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EIU Paris City Campus

Address: 59 Rue Lamarck, 75018 Paris, France | **Tel:** +33 144 857 317 | **Mobile/WhatsApp:** +33607591197 | **Email:** paris@eiu.ac

EIU Corporate Strategy & Operations Headquarter

Address: 12th Fl. Amarin Tower, 496-502 Ploenchit Rd., Bangkok 10330, Thailand | **Tel:** +66(2)256923 & +66(2)2569908 | **Mobile/WhatsApp:** +33607591197 | **Email:** info@eiu.ac

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Introduction

Balance Sheet

The balance sheet is an overview what a company owns and what a company owes at a point in time. It is one of the three main financial statements,

the other two called income statement and the cash flow statement. The income statement and cash flow statement both cover the flow during a certain period. Usually, this period could be a month, a quarter, or a year. So they are like a movie, each with its own focus.

A balance sheet or a statement of financial position is a financial report that gives us a snapshot of a business's assets, liabilities, and equity at a single point in time.

Assets are expanded out into current and non-current. The current assets are short-term assets like receivables and prepaid expenses. On the other hand, non-current assets are long-term assets.

Same concept with liabilities: current liabilities are short-term liabilities

payables, accrued expenses and deferred revenue and non-current liabilities long-term liabilities stuff like long-term loans equity on the other hand is a different kettle of fish.

When reading a balance sheet, it is important to start off by looking at the balance sheet by category. Current assets and non-current assets on the left. Current liabilities, non-current liabilities, and equity on the right. Current assets are cash and other assets that are expected to be converted to cash within a year. Non-current assets are longer-term investments that cannot be converted into cash quickly. Current liabilities are amounts due to be paid to creditors within twelve months.

Non-current liabilities are amounts owed that are to be paid after the period of one year.

Equity on the balance sheet is the book value of the shareholder capital. That's how the balance sheet works on a conceptual level.

Income Statement

The income statement is a financial report that summarizes a business's revenues and expenses over a period. So, it is an overview of how much a company has earned during a period.

It works like if you take a business's revenue and subtract its expenses then you are left with a profit or a loss.

The income statement is known under many names, each of these gives a hint of what we are trying to review in this income statement tutorial: consolidated statement of earnings, profit and loss statement, earnings report, statement of operations, statement of financial performance, or simply: the income statement.

So in case we are unable to find the income statement for a company, we have to try a search with any of these other names.

By reviewing the income statement, and the notes that come with it in the annual report, we will at the same time learn a lot about how the business works.

So income statement is an overview of how much a company has earned during a period, all the way from top line to bottom line.

Cash Flow Statement

Cash Flow Statement is one of the three main financial statements which summarizes a business's cash inflows and outflows over a period.

In accounting there are two main methods for preparing books the cash method and the accrual method, with the cash method company recognize its revenue when cash is received, and company record its expenses when cash is paid out.

However, under the accrual method company recognize revenue as it's earned and record its expenses as they are incurred. With the cash company recognize revenue when cash is received and record expenses when cash is paid out where that leaves it with a net cash inflow or an outflow. So, the income Statement prepared under the cash method is equivalent to a cash flow statement. A useful metaphor is to see the cash balance as the water level in a bathtub at a point in time. Cash flow is how much cash has come in through the taps minus what flowed out during a period. So, if we check the water level in the bathtub at 9 PM and at 9:05 PM, then those are two balances.

If the water level has risen during those five minutes, we have a net cash inflow. If the water level dropped, you have a net cash outflow. Cash is critical at every stage of a company's lifecycle. When we open our own business, we need cash to get started. We will need cash to grow and expand.

If a company runs out of cash to pay its bills, it's game over. What we see in a cash flow statement should be a direct reflection of a company's strategy. Is the company spending enough to build its unique and sustainable competitive advantage? Are customers willing to pay for the products and services that the company supplies? Is the company able to reward its investors for the risk they have taken, by paying a dividend? These and other questions can be answered by analyzing a cash flow statement.

Liquidity

The term liquidity is used very often in financial news. There might be worries about the liquidity of ABC Corp. Will it be able to pay its bills and survive? Central banks might be providing more liquidity to financial institutions in times of economic turbulence, so they in turn can provide loans to consumers and businesses. Consumers might decide to hold more liquidity if they are seeking a safety-net for unplanned expenses.

Liquidity is the availability of liquid assets to a company, market, or trader / investor.

Assets can be fully liquid like water, fully frozen like ice, or anywhere in between.

When review a company's financial statements, liquidity means the ability to pay short-term obligations.

Cash is very liquid; in most cases it can be used immediately by company to pay obligations.

Accounts Receivable are very close to cash. Once the customer pay, company can use that cash to pay its own bills.

Inventory is still reasonably liquid, but company will have to sell it first, and then collect the receivable for inventory to turn into cash.

Fixed assets are not very liquid and to convert them to cash, company will need to produce product on it, sell the product, and collect the receivable.

When compare current assets to current liabilities, things look a little bit better.

The company has a current ratio of 2: for every dollar of current liabilities there are two dollars of current assets. A strong level of liquidity.

Leverage

Leverage is critical from perspective what it means for business. To understand Leverage, we will explain first what a debt is. It is an obligation from one party which is debtor to another party which is the creditor to pay agreed value like money. It's not a modern invention and it goes back as early as 3,500 BC.

Nowadays the concept of debt is the same but with using another forms of written contracts.

Debts are classified to good debt versus bad debt. Good debt is which support build wealth. So if invest by spending money on things that potentially generate more income than we pay interest.

For example let's see we get a \$100,000 loan for which we going to end up paying 4% interest annually. If we can invest that money and get back a return of 10%, we make a profit of 6%. So,

after one year, we are going to have increased our wealth by \$6,000. Taking on a debt will be a good idea only If the interest rate doesn't outpace the level of return. Getting a loan to buy a car

can also be good debt. On the other side, bad debt is that debt that reduces our wealth. Basically, it's buying stuff we don't really need stuff that doesn't create income with money we don't have.

Most businesses need some assets to be able to provide their customers with goods and services.

These assets usually cost money and buying these assets needs to somehow be financed. The money can come from the owners of the business, in which case, equity is put into the business.

But most of the time, the money owners can put into the business isn't enough and the business needs to get external financing like a bank loan. The same principles for good and bad debt apply

here too. If the investment of businesses using the money for it generating more return than it's paying interest, is good debt because it's increasing the wealth.

Now let us address how taking on debt or financial leverage can be a good way to grow a

business faster. Let's say we want to operate a Juice stand. Let us suppose we are going to put

\$100 of our own money as equity into the business to be able to buy the required assets that we

need, like the stand, the equipment, and the inventory. This is all the money we have. Let us suppose we managed to earn a profit of \$10. This means we should earn \$10 on our investment of \$100. In business terms, it means our return on equity is 10%. In fact, because we managed to get a good return, we want to grow the business. Growing the business in this example means running a second juice stand with another \$100 investment. Now at this point, we have two options. We could either wait until we make enough cash from the first stand to finance another stand with our own money, and that's called bootstrapping. Second option, we could go to the bank and get a loan for \$100. This means we are going to take on debt. Let us suppose that we go with the loan option because we see an opportunity to grow, and we don't want to wait that long. Obviously, the bank will charge interest for the loan that they are going to give us, so let's say they charge us 4%. So, we are going to incur interest expense of \$4 for the second juice stand. The operating profit of the second stand is also \$10. So, when we deduct interest expense, we make a net income of \$6. Together with the first stand, this means we now make \$16. The equity, which is our own money that we put into the business still is only \$100. This means now that our return on equity is improved to 16%. Working with other people's money, improved our ROE, our return on equity. Because business is great and we want to grow further, we again go to the bank to get another loan, another \$100 for 4% interest. The third stand makes the same profit as the first two. We make another \$10 with it, minus the interest expense of \$4, gets us a net income of \$6. Together with the other two stands we now make a profit of \$22 on our \$100 investment. The return on equity is 22%. By taking advantage of the leverage effect, we manage to more than double our ROE. However, while leverage can help a business make money faster, we have to be aware of that debt always carries risks. Let us suppose we got loans until we opened sixth stand, so our business had loans of \$500 in its balance sheet and at some point, it's

going to have to pay back this debt. Right now, the business is profitable but what happens when it's a rainy summer and demand for our juice is low? What if regulation come again with lockdown? Will we even make enough profit to pay for that loan? So, a highly leveraged company, always poses a higher risk and that brings us to bad debt.

Because our highly leveraged business will be considered higher risk, banks will be reluctant to open additional credit lines to help us grow and even if we get the additional loans.

Let's say another entrepreneur comes along and opens a juice stand next to ours because they realize that we are onto something and gets better prices for the juice. So, he can be more aggressive on the pricing for his juice. To not lose business, we have to reduce our prices and all of a sudden, we stands don't make an operating profit of \$10 anymore, just \$2. If we still only had one stand, fully financed with equity, we would still be okay, where our ROE would be 2% on the \$100 investment. Not great, but it's still better than what we get from a savings account.

But we took on a lot of debts to finance our growth. So now for the additional five juice stands, financed with bank loans, we have interest expenses to pay that are higher than your profits with operating profit only \$2% and with 4% interest rate for the \$100 loan, we have to pay \$4 interest. Because of the lack of profits, we don't generate cash. So, we can't even pay back that interest.

We have to finance the loss with more loans to even stay solvent. This is not going to continue like that for long and soon our juice business is going to be history.

As a summary for above tragedy story, leverage allows companies to earn income from assets they wouldn't normally be able to afford. So, in good times, it can help us grow faster. It can multiply every dollar of our own money that we put into the business. But in bad times, it can also leverage our losses and puts the business at risk to go down just as fast.

Profitability

ROI relates the payoff (the expected project benefits) to the investment (the initial cash outlay or cost). NPV consider the time value of money and considers cash flows over the entire life of the project. The profitability index incorporates all three of these elements. The profitability index is closely related to ROI and NPV. Following is a project that we will use as the basis for all calculations:

It has an upfront investment of \$1 K (shown as a negative, an outflow), and four years of nominal benefits of \$400 each (shown as positives, inflows).

To calculate ROI, we take the annual benefits and divide them by the investment. \$400 divided by \$1000 is 40%.

Now that we have calculated that ROI outcome, is this a good or a bad number? We can look at this in absolute terms: maybe the company that is considering this project has a minimum requirement of 30% ROI for projects, and the ROI on project A exceeds that minimum. We could also look at this in relative terms: maybe there are many other project proposals with ROIs that are 50% or higher, in that case project A might not be the most attractive one, and other projects might get higher priority. To calculate NPV we start off with translating the future benefits to today's equivalent, these are called present values.

The present value of \$400 one year from now, using a discount rate of 20%, is \$333.

\$400 divided by 1.2

The present value of \$400 two years from now is \$278

\$400 divided by 1.2 times 1.2

The present value of \$400 three years from now is \$231

\$400 divided by 1.2 times 1.2 times 1.2

The present value of \$400 four years from now is \$193.

\$400 divided by 1.2 times 1.2 times 1.2 times 1.2

The longer we wait for those future benefits, the more discount the future benefits and the lower the present value equivalent.

To calculate NPV, we take the cash outflow (negative number) from the investment and sum the present values of the future benefits.

Those five numbers summed (the investment plus the present values), get us to \$35 of net present value.

Now that we have calculated that NPV outcome, is this a good or a bad number? We can look at this in absolute terms: NPVs that are bigger than zero create value for the company. Also, we could look at this in relative terms: maybe there are many other project proposals with NPVs far higher than 35, in that case project A might not be the most attractive, especially when the investment budget is tight and not every project with a positive NPV might end up getting selected.

There is one important number from the NPV calculation that we will need as an input for the calculation of the profitability index: the sum of the present values of the future benefits. In the case of project A, this is \$1035.

Let's calculate the profitability index for project A: put the sum of the present values of the future benefits in the numerator and divide by the amount of the initial investment in the denominator.

Working with present value equivalents is how the profitability index resembles the NPV method. Dividing by the amount of the initial investment is how the profitability index resembles the ROI method. \$1035 divided by \$1000 gives us a profitability index of 1.035

Now that we have calculated that profitability index outcome, is this a good or a bad number?

We can look at this in absolute terms: projects with a profitability index higher than one create value for the company.

We could also look at this in relative terms: maybe there are many other project proposals with a profitability index far higher than 1.035, in that case project A might not be the most attractive, especially when the investment budget is tight and not every project with a profitability index higher than one might end up getting selected.

There are several ways to write down the profitability index formula. We could express it as the sum of the present values of the future benefits divided by the amount of the investment. We could also express it as the sum of NPV plus investment, divided by the investment. Or as NPV divided by investment, plus 1.

When we plug in the numbers from our profitability index example, we see that these versions of the profitability index formula are all equivalent.

\$1035 divided by \$1 K is 1.035

The sum of \$35 and \$1 K is \$1035

Divide this by \$1 K, and you get 1.035

\$35 divided by \$1 K is 0.035

Add 1 to this, and you get 1.035

Different ways of writing the profitability index formula but same outcome.

Main Body

Financial Statements and Annual Reports Analyze Corporation: Nestle

Performance Evaluation:

Profitability

Gross Profit Margin = Gross Profit divide it by Sales then multiply by 100

Year 2018 is 15.08%

Year 2019 is 14.77%

Year 2020 is 10.24%

Year 2021 is 13.6%

Net Profit Margin = Net Profit divide it by Sales then multiply by 100

Year 2018 = 11.45%

Year 2019 = 13.94%

Year 2020 = 13.93%

Year 2021 = 19.75%

Return on Assets = Net Profit divide it by Average Total Assets

Year 2018 = 7.75%

Year 2019 = 9.74%

Year 2020 = 6.34%

Year 2021 = 17.77%

Average Total Assets is computed by Total Assets last Year add Total Assets of Current Year
then divide it by 2

Conclusion

It shows that the profitability of the company suffers greatly during the Year 2020. This was brought by various reasons including Covid -19 pandemic. On the contrary, the company recovered its profitability during the year 2021.

Efficiency

Asset Turnover Ratio = Divide Sales by Average Total Assets

Year 2018= 0.68

Year 2019 = 0.70

Year 2020 = 0.45

Year 2021 = 0.90

Inventory Turnover Ratio = Divide Cost of Goods Sold by Average Inventory.

Year 2018 = 5.03

Year 2019 = 5.05

Year 2020 = 2.22

Year 2021 = 6.24

Day's Sales Inventory = Divide Average Inventory by Cost of Goods Sold then multiply the result by 365

Year 2018= 19.80 days

Year 2019 = 20.03 days

Year 2020 = 19.57 days

Year 2021 = 26.35 days

Conclusion

The company was efficient in utilizing its assets to earn revenue while it diminishes in year 2020 as it lowers to 0.45. However, the company bounced back in year 2021 as can be seen

it ratio of 0.90. Further, the company effectively managed its inventory during 2018, 2019, and 2021. However, it failed to manage its inventory effectively in year 2020

Short term solvency

Current Ratio = Divide Current Assets by Current Inabilities

Year 2018 = 0.95

Year 2019 = 0.86

Year 2020 = 1.86

Year 2021 = 0.98

Quick Ratio = Deduct Inventory amount from Total Current Assets then divide the results by

Current Liabilities

Year 2018 = 0.74

Year 2019 = 0.63

Year 2020 = 1.67

Year 2021 = 0.68

Conclusion

The ratios show that the company's assets are sufficient to meet its current liabilities except in Year 2020. Moreover, the ratios show that except in year 2020 the company has enough assets easily convertible to cash to satisfy its current liabilities

Long-term solvency

Debt to Equity Ratio = Divide Total Liabilities by Total Shareholders Equity

Year 2018 = 1.35

Year 2019 = 1.42

Year 2020 = 1.52

Year 2021 = 1.59

Total Debt Ratio = Divide Total Liabilities by Total Assets

Year 2018 = 0.57

Year 2019 = 0.59

Year 2020 = 0.60

Year 2021 = 0.61

Equity Multiplier = Divide Total Asset by Total Shareholders Equity

Year 2018 = 2.35

Year 2019 = 2.42

Year 2020 = 2.52

Year 2021 = 2.59

Conclusion

The debt-to-equity ratio of the company shows that the company rely on debts and loans than equity because for every 100 of equity 150% is financed through debt. The company's equity multiplier has a good ratio for the whole 4 years meaning it used less liability to finance its assets

Market based ratios

Payout Ratio = Divide Total Dividends by Net Income

Year 2018 = 72.9%

Year 2019 = 62.8%

Year 2020 = 46.2%

Year 2021 = 64.0%

Price Earnings Ratio = Divide Share price by Earnings per share

Year 2018 = 24.30

Year 2019 = 24.30

Year 2020 = 23.36

Year 2021 = 22.31

Conclusion

The company has a high payout ratio which means that the company pays higher dividends to its shareholders. On the other hand, price earnings ratio shows how much money the market is willing to pay for the company's stocks.

Recommendation to improve the company business

I recommend that Nestle company invest more in digital marketing since consumers rely heavily on internet in relation to their everyday transactions as this will bring closer the company to consumers.

Based on my analysis above, I further recommend that the company may invest in expansion and growth like acquisition of needed machineries and technology since it has the capacity

New Investment Project

The investment project I propose is equipment and technology upgrade.

Using NPV

The formula is Present value of cash inflow minus cash outflow. So, for example, if the new investment project will give a positive value of NPV then the company should accept the project since cash inflow is more than the outflow.

Using WACC

First determine the cost of debt by dividing the interest expense of the new project by the total debt. Then, determine the cost of equity by first deducting risk free return from market return then multiply it by the summation of risk-free return and beta. Finally, multiply cost of equity by weight of equity then add the product of multiplying cost of debt and multiply it by 1-tax rate. However, in the facts there is no mention of risk-free return beta and others so WACC cannot be computed here

Conclusion

Company must use its retained earnings. It has sufficient retained earnings that can be used by company for new projects

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