

The investment ratios allow direct comparison of investments economics essay

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J Sainsbury Plc was founded in 1869 in London by John James and Mary Ann Sainsbury. It is one of the oldest food retailers in the UK and begun its operations by selling fresh foods. In 1882, Sainsbury's created its own brand products and nowadays more than 40% of their stocks carry the Sainsbury's brand. Over the decades, it has grown through innovation and consistent behaviour to the consumers. According to Sainsbury's (2012) annual report, the company operates 1000 stores, including 440 convenience stores and employs 150, 000 people.

2. 2 Operations

The firm entered the London stock exchange as J Sainsbury Plc in 1973. In 1997 Sainsbury's became the first food retailer to own a fully licensed bank called Sainsbury's bank which is jointly owned with Lloyds Banking Group. In 2012, the Sainsbury's bank gained pre-tax operating profit of 40%, Sainsbury's annual report (2012). Also, the company engaged in property, energy and pharmacy. Nowadays, Sainsbury's diversified its initial purpose including non-food products such as womenswear, childrenswear, home appliances, papershop and seasonal products. The main aim was to provide high street style at supermarket prices. Sainsbury's also started operating online food and non-food shopping. The facility to order online and pick up the items in store at a time convenient to each customer has proven to gain the preference of the consumers. In 2011, Sainsbury's challenged its operations by introducing Sainsbury Energy. The aim of the new venture is to offer energy products and advice customers for the efficient use of energy. The year 2012 was also a lucrative period for the company. Sainsbury's became a partner in Tamar Energy Ltd which converts waste into energy,

Sainsbury's annual report (2012). The same year, Sainsbury's with the help of Global Media Vault Ltd created Sainsbury's Entertainment website. There you can download music, films, books as well as games.

2. 3 Goals

The main goal of Sainsbury's is to satisfy the needs of customers every day by providing great quality in all services at affordable prices. Their vision is to be the most reliable retailer where people enjoy to work and shop, Sainsbury's annual report (2012). The Chairman of Sainsbury's, Tyler (2011), indicated that Sainsbury's created " Sainsbury's 20x20 Sustainability Plan" which includes 20 targets that they want to fulfill by 2020 and aim in live well for less. The commitments were designed according to previous targets as well as to recent issues faced by the company.

3. 0 Ratio Analysis

This section will analyze the financial performance of Sainsbury's based primarily on performance ratios as well as ratios based on the company's profit. The decision whether to invest on Sainsbury's or not will be based on the ratio analysis and the study of non-financial information. The determination of the business characteristics in terms of risk, efficiency and sustainability is the ultimate objective of the ratio analysis. The sources for this analysis are the income statements, balance sheet and cash flow statement which are found in the annual report of Sainsbury's. The ratios are then interpreted in order to arrive at a comprehensive conclusion.

3. 1 Profitability Ratios

Table 1: Profitability Ratios of Sainsbury's 2011-2012

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Sainsbury's

2011

2012

Operating Profit Margin(%)

4. 03

3. 92

Gross Profit Margin (%)

5. 50

5. 43

ROCE (%)

10. 06

9. 50

Sainsbury's which is basically a food retailer operates on low prices, thus the profit margins were relatively low. A higher value of GPM means the company generates effectively sales to increase profits. The gross profit margin had been slightly decreased from 5. 50% in 2011 to 5. 43% in 2012 due to the increase of cost of sales which was higher than the increase of revenue. The sales revenue was increased by 5. 64% and this was because the company moved to other areas such as banking, pharmacy and property. The figure also showed higher demand on Sainsbury's products and services. Also, the cost of sales was increased by 5. 72% and this was mainly due to the inflation's effect on direct costs as well as the increase of fuels and electricity. The GPM of Sainsbury's implied that the firm could cover administrative expenses but could yield more profit. The same factors

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affecting the performance of gross profit margin such as fuels and electricity also affected operating profit margin. The operating profit margin was 4.03% in 2011 and in 2012 has been decreased to 3.92%. The operating profit margin and gross profit margin are basically driven by sales. Although, the sales revenue had been increased from £21,102m in 2011 to £22,294m in 2012, the reduction of other income from £108m in 2011 to £82m in 2012 due to disposal of properties and the increase of administrative expenses from £417m to £419m led to the overall decrease of OPM. By excluding other income, the company improved operating profit. In fact, the similar figures of administration expenses are as a result of improved productivity and simplification of in-store procedures, Sainsbury's annual report (2012). The declining figure of OPM was not distressing as other retailers in the market were experiencing similar effects due to the price increase of raw materials. Furthermore, ROCE calculates the effectiveness of the new invested monetary assets as well as the scheme in which the existing monetary capital conveys income. The higher the figure, the more productive is the capital employed. As illustrated in Table 1, there was a decline from 10.06% in 2011 to 9.50% in 2012. The non-current liabilities which affected ROCE were 53.27% of total liabilities in 2012 compare to 50.76% which were in 2011. This was due to long-term borrowings which were used efficiently by Sainsbury's to invest in revenue generating assets like new stores. These stores have initially dilutive impact on profits but as the stores mature the value of capital employed becomes higher which is favourable to investors, Sainsbury's annual report (2012). Equally important was operating profit which was increased despite the growing competition in

the industry and the inflation effect during 2012. Another factor that affected ROCE was the total equity which was increased to £5, 629m in 2012 mainly due to retained earnings. Provided that total equity was higher than long term debt, the firm is protected from liquidity problems. Hence, Sainsbury's utilizes appropriately the money invested into the firm. The economy of the United Kingdom has been struggling in the past year as Philip Clarke, the chief executive of Tesco stated, Ruddick (2012). Hence, the profitability ratios illustrated a minor decline but Sainsbury's committed to make strict controls in spending, manage the costs of expanding workforce and deal with inflation to improve margins and ROCE.

3. 2 Efficiency Ratios

Table 2: Efficiency Ratios of Sainsbury's 2011-2012

Sainsbury's

2011

2012

Asset Turnover

2. 5 times

2. 42 times

Trade Receivables

1. 6 days

1. 8 days

Trade Payables

33. 42 days

32. 75 days

Asset turnover ratio gauges the efficiency of the firm in employing its assets in order to generate revenues. The higher the number of the ratio means a higher growth rate for the company. As shown in Table 2, Sainsbury's asset turnover in 2012 was 2. 42 times and in 2011 was 2. 50 times. This is because company invested in new capital expenditure on extra space which produced further increase in sales and profits. However, during Christmas the company appealed a strong market beating performance, Sainsbury's annual report (2012). Although, the inflation rate and petrol prices rose during 2012 and customers struggled, the sales of Sainsbury's were increased. Consumers are stressed with the fact that at least 10% to 25% of their monthly bills are tendered to groceries, Shah (2011). For this reason, Sainsbury's offers promotions and benefits to customers like the Nectar <https://assignbuster.com/the-investment-ratios-allow-direct-comparison-of-investments-economics-essay/>

loyalty card. Trade receivable days measure how long it takes a company to collect money from its debtors, Atrill and McLaney (2009). As the credit days become less, the company has more liquidity. Sainsbury's trade receivable days has increased slightly in 2012 to 1.8 days from 1.6 days which was in 2011. This was mainly because the increase of revenue, which was £22,294m in 2012 compare to £21,102m in 2011, was higher than the increase of trade receivables which became £110m in 2012 from £93m in 2011. However, the figures are very low due to the fact that Sainsbury's is a supermarket and almost all transactions are in cash, only £110m of current assets are related to debtors. As indicated in Sainsbury's annual report (2012), the credit risk is minimal because of the dissimilar large base of clients and the majority of transactions are in cash or through JCC systems. Trade payables days measures the credit period taken by a company to pay its suppliers. In 2012 the payable period was 32.75 days whereas in 2011 it was 33.42 days. The average industry payable days are more than 80 days. This decrease was ascribed to the better terms of payments agreed with the suppliers and Sainsbury's. Despite the fact that trade payables increased in 2012 by 3.6%, payable days slightly decreased due to the fact that purchases increased by 5.8% to £21,209m. The figures implied that the company receives payments from its debtors before paying back the suppliers and so Sainsbury's has no liquidity problems. Recently, Sainsbury's extended its payment terms to suppliers. Hurley (2012) criticized that by saying suppliers will wait twice as long for payment due to the extension of payments to 75 days. This move was actually done by Sainsbury's in order to improve their cash flow position. Besides this, they are still ahead of their

competitors who have an average of 100 days. As reflected in Sainsbury's liquidity ratios it can be concluded that the company has enough to pay their debts.

3. 3 Liquidity Ratios

Table 3. Liquidity Ratios of Sainsbury's 2011-2012

Sainsbury's

2011

2012

Current Ratio

0. 58

0. 65

Quick Ratio

0. 31

0. 35

The liquidity ratios can help prospective investors to assess whether the company has power to generate monetary assets quickly so as to pay current debts. Current ratio compares liquid assets with current liabilities, Atrill and McLaney (2009). The figures presented in Table 4 showed that Sainsbury's has increased its current ratio from 0. 58: 1 in 2011 to 0. 65: 1 in 2012. The change of current ratio was due to the fact that the increase of the value of current assets from £1721m to £2032m was higher than the increase of current liabilities which were £2942m and became £3136m. The current liabilities were increased due to the extra borrowings acquired by the

company which were £76m more than 2011. Likewise, the increase of current assets was due to the increase of cash as well as the increase of inventories which were £938m in 2012 compared to £812m 2011. The goods held for sale were £100m more than 2011 and this was because the fiscal year ending for Sainsbury's was before Easter period. Also, new development properties were £22m in 2012, a figure that was zero in 2011. The quick ratio takes into account the fact that some inventories cannot be converted into actual sales or cash rapidly. The more times you can cover your liabilities the more beneficial it is for the firm. The usual level for liquidity ratios is 1.0 times but for food retailers is usual to be less than 1. In Table 4, the quick ratio in 2012 was 0.35: 1 compared to 0.31: 1 in 2011. This was due to the fact that the excluding inventory changed in 2012. It can be implied that Sainsbury's did not face liquidity risk since the liquidity ratios were above the average industry which were 0.50: 1. The ability of a company to meet short-term debt is the primary concern for investors. The company deals its liquidity risk by maintaining a core of long term borrowings, pre-funding prospect cash flows and holding satisfactory standby liquidity, Sainsbury's annual report (2012).

3.4 Gearing Ratios

Table 4. Gearing Ratios of Sainsbury's 2011-2012

Sainsbury's

2011

2012

Gearing Ratio

35. 86%

38. 84%

Interest Cover

7. 34 times

6. 33 times

Gearing ratios allow potential investors to examine the financial health of Sainsbury's through its capital structure. Through these ratios an investor can compare the company's equity in relation to borrowed funds, Atrill and Mclaney (2009). Sainsbury's gearing ratio was 35. 86% in 2011 and 38. 84% in 2012. There was an increase of 3% as a result of the higher net debt. The net debt was due to the new revenue generating assets. Further, total equity in 2012 had higher figure than non-current liabilities and this raised the value of share capital. The long term debt consisted of additional 9. 10% borrowings in 2012 compare to 2011 and £70m more finance leases in 2012. It can be noted that Sainsbury's is below the industry average and thus is considered non-risky firm. Interest cover has decreased to 6. 33 times in 2012 compare to 7. 34 times in 2011. This is due to the 19% increased of finance costs in 2012 than 2011. Furthermore, borrowings have increased by £354m more in 2012, thus the company had to paid more interests.

Sainsbury's low interest cover can also be attributable to the high level of

gearing ratio which made profit sensitive to changes like the reduction of operating profit margin and the increase of administrative expenses. Besides this reduction, the company could cover its interest payments because the operating profit was higher than interest payables. Sainsbury's performance in gearing ratios can be related to the fact that the company has integrated new objectives of financing and new profit-producing assets such as new stores. Comparing to the gearing of the sector which was 42.88% in 2012, Sainsbury's was considered low financially leveraged company than its competitors as it cover its interest expenses well.

3.5 Investment Ratios

Table 5: Investment Ratios of Sainsbury's 2011-2012

Sainsbury's

2011

2012

Earnings per Share

34. 4p

32. 0p

Dividend yield

4. 10%

4. 16%

Dividend cover

2. 4 times

2. 1 times

The investment ratios allow direct comparison of investments and the creation of trading strategies like removing inventories that are not selling well. The earnings per share reflect the return on a single share acquired by a shareholder. In 2012 the earnings per share were 32. 0p compared to 34. 4p in 2011. This decline can be attributed to the facts that the overall profit was decreased by £42m in 2012 and also the company issued more shares in 2012 compared to 2011. Dividend yield reveals how much an entity pays out in dividends each year relative to its share price, Atrill and Mclaney (2009). Investors who seek to secure a minimum cash flow from their investments can look for companies that pay relatively high stable dividend yields. Sainsbury's dividend yield rose to 4. 16% in 2012 from 4. 10% in 2011 as opposed to its industry average which was 3. 73%. The increment in <https://assignbuster.com/the-investment-ratios-allow-direct-comparison-of-investments-economics-essay/>

dividend yield was attributed to the increase of dividend per share to 15.30p in 2012 compare to 14.50p in 2011. The strong sales performance of Sainsbury's helped the company to sustain good level of returns to shareholders. So Sainsbury's have applied several dividend policies to attract investors such as the DRIP program. This program allows shareholders to reinvest their cash dividends in more shares through a specifically arranged share dealing service, Sainsbury's annual report (2012). Dividend cover represents the ability of the company to pay dividends out of the underlying profits after tax. The more times the dividend is covered, the more preferable is for investors. In 2012 Sainsbury's posted a small decrease in dividend cover and became 2.1 from 2.4. This is because dividend paid in 2012 increased by 7% combined with the decrease of 6% in earnings which was due to the increase of cost of goods sold. Sainsbury's stable figures in dividends the latest years demonstrated that the company remained focus on delivering return to shareholders. According to Atrill and McLaney (2009), food retailers literally post an average of 2.6 a year, thus Sainsbury's had maintained its position in 2012. The company plans to build cover to two times over the medium term, Sainsbury's annual report (2012).

4.0 Limitations of Ratios

Financial ratio analysis varies in terms of the type of company as well as its market structures and regulations. Moreover, the figures interpreted in this paper had been extracted through the use of the figures reported in the annual report which represent a point in time. The data might have been decline at the present time. In addition, financial ratio analysis was always subject to estimates and assumptions and relies on the sector which the firm

operates, thus, might not reflect the actual status of the company. Finally, the ratio analysis presented on this paper dealt with Sainsbury's performance for the past two years, although potential investors might want to look at its present condition.

5. 0 Conclusion/Recommendations

The financial analysis performance revealed that profitability margins declined slightly even though Sainsbury's revenue has been growing progressively. The ROCE is held back by the accelerated investment in space growth but the company is planning to improve returns as the sales from these new stores mature. The efficiency ratios of Sainsbury's revealed that management manages assets, payables and receivables efficiently to promote long-term growth. It is worthy noted that the company doesn't face any liquidity risk as they have large operational cash flows which are monitored regularly. This is also reflected in payable days, as Sainsbury's payment methods are better than its main competitors. Regarding gearing ratios, Sainsbury's posted lower interest cover in 2012 but this is not a major concern as the company can cover interest payments adequately. Moreover, the firm announced that will improve gearing ratios by increasing returns through tight cost controls and improving working capital management. Last but not least, Sainsbury's Board of Directors retains shareholders trust by increasing dividend yield and cover every year. In conclusion, financial analysis of Sainsbury's implies that is a value added company to invest in at the current share price for both conservative investors and not. Sainsbury's has already established its credibility to its clients and strives to maintain this competitive advantage. Although the external environment is plagued

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with economic decline and inflation rates, the company maintains its stronghold as it seeks opportunities for growth, Sainsbury's annual report (2012). Justin King, the chief executive indicated that Sainsbury's is not only considered as a powerful enterprise with a successful core of food and non-food retailing, but also a business with real future perspectives for expansion, Gladding (2011). Besides financial analysis, Sainsbury's commitment to 20x20 Sustainability plan makes the company derives long-term sustainability, increased revenue and greater efficiency, all contributing to shareholder value.

9. 0 References Ratio Analysis

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