HOW TO ANALYZE CORPORATE PROFIT MARGINS?

A company's most important goal is to make money and keep it, which depends on liquidity and efficiency.

Because these characteristics determine a company's ability to pay investors a dividend, profitability is reflected in share price.

That's why investors should know how to analyze various angles of profitability, including how efficiently a company uses its resources and how much income it generates from operations.

Analyzing Profit Margins Using Profit-Margin Ratios

Net earnings alone don't always provide a clear picture of a company. Using it as the sole measure of profitability can be a bad idea.

Profit-margin ratios, on the other hand, can give investors deeper insight into management efficiency.

But instead of measuring how much a company earns from assets, equity, or invested capital, these ratios measure how much money a company squeezes from its total revenue or total sales.

Margins are earnings expressed as a ratio or a percentage of sales. A percentage allows investors to compare the profitability of different companies, while net earnings, which are presented as an absolute number, don't.

Example of a Profit-Margin Ratio

Suppose that Company A had an annual net income of $749 million on sales of about $11.5 billion last year. Its biggest competitor, Company B, earned about $990 million for the year on sales of about $19.9 billion.

Comparing Company B's net earnings of $990 million to Company A's $749 million shows that Company B earned more than Company A, but it doesn't tell you very much about profitability.

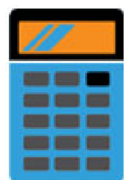
However, if you look at the net profit margin or the earnings generated from each dollar of sales, you'll see that Company A produced 6.5 cents on every dollar of sales, while Company B returned less than 5 cents.

There are three key profit-margin ratios:

- Gross Profit Margin
- Operating Profit Margin
- Net Profit Margin

Gross Profit Margin

The gross profit margin tells us how much profit a company makes on its cost of sales, or cost of goods sold (COGS). In other words, it indicates how efficiently management uses labour and supplies in production.



$$\text{Gross Margin Formula} = \frac{\text{Net Sales} - \text{Cost of Goods Sold}}{\text{Net Sales}} \times 100$$

SWIPE

Suppose that a company has $1 million in sales and the cost of its labor and materials amounts to $600,000. Its gross margin rate would be 40%.

Companies with high gross margins will have money left over to spend on other business operations, such as research and development or marketing.

If this margin is in a downward trend then the company will face problems in the future with its bottom line.

Operating Profit Margin

By comparing earnings before interest and taxes (EBIT) to sales or revenue, operating profit margins show how successful a company's management has been at generating income from the operation of the business.

$$\text{Operating Margin (\%)} = \frac{\text{EBIT}}{\text{Revenue}}$$

SWIPE

This ratio is a rough measure of the operating leverage a company can achieve in the operational part of its business. It indicates how much EBIT is generated per dollar of sales.

High operating profits can mean the company has effective control of costs, or that sales are increasing faster than operating costs.

Net Profit Margin

Net profit margins are those generated from all phases of a business, including taxes. In other words, this ratio compares net income with sales or revenue.

$$\text{Net Profit Margin (\%)} = \frac{\text{Net Income}}{\text{Revenue}}$$

To be comparable from company to company and from year to year, net profits after tax must be shown before minority interests have been deducted and equity income added. Not all companies have these items.

Also, investment income, which is wholly dependent upon the whims of management, can change dramatically from year to year.

Examples of Corporate Margin Analysis

As part of its annual financial statement reporting, Microsoft reported financial information for the year ending June 30, 2022. These comparative income statements also communicated historical results for the same period ending in 2021 and 2020.

INCOME STATEMENTS

(In millions, except per share amounts)

Year Ended June 30,		2022		2021		2020
Revenue:						
Product	$	**72,732**	$	71,074	$	68,041
Service and other		**125,538**		97,014		74,974
Total revenue		**198,270**		168,088		143,015
Cost of revenue:						
Product		**19,064**		18,219		16,017
Service and other		**43,586**		34,013		30,061
Total cost of revenue		**62,650**		52,232		46,078
Gross margin		**135,620**		115,856		96,937

Microsoft generated $198.27 billion in revenue in 2022. Looking further down its income statement, it also generated $135.6 billion in gross margin.

Dividing Microsoft's gross margin by its total revenue yields roughly 68%; this means that for every dollar Microsoft generated in income, it paid roughly $0.32 for the cost of goods sold and kept $0.68 to pay for broader operations.

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Total cost of revenue	62,650	52,232	46,078
Gross margin	135,620	115,856	96,937
Research and development	24,512	20,716	19,269
Sales and marketing	21,825	20,117	19,598
General and administrative	5,900	5,107	5,111
Operating income	83,383	69,916	52,959

Microsoft also reported an operating income of $83,383. This equals roughly 42% of net total sales. This means that after Microsoft paid for both its cost of goods sold and operating costs, it still kept $0.42 from every dollar it earned.

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Research and development	24,512	20,716	19,269
Sales and marketing	21,825	20,117	19,598
General and administrative	5,900	5,107	5,111
Operating income	83,383	69,916	52,959
Other income, net	333	1,186	77
Income before income taxes	83,716	71,102	53,036
Provision for income taxes	10,978	9,831	8,755
Net income	$ 72,738	$ 61,271	$ 44,281

Microsoft paid income taxes and had several income statement lines that further reduced the amount of net income it earned. Rounding up, this left Microsoft with roughly 37% of its total gross revenue. This means that for every dollar that Microsoft sold, it ultimately kept $0.37 after factoring in costs.

Consider that by itself, these margin ratios may not mean much. After all, you may not know if a 37% net income margin is good, especially considering Microsoft's size, industry, and competitive advantages.

Therefore, margin ratios are a tremendous way to compare information across companies to see how one entity may be performing against its competitors.

Last, consider the value profit margins may offer by comparing them over time. Looking at Microsoft's financial information, the company posted a 45.6% net income margin in 2020 and a 52.8% net income margin in 2021.

Therefore, though 37% may sound high, performing a comparative margin analysis may reveal potential trends or downturns.

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