Operating and financial health check of Orica Limited (ASX code: ORI)

Name

Institution

Company background and mission

The chosen company for this assignment is Orica, an Australian company listed on the stock exchange as ORI. It's the world's largest and most prominent producer of commercial explosives and innovative systems designed for the mining, quarrying, construction, oil and gas etc. It's also the leading global supplier of sodium cyanide, a component used in the extraction of Gold, besides providing ground support services in tunneling and mining. Its product and service range include, but not limited to, contracted services, bulk explosives, seismic systems, packaged explosives, initiators and boosters (www.orica.com). Founded in 1874, Orica has over 140 years of experience and investment in its industry, becoming a global leader in mining and civil services. The company employs over 11,500 workers and serves customers spread in over 100 countries.

As a global leader in civil blasting and mining, the company's purpose is to ensure the success of their customers around the world and it takes pride in ensuring safety, sustainability, and responsibility in everything that the company does. This is done by utilizing the best people and technology to develop high-quality products, services through a safe, secure and reliable supply chain. In this paper, we shall analyze the six-year financial statements for the company, with the aim of establishing it's operating and financial health status of the company. A number of financial tools such as horizontal and common size financial statements, trend analysis and financial ratio analysis will be utilized in attaining the above goal.

Common Size and Horizontal analysis

Common size financial statements are represented as a percentage of a base parameter. For instance, a common size income statement is represented as a percentage of total revenues while a balance sheet is represented as a percentage of total assets, total liabilities and equity

(Riedl & Srinivasan, 2008). An analysis of common size income statement reveals that the biggest cost relative to revenues is the operating costs which have remained relatively stable at 82% of the revenues. EBIT (earnings before interest and tax) recorded a negative trend, from a high of 16.41% in 2011, closing at 12% in 2016. The same trend is reflected in the net income after tax which fell from 11% in 2011 to 8% in 2016 (see appendix I-IV).

The horizontal analysis also revealed a similar trend. Assuming 2011 to be the base year, operating revenues started on a high, before dramatically falling to settle at 18% lower in 2016 as compared to 2011, with total revenues exhibiting a similar trend. Earnings before interest and tax, pretax profit and net earnings took a hit, settling at almost 40% lower in 2016 as compared to 2011. The same trend was witnessed in most of the line items, revealing declining results for the company over the period. This could be attributed to a reduced demand for Orica products as most nations slow down on infrastructure development in the face of poor economic indicators.

Cash Flow analysis

The company's cash flows were rather erratic during the period, despite depicting a downward spiral on most line items between 2015-2016 (see appendix V). Receipts from customers reduced from a high of 117% in 2013 to a low of 89% relative to the 2011 base year. A similar trend was witnessed on payments to suppliers and employees, interest received, other operating cash flows and taxes, with interests, received compensating for net operating cash flows to settle at 3% more than in 2011. There is, however, a general trend that affects most of the line items, with the net cash flows at the end of 2016 settling at 8% lower than in 2011. Again, due to the reduced business for the above-stated reasons, there is a general trend where most line items in the cash flow statements show a negative trend.

Income analysis

The company's performance has recorded mixed results. Both operating and total revenues recorded an increasing trend between 2012-2014 before drastically falling in 2015 and 2016, with a trend analysis indicating that both revenue parameters were at least 18% lower in 2016 compared to 2011. Consequently, most performance indicators such as EBITDA, EBIT, pretax profit and net income recorded a declining trend over the years, hitting their lowest in 2016 (See appendix III). Net profit margins, EBIT margins, EBITDA margins etc also recorded a declining trend with some slight improvement in 2016 as compared to 2015. Return on Equity (ROE), Return on Assets (ROA) and return on invested capital (ROIC), all experienced a negative trend, underlying the difficult environment in which the company continues to operate.

Capital Structure analysis

Capital structure analysis relates to how the company has used a mix of debt and equity in its capital structure and its implication on the company's financial stability (Sultan, 2014). We shall evaluate a number of financial ratios such as debt-equity ratios, debt ratios and other gearing and leverage ratios (See appendix VI). Capital structure ratios are a useful tool in determining the debt levels, relative to owner's equity, and also indicates the company's risk profile since the use of excessive debt signals tendencies towards insolvency. For instance, in 2011, the company utilized only 49% of its total capital outlay from debt, as compared to 59% and 58% in 2015 and 2016 respectively. This indicates a higher uptake of debt during this period. While the current use of debt may not necessarily spell doom for the company's future, they are an indicator of an increasing risk, in the event that creditors decide to recall their debt from the company. Higher levels of debt/ leverage also indicate that the company continues to get more susceptible to downturns in the economy and business cycles as it makes it more difficult for lenders to continue advancing credit to the company. Lower debt /equity ratios indicate a company financed mainly through equity, with higher financial strength and access to capital if and when needed.

Coverage ratios

Coverage ratios are an indicator of how the company is well prepared to meet its financial commitments in areas such as debt and interest. The interest coverage ratio, for instance, indicates the company's ability to cover its interest obligations for its debt portfolio. To arrive at the interest coverage ratio, the earnings before interest and tax is divided by the interest amount to get the number of times the company's EBIT can cover the interests. The company's interest cover has been favorable, albeit with a declining trend, with a high of 8.33 times in 2011, closing at 7.62 times in 2016 as shown in appendix VI. Additionally, the debt service ratio is a financial metric that measures the company's ability to pay off its entire debt service including all principal and interest amounts. Calculated as the net income divided by the total debt service, it indicates whether the company generates enough earnings to cover its debt obligations. From the ratio analysis, this ratio has continued to deteriorate from a high of 0.18 in 2011, to a low of 0.11 in 2016. This is occasioned by the increased use of debt against declining net income.

Growth and Risk Analysis

The company continues to witness suppressed growth and increased risk for the period as denoted by the financial ratio analysis. The horizontal analysis of the company financials for the period shows declining revenues and profitability and suppressed growth prospects. The total assets also indicated a declining trend in the backdrop of increasing liabilities. The net profit margin, for instance, reduced from 10.08% in 2011 to 7.64% in 2016 with a similar trend observed in other key metrics such as earnings before interest and tax, return on assets, return on equity and return on capital (Appendix VI). This is a key indicator of the company's declining performance and growth which manifests itself in these financial ratios. Revenues were also observed to be declining over the period, with the lowest revenues reported in 2016 compared to the previous years. The company's risk analysis ratios such as leverage and gearing and coverage ratios also indicate that the company is assuming more financial risks by increasing borrowing in the face of suppressed earnings. These financial ratios, however, do not present a radical deviation from the industry averages, indicating that the company's risks are manageable, at least for the period under review.

Conclusions and recommendations

Orica group has continued to face growth challenges mostly occasioned by a difficult operating environment. In 2016, the company aimed at stabilizing and restoring the company's financial and operational performance with an aim of positioning the business for future long-term growth. Despite these efforts, the company still saw a reduction in earnings by 7% as compared to the previous period while EBIT settled at 6% less than in 2015. Despite the challenges in operations, the company still paid out 49.5 cents per share. Despite the bleak financial performance which is projected to continue in 2017, the company remains optimistic with a vibrant management and improved operational efficiencies that have resulted in a net gain of $76 million (Orica, 2016 annual report). The company is banking on the new management, strategy and operational model to build on existing and capture emerging opportunities with the aim of delivering improved and sustainable value for shareholders.

To meet these objectives, the company will have to institute a more disciplined approach to capital management through business growth and increased returns on all new projects while ensuring safety and reliability of operations.

While the above evaluation indicates that the company is declining in performance, its rich heritage, performance history, and dividend payment history still make it an attractive stock to buy. The declining trend is a perfect opportunity to buy this stock when the prices are still low and wait to cash in as the company's performance improves. Declining financial performance also makes it an attractive takeover candidate, although the recommended strategies above would greatly improve the company's performance and value.

References

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