

# Understanding and Using Benchmark Information

By Scott Ogle

What is the average level of performance for a given ratio/metric in a specific industry?

**B**enchmarks are of interest to many types of financial professionals. If they are gathered and used properly, they can be helpful to the financial analysis process.

In financial analysis, “benchmarks” are financial metrics/ratios/results that show the average ranges of financial performance by companies in a given industry. There are many different types of financial benchmarks. When we use benchmarks, the main question we are trying to answer is: What is the average level of performance for a given ratio/metric in a specific industry? In a way, a benchmark is a scorecard, against which we can assess the relative strength of a company.

Understanding the average financial performance of specific industries is important to commercial lenders, who want to understand industry conditions and how the companies they are evaluating compare to other companies in a given industry. For example, credit analysts and lenders use industry benchmark data as a way to assess the relative health of a given company. In an environment where credit availability is moving through rapid change, benchmarks are of utmost importance and are absolutely critical in determining risk exposure and building the best loan portfolios possible. Benchmarks can provide a “North Star” in uncertain markets. Lenders can also share this comparative analysis with their customers as a way to strengthen and enhance relationships.

## What Is the Quality of Industry Data?

In the United States, it has been challenging to get access to good quality industry benchmark data.

There are many reasons for this. First, historically, companies that have sold benchmark data have sold data gathered largely from companies’ tax return filings. Data from tax returns tends to give conservative and unrealistically low numbers for operating profits. Second, in the United States, private companies are not compelled to publish their financial results. Consequently, access to high quality private company financial data is limited.

When evaluating any industry data, the following items should be assessed:

- **The sample size of the industry.** This is very important. If there are not enough companies in the industry that is being reviewed, the conclusions can be faulty, and the financial results can be skewed and incorrect. Keep in mind that in looking at industry data, and at a particular company in a given sales range, you have to make sure that there are enough sample companies in that particular sales range. Even within the same industry, there can be a different number of companies represented in each sales range. Although there are no perfect rules, it is generally good to see at least five companies represented in each sales range.
- **Where the data has been obtained.** As noted previously, tax returns are generally not a good source of private company benchmark data.
- **How the data provider calculates the key metrics it reports.** Typically, many financial formulas can vary, so it’s important to know how the numbers are calculated. Specifically, any metrics about profitability should be carefully

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scrutinized because net profit formulas vary dramatically, depending on what expense and/or revenue items are included. Possible measures include net profit before taxes; net profit before taxes, amortization, and depreciation; operating profit; and net income after taxes.

- **How often the data provider updates its benchmark data.** Older data is sometimes of little value to users, so it's important to know the age of the data. Market conditions change rapidly, and a close approximation to real-time data will render the most accurate results.

### An Overview of Important Financial Metrics

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Here are the most important financial metrics that should be examined when looking at industry benchmark data:

- **Net profit before taxes margin.** The net profit margin is typically expressed as net profit before taxes during a given operating period divided by sales. A good way to look at net margin is to think of it as determining how many cents of profit a business extracts from each dollar it sells. There are many financial metrics that might be analyzed, but none is as important as the net profit margin.
- **Liquidity ratios.** There are two major liquidity ratios: current ratio and quick ratio. The current ratio is expressed as current assets divided by current liabilities. Generally, this ratio indicates what the overall liquidity position of a company is. There are many limitations to the current ratio, but it is always good to know the relative strength of a company compared to its peers. The quick ratio is typically expressed as cash

plus accounts receivable divided by current liabilities. Many financial professionals put more weight on the quick ratio because it is a better measure of a company's very short-term cash position. Again, the quick ratio is not a perfect indicator of liquidity, but it is helpful to see how a company compares to peers.

- **Turnover ratios.** Three major turnover ratios should be reviewed: accounts receivable turnover (in days), accounts payable days, and inventory days. Accounts receivable turnover (days), calculated as accounts receivable divided by sales times 365 days, roughly indicates the number of days it takes a company to convert accounts receivable to cash. The lower the number, the better. Accounts payable days, calculated as accounts payable divided by cost of goods sold times 365 days, measures the number of days it takes to pay vendors. Inventory days, calculated by inventory divided by sales times 365 days, measures the average number of days it takes to sell inventory. The lower the number, the better.

### Benchmarking for Better Credit Decisions

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It is important to consider these ratios and analyze them carefully. They do not perfectly reflect a prospective or current borrower's health, but generally, they are good indicators. It's especially helpful to know how a company compares to its peer group, because when all things are considered, this gives you an idea of how efficiently the company manages its available resources. As a lender, you want to know how well a company will manage the resources that you are supplying with the inherent understanding that risk is involved.

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