

Financial Insights: Ratios that Drive Returns

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Objectives



Understand Ratios

Analyze key financial ratios for insight



Enhance Decision-Making

Use ratios to inform investment choices



Analyze Performance

Evaluate company efficiency and strategy



Assess Cash Flow

Examine cash flow efficiency and sustainability



Evaluate Risk

Assess leverage and risk in capital structure

Topics Covered



Introduction



Pros and Cons



Definitions



Financial Ratios Checklist



Examples



Summary



Conclusion

Introduction – A financial ratios checklist is great ...



for keeping an investor sane!



to identify one's own biases in the investment process



express an investor's worldview via portfolio holdings



to stay within an investor's circle of competence

Pros and Cons of Financial Ratios




1. Emphasis on fundamentals
2. Focus on quality
3. Importance of consistency
4. Builds confidence in making investment decisions
5. Encourage portfolio weeding/feeding
6. Capital preservation (i.e., loss avoidance)
first, growth/return usually follows over time



1. Backward looking i.e., no predictive value
2. May introduce personal bias
3. Missed opportunities - error of omission
4. Too restrictive in opportunity set
5. Disruptors could displace incumbents

Definitions

1. ROE (%): Return on equity shows how much profit a company generates on the money shareholders have invested in the firm. The calculation is return on assets times financial leverage.
2. ROIC (%): This figure is the percentage a company earns on its invested capital in a given year. The calculation is net operating profit after tax (NOPAT) divided by invested capital.
3. Free Cash Flow/Sales (FCF Margin) (%): Amount of free cash flow generated for each dollar of sales.

4. CapEx/Sales (%): Percent of sales used for internal growth. CapEx is capital deployed in Property, Plant, and Equipment (PP&E).
5. Free Cash Flow/Net Income: Amount of free cash flow generated for each dollar of profit. This is also known as the conversion rate. **Note:** Some companies define conversion rate as EBITDA/Net Income.

Definitions (Cont'd)

6. Gross Margin (%): $(\text{Net Sales} - \text{Cost of Goods Sold}) / \text{Net Sales} \times 100$. Profitability ratio indicates what's left after paying for direct cost of doing business.
7. Operating Margin (%): Operating earnings before interest and taxes (EBIT) expressed as a percentage of revenue.
8. Net Margin (%): Net income divided by sales expressed as a percentage.
9. Return on Assets (%): Net income divided by total assets expressed as a percentage.
10. Financial Leverage: Total assets divided by equity indicates the level of company's leverage.

“The market, like the Lord, helps those who help themselves. But, unlike the Lord, the market does not forgive those who know not what they do.” ... Warren Buffett, 1982

“When you mix raisins and turds, you’ve still got turds.” ... Charlie Munger

Financial Ratios Checklist

1. Return on Equity (ROE): above 15% is good, above 20% is better
2. Return on Invested Capital (ROIC): above 10% is good, above 12% is better
3. Free Cash Flow/Sales (FCF Margin): above 10% is good, above 15% is better



4. CapEx/Sales: lower than 10%, lower than 5% is better
5. Free Cash Flow/Net Income: steady or increasing at around 1.0
6. Gross Margin: above 50% is good, above 70% is better
7. Operating Margin: above 15% is good, above 20% is better
8. Net Margin: above 10% is good, above 15% is better
9. Return on assets (ROA): above 8% is good, above 10% is better
10. Financial Leverage: lower than 2.0, lower than 1.75 is better

Financial ratios criteria above are considered for non-financial companies only!



Morningstar Website ...

MA - Mastercard Inc Class A Key Metrics

morningstar.com/stocks/xnys/ma/key-metrics

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Stocks > Mastercard Inc Class A

Mastercard Inc Class A MA Morningstar Rating Unlock

Stock - XNYS - Rating as of Apr 28, 2025

Summary Chart News Price vs Fair Value Sustainability Trailing Returns **Key Metrics** Financials Valuation Dividends Ownership Executive

Key Metrics

Financial Summary Growth Profitability and Efficiency Financial Health Cash Flow 10 Years As Originally Reported

Income Statement (in Bil, except ratios)	12/2015	12/2016	12/2017	12/2018	12/2019	12/2020	12/2021	12/2022
Revenue	9.67	10.78	12.50	14.95	16.88	15.30	18.88	22.24
Revenue Growth %	2.39%	11.47%	15.97%	19.63%	12.93%	-9.37%	23.42%	17.76%
Gross Profit	7.56	8.55	9.81	11.74	13.35	11.51	14.40	16.97
Gross Profit Margin %	78.22%	79.35%	78.50%	78.50%	79.05%	75.25%	76.23%	76.33%
Operating Income	5.06	5.91	6.74	8.37	9.70	8.16	10.23	12.72
Operating Margin %	52.31%	54.86%	53.96%	56.01%	57.43%	53.35%	54.16%	57.21%
EBIT	5.02	5.74	6.68	7.99	9.96	8.14	10.74	12.20

Examples – (1) Return on Equity (ROE) ...

... above 15% is good, above 20% is better

Morningstar.com → quote → Key Statistics → Profitability and Efficiency

Company 1	2015	2016	2017	2018	2019	2020	2021	2022	2023	2024	03/31/2025
Return on Equity %	59.42	69.48	70.39	107.87	143.83	104.38	126.79	145.92	169.28	191.95	188.92

ROE criteria is met; however, notice abnormally high ROE trend? Check to see if you are comfortable with high financial leverage.

Company 2	2015	2016	2017	2018	2019	2020	2021	2022	2023	2024	03/31/2025
Return on Equity %	17.54	19.46	24.54	24.10	25.32	25.02	25.19	26.91	26.88	15.88	24.33

ROE criteria is met; however, downtrend from 2023 to 2024 is concerning.

Examples – (2) Return on Invested Capital (ROIC) ...

... above 10% is good, above 12% is better

Morningstar.com → quote → Key Statistics → Profitability and Efficiency

Company 1	2015	2016	2017	2018	2019	2020	2021	2022	2023	2024	03/31/2025
Return on Invested Capital %	43.81	40.96	36.89	51.99	64.76	39.41	44.94	49.74	54.35	56.72	59.27

ROIC criteria is met and it is unusually high.

Company 2	2015	2016	2017	2018	2019	2020	2021	2022	2023	2024	03/31/2025
Return on Invested Capital %	10.86	11.16	15.23	15.59	16.28	16.09	16.41	17.19	17.41	10.83	15.10

ROIC criteria is met; however, downtrend from 2023 to 2024 is concerning.

U.S. GAAP accounting is commonly reported accounting principles (CRAP)! Separate the relevant signal from the noise (i.e. CRAP) just like separating the wheat from the chaff.

Examples – (3) Free Cash Flow / Sales (aka FCF Margin)...

... above 10% is good, above 15% is better

Morningstar.com → quote → Key Statistics → Cash Flow

Company 1	2015	2016	2017	2018	2019	2020	2021	2022	2023	2024	03/31/2025
Free Cash Flow/Sales %	38.28	38.07	41.07	38.25	44.16	42.59	45.80	45.41	43.40	48.23	49.24

FCF Margin criteria is met with exceptionally high levels|

Company 2	2015	2016	2017	2018	2019	2020	2021	2022	2023	2024	03/31/2025
Free Cash Flow/Sales %	5.21	4.38	5.75	6.03	6.77	7.83	6.92	7.22	6.91	5.17	6.06

FCF Margin criteria is violated for all the years!

Show me the money! No, no ... show me the free cash!



Review ...

Financial Ratio	Criteria	Company 1	Company 2
1. Return on Equity (ROE)	> 15%+	Y	Y
2. Return on Invested Capital (ROIC)	> 10%+	Y	Y
3. FCF/Sales (aka FCF Margin)	> 10%+	Y	N

Call to Action: Put Company 1 in watch list or accumulate if already in portfolio [when price is right!](#)

Charlie and I are *not* stock-pickers; we are business-pickers.

[Warren Buffett, 2022](#)

Examples – (4) CapEx / Sales ...

... lower than 10%, lower than 5% is better

Morningstar.com → quote → Key Statistics → Financial Health

Company 1	2015	2016	2017	2018	2019	2020	2021	2022	2023	2024	03/31/2025
Cap Ex as a % of Sales	3.54	3.54	3.38	3.37	4.31	4.63	4.31	4.93	4.34	4.24	4.04

Criteria is met!

Company 2	2015	2016	2017	2018	2019	2020	2021	2022	2023	2024	03/31/2025
Cap Ex as a % of Sales	0.99	0.92	1.01	0.91	0.86	0.80	0.85	0.86	0.91	0.87	0.89

Criteria is met!

Examples – (5) Free Cash Flow / Net Income ...

... steady or increasing at around 1.0

Morningstar.com → quote → Key Statistics → Cash Flow

Company 1	2015	2016	2017	2018	2019	2020	2021	2022	2023	2024	03/31/2025
Free Cash Flow/Net Income	0.97	1.01	1.31	0.98	0.92	1.02	1.00	1.02	0.97	1.06	1.09

FCF/Net Income criteria is met and is stable around 1.00 value!

Company 2	2015	2016	2017	2018	2019	2020	2021	2022	2023	2024	03/31/2025
Free Cash Flow/Net Income	1.41	1.15	1.10	1.14	1.18	1.31	1.15	1.16	1.15	1.44	1.12

FCF/Net Income criteria is met and stable around 1.00 value. In fact, it has down trended from 1.44 to 1.12 from 2024 to 03/31/2025, respectively!

This is a **litmus test** for quality of earnings i.e. it shows how much free cash is generated for each dollar of profit.

Remember cash is a fact, profit is an opinion!

[Alfred Rappaport, Creating Shareholder Value](#)

Examples – (6) Gross Margin ...

... above 50% is good, above 70% is better

Morningstar.com → quote → Key Statistics → Financial Summary

Company 1	2015	2016	2017	2018	2019	2020	2021	2022	2023	2024	03/31/2025
Gross Profit Margin %	78.22	79.35	78.50	78.50	79.05	75.25	76.23	76.33	76.01	76.31	76.45

Gross Margin criteria is met with all years above higher threshold!

Company 2	2015	2016	2017	2018	2019	2020	2021	2022	2023	2024	03/31/2025
Gross Profit Margin %	23.57	23.47	23.37	23.80	23.79	26.06	24.22	24.56	24.48	22.33	21.99

Gross Margin criteria is violated for all years!

Examples – (7) Operating Margin ...

... above 15% is good, above 20% is better

Morningstar.com → quote → Key Statistics → Financial Summary

Company 1	2015	2016	2017	2018	2019	2020	2021	2022	2023	2024	03/31/2025
Operating Margin %	52.31	54.86	53.96	56.01	57.43	53.35	54.16	57.21	58.29	57.97	58.03

Operating Margin criteria is met with all years above higher threshold!

Company 2	2015	2016	2017	2018	2019	2020	2021	2022	2023	2024	03/31/2025
Operating Margin %	7.02	7.00	7.56	7.67	8.13	8.71	8.33	8.77	8.71	8.07	8.16

Operating Margin criteria is violated for all years!

Examples – (8) Net Margin ...

... above 10% is good, above 15% is better

Morningstar.com → quote → Key Statistics → Financial Summary

Company 1	2015	2016	2017	2018	2019	2020	2021	2022	2023	2024	03/31/2025
Net Profit Margin %	39.39	37.67	31.33	39.19	48.08	41.90	46.00	44.66	44.61	45.71	45.21

Net Margin criteria is met with all years above higher threshold!

Company 2	2015	2016	2017	2018	2019	2020	2021	2022	2023	2024	03/31/2025
Net Profit Margin %	3.74	3.83	5.38	5.47	5.88	6.13	6.17	6.37	6.23	3.81	5.59

Net Margin criteria is violated for all years!

Examples – (9) Return on Assets (ROA) ...

... above 8% is good, above 10% is better

Morningstar.com → quote → Key Statistics → Profitability and Efficiency

Company 1	2015	2016	2017	2018	2019	2020	2021	2022	2023	2024	03/31/2025
Return on Asset %	24.10	23.23	19.57	25.37	30.01	20.41	24.38	26.00	27.58	28.44	28.86

ROA criteria is met with all years above higher threshold!

Company 2	2015	2016	2017	2018	2019	2020	2021	2022	2023	2024	03/31/2025
Return on Asset %	5.88	5.99	8.06	8.23	8.49	8.30	8.44	8.79	8.62	5.04	7.44

ROA criteria is violated for 2015, 2016, 2024, 03/31/2025!

Examples – (10) Financial Leverage ...

... lower than 2.0, lower than 1.75 is better

Morningstar.com → quote → Key Statistics → Financial Health

Company 1	2015	2016	2017	2018	2019	2020	2021	2022	2023	2024	03/31/2025
Financial Leverage	2.70	3.30	3.90	4.61	4.96	5.25	5.15	6.15	6.13	7.41	7.27

Financial Leverage criteria is violated for all years!

Company 2	2015	2016	2017	2018	2019	2020	2021	2022	2023	2024	03/31/2025
Financial Leverage	3.29	3.21	2.91	2.94	3.02	3.01	2.96	3.16	3.08	3.22	3.26

Financial Leverage criteria is violated for all years!

Summary

Financial Ratio	Criteria	<u>Company 1 (MA)</u>	<u>Company 2 (UNH)</u>
1. ROE	> 15%+	Y	Y
2. ROIC	> 10%+	Y	Y
3. FCF/Sales (aka FCF Margin)	> 10%+	Y	N (10)
4. CapEx/Sales	< 10%	Y	Y
5. FCF/Net Income	steady at 1.0	Y	Y
6. Gross Margin	> 50%	Y	N (10)
7. Operating Margin	> 15%	Y	N (10)
8. Net Margin	> 10%	Y	N (10)
9. Return on Assets (ROA)	> 8%	Y	Y (4)
10. Financial Leverage	< 2.0	N (10)	N (10)

Notes:

1. External links to Company 1 & 2 may not work in the future!
2. Numbers in red indicate the frequency of financial ratio criteria violations over a period of ten fiscal years.

Summary – Company 2 – Do Not Cross the Barbed Wire Fence

Financial Ratio	Criteria	<u>Company 1 (MA)</u>	<u>Company 2 (UNH)</u>
1. <u>ROE</u>	> 15%+	Y	Y
2. <u>ROIC</u>	> 10%+	Y	Y
3. <u>FCF/Sales</u> (aka FCF Margin)	> 10%+	Y	N (10)
4. <u>CapEx/Sales</u>	< 10%	Y	
5. <u>FCF/Net Income</u>	steady at 1.0	Y	
6. <u>Gross Margin</u>	> 50%	Y	
7. <u>Operating Margin</u>	> 15%	Y	
8. <u>Net Margin</u>	> 10%	Y	
9. <u>Return on Assets (ROA)</u>	> 8%	Y	
10. <u>Financial Leverage</u>	< 2.0	N (10)	

Notes:

1. External links to Company 1 & 2 may not work in the future!
2. Numbers in red indicate the frequency of financial ratio criteria violations over a period of ten fiscal years.

Conclusion

Where/what is the investment edge?



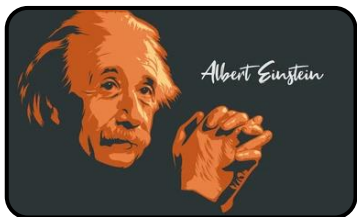
Information Advantage Exists?

Used to exist, but no longer with the advent of readily available information to everyone. ([Regulation FD](#))



Superior Interpretation of Financial Statements?

Helps to some extent but other investors are smarter. The person on the other side of the trade may know something that you don't.



Counting

"Not everything that counts can be counted, and not everything that can be counted counts." ... [Albert Einstein](#) (Examples [CEO](#), [CFO](#), [CRO](#))



Temperament

"Once you have ordinary intelligence, what you need is the temperament to control the urges that get other people into trouble in investing." ... [Warren Buffett](#)

Questions?



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