Report for potential investors in tesco plc

The purpose of this report is for potential investors who are considering buying shares in Tesco plc. The report creates an overall picture of Tesco's financial position and provides an assessment of Tesco's performance over the last three years.

The information used to assess the financial position of Tesco was gathered from the Annual report of the last three years. This information was downloaded from the official Tesco website.

From that, the ratios were calculated from the financial statements within the report.

Results

Ratios

2004

2005

2006

Change (%)

Return on capital employed

13. 99%

14. 77%

17. 29%

19. 09% increase

Net profit Margin

5. 17%

5. 76%

5. 78%

10% increase

Asset Turnover

2. 72 times

2. 56 times

2. 99 times

9. 03% increase

Current Assets

0. 56 times

0. 57 times

0. 52 times

8. 77% decrease

Quick Ratio

0. 35: 1

0. 35: 1

0. 33: 1

05. 71% decrease

Gearing Analysis

35. 35%

34. 52%

28. 38%

19. 72% decrease

Interest Cover

7. 75

8. 31

9. 46

18. 08% increase

Earning per share

15. 05p

17. 44p

20. 07p

25. 01% increase

Dividend Cover

2. 13 times

2. 29 times

2. 57 times

17. 12% increase

Introduction

The aim of this report is to provide an assessment of the company's performance over the three year period to a group of potential investors in the company. So this report will use nine financial ratios which are useful for the investors to help them to identify and highlight area of good and bad performance of the company and area with significant change.

Therefore this report will consist:

brief overview of the history of Tesco and

Then it will analyse the profitability, liquidity, investment analysis of Tesco plc.

The report will also advice potential investors on whether shares in this company would be a good investment.

Brief Background on Tesco plc

It is best known that Tesco Company is the leading retailer in the UK and one of the largest food retailers in the world. The retail industry is a highly competitive market. Tesco competes with a wide range of retailers with a wide range sizes and there face increased competition from UK retailers as well as international operators. Tesco also sell non food goods such as electrical goods and clothing. In general Tesco is a successful profitable company which attract investors to invest in the company.

General Financial Analysis

It is well known fact that the financial ratios become important for investors to help them whether they should buy shares in the business, sell them, or hold on shares which already own them. Therefore ratios analysis helps investors to identify and highlight area of good and bad performance of the company and area with significant change.

In addition, financial ratios explain the relation between different figures in the financial statements consequently we could calculate hundred of ratios fro a set of financial statements, because of this we need to know which ratio provide a good and useful information for the investors , the ratios which are applied incorrectly they may be completely useless and misleading. However if they are used correctly they are useful for understanding the performance of the company and interpreting the company account.

Ratios describe the relationship between different items in the financial; however the relative usefulness of each ratio depends on what aspects of a company's business affairs are being investigated. In this case of Tesco plc, there are four elements of ratios that are been analysed. These are Profitability, Liquidity and Investment analysis.

Return on Capital Employed (ROCE):

The ROCE is an important measure of the profitability of a company. This is because it is a popular indicator of management efficiency by contrasting the net profit generated by the company with the total capital employed (traditionally, total capital employed in this case has been taken to be the long term funding). It does not only incorporate the funds the shareholders have invested, but also funds invested by banks and other lenders, and therefore shows the productivity of the assets of the group.

ROCE = PBIT Ã-100

Capital employed

2006 = 2, 280 Ã-100

9, 444 + 3742

= 17. 29%

2005 = 1, 952 Ã-100

4, 563 + 8, 654

= 14. 77%

2004 = 1, 729 Ã-100

7, 990 + 4, 368

= 13. 99

These calculations show that the return on capital employed has been on steadily increasing for the past three years. For 2006, the ROCE is 17. 29% which is 1. 94 % above the average for the three years. This indicates that Tesco is using its invested resources more efficiently and that by comparing with other leading retailers, they ROCE are higher. This shows that this figure is more likely to be acceptable to potential investor.

Comparison on Return on Capital employed

Year

Tesco plc

J Sainsbury plc

Morrison’s

2004

13. 99

7. 99

6. 01

2005

14. 77

-2. 56

5. 1

2006

17. 29

3. 73

-5. 63

Average

15. 35

3. 053333333

1. 826667

Net profit margin is another widely used ratio in the assessment of company performance and in comparison with companies in the same industry.

Net profit margin = Profit before exceptional items, interest & tax Ã-100

Revenue (turnover)

2006 = 2, 280 Ã-100

39, 454

= 5. 78 %

2005 = 1, 952 Ã-100

33, 866

= 5. 76 %

2004 = 1, 735 Ã-100

33, 557

= 5. 17 %

From the calculation, it shows that net profit margin has been increasing slightly which shows Tesco have kept control of its expenses.

Group sales have increased consistently through 2004/05 by 9. 4% and in 2005/06 by 14. 33%. (Note: in order for comparisons, two different figures were used in 05 sales due to the implementation of IFRS while the comparison for 04/05 was accounted under the standard of UK GAAP).

As for PBIT, there was not much increase in 2004/05, however between 2005/06 there was an increase of 14. 16 %.

Comparison on Net profit Margin

Year

Tesco

J Sainsbury plc

Morrison’s

2004

5. 17%

3. 23%

6. 19%

2005

5. 77

-0. 99%

2. 12%

2006

5. 78

1. 43%

2. 17%

Average

5. 573

0. 012

0. 035

This shows Tesco average on net profit margin for the past three years is way above the averages of other leading supermarkets.

This illustrates that in 2005 and 2006, Tesco profit margin is miles ahead. From this it can be concluded that it is a profitable company which has kept control of its expenses.

The Asset Turnover is a measure of how much sales are generated by the capital asset base of a company.

Asset turnover = Revenue (turnover)

Capital employed

For Tesco plc, asset for the three years are as follows:

For 2006 = 39, 454

13, 186

= 2. 99 times

For 2005 = 33, 866

13217

= 2. 56 times

For 2004 = 33, 557

12, 358

= 2. 72 times

this shows that asset turnover is slightly increasing. This is due to the fact that revenue has increased considerably from £33, 557 in 2004 to £39, 454 in 2006

Comparison on Asset Turnover

Year

Tesco plc

J Sainsbury plc

Morrison’s

2004

2. 72

2. 47

0. 98

2005

2. 56

2. 57

2. 59

2006

2. 99

2. 61

2. 59

Average

2. 7566667

2. 55

2. 053333

This shows that Tesco is above the average asset turnover for the market. From this it can be concluded that Tesco is generating more sales from its capital base.

Liquidity Analysis

It is clear that liquidity ratios analysis important to the investors as liquidity ratios related to the capacity of business to pay its short term debt as become due, therefore the focus is on the relationship between current assets and creditors due within one year, since these measure short term sources of cash and short term calls on that cash, there are two commonly used ratios which highlight such a situation:

Current ratios (current assets/current liability)

The current ratio measure the relationship between the company's current assets and its current liability in Tesco Company's balance sheet shows the current asset for 2006 3991 and current liability of 7518, the current asset for 2005 3224 current liability 5680, for 2004 current assets 3139 current liability 5618

Current ratios = currents assets

Current liabilities

For 2006 = 3919

7518

= 0. 52 times

For 2005 = 3224

5680

= 0. 57 times

For 2004 = 3139

5618

= 0. 56 times

It can be seen from the results the current ratio for Tesco company is stable between 2004 and 2005, however it fell slightly in 2006, this is because of the fact that there was an increase in current liabilities.

Quick ratios (Current assets – inventories) / current liabilities

The quick ratios ignore the stock and concentrates upon those assets which can be turned into cash, the quick ratios important for investors who want to take share in Tesco Company where stock is turned over quickly and the sales are mainly on a cash, consequently the quick ratios compares liquid current assets with current liabilities.

For 2006 = 3919 – 1464

7518

= 0. 33: 1

For 2005 = 3224 -1309

5680

= 0. 35: 1

For 2004 = 3139 – 1199

5618

= 0. 35: 1

As it can be seen from the results the quick ratios test follow much the same trend on average over the three years of 0. 34, which shows low level of resources are tied up in inventory. It can also be concluded that Tesco does not have any cash flow problems and therefore the company is using its resources well.

Gearing Analysis

An important determinant of a company's capacity to develop is its funding structure.

This very important as it enables the company to assess its capacity to satisfy its long term commitment.

The financial structure of a business is an important consideration when assessing the financial health of any entity.

The most commonly used structure is the Gearing ratio, which quantifies the relationship between debt and equity.

The higher the ratio then the more vulnerable the company is perceived to be this is because there is a high and fixed call on its profit before equity can be satisfied. This means that a company that has high gearing will has deal with its long term commitment such as long term debt and this in turn means they will be less fund for payment such as dividend for shareholders.

Gearing Ratio = Long Term Debt Ã-100

Capital Employed

For 2006 = 3742 Ã-100

9444 + 3742

= 28. 38%

For 2005 = 4563 Ã-100

8654 + 4563

= 34. 52%

For 2004 = 4368 Ã-100

7, 990 + 4, 368

= 35. 35 %

From these calculations, it shows that the long term debt has been decreasing steadily for the past couple of years while on the other hand the equity of the company has been increasing steadily, which indicate the finances of the company as moving towards equity and less on debt.

Interest cover ratio:

It is important to recognize that the interest cover ratio is important for investors as they measure the amount of profit available to cover interest payable. The high interest cover ratio it means that the company or business is easily able to meet its interest from profit. in the same way a low value from interest cover ratio it means that the business is in danger to meet its interest obligations therefore the profit available to the shareholder will be very low.

In Tesco company the measure of interest cover ratio as follow:

Interest cover ratio = profit before interest and tax

Interest charge

For 2006 = 2280

241

= 9. 46

For 2005 = 1952

235

= 8. 31

For 2004 = 1729

223

= 7. 75

The measure of interest cover ratio of Tesco within the last three years tells us that the company maintaining increase in interest cover ratio 7. 75, 8. 31, 9. 46 as a result Tesco is able to meet its interest from the profit therefore the profit are sufficient to pay the interest it owes and the profit available to the shareholder increased from 1729m in 2004 to 2280 in 2006.

Investment Analysis

Potential investors who want to buy shares in a company want to be able to have the information they require to compare the benefit from their investment.

There are two measures of benefit to the investor:

One is the profit of the period (usually referring to the profit available for the ordinary shareholders).

The other is the dividend, which is the amount actually paid to the shareholders.

Earning Per Share (EPS)

EPS is a widely used measure of business performance and progress, and importantly the percentage change from year to year should be monitored for the trend. It explains to an investor the kind of return they could receive for each share during the accounting period. Therefore, it is important ratio as earning per share works out the average amount of profits earned per ordinary share issued.

‘ In accordance with FRS 14 Earnings per share, EPS must be disclosed on the face of the income statement’. This means that when producing financial statements companies must disclose the EPS figures for investors to see.

EPS = Earnings (profit)

Number of equity share in issue

For 2006 = 1, 570

7, 823

= 20. 07p

For 2005 = 1, 344

7, 707

= 17. 44p

For 2004 = 1, 100

7, 307

= 15. 05p

As it can be seeing there has been a steady increase of EPS for the past of years. This indicates that potential investors would have an attractable return on there shares

Dividend Cover

The dividend cover ratio is another important ratio for potential investors as it measures the proportion of available profits which are issued to shareholders and the amount which is reserved by the company. In another words, the dividend cover ratio tells the investor how easily a business can pay its dividend from its profit.

Dividend Cover = Profit after tax

Ordinary dividend

For 2006 = 1, 570

609

= 2. 57 times

For 2005 = 1, 344

587

= 2. 29 times

For 2004 = 1100

516

= 2. 13 times

The measure of dividend cover ratio of Tesco plc for the last three years has shown a steady increase. It increased slightly from 2004 to 2005 and again in 2006.

A high dividend cover means that a company can easily afford to pay dividend.

For the last year (2006), the dividend covers shows that for every £2. 57 made in the profit, £1 was issued to the shareholders

Investment Advice

Sales have risen by 14. 94 %to £39, 454m

Pre-tax profits are up by 24%, with earning per share increasing by 25% in 2006 from 2004.

This result shows the excellent performance from all aspects of Tesco strategy.

This is an extract from the Directors report for 2006:

‘ The directors recommend the payment of a final dividend of 6. 10p per ordinary share, to be paid on 14 July 2006 to members …. Together with the interim dividend of 2. 53p per ordinary share paid in December 2005, the total dividend for the year will be 8. 63p compared with 7. 56p for the previous year, an increase of 14. 2%’

This shows that Tesco plc strong performance is been implemented in dividend as can be seen in the increase of payment.

Tesco faces strong competition from other leading supermarket, however with the management strategy implemented by Tesco and their huge experience which has given them good image (every little help!) and trust in the market as a leading retailer. Therefore, it will be worthwhile investment for those who are interested in earning money through share price fluctuations to invest in Tesco.

Conclusion

This report has used nine ratios to analyse and interpret the financial position of Tesco plc. There are many other ratios that could be used and will also assist in the interpretations of the financial accounts.

Although there are limitations to ratio analysis such as; ratios are based upon past performance and hence there are historical data. However ratio analysis is one of the best ways to analyse the financial performance of a company. This is because, it allows managers to spot any problems and therefore concentrate resources on that area.

If ratio analysis is interpreted the right way then it can be useful tool of results which can be understood by accountants and non-financial users such potential investors.