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Edison Explains

Liquidity

Liquidity is a key metric used by analysts when identifying attractive investments. What is liquidity and how can it be analysed?

What is liquidity?

There are two types of liquidity in which investors should be interested. The first is the liquidity of the company's shares and the second is the liquidity of the company's underlying business.

Share liquidity refers to how easy it is for investors to buy and sell shares without affecting the share price. Higher or improved share liquidity should ensure that the share price reflects the company's intrinsic value.

In this regard, not all shares are equal and can be split into different classes. For example, preferred or restricted shares usually have covenants dictating how and when they can be traded, meaning they are more challenging to divest and are considered 'illiquid' compared to ordinary shares. As a result, creating either preferred or restricted shares allows a company to limit liquidity.

In truth, the majority of companies prefer a higher level of share liquidity, rather than attempting to depress the trading of their shares.

How can share liquidity be determined?

Quantifying liquidity can be difficult as it varies with the volume of shares traded over time and due to other factors external to the company, such as general market sentiment.

The most useful indicators of liquidity are average daily traded volume and the bid-offer spread (the difference between the buying and selling prices of the company's shares quoted on an exchange). Simply, the higher the average daily traded volume and the smaller the bid-offer spread, the better.

For example, assuming the same share price, a company whose shares have an average daily traded volume of 100,000 will have better liquidity than a company whose shares have an average daily traded volume of 10,000.

Edison Insight

'Liquidity is an important metric to consider in the context of identifying a financially secure investment and then being able to trade that investment easily.'

Russell Pointon, director, consumer and media.

What is a company's underlying liquidity?

A company's underlying liquidity refers to its ability to meet its short-term financial obligations and commitments. This indicates the ease with which the company converts its short-term assets into cash to meet short-term liabilities with, preferably, a minimum of cost. As with share liquidity, an asset is not considered liquid if it cannot be sold quickly and at a discount to the recorded value in its financial statements.

Therefore, the primary focus in identifying and analysing liquidity are those assets and liabilities that are foreseeable and will fall due in the next 12 months.

How are assets and liabilities recorded in financial statements?

Assets that are expected to be converted into cash within a year are called current assets on the balance sheet. Current assets include cash and the company's other most liquid assets such as trade debtors and inventory. Trade debtors are customers who have not paid the company yet.

Non-current assets are assets that are not expected to be converted into cash quickly and will be used in the business over the long term. Non-current assets include property, equipment and land, which can be sold for cash but would take much longer to convert than the sale of current assets, making them illiquid.

The Coca-Cola Company, for example, is likely to find the process of selling one of its factories (a non-current asset) both more time consuming and costly than selling a can of Coke (a current asset).

Like assets, liabilities are categorised as either current or non-current depending on when the liability falls due. Current liabilities include trade creditors, and non-current liabilities include long-term borrowings and pension obligations. Trade creditors are suppliers which the company is yet to pay.

Movements in the majority of current assets and liabilities between two balance sheet dates are recorded as operating activities in the cash flow statement.

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Movements in non-current assets and liabilities between two balance sheet dates are recorded in the cash flow statement as either an investing activity or a financing activity depending on the nature of the asset or liability. For example, purchasing an asset is an investment in the business, so is recorded as an investing activity.

How can a company's underlying liquidity be analysed?

The starting point for analysing a company's underlying liquidity is its balance sheet, which analysts and managers use to construct a number of ratios.

The current ratio, the ratio of all current assets to current liabilities indicates how easily a company should be able to fund its current liabilities, including its debts.

A current ratio greater than or equal to one suggests more readily realisable assets than short-term liabilities, indicating that a company is in a relatively strong financial position.

Conversely, a current ratio of less than one suggests more short-term liabilities than readily realisable assets and indicates that the company is in a relatively weak financial position, and therefore may be less able to meet its short-term financial commitments.

Although the current ratio is a good starting point for assessing liquidity, certain current assets may not be sufficiently liquid (easily converted into cash in a short space of time) without the value being compromised. This leads to the conclusion that the business has ample liquidity, when in fact it may not. Examples could include old inventory or a trade debtor that cannot be realised quickly.

To overcome this drawback, analysts also calculate the quick ratio. The quick ratio is the ratio of all current assets, minus any non-liquid current assets, to all current liabilities.

Again, a ratio greater than or equal to one indicates a company in a relatively good financial position and vice versa. Although there are other liquidity ratios, these are by far the most common.

How can liquidity be determined over time?

Liquidity ratios provide a snapshot of a company's current financial position as of the balance sheet date. Comparing these ratios on other balance sheet dates can illustrate how a company's liquidity has changed over time.

After an initial view of a company's liquidity has been formed, an analyst should then consdier how the constituent parts of current assets and current liabilities have changed over time and how quickly they may or may not be realised into cash in the future. This requires analysis of the working capital cycle, which indicates how long it takes to convert the company's net working capital into cash.

Analysing the working capital cycle helps evaluate the expected timing of cash flows, both in and out of the business, to more effectively evaluate if short-term obligations can be paid.

Broadly, the shorter the working capital cycle the better. Optimising the working capital cycle involves limiting the number of days it takes for current assets to be converted into cash, while extending the time for cash going out to pay current liabilities, notably trade creditors.

When optimised, the working capital cycle allows a company to maintain a strong financial position, greatly reducing the likelihood of insolvency and enabling cash to be used elsewhere in the business in order to earn a better return.

A company's liquidity and working capital cycle can be analysed in isolation and compared to companies in the same industry or sector to identify relative inefficiencies.