# Inconsistency in BMW's financial indicators

BMW is a very well-managed company, maybe the best-run of all automotive companies. This can accordingly be seen in its financial results for the past 15 years. Nevertheless, a certain inconsistency can be detected in the financial statements concerning the financial objectives BMW's management sets out and how it assesses their fulfilment.

BMW consists of two businesses. The first one is, of course, the automotive division, which develops, manufactures and sells cars and motorcycles. The second, often overlooked, is BMW Bank. The latter finances approximately one-half of BMW sales through leasing and consumer loans, and it also provides financing to dealers. The two businesses complement one another nicely, but they are so different that they are reported separately in the financial statements. Each is evaluated by management on the basis of a different financial indicator.

For the bank, the basic indicator is return on equity (ROE). Over the past 5 years, this averaged 18.7%. That is a very high number for a bank today, and a level unachievable for most large European and American banks. The high ROE stands out especially when we realise the low risk associated with BMW Bank's assets. Their average maturity is around 2 years, and the average proportion of bad debt over the past 5 years was 0.36%.

On the other hand, return on capital employed (ROCE) is the key indicator used by management in the automotive division. Its average value over the past 5 years was 67%. This is again a very high number, and it best shows that BMW has a long-term competitive advantage. Such high returns on capital would not be possible without such an advantage. (ROCE for the motorcycle division over the past 5 years was 30%. This is also a very high number. BMW's motorcycle business, however, is much smaller than its automobile business, and we can omit it in further consideration.)

When we compare BMW Bank's ROE and the automotive division's ROCE with the same indicators for comparable companies, BMW turns out to be doing very well in these relative terms. The absolute values of these indicators in comparison to costs of capital are very high, as well, and both indicators also substantially surpass management's targets. The objective of BMW's management is to reach at least 12% ROE in the bank and 26% ROCE in the automotive division. These objectives have been greatly exceeded in each of the past 5 years. So far, so good, it seems.

But let us take our appraisal a bit further. The ROE of the company BMW as a whole was 15.7% on average over the past 5 years. This number includes both the bank and the automotive division. You may think – how can BMW's overall ROE be 15.7% when one part (the bank) has ROE of 18.7% and the other part (the automotive division) has ROCE of 67%? The explanation is simple. The formula for calculating ROCE excludes net cash from capital. And cash is high for the automotive division. On a 5-year average, its cash amounted to EUR 18 billion even as debt stood at zero. The cash consists in savings collected over years of the company's operations and which gradually are increasing due to the automotive division's positive free cash flow. This is, therefore, capital that is not "employed" in manufacturing and therefore is also excluded from the calculation of ROCE. Because it is part of BMW's equity, though, it is included in the calculation of ROE.

BMW is therefore in a situation of having very high ROCE but only slightly above-average ROE, as it is burdened by a large sum of unused cash. Could this cash be used more effectively and partially paid out to shareholders? A number of investors have posed this question, and one also asked it to the management in a conference call held on the occasion of announcing the company's results for 2018. The management's response was that it is not considering to pay out this excess cash because it will be needed to maintain the high investment rating and, in particular, to support BMW Bank. In other words, the cash is not excessive.

If that is the case, then it should be included either in the calculation of BMW Bank's ROE or in that of the automotive division's ROCE, or partially in both. These indicators would then be much lower. If all this cash were included in calculating the bank's ROE, it would drop to approximately one-half its current level. The management's inconsistency in thinking about BMW's financial indicators is thus fully revealed here. It is not possible to exclude cash from the calculation of financial indicators while at the same time claiming that this money is necessary for doing business going forward.

The same inconsistency appears in the declared targets concerning ROCE and margins in the automotive division. For this year, BMW's management expects to substantially exceed its objective of 26% ROCE. At the same time, it anticipates that the EBIT margin of the automotive division will be substantially under the long-term target of 8–10%. This does not make much sense. Either the ROCE target set is too leniently, or long-term EBIT margins are unrealistic, or the entirety of the capital employed is not properly taken into consideration in calculating ROCE.

BMW's net cash currently stands at almost 40% of its market capitalisation. This is a record-high proportion. BMW's management has two possibilities today. The first option is to admit that its assets allocation is overly undemanding and to pay out part of the cash to shareholders. The second is to admit that the cash is not excessive, then appropriately adjust its calculation of ROCE and ROE and its setting of long-term objectives.

Invest with care !

Daniel Gladiš, May 2019

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