

# Nestle vs cadbury: financial analysis



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The report mainly analyzes and compares two companies' financial reports between 2005 and 2008. The two companies chosen are CADBURY PLC and NESTLE SA. Both of them are renowned in consumer business and are transnational enterprises. The differences between them are NESTLE SA is a Swiss company and listed in several stock exchanges, while the CADBURY PLC origins from United Kingdom and is listed in the London Security Exchange (LSE). Referring to their core businesses, Nestle SA group's principal activities are to manufacture, process and sell food products, including dairy, confectionery and culinary products, coffee, beverage and drinking water, Besides this, they also sell ancillary equipment. Similarly Cadbury group's principal activity is also to manufacture, distribute and sell confectionery products. Its products consist of three categories: chocolate, gum and candy. Thus in the overlap fields, the competition between them exists all the time. The purpose of this report is to evaluate their financial performance in past four year since 2005.

The structure of the report will be as follows. The first part will list the reformulate financial statements, including balance sheets and income statements of the two companies from 2005 to 2008, respectively. The second part will calculate relative ratios based on the reformulated statements; then on basis of these ratios, analyze their probability and growth; finally compare them on the common size, and research their trend during the research period as well. The last part will discuss the result and make a conclusion.

Reformulate financial statement

In the following part, the two firms' reformulate balance sheet and income statement will be exhibited.

Note: taxes are calculated at 30% according to the UK tax

Note: the taxes includes withholding taxes on income from foreign sources, as well as Swiss taxes for which adequate provisions have been established.

### Analysis of profitability

The key indicator for profitability is ROCE-Return on Common Equity. ROCE reflects the average earnings of common shareholders' equity. Under the premise of maximize shareholders' interests, it's a comprehensive indicator to evaluate the production and operation of an enterprise.

It can be clearly seen from the chart that the ROCE of Cadbury increased almost 100% from 2005 to 2006 followed by a sharp decrease in 2007, and then kept steady in 2008. Specific ratios about profitability are as following:

As we can seen from the table above, the Financial Leverage of Cadbury was decreasing from 2005 to 2008. Opposite trend can be seen in Net Borrowing Costs which increased from 0. 0345 to 0. 515. The significant increase in ROCE in 2006 is mainly because the suddenly increase of RNOA in that year.

The Asset turnover was fluctuated slightly around 1 during 2005 to 2008.

The PM saw an incredible increase in 2006 but fall sharply in 2007. So the PM is the main cause for the change of ROCE in Cadbury.

### **FLEV**

FLEV = NFO/CSE

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The financial leverage of Cadbury was decreasing. As we can see from the chart, the NFO is decreasing generally while the CSE is relatively steady.

### **Third-level Breakdown:**

#### **PM:**

Generally speaking, both sales PM and other items PM are in an increasing trend. It can be clearly seen that Sales PM is the main source of PM. The cause of the significant increase in ROCE, RNOA, PM in 2006 is because the other items PM increased to an unusual level.

Selling, General & admin expenses were steady for Cadbury while the Gross Margin continuously increased from 2005 to 2008.

#### **ATO:**

The ATO drivers are shown in the following table:

#### **Nestle**

It can be clearly seen from the line chart that the ROCE of Nestle keeps a good trend of increasing, especially in 2008. The ROCE of Nestle in 2008 was 0.15 more than that in 2007.

Through the table above, we can see that the RNOA of Nestle was increasing from 2005 to 2008. The NBC was fluctuated around 0.05. The FLEV of Nestle had an increasing trend although a slight decrease can be seen in 2008.

It can be clearly seen in the bar chart that both sales PM and other items PM are very steady from 2005 to 2006, significant increase can be seen in both the two kinds of PM.

The components for sales PM of Nestle from 2005 to 2008 had not been changed much. All of them were steady.

## **Comparison**

It can be clearly seen from the chart that the ROCE of Nestle was increasing in the past 4 years while ROCE of Cadbury dropped about 80% from 2006 to 2008. In 2005, ROCE of Cadbury is higher than that of Nestle. But after a 4-year increasing, the ROCE of Nestle had catch up and even 0.25 higher than ROCE of Cadbury in 2008. In terms of RNOA, it is similar to the situation of ROCE, thus the profitability of operational assets of Nestle is better than that of Cadbury. In terms of NBC, they are almost the same, that means the expenses they used on financial obligation were almost the same and very steady. In terms of FLEV, the FLEV of Cadbury is much larger than that of Nestle, which means Cadbury faced with more risk. The OLLEV of Cadbury is larger than Nestle too. It illustrates that Cadbury relies more on liabilities both in operation and general. The PM and ATO of Nestle are both larger than those of Cadbury. The larger the ATO is, the better the firm's ability on sales is. That means the ability on sales of Nestle is better than Cadbury. In a nutshell, the profitability of Nestle is generally better than Cadbury according to the past 4 years' data.

## **Analysis of Growth**

It is a sensible way to view growth in terms of growth in residual earning as a growth firm is ones that can grow residual earnings.

Changes in residual earnings are driven by return on common equity (ROCE), the amount of common shareholder investment (CSE), and the cost of capital. We focus on the analysis of changes in ROCE and CSE.

## **Analysis of Growth in ROCE**

Return on common equity (ROCE) is driven by operations and by the financing of the operations. So the change in ROCE is explained in two parts:

### **1. Analysis of Changes in Operations**

There are two kinds of components in explaining changes in profitability (RNOA). One is generated by repetitive business called core income, while the other is referred to as unusual items (UI) or transitory items, which applies to a particular period, and so are nonrecurring. It is important to distinguish core and unusual components of RNOA in the analysis. The great volatility of RNOA in 2007 and 2006 is largely caused by the changes in unusual items which are not lasting. It is proven in 2008 when RNOA changes little with few UIs.

Unusual item, asset turnover and profit margin play an important role in the change of RNOA in 2006, 2007 and 2008 respectively.

In general, unusual items contribute to the growth of RNOA less in Nestle than in Cadbury. It seems that Nestle is more likely to generate profits from sales..

### **2. Analysis of Changes in Financing**

Changes in RNOA partially explain changes in ROCE. The explanation is completed by an examination of financing. It can be separated into three

parts: changes in operating profitability, changes in spread and changes in leverage.

For Cadbury, the changes in ROCE in past four year are largely due to the rise or drop of core operations or spreads, rather than changes in leverage. For Nestle, the situation is quite similar expect in 2007. The growth of ROCE that year was almost totally due to the financial leverage.

On the whole, it can be concluded that the change in ROCE is driven by core operation to a large extent rather than by changes in leverage in these two companies.

## **Analysis of Growth in Equity Investment**

The change in CSE can be explained by three components: change in sales at previous level of asset turnover plus change in asset turnover while minus change in financial leverage.

Cadbury shows a decline trend in CSE as their sales drop sharply in past four years. Nevertheless, Nestle exhibits a relatively smooth rise trend in both CSE and sales.

It can be derived that sales growth is the primary driver of the change in CSE but sales growth requires more investment in net operating assets, which is financed by either net debt or equity. And investments earn through ROCE and the factors that drive ROCE. Together, investment and ROCE drive residual earnings and abnormal earnings growth. It has been recognized that there is a tension to growing CSE. Equity investment can easily be increased by issuing new shares or reducing dividends. But the new equity might not

be used wisely. It could be invested in projects with low RNOA or financial assets with low return, reducing ROCE, residual earnings, and value.

### Common size analysis

#### Common size analysis on balance sheet

Compare the operating section of common-size Balance sheets of the two companies between 2005 and 2008 respectively, the result will be shown in exhibit 5.

Take the comparison in 2007 as an example. From exhibit, we can know clearly the composition of operating assets for the two firms. For both of the two firms, the most important part in the operating assets is Other Assets, the reason might be the intangible assets take a huge amount in the two companies. In Cadbury, other assets occupied up to 62.08%, much more than that in Nestle SA, which is only 40.56%. The second most important part is Other Investments, occupied 21.59% in the Operating Assets for Nestle SA and 17.84% for Cadbury. Following this, it is Receivables Net, 15.09% for Nestle SA, compared with 10.64% for Cadbury. Besides this, Investment in Unconsol Subsidiaries for Nestle SA is 8.74% but for Cadbury, it is only 0.30%. In other three years, the composition is almost the same.

Refer to the composition of Operating Liabilities for the two companies. For Nestle SA, the most important two parts are Account Payable and Provision for Risk and Charges, which account for 51.50% and 30.81%, respectively. By contrast, the most important parts of Operating Liabilities for Cadbury are Other Current Liabilities and Deferred Taxed, which take up for 35.89% and



30. 69%. The situation did not change too much in other research years, except in 2008, Deferred Taxed for Cadbury decreased hugely, from 30. 69% to -2. 15%. The huge change might be caused by the reassessment of capital losses and the tax basis of goodwill on the classification of Australia Beverages as an asset held for sale in Cadbury.

### **Common size analysis on income statement**

Exhibit 6 compares the reformulated income statements of Cadbury and Nestle on the basis of common-size. Given the Operating expense, the two companies have similar cost structure. With higher cost of sales (47. 58%), Cadbury charge approximately 10% less in General expense than Nestle while the difference between the depreciation costs of the two companies are small. However, when the Nestle cost 0. 24% in Other operating expense per dollar of sales, Cadbury has no Other operation costs.

In comparison with 10. 09% Operating profit margin from sales in Cadbury, this margin in Nestle is just a litter higher with 10. 57%, the extraordinarily small difference is due to a higher gross income and also a higher general expense in Nestle. However, due to the significant extraordinary charge in Cadbury, its profit reduced to only 6. 62% while the Operating income increased a bit to 11. 22% attributable to the earnings from equity interest.

Comparing with the earning of a net 5. 09% per dollar of sales in Cadbury, Nestle earns approximately 10%. The profits are correspondingly decreased by 1. 51% and 0. 64% owing to financing activities.

Trend analysis

In this part, we will analysis how financial items have changed over time for the two firms. For both of the cases, the index is 100 for the base year of 2004.

For Cadbury, Accounts Receivable, Inventories and Property, plant and equipment have grown steadily in the first three years, but decreased in 2008, which resulted huge decreasing in Operating Assets in 2008. Additionally, the Operating Liabilities fluctuated volatile from 2005 to 2008, contributed to the similar change to Net Operating Assets. Cadbury's 2008 Net operating Assets decrease rate was 30.00%, compared with the 50.00% decrease in Net Financial Obligations in the same year. In 2008, Common Shareholder's equity decreased by 20.00%, which indicated that the owners' investment was declined.

Given the income, the sales of Cadbury decreased a bit in 2005, followed by a continuous grow up in the next two years with 110% and 118% but drops dramatically by almost 20% in 2008. The expense of sales in 2007 is higher than other years with 131 percent while it stays stably in other years.

Because the costs of sales have grown quickly than revenue of sales, gross income grow up at a lower rate. The sales of Cadbury in 2005 decrease by nearly 4 percent and grow at the rate of 14.58% and 7.2% in 2007 and 2007 respectively, compared with a significant decline (32.45%) in 2008.

Because of a low operating expense in 2005, the operating income from sales in 2005 has an 11% growth compared with the 7% decrease in gross margin. At the same time, though the company has reduced the expense in 2008, the income from sales also lower than 60%. Finally, the comprehensive income grows up to 177% in 2005, followed by a high growth

rate of 136.74% owing to a gain from asset sales. However, this income to common is only 93 and 84 percent of that in 2004.

For Nestle SA, the steady growth in all of the indexes happened in 2005, 2006 and 2007, but the trend changed in 2008, decrease in these indexes appeared, especially for the Net financial Obligations, it decreased by a much huge amount, almost 50.00%, which is discerned in exhibit 8.

The revenues from sales grow up stably over the four years with 8.1%, 9.2% and 2.42% growth rate. Correspondingly, the comprehensive incomes increase bit by bit as well with 119%, 137%, 158% from 2005 to 2007 and due to a large gain from other income, the income in 2008 is high to 268%, which presents a greater growth trend in comparison to the Cadbury.

Looking forward

In comparison with the stably growth in Nestle since 2005, Cadbury suffers a significant decrease up to 20% in sales. In 2008, Cadbury increase its price, which may be a important reason for the decline combing with the global economic crisis. For Cadbury, in 2009 and even the next few years, it will in a difficult situation to against the unexpected global economic outlook and the high cocoa prices. On the other hand, the company of Nestle shows a bright prospect.