Tesco credit risk and analysis report

As members of Credit Analysis division, our line manager has asked us to prepare a comprehensive credit analysis report for Tesco Plc, as it comes out with a new long-term bond issue, to fund its acquisition of Hilton Foods. This credit risk report focuses among other things, on the business background and strategy of Tesco and Hilton Food, analysis of its annual reports, company websites and other sources, a discussion of the techniques used in the analysis, justification of techniques/ major assumptions used in our analysis and rationale behind our team’s recommendation on the credit rating of the bond issue.

2. Tesco Business Description and Strategy:

Tesco Plc was founded by Jack Cohen in 1919. It employs about 470, 000 staff globally. It is the largest British retailer by both global sales and domestic market share, with profits exceeding £3 billion. It is currently the third largest global retailer based on revenue, behind Walmart and France's Carrefour, but second largest based on profit, ahead of Carrefour.(Ryan 2004).

Originally specializing in food and drink, it has diversified into areas such as clothing, consumer electronics, financial services, telecoms, home, health and car insurance, dental plans, retailing and renting DVDs, CDs, music downloads, Internet services and software. Tesco's operations are divided into UK and International operations. In the UK, Tesco stores are differentiated by size and the range of products sold. (wikipedia. org).

Tesco also retails through its online shopping channels, tesco. com and Tesco Direct. Tesco has international operations in the following countries- China, Croatia, Czech Republic, France, Hungary, Republic of Ireland, Indonesia, Japan, Malaysia, Poland, Slovakia, South Korea, Thailand, Turkey, United States (Annual Report 2009 hereby referred to as -AR2009).

Business strategy:

Tesco follows the concept of " The Tesco Way". It is aimed at improving its competitive

position in the market by becoming more customer focused and concentrated on differentiating itself from other retailers through the services it provides. Tesco has developed principles like “ Better for Customers”, “ Simpler for Staff” and “ Cheaper for Operations”.(Tesco website)

Its present operations are based on its strategy laid down in 1997 which focuses on these 5 key objectives:

To be a successful international retailer

To grow the core UK business

To be as strong in non-food as in food

To develop retailing services-such as Tesco Personal Finance, Telecom and Tesco. com; and

To put communities at the heart of what we do.

(AR 2009)

It is the pursuit of this five-part strategy that has allowed the business to diversify into new emerging markets.

Tesco as a business operates a Steering Wheel – a balanced scorecard process whereby goals are set for different areas of the business and overall progress is assessed on a quarterly basis – in all countries, to help manage performance and deliver business strategy. The Steering Wheel's key areas of focus are: financial, customer, operations, and employee. Every store gets a monthly steering wheel update, a summary of its metrics within each of the four arcs, so that all employees in Tesco's multiple regions and formats get feedback on their performance. The steering wheel has helped the company stay focused on its strategy even as it experienced rapid growth over the past two decades (AR2009).

Please note- For Business Description and Business Strategy og Hilton Food please see Appendix A.

3. Factors affecting credit rating of Tesco:

For the purpose of this credit analysis report I would be analyzing three factors influencing the credit rating of Tesco:

They are namely:

1) Business Risk

2) Corporate Governance Risk

3) Financial Risk

Definitions Table of Factors affecting credit rating of Tesco

Business Risk

According to wisegeek. com, “ A business risk is a circumstance or factor that may have a negative impact on the operation or profitability of a given company. Sometimes referred to as company risk, a business risk can be the result of internal conditions, as well as some external factors that may be evident in the wider business community. When it comes to outside factors that can create an element of business risk, one of the most predominant risks is that of a change in demand for the goods and services produced by the company. If the change is a positive one, and the demand for the offerings of the company increase, the amount of risk is decreased a great deal. Internal factors may also result in the development of significant business risk for the investor.

Corporate Governance Risk

According to SearchFinancialSecurity. com “ Corporate governance is a term that refers broadly to the rules, processes, or laws by which businesses are operated, regulated, and controlled. The term can refer to internal factors defined by the officers, stockholders or constitution of a corporation, as well as to external forces such as consumer groups, clients, and government regulations. A well-defined and enforced corporate governance provides a structure that, at least in theory, works for the benefit of everyone concerned by ensuring that the enterprise adheres to accepted ethical standards and best practices as well as to formal laws. To that end, organizations have been formed at the regional, national, and global levels. ”

Risk management factors are employed to manage Corporate Governance Risk.

Financial Risk

According to Wikipedia. org, " The risk that a company or project will not have adequate cash flow to meet financial obligations; thus causing the business to file for bankruptcy. Financial risk is the additional risk a shareholder bears when a company uses debt in addition to equity financing. Companies that issue more debt instruments would have higher financial risk than companies financed mostly or entirely by equity. Bilateral barter can depend upon a mutual coincidence of wants. Before any transaction can be undertaken, each party must be able to supply something the other party demands. To overcome this mutual coincidence problem, some communities had developed a system of intermediaries who can warehouse and trade goods. However, intermediaries often suffered from financial risk."

4. Discussion of Techniques and Methods Employed for Credit Rating

4. 1 Analysis of Tesco's Business Risk

SWOT ANALYSIS OF TESCO PLC(For Definition and Explanation of SWOT Analysis please refer Appendix E)

Swot Analysis of Tesco

Strengths

Increasing market share

Insurance

Tesco online

Brand value

UK market leadership reinforced

Opportunities

Non-food retail

Health and beauty

Further international growth

(Source: Datamonitor)

(1) Strengths

(a) Sales Growth

With the recent Global Financial Crisis (hereby referred to as GFC) retail sales have fallen, but Tesco does not seem to be affected as its sales revenue grew by 10. 92% in 2008 and 11. 86% in 2009.

(b) Market share

Tesco still holds the largest share of the UK retail market. It maintains this by constantly diversifying into new sectors and consolidating its existing position as a market leader.

(2) Weaknesses

Tesco Finance profit levels were impacted through bad debt, credit card arrears and household insurance claims.

Tesco’s position as a price leader in UK markets can lead to reduced profit margins in order to retain the key price points on must have commercial items.

Grocer outlets are not set up to operate as specialist retailers in specific areas of product which can be capitalised on by other smaller bespoke retailers.

Although international business is growing and it is expected to contribute greater amounts to Tesco’s profit over the next few years. The company is still highly dependent on the UK market.

(3) Opportunities

The development of Tesco Direct through online and catalogue shopping will grow the use of technology, providing the launch pad for larger non food based products with moderate to high margin returns and less focus on sales and margin per foot return to space.

Further international growth.

(4) Threats

Increasing foreign exchange exposure with international growth.

Rising raw material costs from both food and non food items will impact profit margins overall.

Continuous price wars between other retailers e. g ASDA, Sainsbury and WM Morrisons.

(Source: businessteacher. org. uk)

P. T. O (Please turn over)

PESTLE ANALYSIS OF TESCO PLC TABLE(for explanation of PESTLE, please see Appendix F)

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Political

Tesco's organic growth internationally into countries in Europe, Asia and America means it is influenced by the political conditions of these countries. Tesco is subject to a wide variety of regulations in the different countries in which it operates because of the diverse nature of its business. Tesco may be impacted by regulatory changes in key areas such as planning laws, trading hours, and tax rules as well as by scrutiny by the competition authorities. Tesco is influenced in the UK by employment legislations such as the minimum wage requirement

Economical

Economic factors and the state of the economy affects Tesco, because these influence the business environment of operation, business expectation of investors and the consumption level of Tesco's customers which all translate into the levels of demand, supply, and pricing of Tesco's goods and services. The economic factors have been seen to have caused the decrease in profit growth rates being experienced by Tesco. Tesco has responded to these issues by ensuring that its product variation strategy is upheld in all their stores. i. e having the same product with varying quality and price for the different target markets in the same store.

Socio-Cultural Factors

Tesco considers the diversity of its customers in terms of culture and tries to meet their varied expectation by having most food and non food items that are required. This strategy is obvious with aisle for world foods, clothes etc. Benefits from cultural diversity and globalization are also evident in staffing of their stores.

Technological

Technology as a major driver of efficient resource utilization which has allowed Tesco staff to be more efficient at their jobs with the use of a wide variety of scanners for their sales at their tills and for stock/inventory management. A new invention are self service machines where customers can scan and pay for their shopping, this innovation has also lead to a reduction in staff cost.

Legal

In the UK, the Financial Services Authority (FSA) which is the regulator of all providers of financial services requires Tesco Personal Finance to be able to meet its sterling obligations without recourse to the wholesale markets for a period of at least five business days. To meet regulatory requirements a diversified portfolio of high quality liquid and marketable assets is maintained. Cash flow commitments and marketable asset holdings are measured and managed on a daily basis

Environmental

Tesco has been able to manage its environmental impact by adopting a number strategies, some of which are; an energy saving initiative lead, to opening of environmental store in a quest for zero-carbon, carbon labelling of products, green club card initiative which encourages customers to recycle.

4. 2 Analysis of Corporate Governance Risk

An analysis of the Directors' report on corporate governance clearly defines the Directors' roles and goals for Tesco Plc, as its main aim is to generate shareholder value and safeguard their long-term interests. Tesco, follows the Combined Code on Corporate Governance, especially Section 1, as defined by the Financial Services Authority (FSA), on compliance of the Code throughout the year. The Executive Board , complied with the Code, with the exception of the provision that at least half the Board, excluding the Chairman, should comprise Non-Executive Directors determined by the Board to be independent. This was as a result of the resignation of Carolyn McCall and E. Mervyn Davies as Non-executive Directors due to conflicts of interest. Tesco appointed Laurie McIlwee as the new Group Finance Director, and Jacqueline Tammenoms Bakker and Patrick Cescau and Ken Hanna as Non-executive Directors, thus becoming fully compliant again with the code. Laurie McIlwee has been with Tesco for nine years and has a very strong track record in both finance and operations. In his most recent role as Distribution Director Laurie was responsible for transforming the whole network – a tremendous achievement, which reflects careful management succession planning at Tesco.

The structure of the Board and the integrity of the individual Directors ensure that no single individual or group dominates the decision making process. All Directors have to submit themselves for re-election at least every three years if they wish to continue serving and are considered by the Board to be eligible. The Non-executive Directors bring a wide range of skills and experience, as well as independent judgement on strategy, risk and performance

to the Company.

The Board has set out a clear Schedule of Matters Reserved for Board Decision in order to ensure its overall control of the Group's affairs.

These include the approval of:

- the Company's strategic and operating plans;

- annual and interim financial statements;

- major acquisitions and disposals;

- authority levels for expenditure;

- treasury policies;

- risk management and internal control systems;

- group governance policies; and

- succession planning for senior executives

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Additional Corporate Governance Role- Table

Audit, Remuneration and Nominations Committees

The Board governs through a number of statutory Board Committees – the Audit, Remuneration and Nominations Committees – to which certain responsibilities and duties are delegated. These Committees are properly authorised under the constitution of the Company to take decisions and act on behalf of the Board within the parameters laid down by the Board. The Board is kept fully informed of the work of these Committees and any issues requiring resolution are referred to the full Board as appropriate.

A summary of the operations of these Committees is set out. The performance of the Board is a fundamental component of the Group's success. The Board regularly reviews its own performance.

Relations with stakeholders

Tesco maintains a close relationship with all its stakeholders including customers, staff, suppliers, investors, non-governmental organisations and others, to ensure that its long-term strategy is sustainable. These include corporate social responsibility targets towards-

Environment

Community

Suppliers and Ethical trading

Customers

Choice & Health

People

and Key Performance Indicators (KPIs)of the Steering Wheel.

Internal controls The Board is responsible for the Company's system of internal control and for reviewing the effectiveness of such a system. Tesco has a Group-wide process for clearly establishing the risks and responsibilities assigned to each level of management and the controls which are required to be operated and monitored. Both the internal and external audit, PricewaterhouseCoopers LLP, contribute towards maintaining effective internal financial control systems.

Whistleblowing Policy

The Group operates a whistleblowing policy and has a confidential ' Protector Line' service accessible to concerned employees where they can report, anonymously if necessary, on issues of malpractice within the business. These issues include unethical behaviour such as fraud, dishonesty and any practices that endanger their staff, customers or the environment. Complaints made are treated as confidential and are investigated. Where appropriate, matters will be escalated to the Director of Group Security for further action.

Management

At Tesco, trading is tracked on a daily and weekly basis, financial performance is reviewed weekly and monthly, and the Steering Wheel is reviewed quarterly. Steering Wheels are operated in business units across the Group, and reports are prepared of performance against target KPI s on a quarterly basis enabling management to measure performance.

Shareholder engagement

Tesco is committed to maintaining a good dialogue with shareholders through proactively organising meetings and presentations as well as

responding to a wide range of enquiries. During the year, the Chairman, Chief Executive and Finance Director meet with most of the leading shareholders to discuss issues relating to the board, strategy and governance matters, as well as new developments within the business. In addition to this the Company Secretary's office, Investor Relations and other teams within the business engage with shareholders on a regular basis, and on a wide

range of issues.

Director's remuneration Disclosure

Tesco is already a large and profitable company. A 10% increase in Company value equates to some £3bn in additional shareholder value, equivalent to a FTSE 50 organisation. Continuing to grow and expand profitability from such a high base is challenging but forms the core of Tesco's strategy, and its supporting processes including executive remuneration. The result for 2008/9 included improvement on most of the underlying performance measures relating to productivity and growth. More than two-thirds of total remuneration (excluding pension) is linked to performance. Long-term performance is rewarded through delivery of shares and short term performance through a combination of cash and compulsory deferred shares. The Remuneration Committee believes that the majority of total remuneration should be performance-related and delivered largely in shares to closely align the interests of shareholders and Executive Directors. When setting the remuneration of Executive Directors, the Committee considers the Group's performance on environmental, social and governance (ESG) matters. Specific ESG performance targets are applied to certain elements of the remuneration structure, in order to reinforce positive and responsible behaviour by senior management.

(Source for all Corp Governance notes: AR2009)

Tesco Board of Directors- Table

Name

Job Title

Board

Name

Job Title

Sir Terry Leahy

CEO

Executive Board

Jacqueline Tammenoms Bakker

Non-Executive Director

Richard Brasher

Commercial and Trading

Director

Executive

Board

Rodney Chase

Deputy Chairman and Senior

Non-Executive

Philip Clarke

International and IT Director

Executive Board

Charles Allen

CBE Non-Executive Director

Andrew Higginson

Finance and Strategy Director

Executive Board

E. Mervyn Davies

Non-Executive Director

David Potts

Retail and Logistics Director

Executive Board

Dr. Harold Einsmann

Non-Executive Director

Laurie McIlwee

Group Finance Director

Executive Board

Ken Hydon

Non-Executive Director

Lucy Neville-Rolfe

Corporate & Legal Affairs Director

Executive Board

Graham Pimlott

Non-Executive Director

Tim

Mason

Marketing, Ecommerce,

Property and Republic of Ireland

Director

Executive Board

Patrick Cescau

Non-executive Director

David Reid

Chairman

Non Executive Board

Karen Cook

Non-executive Director

(Source-AR 2009)

4. 3 Analysis of Tesco's Financial Risk

For the financial analysis of Tesco, traditional ratio analysis (For Definition and Explanation of Ratio Analysis please refer Appendix C) has been used –

Profitability

Liquidity

Financial Gearing

Investor

and Efficiency ratios.

PROFITABILITY

Ratio

2009

2008

2007

Return on Equity (ROE)

16. 66%

17. 89%

17. 96%

Return on Capital Employed (ROCE)

6. 96%

9. 25%

10. 67%

Net Profit Margin

3. 98%

4. 5%

4. 45%

The analysis of the Return on Equity shows that the return slightly fell in 2008 to 17. 89% from 17. 96% in 2007, it further decreased in 2009 to 16.

66%. Further investigation of this shows that though the retained earnings in 2008 of £6, 871m is an increase from 2007 level of £5, 693m, the management of Tesco was prudent in the use of available resources, due to the recent GFC. Return on Capital Employed reveals a consistent and steady decline in this rate of return from 10. 67% in 2007 to 9. 25% in 2008 and 6. 96% in 2009. This trend was primarily due to a consistent rise in the current assets of Tesco: it rose in 2007 from £4, 576m to £6300m in 2008, then in 2009 to £14, 045m. The Net Profit Margin remained almost the same, from 2007 with 4. 45% to 4. 5% in 2008, but decreased in 2009 to 3. 98% for each pound of sales. This can be attributed to the recession, where people tend to spend less and save more.

LIQUIDITY

Ratio

2009

2008

2007

Current Ratio

0. 76

0. 58

0. 56

Quick Ratio

0. 61

0. 35

0. 32

The Current ratio shows a consistent growth from 0. 56 in 2007 to 0. 58 in 2008 and then highest of 0. 76 due to a 127. 15% growth of current assets in 2009, this shows a continuous improvement in Tesco's liquidity. Even though a good growth is observed the ratio is a reflection that Tesco is highly exposed to its liabilities. This ratio also shows an increased tendency of liquidity problems since it current assets cannot cover its current liabilities. The Quick ratio is similar to that of the current ratio, with much lower ratios of 0. 32 in 2007 to 0. 35 in 2008 and highest ratio of 0. 61 in 2009. These results also show increasing liquidity as well as a poor coverage of current liabilities by the quick assets.

Cashflow Analysis

Tesco's Free Cashflow

Cashflow detail

2009

£In millions

2008

£In millions

Cashflow from Operating activities

4978

4099

Net cash used in investing activities

5974

2954

Dividends paid

883

792

Interest paid

562

410

Tax paid

456

346

Free Cashflow

-2897

-403

Cashflow Ratios

2009

2008

2007

Cash Return on Sales

9. 16%

8. 66%

8. 28%

Cash Debt Coverage

19. 39%

25. 22%

25. 82%

Cash-Flow Coverage

63. 21%

91. 04%

94. 66%

On analysis of Tesco's free cash flow), it dropped significantly from 2007 to 2009, it is in negative of -£199m in 2007, increasing to -£403m, and sharply increasing to -£2897m respectively.. The increase in dividend payout accounts for £91m (between 2008 to 2009) and explains a small portion of the drop . But the total drop in the cash flow from 2008 to 2009 is a sharp -£3300m. The analysis of Cash Return on Sales determines that from 2007 to 2009 it has increased by 8. 3%, to 8. 66% and then to 9. 16% respectively. Tesco's cash return on sales in 2009 of 9. 16% is higher than its Net Profit margin of 3. 98% in 2009, which is a good sign. The Cash Debt Coverage also shows that Tesco's cash position worsened from 2007 to 2009 (i. e) the cash to debt coverage was 25. 82%, 25. 22% and 19. 39% respectively. One of the reasons is that Tesco's long-term debt increased between 2007 to 2009 by £8934m. The CashFlow Coverage shows that the cash generated by Tesco from its operations, to meet its obligations, decreased from 94. 66% in 2007, to 91. 04% in 2008 , to 63. 21% in 2009. To cover the rest of its cash needs, Tesco had to use cash on hand at the beginning of the year, to make up the cash shortfall.

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FINANCIAL GEARING & LEVERAGE Analysis

Ratio

2009

2008

2007

Interest Cover ratio

6. 71 times

11. 16 times

12. 26 times

Debt to shareholder’s equity

2. 54 times

1. 53 times

1. 35 times

Debt to Capital

55. 86%

40. 36%

35. 03%

The Interest Cover ratio shows a decline from 12. 26 times in 2007 to 11. 16 times in 2008 and the lowest ratio of 6. 71 times in 2009. The Analysis of the finance cost shows the drop in 2009 was primarily due to an 87. 75% increase in non-current liabilities which lead to a 91. 2% increase in finance cost. Debt to shareholder’s equity, shows the usage of creditors by Tesco for every £1 from investors, increased from 2007 to 2009, by £1. 35, £1. 53 to £2. 54 times respectively. This reflects that the dependence of Tesco on money raised by borrowing has sharply increased in 2009, from 2007 compared to its usage of money raised by selling shares to investors. This also reflects that in 2009, Tesco had a high amount of debt at 2. 54, which means it will have to pay higher interest rates to finance its capital activities. Tesco’s Debt to Capital increased from 35. 03% in 2007, to 40. 36% in 2008 and rose to 55. 86% in 2009, which is very high, and indicates an increasing cost of operating, as it tries to meet its obligations of paying higher interest rates.

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INVESTOR RATIOS

Ratio

2009

2008

2007

Dividend Payout Ratio

26. 8%

24. 4%

21. 6%

Earnings per Share (EPS)

27. 50p

26. 95p

23. 84p

Price/Earnings (P/E) Ratio

16. 30 times

16. 73 times

18. 91 times

The analysis of Dividend Payout Ratio shows the payout ratio has been increasing from 21. 6% in 2007 to 24. 4% in 2008 and 26. 8% in 2009. Earnings per Share shows that it is increasing year to year, with EPS in 2007 of 23. 84p, in 2008 of 26. 95p and 2009 of 27. 50p, with the largest increase between 2007 and 2008. The profit for the year in 2008 was higher than in 2007and there was also a reduction of shares in issue from 7, 947m to 7, 863m in the same year. The analysis of the Price/Earnings shows a continuously declining P/E ratio, with 18. 91 times in 2007, 16. 73 times in 2008, and 16. 30 times in 2009, probably due to a decreasing growth rates in profits- 12. 16% growth in 2008 and 1. 69% growth in 2009.

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EFFICIENCY Ratios

Ratio

2009

In days

2008

In days

2007

In days

Inventory Turnover Period (ITP)

19. 44 days

20. 31 days

17. 89 days

Trade Receivables Period (TRP)

12. 08 days

10. 12 days

9. 24 days

The analysis of the Inventory Turnover Period shows an increase from 17. 89 days in 2007 to 20. 31 days in 2008 and fell to 19. 44 days in 2009. The Trade Receivables Period shows a consistent increase in the TRP: in 2007 9. 24 days to 10. 12 days in 2008 and a higher increase to 12. 08 days in 2009. This could be due to stiff competition in the retail industry and increased credit sales demands of customers.

Please note- For Analysis of Financial Risk of Hilton Food, please refer to Appendix B.

5. Justification of assumptions made and techniques used:

5. 1 Justification of assumptions made: -Table

a)

It is assumed that Tesco will takeover Hilton Food and fund its acquisition by

the potential issue of long -term bonds. This assumption is taken to conduct this particular credit risk analysis.

b)

Tesco Financial Year (FY) ended on Feb 28, 2009, and Hilton Food FY ended on 31 December 2008, so despite the accounting year differences, we have maintained that all accounting conditions still remain the same for the sake of comparative study.

c)

Tesco is one of the biggest retailers in the world with a diversified business, and the assumed acquisition is due to Hilton Food (HF) being a customer of Tesco in the real world, where HF supplies packed meat to Tesco stores across UK and Europe. So this acquisition, would make economic sense to Tesco's business expansion, by supplying packed-meat under its own brand name, and economies of scale.

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5. 2 Justification of techniques used: -Table

a)

We have only conducted Business Risk and Corporate Governance Risk Analysis for Tesco, and not for Hilton Food (HF), as with the future acquisition HF would either be a subsidiary or merge with Tesco's entity, and come under Tesco's management. Therefore, it would be Tesco's Business and Corporate Governance risk which would influence Hilton Food.

b)

We have analyzed both Tesco's and HF's Financial Risk, because when an investor would look at Tesco's long-term bond issue, he would like to know about the business and financial risk of both Tesco and HF.

c)

Financial Risk Analysis (FRA) of Tesco has been done for 2007, 2008 and 2009 and FRA has been done for HF only for 2009, because we have presumed after the acquisition, HF would be a part of Tesco's business, so only current2009 FRA is done for HF.

d)

We have not designated any credit rating like AA, BB etc. according to S&P, Fitch or Moody's, because, they use sophisticated credit risk models, and calculations for default and recovery rates, and credit scoring system, Our analysis is based on studying the Business, Corporate Governance and Financial Risk by simpler analytical tools.

6. Rationale Behind Recommendation- Highlights Table

a)

The analysis of Tesco Plc, reveals that the company has shown good profitability and revenue growth, with good sales growth even in difficult times (GFC). Tesco as a business has revealed further expansion plans across different countries. The SWOT Analysis of Tesco reveals that Tesco, is following a sound business model.