

# Impact of economic events on ftse 100 corporations



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**Current economic events and their impact on four FTSE 100 corporations**

Over the course of the past eighteen months the global economic climate has suffered a severe blow resulting from the combination of the “ credit crunch,” which resulted in the near collapse of the world’s financial markets followed by a global economic downturn that is pushing western economies such as the UK into a recessionary period. These events have had a major impact upon the economic decisions being made by corporate management,

The intention of this paper, using four FTSE 100 corporations, is to assess the impact of economic events upon these companies and evaluate the manner in which corporate decisions have been affected by these events. In particular this assessment will cover the five week period from opening of the stock market on 27<sup>th</sup> October until its close on 28<sup>th</sup> November 2008. Furthermore, using the interactive share graph facilities available at FT. com, the share performances included within the paper have been set within the custom range of the above dates.

Diageo (2008) is a corporation that operates within the alcoholic beverages industry, concentrating mainly in the spirits sector of the market. It has a number of brands within its stable of products, which include Smirnoff Vodka, Johnnie Walker, Captain Morgan and J&B Whisky’s, Guinness and Baileys. To date, the strategic policy for the business has been to expand its brands based on organic growth combined with selective acquisition. In other words, where the acquisition route has been chosen, this has been designed to attract target corporations that have significant synergies with the existing business, thus providing Diageo with economies of scale (Johnson et al 2007).

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In response to the current economic situation the management of Diageo has taken some strategic decisions. The first of these, designed to secure its funding requirements for the immediate future is the issuance of a five year \$1, 000 million bond with a coupon of 7. 375%. This will enable the business to maintain its growth strategy during the current period of financial crisis.

In the latter part of the period it has been announced that Diageo has already begun utilising this additional funding. It was announced on the 24<sup>th</sup> November that the company has completed a strategic alliance with UB Spirits in India with a 15% stake that is likely to cost around \$600 million (Kazmin and Wiggins 2008). With the trade tariffs on spirits in the Indian markets being reduced this move opens up the world's second largest market and will put the Diageo brands into a commanding market position in this country.

In addition to the above actions, the management has placed further emphasis on strategic marketing of product brands. For example, with research indicating that the Bailey's brand represents a drink that has particular importance to consumers at Christmas time, Diageo recently announced a £25 million promotional campaign for this product (Editorial 2008). The adoption of this strategy helps to offset potential falls in revenue and profits that might be experienced for products that are considered by consumers to be luxury items that can be discarded in times of economic crisis.

A Further event that could have a positive impact upon Diageo's international sales has resulted from the result of a court case in China

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(Anderlini 2008). In this event a Chinese spirits corporation had been “passing off” their product as being Johnnie Walker whisky by using packaging this product with a virtually identical brand design to Diageo’s original. In addition to be fined Rmb 1. 25 million (approximately £115, 000), the fact that the Chinese corporation has been ordered to desist will mean that Diageo should see sales of this product increasing in China.

The only recent news that might be of concern to the business is the latest moves by the UK government to encourage responsible drinking (Murden 2008). With raised taxes on alcohol, a move that has already been indicated in the Chancellors recent pre-budget speech, and separate tills for beers and spirits in supermarkets being considered, both of which are opposed by the management, these could have an adverse effect upon UK sales.

### *Share Price*

The share price for Diageo has risen from an opening position of 873p at 27 October to a closing position of 890p at 28 November 2008, which represents a 2. 06% rise for the period.

It can be seen from the following graph (figure 1) that the Diageo share price, despite underperforming the FTSE 100 during the period has followed a similar pattern. In addition, despite the fact that during the course of the last twelve months, the share price has reduced by 19. 03% (FTSE 100 – 34. 96%) in the past year <sup>[1]</sup>, the past five weeks has seen this position stabilise (Table 1).

However, when compared against the performance of its main competitors during the past five weeks, Diageo's shares have a mixed result. SAB Miller has achieved a growth in the period of around 25%. However, this corporation has a much stronger presence in areas of the world such as India, which Diageo is only recently developing. Nevertheless, when compared with InBev, Diageo is performing considerably better.

Furthermore, although the share value has reduced by 19.27% over the past twelve months (FTSE 100 - 36.58%), as a longer term investment, with a gain of 22.71% in five years (FTSE -10.14%), it has proven to be a secure investment.

Table 1 Diageo against FTSE 100

Name	1 Week	1 Month	6 Month	1 Year	5 Year
Diageo DGE:	-3.01%	-6.94%	-10.15%	-19.03%	+19.19%
LSE	+0.74%	-4.42%	-29.92%	-34.96%	-4.74%
FTSE 100					

*Source:* <http://markets.ft.com/tearsheets/performance.asp?s=DGE%3ALSE>

In addition to the impact of the strategic decisions other events that have affected the corporation's performance during the period being reviewed, the limiting of its underperformance against the FTSE has been helped by <https://assignbuster.com/impact-of-economic-events-on-ftse-100-corporations/>

the strong financial performance of the business during the year to 30<sup>th</sup> June 1998 [2]. Preliminary results show that revenues have increased by 7% whilst profits, due to increased efficiency, have improved by 9%. This, together with global growth in all areas being at least 2% provides Diageo with a strong platform from which to build upon in the coming year. It is for these reasons that ten of the analysts' opinions sought by the Financial Times recommended holding these shares; with a further seven analysts' suggesting that they represented a good buy.

It is considered that, once the full impact of the strategic decisions, in terms of the brand marketing and the expansion into India, has been experienced an upward improvement in the share performance of Diageo should result.

BT (2008) is the UK's largest telecom and internet broadband provider. It also operates in 170 countries globally, providing international telecommunications and other related services. However, despite a continual increase in profits over the past five years, the results for the first six months of 2008/2009 show that business profits before taxation have fallen by 11%, which as Ian Livingston, BT's CEO recently admitted, "*is not good enough.*"

[3]

It would appear from the financial and share data discussed in the following section that the management of BT have been guilty of allowing a strategic drift to occur within the business (Johnson et al 2007, p. 27). In other words they have not been maintaining a strategy that has enabled the business to address changes in the external environment.

In line with many other telecommunications businesses BT is also seeking a strategy of reducing its cost base <sup>[4]</sup>. The purpose of this move is designed to improve its competitiveness in a market that is experiencing challenging economic conditions. The measures being introduced to address this situation includes reducing the workforce by 10, 000, with most of the direct job cuts being delivered in the UK, and reorganising its pension plans, a move anticipated to save the business around £100 million per annum. In addition, and in an effort to remain competitive in an increasingly price driven market, the business is looking to decrease prices by reducing its profit margins.

Concerning positive strategic moves made by the corporation during the period being reviewed there is two that might have a positive impact upon the business value. The first of these is its planned investment in a new “*superfast*” broadband network, an area of business where it is currently losing out to Virgin Media. However, at present these plans are being thwarted by delays in gaining the required approval from the telecommunications regulator Ofcom. The concern is that if this issue is not settled in the near future the investment needed for BT to catch up with Virgin’s position will increase significantly. Secondly, it was announced on the 17<sup>th</sup> November that BT had formed a strategic alliance with Avanti Communications to manage their satellite broadband traffic when this comes on line in 2009 <sup>[5]</sup>. However, both of these events should help the business to increase market share and revenue in the future.

### *Share Price*

The share price for BT has risen from an opening position of 124. 9p at 27<sup>th</sup> October to a closing position of 135. 20p at 28<sup>th</sup> November 2008.

Although when taken in isolation the BT shares have outperformed the FTSE 100 during the past month (Table 2), which coincided with the job cut announcement, it is apparent from the share performance chart (figure 2) that during the course of the past week that the reverse has been the case, bringing to an end the positive effect. Furthermore, it is equally apparent from the graph that BT shares have consistently under-performed both the FTSE 100 and those of its global competitors, although in the past few days it has outperformed Swisscom. However, the latter event should not be taken as an indication of improvement for BT considering the relative size of the two corporations and the domestic market available to them.

The recent performance situation of BT was further exacerbated on the 31<sup>st</sup> October when it issued a profit warning <sup>[6]</sup>. Blaming this on the global service unit the CEO stated that the earnings in this area would be “*significantly below expectations.*” Indeed, the interim results for business for the half year to September 2008 <sup>[7]</sup> showed that, despite increased revenues of 4% when compared with the same period in the previous year, operating profits were down by 1% and net profits by 11%. These results also confirmed that a 36% reduction in EBITDA for BT global services was the main contributing factor.

As can be seen from the graph (figure 2) this single profit warning event caused a slump in the share price of nearly one fifth.



Table 2 BT against FTSE 100

Name	1 Week	1 Month	6 Month	1 Year	5 Year
BT Group BT. A:	-0.	+16.	-39.	-53.	-23.
LSE	52%	94%	84%	06%	52%
FTSE 100	+0. 76%	-4. 41%	-29. 91%	-34. 95%	-4. 73%

Furthermore, despite the impact of the current economic climate the current performance of BT shares is not a recent occurrence. Indeed, data available from market indicators shows that the performance of BT shares has been exhibiting this decline in value for the past five years. For example, during this extended period BT has been underperforming the FTSE 100 by nearly four times. During this period, BT share values have reduced by 23.52% (FTSE -4.73%). This suggests that there are serious issues relating to the management and operations of the business that need to be addressed.

In fact from a peak of 1,403 on 1<sup>st</sup> December 1999, the shares have lost nearly 90% of their value, closing at 135.2p on the 28<sup>th</sup> November 2008. Furthermore, when it is considered that, during the course of the past few weeks the share valuation of the business has been less than 10p higher than the level at which they were sold on privatisation<sup>[8]</sup>, this fiscal evidence confirms the strategic drift allowed by management as mentioned previously is seriously damaging the attractiveness of BT to investors.

Scotland's premier financial institution, the Royal Bank of Scotland has been noted for its aggressive strategy policy of expansion by acquisition. This has been evidenced in the past by its acquisition of the National Westminster bank and, more recently, by the RBS intervention in the proposed takeover of ABN Amro by Barclays, a competitive acquisition that RBS together with its strategic partners won. The problem with this strategy is that it exposes the corporation to additional risk due to reduction of cash flow and potential issues within the acquired organisations (Gallati 2003), such as achieving a synergetic fit of operations. Whilst these risks might be manageable in times of economic stability as has been witnessed recently they leave a business vulnerable in times of crises.

As Porter (2008) advised in a recent speech, "*sound strategy is key*" for any business in times of economic stress. It is apparent from the performance of RBS over the past year that this has not been the case in the past. However, the business has now adopted three strategic moves. To maintain the capital adequacy levels required by financial regulators (FSA 2007) it has accepted an injection of £20 billion from the UK government, 75% which will be in the form of ordinary shares thus not adversely affecting its debt ratio, with the other 25% provided in the form of preference shares. This investment was completed on the last day of the period under review (28<sup>th</sup> November 2008). Despite having to offer the rights issue to all of its shareholders, the ultimate result was that less than a quarter of a percent of these took up the offer, leaving the government as a majority owner of the business with a 59.76% stake (Thomas 2008), which made this one of the worst performing rights issues ever witnessed <sup>[9]</sup>.

The second step being taken by the bank is the demerger of some of its non-core business activities (Johnson et al 2007). For example, RBS is currently looking for buyers for its insurance operations, including such brands such as Direct Line and Churchill (Costello 2008). Finally, it is seeking to reduce costs by streamlining its global human resources, which involves the loss of 3, 000 jobs. However, in recent weeks the completion of this sale has become a matter of debate <sup>[10]</sup>, with the new RBS CEO suggesting that a) there were funding difficulties to be overcome and b) that the UK government's injection of capital made the sale less urgent.

Furthermore, following the change of CEO on the 21<sup>st</sup> November, the new chief executive has announced that he will be conducting a complete review of the business operations, which will inevitably lead to the sale of other assets of the business, as well as potentially an increase in the numbers of global job cuts. These actions are designed to return the business from a position where it moved from a £10 billion profit to a loss of £691 million in the space of one year to a more stable and sustainable level of ongoing operations.

### *Share Price*

The share price for RBS has reduced from an opening position of 58p at 27 October to a closing position of 55. 3p at 28<sup>th</sup> November 2008. This represents a fall of over 4. 5% for the period.

Like most of the financial institutions, the share performance of RBS (figure 3) has been severely affected by the “ credit crunch” and the global financial

crisis. As can be seen from this graph the banking industry in general has been underperforming the FTSE 100 during the period. However, when compared with UK competitors over the past month, it is apparent that the RBS performance is mirroring the activity of the financial market sector in general, although it has experienced a greater level of improvement in recent days when compared with that of Barclays.

Furthermore, when one considers the performance of RBS over a five year period the position is also weak and should have indicated to the management that there were strategic issues that needed to be addressed. The reason for this is that, although the financial sector during this period has under-performed against the FTSE 100 during this period the RBS result was particularly bad (table 3), showing a drop in share value of 88.04% (FTSE -4.37%) from a high at that time of 455.4p, with nearly 19% of that fall experienced within the past five weeks. This gap has indeed worsened during the period review, despite the intervention of the UK government and their purchasing a controlling interest in the business.

This situation confirms that the economic strategies adopted by the management are not achieving the business objective of added shareholder value and, based upon the adverse record of accomplishment by the bank it is easy to see why investors have shied away from this stock, both in the past and following the government's intervention.

Table 3 RBS against FTSE 100

Name	1 Week	1 Month	6 Month	1 Year	5 Year
Royal Bank of Scotland Group	+8.	-18.	-77.	-85.	-88.
RBS: LSE	07%	67%	45%	72%	04%
FTSE 100	+1.13%	-4.05%	-29.65%	-34.71%	-4.37%

It should be noted that the fall in the RBS share price between 20-28 November is almost certainly a negative reaction to the shareholder's agreement to the UK government's £20 billion bailout. There is little doubt that much of this fear relating to this stock is being driven firstly by the fact that many consider it to be insufficient to requirements and others concerned that this might lead to RBS becoming the third bank to be nationalised in recent months, which would seriously reduce the value of the investment.

#### 4 Marks and Spencer

Possibly the UK's most renowned high street retailer Marks and Spencer, which delivers fashion, food items and household products to the consumer had just completed a revival of the company's fortunes, returning a profit of £1 billion for the first time since 1998, when the current economic and financial crises hit the markets and consumer confidence. However, this success has been short lived. The recent release of half year results to September 2008 (Marks and Spencer 2008 b) showed profits before tax had fallen from £550.1 million to £307.8 million, a drop of over 44%.

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One of the major concerns that face the corporation in the present environment is that with a current business valuation of just over £3.1 billion, it is in danger of seeing its debt mountain exceed this at current rates of borrowing (Davey 2008). To address this, the management have made the economic decision to employ stricter controls on costs and review its capital expenditure programme, reducing the store refurbishment programme by £300 million in the current year and £400 million for 2009/2010. In addition the business is reducing its promotional budget by 30% for the remainder of the current year, with similar cuts being likely for the following financial year. A second concern, but equally worth noting is that this current valuation is less than half of the value that was offered for the business in 2004 by the retail entrepreneur Philip Green. Therefore, it is true to say that, at this time Marks and Spencer is vulnerable to the potential of another take over bid. It is considered that the only reason this has not transpired during the past five weeks is due to the fact that the condition of the financial markets makes it difficult for suitors to arrange the necessary funding.

On the positive side, strategic changes have been made by the introduction of a low cost pricing strategy (Porter 2004), which is intended to enable the business to maintain its market share (M&S 2008b and Davey 2008). This is particularly evident in food, an area that has seen a drop of 5.3% over the first six months of the financial year. The introduction of the “£10 ‘dine for two’” promotion is aimed at reversing this trend. In addition, during the course of November the business has introduced a series of 20% sale days in a bid to entice consumers to buy. However, with reports that consumer spending dropped by 2% in the quarter to September (Cohen 2008),

following a similar drop in the previous quarter, whether the discount offers will prove successful is highly debatable. Added to this is the concern that the recent two and a half percent reductions in the VAT rate appear to have made little difference to the retail environment.

### *Share Price*

The share price for Marks and Spencer has risen from an opening position of 214.75p at 27 October to a closing position of 225.75p at 28<sup>th</sup> November 2008. Although this shows an improvement of 4.87% for the period being examined, this is little consolation for the business or its investors when it is considered that this current value is still 18.64% lower than the same time in 2004 (277.50p at 1 December 2004). It was at that time that the business was starting its recovery programme, having narrowly escaped losing its independence when Philip Green made an £8 billion bid for the retailer. However, in view of the performance of its competitor NEXT, whose shares have consistently outperformed Marks and Spencer's during the five week period, it would not be totally correct to suggest that the poor M&S performance can be explained by current market conditions. It is equally important for the management to recognise that part of the reasoning for the current position of the business has to be due to the fact that, despite the successes achieved in its recovery programme since 2004, there are still some areas of strategy that need to be reviewed.

It is apparent from the following graph (figure 4) that although there was a period where the shares of M&S outperformed the FTSE during the course of the past five weeks, if one takes the period as a whole, this position was not

sustained. In addition to the economic condition, an exacerbation for the recent share performance has resulted from the release of half year financial statements showing the fall in business revenues and profits. This chart also reveals that during the period being reviewed as a whole M&S shares have underperformed the FTSE 100 and its clothing competitor NEXT. However, compared with a more direct department store competitor, Debenhams M&S has proved the better investment during this period.

Table 4 Marks and Spencer against FTSE 100

Name	1 Week	1 Month	6 Month	1 Year	5 Year
Marks and Spencer Group	-0.	-1.	-43.	-62.	-20.
MKS: LSE	69%	03%	04%	85%	31%
FTSE 100	+0.	-4.	-29.	-34.	-4. 64%
	85%	32%	84%	89%	

Despite the share performance improvement following the change in management in 2004, when reviewing the share performance of M&S over a five year period at a value loss of 20. 31% (FTSE -4. 64%) it must be considered as a matter of concern (table 4). Indeed, there is a view amongst some analysts' that the current share value is at the upper end of the value for the business.

### Conclusion



Whilst a review of these four corporations have shown that the economic and financial crises have impacted upon their share performance, it is apparent from this assessment that there have also been errors and misjudgements made in the strategic decisions of a number of these businesses. Of the four the only business that can be considered to have taken the most appropriate approach is Diageo, which has managed to maintain a reasonably stable position over the five weeks. The management of the other three corporations need to re-access their corporate strategy and refine this to enable a recovery programme to be implemented.

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## Footnotes

[1] Opening price at 3/12/07 was 1100p

[2] See: <http://www.diageo.com/NR/rdonlyres/02C03FC6-0C6E-4A82-B31C-BD37C2FE8F35/0/Prelims2008IRFINAL.pdf>

[3] <http://www.btplc.com/News/Articles/Showarticle.cfm?ArticleID=27494718-77f6-4cd9-976f-ecc9c13f7559>

[4] <http://uk.reuters.com/article/wtMostRead/idUKTRE4AC1I020081113>

[5] See <http://announce.ft.com/index.aspx?a=648530>

[6] <http://news.bbc.co.uk/1/hi/business/7701626.stm>

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