

# Financial analysis of next plc

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This report focuses on the financial analysis of Next plc. Next plc's principal activities are high street retailing, home shopping, and customer service management. This report has been prepared based on the year 2002 and the year 2001's annual report of Next plc. As follows, the report analyses Next plc's financial position based on the financial statements and its notes to accounts by using concerned ratios and specific points, such as taxation, trends, and future perspectives.

### **Financial Status, Cash Flow, and Liquidity**

In the year 2003, both the current ratio and the acid ratio of New look plc looks better than the NEXT. (Appendix 1) For the current ratio, next is 0.89 and the new look is 1.26 in 2003. But that doesn't mean that Next is facing the solvency troubles. In 2002, next's current ratio is 1.62, however at the same time, the new look only 1.04. While next's figure somewhat becomes weaker than the new look in 2003. The drop of both the current ratio and the acid test in 2003 indicates the declining solvency of Next plc in the short run. This is quite considerable and we can see the reason for the cash flow statement.

The cash flow in 2003 is negative for next, but net cash £314.9 million get from operating activities during 2003 is not bad comparing cash £363.8 million get from operating activities during 2002. The main reason for the negative cash flow of the year 2003 is due to the big amount of company shares purchased for cancellation. Due to Next's financial strategy which aims to raise the long-term EPS, Next buy back its own shares for £391.8m during 2003. However, in 2002, that is only cost £53.8m. That is the major reason cause the liquidity problem.

Another problem may be due to borrowing too much additional short-term debt for both of the buybacks of shares and other expansion activities. From 2002 to 2003, the next's short-term increase from £ 403. 2m to £ 664. 9m. these reasons have resulted in the erosion of its liquidity and cash balance. On another hand, a new look has a better liquidity position than next although it also got a negative cash flow in 2003. Its current ratio raises from 1. 04: 1 in 2002 to 1. 26: 1 in 2003. The reason causes its negative is mainly due to the New look's strategy to expand its trading space, to raise the profit.

As a result, its capital expenditure and taxation increase a lot. But that will not influence the liquidity too much. By Comparing the liquidity of the next and new look, the next is quite dangerous. The new-look acid ratio is 0. 79: 1. its cash is about £ 50. 4m compare with current liabilities of £ 88m. However, next's acid ratio is only 0. 53: 1 because its cash is dropped significantly £ 201. 4m in 2002 to £ 32. 6m. And its current liabilities is £ 664. 9m in 2003. All of this is caused by its share buyback strategy. So although it is a downward trend in 2003, it doesn't need to worry about it.

The cash generated in 2002 is great. Clearly, from the cash flow, in the year 2002, we can see the company has the ability to deposited large amounts of cash. (annual report pp23) And the growth rate of its gross profit margin is around 30% for the last three years. (appendix) Therefore in the future, there will be s substantial improvement in both the current ratio and the acid ratio if the Next plc didn't buy back shares for the long term growth in earnings per share and did not purchase the fixed assets for the expansion. So I think that the liquidity position will be extremely strong in the future.

## Gearing

Gearing is relevant to an appraisal of the long-term financial stability of the business. The gearing of NEXT rose steadily from 5.28% in 2001, 6.68% in 2002 to 16.98% in 2003 (appendix) as we might expect as a result of the expansion of stores and branches and the purchases of fixed assets and his own shares. The gearing of New look plc dropped down from 37.97% in 2001, 21.92% in 2002 to 12.53% in 2003. During the last three years, Next plc keep expanding its trading space. And that might be a reason, which increased the long-term liability.

At the meanwhile, Shareholders' funds over capital employed decrease from 0.95: 1 to 0.83: 1 in the last three years due to the purchase of his own shares. This increased the gearing ratio. The gearing ratio of the Next plc has continued to rise in the future due to its strategy of share buyback program and trading space expansion. However, the New look has got the same trading space expansion strategy. During these years, the cash that New look deposited keeps going up. That might decrease the trading space expansion's reliability for the liabilities.

In this way, long-term liabilities dropped during the last three years! From creditors', the higher the level of gearing the higher the level of risk. So if Next plc can't control it properly, the steady increase in total long-term liability as a proportion of total funds is likely to make it restricted for the company to raise new loans in the future, a particularly worrying point when there are indications of potential liquidity problem. Therefore the company must keep a good balance. However, the new look is in a quiet position and don't need to worry about future potential liquidity risk.

But if it wants to keep the gearing further decrease, the stable increase in cash is a necessary condition.

## Performance

The Return on Capital Employed has a sharp increase of almost 10.6% in 2001 and remains stable in 2002. The increase in the profitability of the business part is due to the increased investment from nil in 2001 to 200,000 in 2002. This increased 2,200,000 of the interest receivable. Another two reasons are the profit margin and the asset turnover ratios which we can see from appendix 1, which rose steadily during the past three years.

The rising of the profit margin indicated benefits gained from the control of expenses or increased sales price. We can see this point from the total expenses. The distribution has slightly increased during the past three years because Next plc emphasized the qualified customer services such as the better delivery services and the expansion of the product offer. On the contrary, the administrative expenses steadily fell about sales and this is not surprising, since it would expect a part of these costs to be fixed while sales have increased by an average of about 14% each year.

From the whole view, the proportion of the increased percentage of the distribution costs is smaller than the decreased percentage of the administrative expenses, therefore, the total expenses ratio consequently decreased from 19.33% from 2000 to 16.80% in 2001 and remain stable in 2002. This indicated Next plc has better control over expenses and it is a sign of good management. It induced an increase in the net profit margin. The increase in asset turnover is attributable both to the tightness of working

capital control and an increase in sales concerning the large expansion of selling spaces during the past three years.

The large expansion has generated 6.31 times their value in sales in 2002 and 4.94 times their value in sales in 2000. At the meanwhile, the net current assets also earned more sales in 2001. We can see this point in the following details. The stock turnover in 2002 is 9 days quicker than in 2001 and 8 days quicker than in 2000. This is good news. We can see Next plc tried to minimize stock needed to run their business. They did so to minimize interest charges on the money tied up in stocks, to save the cost of the extensive storage, and to reduce the risk of clothes of going out of fashion.

Another good sign is a falling 8 days' debt collection. It is an indication that Next plc will have effective financial control and on the other hand, it also may be the result of the falling 6-day payment which indicates that Next plc must pay back quicker to suppliers in 2002 than in 2001. We can also notice that in 2000, there are no debts. Although it maybe means the company has powerful control over their finance, in fact, as a matter of policy, It is not a good strategy to undue pressure on customers under the competitive market.

On the other side, it also shows that maybe Next plc. has a desperate need for cash. So in 2001, the company gave 51 generous debtors' collection days to give themselves a competitive edge. From the whole view, improved performance has been achieved as a result of the increase in sales. While the gross profit margin slightly decreased by about 1% in 2001 due to the increasing cost of sales during the past three years, such as the increased

depreciation due to the purchase of the fixed assets which spent from £ 59. 7 million in 2001 to £ 71. 4 million in 2002.

However, the gross profit margin was rather stable comparing the large scale of expansion. It is a positive sign in light of new store openings featuring many " sale" and many discounted items to attract customers such as the Choice Discount Stores. The increase in operating profit margin is especially noteworthy since it occurred during an expansionary period. The remained profit for the year 2002 also improved despite the increase in the tax expenses due to the increased profit and the increases in the dividend paid. Next plc trades from over 330 stores in UK and Eire and 49 stores overseas.

The operation in the UK, the rest of Europe, North America, the Middle East, and Asia is quite well during the past three years. Turnover and operating profit are continually increasing. But the operation in Australasia is quite confusing. Both the turnover and the operating profit have a downward trend during the past three years and in 2002 the operating profit has a negative £ 0. 2 million. Maybe Next plc will give more attention to it. From the view of the business sector, the Next brand accounted for 92% of fiscal 2002 revenues; Ventura, 5%, next franchise, 1%, and other activities, 2%.

All of the sectors have an upward trend during the past three years, especially the operation of Ventura, which operating profit increased 276. 67% in 2001 and kept going 15. 04% in 2002. The increased operating profit is a good sign of better customer services. Investment potential Earnings per share (EPS), price/earnings ratio (P/E ratio) and dividend cover are the core ratios that shareholders are interested in the companies. EPS reflects the

actual earnings available to shareholders. Next plc, the EPS increases gradually by 33% over the past three years, from 38.

4p in 2000, 46. 8p in 2001 and 58. 4p in 2002. The increasing rate is due to the keep-going increasing earnings for shareholders with the contrary keep-going decreasing the number of shares. Because the company's strategy is aimed to maximize the shareholders' funds by purchase its own shares in the open market. We can see that in January 2000 there were 365, 100 ordinary shares while in January 2001, there were 336, 500 ordinary shares and a further drop in 2002 to 326, 800 ordinary shares. It gives the final result of the steady growth in the EPS.

Under this strategic planning, to a large extent, the EPS will grow continuously in the future in which shareholders and potential investors are pleased to see its performance. Comparing with Newlook plc, a similar retail company in which EPS is 19. 80p calculated at the end of the year 2002, Next plc has a much higher EPS, 58. 10p at the same time. It shows that the actual earnings available to the shareholders of Newlook plc are less than the shareholders' in the Next plc. Shareholders will be more inclined to Next plc. (see appendix 3) Not only the EPS but also the P/E ratio reflects the ordinary activities of the business.

The P/E ratio indicates the market confidence in the shares of the company. In the past three years, the P/E ratio is lower in 2001 than in 2000 before went up in 2002. The decrease in the P/E ratio in 2001 indicates maybe a lack of confidence in the company's ability to maintain earnings in 2002. But it was cleared in 2002 that earnings increased 20. 43%, much higher than the maintenance level. The sharp increased P/E is due to the share price



which was bid up sharply in 2002 because of the repurchasing of the shares of his own company.

Apart from the internal influence, the changes in the P/E ratio could also be affected by macro factors. It could be due to the level of the stock market or the market policy to react cautiously to the Next plc's good year. Compare with the Newlook plc, its P/E ratio is 11.24 calculated at the end of 2002 compared with 14.02 of Next plc. By contrast, both companies are well confident but Next plc is better. On the other hand, the P/E relative which P/E of the company compares with the P/E of the market as a whole, using the historical P/E based on the FTSE all-share PER, is 81.58%. (see the appendix 4)

The high historic P/E compared with the industry group suggests either that the company is a leader in its sector or that the share is overvalued. So Next plc appears the strong prospective outlook. A company's dividend policy affects the P/E ratio as the share price is influenced by the dividend which distributes to the no. of shares. While the safety of a dividend is decided by the dividend cover, which is the extent of profit retention. The dividend cover in the Next plc is quite stable over the past three years, in which its cover is 1.8 times in 2000 and 2.1 time in 2001 and 2002. This can be interpreted from the steady increased in its dividend payment in the period. The stable dividend cover gives shareholders' confidence in reinvestment in the Next plc and therefore diversified the company's risks in investment. It also implies a good performance of the company. A positive signal will be given to the shareholders regarding the future outlook. The dividend yield, which shows the return a shareholder is currently expecting on the shares of a

company decreased from 4.25% in 2000 to 3.28% in 2002, although there is an increase of 0.43% in 2001. Despite the decrease in shareholders' return on market price, the low yield reveals the company retains a large proportion of profits to reinvest whereas the high yield indicates it is a risky company. From the investors' point of view, with the stable and improved overall performance, they would incline to choose Next plc as an investment more for its long-term capital appreciation than for its dividend yield.

## Comparison

Comparing with the company in the same industry sector, Monsoon plc which is a design-led retailer based on the ratio data in 2002, (appendix 5), Next plc seems weaker in terms both of financial status and performance. But Next plc has a substantial cash balance which has a safer situation in dealing with exceptional business. Such in 2001, due to the large number of shares purchased for cancellation, the cash flow of Next plc is negative, but due to a large amount of cash brought from 2000, the business performance as a whole is not influenced very much and there were still well-performed in 2002.

Monsoon plc's current ratio and acid test are very similar to Next plc. But the day's debtor with Monsoon is alarming low. It indicates that Monsoon plc has powerful control over finance. On the other hand, it is not wise to keep the day's debtor so low in the competitive market. The day's creditor is very similar in two companies, but the stock turnover 86 days with Monsoon plc is quite higher. This is maybe not a good sign, because the slower stock turnover is, the easier the clothes are out of fashion. Maybe Monsoon plc's

strategy is to keep high prices and delay markdowns and concentrate on improving margin.

While the Next plc emphasizes on improving sales and keep their prices rather lower comparing with Monsoon plc, especially in Next plc's discounted stores such as Choice Discount Store. The gross profit and the ROCE of Monsoon plc are quite higher, especially the gross profit margin with Monsoon is double than the gross profit margin with Next plc. But they have almost the same net profit margin. This is because Monsoon plc has a vastly more costly administration fee. Both two companies have different financial strategies. We can see that Monsoon plc with a dividend cover ratio 2.55 comparing with Next plc 2.1, they have emphasized the expansion of the selling spaces, especially in international investment. While the directors of Next plc have emphasized using the accumulated cash to for purchasing of his own shares to increase share price as well as expanded selling spaces which concentrated in UK stores. The comparing higher increased share price of Next plc is an attractive point to shareholders. Above all, these two companies are different in their financial position but they are both good performers.

Monsoon plc seems a more retailer comparing with the Next plc and seems to have problems of controlling administrative costs as well as working capital but better performed comparing with Next plc. Next has a tightly run trading operation and uses the funds generated from that to increase the share price and expand the selling spaces therefore further increase the trading profits. Trends analysis From the appendix 7, the horizontal trend

between 2001 and 2002, we can see the turnover has increased by 17.8%, but most of the other items have increased by around 20-30%.

Taxation has increased by 25%, a little bit higher than most of the other items which are partly due to a large amount of increasing operating profit and partly due to the large amount of deferred taxes incurred by the large increasing amount in depreciation. The obvious exception to this is the very high growth in net interest receivable 56.5%, which indicate Next plc spend much more money on an investment in 2002 than 2001, including investment on building up big store, the potential usefulness of a return on investment figure shows good performance and give a guide to future performance. Earning per share increased by 24.9% despite a large amount of increasing taxation. From the whole view, the company is well performed in 2002. From appendix 8 which shows five years trend from 1998 to 2002, we can get the following information: Next plc's turnover increased every year especially in the financial year 2002, turnover increased 17.88%, this might be caused by the large expansion of selling spaces and ranges of products. Gross profit increased every year, in the financial year 2000 to 2001, a slow increase, the reason for this may be turnover is slow down. Profit before taxation kept increasing every year after it decreased in 1998-1999 not only profit before taxation but also the market capitalization is decreased compared with the previous year, this may indicate that the company had poor management control over expenses. Dividends keep going up every year, especially in 2002, it increased 14.58% due to the large receiving from the operating profit and well-control working capital. Shareholders' funds keep increasing from 1998 to 1999 before it drops back

in 2001, it is because of the change of the financial strategy which the director of Next plc wants to use surplus capital to purchase their own shares, therefore, increases in earnings per share. This is a good point for shareholders.

## **Future Prospects**

Above all, Next plc can look forward to a future with increased profit margins and an expanded level of trade. Improved cash flows from trading can be expected to replenish cash balances, while the company appears to have ample security to offer should a short term loan appear necessary. Reported net income in the coming years will be boosted both by these steadily improved trading results and by the steady reduction in depreciation charges on the new fittings.