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Evaluation of Financial Performance of Selected Company and Proposals for Improvement

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Acronyms

CAPEX	Capital Expenditures
CAPM	Capital Assets Pricing Model
CF	Cash Flow
EAT	Earnings After Taxes
EBIT	Earnings Before Interest and Taxes
EPS	Earnings per Share
EVA	Economic Value Added
FCFF	Free Cash Flow to the Firm
IFRS	International Financial Reporting Standards
M&A	Mergers and Acquisitions
NOA	Net Operating Assets
NOPAT	Net Operating Profit After Taxes
NOPBT	Net Operating Profit Before Taxes
NOPLAT	Net Operating Profits Less Adjusted Taxes
PLC	Public Limited Company
R&D	Research and Development
ROA	Return on Assets
ROCE	Return on Capital Employed
ROE	Return on Equity
SWOT	Strengths, Weaknesses, Opportunities, Threats
US GAAP	United States Generally Accepted Accounting Principles
WACC	Weighted Average Cost of Capital

Introduction and the Aim of the Thesis

Companies nowadays strive to prosper by maximizing their profit and shareholders value. In order to make the right decisions, financial management serves to achieve this goal.

One of the financial management tools is a financial analysis which assess a company based on the historical data, current situation and is used to predict the future financial health of a company. Moreover, financial analysis reveals a potential opportunity to enhance financial performance.

The purpose of this thesis is to evaluate financial performance of a company and provide proposals for improvement.

The subject of my thesis will be Cobham PLC. The financial analysis, valuation, and proposals are based on annual reports which comprise the strategic report, corporate governance, and financial statements. All of the annual reports are available at their websites in the investors' section. I have chosen the company because of the accessibility of information and its R&D.

The thesis is divided between theoretical and practical part. Chapters covering the theoretical part are sections 1 to 6. Section one provides a theoretical background for objectives and purpose of financial analysis along with source and users and concluding by financial analysis phases.

The second section discuss components of business analysis and focus on financial statement analysis. While the third chapter is devoted to horizontal and vertical analysis.

The purpose of the fourth section is to describe the elementary financial analysis methods such as profitability ratios, liquidity ratios, financial leverage ratios, activity ratios, and investment valuation ratios.

The fifth section is dedicated to economic value added and aims to provide comprehensive information in order to calculate economic value added.

The content of a sixth chapter is credit scoring and is represented by Altman's Z-score model and Kralicek Quick test.

The practical part of the thesis begins in chapter seven which introduces the Cobham PLC and follows with SWOT analysis and Porter's five forces model.

The purpose of the eighth section is to provide further information about Cobham PLC's financial statements and includes vertical and horizontal analysis of them.

In the ninth chapter, the ratio analysis is demonstrated on Cobham PLC covering all of the ratios described in a theoretical part of the thesis.

The tenth section is devoted to the calculation of economic value added and describes a determination of net operating assets, net operating profit and costs of equity along with the weighted average cost of capital.

In order to provide a comprehensive analysis, the eleventh chapter is dedicated to credit scoring.

In conclusion, the twelfth chapter provides proposals for improvement based on performed analysis and obtained findings.

1. Theoretical Background to the Issue of Measuring Financial Performance

1.1. Theoretical Framework

The financial analysis becomes one of the most useful tools to study the financial aspect of a business. It illustrates not only the financial health of the company but evaluates a company's performance in the past, operating trends over the years and the current position on the market. The financial analysis provides a data source for financial management on one hand as well as valuable information for forecasting the future performance and gather anticipating prospects and risks to make business decisions on the other.

In the literature, the financial analysis is defined as "the use of financial statements to analyze a company's financial position and performance and to assess future financial performance" (Wild, et al., 2013 p 13). Note that financial statements do not provide sufficient data for economic decisions, because they are not able to inform us about economic activities in detail. Hence, a strategic analysis should be considered to identify strengths, weaknesses, opportunities, and threats that might have an impact on the business.

Typical financial analysis is divided into two overlapping parts:

a) qualitative - fundamental,

b) quantitative – technical.

The fundamental analysis considers "economic and political conditions, industry factors, and future outlook of the company." (Shim, et al., 2007 p 202). Delivering high-quality analysis, it is necessary to understand macro and microenvironment just as specifications within a particular sector. Fundamental analysis is regarded as background for technical analysis.

According to J. K. Shim ", the market can be predicted in terms of direction and magnitude." (Shim, et al., 2007 p 202). Technical analysis is based on the approach of analyzing historical data employing statistic methods and algorithms.

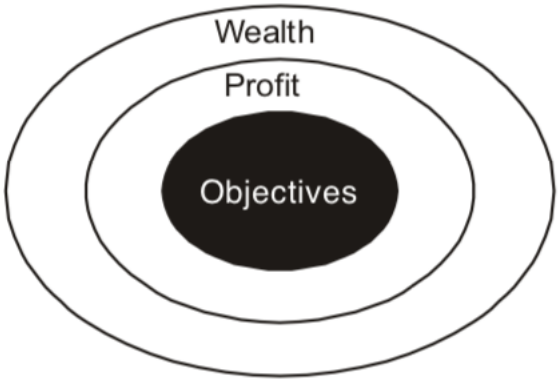
Nevertheless, both fundamental and technical parts need to be synthesized to draw the correct conclusion.

1.1.1. Objectives and Purpose of Financial Analysis

Taking into account that financial management strives to utilize resources by the business concern, objectives of financial management may be generalized into two parts such as:

a) profit maximization,

b) wealth maximization. (Subramanian, et al., 2008).



Source: C. Paramasivan, T. Subramanian, 2008, page 5

Fig. 1 Objectives of Financial Management

Profit is the traditional technique to measure business efficiency and according to C. Paramasivan and T. Subramanian „profit maximization objectives help to reduce the risk of the business.“ (Subramanian, et al., 2008 p 6). Contrary to favourable arguments, profit maximization is also considered as an incentive for immoral practices such as corruption and unfair trade. Moreover, from a financial point of view, Paramasivan et al. (2008) state that profit maximization „does not consider the time value of money or the net present value of the cash inflow. It leads to certain differences between the actual cash inflow and net present cash flow during a particular period. “ (Subramanian, et al., 2008 p 6).

Wealth maximization may be regarded as value maximization. This concept aims to improve shareholder's value and involves a more innovative approach in the business field. (Mans-Kemp, 2014). In this thesis, I will take this approach to evaluate the performance of a selected company.

The financial analysis aims to assess past trends to manage financial resources concerning decision-making. It may have a character of evaluating investment opportunities, optimizing capital structure or defining dividend policy. (Kopaneli,

2014). Specialists study algorithms in outputs and focus on deviations from normal progress. By examining economic trends, analysts can predict future performance.

1.1.2. Sources for Financial Analysis

Nowadays many different sources might be employed concurrently to obtain information for financial analysis. All relevant sources shall be used as well as financial statements. They could be differentiated between public and internal. The most important public publications according to Fabozzi et al. (2015) are:

- annual reports (including financial statements such as balance sheet, income statement, statement of shareholder's equity and statement of cash flows);
- auditor report;
- company register;
- business segment data;
- press releases;
- economic data (Fabozzi, et al., 2015).

In contrast to public sources, management accounting, internal accounting regulations, and collected data, for instance, are considered internal – confidential information.

Financial statements are prepared at the end of the accounting period. The balance sheet works on accounting equation basis which is given as Assets = Liabilities + Equity. Assets related to the resources the company operates with, and "these resources are investments that are expected to generate future earnings through operating activities. " (Wild, et al., 2013 p 42). On the other side of equation lie liabilities and equity as a funding source for operating activities. Liabilities represent obligations to creditors. Shareholders' equity is consisted of investments by owners and accumulated retained earnings. Liabilities and assets are divided into current and noncurrent assets. Current assets supposed to be used in operations or converted to cash within one year compare to noncurrent assets. Current liabilities are due one year. The difference between these two is called working capital. (Wild, et al., 2013).

The income statement shows a company’s financial performance as a result of operating activities. It provides details of revenues, gains, expenses, and losses over a specified period. Net income is determined under accrual basis in a meaning that revenues are recognized at the moment when a company sells goods regardless of cash receiving. A similar approach is applied for expenses that match revenues. (Wild, et al., 2013).

The cash flow statement reports incoming money and outflows generated separately by operating, investing and financing activities. Moreover, they can imply a company's ability to pay debt, dividends and other liabilities. The statement is prepared either direct or indirect method. The direct method uses actual cash flow information from operations and is not commonly used among medium-sized and large companies because it is based on cash receipts and payments. Contrary to that, the indirect method derives transactions from the income statement and changes in the balance sheet, both are based on accrual accounting. (ABC Amega, 2010).

Last but not least, the statement of shareholder’s equity is comprised of retained earnings, comprehensive income and changes in capital accounts. This statement informs us about movements in equity holders’ claims on the assets of a company. (PricewaterhouseCoopers LLP, 2018).

Bill Rees advice: "use financial statements concerning the broader context of the other available information. The meaning of financial statements is conditional on the environment." (Rees, 2012 p 3).

1.1.3. Users of Financial Analysis

Apparently, many entities may utilize a financial analysis for their decisions. Users are a determining factor for sources and techniques used in financial analysis. Considering their requirements for the content, users may be divided as follows:

Tab. 1 The users of financial information

Investors in the firm	Shareholders Bondholders Banks
Business contracts	Suppliers Customers Employees
Other	Taxation agencies Government Local government Regulators Competitors Public
Intermediaries	Analyst Media

Source: Adapted from Financial analysis, Rees, Bill, 2012, page 4.

(1) Investors in the firm

Shareholders are interested in financial analysis as a measurement for current progress and estimations about future performance. Investors are also interested in identifying a market opportunity to sell over-priced shares and buy under-priced shares. When they assume that the market value of the share is a fair value, they focus their attention on other attributes of the investment such as the risk, yield, and growth. Different techniques were classified into two principal approaches: technical and fundamental analysis. The technical analysis examines patterns and

trends in the share price compared to fundamental analysis, which examines all relevant sources of information to establish a value for the share.

Debt-holders has different objectives than equity investors. They are interested in a firm's solvency and if the debt is adequately secured. The concern of investors who buy fixed interest securities, bonds and debentures is the value of the assets and liabilities.

Other investors like banks will be concerned to monitor the security of the principal and interest payments. (Rees, 2012).

(2) Business contracts

Suppliers, customers, and employees have a different point of view compare to the above. They are interested mainly in the company's ability to meet financial obligations and in conclusion, make some assumptions regarding long-term business relationships.

(3) Other users

Other users involve subjects of public interest including taxation agencies, government, local government, regulators, public and competitors primarily. The concern of these users is related to taxes, statistics purpose, financial support, and ownership interest for instance.

(4) Intermediaries

The list of users is not comprehensive. Additionally, there are analysts, brokers, media, credit rating agencies and some others who pay attention to these as well.

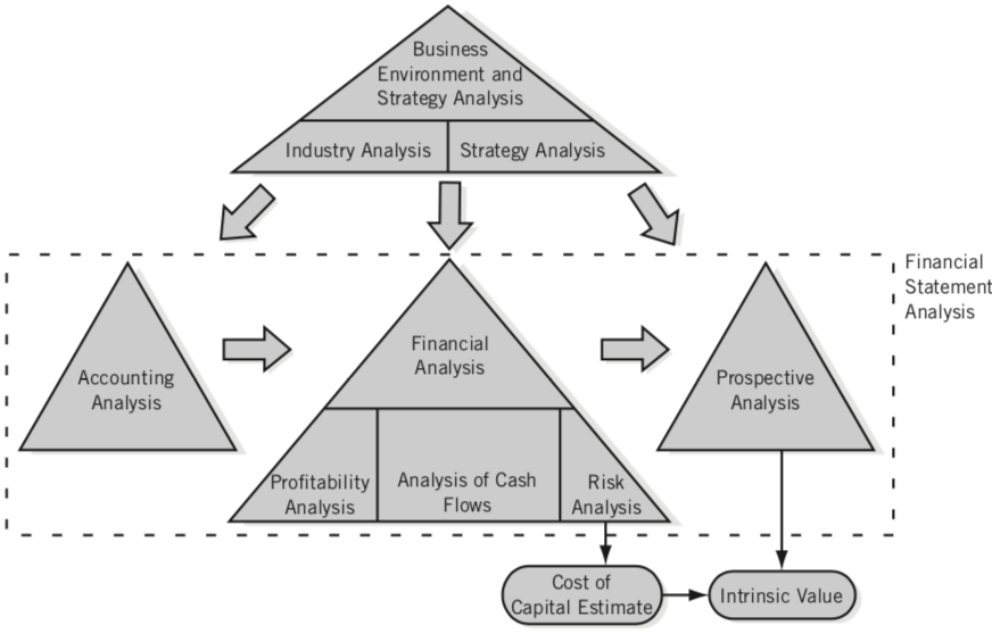
1.1.4. Financial Analysis Phases

The process of financial analysis is presented as follows:

1. User identification – First of all, we have to target the user considering that each of whom has a slightly different emphasis and requirements about context. Furthermore, a level of detail needs to be asses for achieving the desired purpose.
2. Data collection – Next step is to access available data and evaluate them to provide complexity, objectivity, relevance, and correctness of indicators.
3. Followed by method selection as another critical element.
4. Then analyze the international environment, business segment and the market economy come after that.
5. Analysis of particular company – Data is subsequently processed, analyzed and interpreted considering a comparison of similar outputs with previous years or competitors.
6. Next is a comprehensive business's financial situation assessment including identification of strengths and weaknesses.
7. Feedback for management – Conclusions supported by financial analysis should provide materials to take necessary measures to sustain and support strengths and prevent the company from weaknesses. (Peterson, et al., 2003).

1.2. Components of Business Analysis

As we can see in the picture below, the process to estimate the value of the business – the intrinsic value combines several elements. The model encompasses an accounting analysis, financial analysis and effects prospective analysis which forecasts future payoffs. Note that financial statements analysis, as well as business prospects, are crucial for accurate prospective analysis.



Source: J. J. Wild, R. K. Subramanian 2013, page 11

Fig. 2 Component Processes of Business Analysis

The aim of the business environment and strategy analysis is to identify economic and industry circumstances along with an assessment of a company's competitiveness whether they are advantaged or whether they are under threat.

The financial analysis is accompanied by an accounting analysis to provide a picture of the quality and reliability of statements. The financial analysis consists of three areas. First one is a profitability analysis, where we examine a company's return on investment. It indicates the impact of profitability drivers. Followed by a risk analysis that focuses on an evaluation of a company's solvency and liquidity. Moreover, it assesses its earnings variability.

The purpose of the prospective analysis is to estimate future payoffs – usually earnings or cash flows. It draws on previous analysis and it all results in a valuation. Valuation refers to the method of transforming forecasted future payoffs into an estimated company value. To be able to determinate the value, an analyst

must first select a model for valuation and then forecast the company's cost of capital. (Wild, et al., 2013). Further, I will focus on financial statement analysis.

1.2.1. Financial Statement Analysis

Financial statement analysis transforms data from financial statements into valuable information that is used in decision making. Analyzing various scenarios using a computer spreadsheet program that permits changes in assumptions and simulations, allows a richer insight.

There are two widely applied accounting standards within the developed world – US GAAP and IFRS. US GAAP determines the principles for preparation, presenting and reporting a corporation's financial statements by issuing SFAS (Statements of Financial Accounting Standards). Otherwise, in the EU, countries adopted IFRS to be able to convert accounting standards to narrow and remove distinctions for investors.

- Balance sheet

The balance sheet informs us about a company's financial position. Balance sheet ratios take both numerator and denominator directly from the balance sheet. Considering only information from the balance sheet, there are two types of ratios – liquidity ratio and financial leverage (or debt) ratio. To ratio analysis is dedicated following paragraph.

- Income statement

Income statement sums up a firm's revenues and expenses resulting in net income or loss over a particular period. Income statement ratios compare one ‘flow’ item with another, each from the income statement or income statement/balance sheet ratios poses that denominator is from the balance sheet. We can subdivide ratios into these three - Coverage ratio, activity ratios and profitability ratios. (Horne, et al., 2008).

- Cash flow statement

The primary goal of cash flow statement is to inform us about the company's liquidity and ability to generate enough funds for investments. In fact, the ability to produce enough cash determinates the company's financial position regardless of its profitability. Note that separate activities assess the cash flow statement:

- Cash flow from operating activities,
- Cash flow from investing activities,
- Cash flow from financing activities. (Jury, 2012).

Operating activities covers the actions of buying and selling goods as well as manufacturing goods for resale or providing a service to customers. Investing activities are those which include purchasing or selling non-current assets for long-term purposes. Financing activities are the actions when the long-term finance of the business is raised or repaid. Regarding company reports, a commonly used term is free cash flow. Free cash flow is calculated as the net cash flow generated from operating cash flow after tax deducted with the capital expenditure of the period. The surplus amount is available for dividend payouts to shareholders or for future investments or expanding plans. In the case of the negative figure, management is forced to borrow cash accordingly. (Weetman, 2006)

1.3. Horizontal and Vertical Analysis

Horizontal analysis, or so-called trend analysis, is the evaluation of financial performance based on a restatement of financial statement items to percentages or in absolute figures. The base year is typically the oldest year and is always stated as 100%. It aims to investigate whether an increase and decrease occurred. (Weygandt, et al., 2015)

In contrast, the vertical analysis is the comparative structured analysis of a financial statement, where each line item is listed as a percentage of an aggregated item. (Hermanson, et al., 1986). Taking the income statement into account, the base amount is usually sales, especially comparing the percentage of the cost of goods sold to sales. Considering balance sheet analysis - total assets, liabilities or shareholders' equity is commonly used as the base amounts.

1.4. Ratio Analysis

No single ratio gives us sufficient information in order to judge the financial condition and performance of the company. Ratio analysis indicates a mathematical relation within items in the financial statements. It aims to provide a figure that shows a company's strengths or weaknesses. According to Fabozzi etc., ratios can be classified considering "how they are constructed or according to the financial characteristic that they capture." (Peterson, et al., 2003 p 722).

Ratios can be designed to evaluate six aspects of operating performance and financial condition. Aspects are as follows:

1. profitability,
2. rentability,
3. activity,
4. liquidity,
5. financial leverage,
6. and return on investment.

Further, there are several ratios commonly used for reflecting each of the five aspects. (Peterson, et al., 2003).

1.4.1. Profitability Ratios

These ratios express the ability of the company to earn money seen as the profit before interest in comparison with capital (assets) invested in the company. Ratios also point out how effectively and efficiently the company is being managed. Additionally, shareholders are concern about profitability in relation to their expectations regarding dividends. Moreover, analysts focus on the profit margins which compares components of income with sales. Especially gross profit margin, operating profit margin, and net profit margin. (Bredgaard, et al., 2008).

- Gross Profit Margin

This ratio tells us the portion of each dollar of sales that remains after deducting production expenses.

Gross profit margin is calculated as:

$$Gross\ profit\ margin = \frac{Gross\ profit}{Net\ Sales\ (Revenues)} \quad (1)$$

Any change in the gross profit margin is caused by one or more of these factors:

1. variation in sales volume, which affect sales and cost of goods sold,
2. variation in the sales price,
3. variation in the cost of production. (Peterson, et al., 2003).

- Operating Profit Margin

Another profitability ratio evaluates the operational efficiency of the business by considering operating expenses in addition to the cost of goods sold. Note that we need to remove operating expenses from gross profit, leaving us income from operations, also known as earnings before interest and taxes (EBIT). (Wild, et al., 2013). Operating Profit Margin is calculated as follows:

$$Operating\ Profit\ Margin = \frac{EBIT}{Sales} \quad (2)$$

- Net Profit Margin

Assuming we want to asses both operating and financing decisions, it is necessary to compare net income with sales. Net profit margin, or also referred to as return on sales (ROS), express how efficiently a company earns net income from sales.

It takes financing costs into account contrary to the operating profit margin. (Peterson, et al., 2003). It is calculated as:

$$Net\ Profit\ Margin = \frac{Net\ income}{Sales} \tag{3}$$

- Total Assets Turnover

This ratio illustrates how many times has been total assets transformed into sales. Besides, it serves as an indicator of the company's ability to adjust the invested capital to the turnover. (Bredgaard, et al., 2008). Total Assets Turnover is calculated as follows:

$$Total\ assets\ turnover = \frac{Revenue}{Average\ total\ assets} \tag{4}$$

- Return on Assets

The ratio Return on assets (ROA), sometimes called a first earning power ratio, indicates how much the total invested capital yield concerning generating income. This ratio can be compared to alternative ways of investing the capital. It is obtained as:

$$Return\ on\ total\ assets = \frac{EBIT}{Total\ Assets} \tag{5}$$

Besides, there is a connection between the three ratios mentioned above. (Bredgaard, et al., 2008).

$$Return\ on\ total\ assets = \frac{Net\ profit\ margin}{Assets\ turnover} \tag{6}$$

- Return on Equity

From a shareholders' perspective, they are interested in the return of their investment. The return on equity measures the net income shareholders receive to their equity in the stock. (Peterson, et al., 2003). Shareholders hope for the highest possible return on their investment, but at the same time focus on the security of the investment.

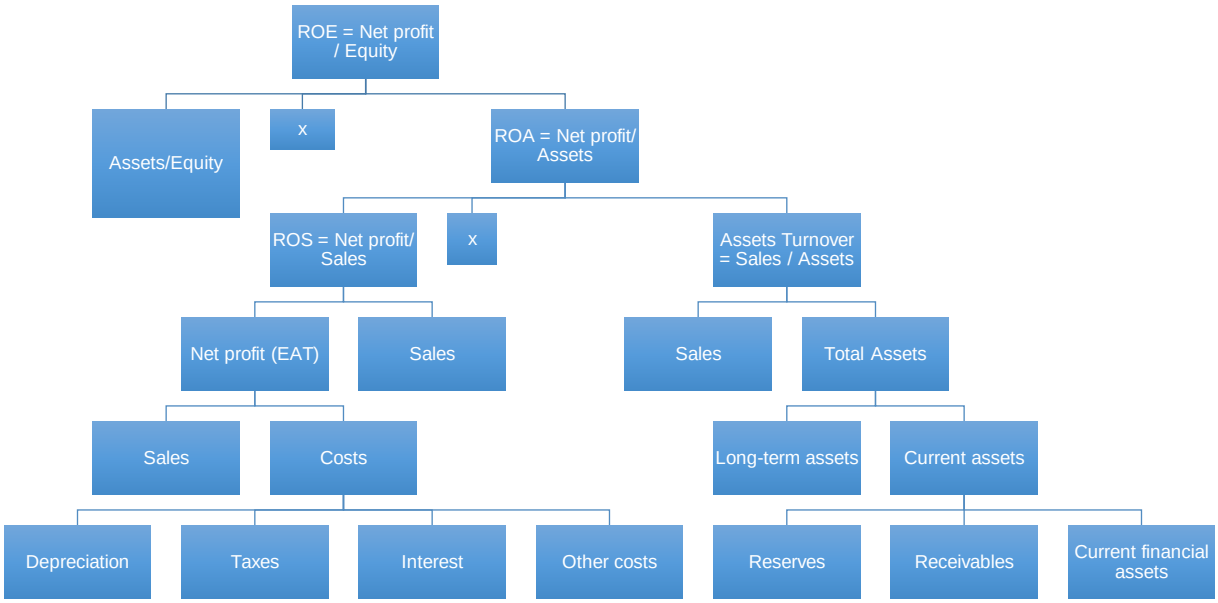
$$Return\ on\ Equity = \frac{Net\ Income}{Shareholders'\ equity} \quad (7)$$

- Du Pont decomposition of ROE

The Du Pont analysis provides a framework that ties previous ratios together.

The purpose of the Du Pont equation is to show how the sales margin, the total assets turnover ratio and the equity multiplier combine to determine the Return on equity ratio. The Du Pont analysis aims to form an evaluation system between the ratios mentioned above. According to Hongquan Zhu, Du Pont financial indicators have significant incremental information content in predicting the company's future earnings through empirical analysis. (Shuangyuan, 2014). Kevin Bernhardt states that DuPont model measures:

1. Earnings - how efficiently inputs are being used in order to generate profits,
2. Turnings – how well capital assets are being used to generate gross revenues,
3. Leverage – how well the business is leveraging its debt capital. (Bernhardt, K., 2013).



Source: Adapted from Synek, Kislingerová, 2015, page 257

Fig. 3 DuPont chart example – decomposition of ROE

In conclusion, the DuPont analysis provides an insight to identify where the company makes a profit or not and helps managers to identify which activities put more emphasis.

- Return on Capital Employed

The return on capital employed (ROCE), also can be called return on invested capital (ROIC), is a useful profitability indicator for comparing the relative profitability of businesses after considering the amount of capital used. In a situation, when the return on capital is higher than the cost of capital, the company utilize its capital at higher returns than it costs. Therefore, the company is creating value for its providers of capital.

In order to compute the value of the company, three inputs need to be defined.

- Net operating profit after tax $(NOPAT) = EBIT\ x\ (1 - \%\ tax\ rate)$,
- $Invested\ capital = Total\ assets - Current\ liabilities$,
- Return on Capital Employed (ROCE). (Fernandes, 2014)

$$Return\ on\ Capital\ Employed = \frac{NOPAT}{Invested\ Capital} = \frac{EBIT\ x\ (1 - \%\ tax\ rate)}{Invested\ Capital} \quad (8)$$

- Earnings Per Share ratio

Earnings per share ratios (EPS ratio) measure the profit attributed to shareholders allocated to each outstanding share of common stock. EPS is an additional factor that informs us about a company's profitability. Shareholders use the EPS ratio to estimate future growth over time. However, there are limitations in its use as a performance indicator. The limitations affecting the application of EPS include the following:

- It is based on historical earnings. Assuming that management have made decisions in the past to enhance current earnings growth by reducing the amount spent on capital investment and R&D. Growth in the EPS can't be counted on as a predictor of the rate of growth in the future.
- EPS doesn't consider inflation. (Elliott, et al., 2011).

EPS is calculated as:

$$Earnings\ Per\ Share\ ratio = \frac{Net\ Income\ -\ Dividends\ on\ Preferred\ Stock}{Weighted\ average\ number\ of\ shares\ in\ issue} \quad (9)$$

According to Anderson, the weighted average needs to be applied because of companies likely issue more shares during the year as a part of their executive bonus scheme. Furthermore, "this increase the number of shares in issue and so dilutes the earnings attributable to each existing share." (Anderson, 2012 p. 30).

1.4.2. Liquidity Ratios

In order to analyze the liquidity, we understand liquid assets as the assets we can convert into money at relatively short notice. This description meets cash and cash equivalents, bank deposits, stocks, short-term receivables, and inventories. On the other hand, current liabilities involve accounts payable, accrued wages, taxes, etc. The result of this ratio should exceed 100% in order to be meet payment obligation with available liquid assets. Additionally, it shouldn't be too high. That indicates that the cash could be used more efficiently. (Peterson, et al., 2003).

- Current Ratio

The current ratio also called the working capital ratio measures the current assets needed for satisfying current liabilities. (Wild, et al., 2013) The formula states as follows:

$$Current\ ratio = \frac{Current\ assets}{Current\ liabilities} \quad (10)$$

- Quick Ratio

The quick ratio, also known as the acid-test ratio, is a more stringent test of short-term liquidity. This alternative uses a slightly different set of current assets. In the quick ratio, we use only the most liquid assets: cash, short-term investments and accounts receivable. Thus, we typically exclude inventories. (Wild, et al., 2013). The Quick ratio is calculated as follows:

$$Quick\ ratio = \frac{Current\ assets - Inventories}{Current\ liabilities} \quad (11)$$

- Cash ratio

Cash ratio is additional evidence of the company's very short-term ability to pay off its liabilities. This ratio uses only cash and short-term financial assets to see what proportion of liabilities can be paid right away. (Bragg, 2010).

$$Cash\ ratio = \frac{Current\ financial\ assets}{Current\ liabilities} \quad (12)$$

1.4.3. Financial Leverage Ratios

Financial leverage ratios assess the financing structure as well as the credit risk. The extent to which a company uses debt financing has three implications:

1. by raising funds through debt while stockholders can maintain control of a company without the necessity of increasing their investment.
2. In a situation that company earns more on investments financed with borrowed money than it pays in interest, then its shareholders' returns are leveraged, but their risks are magnified.
3. Creditors focus on the equity to provide a margin of safety, assuming that the higher shareholders supply the proportion of funding, the fewer risk creditors face. (Brigham, et al., 2015).

Taking creditor's point of view into account, there are the following ratios to examine leverage:

- Debt-to-Asset ratio

The debt ratio is defined as total liabilities to total assets. It measures the percentage of funds provided by current liabilities and long-term debt to its total assets and reports how much the company relies on debt in order to finance assets. Furthermore, it informs creditors about their position in case of a company's insolvency. (Wild, et al., 2013). It is defined as follows:

$$Debt - to - Asset\ ratio = \frac{Total\ liabilities}{Total\ assets} \quad (13)$$

- Debt-to-Equity ratio

The debt-to-equity ratio shows the financial risk concerning the use of debt to equity. It provides us with information about how the company finances its operations with debt relative to the book value of equity. (Fabozzi, et al., 2015). The ratio is obtained as:

$$Debt - to - Equity\ ratio = \frac{Total\ liabilities}{Shareholders' equity} \quad (14)$$

- Times interest earned ratio

The time interest earned ratio expresses a company's ability to handle financial burdens and tells us if the company can cover the interest payments associated with debt. (Wild, et al., 2013). The ratio compares the funds available to pay interest (EBIT) with the interest expense. Note that other costs do not arise from debt. Time interest earned ratio is calculated as:

$$Time\ Interest\ Earned\ ratio = \frac{Earnings\ before\ interest\ and\ taxes}{Interest\ expense} \quad (15)$$

- Financial leverage

The financial leverage involves the use of funds obtained at a fixed cost in the hope to increase the return to the shareholders. The financial leverage is described as the tendency of the residual net income to change disproportionately with operating profit. It indicates the presence of a fixed cost of capital in the total capital structure. These fixed charges do not vary with the EBIT or operating profits - they need to be paid regardless of the amount of EBIT available to pay them. From the shareholders' point of view, financial leverage may be favourable and unfavourable. The favourable leverage occurs when the company earns more on the assets purchased with the funds as compared to the fixed cost paid for their use. On the other hand, the unfavourable leverage is in a situation when the company doesn't earn as much as the funds cost. (Khan, et al., 2007)

Financial leverage can be computed according to the formula below:

$$Financial\ leverage = \frac{EBIT}{EBIT\ -\ Interest} \quad (16)$$

1.4.4. Activity Ratios

Activity ratios are closely linked with profitability analysis. These ratios relate sales to different asset categories and are crucial determinants of return on investment. If a company has an excessive investment in assets, then its operating capital will be unduly high, which will reduce its free cash flow and ultimately its stock price. In contrast to that, if a company doesn't have enough assets, then it will lose sales, which will hurt profitability, free cash flow, and stock price. (Brigham, et al., 2015).

- Inventory Turnover

The inventory turnover is defined as the cost of goods sold divided by average inventories. The ratio measures the inventory' liquidity. (Wild, et al., 2013).

$$Inventory\ turnover = \frac{Sales}{Average\ inventories} \tag{17}$$

- Accounts receivable turnover

The accounts receivable turnover serves as an indicator of the liquidity of the receivables and is calculated as follows: (Gibson, 2013).

$$Accounts\ receivable\ turnover = \frac{Sales}{Average\ accounts\ receivable} \tag{18}$$

- Days Sales Outstanding

Days Sales Outstanding, or so-called, Collection period ratio is calculated as accounts receivable divided by credit sales per day. If credit sales are unavailable, use sales. (Higgins, 2012). Thus, the ratio represents the average period that the company must wait after making a sale before receiving cash. The formula states as follows:

$$Days\ Sales\ Outstanding = \frac{Accounts\ receivables}{Credit\ sales\ per\ day} \tag{19}$$

1.4.5. Investment Valuation Ratios

The attractiveness of an investment could be estimated by various ratios. The following ones attempt to simplify the evaluation process based on relevant data.

- Market to Book Ratio

The book value per share is showing the cumulative amount that stockholders have invested, either by purchasing newly issued shares or indirectly through retaining earnings. In contrary to that, the market price is forward-looking record incorporating investors' expectations of future cash flows. (Besley, et al., 2015). First, we obtain the book value per share:

$$Book\ value\ per\ share = \frac{Shareholders' equity}{No\ of\ common\ shares} \quad (20)$$

Next, we obtain the Market to Book ratio by dividing the market price per share by the book value per share. The formula is as follows:

$$Market\ to\ Book\ ratio = \frac{Market\ price\ per\ share}{Book\ value\ per\ share} \quad (21)$$

- Dividend Payout Ratio

The payout ratio is the proportion of earnings that are distributed as dividends. Changes in a ratio are depended on dividend policy and earnings capability. (Tulsian, et al., 2017)

$$Dividend\ Payout\ Ratio = \frac{Dividend\ per\ share}{Earnings\ per\ share\ (EPS)}\ x\ 100 \quad (22)$$

- Price Earnings Ratio

The price/earnings (P/E) ratio shows the relationship between the market price of a share of common stock and stock's current earnings per share. In other words, it expresses an investor's willingness to pay per dollar of reported profits. According to Gibson (2012), the P/E ratio should be computed using diluted earnings per share for continuing earnings per share. P/E ratios are available from many sources, such as The Wall Street Journal. (Gibson, 2012). The formula is given as follows:

$$P/E\ ratio = \frac{Market\ price\ per\ share}{Earnings\ per\ share\ (EPS)} \quad (23)$$

1.5. Economic Value Added

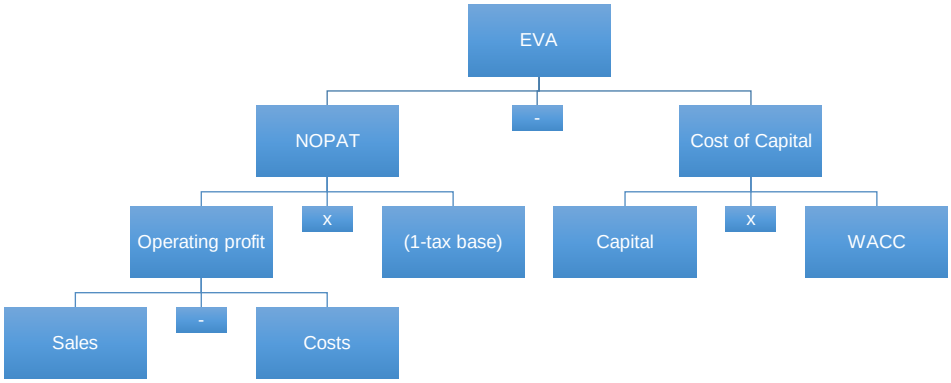
Financial ratios don't reflect the primary purpose of the business which is maximization the value for shareholders. The financial analysis developed additional performance measurement that incorporates stock price. This measurement was published in 1989 by Stern Stewart & Co Consultancy. (Shil, 2009). Economic Value Added (EVA) focus on managerial effectiveness in a given year and measures the extent to which the company has increased shareholders value. The method is based on the economic concept of profit. According to Venanzi (2012), "the main modifications consist of accounting adjustments designed to convert accounting income and accounting capital to economic income and economic capital." (Venanzi, 2012 p. 18). Therefore, the difference between EVA and residual income depends on these accounting adjustments. The formula deducts after-tax operating profit obtained at the beginning of the period from the total cost of capital, including the cost of equity capital. EVA symbolize the residual income that remains after costs of all capital, including equity capital, and other opportunity costs have been subtracted. Considering opportunity costs, note that equity capital has a cost due to shareholder's willingness to give up the opportunity to invest elsewhere. (Mařík et al., 2018). Economic Value Added differs substantially from accounting profit because accounting profit doesn't reflect the use of equity capital. (Brigham, et al., 2015).

$$EVA = NOPAT_t - NOA_{t-1} * WACC_t \quad (24)$$

The equation above represents the 'capital charge' approach considering the cost of the capital. The second approach is called 'value spread' and provides the same result as the previous one. Furthermore, NOPAT should comprise expenses and revenues that relate to NOA. Net operating assets stand for assets involved in main business activities after deduction of non-chargeable funding (namely short-term liabilities) and extraordinary items. Using of NOA_{t-1} stands for opening assets at the beginning of the period taking into consideration that these assets gained operating profit. (Mařík et al., 2018).

The concept says that a company generates value for owners only when its operating income (NOPAT) exceeds the cost of capital ($NOA_{t-1} * WACC_t$) employed. (Higgins, 2012). This means that the business can earn the funds necessary for running operating assets. Otherwise, there are two approaches to

increasing EVA. One of them is to rise NOPAT, and the other one advises to reduce costs for capital. The deduction of EVA is portrayed below:



Source: Adapted from Knápková Adriana, Pavelková Drahomíra, 2010, page 205

Fig. 4 EVA decomposition

According to Higgins, "EVA's appeal is that it integrates three crucial management functions: capital budgeting, performance appraisal, and incentive compensation." (Higgins, 2012).

- Calculation of EVA

Calculation of EVA is a simple technique, although determining NOPAT, NOA, and WACC is a tricky part. In order to express economic value added for shareholders in the most accurate way, one has to transfer these attributes from accounting to economic items. And at the same time, the symmetry between NOA and NOPAT has to be maintained, i.e., costs and revenues arising from assets classified in NOA must be considered to determine the NOPAT and vice versa. (Mařík et al., 2018).

Adjusting NOA

Various operations are necessary to obtain net operating assets. The starting point is a balance sheet, where analysts:

- Separate unnecessary assets from total assets,
- Deduct non-interest external capital from assets,
- Exclude extraordinary items,
- Activate items that are not reported in assets. (Mařík et al., 2018).

NOPAT determination

Net operating profit after taxes can be acquired from operating profit/loss and, where applicable, should be adjusted as follows:

- Deduct depreciation of leased property,
- Add depreciation of non-operating non-current tangible assets that were removed from NOA,
- Adjust tax to correspond with NOPAT. (Mařík et al., 2018).

- Strength and Weaknesses of EVA

EVA, as every indicator, has its strengths and weaknesses. For example, assuming that the increase in present EVA was achieved to the detriment of future value, the overall effect is not desirable.

On the other hand, EVA's most significant advantages are taking the time value of money into the account; comparison between different companies across the geographical locations; alternative approach in financial reporting; considering risk and investors' profit requirements. EVA eliminates the deficiency of financial analysis.

- Weighted Average Cost of Capital

The weighted average cost of capital (WACC) quantifies average costs emerging from funding economic activities of the company. WACC merge a company's cost of equity and cost of debt weighted by their proportion in the company's capital structure. The weighted average cost of capital is widely used as the risk-adjusted discount rate in the discounted cash flow method for company evaluation. However, it can also be applied in the assessment of any project or financial investment. For project evaluation, the WACC is usually adjusted according to the business or financial risk. (Eiteman, et al., 2015).

WACC is calculated as follows:

$$WACC = k_e \frac{E}{V} + k_d (1 - t) \frac{D}{V} \quad (25)$$

, where:

k_e is a risk-adjusted cost of equity,

k_d is a before-tax cost of debt,

t is marginal tax rate,

E is the market value of a company's equity,

D is the market value of the company's debt,

V is the market value of a company's securities (D + E).

One can say that the enterprise can't control 3 factors affecting the result. The first factor is an actual situation on financial markets, second is the investor's risk aversion associated with the given market (market risk premium), and the last one is the tax rate. First two factors influence the k_e variable. The third factor is known as a tax shield and represents tax deductions on interest paid. In practice, it describes a situation that if debt along with interest payment increase, it results in higher tax deductions. The tax shield reduces the net cost of debt and therefore must be comprised by multiplying the cost of debt with (1-t). (Ross, et al., 2003).

In contrast to the above, the company can change WACC by its capital structure, dividend, and investment policy. (Brigham, et al., 2015)

- CAPM method

William Sharpe, who published an idea about portfolio return and risk as the only attributes to be concerned in assets evaluation, developed a model called capital assets pricing model (CAPM). (Sharpe, 1963).

The CAPM model introduces the return on an asset as a function of the return on a risk-free asset plus a risk premium. The return on the risk-free asset serves as compensation for the time value of money. Overall, these elements in the CAPM model says that expected return on asset equals to the expected return on a risk-free asset plus the risk premium. (Peterson, et al., 2003).

A market portfolio is consisting of all assets in a market and represents the most well-diversified portfolio. The only risk that the portfolio faces is a non-diversifiable risk. Since assets are priced to compensate for the assets' risk and also the only risk in the portfolio is represented by non-diversifiable risk, then the risk applies only to non-diversifiable risk. Thus, we can refer to this non-diversifiable risk as market risk. (Peterson, et al., 2003 p. 295).

Taking into account that market portfolio is consist of all assets, each asset possesses some level of market risk. A systematic risk represents market risk which systematically pervades across assets. Contrary to an unsystematic risk that stands for diversifiable risk. Additionally, there is a company-specific risk referred to the risk that is not associated with the market and considers specific situations related to the company. A CAPM formula is composed as follows:

$$r_i = r_f + (r_m - r_f)\beta_i \quad (26)$$

The expected return on assets i is referred to as r_i. On the right side of the equation, the expected return on the risk-free asset is represented by r_f, also referred to as a time value of the money or risk-free rate. The risk-free rate is usually the yield on government bonds. r_m represents the expected return on the market. Thus, the difference of the return on a portfolio including all stocks on the market and the risk-free rate $(r_m - r_f)$ stands for the market risk premium. The market risk premium is the interest an investor claim above the risk-free rate on an investment. (Ross, et al., 2003).

In other words, risk-free rate of return represents the minimum rate that an investor is willing to accept for any investment because he will not bear additional risk unless the potential rate of return exceeds the risk-free rate. (Koller, et al., 2015).

A parameter beta *(β_i)* refers to a market risk concerning the sensitivity of asset's return to the market's return, namely it is a degree of market risk for an asset i. Beta reflects how risky is an asset in comparison to overall market risk and is a function of the volatility of the asset as well as the market which correlates between the two. The expected return on a single asset is the sum of the expected return on the risk-free asset and the premium for potential market risk. Considering stocks, the market is traditionally represented by market index like the S&P 500 for instance.

Calculating the β_i, the greater the figure, the higher the return can we expect. If there is no market risk on an asset and beta equals zero, its expected return would be similar to the expected return on the r_f. On the other hand, considering that an asset's risk is according to the industry's stock performance, that result in beta equals to 1.

In conclusion, the result of the CAPM model represents the expected return that investors require for their equity investment. It serves to investors as an indicator of whether to withdraw their holdings or not. The drawback of the model is that application concerning decision regarding future investment could be uncertain due to past orientation. Using CAPM for future investments might be misleading. (Eiteman, et al., 2015)

1.6. Credit Scoring

Credit scoring as an analytical technique that aims to examine a company concerning its financial health.

1.6.1. Altman's Z-Score

Bankruptcy models were developed to identify and prevent the risk of potential bankrupt. The method was deducted based on bankrupted enterprises and work on the assumption that we can develop an indicator for symptoms of potential difficulties.

Professor Altman compiled his model during '60s, and 80's from the discriminant analysis. He derived a function leading to the estimation of financial health for both publicly tradable and non-traded companies. (Vernimmen, et al., 2017) Foreign analysts amended it in recent years and replaced with the latest version of the formula:

$$Z^n = 6.56X_1 + 3.26X_2 + 6.72X_3 + 1.05X_4 \quad (27)$$

, where:

X_1 $working\ capital\ /\ total\ assets$,

X_2 $retained\ earnings/\ total\ assets$,

X_3 $EBIT/\ total\ assets$,

X_4 $shareholders'equity\ /net\ debt$.

If Z^n is less than 1.1, then the probability of corporate failure is very high, and if $Z^n$is greater than 2.6 then the probability of corporate failure is low. The values in between are referred to as a grey area.

The Altman Z-score model was estimated on a U.S. enterprise, which might cause some complications in applying to non-U.S. firms. First, accounting principles vary from country to country. Second, in predicting financial distress, the likelihood that financial distress leads to bankruptcy depends on national bankruptcy laws and therefore differs from country to country. Fortunately, Richard Taffler developed a Z-score commonly used in the UK. (Healy, et al., 2007 p. 419)

$$Z^n = 3.20 + 12.18X_1 + 2.5X_2 - 10.68X_3 + 0.0289X_4 \quad (28)$$

, where X_1 $profit\ before\ tax\ /\ current\ liabilities$,

X_2 $current\ assets/\ total\ liabilities$,

X_3 $current\ liabilities/\ total\ assets$,

X_4 $no - credit\ interval\ (in\ days)$.

The no-credit interval is defined as immediate assets, which is a sum of current assets excluding inventories and prepaid expenses minus current liabilities, divided by total operating expenses excluding depreciation and multiplied by 365 days. (Healy, et al., 2007 p. 419). This variable informs us how long the firm can fund its current operations when other sources of short-term finance are unavailable.

If Z^n is negative, then the model predicts bankruptcy within two years.

Either Altman nor Taffler model can serve as a replacement for in-depth analysis. However, they provide a useful reminder of the power of financial statement data.

1.6.2. Quick Test

Besides Altman Z-score which serves as a bankruptcy model, professor Kralicek introduced a model of creditworthiness called Kralicek Quick test in 1990. (Grünwald, et al., 2009).

The model uses ratios which wouldn't yield to any disruptive factor, but on the other hand, must representing the informational potential of financial statements. Due to this, Kralicek nominated four ratios from the main subjects of financial analysis – stability, liquidity, profitability, and rentability in order to balance the analysis of the financial situation. (Sedláček, 2011).

The quick test uses the following ratios:

- Equity ratio

$$Equity\ ratio = \frac{Shareholders'equity}{Total\ Assets} \quad (29)$$

Equity ratio expresses the capital strength of the company and informs us about long-term financial stability and independence concerning generating enough funds for covering its need.

- Debt payback period from cash flow

$$Debt\ payback\ period\ from\ CF = \frac{Total\ liabilities - Current\ financial\ assets}{Adjusted\ cash\ flow} \quad (30)$$

This ratio illustrates the period required by the company to be able to pay for its liabilities. Adjusted cash flow is calculated from income statement as EBIT minus tax plus depreciation of non-current intangible and tangible assets. The obtained value is defined in order to achieve comparability.

- Cash flow as a percentage of sales

$$CF\ [\%\ of\ sales] = \frac{Cash\ flow}{Sales} \quad (31)$$

- Rentability on total assets

$$ROA = \frac{EBIT}{Total\ Assets} \quad (32)$$

A cash flow expressed as a percentage of sales and ROA are ratios that analyze the profitability of observing company.

In order to determinate the creditworthiness, we need to examine the above ratios in the following table and then average obtained grades as a final result of creditworthiness. (Sedláček, 2011).

Tab. 2 Scale for ratio assessment

Ratio	Excellent (1)	Very good (2)	Good (3)	Poor (4)	Solvency threat (5)
Equity ratio	> 30 %	> 20 %	> 10 %	> 0 %	negative
Debt payback period from CF	< 3 years	< 5 years	< 12 years	> 12 years	> 30 years
CF [% of sales]	> 10 %	> 8 %	> 5 %	> 0 %	negative
ROA	> 15 %	> 12 %	> 8 %	> 0 %	negative

Source: Adapted from Financial analysis, Sedate, Jaroslav, 2011, page 107.

2. Cobham PLC

2.1. Company Profile

Flight Refuelling was founded by Alan Cobham and became a public limited company in 1954. The company obtained the name Cobham PLC in recognition of its founder in 1994. Cobham PLC offers technologies and services across its defense aerospace and space markets. It has leading market positions in air-to-air refuelling; aviation services; wireless, audio, video and data communications, including satellite communications defense electronics; life support and mission equipment. The revenue is split between 40% in the commercial sector, 36 % in US defense/ security, and 24 % for the UK and the rest of the world defense and security. They have customers and partners in more than 100 countries. (Cobham PLC, 2018). According to Defense News, Cobham PLC is the 49th largest defense company ranked in Top100 for 2018 based on a percentage of total revenue. (Defense News, 2018).

The company is based in Dorset, England. Cobham PLC employs about 11.000 people in the US (49%), UK (22%), Europe and Australia. (Cobham PLC, 2018)

Cobham PLC is listed on the London Stock Exchange since January 1954 and is also a constituent of the FTSE 250 Index, which comprises mid-capitalized companies not covered by the FTSE 100, and represents approximately 15% of UK market capitalization. (FTSE Russell, -). Cobham PLC two significant shareholders are Silchester International Investors LLP and Ameriprise Financial Inc. (Cobham PLC).

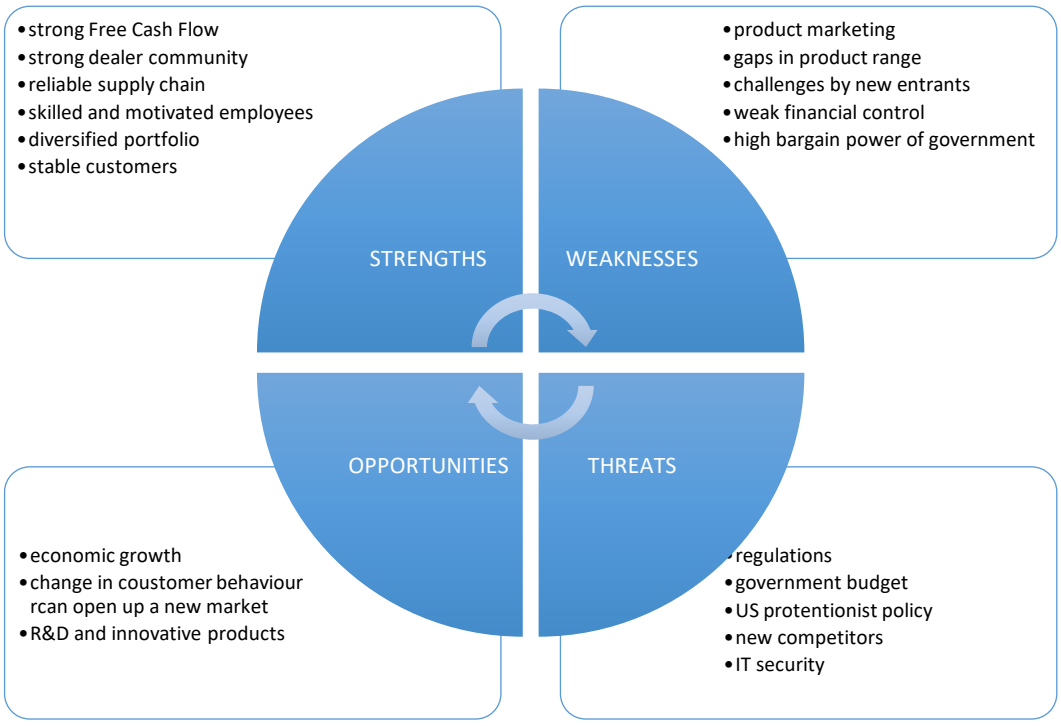
Company's vision is to work together to be the leading global technology and services innovator, as well as to be respected for providing solutions to the world's most challenging problems. Its strategy is to strive to build and maintain leading positions in their chosen markets by leveraging innovative technology and know-how with a deep insight into customer needs. (Cobham PLC).

Cobham PLC operates in four sectors – communications and connectivity, mission systems, advanced electronic solution, and aviation services. First one provides high-performance equipment and solutions to enable reliable connectivity across a range of demanding environments in aerospace, avionics, satellite and radio, wireless and mobile connectivity markets. Mission Systems segment provides safety and survival systems for extreme environments, aerial refuelling system,

and wing-tip to wing-tip mission systems for fast jets, transport aircraft, and rotorcraft. The Aviation Services segment delivers outsourced aviation services, including military training, special mission flight operations and outsourced commercial aviation with central operating locations in Australia and UK. The Advanced Electronic Solutions segment provides solutions for communication on land, at sea, in the air, and in space through off-the-shelf and a range of products, including radio frequency, microwave, and microelectronics, antenna subsystems and motion control solutions. These activities are also operated in Mexico. (Cobham PLC, 2018)

2.2. SWOT Analysis of Cobham PLC

The SWOT analysis is a commonly used technique that provides a better understanding of the company's strengths and weaknesses as well as identifying opportunities and threats that the company might face.



Source: Author

Fig. 5 The SWOT Analysis

- Strengths

According to Cobham PLC's annual report from 2017, Cobham PLC has a significant amount of free cash flow that represents an opportunity to engage into new projects. Cobham PLC also developed a strong culture among its distribution network in meaning that dealers not only promote the company's products but they also invest in sales training to enhance customer experience. Moreover, through that they can reach the majority of its potential market. Due to successful mergers and acquisition, the company built a reliable supply chain by integrating technology companies. On top of that, Cobham PLC provides training and learning sessions across its workforce resulting in skilled and highly motivated employees.

Last but not least, one of the most substantial advantages of the company is a diversified product portfolio which covers different sectors and markets. (Cobham PLC, 2018).

- Weaknesses

On the contrary, considering the company's weaknesses, I identified areas for improvement or what should be avoided. Firstly, from the marketing point of view, the positioning of the product needs to be determined clearer. Besides that, product portfolio has gaps in the product range which might be recognized by its competitors as an opportunity to enter the market. Moreover, the company was not able to compete in challenges present by the new competitors in the segment and lost small market share. As mentioned above, Cobham PLC successfully acquired small technology companies, but on the other hand, they failed in integrating firms with different work culture. (Cobham PLC, 2018). Due to weak financial control, profits slowed down in 2016. (Cobham PLC, 2017). Ultimately, Cobham PLC is highly dependent on governments who have high bargain power.

- Opportunities

Economic turnaround followed by growing customer spending is an opportunity to attract new customers and increase current market share. On top of that, the change in consumer behaviour represents a potentially new market for Cobham PLC to enter. Regard this as an opportunity to develop a new revenue stream and diverse product range. Segments for more in-depth consideration could be cybersecurity or artificial intelligence. Referring to the strong free cash flow

mentioned above; this could be used for funding a new project or for expansion. Besides, current R&D findings could be implemented in various products.

Cobham PLC looks towards the future. Thus, the company invests in R&D and introduces innovative products. According to the company's business model, customers could be considered as stable which gives Cobham PLC the advantage to secure their bonds.

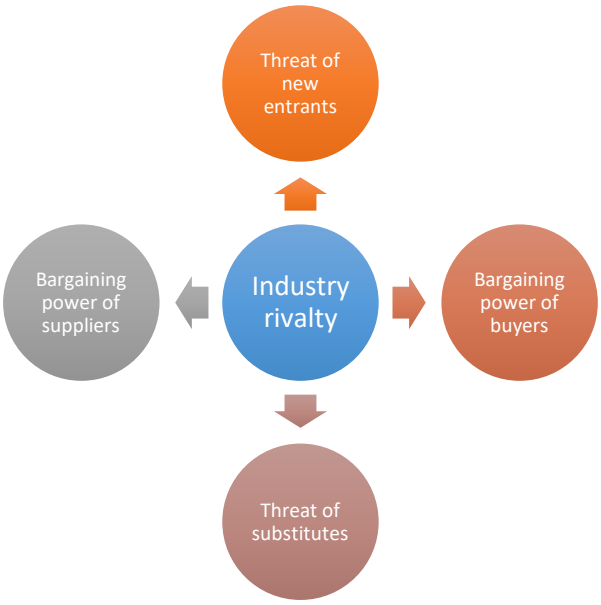
Furthermore, aerospace and defense sector notice positive outlook.

- Threats

When identifying threats, we shall be very precise and careful, because they represent risks and obstacles that may hurt the business in several ways. Regarding profit, it can be affected by the introduction of new government regulations as well as limited spending. Fifty percent of Cobham PLC's revenue is made by the US government and considering increasing trend towards protectionists economy; this can lead to a dramatic impact on international trade. At the same time, stable profitability attracted new competitors which decreased Cobham PLC's market share affecting profit margin negatively. Besides, Cobham PLC faces a high risk of intellectual property theft. Fortunately, they are aware of this issue and continuously update and improve their IT security to keep pace with the changing nature.

2.3. Porter's Five Forces

Industry analysis is a strategic management tool which outlines crucial aspects of profitability and also forecasts an outlook to the future. (Porter, 1980). This industry is regarded as highly demanded resources in terms of capital, R&D and labour. I applied Porter Five Forces Analysis to determinate core factors affecting the given industry.



Source: Own adaptation based on Porter's Five Forces: Analyzing the Competition retrieved from https://www.businessnewsdaily.com/5446-porters-five-forces.html on the 15th November 2018

Fig. 6 Porter Five Forces Model

- The Threat of new entrants

The Threat of new entrant symbolizes significant risk within every industry. Fortunately, considering industrial goods and services market, there are many entry barriers. However, at the same time, new entrants think outside of the box, bring innovation, a new approach, and furthermore, they push down price and costs to its limits. According to recent trends, they are even able to identify customer's added value and target on that. Cobham PLC has protected itself by innovations, economies of scale and investing in R&D. Besides, entering the market for new entrants is less attractive considering already established players who determinate the industry.

- Threat of substitutes

The threat of substitutes represents a recent strategy of many competitors. Customer needs may be satisfied differently, and the goal of these rivals is to find

a new product to meet similar needs resulting in lower profitability for present players. In order to avoid this threat, the company should focus on understanding the core need of the customer rather than be only product oriented.

- Bargaining power of buyers

Taking this bargaining power of buyers into account, Cobham PLC faces most powerful governments in the world as their customer base assuming that their purchase power is very high. On the other hand, it represents a challenge for Cobham PLC to expand the customer base to reduce the bargaining power of the buyers. And at the same time, to increase sales.

- Bargaining power of suppliers

If we have a look at the other side of the supply chain, suppliers represent a threat too. Considering suppliers in a dominant position, they tend to ask for higher prices by applying their negotiating power. To prevent such a thing, Cobham PLC can build a supply chain employing multiple suppliers as well as experimenting with different raw materials used for product designs to achieve the ability to shift from one to another depending on the price. (Marci, 2018)

- Industry rivalry

In a case of high competitiveness within the industry, this would result in decreasing of the overall profitability for all of the players. Industrial goods and services are regarded as very competitive which may affect the firm especially from the long-term point of view. (Fern Fort University, 2017). Some of the real rivals are listed below:

- AAR Corp.,
- Alabama Aircraft Industries, Inc.,
- API Technologies Corp.,
- BAE Systems Plc,
- Cooper Antennas Ltd,
- Dassault Aviation SA,
- Elbit Systems Ltd,
- Kongsberg Gruppen AS,

- Moog Inc.,
- Northrop Grumman Corp.,
- Senior Plc. (GlobalData, 2018), (Financial Times, 2019).

Considering accounting principles, scope of territory and activities, I selected three competitors to be compared to Cobham PLC - BAE Systems Plc, Kongsberg Gruppen AS and Senior Plc. The company Moog Inc. belongs to one of the strongest competitors but for the purpose of the financial analysis, it has to be excluded due to different accounting principles. In conclusion, the Porter Five Forces model and SWOT analysis provide valuable input for the company's strategy to expand their competitive advantages and identify various impacts on profitability. Furthermore, it shows game-changing trends and provides an opportunity to respond to them.

3. Analysis of Cobham PLC's Financial Performance

3.1. Financial Statements Analysis

Financial statements provide helpful source regarding business' economic activities during the time period. The chapter is dedicated to accounting principles and introduce a company's financial statements with a focus on its informational ability.

3.1.1. Accounting Principles

To be able to perform a financial analysis of a company, it is necessary to work with reliable and consistent data. Furthermore, to be able to compare the data within periods and among competitors, they need to be reported under the same accounting principles. Most of the countries require by law the companies incorporated on the stock market to apply IFRS for their annual reports along with an audit by an auditing firm.

In 2017, the IFRS Interpretations Committee issued an agenda decision on interest and penalties related to income taxes. This decision clarified that entities do not have a policy choice between applying IAS 12 ‘Income taxes’ and applying IAS 37 ‘Provisions, contingent liabilities’ and contingent assets to interest and penalties related to income taxes. As a consequence, 2016 balances have been restated accordingly. (Cobham PLC, 2018).

Furthermore, IFRS 15 - Revenue from Contracts with Customers, was adopted on 1 January 2018 with effect to financial statements up to past 3 years. Under IFRS 15, revenue is recognised over time for contracts where there is no alternate use for the product and there is a right to payment at all times throughout the contract. A number of long term development programmes, notably within the Mission Systems Sector, meet these criteria. Revenue is also recognised over time for contracts where control transfers as the product is being manufactured. This occurs on some contracts directly with government bodies, most notably in the Advanced Electronic Solutions Sector. On both types of contract, where revenue is now recognised over time, the amounts previously included within inventories as work in progress or finished goods are now recognised, including margin, as a contract asset described as unbilled receivables. (Cobham PLC, 2019) IFRS 15 has been applied retrospectively and therefore comparative information presented in these financial statements has been restated as disclosed in the tables below.

It is important to note that Cobham PLC has been preparing for an adoption of IFRS 16 - Leases, which becomes effective from 1st of January 2019. This standard requires all leases to be recognised on the balance sheet and depreciation of lease assets separate from interest on lease liabilities in the income statement. (The International Financial Reporting Standards Foundation, 2016). However, it is not expected to have an impact on the Cobham PLC's financial reporting.

3.1.2. Annual Statements Analysis

An annual statement informs us about all business transactions of a company over a certain period of time. Even though the values assigned to items are only a snapshot due specific date, usually 31st December, it still represents a useful overview to compare statements within previous periods.

- Balance sheet

The balance sheet compares company's assets with its liabilities and equity. The table in Appendix 1 sums up the most significant figures of Cobham PLC's balance sheet.

Considering the trend over the years, Cobham PLC's balance declined every year due significant reduction of intangible assets due to the impairment provision of goodwill and reclassification of customer relationship, technology based assets and goodwill that arised from business combinations as held for sale. (Cobham PLC, 2018) Acquired investment properties from business combinations were burden with depreciation and disposals over the years. Trade and other receivables are accumulating which is also reflected in declining cash flow from operating activities. Current borrowings went down compare with 2013 (£344.5m) to the prejudice of non-current borrowings which are mainly consist of senior notes. Retained earnings turned to negative figure due to reported loss and paid dividends in 2016. (Cobham PLC, 2017).

- Income statement

The Income statement shows revenues or sales of the company at the top and then deducts different type of expenses. It provides a follow up for a reader to see how net income evolved from revenues. The Cobham PLC's income statements are included in appendix 2.

Operating costs in 2016 rocketed due to impairment of goodwill and other intangible assets of £573.8m.

This impairment is made up of charges against:

1. The Wireless business unit, within the Communications and Connectivity Sector, where there is an impairment of goodwill and intangible assets of £196.1m. This unit includes part of the Aeroflex acquisition in 2014 and Axell Wireless in 2013.
2. The Integrated Electronic Solutions business unit, part of the Advanced Electronic Solutions Sector, where there is an impairment of goodwill of £185.7m. This unit includes part of the Aeroflex acquisition in 2014.
3. The Semiconductor Solutions business unit, also within the Advanced Electronic Solutions Sector, where there is an impairment of £192.0m. Also, part of the Aeroflex acquisition in 2014. (Cobham PLC, 2017).

Operating profit continuously increase since 2015 (cleaned up of the impairment in 2016 described above) but remaining negative results derive mainly from acquisition of Aeroflex in 2014.

- Cash flow statement

The factor of liquidity should not be neglected. Only those companies which have available cash and are able to pay its debt can last in the long-term future. The table in appendix 3 summarizes all the cash flows divided between operating, investing and financing activities and shows how is the company performing in terms of liquidity.

Cash flow from operations represent company ability to generate cash from its daily business. Cobham PLC generate positive cash flows which is slightly decreasing over a time, peaked in 2017 and declined again in 2018. This was mainly affected by increasing receivables and interest paid.

Cash flow from investing activities should be generally negative as it indicates that company invests in order to generate cash flows from these investments in the future. In 2014, Cobham PLC acquired Aeroflex Holding Corp. Approximately 70% of Aeroflex's revenue was focused on commercial markets with exposure to wireless, space, microelectronics, industrial, energy and other sectors, increasing the proportion of Cobham PLC's commercial revenue and building on Cobham

PLC's focus on connectivity capabilities, customers and characteristics. Aeroflex operations were integrated into Cobham PLC's Advanced Electronic Solutions and Communications and Connectivity Sectors (Cobham PLC, 2015).

On the other hand, cash flow from investing activities was positive in 2015 because of number of divestments that have been completed - Weinschel and Inmet, Advanced Electronic Solutions Sector; Cobham PLC Composites, primarily Communications and Connectivity Sector; Wireless operations in Nanjing, China, Communications and Connectivity Sector; Metelics, Advanced Electronic Solutions Sector. (Cobham PLC, 2016). Positive figure also occurred in 2018 due to business divestment of £324.7m of the Group's AvComm and Wireless test and measurement businesses, part of the Communications and Connectivity Sector. In the Group consolidated financial statements for the year 2017, the assets and liabilities of these businesses were classified as held for sale and were measured on a non-recurring basis at fair value. (Cobham PLC, 2019)

The cash flow from financing activities indicates whether the company is taking on new equity or debt and if it repays some of its liabilities. In 2014, 2016 and 2017, the Cobham PLC issued shares of capital, which is also reflected in the balance sheet. Cash flow from financing in 2014 also includes new borrowings of US$1.300m from September 2014 that was drawn under an acquisition finance facility agreed in May 2014 and US$930m of this was repaid in October 2014 following the issue of US$930m fixed rate senior notes. (Cobham PLC, 2015).

3.1.3. Use of Alternative Measures

For better understanding of earnings trends, Cobham PLC has included within its financial statements alternative performance measures. Management uses underlying measures to evaluate the operating performance of the entity. They define underlying operating profit as an operating profit from continuing activities excluding the impacts of business acquisition and divestment related items, likewise other items identified as non-operating character. Changes in the marking to market of the non-hedge accounted derivative financial instruments are also excluded as well as gains and losses arising on dividend related foreign exchange contracts. (Cobham PLC, 2018). These underlying results were used for financial analysis instead of values given on the financial statements. The modified income statement would be as follows and balance sheets were adjusted accordingly.

Tab. 3 Modified Income statement

Income Statement	31-Dec-14	31-Dec-15	31-Dec-16	31-Dec-17	31-Dec-18
Revenue	**1 851.7**	**2 072.0**	**1 943.9**	**2 091.6**	**1 863.3**
Cost of sales	1 290.1	1 408.2	1 358.6	1 494.8	1 339.9
Gross profit	**561.6**	**663.8**	**585.3**	**596.8**	**523.4**
Operating costs	274.9	331.6	360.3	383.7	327.3
Operating profit/(loss) - EBIT	**286.7**	**332.2**	**225**	**213.1**	**196.1**
Finance income	0	0	4.1	6.1	10.5
Finance costs	29.7	51.8	53.9	43.3	51.4
Profit/(loss) before taxation	**257**	**280.4**	**175.2**	**175.9**	**155.2**
Taxation	52	60.4	39.6	37.3	35.6
Profit/(loss) after taxation for the year	**205**	**220**	**135.6**	**138.6**	**119.6**
EPS	13.7	14.3	7.8	6.2	5.0

Source: Author, based on Cobham PLC annual statements

3.2. Ratio Analysis

This chapter will be dedicated to examining selected financial ratios and comparing them among Cobham PLC's competitors. Analyzing financial statements thoroughly, it's important to understand relationships between these figures. Ratio analysis becomes commonly used technique to compare different companies over time periods to spot trends and make estimations about the future. The calculation of industry average is sometimes used within the comparison as well. Industry averages are obtained from Damodaran online, which comprises all of the investigated companies and from CSImarket.com, which provides the average for Aerospace & Defense industry. Ratios are grouped by categories, i.e. profitability, liquidity, financial leverage, activity and investment valuation ratios.

3.2.1. Profitability Ratios

Profitability ratios enable information regarding a company's ability to generate enough revenue to cover its costs and more. Profitability indicates how efficiently company utilize its resources and assets to create a profit. It is one of the main objectives for most of the managers.

- Gross profit margin

As we can see from the table 7, the Cobham PLC's gross profit margin oscillate around 30% and remains stable over the years with a leading position. The highest revenue was reached in 2017 following by 2015 and the lowest cost of sales were in 2014, which is reflected in the figures. The gross profit margin is mainly burden by employment costs which makes about 60 % of costs of sales.

Tab. 4 Gross profit margin

Gross profit margin	31-Dec-14	31-Dec-15	31-Dec-16	31-Dec-17	31-Dec-18
Cobham PLC	30%	32%	30%	29%	28%
BAE	14%	9%	10%	8%	10%
Kongsberg	29.6%	28.5%	28.1%	29.6%	28.9%
Senior PLC	24.6%	24.2%	21.9%	21.3%	20.8%
Aerospace & Defense Industry	21.2%	25.3%	24.9%	24.9%	28%

Source: Author, based on Cobham PLC, BAE Systems, Kongsberg Gruppen and Senior PLC annual statements and Damodaran online.

- Operating profit margin

Declining operating profit margin was observed during last five years within 3 out of 4 competitors. The highest operating profit margin was reached in 2015, when Cobham PLC introduced EiD (Excellence in Delivery) programme that enabled them to simplify the business and achieve significant efficiency savings by reducing costs through an extensive site integration and rationalisation programme

Tab. 5 Operating profit margin

Operating profit margin	31-Dec-14	31-Dec-15	31-Dec-16	31-Dec-17	31-Dec-18
Cobham PLC	15%	16%	12%	10%	11%
BAE	7%	8%	9%	9%	8%
Kongsberg	7.6%	5.5%	4.4%	5.3%	6.6%
Senior PLC	10.9%	8.5%	7.2%	6.4%	6.5%
Aerospace & Defense Industry	9%	10%	10%	9%	9%

Source: Author, based on Cobham PLC, BAE Systems, Kongsberg Gruppen and Senior PLC annual statements and Damodaran online.

Note that most significant items are not included in underlying profit such as amortisation expense on intangible assets arising on business combinations of £114m (2014), £177m (2015), £161.2m (2016), £138.9m (2017).

- Net profit margin

BAE Systems net profit margin is burden by financial costs comprised of interest expense on bonds and other financial instruments and loss on measurement of financial instruments at fair value through profit or loss. (BAE Systems, 2017) In a comparison to Cobham PLC which manages its financial costs that consist of interest on bank overdrafts and loans and interest on net pension scheme liabilities more efficient. Cobham PLC's floating rate Euro and US dollar loans acquired in 2015 doubled financial costs since then. Moreover, take tax rate into account because it rose from 20 % (2013) to 23 % (2018).

Tab. 6 Net profit margin

Net profit margin	31-Dec-14	31-Dec-15	31-Dec-16	31-Dec-17	31-Dec-18
Cobham PLC	11.1%	10.6%	7.0%	6.6%	6.4%
BAE	4.5%	5.6%	5.3%	5.0%	6.1%
Kongsberg	5.3%	4.4%	4.1%	3.9%	4.9%
Senior PLC	7.7%	5.7%	5.0%	5.9%	4.6%
Aerospace & Defense Industry	5.5%	6.6%	4.7%	5.2%	5.8%

Source: Author, based on Cobham PLC, BAE Systems, Kongsberg Gruppen and Senior PLC annual statements and Damodaran online.

- ROA

Except to BAE's Systems, Cobham PLC and competitors observe declining return on assets in a contrast to stable 6 % in Aerospace & Defense industry. The decrease in ROA is a reflection of declining EAT over the years. According to Deloitte study from 2018, the global A&D industry's ROA rose to 5.2 percent in 2017, from 4.5 percent in 2016, as overall profitability for the industry experienced significant improvement and A&D companies continued to become more efficient in utilizing their asset base. (Lineberger, et al., 2018)

Tab. 7 ROA

ROA	31-Dec-14	31-Dec-15	31-Dec-16	31-Dec-17	31-Dec-18
Cobham PLC	5.7%	6.6%	4.9%	5.0%	4.6%
BAE	3.8%	4.7%	4.0%	3.7%	4.2%
Kongsberg	4.3%	3.9%	3.1%	2.7%	2.5%
Senior PLC	8.6%	5.6%	4.7%	6.3%	4.9%
Aerospace & Defense Industry	6%	6%	6%	6.2%	6.3%

Source: Author, based on Cobham PLC, BAE Systems, Kongsberg Gruppen and Senior PLC annual statements and https://csimarket.com/Industry/industry_ManagementEffectiveness.php?ind=201

- ROE

Cobham PLC's ROE in 2016 and 2017 were restated accordingly to underlying measures which changed retained earnings (ROE originally resulted in -162.3% (2016) and 9.7% (2017) before IFRS 15). Current figures are affected by issued shares of £496.7m (2017) and £490.6m (2016) which had negative impact on the return of the equity as well as higher retained earnings due to excluding an impairment provision of £573.8m on amortisation of software in 2016 considered

as exceptional item. The proceeds of the issued capital were partially used to repay senior notes of face value US$44m in May 2017 and US$75m of scheduled repayment in October 2017, with the remaining proceeds after partial repayment of the Group's revolving credit facilities held on deposit at the year end. The remaining raised net proceeds were held as bank deposits. This step was taken to strengthening the balance sheet and allowing the management team to focus on the business aims of: customer focus; leadership and simplification; control and execution. (Cobham PLC, 2017). As we can deduct from the table, Kongsberg with similar capital structure is following Cobham PLC's trend. Cobham PLC would need to increase its EAT by 5% to outperform Kongsberg in 2018.

Tab. 8 ROE

ROE	31-Dec-14	31-Dec-15	31-Dec-16	31-Dec-17	31-Dec-18
Cobham PLC	18.4%	24.2%	9.4%	6.8%	5.4%
BAE	40.1%	31.4%	26.7%	18.0%	18.4%
Kongsberg	14.0%	12.3%	9.7%	7.6%	5.6%
Senior PLC	15.4%	11.3%	9.1%	11.3%	9.4%
Aerospace & Defense Industry	18%	21%	12%	17%	22%

Source: Author, based on Cobham PLC, BAE Systems, Kongsberg Gruppen and Senior PLC annual statements and Damodaran online.

ROE is traditionally considered as one of the most important ratio in financial analysis and is analyzed by Du Pont decomposition. If we consider long-term point of view, the key impact on ROE has Assets to Equity ratio. All of the components have multiplicative effect on ROE, but the principal impact lie with this ratio and its results driven in the same direction as ROE itself.

Tab. 9 Assets - Equity ratio

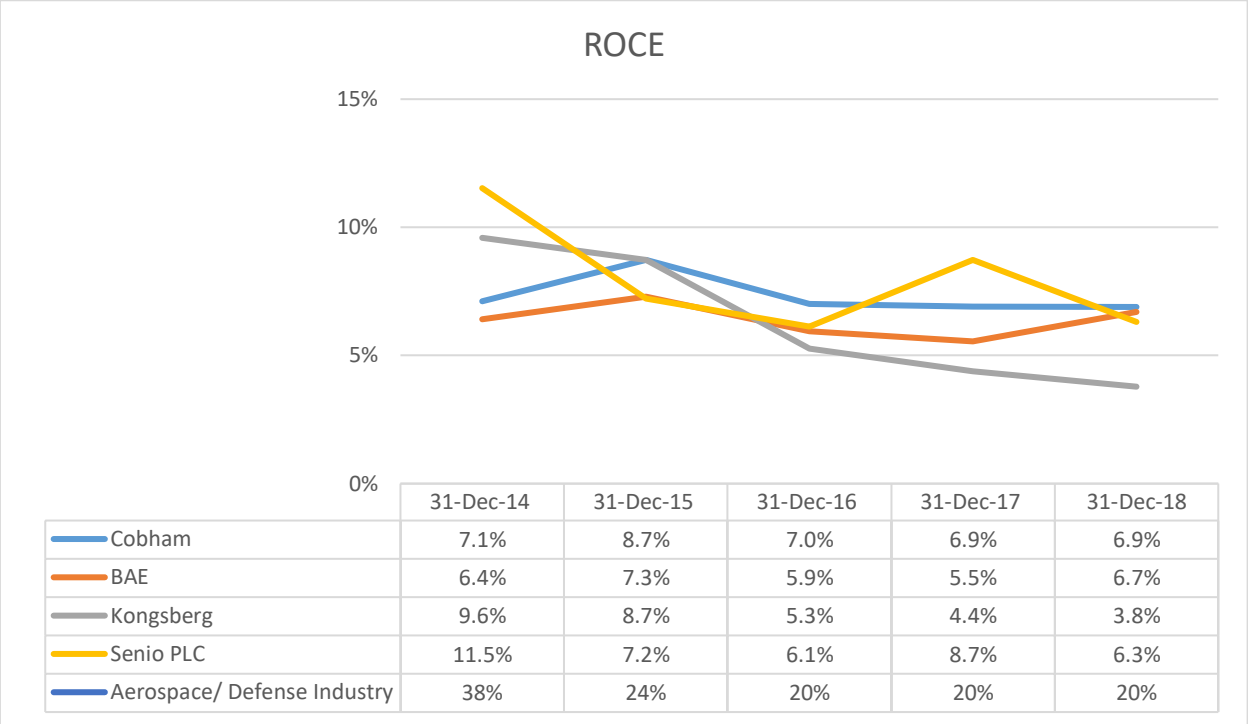
Assets - Equity ratio	31-Dec-14	31-Dec-15	31-Dec-16	31-Dec-17	31-Dec-18
Cobham PLC	3.22	3.65	1.91	1.36	1.18
BAE	10.54	6.69	6.71	4.84	4.40
Kongsberg	3.23	3.12	3.15	2.81	2.19
Senior PLC	1.79	2.00	1.95	1.79	1.93

Source: Author, based on Cobham PLC, BAE Systems, Kongsberg Gruppen and Senior PLC annual statements

- ROCE

Return on capital employed is pictured in the graph below and follows similar trend as ROE. Cobham PLC's ROCE is affected by equity change mentioned above but the average during years is on similar level compare with its rivals. If the company is able to increase earnings on the same capital base or find new efficiencies that require less capital to produce earnings, the ROCE would increase.

Graph 1: ROCE



	31-Dec-14	31-Dec-15	31-Dec-16	31-Dec-17	31-Dec-18
Cobham	7.1%	8.7%	7.0%	6.9%	6.9%
BAE	6.4%	7.3%	5.9%	5.5%	6.7%
Kongsberg	9.6%	8.7%	5.3%	4.4%	3.8%
Senio PLC	11.5%	7.2%	6.1%	8.7%	6.3%
Aerospace/ Defense Industry	38%	24%	20%	20%	20%

Source: Author, based on Cobham PLC, BAE Systems, Kongsberg Gruppen and Senior PLC annual statements and Damodaran online.

- EPS

Since the companies' shares are publicly tradable, shareholders consider EPS and desire for maximized sustained long-term figures. EPS growth is non-market based measure. Cobham PLC reported dwindling EPS and compare to others is less attractive.

Tab. 10 EPS

EPS	31-Dec-14	31-Dec-15	31-Dec-16	31-Dec-17	31-Dec-18
Cobham PLC	£0.1850	£0.1947	£0.0900	£0.0621	£0.0503
BAE	£0.2169	£0.2720	£0.2705	£0.2472	£0.2979
Kongsberg	£0.0330	£0.0473	£0.6206	£0.0624	£0.0354
Senior PLC	£0.1525	£0.1159	£0.1084	£0.1439	£0.1199

Source: Author, based on Cobham PLC, BAE Systems, Kongsberg Gruppen and Senior PLC annual statements and Damodaran online.

Based on the considered ratios, Cobham PLC didn't reach pleasing position in most of the selected profitability ratios. Although, profit margins indicate that Cobham PLC's performance can be considered as strong and convincing and it should be in Cobham PLC's interest to focus on their main business activities along with reducing useless assets and meet shareholders' expectations. On the other hand, considering Cobham PLC's M&A activities and the fact that the company announced they booked a further £574m in impairment charges against many of the businesses acquired in an ill-judged acquisition spree under previous management. In blunt terms, Cobham PLC's performance is burden by its past acquisitions. (Hollinger, 2017)

3.2.2. Liquidity Ratios

Liquidity ratios measure company's ability to convert assets to cash and whether company is able to pay off its short-term debt obligations.

Cobham PLC's liquidity ratios are enhancing over a time the more liquid assets we are taking into account. It is believed that current ratio should be within the range 1-2.5, quick ratio should be within 0.7-1.0, whereas value of cash ratio should exceed 0.2. Cobham PLC faced liquidity risk in 2013 and recovered onwards. Cobham PLC reduced cash and reported lower inventories and trade receivables in 2013 compare to following years. Altogether, Cobham PLC handle enough cash

to meet its current liabilities over the years 2014 to 2018. Compared to Aerospace & Defense industry, Cobham PLC's quick ratio outperforms industry average.

With current liabilities at £864.4m, the company has been able to meet these obligations given the level of current assets of £1.1b, with a current ratio of 1.33x. Usually, for Aerospace & Defense companies, this is a suitable ratio since there is a bit of a cash buffer without leaving too much capital in a low-return environment.

Tab. 11 Current ratio, quick ratio, cash ratio

	31-Dec-14	31-Dec-15	31-Dec-16	31-Dec-17	31-Dec-18
Current ratio					
Cobham PLC	1.58	1.39	1.21	1.70	1.33
BAE	0.74	0.89	1.00	1.10	1.03
Kongsberg	1.30	1.26	1.39	1.48	2.06
Senior PLC	1.45	1.52	1.40	1.25	1.57
Quick ratio					
Cobham PLC	0.96	0.87	0.87	1.37	1.01
BAE	0.66	0.78	0.90	1.01	0.95
Kongsberg	1.00	0.91	0.86	1.24	1.82
Senior PLC	0.81	0.85	0.74	0.66	0.80
Aerospace & Defense Industry	0.27	0.27	0.31	0.31	0.31
Cash ratio					
Cobham PLC	0.34	0.38	0.29	0.60	0.47
BAE	0.29	0.36	0.39	0.45	0.37
Kongsberg	0.42	0.20	0.25	0.39	1.13
Senior PLC	0.07	0.08	0.07	0.05	0.07

Source: Author, based on Cobham PLC, BAE Systems, Kongsberg Gruppen and Senior PLC annual statements and Damodaran online.

There are no concerns around Cobham PLC’s liquidity needs. Nonetheless, note that Cobham PLC's liquidity is funded from bank loans, senior notes and issued capital. In February 2017, Cobham PLC revealed it was taking a £150m charge for delays to certification of its wing aerial refuelling technology to be used on the KC-46 tanker being developed by Boeing for the US Air Force. (Hollinger, 2017)

3.2.3. Leverage Ratios

Leverage ratios show the financial stability of a company by measuring the debt in relation to assets and equity. They also give a better picture of flexibility of a company when business conditions change, such as the interest rate.

- Debt-to-Assets ratio

Debt-to-Assets ratio measures the percentage of the firm's assets financed by creditors. Creditors prefer low debt ratios, because lower the ratio the greater the cushion against creditors' losses in the event of liquidation. Ratios among the companies follow declining trend. BAE's assets are financed mainly by funds supplied by creditors. Cobham PLC attained similar results as Kongsberg as already observed in ROE. When Cobham PLC reached 82% in 2016 and paid highest net interest, it was easier to raise additional equity capital than borrow extra funds. Therefore, the debt-to-assets ratio returned to previous figures.

Tab. 12 Debt-to-Asset ratio

Debt-to-Asset ratio	31-Dec-14	31-Dec-15	31-Dec-16	31-Dec-17	31-Dec-18
Cobham PLC	0.69	0.73	0.82	0.63	0.54
BAE	0.91	0.85	0.85	0.79	0.77
Kongsberg	0.69	0.68	0.68	0.65	0.54
Senior PLC	0.44	0.50	0.49	0.44	0.45
Aerospace/Defense Industry	0.50	0.40	0.46	0.49	0.49

Source: Author, based on Cobham PLC, BAE Systems, Kongsberg Gruppen and Senior PLC annual statements and Damodaran online.

- Debt-to-Equity ratio

With an average debt-to-equity ratio of 2.22, Cobham PLC can be considered as an above-average leveraged company. This is not unusual for a mid-cap company given that debt tends to be lower-cost and sometimes more accessible.

The drop in 2014 was caused by M&A activities. The defense equipment company’s diversification into commercial connectivity and communications markets through the debt and equity funded $1.5bn purchase of US rival Aeroflex in 2014 proved to be ill-timed, over-priced, and badly structured.

Tab. 13 Debt-to-Equity ratio

Debt-to-Equity ratio	31-Dec-14	31-Dec-15	31-Dec-16	31-Dec-17	31-Dec-18	Average
Cobham PLC	2.22	2.65	1.58	0.86	0.64	2.22
BAE	9.54	5.69	5.71	3.84	3.40	9.54
Kongsberg	2.23	2.12	2.15	1.83	1.19	1.90
Senior PLC	0.79	1.00	0.95	0.79	0.86	0.79

Source: Author, based on Cobham PLC, BAE Systems, Kongsberg Gruppen and Senior PLC annual statements

We can check whether Cobham PLC is able to meet its debt obligations by looking at the net interest coverage ratio. The ratio is calculated by dividing a company's earnings before interest and taxes (EBIT) by the company's interest expenses for the same period. A company generating earnings before interest and tax (EBIT) at least three times its net interest payments is considered financially stable. (Besley, et al., 2015) The threshold between investment and speculative zone is given by rating agencies.

In our case, the ratios suggest that interest is strongly covered, which means that debtors may inclined to loan the company more money in the future for growth through debt.

Tab. 14 Net Coverage ratio

Cobham PLC	31-Dec-14	31-Dec-15	31-Dec-16	31-Dec-17	31-Dec-18
Underlying EBIT	286.70	332.20	225.00	213.1	196.1
Net Interest	31.5	37.3	68.8	34.90	35.3
Net Interest Coverage ratio	9.10	8.91	3.27	6.11	5.56

Source: Author, based on Cobham PLC annual statements

Cobham PLC's financial health could be assessed as healthy given debt-to-equity ratio over 40%, short term assets are greater than short term and long-term liabilities and earnings greater than 5x the interest on debt.

- Financial leverage

Financial leverage is defined as EBIT divided by EBIT minus net interest. Cobham PLC took advantage of highest financial leverage in 2016, when it hit 1.29. In upcoming years, the financial leverage dropped to previous level. In order to enhance financial leverage, Cobham PLC may modify its funding structure and reduce shareholders' equity. This step would make a sense if the company had an opportunity to invest in a project with higher appreciation. Considering given time period, the highest appreciation reported mission systems sector with an increasing average profit margin of 15.6%. Contrary to that, majority of revenue is generated from communications and connectivity sector (34% in 2017). However, the profit margin decreased from 17.8% (2013) to 9.8% (2017).

Tab. 15 Financial leverage

Financial leverage	31-Dec-14	31-Dec-15	31-Dec-16	31-Dec-17	31-Dec-18
Cobham PLC *	1.10	1.18	1.29	1.20	1.22
BAE	1.14	1.14	1.14	1.15	1.16
Kongsberg	1.04	1.04	1.14	1.17	1.00
Senior PLC	1.10	1.06	1.08	1.09	1.07
Aerospace & Defense Industry	2.68	2.68	3.00	3.17	3.17

* (underlying measures)

Source: Author, based on Cobham PLC, BAE Systems, Kongsberg Gruppen and Senior PLC annual statements and Damodaran online.

3.2.4. Activity Ratios

Activity ratios examine how efficiently the business entity manage its assets. Turnover indicates how many times a selected asset is used within a firm per year. Underlying measures didn't have an impact on activity ratios. Although, a deferred tax was removed.

- Total assets turnover

Bottom-line recommended value for total assets turnover is 1 which means that Cobham PLC doesn't utilize its assets compare to the Aerospace and Defense industry average which states that other rivals utilize its assets more intensively.

Tab. 16 Total Assets Turnover

Total Assets Turnover	31-Dec-14	31-Dec-15	31-Dec-16	31-Dec-17	31-Dec-18
Cobham PLC	0.62	0.60	0.64	0.75	0.69
BAE	0.84	0.84	0.82	0.74	0.70
Kongsberg	0.88	0.86	0.79	0.69	0.60
Senior PLC	1.17	1.06	1.00	1.06	1.10
Aerospace & Defense Industry	1.25	1.21	1.29	1.25	1.60

Source: Author, based on Cobham PLC, BAE Systems, Kongsberg Gruppen and Senior PLC annual statements and Damodaran online.

- Inventory turnover

Inventory turnover range between 4.92 to 7.77 times per year. Cobham PLC outperforms only Kongsberg and falls behind the rest of the competitors and industry average. The highest turnover was noticed in 2017 which corresponds to 44 days to use them up. Inventories consist more than 60 % of item called 'work in progress' that is connected with particular contracts. The result of 2014 was achieved due to increase in inventory by acquiring Aeroflex and its current assets.

Tab. 17 Inventory turnover

Inventory turnover	31-Dec-14	31-Dec-15	31-Dec-16	31-Dec-17	31-Dec-18
Cobham PLC	4.96	4.92	5.60	7.77	7.03
BAE	24.29	23.71	23.69	22.83	22.32
Kongsberg	5.35	4.91	3.80	4.43	7.11
Senior PLC	7.51	6.90	6.52	6.63	6.51
Aerospace & Defense Industry	6.56	6.64	6.58	6.58	6.58

Source: Author, based on Cobham PLC, BAE Systems, Kongsberg Gruppen and Senior PLC annual statements and Damodaran online.

- Receivable turnover and ratio

Accounts receivable turnover measures the liquidity of receivables. The ratio is intended to evaluate the ability of a company to efficiently issue credit to its customers and collect funds from them in a timely manner. A high turnover ratio indicates a combination of a conservative credit policy and an aggressive collections department, as well as a number of high-quality customers. (Bragg, 2017).

The most favourable result is in 2017. It could be interpreted that the company collected receivables every 2 months.

Tab. 18 Accounts receivable turnover

Accounts receivable turnover	31-Dec-14	31-Dec-15	31-Dec-16	31-Dec-17	31-Dec-18
Cobham PLC	4.91	5.16	5.30	6.33	5.64
BAE	5.65	5.80	5.16	4.20	3.57
Kongsberg	5.29	4.64	4.28	4.48	4.51
Senior PLC	6.53	6.12	6.26	6.67	6.78
Aerospace & Defense Industry	7.45	7.47	7.46	7.46	7.46

Source: Author, based on Cobham PLC, BAE Systems, Kongsberg Gruppen and Senior PLC annual statements and Damodaran online.

Days Sales outstanding indicates a number of days that a business entity awaits to collect its receivables. Cobham PLC reached second worst average among others. The longest receivables collection in 2014 occurred due to increase in receivables by £118m including acquired £55.9m from Aeroflex.

Cobham PLC creates provision for impairment of trade receivables, but significant proportion of the Group's business is directly with government agencies or in respect of large government funded military programmes, therefore the risk is considered to remain low.

Tab. 19 Days Sales Outstanding

Days Sales Outstanding	31-Dec-14	31-Dec-15	31-Dec-16	31-Dec-17	31-Dec-18
Cobham PLC	85.04	72.30	53.33	44.36	54.07
BAE	15.14	15.79	15.92	15.53	16.80
Kongsberg	71.71	78.76	107.48	47.18	55.18
Senior PLC	53.05	54.52	61.46	55.10	59.97

Source: Author, based on Cobham PLC, BAE Systems, Kongsberg Gruppen and Senior PLC annual statements

High level of working capital (inventories, stocks, and unsold assets) due to unsuccessful diversification aimed at reducing the group's exposure to constrained defense markets negatively affected activity ratios. Despite many completed acquisitions, they were unfortunately poorly integrated.

3.2.5. Investment Valuation Ratios

Investment valuation ratios examine an attractiveness of a company for potential investors.

- Market to Book Ratio

The book value per share formula is used to calculate the per share value of a company based on its equity available to common shareholders. It is used as a denominator for market to book ratio. Market to book ratio, also referred to as the price to book ratio, is used as a measurement to compare a company's net assets available to common shareholders relative to the sale price of its stock. A ratio over one implies that the market is willing to pay more than the equity per share. A ratio under one implies that the market is willing to pay less. (Borad, 2018).

In a case of Cobham PLC, one may argue that an average ratio under 0.2 implies that the company is undervalued and a favourable investment. On the other hand, another may argue that the ratio ignores the intangible assets of a company like goodwill, brand equity, patent etc. Due to these discrepancies of opinion, using other stock valuation methods along with or apart from the price to book value formula may be beneficial.

Tab. 20 Market to book ratio

Market to book ratio	31-Dec-14	31-Dec-15	31-Dec-16	31-Dec-17	31-Dec-18
Cobham PLC	0.22	0.23	0.29	0.12	0.08
BAE	0.25	0.17	0.17	0.12	0.08
Kongsberg	0.02	0.02	0.02	0.02	0.01
Senior PLC	0.67	0.56	0.39	0.49	0.36

Source: Author, based on Cobham PLC, BAE Systems, Kongsberg Gruppen and Senior PLC annual statements

- Price Earnings Ratio

The P/E ratio is one of many ratios used in relative valuation. By comparing a stock's price per share to its earnings per share, we are able to see how much investors are paying for each dollar of the company's earnings.

Cobham PLC trades with P/E ratio of 31.52 which is below Aerospace & Defense industry average with 39.40 but higher than a sector average of 26.24 (Reuters, 2019). Regardless of underlying measures, the figure would be 19.54 which may

seem appealing and some investors may jump to the conclusion that you should buy the stock. Underlying measures exclude a charge of £200.0m has been taken against increased estimates of cost to complete and recovery on the KC-46 contract comprising £40.0m recorded in the half year and a further £160.0m recorded following the announcement on 19 February 2019. This reflects an adjustment to an item previously disclosed as exceptional and hence it has been presented as a specific adjusting item. (Cobham PLC, 2019). On the other hand, this problematic contract reflects burdens that Cobham PLC faces and can't be omitted.

Tab. 21 P/E ratio

P/E ratio	31-Dec-14	31-Dec-15	31-Dec-16	31-Dec-17	31-Dec-18
Cobham PLC	17.46	14.80	18.24	34.14	31.52
BAE	20.05	17.23	21.01	22.00	14.77
Kongsberg	14.80	20.22	19.96	28.92	21.04
Senior PLC	18.03	20.78	17.92	18.12	15.93

Source: Author, based on Cobham PLC, BAE Systems, Kongsberg Gruppen and Senior PLC annual statements

- Dividend Payout Ratio

Cobham PLC's plan for a zero-dividend payment in 2016 was abandoned and the company reached its highest ratios of 1.1%. In a comparison with its competitors, it makes Cobham PLC unattractive to potential investors. Moreover, Cobham PLC only postponed the plan and didn't approved any dividends in 2017 nor 2018. (Cobham PLC, 2019)

Tab. 22 Dividend payout ratio

Dividend payout ratio	31-Dec-14	31-Dec-15	31-Dec-16	31-Dec-17	31-Dec-18
Cobham PLC	0.71%	0.76%	1.07%	0.00%	0.00%
BAE	0.79%	0.65%	0.68%	0.76%	0.65%
Kongsberg	0.32%	1.11%	8.92%	1.08%	0.41%
Senior PLC	0.34%	0.50%	0.58%	0.46%	0.59%

Source: Author, based on Cobham PLC, BAE Systems, Kongsberg Gruppen and Senior PLC annual statements

Taking all of the ratios above into consideration, Cobham PLC doesn't seem to be appealing compare to its competitors. On the other hand, if we wouldn't consider past 5 years but 10, Cobham PLC performed much better and has a potential in the future based on its unique R&D. The evaluation will provide closer insight.

3.3. Economic Value Added

This chapter is dedicated to calculation of Cobham PLC's EVA. EVA measures economical profit and aims to reflect opportunity costs into operating profit and therefore provides an indicator of an amount that a company earns on the top of minimum requirements by shareholders. This generated added value could be invested to maximization of a company's value. A calculation itself is not difficult but a tough proposition lies within its inputs.

3.3.1. NOA Determination

As stated in theoretical part of this thesis, book value of assets needs to be transferred into economical values. By following Marik's recommendations, unnecessary assets were separated from total assets, non-interest external capital was deducted from assets and extraordinary items were excluded. There was no need to activate items that are not reported in assets due to IFRS 16 which declares that leasing is recognised on the Balance Sheet by lessees, and the distinction between operating and finance leases is removed. (Cobham PLC, 2019)

Cobham's assets and liabilities are reported in fair values which means the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the balance sheet date. (Cobham PLC, 2019 p. 101)

By examining annual reports, intangible assets arising on business combinations and related costs were deducted from financial statements. Considering a scope of an Aeroflex acquisition in 2014 and a fact that the acquisition didn't enhance revenue since then and only burden administrative costs, these assets could be considered as unnecessary. (Cobham PLC, 2019 p. 120) Further eliminated items include assets under construction because their contribution to profit can't be proven yet. Items that are not related to core business are investment properties held to earn rentals or for capital appreciation, investments in joint ventures and associates and assets classified as held for sale. (Cobham PLC, 2018 p. 110)

Surplus cash and cash equivalents might be also considered as unnecessary but based on ratio analysis, they will leave as they are.

Tab. 23 Cobham PLC's Operating Assets

Balance Sheet	31-Dec-13	31-Dec-14	31-Dec-15	31-Dec-16	31-Dec-17	31-Dec-18
Assets						
Non-Current Assets						
Intangible Assets	118.7	231.6	222.7	169.6	113.7	88.5
Property, Plant & Equipment	331.4	366.9	352.2	352.8	351.0	350.4
Investment Properties						
Investments in joint ventures and associates						
Trade & Other Receivables	22.2	53.3	71.3	33.2	28.5	28.4
Non-current contracts				56.2	64.3	55.9
Current Assets						
Inventories	315.9	431.4	410.4	284.0	254.2	276.0
Trade & Other Receivables	317.7	436.6	366.0	367.1	293.8	322.2
Contract assets				166.8	125.9	131.0
Cash and cash equivalents	200.7	225.6	294.7	236.2	451.9	406.9
Assets classified as held for sale						
Total Operating Assets	1 314	1 754.5	1 735	1 677.5	1 700.9	1668.7

Source: Author, based on Cobham PLC annual statements.

Furthermore, non-interest external capital must be deducted from operating assets. For a purpose of our calculation, trade payables, other taxes and social security will be taking into account along with contract liabilities (covered in trade payables before adoption of IFRS 15). On a top of that, current tax liabilities are deducted. Even though Cobham PLC report current provision as non-interest external capital, according to Marik (2018), provisions are considered as specific equity and are not deducted from operating assets.

Tab. 24 Cobham PLC's Net Operating Assets

	31-Dec-13	31-Dec-14	31-Dec-15	31-Dec-16	31-Dec-17	31-Dec-18
Total Assets	2419.2	3 583.0	3 317.6	2 770.8	2 778.5	2 597.9
Operating Assets	1 314.0	1 754.5	1 735.0	1 677.5	1 700.9	1 668.7
Non-interest liabilities	482.5	622.8	523.2	636.4	588.8	694.3
NOA	831.5	1 131.7	1 211.8	1 041.1	1 112.1	974.4

Source: Author, based on Cobham PLC annual statements.

For illustration, table above shows net operating assets separated from book value of total assets and deducted by non-interest liabilities. The highest difference between total assets and NOA was in 2014 and it reached £2.4b, mainly because acquired intangible assets along with inventories and trade receivables.

3.3.2. NOPAT Determination

Along with determination of NOA, NOPAT must be obtained by same measures. Marik (2018) recommends excluding exceptional items from operating profit as well as revenue and costs associated with non-operating assets. Net operating profit after tax works on the presumptions described in theoretical part of this thesis.

Cobham PLC's income statement was adjusted according to costs and revenue related to non-operating assets and investment properties, such as depreciation and amortisation and impairment. (Cobham PLC, 2019 p. 123) Furthermore, a profit on divestments and estimates of fixed price contract profitability (estimates of cost to complete and recovery on the KC-46 contract) was excluded from a revenue. (Cobham PLC, 2019 p. 109) The tax was estimated based on UK corporate tax rate which was 21% in 2014, 20% in 2015-16 and 19% in 2017-18. (Damodaran, 2019)

Tab. 25 Cobham PLC's Net Operating Profit After Tax

Income Statement (£ m)	31-Dec-14	31-Dec-15	31-Dec-16	31-Dec-17	31-Dec-18
Operating profit/(loss) - EBIT	**57.6**	**12**	**-779.1**	**106.9**	**111.9**
Profit on divestments or Investment properties	0.3	55	0.7	1.8	237.4
Amortisation, depreciation and impairment costs	86	142.5	718.2	136.1	67.8
Exceptional costs	74.4	149.9	236.8		205.6
NOPBT	**217.7**	**249.4**	**175.2**	**241.2**	**147.9**
Taxation	45.7	49.9	35.0	45.8	28.1
Net Operating Profit After Tax	**172.0**	**199.5**	**140.2**	**195.4**	**119.8**
Profit/(loss) after taxation for the year	29.0	-37.7	-795.1	84.1	73.7
Profit/(loss) after taxation for the year - underlying measures applied	205	220	135.6	138.6	119.6

Source: Author, based on Cobham PLC annual statements.

The table above provides NOPAT that will be used for calculation of EVA. To get a better perspective, profit/(loss) after taxation for the year and the same indicator after adoption of underlying measures were put in a table for a comparison. As we can see from the table, NOPAT follows same trend line as NOA.

3.3.3. Calculation of Equity Costs

In order to calculate WACC, I must obtain equity costs first. Equity costs (k_e, r_i) were determinated by CAPM model with an equation (26).

The expected return on the risk-free asset r_f, also called risk-free rate, was substituted by yield on 10-year UK government bonds available at ft.com. (Financial Times, 2019). While r_m represents the expected return on the market, $(r_m - r_f)$ stands for the market risk premium which was retrieved from professor Damodaran's websites. Risk Premiums for Other Markets section provides values for US and UK market, based on revenue geographical allocation, and were used as an average. (Damodaran, 2019)

A parameter beta (β_i) refers to a market risk and was adjusted accordingly to Kislinger using formula below (Kislingerová, et al., 2008):

$$\boldsymbol{\beta_{leveraged} = \beta_{unleveraged}\ (1 + (1 - t) * \frac{D}{E})} \qquad (33)$$

Unleveraged coefficient beta ($\beta_{unleveraged}$) is also available at Prof. Damodaran's websites in a section Levered and Unlevered Betas by Industry. For this purpose, I used global data for Aerospace/ Defense industry and calculated $\beta_{leveraged}$ with formula above.

Tab. 26 Equity cost

	2014	2015	2016	2017	2018
k_e , r_i	5.16%	6.09%	6.59%	5.93%	7.43%
$r_{f,}$	2.71%	1.67%	1.88%	1.36%	1.22%
$\beta_{unleveraged}$	0.84	0.9	0.98	0.99	0.99
t	20%	20%	20%	19%	19%
$\frac{D}{E}$	0.16	0.15	0.22	0.19	0.29
$\beta_{leveraged}$	0.95	1.01	1.15	1.14	1.22
r_m	5.30%	6.05%	5.97%	5.37%	6.31%

Source: Author, based on Cobham PLC annual statements, Damodaran online database and ft.com.

3.3.4. Calculation of WACC

Remaining parameter for EVA calculation is WACC. To be able to determinate WACC, we need cost of equity, cost of debt, tax rate and market value of company's equity and debt. Weighted average cost of capital will be calculated by equation (25).

Cost of equity was set by CAPM model while cost of debt was obtained by dividing financial debt with net interest as follows:

$$k_d = \frac{Financial\ debt}{Net\ interest} \tag{34}$$

The tax rate was replaced with effective tax rate per year calculated as $1 - \frac{profit\ after\ tax}{profit\ before\ tax}$. Market value of company's equity (*E*) corresponds to security market capitalisation available at London Stock Exchange websites. Market value of company's debt (*D*) equals to interest-bearing liabilities.

Tab. 27 ***Weighted Average Cost of Capital***

	2014	2015	2016	2017	2018
k_e	**5.16%**	**6.09%**	**6.59%**	**5.93%**	**7.43%**
Financial debt	1 446.8	1 345.1	1 203.5	835.3	338
Net interest	31.5	49.7	68.8	34.9	35.3
k_d	**2.18%**	**2.77%**	**5.72%**	**4.18%**	**10.44%**
t	20%	22%	23%	21%	23%
$\frac{E}{V}$	0.32	0.35	0.36	0.27	0.23
$\frac{D}{V}$	0.68	0.65	0.64	0.73	0.77
WACC	**2.83%**	**3.56%**	**5.20%**	**4.01%**	**7.91%**

Source: Author, based on Cobham PLC annual statements and London stock Exchange.com

WACC from 2014 to 2018 are put in table 27. As we can see from the table, weighted average costs of capital increased within the years. The WACC rise in 2018 is caused by high before-tax cost of debt along with the low amount of company's debt market value as well as lower company's market value of equity.

3.3.5. Economic Value Added

The aim of this thesis was to evaluate the Cobham PLC. Considering previous calculations, we are able to compute economic value added for observed time period. For a calculation will be used equation (24). Detailed computation is illustrated in following table.

Tab. 28 ***Economic Value Added***

	2014	2015	2016	2017	2018
NOPAT	172.0	199.5	140.2	195.4	119.8
NOA	1 131.7	1 211.8	1 041.1	1 112.1	974.4
WACC	2.83%	3.56%	5.20%	4.01%	7.91%
EVA	**148.4**	**159.2**	**77.1**	**153.7**	**31.9**

Source: Author, based on own calculations.

For calculation of EVA in 2014 was used NOA from 2013 in amount £831.5m. The table shows that Cobham PLC created positive economic value added within years with significantly fluctuating trend over the years. The peak was reached in 2015 due to highest NOPAT but fall in following year and recovered in 2017. A

dramatic reduction came in 2018 when EVA dropped by 80% compare to previous year. This was caused by the highest WACC along with lowest NOPAT within time period.

Overall, in the case of Cobham PLC, the effort to create an EVA can be taken for granted. There is a very close relationship between the owners of the business and the business itself. Positive EVA means that the company creates a value for shareholders. On the other hand, a reduction in EVA indicates that there may not be any spare capital for R&D.

3.4. Credit Scoring

Last but not least, I am focusing on credit scoring with an aid of Altman's Z-score and Quick test.

3.4.1. Altman's Z-Score

Results of Altman's Z-score are represented in the last row of the table below. It was calculated with formula (32) for non-US companies. Resulting in negative figures in 2016 indicated a potential threat to a company. As mentioned in theoretical part, negative numbers predict a bankruptcy within 2 years. On the other hand, Cobham PLC might be aware of this risk and achieved to recovered back to green numbers in following years. Cobham PLC reported increase in current liabilities in 2016 which is entered in parameter $\mathbf{x_1}$, $\mathbf{x_2}$ and caused a slight turn into red numbers.

Tab. 29 Altman's Z-score

	Altman's Z-score	2014	2015	2016	2017	2018
3.2						
12.18	x_1	0.4	0.4	0.2	0.2	0.2
2.5	x_2	0.4	0.5	0.4	0.8	0.8
10.68	x_3	0.2	0.2	0.3	0.3	0.3
0.0289	x_4	-48.9	-144.9	-140.9	352.9	10.4
		5.3	1.9	-0.5	15.1	4.2

Source: Author, based on own calculations.

3.4.2. Quick Test

Ratios computation is based on equations (29) to (32). Kralicek's quick test calculations are shown in table 30 and final results are in table 31.

Tab. 30 Quick test calculations

	2014	2015	2016	2017	2018
Equity ratio	31%	27%	52%	73%	85%
Debt payback period from cash flow	7.8	7.1	9.4	5.7	5.0
Cash flow as a percentage of sales	11%	11%	9%	10%	7%
ROA	6%	7%	5%	5%	5%

Source: Author, based on own calculations.

Quick test evaluates 2014 and 2017 as the years with the best performance. As we can see from the table, all results are burden with assessment of ROA. The worst performance is reported in 2018, especially because of a half operating cash flow compare to previous years. The test asses a company as stable and profitable but on the other hand facing liquidity and rentability risks. Note that Debt payback period from cash flow ratio tell us that it would take 9.4 years to cover company's liabilities from its cash flow. On the other hand, the ratio recovered to better results in following years. Overall, an evaluation for a creditworthiness would be between very good and good.

Tab. 31 Quick test score

	2014	2015	2016	2017	2018
Equity ratio	1	2	1	1	1
Debt payback period from cash flow	3	3	3	3	3
Cash flow as a percentage of sales	1	1	2	1	3
ROA	4	4	4	4	4
Quick test score	2.25	2.50	2.50	2.25	2.75

Source: Author, based on own calculations.

4. Proposals for Improvement

This last chapter is dedicated to proposals regarding how to enhance the financial situation and therefore increase EVA. The proposals are based on performed financial analysis and will aim at capital structure and profit margin.

4.1. Proposal to Change the Capital Structure

According to the results of the financial analysis, Cobham PLC reported declining trend in profitability and rentability ratios. An especially significant drop was noticed with net profit margin and return on equity over years. In some cases, ratios decreased by 50 %. Despite that, Cobham PLC outperformed or was close to its main competitor – Kongsberg and industry average considering following ratios.

Tab. 32 Cobham PLC's selected ratios and EVA

	2014	2015	2016	2017	2018
ROA	5.7%	6.6%	4.9%	5.0%	4.6%
ROE	18.4%	24.2%	9.4%	6.8%	5.4%
ROS	11.1%	10.6%	7.0%	6.6%	6.4%
Debt-to-Equity ratio	2.22	2.65	1.58	1.43	0.82
EVA	148.4	159.2	77.1	153.7	31.9

Source: Author, based on Cobham PLC annual statements.

The above findings correspond to declining EVA within years, except for 2017 where the value increased.

Assuming positive financial leverage effect, cost of debt must be lower than return on capital employed (ROCE). Cost of debt (k_d) was calculated same way as in computation of WACC.

Tab. 33 Cost of debt vs Return On Capital Employed (ROCE)

	2014	2015	2016	2017	2018
k_d	2.18%	2.77%	5.72%	4.18%	10.44%
ROCE	7.1%	8.7%	7.0%	6.9%	6.9%

Source: Author, based on own calculations.

Most years, the requirement was met and the increase of debt should have a positive effect on ROE.

Assuming that Cobham PLC increases its debt instead of issuing new shares in 2017 by £479.6m, the ROE in 2017 and 2018 would be slightly recovered to 2016.

Tab. 34 ROE before and after increase of debt

	2014	2015	2016	2017	2018
ROE before increase of debt	18.4%	24.2%	9.4%	6.8%	5.4%
ROE after increase of debt	18.4%	24.2%	9.4%	8.9%	7.0%

Source: Author, based on own calculations.

The debt decrease affected WACC by causing a decrease in 2017 from 4.01% to 3.65% and from 7.91% to 5.11% in 2018. For the purpose of this thesis, Cobham PLC's equity remained the same as in 2016 which had an impact on cost of equity.

Tab. 35 Weighted Average Cost of Capital after debt decrease

	2014	2015	2016	2017	2018
k_e	**5.16%**	**6.09%**	**6.59%**	**6.50%**	**7.89%**
Financial debt	1 446.8	1 345.1	1 203.5	1314.9	817.6
Net interest	31.5	49.7	68.8	34.9	35.3
k_d	**2.18%**	**2.77%**	**5.72%**	**2.65%**	**4.32%**
t	20%	22%	23%	21%	23%
$\frac{E}{V}$	0.32	0.35	0.36	0.34	0.33
$\frac{D}{V}$	0.68	0.65	0.64	0.66	0.67
WACC	**2.83%**	**3.56%**	**5.20%**	**3.61%**	**4.84%**

Source: Author, based on Cobham PLC annual statements and London stock Exchange.com

As we can see from the table 36, Economic value added in 2018 increase by £4.5m but the sum of 2017 and 2018 remained the same.

Tab. 36 Economic Value Added after debt decrease

	2014	2015	2016	2017	2018
NOPAT	172.0	199.5	140.2	195.4	119.8
NOA	1 131.7	1 211.8	1 041.1	1 112.1	974.4
WACC	2.83%	3.56%	5.20%	**3.61%**	**4.84%**
EVA	148.4	159.2	77.1	157.8	66
EVA increase [%]	0 %	0 %	0 %	- 2.7 %	+ 107.1 %
original EVA	148.4	159.2	77.1	153.7	31.9

Source: Author, based on own calculations.

Considering decreased WACC in 2018, the EVA would have beeen positively affected by that in the following years. Unfortunately, after deeper investigation, optimal capital structure couldn't be strictly determinated. Because even though the Cobham PLC reached highest ROE of 24.2 % in 2015 along with 2.65x debt-to-equity ratio, similar ROE (22.1%) was achieved with 1.32 ratio in 2013.

In a case of Cobham PLC, the company needed to boost its liabilities and equity to fulfil promises on some big, but troublesome defense contracts and therefore strengthened its liabilities and equity by issuing new shares.

4.2. Proposals to Enhance Profit Margin

Simulated debt decrease had positively affected EVA but the impact was not significant. Based on that, we assume that it's necessary to focus on profit and net operating assets.

Examining NOA, we can see that EVA in 2017 was reached even with high NOA of 2016. Assuming a reduction in NOA of 30% to £778.5m and other things held constant, the EVA would increase only to 58.2 which is not the highest possible result in a comparison to NOPAT increase. Therefore, we will pay more attention to profit.

Critical year for a company was 2018 which is reflected in the ratios and Kralicek's quick test. Cobham PLC reported the worst NOPAT within the period and revenue was almost at the same level as in 2014. The curiosity is that NOPAT in 2018 is only slightly higher than accounting EAT.

If we have a look at the profit margins, the net profit margin noticed biggest drop within the period. Nevertheless, note that the ratio still outperforms the industry and competitors. The net profit margin was burden by financial costs. This finding supports the proposal to change the capital structure described above.

Tab. 37 EAT, NOPAT and profit margins

	2014	2015	2016	2017	2018
EAT	205	220	135.6	138.6	119.6
NOPAT	172.0	199.5	140.2	195.4	119.8
Gross profit margin	30%	32%	30%	29%	28%
Operating profit margin	15%	16%	12%	10%	11%
Net profit margin	11.1%	10.6%	7.0%	6.6%	6.4%

Source: Author, based on own calculations.

Future outlook regarding US defense spendings is promising due to Trump's defense strategy and might have a positive impact on Cobham PLC's revenue. (Seligman, 2019)

Assuming that NOPAT would increase to former values, the EVA should be more pleasing. Demonstrating an increase of NOPAT by 30% to £155.7, EVA would rise by 113%.

Tab. 38 Economic Value Added after NOPAT increase

	2014	2015	2016	2017	2018
NOPAT	172.0	199.5	140.2	195.4	155.7
NOA	1 131.7	1 211.8	1 041.1	1 112.1	974.4
WACC	2.83%	3.56%	5.20%	4.01%	7.91%
EVA	**148.4**	**159.2**	**77.1**	**153.7**	**67.8**
EVA increase [%]	0 %	0 %	0 %	0 %	+ 113 %
original EVA	148.4	159.2	77.1	153.7	31.9

Source: Author, based on own calculations.

Cobham PLC's operating costs were negatively driven by its operational performance and poor execution, including programme charges. Late delivery to customers and the rework of products that have failed post- production quality tests are significant costs. They also often result in the need to have in place additional overheads resulting in cost inefficiencies.

Cobham PLC's incident rate also increased since 2017 and caused additional operating costs. (Cobham PLC, 2019). Failure to deliver consistently high standards of health and safety could lead to accidents or incidents which may result in employees being injured or otherwise harmed. Such an incident could

also result in legal claims, financial damage and reputational loss. Therefore, Cobham PLC should listen to employees and engage them to participate on improvements in Health & Safety along with professional consultation.

Considering division of Advanced Electronic Solutions, which reported underperforming results compare to company's expectations, Cobham PLC should focus on training in continuous improvement techniques, simplification of structures, reporting and processes as well as investment in technology and infrastructure.

Conclusion

The final thesis examines financial situation of Cobham PLC which is based on the financial analysis, especially ratio analysis and economic value added approach.

The thesis is consisting of evaluation of financial performance along with proposals for improvement. The main resources for the financial analysis was were annual reports from 2014 to 2018.

Cobham PLC demonstrated falling trend within observed period nevertheless the economic value added remained positive over years. The tough year for Cobham PLC was 2018 with the worst ratios and drop in EVA. Air Force's KC-46 tanker program was delayed in delivery of refuelling kit for Boeing which withheld payment for the programme. Cobham PLC provides the Wing Aerial Refuelling Pod and Centerline Drogue System for the KC-46 tanker. The company reported additional costs in 2017 (£150m) and 2018 (£200m).

Ratio analysis shows that the decreasing trend resulted in a reduction of original values to the half which is also reflected on the economic value added. Although, profit margins indicate that Cobham PLC's performance can be considered as stronger compare to its rivals, it should be in Cobham PLC's interest to focus on their main business activities along with reducing useless assets.

Cobham PLC's financial health could be evaluated as healthy given debt-to-equity ratio over 40% and there are also no concerns about company's liquidity.

Taking into account performed financial analysis, the proposals for improvement were recommended in the previous chapter.

After examining Cobham PLC's rentability, the proposal for changing capital structure was introduced. Even though the financial leverage had positive impact on the rentability and weighted average cost of capital, it didn't significantly affect EVA.

The same drawback lies with reducing net operating assets which is not reflected as much on EVA as suspected. The effective proposal lays with enhancing profit margin.

The grow in NOPAT has multiple effect on EVA and could be reached by increase in profit as well as avoiding unnecessary operating costs, especially driven by its operational performance and programme charges. Late delivery to customers and

the rework of products makes significant costs. They also often caused overheads resulting in additional costs.

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Appendix No. 1

Key items of Cobham PLC's balance sheet

Balance Sheet	31-Dec-14	31-Dec-15	31-Dec-16	31-Dec-17	31-Dec-18
Assets	**(£ m)**	**(£ m)**	**(£ m)**	**(£ m)**	**(£ m)**
Non-Current Assets	**2 478.2**	**2 212.0**	**1 755.1**	**1 463.8**	**1 452.4**
Intangible Assets	1 997.2	1 729.5	1 165.9	893.8	821.2
Property, Plant & Equipment	390.0	379.9	422.9	380.9	388.2
Investment Properties	10.4	4.3	3.6	2.4	2.3
Investments	3.1	3.0	3.6	3.6	4.1
Trade & Other Receivables	53.3	71.3	33.2	28.5	28.4
Non-current contract	-	-	56.2	64.3	55.9
Current Assets	**1 104.8**	**1 105.6**	**1 015.7**	**1 315.1**	**1 145.5**
Inventories	431.4	410.4	284	254.2	276
Trade & Other Receivables	436.6	366.0	367.1	293.8	322.2
Contract assets	-	-	116.8	125.9	131
Cash and cash equivalents	225.6	294.7	236.2	451.9	406.9
Assets classified as held for sale	2.1	16.8	-	171.7	-
Total Assets	**3 583.0**	**3 317.6**	**2 770.8**	**2 778.5**	**2 597.9**

Liabilities	**31-Dec-14**	**31-Dec-15**	**31-Dec-16**	**31-Dec-17**	**31-Dec-18**
Current Liabilities	**699.1**	**797.2**	**839.7**	**771.9**	**862.4**
Borrowings	1.5	156.4	60.9	0.1	58.6
Trade and other payables	503.6	398.1	351.5	347.8	376.7
Contract liabilities	-	-	104.3	105.2	180.9
Non-Current Liabilities	**1 771.6**	**1 610.7**	**1 441.1**	**974.2**	**543.8**
Borrowings	1 446.8	1 345.1	1 203.5	835.3	338
Total Liabilities	**2 470.7**	**2 407.9**	**2 281.1**	**1 746.1**	**1 406.2**

Equity	31-Dec-14	31-Dec-15	31-Dec-16	31-Dec-17	31-Dec-18
Share Capital	30.4	30.4	44.60	61.7	61.7
Share Premium	301.9	301.9	778.3	1 257.9	1 257.9
Retained Earnings	736.4	576.8	- 372.2	- 278.9	- 161.7
Total Equity	**1 112.3**	**909.7**	**489.7**	**1 032.4**	**1 191.7**

Source: Author, based on Cobham PLC annual statements

Appendix No. 2

Cobham PLC's income statements

Income Statement (£ m)	31-Dec-14	31-Dec-15	31-Dec-16	31-Dec-17	31-Dec-18
Revenue	**1 851.7**	**2 072.0**	**1 943.9**	**2 091.6**	**1 863.3**
Cost of sales	1 290.1	1 408.2	1 567.3	1 494.8	1 539.9
Gross profit	**561.6**	**663.8**	**376.6**	**596.8**	**323.4**
Operating costs	504.0	651.8	1 155.7	491	438.5
Operating profit/(loss) - EBIT	**57.6**	**12.0**	**-779.1**	**106.9**	**111.9**
Finance income	6.4	5.2	4.1	6.1	10.5
Finance costs	39.7	57.0	72.9	43.3	51.4
Profit/(loss) before taxation	**24.3**	**-39.8**	**-847.9**	**69.7**	**71.0**
Taxation	4.7	2.1	52.8	14.4	2.7
Profit/(loss) after taxation for the year	**29.0**	**-37.7**	**-795.1**	**84.1**	**73.7**
EPS	2.6	-3.4	-52.8	3.7	3.1

Source: Author, based on Cobham PLC annual statements

Appendix No. 3

Cobham PLC's cash flow statements

Cash Flow Statement (£ m)	31-Dec-14	31-Dec-15	31-Dec-16	31-Dec-17	31-Dec-18
Cash and cash equivalents at start of year	**199**	**224.3**	**294**	**236.2**	**451.9**
Cash generated from operations	167.9	189.1	134.7	215.2	125.3
Cash flows from investing activities	-950.8	53.9	-86.5	-75.5	262
Cash flows from financing activities	839.4	-160.1	-120.3	137.5	- 470.3
Net increase/(decrease) in cash and cash equivalents	**56.5**	**82.9**	**-72.1**	**277.2**	**- 83.0**
Exchange movements	-31.2	-13.2	14.3	-61.5	27.8
Cash and cash equivalents at end of year	**224.3**	**294**	**236.2**	**451.9**	**396.7**

Source: Author, based on Cobham PLC annual statements

Appendix No. 4

Book value per share

Book value per share	31-Dec-14	31-Dec-15	31-Dec-16	31-Dec-17	31-Dec-18
Cobham PLC	1.00	0.81	0.33	0.46	0.50
BAE	0.54	0.87	1.01	1.37	1.62
Kongsberg	0.24	0.38	6.41	0.82	0.64
Senio PLC	0.99	1.03	1.20	1.27	1.27

Source: Author, based on Cobham PLC, BAE Systems, Kongsberg and Senior Plc annual statements

ANNOTATION

AUTHOR	**Bc. Adéla Špirková**		
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THESIS TITLE	**Evaluation of financial performance of selected company and proposals for improvement**		
SUPERVISOR	doc. Ing. Romana Čižinská, Ph.D		
DEPARTMENT	**KFU - Department of Finance and Accounting**	**YEAR**	**2019**

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NUMBER OF PICTURES	**6**
NUMBER OF TABLES	**38**
NUMBER OF APPENDICES	**4**

SUMMARY	The aim of this thesis is to analyze the financial situation of the company called Cobham PLC and make the proposals for impovement. For evaluating the financial health the financial analysis was performed focusing on financial ratios and economic value added. Based on the assessment of the financial analysis, it was found out that neverthless the company outperforms its competitors, it reported declining trend over years. The recommendations are regarded to the changes in capital structure because the return on equity ratio significantly dropped. Another proposed measure is dedicated to the profitability of the company because it decreased and had negative impact on the economic value added.
KEYWORDS KEY WORDS	Financial analysis, financial ratios, economic value added, assessing the financial health of the company, Cobham PLC, defense industry

ANOTAČNÍ ZÁZNAM

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POČET TABULEK	**38**
POČET PŘÍLOH	**4**

STRUČNÝ POPIS	Cílem diplomové práce je analyzovat finanční situaci společnosti Cobham PLC a podat návrhy na zlepšení. Pro hodnocení finančního zdraví byla provedena finanční analýza se zaměřením na finanční ukazatele a přidanou ekonomickou hodnotu. Na základě posouzení finanční analýzy bylo zjištěno, že společnost překonává své konkurenty, ale vykazuje klesající trend v průběhu let. Doporučení se týkají změn struktury kapitálu, protože míra návratnosti vlastního kapitálu významně poklesla. Další navrhované opatření je věnováno ziskovosti společnosti, která se snížila a měla negativní dopad na přidanou ekonomickou hodnotu.
KLÍČOVÁ SLOVA	Finanční analýza, finanční ukazatele, přidaná ekonomická hodnota, hodnocení finančního zdraví podniku, Cobham PLC, obranný průmysl