

An equity valuation and analysis of kroger co.



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BUSTER**

Investment Recommendation: Overvalued; Sell 11/01/07
 KR - NYSE (11/1/2007):

52 Week Range:

Revenue:

Market Capitalization:

Shares Outstanding:

Percent Institutional

Ownership:

Book Value Per Share:

ROE:

ROA:

\$28.		20	
\$21.	12	-\$31.	94
\$66,	111		M
\$20.	16		B
\$715		M	
81%			
6.		89	
22.		65%	
5. 26%			

Cost of Capital Est.

Estimated:

3-Month

1-Year

2-Year

5-Year

7-Year

10-Year

R2

Beta

Ke

-0. 0078

0. 0233

0. 0230

0. 0227

0. 0225

0. 0223

-0. 7051

-0. 724

-0. 6997

-0. 6980

-0. 6974

-0. 6964

-1. 29%

-1. 11%

-0. 08%

-1. 30%

-1. 21%

-0. 17%

Published

Beta:

Kd(BT):

WACC(BT):

1. 05

13. 90%

8. 50%

WACC(AT): 7. 75%

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2002

3. 26

Altman

Z-Score

2003

2004

3. 18

3. 17

Valuation

Estimates

Actual Price (11/1/2007): \$28. 20

Financial Based Valuations

Trailing P/E:

\$27. 79

Forward P/E:

\$22. 09

P. E. G.:

\$18. 86

P/B:

\$17. 07

P/EBITDA:

\$45. 17

P/FCF:

(\$41. 14)

EV/EBITDA:

\$28. 36

Dividend Yield

\$21. 25

Intrinsic Valuations

Discounted Dividend:

\$6. 82

Free Cash Flows:

\$85. 37

Residual Income:

\$9. 03

LR ROE:

\$20. 48

AEG:

\$7. 73

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2005

3. 62

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2006

3. 81

Industry

Analysis

The retail grocery sector is a highly competitive industry. Kroger Company's top competitors are Safeway (SWY), Supervalu (SVU), Whole Foods (WFMI), Wal-Mart (WMT) and Winn Dixie (WINN). Kroger has to compete against 1,262 super centers, which are a growing trend in the market. The grocery store industry is highly competitive and profit margins are narrow. Each firm in the industry offers almost identical products. Firms in the industry must compete on price. In order to be successful and capture market share, Kroger administers the strategy of costleadership. Kroger achieves cost leadership through economies of scale and scope, low-cost distribution, efficient production and minimizing research costs. Kroger's creates a competitive advantage by their ability to differentiate themselves. In the industry, a customer can walk across the street and purchase the same products; switching costs are very low. Kroger differentiates from competitors by excelling in product quality, product variety, and customer service. If Kroger can correctly utilize these success factors, they will be able to maintain their domination within the industry and acquire more market share.

Firms that have established themselves in the market place have experience difficulties through the year: including, differentiating their products, decreases in demand, high concentration, high economies of scale, and high fixed costs. A firm must have a well planned product mix to go with efficient operations to be profitable. Large companies and chains dominate the

industry. Small grocers can be effective if they develop a niche product or service. Companies already established in an industry have an advantage over new entrants due to the large investments that are required to begin operations. Large economies of scale, first mover advantages, access to distribution channels, and legal barriers are elements in the industry that new entrants must evaluate.

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In the US Retail Grocery Industry the threat of substitute products is almost non-existent. Though there are substitute means of getting food, such as fast food, restaurants, and convenient stores, the actual products sold within “grocery” stores usually are the same at all locations. The power with which buyers have affects a company’s business strategy greatly. It can determine whether or not they want to compete by differentiation strategy or low cost approach. The greater power the consumer has, the more the company is driven towards a low cost approach. The lower the amount of bargaining power, the more freedom the company has in determining what kind of strategy approach they wish to take.

Accounting

Analysis

The accounting analysis is conducted by analysis to gain an idea of a company’s flexible accounting policies, their actual accounting strategy, and their level of disclosure. Through this process, we can determine the quality of a firm’s disclosure, quality of a firm’s actual information, and any possible distortions. The key material used from the 10-K are the income statement, balance sheet, statement of cash flows, and the footnotes regarding key

accounting policies. A firm's key accounting policies should be linked to a company's key success factors.

Kroger Co. and the majority of its competitors have key accounting policies surrounding post-retirement benefit plans and their leases structure. This is a key accounting policy because a firm can hide the present value of pension obligations by using an aggressive discount rate. These benefit obligations can be affected greatly if the discount rate is overstated or understated. Kroger provides a very thorough disclosure in their 10-K as to how they assess the discount rates and benefit obligations owed to their employees. Kroger uses an outside consultant to assess discount rates; eliminating managers incentives to decrease these benefit obligations. These efforts demonstrate

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Kroger's initiative to disclose valuable accounting information; allowing their financial records to be more transparent. Kroger and its competitors are also given the choice of accounting for their leased property as either an operating lease or a capital lease. Capitalized leases are recorded as capital leased assets and liabilities on a firm's balance sheet, while operating leases are not. This can give managers an incentive to reduce their lease obligations and increase earnings for the period. The majority Kroger's leased assets are in the form of operating leases. For example, in 2007 Kroger will have operating lease payments of \$778 thousand compared \$57 thousand in capital lease expenses. Although Kroger uses operating leases on the majority of their leased facilities, these obligations are not significant when compared to the company's total assets and total liabilities.

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Kroger also showed \$649 thousand in operating lease expenses for the year 2006 (Kroger 10-K). This information is included in Kroger's detailed disclosure regarding their lease structures. The accounting flexibility within Kroger is based on their choice of using Operating Leases vs. Capital Leases and their ability to influence the discount rate on their Post-Retirement Benefit Plans. Kroger's flexibility in these areas gives them the choice of being more informative to investors or to hide the true nature of their activities. Kroger does a great job disclosing areas of accounting flexibility. Kroger's transparency has improved over the last five years; providing shareholders with valuable information.

Kroger's sales and expense diagnostic ratios show there are no major "Red Flags." For companies like Kroger, it is very difficult to manipulate sales because due to technology. Kroger's expense diagnostic ratios have not experienced any major changes the past few years and they provide no red flags to investors. Overall, Kroger does a very good job of disclosing the majority of their key accounting procedures to their investors and they also continue to increase the level of their exposure by implementing newly accepted accounting standards that are recommended by the FASB.

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Financial Analysis, Forecast Financials, and Cost of Capital Estimations The Financial analysis of a company is conducted by analyst and investors to gain insight into how a firm is performing compared to its competitors and the rest of the industry. This analysis requires the use of financial ratios to evaluate a company's liquidity, profitability, and capital structure. These ratios are compared against other companies in the industry in order to

determine company and industry trends. These trends are used as guidelines in the forecasting of a firm's financial statements. A company's cost of equity can be estimated using a Regression Analysis or the Back Door Method. The cost of debt is determined by allocating the appropriate weights and rates to debt items on a company's balance sheet. Plugging these values into the Weighted Average Cost of Capital formula will then provide an estimated cost of capital for a firm. The liquidity ratios provided in the financial analysis for Kroger indicate that Kroger and the retail grocery industry as a whole are not very liquid. Kroger's current ratio and quick asset ratio indicate that the firm does not have a substantial amount of current assets to pay off their current debt obligations. Although, due to Kroger's size and financial health, this should not scare away investors. Kroger's profitability ratios indicate that the firm is performing above its competitors and the retail grocery industry as a whole. Kroger's high gross profit margins, net profit margins, and return on equity ratios demonstrate the Company's financial strength over the last few years. Kroger's capital structure ratios show that the Company has continued to finance the majority of their capital expenditures through debt. Kroger is able to obtain debt financing rather cheaply due to their high credit rating.

In our ten year forecast of Kroger's financial statements, we used trends that were found in our financial ratio analysis. This required us to make assumptions for our forecasted financial statements that we felt were appropriate. A few assumptions we made regarding Kroger's forecasted financial statements include: a 6% sales growth each year, an asset turnover ratio of 3.30

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times, and that CFFO should be forecasted using the CFFO/Sales ratio. These assumptions allowed us to forecast the remainder of the forecasted financial statements and a detailed discussion regarding each statement is provided in the forecasted financials section.

In estimating Kroger's cost of capital we discovered that the regression analysis provided us with insufficient data in order for us to determine the cost of equity for the Company. We used an alternative technique, known as The Back Door Method, to determine Kroger's cost of equity. Kroger's cost of debt before and after tax was then determined by weighting each debt item and multiplying it by the appropriate rate. After finding Kroger's cost of equity and cost of debt we were then able to calculate the Company's Weighted Average Cost of Capital. Valuations

The last step in an equity evaluation is to determine the company's appropriate share price and to evaluate whether it is overvalued, undervalued, or fairly valued. This step requires analyst to use several different methods to value the equity of a firm.

In our equity valuation of Kroger, we began by using the Method of Comparables technique to take a quick glance at how the Company's share price compared to other companies in the industry. The trailing price to earnings and Enterprise Value to EBITDA ratios indicate that Kroger's observed share price of \$28.20, on November 1, 2007, is fairly valued with calculated share prices of \$27.79 and \$28.36. The forward price to earnings, price to book, dividend yield, and price earnings growth ratios all showed Kroger's observed share price as being overvalued with share prices

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of \$22.09, \$17.07, \$21.25, and \$18.86, respectively. The price to EBITDA ratio (\$45.17) was the only ratio that showed Kroger's observed share price as being undervalued and the price to free cash flow ratio (\$-41.14) was useless in our equity valuation.

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Our decision regarding the issue of whether Kroger's share price was overvalued, undervalued, or fairly valued was based on the Intrinsic Valuation Models. The discount dividend model generated an implied share price of \$6.82 on 11/01/07, indicating that the observed share price of \$28.20 is overvalued. This model is not the most accurate method to calculate Kroger's share price because Kroger's dividends are relatively small and the Company just started to pay dividends in 2006. The free cash flow model provided us with a share price of \$85.37 for 11/01/07 and indicates to investors that the observed share price is undervalued. This model is also inaccurate because Kroger's forecasted free cash flows are fairly high and when discounted back to the present they generate a very large firm value.

The residual income model gave us an implied share price of \$9.03 on 11/01/07, which shows the observed share price as being overvalued. This model is known to be the most accurate and we agree because of our confidence in our forecasted future earnings for Kroger. The long run return on equity residual income model gave us an implied share price of \$20.48 for Kroger on 11/01/07, which also shows that Kroger's observed share price is overvalued. This model uses forecasted book value of equity, long run ROE, cost of equity, and a long run equity growth rate in a perpetuity formula to determine a company's share price. The last model we used in

our equity valuation of Kroger is the Abnormal Earnings Growth Model. This model gave us an implied share price of \$7.73 for Kroger on 11/01/07, indicating that the observed share price is overvalued. This model is also considered to be fairly accurate because it can be directly linked to the residual income model. After evaluating our Intrinsic Valuation Models for Kroger, it can be concluded that Kroger's observed share price on 11/01/07 is overvalued.

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Business and Industry Analysis Company Overview

The Kroger Co. (KR), (or "The Company"), is one of the largest retail grocers in the nation. The Company was founded by Barney Kroger in 1883 and was incorporated a few years later in 1902. Barney Kroger believed in his credo to, "Be particular. Never sell anything you would not want yourself." Mr. Kroger's inspiration still stands strong with Kroger Co. He is still a big part of their success; achieving 60 billion dollars in sales annually. The Kroger Co. headquarters are in Cincinnati, Ohio.

"The Kroger Co. operates retail food and drug stores, multi-department stores, jewelry stores and convenience stores throughout the United States (OneSource)." Although Kroger is a multidimensional company the main portion of their sales comes from food products; about 95% of Kroger's total sales are associated with food stores that they own.

Kroger Co. has stores across 31 states in U. S. with 2,468 supermarkets, 779 convenience stores and 412 fine jewelry stores (10-K). Kroger Co. has multiple banner companies which include Kroger, Food 4 Less, King Soopers, <https://assignbuster.com/an-equity-valuation-and-analysis-of-kroger-co/>

Ralphs, Fred Meyer, Smith's, Baker's, Fry's, Dillions, QFC, and City Market. Kroger is a multidimensional company considered to be in the grocery industry. Kroger's revenue comes from their customers, who buy their products at price level. Kroger, who sells these products at the price level, in turn makes the difference between the price and cost of the product. Operational costs and distribution costs are two of the costs Kroger can profit from. The market cap for Kroger is 19.4 Billion, which is larger than Safeway, Supervalu, Whole Foods and Winn-Dixie. Wal-Mart blows out everyone for market cap however that is expected since they are a larger firm and compete in different areas, not just groceries. The graph below represents the price fluctuation over the last five years of Kroger and its competitors.

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The 2006 year for Kroger was quite impressive; growing by 5.6% in their supermarket sales. Kroger Co.'s market share increased as well (approximately over 70 points according to their 10-K). They increased on a volume-weighted basis by 65 points, which is a trend Kroger would like to continue. Kroger has an increasing trend in net sales through the past five years. The stock price for Kroger took a major jump from 2006 to 2007. The chart below shows Kroger's total assets, net sales, and stock price over the last five years.

2003

2004

2005

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2006

2007

Total Assets

20, 349

20, 767

20, 491

20, 482

21, 215

Net Sales

51, 760

53, 791

56, 434

60, 553

66, 111

Stock Price

15. 09

18. 53

17. 1

18. 4

25. 6

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Industry Overview

Retail	Grocery	Industry
Kroger	Company	
Industry	Competition	
Rivalry	Among Existing	Firms
Threat	of New	Entrants
Threat	of Substitute	Products
Bargaining	Power of	Buyers
Bargaining	Power	of
Suppliers		

Competitive Advantage

RETAIL	GROCERY	INDUSTRY
HIGH		
HIGH		
LOW		
LOW		
LOW		
HIGH		

PURCHASING & DISTRIBUTION

The chart above is an overview of the five forces model and Kroger’s competitive advantage. The retail grocery sector is a highly competitive industry. Kroger Company’s top competitors are Safeway (SWY), Supervalu (SVU), Whole Foods (WFMI), Wal-Mart (WMT) and Winn Dixie (WINN). Kroger has to compete against 1, 262 super centers, which are a growing trend in <https://assignbuster.com/an-equity-valuation-and-analysis-of-kroger-co/>

the market. “ WalMart is the leading seller of groceries in the country” (First Research). According to First Research, the industry has 70, 000 grocery stores with 40, 000 companies that operate them. However, the industry is concentrated, with the largest companies owning 70 percent of the grocery industry market.

In the grocery store industry, the stores have three different types of products to sell to customers in perishable foods, non-perishable foods, and nonfood items. The larger companies such as Kroger, Safeway, Supervalu, Whole Foods and Winn-Dixie buy their products from wholesale distributors or from the manufacturer. The choice depends on the relationships and contracts set in place.

When firms grow large enough, such as Wal-Mart, they have the ability to have their own distribution center. The grocery industry’s inventory system is very similar between all of the firms by keeping track of their inventory using computers and SKU’s. A growing trend in this industry is that retail grocery stores are beginning to compete more heavily in their fuel centers. This has led

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to an increase in their overall profitability due to the fact that being able to fill up with gas at your local grocery store is convenient for consumers.

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Five

Forces

Model

The Five Forces Model is a tool used to analyze the structure and identify profit potential in a given industry. The analysis will help determine the value

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drivers associated with the firm. The model is broken into two separate groups: Degree of Actual and Potential Competition and Bargaining Power in Input and Output Markets. The Actual and Potential Competition section of the model can be further divided into subgroups that include; Rivalry Among Existing Firms, Threat of New Entrants, and Threat of Substitute Products. These categories take an in-depth look at the competition in an industry and determine the profit potential of the industry. Bargaining Power in Input and Output Markets can be subdivided into Bargaining Power of Buyers and Bargaining Power of Suppliers. These five forces can help an analyst determine the structure and profitability of an industry. The chart below is a collection of the five forces in the retail grocery industry that will be analyzed in detail in the next sections.

Retail	Grocery	Industry
--------	---------	----------

Rivalry Among Existing Firms		
------------------------------	--	--

HIGH		
------	--	--

Threat of New Entrants		
------------------------	--	--

LOW		
-----	--	--

Threat of Substitute Products		
-------------------------------	--	--

LOW		
-----	--	--

Bargaining Power of Buyers		
----------------------------	--	--

HIGH		
------	--	--

Bargaining Power of Suppliers		
-------------------------------	--	--

MODERATE		
----------	--	--

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Rivalry among Existing Firms

The retail grocery store industry is a very mature and competitive market. Firms that have established themselves in the market place have experienced difficulty in differentiating their products, decreases in demand, high concentration, high economies of scale, and high fixed costs. In this highly competitive industry, a firm needs to have a well planned product mix to go with efficient operations to be profitable. Large companies and chains dominate the industry. Small grocers can be effective if they develop a niche product or service.

Industry Growth

% Change in Sales Growth

Five	Year	Industry	Growth
5			
4.		5	
4			
3.		5	
3			
2.		5	
2			
1.		5	
1			
0.		5	
0			

4. 1

4. 4

4. 1

2. 3

0. 4

2002

2003

2004

2005

2006

*Statistics are provided by First Research

The chart above is an illustration of the retail grocery industries growth during the previous five years. Industry growth is a very important component when determining the level of competition between existing firms in an industry. When industry growth is fairly stable, firms attempt to take market share from

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their competitors. When a firm captures more market share they are able to grow. Firms do not have to fight over market share for them to grow when an industry is expanding rather quickly. The retail grocery store industry has seen low to moderate growth over the past five years. For the past five years, the industry on average has grown at only 3. 1 percent a year

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(www. firstreasearch. com). The average growth of the industry is about the same as the average inflation rate on the entire economy. The industry must keep their growth rate above inflation to maintain the dollar value within the industry. Although growth rate has been low, the top ten retail grocery companies have grown at an average rate of 15. 31 percent (yahoo/finance. com). The low average growth rate is a direct result of the high concentration in the industry.

The retail grocery industry currently has 70, 000 operating stores and the number continues to increase with the vast expansion of supercenters. Wal-Mart has continued to increase their number of stores throughout the U. S. and has also increased their same store sales year after year. In 2006, Kroger closed down more stores than they opened but still managed to increase their same store sales the last few years. Most firms in the industry are closing down their weaker locations and investing their assets in store locations that have the most profit potential. Across the industry, average same store sales have continued to increase. This can be accredited to the diversification of grocery store. Stores are starting to offer a wider range of services; such as fuel centers, commercial banking, prepared foods, gift cards, and many other one stop shopping amenities. Companies such as Winn-Dixie are having difficulty competing with super centers like Wal-Mart and Super Target. The struggling retail grocers have experienced declines in sales and rapid store closings across the country. A major factor in the limited growth can be contributed to a slow U. S. population growth of only one percent a year in most areas (www. firstreasearch. com). The average

birth rates are at an all time low. The population flow from integration is the only factor that is fueling industry growth on a population basis. 17

For firms to grow in this industry it is very important for them to move large quantities of product. It is crucial to have the right product mix. Large retail grocers are able to efficiently buy and distribute their products in this low margin industry. This has made it very difficult for small grocery stores to enter the market and compete with large retailers on price. A small retailer must find alternate methods to compete on. Product prices are very important to compete, but low prices are not a necessity in the industry. In recent years, large retailers have seen the majority of their growth form the acquisition of small grocery chains ([www. firstreasearch. com](http://www.firstreasearch.com)). The chart below illustrates the retail grocery industries percentage of growth in sales over the past five years. Concentration

To determine whether an Industry is concentrated or not, it is important to analyze the number of firms in a market and their market share. Firms that are in industries with high concentration can coordinate and set prices that others must follow to compete in the market. If an industry has low concentration there can be extremely high price competition between the competing firms. The retail grocery industry includes 40, 000 companies that operate 70, 000 stores in the United States. The industry has high concentration; 50 of the 40, 000 companies hold approximately 70 percent of the market ([www. firstreasearch. com](http://www.firstreasearch.com)). Although the traditional grocery store industry is concentrated, firms have had to deal with Mass Merchants and Wholesale Clubs such as Wal-Mart, Target, Costco and Sam's Club entering the grocery market with low price strategies. These Mass Merchants

and Wholesale clubs have been able to take market share; they provide lower prices than traditional grocers. These industry giants have very efficient purchasing and distribution systems. As a result, retail grocery stores enter into price competition with these mass merchants and wholesale clubs; despite that they are in a high concentration industry. The chart below illustrates the level of concentration in the retail grocery industry. As can be seen, Wal-Mart has continued to increase their 18 market share in the retail grocery industry. Kroger has also continued to increase their market share and sales. Unfortunately, they are no longer the leader in grocery sales. Wal-Mart's recent conquest of world domination in this retail industry has caused them to surpass all other competitors; Wal-Mart surpassed Kroger in 2005.



0

2002

2003

2004

2005

2006

Year

*Statistics are provided by edgarscan. com

Differentiation and Switching Costs

In the retail grocery industry, it is very hard to differentiate yourself from your competitors because all the firms in this industry sell the same general products and have equal quality. These products include: perishable foods, nonperishable foods, and non-food items (www. firstreasearch. com). Retail grocery stores compete on price and increases in price could lead to the potential lose of customers due to the low switching cost in this industry. Switching cost are the costs associated with stopping your current operations in an industry and

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attempting to produce goods and services in a different industry. Switching costs are high in the retail grocery industry because firms in this market would find it relatively hard and costly to stop their grocery operations and engage in other retail activities. Companies wanting to differentiate

themselves in this industry need to select a unique product mix and offer more services such as; online ordering and gasoline stations.

Economies of Scale

TOTAL ASSETS

2002

2003

2004

2005

2006

Kroger

\$20, 102

\$20, 184

\$20, 491

\$20, 482

\$21, 215

Safeway

\$16, 047

\$15, 096

\$16, 377

\$15, 756

\$16, 273

SuperValu

\$5, 896

\$6, 161

\$6, 278

\$6, 153

\$21, 702

Winn Dixie

\$2, 790

\$2, 619

\$1, 987

\$1, 608

\$1, 670

Wal-Mart

\$83, 451

\$94, 808

\$104, 912

\$138, 187

\$151, 193

\$1, 213

\$1, 521

\$1, 889

\$2, 043

\$943

Whole	Foods	Market
*Numbers	in	Millions

*Statistics are provided by edgarscan. com

The chart above shows Kroger's and its major competitors total asset figures from 2002 to 2006. In many industries the size of the company is vital to their success and profitability. In the retail grocery industry, economies of scale exist with distribution efficiency and purchasing. By looking at the concentration of the market, where 50 of the 40, 000 grocery companies represent 70 percent of the market, it is evident that large companies dominate the industry (www. firstreasearch. com).

Large companies are able to thrive in this market

because they have significant buying power and very efficient distribution operations. Many of the larger retail grocers own and operate their own distribution centers (www. firstreasearch. com). These factors allow large retail grocery stores to charge lower prices than small and midsize companies.

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Although this is a large firm industry, small companies have and can compete effectively if they differentiate themselves from larger retail grocery store chains. Fixed-Variable Costs

The level of competition in an industry can be influenced by the companies

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fixed to variable cost. In industries where companies have high fixed costs to variable costs, they attempt to lower price to increase demand in their current stores in operation. In the retail grocery industry, the majority of retail grocery stores own and operate their own stores and distribution centers (www. firstreasearch. com). This increases firms' fixed cost in this industry because companies accrue maintenance and overhead cost. Although fixed cost can be relatively high in this industry, they are offset by the variable cost of goods sold. Cost of goods sold (COGS) is the second highest cost retail grocery stores encounter. Grocery stores need to move large quantities of products in order to be profitable in this low margin industry; leading to high inventory turnover and increased variable cost in this industry.

Fixed Assets/Variable Costs

The ratio of fixed assets to variable costs plays a large role for a company participating within the industry. The chart below shows the fixed asset to variable cost ratios for Kroger and their competitors.

Fixed Assets/Variable Costs

2003

2004

2005

2006

2007

Kroger

1. 10

1. 07

1. 08

1. 03

0. 99

Safeway

0. 97

0. 89

0. 92

0. 91

0. 98

Supervalu

1. 09

0. 96

0. 98

0. 80

1. 23

* The information comes from each company's annual 10-K

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The higher the ratio, the more focused the company is on central items within the firm. It is harder for them to break from this focal point. The lower the ratio, the more leeway the company has to go into different areas; they can distinguish themselves from the industry. If they feel that they are not successful, they have to sell the assets in that area and invest in other areas and try to make a profit. This is why companies tend to operate from operating leases instead of capital leases. It allows them to easily and readily exit the industry should the company operate poorly.

Kroger operates the majority of their leases on operating leases. This is why they report their variable costs are close to their fixed assets; explaining why they have a fixed asset to variable cost ratio of about 1: 1. In the grocery industry, fixed assets and variable costs are close in value. It is important for Kroger to maintain a ratio above 1: 1. A ratio below 1: 1 usually means that a firm is not operating efficiently. Kroger's ratio has declined over the last five years. This is a result of their growing operations that increase variable costs and the lack of investment into fixed assets. Kroger ratio shows consistency and reaches the desired 1: 1 mark. An analyst can see that Kroger is using efficiently using their fixed assets.

Excess		Capacity	
Same	Store	Sales	Growth
2002			
2003			
2004			
2005			

2006

KROGER

3. 32%

3. 92%

4. 91%

7. 30%

9. 18%

SAFEWAY

1. 36%

2. 26%

0. 27%

7. 24%

4. 60%

SUPERVALU

2. 38%

1. 64%

-3. 30%

5. 47%

-5. 58%

WINN DIXIE

0.78%

-1.30%

-0.04%

-6.69%

1.51%

WAL-MART

14.10%

12.55%

22.59%

9.75%

11.67%

18.40%

Whole

Foods

Market

*Statistics are provided by edgarscan.com

17.03%

22.78%

21.63%

19.27%

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The above table gives you the same store sales growth rates for Kroger and their major competitors. The majority of the companies in the chart above

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have been able to increase their same store sales growth year over year. These already established companies increasing sales growth every year indicates that the industry has not yet reached excess capacity.

Excess capacity can play a major role in determining the price competition in an industry. An industry is said to have excess capacity when supply is greater than demand. When supply is greater than demand, firms inside the industry tend to reduce prices in order to increase demand for their products and services. The retail grocery store industry is saturated with large retail stores and is reaching excess capacity. As a consequence of consumers having many different shopping alternatives, supply exceeds demand in the grocery store industry. Limited demand for grocery products can also be contributed to the U. S. population growing at only 1 percent a year (www.firstreasearch.com). As a result, many retail grocery companies have been cutting prices and offering discounts to increase demand in their stores. This makes it very difficult for small firms to compete because they do not have substantial buying power or the efficient distribution operations that large firms have. Exit Barriers

Exit barriers limit a firm's ability to exit an industry because of the high cost associated with their departure. Companies that have specialized assets that can only be used for the nature of their business could experience very high exit costs. The retail grocery store industry does not face high exit barriers because the majority of companies in this industry own and operate their stores and distribution centers. These stores are not considered specialized property and could be sold along with inventory if a company in this industry

decided to exit the market. There are also no costly regulations regarding leaving the industry.

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Conclusion

The retail grocery industry is a very mature market that is involved in intense competition. It is important for firms in this industry to create the right product mix and establish efficient distribution operations. Large retail grocers have a competitive edge in this industry due to their efficient distribution operations and their purchasing power. However, small firms can be competitive in this industry if they differentiate themselves by selling specialty products, providing superior quality goods, or by creating specialty services. Companies in the retail grocery industry deal with many critical issues such as: slow growth, high concentration, lack of opportunities to differentiate product offerings, low consumer switching cost, and a market that has high excess capacity. Threat of New Entrants

Companies experiencing substantially high profits face the threat of new entrants entering their respective industry. Other firms will attempt to capitalize on the profits other firms have achieved in the industry. In order to be successful, new entrants need to evaluate an industry before deciding to enter. Large economies of scale, first mover advantages, access to distribution channels, and legal barriers are elements in the industry that new entrants must evaluate. Companies already established in an industry have an advantage over new entrants due to the large investments that are required to begin operations.

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Economies of Scale

TOTAL ASSETS

2002

2003

2004

2005

2006

Kroger

\$20, 102

\$20, 184

\$20, 491

\$20, 482

\$21, 215

Safeway

\$16, 047

\$15, 096

\$16, 377

\$15, 756

\$16, 273

SuperValu

\$5, 896

\$6, 161

\$6, 278

\$6, 153

\$21, 702

Winn Dixie

\$2, 790

\$2, 619

\$1, 987

\$1, 608

\$1, 670

Wal-Mart

\$83, 451

\$94, 808

\$104, 912

\$138, 187

\$151, 193

\$1, 213

\$1, 521

\$1, 889

\$2, 043

\$943

Whole	Foods	Market
*Numbers	in	Millions

*Statistics are provided by edgarscan. com

The above chart illustrates Kroger's and its competitors total asset number over the past five years. New entrants evaluate the economies of scale to determine how competitive and profitable they can be in an industry. Industries that have large economies of scale make it difficult for new firms to enter the market because of the high cost associated with startup. The retail grocery industry has high economies of scale due to the large retail grocers having tremendous buying power and efficient distribution systems that allow them to reduce prices (www. firstreasearch. com). As a result, new entrants into this industry will find it difficult to compete with these large retailers pricing strategies.

First	Mover	Advantage
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Firms that enter a market early can have a competitive advantage over firms that enter the market late because they can set industry standards and establish exclusive selling agreements with suppliers. Companies can also create a first mover advantage by providing products and services that were not already available to consumers. In the retail grocery industry, companies are engaged in intense price competition and they all sell very similar products of the same

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quality. Given the relatively low consumer switching cost in this industry, it makes it very difficult to gain a first mover advantage in this market. New
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entrants into this market can gain a first mover advantage by providing differentiating products and services to consumers. New entrants can offer services such as take-out orders, loyaltycards, prepared foods, and internet shopping in order to increase their share of the market

(www.firstreasearch.com).

Distribution Access and Relationships

New entrants into an industry often face the critical issue of developing relationships with their distributors. Existing firms in an industry have an advantage over new entrants because they have established healthy relationships with their suppliers.

New entrants are faced with very high cost associated with the development of their distribution channels. Most firms in the retail grocery industry own and operate their distribution centers. This is a disadvantage to new entrants because the cost of establishing distribution centers is very high. These high distribution startup cost would not allow new entrants to compete effectively on price with the larger firms in this industry. Superb distribution access and relationships enables a firm to get their products on the shelves in an economically efficient manner.

To achieve distribution and access, a company must invest significant capital and expense dollars to ensure that their information systems and logistics network operate efficiently. A firm must have sufficient technology systems, labor forces, warehouse capacity, supply chains, and transportation abilities to operate a successful distribution. A firm's logistics network is vital to the distribution process. An efficient system can eliminate unnecessary setbacks in the distribution process. Grocery chains distribute their own products

throughout the company's stores. The grocery stores are able to supply the same products at a lower cost.

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Firms in the grocery industry operate their distribution of products on the same based system. Companies must have different locations that distribute various products. Firms must operate distribution centers that are close proximity to their final destination. These locations are for goods that are quick turn and perishables. Stores usually have separate distribution centers that concentrate on pharmaceuticals, health and beauty products, and dry grocery products. It is vital for firms to own and operate an adequate transportation fleet. A company must run enough trucks to transport needed inventories from distribution centers to their stores. Distributions processes in the industry greatly differ after the basics. Firms will implement techniques and strategies such as data warehouses, expanded software systems, voice-pick technology, label-base picking, real-time warehouse management, and global positioning systems

(www.firstresearch.com).

Relationships are crucial in a firms' distribution process. In the industry, grocery stores buy from manufacturers that use marketing strategies like product bundling, product lining, and family branding. It is very important to establish a good and positive relationship with these large manufacturers. A good rapport with companies, like Proctor and Gamble, can lead to purchase discounts and cheaper rates on procured items. It is also important to build a connection with advertising agents and brands that you offer. A company needs every opportunity to advertise their store name.

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Legal

Barriers

Legal barriers play an important role when firms are looking to enter an industry. New entrants into an industry need to be aware of these legal requirements to insure a smooth entrance into the market. New entrants into the retail grocery industry would be subject to regulations regarding state health departments, Food and Safety, and food inspection services of the FDA, OSHA, and USDA ([www. firstreasearch. com](http://www.firstreasearch.com)).

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Conclusion

New entrants into the retail grocery industry face many different challenges along the way to establishing a profitable company. A few of these challenges include large economies of scale with purchasing and distribution, costly startup purchases for distribution centers, and food health and safety regulations by US and state governments. New entrants into this industry can be effective if they sell specialty products or provide specialty services to help differentiate themselves from the rest of the market.

Threat of Substitute Products

In the US Retail Grocery Industry the threat of substitute products is almost non-existent. Though there are substitute means of getting food, such as fast food, restaurants, and convenient stores, the actual products sold within “grocery” stores usually are the same at all locations. With the exception of Mass Market Retailers, such as Target and Wal-mart, who sell to all areas of retail, or Warehouse stores, like Costco and Sam’s club, who sale food in bulk at discounted prices, you will find mainly the same products with miniscule

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variations on their pricing. That is why companies in the retail grocery industry, whose target market varies from low to high income families, do not perceive substitute products as a major threat. They carry all of the substitute products that are offered at other Retail Grocers.

Relative Price and Performance

Consumers tend to relate the quality of the product with the value and popularity of a brand. The more well known brands usually tend to be higher in cost due to the popularity of the product. However, an off brand product tends to be cheaper. Most retail grocery stores specialize in selling both products due to the fact that their market entails families reaching both ends of the income

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spectrum. This also increases the chance that a lower income family would choose a higher priced product or a higher income family would choose a lower end product due to the proximity of the products being next to each other. Because of intense competition, grocers have difficulty raising prices. Most grocers have direct competition in their market area. Overall, consumer food prices grew 20 percent in the last ten years, but in some years the increase was just 1 percent. (www.firstreasearch.com)

Buyer's willingness to switch

Substitute products are a way of life within the Retail Grocery Industry. You never tend to have on without the other. Consumers tend to have different wants and needs. For this reason, companies attempt to cater to all of their different needs. Whether or not it is a high priced named brand product or an off brand cheaper product, their costumers have the full range of products to

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pick and choose from due to their shopping nature. Adhering to all of their different customer's tastes and financial problems is the driving factor and motivator for the way Kroger stocks and sells their products.

Conclusion

Substitute products are not a major threat to the retail grocery industry because the quality of substitutes available is low. This is why these products do not pose much of a threat to the industry. The majority of the different retailers in the market carry the same general products. Due to the many different choices in food selection, with the exception of specialty type food vendors, tends to lead to the death of a particular company. With all of the choices within this day and age, you have to be flexible with what you are willing to sell in order to compete with the competition.

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Bargaining Power of Buyers

The power with which buyers have to affect the Retail Grocer Industry usually affects that company's business strategy greatly. It can determine whether or not they want to compete by a differentiation strategy or a low cost provider approach. The higher the amount of power that the consumer has, the more the company is driven towards a low cost approach. The lower the amount of bargaining power, the more freedom the company has in determining what kind of strategy approach they wish to take.

The percentage of food bought at food stores has been declining for decades, as changes in lifestyles have caused Americans to turn to other sources like restaurants, take-out, and convenience stores. Americans buy only 40 percent of their food at food stores, down from 45 percent a decade

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earlier (www. firstresearch. com). This has caused the industries growth of prices to come to a screeching halt. Because of this change in lifestyle, the consumer has more leeway to pick and choose what it wants when it wants it. This has caused the Grocer industries growth to slow down immensely. Overall, consumer food prices have only grown 20 percent in the last decade. (www. firstresearch. com) Because of the fact that the consumer has so much leeway with which to choose how to eat, the Grocer Industry has had to almost completely compete on a low cost approach against its other retail competition. This just shows how much power the consumer has.

Price

Sensitivity

Price sensitivity involves what the average consumer is willing to pay for a particular product. What the average value of that product is determined by a number of different things: production costs, labor costs, scarcity, and docking costs. Since the consumer has to eat everyday, there is a great need for the Grocer Retail Industry. The basis with which they will choose what to buy will be

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determined by which company has the product they desire at the price with which they are willing to pay for it.

Many of the different retailers, such as Kroger's, Randall's, HEB, etc., carry many of the name brand products that people typically wish to buy. They also each carry their own type of off brand item that is similar to the name brand item but which they can buy at a cheaper and more affordable price. They also utilize positioning within their stores to locate both the name brand items and their low cost version together so that they can choose either

brand. Ultimately it comes down to what the consumer wishes to allocate their money towards. What products they wish to take home at night. It all depends on what the consumer desires. However, if any of the companies choose not to follow this low cost approach, with all of the different options the consumer can choose for food consumption, they will surely collapse as a company. Relative Bargaining Power

The consumers bargaining power is determined by the numbers of consumers relative to the producers, the sheer amount of purchases by a single buyer, and the alternative " substitute" products available to the consumer. The problem that most grocers face is the fact that most grocers carry the same products. The consumers lose no money by purchasing their products at a different store location. Granted there are a large number of consumers within an area, still the simple fact that the industry is short on price growth feeds the fact that the stores must maintain a constant number of consumers at their store locations. Otherwise these companies are going to decline and eventually fall suspect to bankruptcy. Therefore the consumer tends to have a higher than normal level of bargaining power within this industry.

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Conclusion

Though there are many differing factors that contribute to how much power a consumer has over the producer, the main two that are dealt with are price sensitivity of products within the stores and the relative bargaining power which the consumer has over the stores. If a company truly wishes to

compete and make a profit within this industry, they must take these items into account and deal with them as they feel is necessary.

Bargaining Power of Suppliers

Bargaining power of suppliers is very important in an industry because it can determine the structure and pricing of industry products. Suppliers are said to have high bargaining power when the number of companies in an industry is relatively small and there are very few substitutes available. Suppliers can also have the upper hand when the supplier's product is superior to other products offered in the market. When suppliers have high bargaining power they can control industry prices and distribution schedules for firms in their respective industry. On the other hand, suppliers are said to have low bargaining power when there are many firms, a variety of substitutes, and companies in the industry sell similar products.

In the retail grocery industry, the bargaining power of suppliers is moderate. The majority of grocery stores have their own distribution centers; therefore they buy their goods directly from manufacturers. These manufacturers serve as the grocery stores suppliers. The manufacturers in this industry have some bargaining power because the products they produce are very desirable to the end consumer. If a retail grocery store does not sell a specific brand, this could lead to customers using a different store depending on how popular the brand. For example, Proctor and Gamble sell many different products to retail grocery stores that are in high demand by consumers. If a retail grocer did not

carry Proctor and Gamble products, many consumers would probably elect to use a different grocer. The reason suppliers have moderate instead of high bargaining power is due to the issue of manufacturers needing their products to be on grocery store shelves. Large retail grocery stores are very desirable for manufacturers because in order to be profitable and increase growth, manufacturers need to establish lasting relationships with large retail grocers. The industry as a whole experiences moderate supplier bargaining power because both retail grocers and manufacturers need each other equally. Price Sensitivity

Price sensitivity measures a supplier's/manufacturer's perception of price as it increases and decreases in the market. Suppliers want to sell their products at the highest possible amount that will generate the highest possible return. In doing so, suppliers engage in price competition with other companies selling products of the same quality. Suppliers will normally charge higher prices for specialty products or products that are more popular and generate the most demand by consumers.

In the retail grocery industry, most grocery stores buy their products directly from manufacturers who then ship products to the retailer's distribution centers. Manufacturers compete directly with one another in price competition in order to push their product on to the grocer's shelf. The retail grocery industry is a low margin industry, which means that they need to move their products quickly and efficiently in order to be profitable. Retail grocers also compete with each other on price and getting products at the lowest possible cost from manufactures allows them to compete with their competitors effectively. Large retail grocers have substantial buying power in

this industry and suppliers can not afford to be price sensitive if they want their products on display at these stores.

Quality plays a very important role in the price suppliers/manufacturers can charge retail grocery stores. Retail stores private label brands are the 33 highest margin products they sell and are the cheapest ones to purchase. Popular brands allow suppliers and manufacturers to charge retail grocers higher prices due to consumers demand for these products. These higher prices lead to an increase in the price grocers charge their consumers.

Relative Bargaining Power

Bargaining power is a major factor in an industry that can determine the final price of goods and services. The cost associated with not doing business with a supplier or retailer is a major issue involved in who has relative bargaining power in an industry. Suppliers have high relative bargaining power when they sell a specialty product that the buyer can not find elsewhere. This allows the supplier to charge a higher price for the specialty product because of the bargaining power they have over the buyer. Also, suppliers have high relative bargaining power when there are only a few companies in an industry looking to buy the products they sell and there is a lack of substitutes for their products. In the retail grocery industry, suppliers have moderate bargaining power with retail grocery stores. The industry has a variety of grocery stores and substitute suppliers are available. Suppliers have moderate bargaining power in this industry because consumer demand is high for many popular brand name products these suppliers/manufacturers produce. The reason the word " moderate" is used is be