENT ECONOMIC AND FINANCIAL CRISIS

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**Abstract**

*The choice of rates must be made according to the position where the analyst is placed and the problems that are to be solved. Therefore, the financial manager is concerned, for example, with obtaining the highest possible profit in order to remunerate the share-holders, to self-finance the expansion, to assure the capacity of financial debts reimbursement, while the investors wish to know, in particular, the profitability of the investments and the risks related to the debts repayment.*

*It can be said that the importance of the method of analysis by means of financial rates lies in that it allows a systematic management analysis at a certain point. At the same time, its evolution over a period of more consecutive exercises provides suitable information regarding the causes and effects of certain changes as well as the answers to the questions that the business interlocutors ask and the steps that can be taken in order to reach the objectives.*

**Keywords:** *financial rates, economic risk, financial performances.*

**JEL Classification**: G31, G32.

## 1. Introduction

Good company management requires managers to know the state of their enterprise in the smallest detail and to timely detect the various causes, effects and issues that generate expected or unwanted changes in its activity. To attain this purpose, the use of rates represents a means to analyze and establish the financial diagnosis, also being known as a *method of analysis by means of financial rates (By rates one understands the ratios between sizes or levels, closely related between them and which characterize general situations or sectors of activity. The ratio must be significant and the calculation elements must be comparable and related, generally, by a cause-effect relation. Therefore, the rate serves to measure this relation, and its result can be expressed under the form of a "ccoefficient" or "percentage").* These rates are perceived as orientation parameters for the company management with regards to the influence of the cost of financing sources on the degree of efficiency of the company activity, but also as vital information for the prospective investors concerning the borrowed capital reimbursement risk (Vintilă, 1998).

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**2. The analysis of the financial profitability rates**

The financial profitability expressed under a relative form shows the degree of remuneration of the capital invested into an entity by the investors.

The financial profitability rates can be categorized as follows:

- *the common equity profitability rate*
- *the engaged capital profitability rate*

*The return on common equity* (ROE) shows the efficiency of shareholders capital usage and can be determined as the ratio between the net profit obtained (RN) and the common equity (CPR) as follows:

$$\text{ROE} = \frac{\text{RN}}{\text{CPR}} \times 100$$

The importance of the analysis of this indicator is due to at least the following reasons:

- the indicator shows the degree of allotment of the share-holders' funds into the current activity, on the one hand, as well as the efficiency with which the company engages the share-holders' capital in business, on the other hand.
- the indicator also shows the profitability of the share-holders'capital, constituting an instance of the entity's capacity to pay for the dividends due to the share-holders;
- the indicator allows the estimate of the profit per capital unit invested in shares or the profit that is to return to the owners for the investment made in the company.

The return on common equity can also be expressed by means of the interconditioning factors and causes in the framework of a multiplicative model as follows:

$$\text{ROE} = R_{MRN} \times K_{AT} \times Lev_F = \frac{\text{RN}}{\text{CA}} \times \frac{CA}{AT} \times \frac{AT}{CPR}$$

$R_{MRN}$ represents the rate of the net profit margin, a significant indicator for the dimension of the *trading profitability* of the activity; it is to be determined as the ratio between the net result of the exercise (RN) and the net turnover (CA).

$K_{AT}$ represents the rotation speed of the total assets, a representative indicator for the *assets management reflection* by means of activity indicators; it is to be determined as the ratio between the net turnover (CA) and the total value of the assets as shown by the balance (AT).

$Lev_F$ represents the financial leverage, a significant indicator for the *degree of indebtedness* dimension; reflects the degree to which the total assets (AT) are financed by company sources (CPR).

*The analysis of the common equity profitability rate aims at:*

- *for share-holders/investors*, *raising* this rate becomes an incentive for the participationto the social capital augmentation both for the existing share-holders and the investors as well. By means of this the latter „appreciate if their investment is justified and will go on to support the development of the entity by bringing in new capitals or by giving in, for a limited period of time, a part of the dividends due to them" (L. Buşe, 2005:285).
- *for managers, raising* the profitability rate of the share-holders'capital also constitutes a goal to be attained because it is only by means of this that they can keep their position and be supported by share-holders in the creation of future value.

Drawing the comparison with the *domains of activity average* of the common equity profitability rate is relevant for the evaluation of the profitability status of share-holders' capital.

The analysis of the multiplicative model of financial profitability formation shows that the increase of the net profit margin, of the rotation speed of the total assets as well as of the degree of financing the assets out of company sources represent the *factors-main ways of raising* financial profitability. Consequently, the common equity rate fluctuations can be explained by means of a factorial analysis on the basis of the three factors mentioned in the analysis model.

*The engaged capital profitability rate*[1] *or that of the permanent capital (*RCPM*)* represents the profit the entity yields from the capital invested in the business. One is to determine as ratio the results obtained by the entity before the interest clearing and profit tax (RBDI) clearing, the total of the capital invested into the entity both by the share-holders and the long-term creditors (CPM).

$$R_{CPM} = \frac{RBDI}{CPM} \times 100$$

For the numerator one can also use the gross result of the exercise (RBE) or the net result of the exercise (RNE), but the option of using the result of the exercise before the profit tax (RBDI) and interest payment is the one favored and recommended by accounting regulations in Romania.

*The analysis of the engaged capital profitability rate aims at:* Increasing this rate is appreciated as an objective to be reached both by the share-holders and the financial

[1] The engaged capital can be found in the balance structures recommended by the O.M.F.P. 3055/2009 on the position "Total of assets minus current debts".

creditors who will thus deem the investment made in the respective entity as efficient.

**3. Analysis of the economic (exploitation) risk**

Risk, in general, represents the possibility of an occurence that would jeopardy the entity activity. The economic risk constitutes the enterprise incapacity to adapt on time and with the lowest costs to the environment variations. More precisely, it expresses the volatility of the economic result under the exploitation circumstances.

The activity of an enterprise is subject to the economic risk because it cannot certainly foresee the various components of its result (cost, quantity, price) and of the exploitation cycle (buying and selling). The economic risk is translated by the possibility of recording an insufficient result or even a loss. This possibility is related to the importance of fixed costs that diminish the flexibility of the enterprise, namely its capacity to adapt to the turnover (CA) fluctuation.

In the economic literature the economic risk analysis is to be achieved from various points of view. One point of view starts from the analysis of the cost – resulted volume relation also called the analysis of the profitability threshold as an operational and efficient method of risk analysis. The profitability threshold is the point where the turnover covers the exploitation costs delimited as fixed costs and variable costs, by calculating it as physical or value units, for a product or the entire activity. According to the units of expression, the profitability threshold is determined as follows:

$$CA^{*} = \frac{CF}{1 - \overline{Rv}} = \frac{CF}{\overline{Rmv}}$$

$CA^{*}$ represents the turnover related to the critical point;

Rv represents the medium rate of variable costs;

Rmv represents the variable costs margin rate.

The economic risk analysis starting from the profitability threshold is made by calculating the following *indicators:*

$$\alpha = CAN - CAN^{*}$$

CAN represents the net turnover corresponding to a certain level of activity;

CAN* represents the critical turnover.

The indicator of position expressed in absolute values is also called *„absolute flexibility"* and it expresses the capacity of the company to modify the production and adapt to the market requirements. The larger this indicator is, the larger the entity flexibility gets, namely the exploitation risk is more reduced.

$$\alpha = \frac{CAN - CAN^{*}}{CAN^{*}} \times 100$$

The position indicator expressed in relative values is also called „*volatility coefficient"* and has got the same interpretation as above. Statistics studies have proven that entities can undergo the following economic risk:

- High economic risk when the net turnover is situated at more than 10 % over the profitability threshold;
- Medium economic risk when the turnover is over 10% up to 20% larger than the one corresponding to the profitability threshold;
- Low economic risk when the net turnover exceeds the profitability threshold by over 20%.

Closely related to the economic and financial risk there is the entities' bankruptcy risk.

The study of entities found in difficulty presents a special importance for a large series of business partners as follows:

- banks, which are obviously concerned by the quality of the credit portfolios that they forms;
- various categories of share-holders, who are interested in protecting the invested capital and enjoying the benefits offered by the respective investment (obtaining dividends);
- investors, who wish to know the state of the entity before investing the owned capital;
- creditors, who are interested in recovering the capital granted as a loan;
- business partners (clients, suppliers) wish to sign up with safe companies that are able to meet the contract requirements.

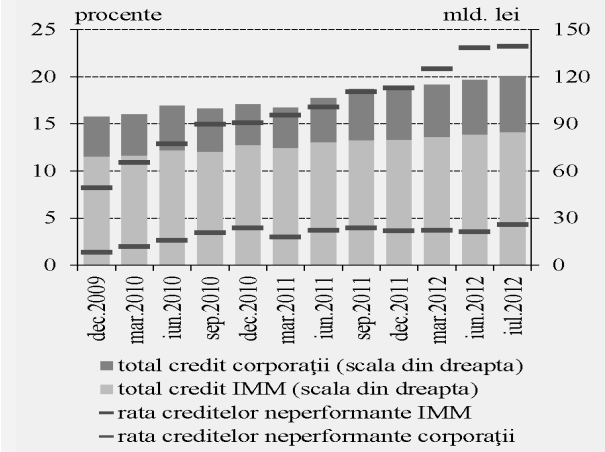
**4. Companies' economic and financial performances**

The main challenges coming from the dynamics of the companies' financial situations have had mixed evolutions: the financial health of companies improved, but the evolutions were heterogenous, with important vulnerabilities in their structure and the process of sustainable change of the economic growth model continued.

At the aggregate level, companies have recorded an improvement of financial situations. Capital profitability increased by 2% as compared to previous years (2010-2011), reaching 8,2% (2012), in the context of an intensive use of the assets (the assets' rotation speed increased at 84,9%). The cash flows resulted from the basic activity were reduced to 4%, but the total cash flows were positive and increasing. The favorable evolutions mentioned were manifested unequally in the framework of the economy, with important differences in the structure.

The company analysis according to the dimension criterion shows that small and medium-sized enterprises (SME) have registered an increasing credit risk (the rate of non-performing credits in the case of SMEs was 23,2%, while in the case of corporations the rate of non-performing credits was 4,3%.

**Graphic 1. Evoluţia creditelor neperformante în funcţie de mărimea solicitantului**




*Sursa: Raport de stabilitate financiară 2013, BNR*

The increase of the risk in the case of SMEs occurred because of:

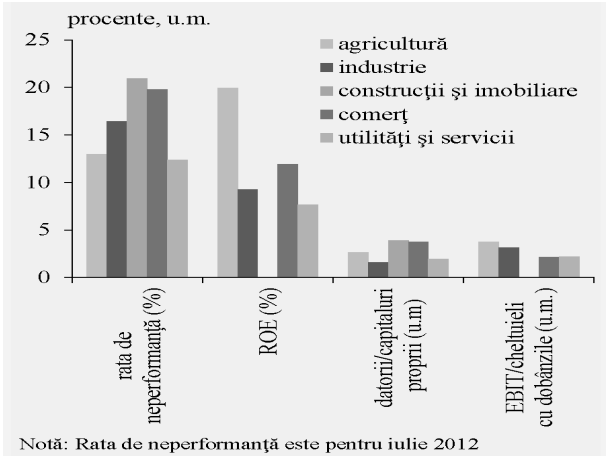
- a reduced rate of covering costs by profit interests;
- cash flows generated by the reducing basic activity;
- diminishing the gross profit margin. This last unfavorable evolution was counteracted by the increase of the indebtedness degree and the rotation speed of the assets, so that the capital profitability was slightly increasing.

The SMEs that were supported by the credit guaranteeing funds had superior performances:

- capital profitability was 23,5%;
- the rate of covering costs by profit interests maintained as supraunitary and at a comfortable level 2,1%;
- the degree of assets use was superior (the assets' rotation speed was of 125%);
- the rate of non-performing credits was significantly less than the average of 10,9%.

The analysis according to the activity sector criterion highlights the fact that trading, constructions and real estate businesses exhibit a riskier financial profile and honor their commitments to banks more difficultly (these owning 48,7% of the portfolio of credits given to businesses). The rate of non-performing credits in the case of constructions and real estate businesses is 21,5%, and the one pertaining to trading businesses is 20%.

**Graphic 2. Evolutia indicatorilor de performanţă financiară a companiilor structurate după sectorul de activitate**




*Sursa: Raport de stabilitate financiară 2013, BNR*

At the same time, businesses in the mentioned sectors have the highest indebtedness degree of all economic sectors, while the capacity of constructions and real estate businesses to pay the credit interests from the obtained profit is reduced. The modest economic and financial performance of trading businesses will improve as the economic growth consolidates, and the perception to risk of consumers will get better.

According to the origin of businesses capital there can be identified two challenges:

a) *private companies having major Romanian capital have registered a modest evolution of the financial situation*. The capacity to honor the debt service was reduced, and the rate of the non-performing credits reached 20,9% as compared to 12,6% in the case of private companies having major foreign capital in the context of:

- a degree of covering costs from decreasing profits;
- diminishing the capital profitability to 10,2%;
- the contraction of the gross profit margin to 2,7%.

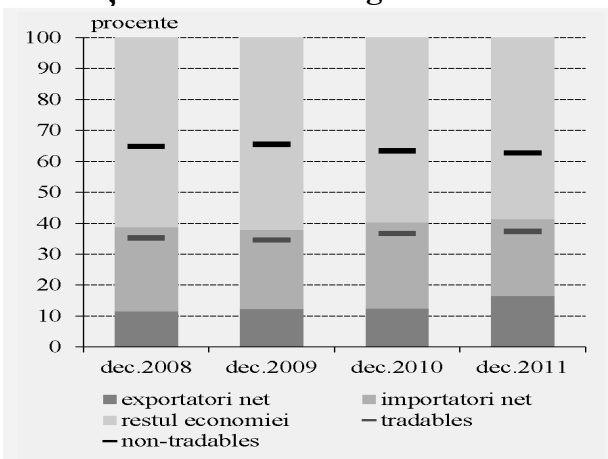
b) *companies having major state-owned capital continues to characterize the same mixed evolution, the majority of these having had a positive net result*, so as the capital profitability was 2,9% as compared to 9,8% which the major private capital businesses registered. The degree of assets use is maintained at a low level (the rotation speed of assets is 29,5%, while in the case of major private capital companies this reached at 95%).

Companies in the process of insolvency or bankruptcy generates certain challenges on the financial stability by means of the large volume of: owned bank credits, generated major payment incidents and arrears to partners.

There are three challenges on the financial stability generated by these companies:

- *The debt of the businesses in insolvency or bankruptcy to the banking sector* is relatively important. The credits granted by banks to these represent approximately 14,4% of the bank creditting of non-financial businesses. The companies in insolvency generates 66% of the credits of non-financial companies affected by arrears exceeding 90 de zile.
- *The companies in the process of insolvency or bankruptcy significantly influences the payment discipline in the economy*. The major payments incidents generated by these companies rose to 57,7% of the total of the major payments incidents generated by non-financial companies.
- *The arrears to trading partners* generated by insolvent companies are important, the long term of debt recovery partly explaining the reduced capacity to honor obligations. Arrears to suppliers generated by insolvent companies amounted to approximately 28% of the total arrears to suppliers generated by the non-financial companies. These are recorded in the context of a risen level of the debts' volume, while the annualized debt recovery deadline is of 295 days, as opposed to 100 days the average value per economy. The trading debts from balances are of 47,4% of the total of the trading debt of non-financial companies.

**Graphic 3. Contribuţia la valoarea adăugată brută din economie**




*Sursa: Raport de stabilitate financiară 2013, BNR*

The sustainable change of the economic growth pattern continued, confirming expectations. During the 2010–2012 period, domestic banks increased their exposures on the *tradables* sector by 17% in real terms. These companies have had favorable evolutions superior to the ones from the *non-tradables* sector*:*

- their position in economy consolidated (the VAB preponderance created by *tradables* businesses inthe VAB total generated by the non-financial companies rose to 37,3%;
- the capacity to cover interest costs from profit is satisfying;

- the risk generated in the banking sector is inferior to the one pertaining to the *non-tradables* businesses (the rate of non-performing credits *tradables* businesses is 14,8%, as compared to 19,1% pertaining to the *non-tradables* sector.

The *tradables* sector's reduced degree of indebtedness (the debts versus common equity ratio is 1,5, under the empirical threshold of alert of 2 and significantly smaller than 3,5 in the case of companies in the *non-tradables* sector), together with the favorable evolutions enumerated above, provide support for the creditors to continue to increase the exposures to the *tradables* sector businesses.

The premises for the change of the economic growth model were consolidated by the increase of exporting net companies' economic performance and of their role in the economy. The preponderance of the added value generated by exporting net enterprises in the VAB total created by the non-financial companies' sector increased to 16,5%, in the context of a profitability exceeding the economy's average. The capacity to honor the duty service is significantly better in the case of exporting net enterprises as compared to the total of the non-financial companies' sector (the rate of the non-performing credits is 4,4% as compared to 17,6%, the economy average), also sustained by a very good and increasing coverage of interest costs by profit (the ratio between the EBIT and the interest costs being 6,4).

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