

Financial and strategic evaluation of tesco plc



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Executive Summary

To understand how a business is performing, understand what might be expected in the future and determine whether the business is a risky investment. An investor, analyst, researcher or accountant needs to understand the strategy of a business and how they plan to achieve this. The capital structure of a business can determine whether the company has enough finance in order to achieve targets and investments, determining certain risks involved and level of return required. This report looks at the level of gearing Tesco has whether financed by debt or equity, going on to look at the weighted average cost of capital.

Investment is also important as investors expect, and the company looks to achieve growth. With Tesco this report looks at both future and past investments, analysing the non financial and financial benefits from them. Dividend policy and yields are analysed looking into theory behind them.

Tesco shares are analysed using valuation techniques, looking at what may be the reason for Tesco's success through the recession, helping them stabilise share price after the peak of recession despite some contractual and ethical issues. Finally looking into how the international market has benefited Tesco by non financial means.

An overview of a few strategic issues Tesco has faced over the years is provided, looking into some of the challenges and results of these issues. Problems such as competition, international expansion and contract disputes are shown in detail later in the report.

1. 0 Introduction

Tesco's overall strategy is growth, which has helped strengthen their core business within the UK, (Tesco, 2010). Tesco plan to achieve this strategy through diversifying their product range away from food and to include financial, non financial and telecommunication services/products also by penetrating new markets globally. This report evaluates Tesco, analysing their capital structure and the level of debt discussing how this can influences the company value and investing decisions, looking at how past investments and future investments are beneficial for Tesco. Dividend policies are related to theory and share prices are questioned using different valuation techniques available to any investor. Going on to look at survival through the recession looking at different strategic issues they have faced over the years.

2. 0 Capital Structure and Finance agreement

Figures above referenced from FAME database, show for expansion of its business Tesco Plc increased gearing from 51. 58% to 91. 38% within years 2000 and 2003. Increasing debt can be a cheaper less risky option as cost of debt is lower than equity and increasing levels of debt can reduce the weighted average cost of capital. By reducing weighted average cost of capital, company value can be increased and therefore shareholder wealth is increased. WACC can be used against cash flows in order to determine the net present value of a project. Tesco probably used this as a means to decide which investments are beneficial.

After this period global financial crisis began to hit the market, Tesco Plc reduced its gearing ratio and kept the ratio level at around 75% until 2007.

This was sensible at the time due to recession risk of lower turnover levels could mean the ability to repay certain levels of debt more difficult. Having higher levels at the time would have meant financial risk, repayment risk etc, would affect interest rates on loans and increase the cost of equity as shareholders are taking a higher risk therefore require a higher rate of return. Tesco's main competitors suffer the similar situation; ASDA and Sainsbury were also affected by the global financial crisis, they also reduced their gearing ratio level and keep it to relatively low level to about 35%. However, with the positive profit figure, Tesco changed its current strategy. Tesco have geared up its business rapidly from 2008, and reached 149.14% in 2009. As the figures show that Tesco had borrowed in a huge amount of debt in 2009. Recently, a joint venture between Tesco and property firm British Land has refinanced its retail portfolio with a new 315 million pounds five-year term loan. (British Land, 2010) it is to believe that a rapid market expansion and investment will be followed.

Years 2005 to 2009, sales and income figures of TESCO have steadily increased; it generated a very positive profit return for investors. With the global finance crisis continuing to affect UK's economics, the government may loosen its restriction towards TESCO; whatever happens, people need foods and basic living materials, it is a perfect moment for Tesco's expansion. The high level of gearing may support Tesco to expand its business; however there is potential risk of default on loans. Can Tesco maintain its level of income, if not how can TESCO to repay the debt it borrowed? This problem could influence investor decisions.

3.0 Investment

UK's largest retailer Tesco expanded into foreign markets attempting to increase future growth in the global retail industry. The company initiated its international expansion strategy by venturing into Central Europe, Asia and the US. Figure 1 shows Tesco PLC sales profits before recession had an impacted. This shows sales profits in the overseas market amounted to a fair percentage of Tesco's profit figure. Comparing growth over 5 years in the UK with Asia, UK only generates a 49% increase when the Asian market increased 250%. Tesco has placed increasingly focuses on their international venture. Nearly two-thirds of the group's space is now overseas, although these markets still only account for a quarter of group turnover (Rigby, 2009).

Tesco's Summary Five Year Record

Year ended February

2001 (m)

2002 (m)

2003 (m)

2004 (m)

2005 (m)

Group Sales

22, 585

25, 401

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28, 280

33, 557

37, 070

Turnover excluding VAT

UK

18, 203

19, 821

21, 309

24, 760

27, 146

Rest of Europe

1, 737

2, 181

2, 664

3, 385

3, 818

Asia

860

1, 398

2, 031

2, 669

3, 010

20, 800

23, 400

26, 004

30, 814

33, 974

Philip Clarke, head of Tesco's international operations, singled out South Korea, along with China. Mentioned as Tesco's two most promising markets, planning to open 100 new stores in South Korea alone (Rigby, 2009). This is a wise decision due to current economics Britain has been impacted among some of the worst around the world, where China especially was not greatly affected with vast growth. Probable reasons for Tesco expanding internationally rather than nationally may be due to competition policy trying to limit Tesco's growth, also there is little land space to continue building new structures, and Tesco already purchased the most profitable local convenience stores in the past.

3. 1 Environmental

Tesco, now 4th largest retailer in the world, have announced that it will open the first zero carbon store as part of its bid to be a carbon neutral company by 2050. They stated its corporate commitment towards reducing climate change, for example halving its energy use per square foot by 2010, reuse and recycling packaging where possible (Leahy, 2009). A green example of this is where they use returnable ' Green trays' saving around 132, 000 tonnes of cardboard packaging in 2007/08. Tesco plans to invest £100m in sustainable environmental technology which is finding more practical ways to use renewable energy, such as solar and wind power, and to help develop the green technologies of the future (Tesco Media, 2010).

Environmental issues are becoming increasingly important over the years. Climate change has become a huge focus for businesses. The Climate Change Act 2008 makes the UK the first country in the world to have a legally binding long-term framework to cut carbon emissions (OPSI, 2008). Government ensures that organisations are adapting and that its policies, programmes and investment decision are made in the context of climate change. By continuously making environmental changes Tesco builds reputation as a more ethical company.

3. 2 Diversification

On the other side of expansion, Tesco is looking to take advantage of the current mistrust towards banks following their role in the economic crisis. They had spent £950m for purchasing 50% of Royal Bank of Scotland's share of TPF last year (This Is Money, 2008). It is also planning to expand its

telecoms operation industry following the appointment of Tesco marketing director Lance Bachelor as Tesco Telecom chief executive.

Tesco are going to attempt penetrate the finance market further by offering current accounts within two years and also offering mortgages for their first time. Offering credit cards, insurance and savings deals already Tesco has a huge customer base. They have a huge potential to increase turnover by selling more products to their existing customers. They plan to open branches globally not on in the United Kingdom which could be a huge challenge for the company. They need to time this investment perfectly, especially amidst the recession. They stated that it has to build the IT infrastructure which required supporting the bank system, and this project is described as a “ huge undertaking”. As a Tesco bank customer, you will also be able to accrue loyalty points under its Club card program (Tesco, 2008).

4. 0 Shareholder Information

An important factor in the eye of an investor is predicting the future.

Shareholders are interested in company performance, both long and short term. They are also interested in the company’s investment not only to expect growth but so they are able to assume levels of retained earnings and cash flows. This allows shareholders to make estimations on dividend payout, the only form of cash flows a shareholder receives and predict any growth on share price.

4. 1 Dividend Policy

Tesco pay cash dividends as interim and final year. The dividend is steadily increasing even through the Recession. Annual Dividends per share has increased 26. 48% from 8. 91p in 2007 to 11. 27p in 2009 (Tesco, 2007-9).

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The company pay a fairly low dividend with a yield averaging 2.43% from 2007-09. Low yields can lead to possible patterns of high growth unlike high yields resulting in sharp falls (Arnold, 2008).

Steady dividend payments and low dividend yield targets higher earners and those on looking for long term investment. Cash in the business is expected to be invested in projects with positive net present values as investors are looking for capital gains. This suits Tesco as one of the reasons for a lower yield and dividend is due to large investments in expanding and making the company more diverse.

4.2 Share Price

Capture. PNGShares are hard to say what influences price, there are many factors which can all influence share price such as earnings per share and price earnings multiple. News can have affects such as bad press can decrease share price, disputes or contractual issues etc. Other areas may be dividends, although according to Modigliani and Miller theory whatever dividend policy is used, firms which pay more dividends offer less price appreciation and pay the same shareholder return, according to cash flows from investments and risk measurements (Arnold, 2008). This theory provides proof given assumptions of no tax, investment decisions are not affected by dividends and there are no transaction costs converting price into cash when selling stock.

In the current economic position this theory would most likely be irrelevant as there are always taxes upon a business. Transaction costs would almost always apply therefore this theory has its limitations. If dividends were

irrelevant, the business may be wasting time analysing which shareholder are indifferent (MM Theory, 1961).

As market leader for United Kingdom Tesco has shown stability during the crisis. Share price over the peak of the recession until recently has remained more stable for Tesco than competitor Sainsbury. Sainsbury had been affected severely between August and November 2007 as Delta Two pulled out in belief Sainsbury's did not have enough capital to maintain competitiveness (Birmingham Post, 2007). This was a high in the recession. Financial markets began to stop trading between each other and there was the near collapse of Northern rock, (Telegraph, 2009).

The Sector was hit hardest in years however Tesco has begun to make its recovery with share price increasing unlike Sainsbury who only managed to stabilise over the last year.

4.3 Valuation

Capture7. PNGInvestors may use share valuation techniques to determine whether shares are over or under value. Dividend yield valuation shows share price was fairly valued in 2007 but undervalued in 2008 and overvalued for 2009. This is calculated by dividing share price by the yield seen in Figure 3. Dividend yield was based upon Annual Dividend/ Share price. This valuation method can be affected by the level of dividend especially if the company is going to invest, which Tesco has made some huge investments purchasing 50% of RBS. This could be the reason why value is currently low here, whereas real value accounts for all affects.

kill. PNGThe final method for this report is Price Earnings Valuation.

Multiplying earnings per share by the P/E multiple. A higher P/E multiple indicates the price of stock is more than a lower P/E. In Figure 4 P/E*EPS shows similar results as using the dividend yield however P/E over the past 3 years has been decreasing, which shows investors are not willing to pay as much for a stock than previously.

Tesco shares have remained strong, recovering after a downfall in peak of recession. Share valuation techniques however have shown share value may be overvalued in 2009. There seemed to be a recovery but using P/E and Dividend yield valuation, which provided a comparable result share value should be lower. This may mean it is safe to sell shares in Tesco now as price may fall. Dividend payment however suggest chance of expected growth in the future but looking at long term trends there have not been any dramatic changes in dividend payment or yields.

5. 0 Surviving the Recession

Researchers and Accountants believe Tesco was the number one company to survive the recession in the research survivability index. The information considered for this was not just cost cutting but based upon factors such as; branding, cost management, internet potential and customer targeting, (Ruddick, 2008). For instance, Tesco replaced a lot of high brand products with Tesco value products, which sell for less however attract more customers generating higher turnover, this helped reduce costs related to more expensive products. Other cost savings are through better use of IT, and from policies and management of suppliers to ensure the greatest value to the business and customer (Business, 2009).

Tesco club card points and vouchers have been a huge impact for customer targeting, by offering double club card points many customers who aren't regular shoppers become regulars. Tesco also monitor their customers far more intensely than other supermarkets. They analyse buying patterns and send vouchers in the post to attract customers back, or when customers have not returned for a while they send vouchers to entice them.

6.0 Competition

Severe rivalry within the UK retail market is forcing cost cuts and ways new ways that they can differentiate themselves from competitors. The retail market is mature and oligopolistic in its nature, with a few major multiple retailers dominating the market (Business, 2009). Competition between the large retailers resulted in price wars with the big two, Asda and Tesco reducing price margins for the industry as a whole as other competitors have to react according to the market.

The market is well regulated. The monopolies and mergers commission constantly examines the market to ensure fair competition. The government has also been active in planning restrictions for new store openings (BBC, 2004). Growth appears to come from gaining new customers, improving product offerings, and from non food products, such as financial services. In Tesco's case they have expanded overseas as well as diversifying their product range.

Customers are still number one in the eye of the retailers. Success in the industry is still dependent on how well the retailer can meet the customer needs. Price, particularly in the UK has become a dominant feature.

Considering the recession, this will place stress on retailers to set low prices and maintain that level. The main reason being consumers are tightening their spending level and are not willing to purchase luxury items and are purchasing the necessities.

7.0 Bad Credibility

Tesco were faced with a big contractual issue back in 2007. Tesco delivery drivers were offered new contracts, which had worse conditions and around 3000 to 6000 pounds less pay. This resulted in drivers going on a 3-day strike, causing problems for Tesco when shoppers refused to shop in their stores and many drivers rejected the new contracts which resulted in Tesco terminating their positions (BBC, 2007). This issue meant Tesco had to spend a lot of time and money with unions, whilst losing sales from shoppers refusing to shop with them and deliveries not being made. Although this issue was only in one area, the business's image would have been damaged by news and publicity on the matter.

The competition commission has started to realise that the bigger the retailer they have a stronger capability to force prices lower from suppliers. Described as a "master servant" relationship farmers complain about Tesco's cancelling orders at last minute and forcing cost lower than production cost (Hird, 2005). In extreme cases farmers have protested especially over milk prices (Mullin 2009). This shows Tesco has done little to improve their relationship with farmers over the years. It could be assumed that government may begin to intervene soon as Tesco becomes more unethical.

Issues like this make people lose trust, they are unsure if in the future more problems will arise. When looking at investing you must trust a company making sure they are reliable and able to give you what you want from them. Other investors who catch news of problems tend to back out and sell stock. If enough people sell share price will begin to fall, this may be an opportunity to purchase shares at a lower price as long as you accept the risks.

8.0 Environmental Issues

One big issue that Tesco is facing is the environment element; as the increasing global concern of environmental problem, how Tesco react to this issue will have huge impact to its future business performance. The public demands more than ever that firms should take their responsibility as a member of the society. Tesco has taken a lot of effort to respond the challenge; in 2007, Tesco unveiled its green pledges; “ If we fail to mitigate climate change, the environmental, social and economic consequences will be stark and severe” Sir Terry Leahy, Tesco chief executive. (BBC news, 2007) In the statement, he promised that Tesco would cut emissions from existing stores worldwide by at least 50% by 2020, and would seek to restrict air transport to less than 1% of the firm’s products. Moreover, for cutting CO2 and energy saving, Tesco also introduce a series of strategy; by encourage customers to use reusable carry bag and reward shopping points to club members to reduce the usage of plastic bags; Tesco also introduce new energy saving store to the public; in January 2009, Tesco opened UK’s most energy efficient store in Cheetham Hill. As part of the climate change program, the store’s carbon footprint is 70% less than an equivalent store

built in 2006. (Tesco, 2009) So far, Tesco has already made a lot of progress, yet there are much more problems waiting.

9.0 Overseas

Tesco's expansion internationally has not only benefited the company financial. They would develop new understandings and learn new techniques have diverse teams within the organisation. Tesco successfully penetrated the overseas market, being able to adapt to new cultures. To do this they would need incredible management with a perfect strategy. On the Tesco website they take a different approach internationally, strategy changes and their main focus is more of a cultural issue. For instance being "Flexible" as in Japan they shop in small amounts but prefer fresh items, also "Act local" such as in India, who prefer less or no packaging so they can go through piles of produce. With 10 years of experience Tesco has wide experience of cultures (Tesco, 2009).

Culture isn't only going to affect Tesco through the market i. e. selling, but will be a part of the business. Tesco employees local staff this affects the organisations culture, especially within head offices and management.

Teams will include people from all different ethnic backgrounds growing up to have different culture, educated with a diverse range of skills. Having this within a business can be very successful and can create more effective team working (Brooks, 2006).

10.0 Conclusion

Tesco on a financial level has a lot of risk involved. They are currently very highly geared and have a huge financial risk which can and most likely will affect the company value and share holder wealth. However over the next 2

years could be a crucial time for Tesco as their investments go under way which could result in a very prosperous future for shareholders through diversification and international expansion. A lot of risk relies on customer targeting, which in the past Tesco has been very successful. Dividend yields and dividend payments seem to be targeting high earners who can face risk and are looking for long term capital gains; however share price for 2009 seems to be overvalued and may decrease. It may be safer to sell shares now and buy again after share price falls.

Tesco has had a lot of success and faced many different strategic issues, some which could result in a stronger business such as cultural diversification within the company. A lot of issues have occurred though, damaging the image as a result. Little seems to have been done to improve some of these problems especially with farmers. Tesco only seems to care if regulation intervenes, then they will do something about it which could be seen with some of the environmental problems.

As a result of the analysis provided throughout the report Tesco seem like an opportunity for those who are willing to take high risks.

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