

Tesco versus sainsbury financial performance analysis finance essay



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Food retailing has traditionally been highly competitive with significant pressure on margins and cost control. The UK retailers like Tesco, M&S, Sainsbury's, Asda faced further challenges when the consumer confidence index surged due to the financial crisis and job losses. Still, food retailers seemed to have found successful anti-crisis policies when compared to the performance of their high-street competitors (Brand Republic, February 2009).

The report hereto would investigate and compare the financial performance of two of the largest UK food retailers J Sainsbury plc and Tesco plc. The scope of the analysis would be the three latest financial years 2007-2009. The main analytical technique would be ratio analysis looking at companies' profitability, performance and financial stability. Latest share information would also be examined briefly. The report would start with a short introduction of both businesses, proceed to a comparison between them based on certain ratios or indicators and end with a conclusion identifying which business performed better in the last three years.

Tesco plc – Company Profile

Tesco plc is a UK-based retail business being number one in its home market and the third world's largest retailer in terms of revenue after Wal Mart and Carrefour (Tesco, 2010). The company was established by Jack Cohen in 1919 in East London as a grocery selling stall. He expanded the business and in 1947 Tesco plc was floated on the London Stock Exchange (Tesco, 2010).

At present Tesco has operations across varied retail segments and in about 15 international locations including Europe, US and Asia (Tesco, 2010). As

per latest company data Tesco has a portfolio of 2 306 stores in the UK and its UK market share reached 30, 7% in 2009 (The Guardian, Nov 2009).

Tesco has further 2 400 stores internationally (Tesco, 2010). The corporate strategy of business and geography diversification of Tesco was initiated in mid 1990s with the aim of broadening the business scope in order to deliver strong sustainable long-term growth. Currently, the business includes also financial services and the Tesco mobile since 2003.

Currently, Tesco plc has a market capitalization in excess of GBP 33b and employs about 440 000 people. Terry Leahy was appointed for a CEO in 1997 (Tesco, 2010).

J Sainsbury plc – Company Profile

J Sainsbury plc is the corporate entity of the food retail chain Sainsbury's. The company is UK-based and is currently the third largest supermarket chain in the UK with an estimated market share of approximately 16. 3% (Sainsbury's, 2010).

Sainsbury's was initially founded in 1869 as a family business by John James Sainsbury and his wife Mary Ann. The business expanded quickly and became the largest grocery retailer in 1922 (Sainsbury's, 2010). It kept its leadership position up until the mid 1990 when due to internal problems and loss of focus it was replaced by Tesco and Asda (becoming second largest retailer in 2003, The Telegraph, June 2009). Presently, as per latest company information, Sainsbury's consists of a chain of 525 supermarkets, 303 convenience stores, a Real Estate Division managing some of the store properties and a Financial Services Division (Sainsbury's Bank, offering

insurance, credit cards, loans, etc.). The company employs about 150 000 employees (Sainsbury's, 2010). The business serves over 18.5 million customers a week, as the product range already includes clothing and home furnishing lines. Online shopping and delivery is also available to the Sainsbury's customers.

With respect to ownership and management, J Sainsbury plc is publicly traded company listed on the London Stock Exchange and ranks into the FTSE 100 index. The Sainsbury family has approximately 15% interest in the company. Justing King with a number of top management position in the UK retail industry was appointed for CEO of J Sainsbury plc. David Tylor is the chairman of the board. (Sainsbury's, 2010)

Tesco plc and J Sainsbury – Financial analysis

The section would present the financial analysis of both Tesco and Sainsbury's. The analysis will be based on the calculation of a number of ratios measuring profitability, efficiency, financial standing and investment opportunities. As discussed by Berk and DeMarzo (2007), ratio analysis is most powerful when the results for a given company are compared with the ones of a close competitor, the industry average or to the historical trend for the same company. Thus, the analysis would cover a period of three years 2007-2009 and would contrast the performance of both companies which are considered to be a very close business match. Both companies' performance would be benchmarked to the industry average indicators where appropriate. The calculations are based on financial information available in the company annual reports.

Profitability analysis

As discussed by Atrill (2002), profitability measures (ratios) show how a company uses its resources. Profit margins show how much the business is able to retain in excess to the cost of its operations. Return ratios, on the other hand, indicate if it is able to generate enough return for the capital supplier.

Return on capital employed (ROCE) represents the overall return on the all capital employed (equity and debt) in the business. As discussed in the business valuation literature (Palepu, 2004), there is empirical evidence that ROCE is affected by market forces and mean reverts in long-term and for mature companies. The level of mean-reversion is towards the long-term weighted-average cost of capital (WACC) of about 8-10%, suggesting elimination of abnormal profits over long periods of the business life. Looking at the ROCE of both companies, Tesco fits in the expectations with its measure declining from 13% in 2007 to 9% in 2009. On the contrary, Sainsbury's operates substantially below the average at 4-5% ROCE over the period. It is further alarming that Sainsbury's ratio is on decreasing trend in 2009. It should be kept in mind that the ratios may be affected by the accounting practices, as the so-called dirty-surplus items are usually put in the equity section of the balance sheet. Further, the ROCE itself does not give information where the performance comes from. So, decomposition of the ratio is needed ($ROCE = RNOA + FLEV \text{ EFFECT}$)

Return on net operation assets (RNOA) behaves similarly to ROCE, as in long-term RNOA levels of old companies have proven to mean revert to average

levels between 8 and 15%, as companies with lower RNOA levels tend to increase and visa versa (Palepu, 2004). In the particular case, we can see that Tesco again generates higher return of about 8-5% compared to 3% for Sainsbury's over the three year period. It can also be noted that the Sainsbury's RNOA is stable over the period while the one of Tesco decreases almost 50%. A possible reason may be disproportionate addition of assets compared to the sales growth. Investigating this further, we see that Tesco's sales grew by 10% and 13% in 2008 and 2009 respectively, while its total assets grew by 22% and 53% for the same period. Sainsbury's shows a more proportionate behavior of growth with sales increasing 3% and 5% in 2008 and 2009 and total assets growing by 5% and -1% over the same period. The 5% sales growth in 2009 is even more impressive when noted that it is achieved by the same asset base as in 2008. Still, for a better understanding of the profitability drivers, RNOA can be further decomposed to the expression $\text{NOPAT margin} \times \text{asset turnover}$.

Looking at the profit margins of both businesses, expectedly their margins are low due to the saturation of the industry. Tesco's gross profit margin (GPM) has been stable at about 7, 5%, while the one of Sainsbury's decreased from 6, 8% in 2007 to 5, 5% in 2009. Still, both companies operate at substantially higher margins than the industry average of 2, 2% (Reuters). The further vertical analysis of the income statements shows that the decrease in Tesco's GPM translates into decreasing operating profit margin as well (from 6, 2% to 5, 9%), while Sainsbury's actually achieved a stable increase in the OPM of 0, 6% over the three years period. Sainsbury's performance suggests management involvement in operational efficiency

and cost control trying to improve the bottom line. However, the after tax profit margin of Sainsbury's actually decreased with 0, 4% to 1, 5% in 2009. Tesco NOPAT margin also decreased over the period, but is materially higher being 4% in 2009. As suggested by Palepu (2004), mature industries with high level of competition are normally expected to compensate low margins with high turnover.

The asset turnover ratio (ATO) is an efficiency measure rather than profitability one. However, it would be considered here as it has direct effect on the overall ROCE. The ATO ratio shows how effectively the assets of the company are used to generate sales (Berk and DeMarzo, 2007). Empirical evidence shows that it tends to stay constant over time except when some new technology is introduced and efficiency of operations is improved (Palepu, 2004). Retail industry is not technology-intensive and substantial changes in ATO are not expected to occur over short periods as the scope of the analysis hereto. Still, Tesco's ATO decreased notably from 1, 72 in 2007 to 1, 18 in 2009. The anomaly can be explained with the aggressive growth in assets (22% and 53% in 2008 and 2009 respectively) which did not translate into the same level of sales growth. On the contrary, Sainsbury's ATO improved slightly from 1, 78 in 2007 to 1, 88 in 2009 being again an evidence of tight efficiency control and focus. Sainsbury's definitely compensate lower profitability with much higher efficiency of operations. Both companies operate at ATOs higher than the industry average of 0, 26 (Reuters).

Efficiency measures – working capital management

Working capital management and its components are further indication of a company operational efficiency. As explained by Weetman (2003), the working capital cycle presents the proportion of the operating activities that need to be covered with long-term financing. Thereby, the longer the cycle, the greater the need to employ long-term debt in operations rather than in investment activities.

The inventory turnover in days for both Tesco and Sainsbury's is 16-18 days and 13-14 days respectively. The period is quite short, even though it is in line with the expectations for the retail industry. Still, Sainsbury's perform slightly better in terms of inventory management. Sainsbury's seems to have also better receivables collection management with its days receivables being below a day opposed to Tesco's days receivables of 1, 85 days in 2009. The measure increased slightly (with 0, 5 days) for both companies over the three years. Still, a good explanation of the trend may be the increased number of card payments and online shopping volume over the years.

In terms of negotiating credit from suppliers (days payables) both companies pay settle payables within 35-36 days on average in 2009. However, the measure has been increasing for Tesco (from 32 days in 2007), while decreasing for Sainsbury's (from 39 days in 2007). Being times bigger, Tesco would be expected to have better negotiation power over its suppliers, however Sainsbury's also managed to stay competitive in this respect.

Overall, calculating the total length of the working capital cycle for both, we obtain negative numbers due to the short inventory and receivables cycles

and the long credit lines with suppliers. The result suggests that Tesco and Sainsbury's have healthy short-term financial management and they actually utilize suppliers financial resources.

Solvency and liquidity analysis

As indicated by Atrill (2002), solvency and liquidity ratios indicate the ability of a business to cover its current liabilities, as well as its long-term financial health and stability. In short-run ability to cover debt-servicing payments, as well as other trade claims, is vital, while the capital structure and the debt burden on the total assets is more important in long-run.

Tesco has healthy current ratio close to 6 in 2009 (about 3 in 2007-2008) and a quick ratio strictly above 1 for the whole period. However, Sainsbury's financial position is quite different. Both ratios are below 1 and have been following a decreasing trend over the three years period. Food retailing is high turnover industry and definitely is not considered to be among the high volatility ones. Thus, current and quick ratios below one are normal. Still, Sainsbury's ratios are materially lower even than the industry average (Sainsbury's quick ration was 0, 31 in 2009 compared to 0, 82 for the industry). Still, it is positive that the company has healthy interest coverage which appears negative due to interest income being more than interest expenses. Tesco also has good interest coverage of 8 in 2009 (decreasing from 12 in 2007).

In terms of solvency, as expected from the industry context, both companies have relatively high debt levels at about 50% of equity. The levels are twice the industry average of 24% (Reuters). Tesco loaded on debt aggressively in <https://assignbuster.com/tesco-versus-sainsbury-financial-performance-analysis-finance-essay/>

2009 with its financial leverage reaching 50% in order to finance expansion. Still, this is not considered as a serious threat given the good performance and short-term financial stability indicators.

Share price analysis

Tesco's share price has been fluctuating over the past 3 years between 300p and 470p. It currently trades at about 445p a share and has been increasing since April last year from its low at 300p per share.

Sainsbury's share price seemed to be a bit less volatile in short-term, even though it traded in the range of 280 – 600p over the 3 years period. The price went through a few significant drops and adjusted to an annual average of 330p for the last year.

In terms of multiples, both Tesco and Sainsbury's trade at P/E ratios close to 16 indicating high confidence of investors in the future growth of the businesses. Still, Tesco trades at a bit better P/B of 2, 60 compared to Sainsbury's P/B of 1, 44 (Reuters). Generally, both P/B ratios are low, still it needs to be accounted that the industry is very competitive and mature. Analysts seem to be more confident in Tesco's performance (Bar Cap Wealth Management), with Tesco being a "buy" and Sainsbury's being "hold" as at the last recommendations available (Reuters).

Conclusion

Financial analysis and ratio analysis in particular are only one of the tools that a potential investor may and should use. The analysis is mostly based on accounting information (company's annual reports) that due to

accounting practices may not fully reflect the market value of a company. Furthermore, the analysis examines the past performance of a company and it may be a point considering its future abilities, but it is in no way decisive. Past cannot be used as a determinant of the future.

Applied to Tesco and Sainsbury's, the tool revealed useful baseline for further study of the companies. Tesco can definitely be seen as a leader in growth and profit margins. However, it performed relatively poor in terms of efficiency compared to Sainsbury's. Still, as both company's report annual accounts early in the year, the information analyzed failed to account for the later fast growth in like-for-like sales of Sainsbury's at 7, 8% compared to 4, 3% of Tesco (The Telegraph, June 2009) and the announcement of aggressive expansion plans. Still, assuming the markets have reacted efficiently, the information should be captured in the current share prices of companies.