Financial comparison of uk clothes retailers

Introduction

Growing economic recession has adversely impacted the entire clothing sector as consumers are more wary of their purchases and prices offered by clothing retailers (Mintel, 2007). Despite this downturn, NEXT and M&S captured the greatest market share during 2007 and 2008 (Mintel, 2008). This paper assesses financial performance of NEXT and M&S by analyzing financial ratios and share price information, for previous 3 years and financial indicators will review profitability, efficiency, liquidity and stability of both companies. Share performances are analyzed by scrutinizing share price trends along with an evaluation of Earnings per share and Price to Earning Ratio. In this context, the paper uses secondary data sources such as Mintel, Keynote, FAME, journals and newspaper articles, along with primary resources, comprising of company annual reports.

Company Overview

M&S

M&S originated during 1884 as a small stall in Leeds where all products were sold for a penny (Burt, 2002) and has been established as UK's most flourishing retailer of clothing, home-ware and food. Despite turbulent economic conditions, M&S recorded tremendous success and is the most preferred brand by consumers. This has been achieved by consistent focus on product quality, value for money and customer services (M&S, 2008). According to a report by Mintel, M&S accounts for 10. 5% of total clothing spending by consumers and 43% of the total consumers, shop at M&S outlets (Mintel, 2008). During late 90's and early 2000's, M&S experienced deteriorating financial performance due to fierce competition, poor supply chain management, inferior products and ineffective cost management. However, with appointment, Sir Stuart Rose, M&S has regained its eminent position in retail sector, primarily by, refurbishing and modernizing city centre outlets, aggressive advertising campaigns and store expansion (Mintel, 2008). Consequently, M&S reported net profit of £660m during 2007 which increased to £821m in 2008 (M&S, 2008). However, due to growing economic recession in UK, Christmas spending on clothes and other accessories, appeared more subdued and M&S recorded a slow-down in sales (Hamilton, 2008).

NEXT

Next is UK's second, most preferred clothing retailer, after M&S. The company has differentiated itself from competitors by specializing in designing stylish outfits with a contemporary look, offering a good value for money to customers (Mintel, 2008). Next has diversified its portfolio through Next Directory and website with over 2 million customers accessing their website on a daily basis (Next, 2008). It started its retail business during 1982; predominantly specializing in women clothing and accessories, it quickly expanded its product range catering men and children. However, Next has not been quite successful in positing itself in the market as it lacked focus of changing market trends (Lindsay, 2009). It has therefore, lost considerable market share since late 90's, due to poor cost control and aggressive pricing strategy that restrained consumer spending (Next, 2006). In order to progress further, Next has been expanding its retail business by opening more outlets across UK. Consequently, it reported £331m profit for 2007 which increased to £354m in 2008 (Next, 2007). According to a report by Mintel, Next reported a 27% market penetration and has out-performed Primark and Asda (Mintel, 2008).

Financial Ratio Analysis of NEXT vs. M&S

Traditional ratio analysis assists in a thorough assessment of a company's financial position and insolvency situation (Bragg, 2007; Atrill & McLaney, 2007). Table 1. 1 lists profitability ratios for critically evaluating the financial performance of Next and M&S.

It can be inferred that gross profit margin (GPM) for Next, gradually increased from 15. 1% in 2006 to 16. 1% in 2008, as growth in revenues exceeded rise in cost of sales (Next, 2008). Revenue growth can be attributed to Next's high pricing strategy resulting in efficient savings coupled with improved core business operations (Financial Times, 2007). In contrast, GPM for M&S augmented from 38. 3% in 2006 to 38. 6% in 2008. Even though GPM increased gradually but it was substantially higher compared to Next. This difference can be attributed to M&S moderate pricing strategy and superior supplier relationships (M&S, 2008). However, economic downturn and prevailing recession inflicted a pressure upon profit margins for both companies during the last quarter of 2008 (Mintel, 2009).

Next's Operating profit margin depicts a similar trend and increased approximately 1. 1% from 2006 to 2008 implying that core business operations were profitable. OPM increased as Next inflated product prices that augmented earnings before interest and taxes. Average selling prices were raised more rapidly during 2007/8, attributing to greater percentage rise in OPM, as compared to 2006 (Next, 2007). Opposed to Next, OPM declined by 1. 2% for M&S in 2007 (M&S, 2006) primarily due to high operating expenditure and promotional expenses that exceeded growth in revenues. However, M&S OPM increased to 14% in 2008, due to effective cost management that improved profitability of its core business (Mintel, 2009).

Next’s ROA remained almost static from 2006 to 2007 but improved slightly, during 2008. Therefore, for every £1 of investment in assets during 2006/7, Next generated £21 profit, which increased to, approximately £22, during 2008. Fluctuations in ROA must be attributed to changes in net profit margin (NPM) and total asset turnover (Horne & Wachowicz, 2009). Therefore, ROA deteriorated in 2007 mainly due to decline in total asset turnover. Even though total asset turnover reduced in 2008, but Next’s ROA increased due to higher NPM. Therefore, Next’s management seems to utilize assets efficiently, but acquiring more assets through store expansion, can escalate costs with a resultant decline in after tax profits and reduction in ROA. In comparison, M&S ROA increased from 2006 to 2007 as the management utilized assets effectively to generate sales. However, M&S only generated £12. 5 profit for £1 invested in assets which decreased to £11. 5 in 2008. During 2008, even though M&S depicted continuously rising NPM, ROA reduced due to a drop in total asset turnover. Lower ROA for M&S is also due to growing recession which adversely impacted Christmas sales in 2008 and turnover did not increase as substantially as expected (Keynote, 2008; The Economist, 2008). According to these results, Next appears to generate greater profits for each pound invested in assets implying that resources are allocated more effectively to generate revenues, compared to M&S.

Return on capital employed for Next, illustrates a trend similar to ROA and deteriorated by 8% during 2007 implying that Next's profits reduced by £5 for every £1 invested in business operations (Hudson et al., 2008). However ROCE increased tremendously in 2008 and Next generated £85 for every £1 pound of capital invested. In contrast, ROCE for M&S increased during 2007 compared to 2006 but fell by 6% in 2008; therefore M&S generated approximately £1. 4 less revenue for every £1 invested in the business. Compared to Next, ROCE is much lower because capital employed increased more rapidly than earnings before interest and taxes. Therefore, in 2008, Next earned 87% on capital investments, while M&S earned only about 23%.

Efficiency ratios are crucial in analyzing how effectively resources invested in fixed assets and working capital are utilized (Williamson, 2006). From table 1. 2, total asset utilization figures for Next explain, that for every pound invested in assets Next generated approximately £20 in 2006 which reduced to £14 in 2007. However in 2008, Next generated a tremendous £53 for each pound of asset investment primarily because average selling prices were raised, resulting in higher turnover that exceeded capital employed. Also Next's website and Directory sales grew tremendously. Conversely, high TAU also suggests that Next might be over-trading on its assets to some extent. In comparison, TAU for M&S indicates a declining trend; therefore assets are not being used quite productively for revenue generation. From 2006 to 2008 TAU fell 27% as capital employed exceeded revenues. While Next generated £53 of revenues for each pound of asset investment, M&S was only able to generate £2. It is inferred that from 2007/8, eroding consumer confidence, inflicted a pressure upon M&S prices which deteriorated sales to a greater extent as compared to Next (Lakhal & Pasin, 2008).

In context of fixed asset capacity, Next utilized its assets efficiently for revenue generation. The ratio fell slightly during 2008 and Next was generating 47p lesser revenues for every £1 invested in fixed assets. This slight difference is attributed to capital invested for store expansion, which increased fixed assets more than sales, during. In contrast, FA capacity for M&S deteriorated from 2006 to 2008; therefore M&S was merely breaking-even by covering its expenses and generated average revenue of £2 for every £1 invested in fixed assets. It is evident that M&S used fixed assets less efficiently to generate sales and this is due to acquisition of more fixed assets through store expansion while revenues were restrained as a result of recession and heavy discounting by the company (The Economist, 2008). Therefore on average, fixed assets generated less revenue for M&S, compared to Next.

It is observed that Next's Debtor's turnover increased gradually by 7. 5% from 2006 to 2008. In 2008, debtors took 1 month and 3 weeks, to pay back debts, representing an increase of 3 days, since 2006. This trend is attributed to deepening recession that reduced paying capacity of customers who paid off debts at much slower pace than previous years. Therefore, Next's debt collection policy must be effective enough to retrieve credit given out to customers. M&S has been able to manage debtors more effectively in comparison to Next as debtors have been paying off within an average 3 days' time. Debtor turnover for M&S decreased by a day from 2006 to 2007, and increased by only half a day in 2008, which is quite reasonable considering the fact that businesses and customers are adversely affected by economic slump.

Since 2006, Next has been paying off liabilities rather slowly (within 3 weeks). During 2008, Next took a day less to pay off creditors, compared to 2006, primarily due rising revenues that slightly exceeded accounts payable. Compared to Next, M&S creditor turnover has not exceeded more than 11 days and liabilities were paid off more rapidly during 2008. The ratio decreased by 3 days in 2007-2008, implying that suppliers were paid more quickly during 2008. This is attributed to M&S appraisal of suppliers' terms and conditions in an effort to develop superior supplier relationships. Compared to M&S, Next took much longer to pay back suppliers due to delayed customer payments. However, both companies have reduced their payback time which is crucial in maintaining superior supplier relations but if the trend persists it might imply that free credit by suppliers is not efficiently utilized.

Next's stock turnover depicts gradual reduction due to its tight inventory control policy (Trading Markets, 2009). During 2008, Next cleared underlying stocks within 46 days; a reduction of 5 days since 2006. Next's increasing selling prices adversely affected consumer spending and stock turnover reduced just by a day in 2008 (Financial Times, 2007). In comparison, M&S depicts an average stock turnover of 28 days over the past 3 years, implying that outstanding stock was sold within a month. Therefore, M&S is more efficiently managing and allocating resources compared to Next. Even though it took 3 more days to clear off stocks in 2008, it was still reasonable, compared to Next; primarily because M&S adopted a moderate pricing policy during recession when paying capacities have contracted hence customers have a greater preference for its products (Financial Times, 2009).

Current and quick ratios for M&S are much lower compared to Next. It is inferred that during 2008 Next had only 94p for every £1 of liabilities while it had £1. 33 available in 2007. According to Atrill and McLaney (2007), minimum liquidity ratio should be 1: 1 and based upon this benchmark, Next depicts deteriorating liquidity as it had insufficient cash to cover short term obligations during 2008. This is also because debtors took more than a month to pay back cash, hampering Next’s liquidity position. However, M&S liquidity situation is worse as both liquidity ratios reduced considerably since 2006. After deducting current liabilities, M&S only had 27p available for every £1 of liabilities which increased to 35p in 2008. These results for M&S are much lower than the benchmark ratio, primarily because investments in current assets are too low (Ganesan et al., 2009). Both companies depict inferior liquidity position where the management is not utilizing resources efficiently resulting in a greater liquidity risk for M&S compared to Next.

Next appears highly geared; it depicted a significant rise in gearing from 231. 8% in 2006 to negative 1148. 7% in 2008. This is due to considerable reduction in retained earnings that reduced by 19% in 2008 together with persistent borrowings which exceeded shareholder funds. Gearing ratio augmented as Next borrowed excessively for financing store expansion which increased long term debts. As gearing is exceeding 50% it indicates substantial bankruptcy risk for Next. Gearing ratio for M&S also indicates that, investments are mostly financed by borrowing rather than shareholder funds. Gearing fell to 157% in 2007 due to greater use of equity financing but increased to 177% in 2008 when borrowings exceeded shareholder funds. Even though M&S gearing also exceeded the 50% benchmark, it is better-off than Next as it has greater shareholder funds and retained earnings and utilizing them effectively. M&S therefore, entails lower bankruptcy risk compared to Next. This might result in demoralization of shareholders as they perceive Next is loosing its business stability in currently prevailing economic situation (Kopalle et al., 2009).

Closing share prices for both companies deteriorated from 2006 to 2008 due to economic uncertainties. Worsening economic crisis resulted in M&S share price to drop from £7. 2 in 2006 to £2. 1 in 2008; causing a significant reduction in share price, of approximately 71%. Similar trend was observed for Next, where share price declined from £16. 9 in 2006 to £13. 8 in 2008; reporting a decline of approximately 18%. Compared to M&S, Next's share price declined by a much lower percentage and shares were traded at relatively higher prices from 2006 to 2008. Where Next's maximum share price was £19. 5 in 2007, M&S reported a share price of £5. 6 which declined to £2. 1 in 2008. Consequently, Next's P/E ratio was higher as its share prices are relatively higher than M&S; hence Next's shares appear to yield higher returns and attract investors. Nonetheless, P/E ratios for both companies have declined since 2006 implying that investors might be unwilling to invest in company shares if the trend persists (Yorkshire Post, 2008). However, Next is highly geared compared to M&S and share prices might fall even further as investors perceive higher risk of investing in Next's shares. EPS for Next and M&S increased from 2006 onwards as both companies reported rising after tax profits which exceeded growth in number of outstanding shares. The primary reason for rising EPS in 2007 for both companies pertains to a rising ROCE value which reduced in the subsequent year. Compared to Next, M&S has lower EPS during 2008 so from an investment point of view, investors might be more willing to invest in Next’s shares.

Since 2005, M&S shares have been out performing the market and were well correlated with FTSE 250 index. However the trend reversed after 2007 when shares underperformed the market explaining falling share prices. Next’s shares were also well correlated with FTSE 250 but unlike M&S, they have not yet out-performed the market and share prices have been falling after 2007 due to economic slowdown (Shen, 2000).

Conclusion

From the above analysis it is evident that both Next and M&S are confronted with deteriorating financial performance. Share prices are falling and performance is adversely affected causing investors to become cautious of their capital investments (Verdict, 2008). Therefore, retailers must take account of consumer’s purchasing capacity, and aggressive pricing strategies during economic slowdown, might erode turnover, as consumers divert towards cheaper quality products at lower prices. Next and M&S must revise their investment decisions and utilize existing resources efficiently to maintain their competitive edge. Expansion plans can escalate financial costs and will induce more borrowing; therefore both companies must wisely invest capital in productive projects.

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