

Tesco's capital structure

Government, Capitalism



Firstly, as we can see from table1, the gross profit margin of Tesco Group increased during the last five years, from 5.65% to 6.08%. Since a subtle change (increase or decrease) in profit margin will induce a significant change in the overall profits, a 0.43% increase from 2002 to 2006 has indeed induced a dramatic increase in the total profits. Secondly, except for 2002, the gearing ratio decreased from 0.70 to 0.58, which indicates Tesco's attempt to reduce the leverage ratio in these years.

This trend was coupled with the increase of earnings per share (EPS), from 12.05p in 2002 to 20.20p in 2006. Unquestionably, this can increase the confidence of existing investors and equally importantly, it can attract more potential investors. However, this trend is in some way or another contradicts the traditional theory about the consistency of the gearing ratio (leverage ratio) and EPS. It is commonly accepted that the increase of the gearing ratio will significantly couple with the increasing trend of EPS, and vice versa (Rolf, 1981).

In Tesco's case, the decline of gearing ratio parallels the incline of earnings per share. This shows that rather than raising more debt to finance capital expenses and operating costs, Tesco uses other methods (such as ploughing substantial proportion of its profits back to its businesses) to maintain its strong growth momentum. Thirdly, return on capital employed ratio (ROCE) increased from 10.8% to 12.7%, or by 18%. This is an efficiency ratio of the performance of management.

Virtually, the company has increase the utility of the capital employed in its businesses. Fourthly, the interest cover also increased from 8.64 to 12.39,

or 43.4% during the last five years. It shows the strengthened ability to pay interest, due to the significant increase of operating profits these years. And incontestably, this good news is inconsistent with the increase of the gross profit margin mentioned before.

Last but not least, for international companies like Tesco, the rule of thumb is that a debt/equity ratio (also known as leverage ratio or gearing ratio) of less than 100 per cent is reasonable. But the most appropriate gearing ratio is dependent on more external and internal variables. According to the mainstream theories that companies with a strong ability to generate cash flow can safely hold a higher level of debt and thus they will tempt to raise more debt (Olivier, 1993).

However, this is contradicted by Tesco's case in which the international retailer tempted to lower its gearing ratio while keeping an increasing amount of operating profits. So, there is a fundamental question to be answered: what's the appropriate mix of debt and equity? Is the mix of debt and equity optimal on Tesco's balance sheet? In order to answer the questions above, it is better to analyze more specifically the capital structure of Tesco reflected by its balance sheets.

As mentioned above, some traditional theories focus on the positive relationship between the leverage ratio and earnings per share, however, the situation of Tesco is the reverse version. When the historical leverage ratio decreased, the earning per share climbed to a historic new high in 2006, or even higher in 2007 (from the semi-annual report of Tesco).

The mix of equity and debt is primarily related to financial leverage, namely long-term liabilities, which have significant influence on other financial indices such as earnings on earnings per share (EPS), return on capital employed (ROCE), return on investment (ROI), dividend per share (DPS), weighted average cost of capital (WACC), cost of equity and cost of debt (William and Jorion, 1993). Among all this indicators, the weighted average cost of capital (commonly known as WACC) is used to measure the total cost of capital of a business, including equity and debt.

Actually this indicator has been utilized by many businesses as a discount rate to calculate and estimate the net present value (NPV) of a financed project. Weighted average cost of capital is also referred to as the return a company must earn from its assets to keep its sustainability and constant development (by paying the tax, interest, and satisfying its creditors and owners). In effect, the indicator WACC allows for the relative weights of each element within the capital structure (debt and equity).

Notes: K_e = the cost of equity capital, K_L = Cost of loan capital, V_e = Current market value of all equity capital, V_L = Current market value of all debt

During the early development of the capital structure theories, many scholars focus on that an optimal capital structure can be achieved when the WACC is minimal. However, this theory has run into many skeptics due to its strict assumptions: no reserved earnings, no taxes, etc. Those assumptions began to be released from 1958, when Franco Modigliani and Merton Miller put forward their theory of capital structure.

Also, in 1963, tax factor is introduced into the capital structure model as a tax shield and a business can gain benefits by raising more debt rather than using its equity to reduce the tax payment. Under this circumstance, the value of a firm can be calculated as: Further, other theories tried to break more limitations of the assumptions; they allowed for more influential factors which can affect the cost of assets and further the capital structure, such as agency costs, bankruptcy costs, financial distress costs, etc.

In this report, we use the revised MM model and the WACC model to calculate the value of Tesco Group as an attempt to determine the optimal capital structure of the company. The cost of equity capital, cost of loan capital, current market value of all equity capital, current market value of all debt of Tesco and the WACC value are calculated by SPSS in figure 2 and table 3.