

Financial management – kingfisher plc

[Business](#), [Management](#)



1. Introduction

The first part of this paper will critically evaluate the Financial Management policies and practices of Kingfisher for the five-year period 2004 through 2008 by looking how the company has kept its stock prices attractive to investors in relation to the measurable revenue growth and profitability. This will also look into the liquidity position and solvency position as well as the company's efficiency in the management of company resources. The second part will determine whether or not the current share prices of Kingfisher plc represent a "fair value" by conducting stock valuation using the company's estimate of cost of capital. The first part will include an analysis on the financial ratios of Kingfisher for the years 2004 through 2008 as basis of knowing how the company performed financially and the results of the analysis will be used as proofs or in evaluating the company's financial policies and practices.

2. and 3. Analysis and Discussion with Conclusion

First Part

2. 1 How has the company's stocks performed?

The best evidence of well performing company is the stock price of the company. Increasing stock price is the evidence of a growing and well performing company since a company will always logically aim to have higher stock price. The stockholders are first and foremost interested in the maximization of their wealth and they desire to have higher stock prices. There is thus a need to compare current prices with their old price and if the former is higher, the same would point to increased wealth after adjustment

for inflationary effects. Increasing wealth is the dream of every stockholder since each stockholder has other options with their money other investing with Kingfisher.

Using the stock price as basis to evaluate the company's financial performance, Kingfisher exhibited a continued decline in stock price for one year. See Figure 1 below.

Figure 1. Graph of Kingfisher stock for one year

Source: MSN, 2008a

The declining stock price appears to be more disastrous for the company considering that the company appears to have shown only a increase in revenues from 2007 to 2008 after suffering a continued decline in revenues for the years 2004 through 2007. This means that company has not impressed investors by the increase in its revenues for 2008 in terms of increasing stock prices in the stock market. See Figure 2 below.

Figure 2.: Revenues for the last five years., Source MSN, 2008b

2. 2. How has the company performed financially?

Looking at the company financial performance is best attained by understanding its revenue and profitability growth. This portion will therefore analyze the company's gross margin, operating, and net profit margins on whether they are growing in the normal course of events. This will also look into other measures of profitability like return on assets and return on equity and relate the same with the margin ratios.

Sales revenues showed continued decline for the past four years from 2004 through 2007. The company managed to have caused a revenue increase in 2008 but the increase was not even able to reach the 2004 level of revenues, the fall started. Sales revenues in 2004 got recorded at £9.3 billion. This amount decreased to £8.6 billion in 2005, further went down £8.0 billion 2006 and still not enough for it went down further to £7.6 billion. Fortunately, the 2008 revenues showed an increase to \$8.8 billion but it still lower than the 2004 revenue level of £9.3. See Figure 2 above. Moreover, the increase in 2008 was not reflected in the stock price behaviour from 2007 to 2008 because of the latter's decline for the same period. As to why the increase in revenues countered the decrease in stock price may be appreciated by studying further the company's profitability. Although increase in revenues is an important goal of every business, Kingfisher was sacrificing or giving up profitability in exchange.

Gross margins exhibited to some extent an increasing trend for the years 2004 through 2007 within the range of 34 to 37% and in 2008 a remarkable rate was reflected at 50%. When viewed in the context of decreasing sales revenues for the years 2004 through 2007, the growing trend in gross margins can be considered a favourable development. But the increasing gross margins will still have to be verified if the said sign of positive development is sustained in terms operating margins and net margins. See Figure 3 below.

Net operating margin for Kingfisher started at 5% in 2004, slightly increased to 6% in 2005 and then went down to 3% in 2006. A fluctuating trend was therefore notable with the net profit margin since after the decrease in 2006,

it went up again to 9% in 2007 but only to fall again to 6% in 2008. It could be further observed that the increase in gross margin in 2008 was not matched by the decrease in operating margin for the same period. See Figure 3 below. Kingfisher's net profit margin may further provide explanation on whether the increase in gross margin in 2008 has in fact contributed to the profitability or not of the company.

Figure 3. Gross Margin, Net Operating Margin, Net Profit Margin Analysis, Source MSN, 2008b

The company's net profit margins have behaved almost similarly as that of the net operating margins. In addition, the profitability of the company was further made lower if net profit margins are compared with net operating profit margins. The fact that net profit margins are lower than net operating margins, is an indication that the company has no other non-operating income that could have increased its income from operations. The company was spending additional expenses for interest expenses due to loans made with creditors. If assessed at this point whether the company is growing, it can be stated that there has been poor growth in revenues and low profitability. There are other ways of verifying the truth of this preliminary assessment using other profitability ratios.

The company's return on assets (ROA) is one way of confirming or denying the preliminary finding as to low profitability of Kingfisher. The company reflected a 3% ROA in 2004 and that it was able to increase the same to 4% in 2005 but only to allow it to fall to 2% in the 2006. See Figure 4 below. Like the other ratios, the company was able again to increase the rates after the fall when its ROA increased to 6% in 2007 but again drove down to 3% in

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2008. On the average, the company was getting only about 3% at return out of its assets for the last five years and when inflation is factored in, the return could actually be almost wiped out. ROA is computed by dividing Net Income After tax by the Total Assets of the company for the year. See Figure 4 below.

The company's return on equity in particular could offer an additional way of understanding the company's profitability performance. It will be observed that like the gross margin, net operating margin and net profit margin ratios, the return on equity also showed fluctuating trend. Starting at 6% return on equity in 2004, Kingfisher was able to have increased the rate to 8% in 2005 but failed to maintain the same rate when it went down to 3% in 2006. Again the company appeared to have done well in 2007, when it was able to bring the ROE to 10% but only to allow it to fall again to 5% in 2008. See Figure 4 below. From the point of view of an objective analyst or researcher, the lack of control in the increase and decrease of the company's profitability ratios is an evidence of lack of control with operations and may indicate lack of proper planning or strategy formulation.

Figure 4. ROA and ROE Graph, Source MSN, 2008b

When viewed in the context of the home improvement retailing industry, Kingfisher may be said to be performing below competition. The company had only shown a return on equity of 6% in 2008 as against the industry average of 21.01%. From a simpler point of view, other players are earning more than three times than the company does. See Appendix I.

2. 3 How has the company performed in terms of liquidity and solvency position?

One way of evaluating a company's performance is by looking at its liquidity position which may be broken down into liability position and cash position for the past five years. This part will therefore discuss on how the company is managing its debts and its cash for the purpose of determining the efficiency of the use of cash in the way the management of Kingfisher runs the business.

Kingfisher like other companies has its share of liabilities which are broken into current and non-current liabilities. The company's assets are not fully owned by stockholders as indicated by the presence of liabilities which constitute not less than 25% of the total assets as shown in the Figure 5 below.

Figure 5- Liability Position Graph of Kingfisher

Source: MSN, 2008b

Given the company's assets in relation to liabilities, it is very relevant to examine the company's liquidity ratios which include the current ratios and quick asset ratios. The current ratio of Kingfisher was pegged at 1.03 in 2004, improved a little to 1.06 in 2005, declined to 0.98 in 2006, decreased further to 0.97 in 2007 and still further down to 0.91 in 2008. See Table 1 below. In the period of five years, it was only in 2005 that the company's current ratio experienced an increase and the others are joined in declining movement. This means that the company's low profitability was not able to sustain its liquidity ratios because of the noted decline in the later.

The quick asset ratios of Kingfisher almost behaved similarly as that of the current ratios since from 0.24 in 2004 it increased slightly to 0.32 in 2005. After this increase, the same was followed by two periods of decline when it went down to 0.30 in 2006 then to 0.25 in 2007. See Table 1 below. Instead of declining in 2008 as that of current ratio, a slight increase to 0.31 was fortunately noted. However, the improvement in quick ratio in 2008 was almost not felt since even if there was an increase, the company appears to be still below to what is normal ratio for a liquid company. The current ratio was already below 1.0 in 2008 hence the slight increase in quick ratio will almost be not appreciated by creditors, which will most likely be affected by the declining liquidity ratios.

Table 1- Liquidity and Solvency ratios, Source MSN, 2008b

Liquidity means the company's capacity to meet a company's currently maturing debts and obligations. The current ratio and the quick asset ratio are the conventional ways of measuring the company's liquidity. To get current ratio, current assets will have to be divided to current liabilities and to get quick assets ratio, current assets must be reduced by the amount of inventory and prepaid expenses to get the quick assets before the dividing to the total current liabilities that was used in current ratio. Thus, it is normal to have quick assets in the form of cash, marketable securities and accounts receivable. These quick assets are more readily convertible to cash; hence they are called to be quick assets. If compared therefore with current ratio, quick asset ratio is a theoretically a better measure of liquidity because of its more readily convertible to cash characteristics. In the case of Kingfisher, its current ratio has been declining to even below 1.0, hence looking at quick

asset ratio, could only indicate that the latter could be lower and indeed the same was found to be true.

If the company's declining liquidity is related with poor revenue and growth and low profitability, it could be deduced that the result was somewhat expected since profitability is one of the best source of liquidity. Since the company could barely sustain operations because of low profitability, improving its liquidity could not also be attained. In a sense it could be stated that low profitability is causing declining liquidity.

A more specific way to examine the company's capacity to avoid the risk of running into bankruptcy is the use of the company's cash position. See Figure 6 below. The company in the figure below has shown too much dependence from cash from operations.

Figure 6: Cash Position Graph

Source: MSN, 2008b

It can be learned that Kingfisher has been able to keep positive cash position for the last five years with cash basically derived from operating activities. This could be based for both investing and financing activities when Kingfisher was a net user of cash, except in 2004 when cash from investing activities appeared positive through out the five year period from 2004 through 2008. This is an indication that without the company positive cash flow from operations, the company would have had negative cash balances for the last five years. It could be recalled that the company has already suffered continuously decline in revenues except in 2008 and fluctuating yet low profitability level of the company. To be informed that the company is

depending from operations given such situation for the company would make it very precarious for Kingfisher as if a slender stem is being made to hold many branches of a tree. This could be confirmed by the fact that if the net cash from operations are compared or divided with the current liabilities, where the resulting ratios are very much below what a normal health company has. From a ratio of 0.17 in 2004, it increased a little to 0.27 in 2005, but only to fall again in 2006 to 0.14 and then rose again to 0.24 in 2007 but followed again by a decline to 0.18 in 2008. See Table 2 below.

Table 2- Operating Cash Flow Ratios, Source MSN, 2008b

This confirms earlier findings of declining liquidity which could lead the company to bankruptcy brought by its inability to meet its currently maturing obligations. It could be asserted that Kingfisher failed to avoid the danger of having low revenue growth and low profitability. The best thing that could be done by a company with a low profitability is to at least maintain its short term health by maintaining at least good liquidity position but the company appears to be least concerned on the matter. It could be taken as poor use of limited funds and inefficient use of money.

As to whether there is further basis to the claim of inefficient funds may be examined further by looking at the solvency ratios of the company. Kingfisher's debt to equity ratio was pegged at 1.00 in 2004, improved to 0.95 in 2005, and then improved further to 0.94 in 2006. Indeed the improvement in the ratio was consistent as the company has further improved to 0.76 in 2007 and then to 0.62 in 2008. See Table 1 above. The ratios are certainly eye-catching since the continued decline to below 1.0 is <https://assignbuster.com/financial-management-kingfisher-plc/>

an indication that the company is bent on really strengthening its long-term health. It would mean however that the company is giving priority to long-term health over that of short term health because of the declining liquidity.

A company is said to be solvent if it has the company's long-term capacity to maintain its stability over the long term. The industry makes use of the debt to equity ratio, which is computed by dividing the total debt of the company to its total equity. A solvent company may be inferred also to have the capacity to balance long term risk and could be taken as evidence of a well functioning capital structure if the supported by increasing stock price of the company. A deeper analysis would however reveal that such was not the case. It is undeniable that the company has been able to continuously improve its debt to equity but when compared with the way its stock price has improved for the recent year, the end of strengthening solvency seems to be not justified because of the declining stock price. The same could be further confirmed when solvency is compared with the resulting profitability and liquidity of the company. There is clear evidence that liquidity position is being considered a less desirable objective as that of improved solvency position is given priority yet not producing the expected result in the price of stocks.

Given the desirability of all the ratios, it must be made clear that one ratio could influence the result of the other ratios. Generally a profitable company should be interested to maintain its liquidity ratios at desirable level so that creditors would be assured that they would be paid on time and which cause said creditors to continue transacting business with the company. At the same time, a company would want to have long-term health since investors

and creditors want to be assured of their investment without thinking or worrying that the next day would not be good day or next month for these investors and creditors. The profitability, liquidity and solvency ratios must all be brought to their desirable level and that by doing so, it would be easier to see the effects in terms of higher stock price of the company which will assure investors or present stockholders that they could sleep and wait to have higher wealth in the future because the business the business is generating profits above cost of capital.

In the case of Kingfisher, declining revenues or low revenue growth could only produce low profitability level and that the company was being force to choose whether liquidity or solvency is more important over the other. The company has incidentally chosen solvency but unfortunately, the effect was not seen in terms of increasing prices of its stocks for the period concerned.

2. 4 Conclusion - Evaluation of financial strategy, policy and practices of Kingfisher.

The framework for evaluation is whether the company's financial strategy is accomplishing corporate objectives in terms of revenue growth and profitability, liquidity and solvency. In particular, there is need to determine whether the company makes and executes its financial strategies in relation to its competitors.

The management cannot be said to be doing well in accomplishing its objectives when its stock prices and revenues are not increasing and its profitability continued to be low for the last five years. Compared with its competitors, the company is doing poorly.

By Kingfisher's failure to stop the decline in its stock price as shown earlier, there is basis to deduce a management failure to accomplish what the investors expect the company to attain. There is a strong evidence of failure to maintain an increasing growth in revenues for the past years and being made more bothersome by its low profitability level. The noted increase in revenues in 2008 after four years of decline was not complemented by an increase in profitability; hence a poor way of handling financial strategy could only be derived or extracted from said results.

The company's competitors include among others Home Depot, and Land of Leather. The company's poor financial performance is very much evident given its 6% Return on Equity which is very much below that of Home Depot of 16.69% and that Land of Leather at 40.35%. (MSN, 2008) The average ROE of the three companies including that of Kingfisher was at 21.01% which is more than three times that of the company. See Appendix I.

Second Part

3.1 Determination of intrinsic stock price whether it represents "fair value"

3.1.1 Estimate of cost of capital for Kingfisher

To determine the value of Kingfisher's stocks of Kingfisher requires the use of the company's cost of capital which is the opportunity cost of choosing an alternative. By the cost of capital the investor is guided whether one is earning from the choice of alternative or not. This cost of capital is aimed to be minimized by every business so that wealth maximization objective is best attained. Upon determination of the cost of capital, the same will be used as discount rate in bringing cash flows for the company to their present

values. The same cost of capital will be used in determining the estimated selling price of the company stocks under the dividend discount model.

The same cost of capital may be determined using the capital asset pricing model (CAPM). The model requires the use of risk free rate investment which may be represented the rate in earned in government Treasury bill plus a premium for the additional risk as a result of making investment decisions which carry higher rate of return than risk free investments. CAPM formula is described as follows: Required (or expected) Return (K_s) = RF Rate + ((Market Return - RF Rate) * Beta)

RF stands for risk free rate as may be represented by the Bank of England (2008) base rate of 5%. The same rate assures the investor of getting more or less the said rate without any risk since it is the government which will make it sure the rate is honoured since it assumed that no government will become bankrupt. The beta in the formula above measures market risk, or the extent to which the returns on a given stock move with the market. The formula still needs the market return which is estimated at 15.15% derived by taking the average market rates of at least three players in the industry including that of subject company. Kingfisher's beta is 1.17 (MSN, 2008a). By substituting the given and extracted data into the formula, the estimated cost of capital of the company is 16.875% calculated as follows: Required (or expected) Return = RF Rate + Beta (Market Return - RF Rate) = 5% + 1.17 (15.15% - 5%) = 16.875%.

Based in the computation above using CAPM, Kingfisher has a required rate of return of 16.875%. An investor who plans to invest in the stock of the company should be earning at least 16.875% return on his investment. The

inability to earn a minimum of this required rate of return or cost capital would be a sign for financial management decision since earning below this would just be waste of time and money. If the average 6% ROE of Kingfisher is brought at this point, it could be asserted that the rate is very low considering this double digit cost of capital that the company has. Thus to see investors of Kingfisher disposing their stocks would be a normal expectation given the low profitability level of the company and high cost of capital.

An alternative way to arrive at the cost of capital is extracting the reciprocal of the price of the company's price earnings (P/E) ratio. Arriving at P/E ratio required dividing the market value per share of Kingfisher's stock by the company's earning per share as taken from its financial statement. As applied, using the reciprocal of the P/E ratio, Kingfisher was found to generate an estimated cost of capital of 11.76%. See Appendix I.

3. 1. 2 Computing the intrinsic value of the company' stock using discount rates as estimated above

The market value using the constant growth model is determined by using the growth rate of the dividend per share of -7% per year (See Appendix III) and the cost of capital computed at 16.875% using the CAPM.

The resulting market value per share would be is £0.66. See Appendix II. Computation of the market value necessitates information on Dividend last year D_0 , expected growth rate in dividends (g), and the discount rate (K_s). The dividend paid the latest year (2008) is given at 0.07 pence while the expected growth rate was computed by getting the average rate of the

dividend per shares for the prior years computed at negative 7% while the discount factor used is the one computed using the CAPM model at 16.875%. If the 11.76% discount rate as computed using the reciprocal of price-earning ratio, the stock price for Kingfisher is £1.37.

3.1.3 Does the company's stock price represent fair value?

The determination of whether the stock of the company is quoted at its fair value or not needs comparison to the same the intrinsic value as computed. Using last sale of £0.98 quoted price from stock exchange by the company (Kingfisher, 2008a) as against £0.66 intrinsic value, the stock price of Kingfisher may be concluded to be overvalued by £0.32 per share. If the price using P/E reciprocal is used, where the intrinsic value of £1.37 was found, the stock value of the company's stock may be asserted to be undervalued by £0.39. It would appear that there is over or undervaluation depending on the formula that is used.

3.2 Conclusion

Using CAPM model, this paper discovered that Kingfisher has a required rate of return of 16.875% or using the P/E reciprocal to be 11.76%. The resulting prices of stock using these two discount rates led to the discovery that the company's stocks are indeed overvalued or undervalued depending on the method compared with quoted price from the London Stock Exchange. This would mean that holders of the present stocks of the company would be advised to dispose of their stocks if the CAPM method is used on valuation since there was a finding of overvaluation of £0.32 per share or keep their stock if the P/E reciprocal is used because of

undervaluation of £0.39 per share. For the purpose of this paper, this researcher believes that the use of CAPM is more accurate than simply getting the reciprocal of the P/E ratio, then this paper adheres to the finding of overvaluation.

Given the failure of the company to prevent the declining sales and low profitability as well as declining liquidity, the overvaluation may be in order. Investors are therefore advised to dispose of their stocks from Kingfisher based on the finding of overvaluation.

4. Appendices

Appendix I- Competitors data and averages

Appendix II- Computation under Dividend discount model

Appendix III- Computation of dividend growth rate

Source: MSN, 2008b

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