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Courswork

Tesco – The leading Supermarket in Britain

Background

It all started in 1924, when a Sir Jack Cohen started selling groceries in London's East End markets. By the1950's, this had grown and supermarkets were now in development. Tesco opened its first and indeed the UK's first superstore in 1967, and by the 1980's had opened many cornerstores.

Tesco quickly overtook Sainsbury to become the largest food retailer in the UK, with 1,982 UK stores, consisting of 62 Extra stores, , 442 Superstores, 167 High s treet stores, 109 Express stores, with many accompanying a Tesco petrol station, and 1,202 newly acquired T&S stores, which was a leading convenience retailer.

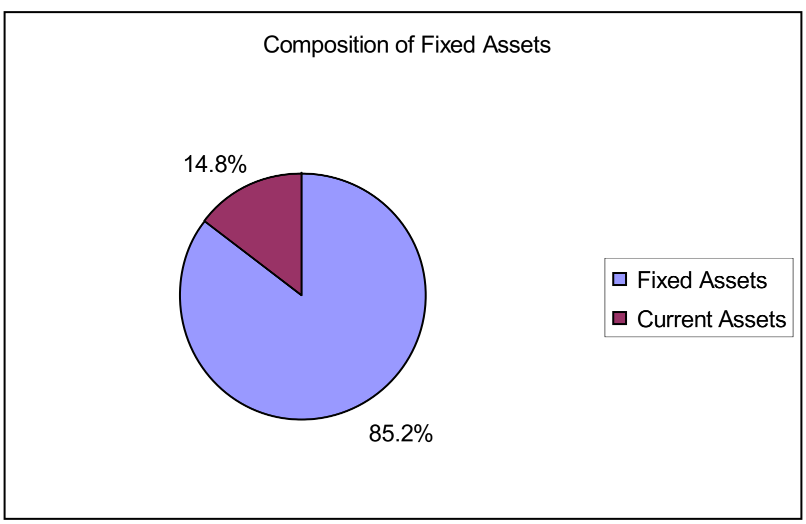
Tesco offers a wide variety of food products, in-store bakeries, household goods, clothes and toiletries. Tesco has also adapted to the rapid technological changes, increasing its sales by 26% (£447m) from last year, on the on-line sales site – Tesco.com, alone.
Tesco has achieved this position as Britain's number one food retailer by offering excellent value and service to its customers.

Tesco's reputation as the supermarket choice has grown in the last five years. It now has a 53.93% (as at 21/11/03) Market share of the Food & Drug Retailers sector.

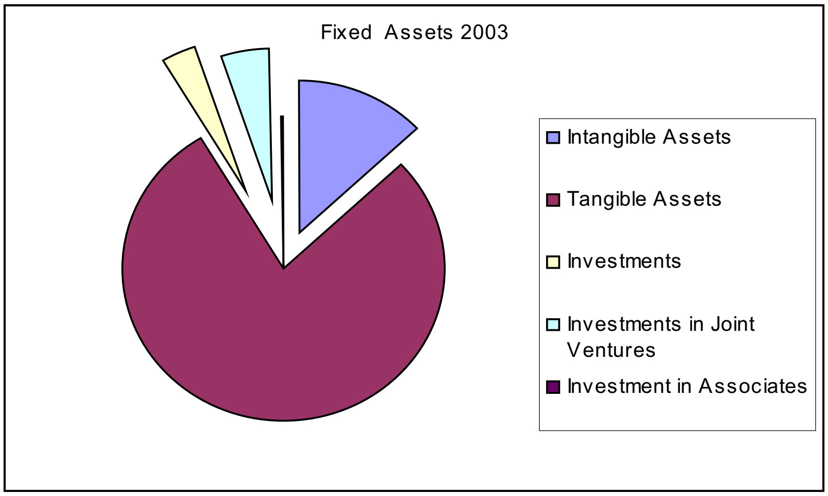
Group sales for the financial year end 23 February 2003 rose 11.5% to £28.613bn. Tesco's joint venture with the Royal Bank of Scotland, made a profit of £96m in the year, of which Tesco get £48m.

Composition of Fixed assets

The composition of the **Fixed Assets** accounts for 85.2% of the total assets.

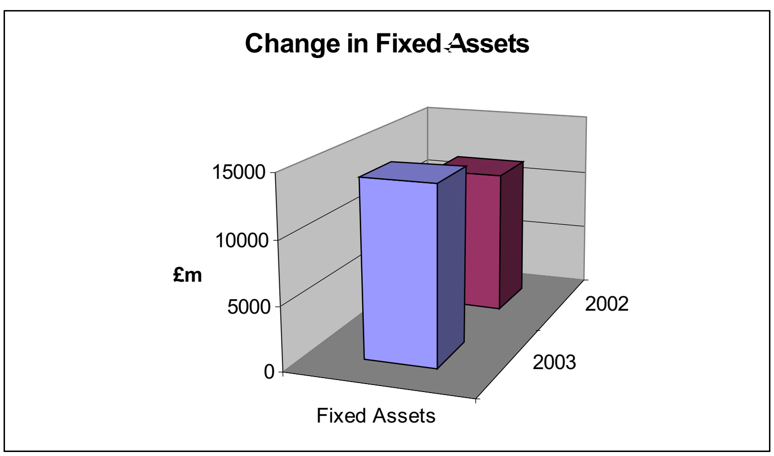


It includes Intangible assets, Tangible assets, Investments, Investments in joint ventures – most recently being with the Royal Bank of Scotland, and investments in associates – being Grocery Works Holdings Inc, who are based in USA.



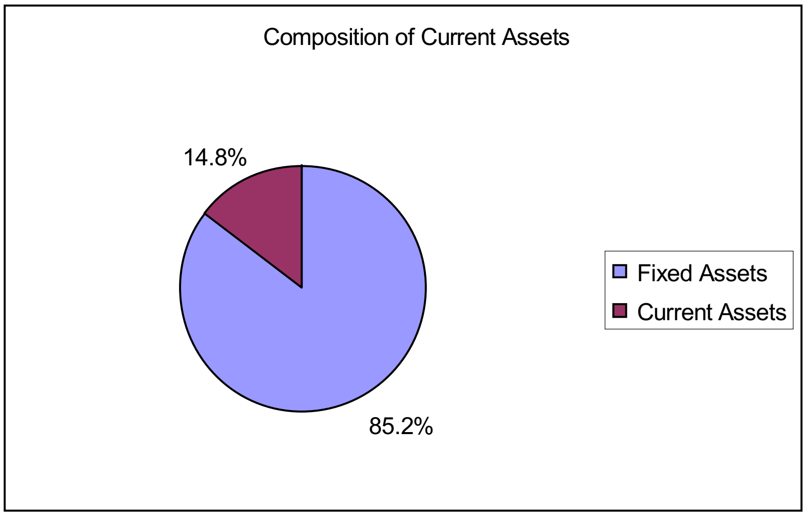
The composition of the Fixed Assets has stayed roughly the same from the previous year end, which was 84.9%.

However, Fixed Assets alone, there has been a 22.24% change. This is mainly due to the goodwill in assets arising from investments in subsidiaries in the year.

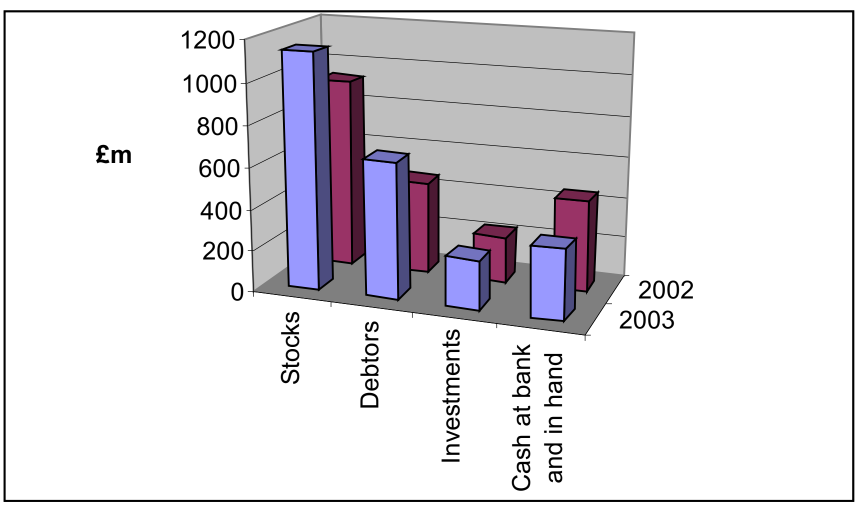


Composition of Current Assets

The composition of **Current Assets** accounts for 14.8% of the total assets.



It includes Stocks, Debtors, Investment and Cash at Bank and in hand.

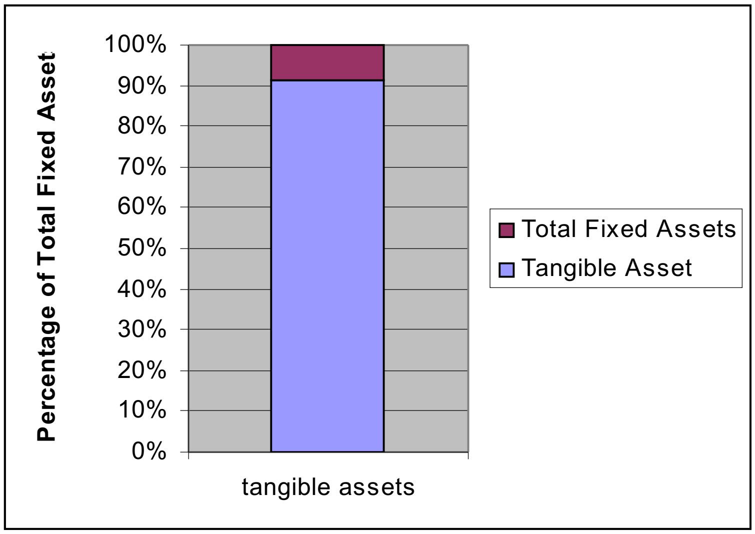


Current assets the previous year end 2002 accounted for 15.14% of the total assets.

There has been an 18.85% change in Current Assets between the year end 22nd Feb 2002 and 22nd Feb 2003. This was down to more stock being held for resale.

Tangible fixed assets

Tangible fixed assets comes to £12.828bn, which makes up 91.2% of fixed assets.



This comprises of land and buildings, plant, equipment, fixtures & fittings and motor vehicles, and includes £62m in respect of interest capitalised relating to land & building assets.
This increased by 16.28%, which was mainly due to the acquisitions of T&S stores, which operated the One Stop C-store chain.
Tesco plans to convert most of these stores into Tesco Express stores.

Intangible Assets

Intangible assets take up 6.33% of fixed assets, an increase of 477.9% from last years tangible assets value. This is down to goodwill arising from investments in subsidiaries in Europe and Asia.

Stock

Stock accounts for 46.72% of the total current assets. This is an increase of 22.71% from the previous year. The stocks consist of goods held for resale and properties held for development. It is valued at the lower of cost and net realisable value. The stocks that are in store are calculated at retail prices and reduced by suitable margins to the lower of cost and net realisable value. (source: Tesco's published accounts)

Debtors

Debtors account for 27.13% of current assets. This has increased by 5.02%.
The debtors figure has increased 45.81% in between the financial years. This is due to amounts owed by undertakings in which Tesco's have a participating interest.

Company's policy towards asset revaluation

This policy is not stated in the annual reports, as it is confidential to Tesc o. However, in the annual reports, there is a small section which states that valuations are obtained from independent experts.

Company's policy towards depreciation

Depreciation is provided on a straight-line basis over the expected useful life of the assets. Tesco uses rates which have been the same for the previous financial year.

- Land premia paid in excess of the alternative use value – at 2.5% of cost.
- Freehold and leasehold buildings with greater than 40 years unexpired – at 2.5% of cost.
- Leasehold properties with less than 40 years are amortised by equal annual instalments over the expected period of lease.
- Plant, equipment, fixtures and fittings and motor vehicles – depreciated at rates varying from 10% to 33%.

(source: Tesco's published accounts)

Different valuation methods

There are three basic methods of valuation :

- Net Asset Value
- Price – earnings ratio
- Discounted cash flow .

Net Asset Value

The NAV is the value of net assets, or the owners' stake in the company, otherwise known as 'owners equity'. It is a measure of the shareholders' wealth in the company, which is the total assets minus its total liabilities.

However, we cannot just take this figure as the value of a company. This is for three main reasons:

1. Fixed Assets are likely to be undervalued, especially as Tesco includes land and buildings. The accounting policies used when preparing the balance sheet accounts states assets at their historical value, which most of the time does not resemble to market value.
2. The stock values are often unreliable, as it shows in Tesco's case. GAAP values stock at the lower of cost and net realisable value, so stock may not really be worth the value the balance sheet states it is.

3. The debtors figure can also be incorrect, as the company may not be able to receive all the money it is owed to them. In this case, Tesco have money owed to them by their subsidiary undertakings.
4. The last big problem with NAV, is that it does not say anything about the earnings potential of the assets in the business. It is the intangible assets of the company such as brands, the skills of its workforce and the knowledge which the employees hold, that are the most important assets a business has. These intangible assets are very difficult to value, which is why they are not included on the balance sheet.

Price Earnings ratio

The P/E ratio is a valuation of a company's current share price compared to its earnings per share. The calculation for the P/E ratio is:

$$\frac{\text{Market Value per Share}}{\text{Earnings per Share (EPS)}}$$

The P/E tells us how much investors are willing to pay per pound of earnings. For this reason it's also called the "multiple" of a stock. For example, a P/E ratio of 20 suggests that investors in the stock are willing to pay £20 for every £1 of earnings that the company generates.

The P/E ratio is a reflection of the market's optimism of a company's growth prospects.

A company with a P/E higher than the market or industry average means the market is anticipating huge things over the foreseeable future. A company with a high P/E ratio will have to live up to the high rating by either increasing its earnings, or the stock price will need to drop.

It's difficult to state whether a particular P/E ratio is high or low without comparing companies in the same sector industry that have the same high growth rate.

A low P/E ratio does not necessarily mean that a company is undervalued. It could mean that the market believes the company is in for a difficult time in the near future. Stocks that go down usually do so for a reason. It may be that a company has warned that earnings will come in lower than expected. This wouldn't be reflected in a falling P/E ratio until earnings are actually released, in which time the company may look undervalued.

In general, a high P/E means high projected earnings in the future. However, it is usually only useful to compare the P/E ratios of companies in the same industry, or to the market in general, or against the company's own historical P/E.

Discounted cash flows

DCF is used to determine a company's current value according to its estimated future cash flows. Forecasted free cash flows (operating profit + depreciation + amortisation of goodwill – capital expenditures – cash taxes - change in working capital) are discounted to a present value using the company's weighted average costs of capital.

DCF paints a picture for an investor of what factors can increase share prices, e.g., expected growth in operating earnings, capital efficiency, balance sheet capital structure, cost of equity and debt, and expected duration of growth.

DCF also shows that changes in long-term growth rates have the greatest impact on share valuation. A change in interest rates can also make a big difference. Investors can also use the DCF model to calculate how fast the company would need to grow to defend its valuation. Investors can come up with a target share price, by simply entering in the current share price and, working backwards.

Discrepancy between NAV and the market value

The market value is the quoted value of the company set by the stock market, given that all information is known.

The NAV of Tesco at the year end 22nd February 2003 was £6.559bn.
The Market Value (MV) of the equity using today's share price of £2.38 (as at closing 21/11/03, FT) and the amount of shares issued by Tesco (7,237,609,183 billion shares in issue - source: Tesco's annual report) is £17.226bn.
The MV at the end of the financial day 21/11/03, given by the Financial Times, has it at £16.755bn.

There is a big difference between the MV of today and the NAV at the year end.
This is because of the reasons I have discussed, in that the NAV figure undervalues fixed assets and states assets at their historical value, which most of the time does not resemble to market value.
The stock value is also valued at the lower of cost and net realisable value, so stock may not really be worth the value the balance sheet states it is.
The debtors figure can also be incorrect, as the company may not be able to receive all the money it is owed to them.

However, in March 2003, Tesco plc bought iVillage UK, the UK's leading website for women. The move for Tesco, is that iVillage.co.uk provides absolute appeal to its core customers and means it will be able to build closer relationships with its customer. In taking overall control of iVillage.co.uk, Tesco is increasing value by bringing together competencies, skills and business models.

Audiences will be able to interchange between sites, with iVillage.co.uk and Tesco.com offering a wide-range of joint package opportunities to advertisers.

The increase in MV is also due to the fact that Tesco have announced plans to build a £7.8m superstore in Workington by 2007, (October 03) and expanding its Tesco Express convenience stores, crating more job opportunities.

Tesco have also acquired the C Two-Network chain of 78 convenience stores in Japan for £139m, and aims to open up to 20 new stores a year. (June 03)

Tesco is forming a mobile phone joint venture with MMO2, and each company will invest £8m over the next two years with a view to reaching up to 2m customers within five years. (June 03)

Tesco also has plans to convert 136 One Stop convenience stores into a Tesco Express. (April 03)

P:E ratio

The P:E ratio of Tesco plc, stands at 19.63 times, as at 21/11/03. The P:E ratio I worked out was 18.21 times. I arrived at this figure by using todays market share price (21/11/03), and dividing it by the EPS in which I again figured out using the Earnings after tax & preference dividends, divided by the number of ordinary shares in issue, which is found in the Published accounts. (see appendix).

The P:E ratio of the sector that Tesco is in, Food & Drugs retailers, is 15.87, as at 21/11/03. This shows that the market is expecting huge changes over the foreseeable future for Tesco. This is backed up by latest reports that Tesco have signed an agreement to buy an 84.33 % stake of the Turkish retailer Kipa, worth £75m. (FT, 11/11/03).

Comparing other companies in the sector

A company which is in the same sector as Tesco is Sainsbury's. Sainsbury's is the second leading UK food retailer with interests in financial services and property.
The P:E ratio for Sainsbury's as at 21/11/03 is 12.9, and Somerfield, another Supermarket chain, is 15.0.
This is proof that Tesco is the biggest supermarket company, as their P:E ratio is greater, showing signs that their future expectation is heavily relied on. Their investments and joint ventures, and acquisitions all around the world, have propelled Tesco to unreachable heights, thus increasing its market value and P:E ratio, and making it the sought-after company.

Shares Over – or – Under Valued?

There are various way of valuing shares. The first one is the stock market valuation. This can be pulled straight out of the Financial Times.
As at 21/11/03, the closing share value of Tesco, was 238p.

The second one is the Net Asset Method. This is taking the NAV figure and dividng it by the number of shares issued, using the called up share capital divided by the amount the share is issued at.
Using the NAV figure obtained from the published accounts, £6,559m and the number of shares issued, 7,240m, I calculated a share price of 90.6p (see appendix).

The third method is using the P:E Ratio, which uses the P:E ratio multiplied by the EPS. Using the figures I calculated for the EPS and P:E ratio, I got a share price of £2.379. Using the P:E ratio as at 21/11/03 and the EPS given in the published accounts, a share price of £2.74 is produced.

The fourth method is the dividend valuation model. The DVM is apropriate for assessing the value of shares by capitalising the future dividents. In order to work out the share price, the dividend yield is needed. The dividend yield is the gross dividend per ordinary share (which includes interim and final dividend) divided by current share price. (Appendix)

Using this approach, I came up with two share value figures. The first value is using the Dividend Yield figure from the FT, in which a value of £2.40 per share is calculated. The second value is using the Dividend Yield figure I calculated using the current share price, and then using the dividend per share figure in the published accounts divided by the Yield I calculated to give me a share price of £2.375.

The last method of calculating share value is the Dividend Growth Model (DGM). This valuation model states that the value of a company is equal to the current value of all its future dividends. However, a few problems with DGM is forcasting future cash flows, and that the company may not pay out any dividends if faced with a highly attractive investment opportunity.

In this method, I used the future growth rate as the increase in percentage of the dividend from the previous year prior to the year end 22nd February 2003, and the current share price as at 21/11/03. Using these figures is an estimate, as it is hard to forcast next years dividend without knowing the shareholders required return. This is why I worked out the cost of capital as an estimate.
Using this model, I calculated the shareholders required return at 13.58%, I used the same future growth rate figure of the dividends, 10.7%.
This gave me a share value of £2.38, which reflects the company share value as at 21/11/03.

Here is an outline of all the share prices that I have calculated and obtained:

Financial Times 21/11/03:	£2.38
Net Assets Basis Method:	£0.906
P:E ratio method (calcuated)	£2.379
P:E ratio method	£2.74
(EPS taken from published accounts, P:E taken from FT 21/11/03)	
DVM 21/11/03	£2.40
(Dividend yield taken fom FT)	
DVM (Dividend yield calculated)	£2.375
DGM	£2.38
(calculted using last year growth figures)	

From the figures above, I believe Tesco is slightly undervalued. Clearly the Net Asset Basis is wrong, while all the other figures tend to be ranging in from £2.38 - £2.40. The value of £2.74 is a figure based on fact, using the actual EPS figure and closing price of the share on that date.

I believe the shares are slighlty undervalued, because at the point of writing this Tesco was in negotiations with the The Co-operative Group (Co-op). Co-op is involved in food retailing, funeral services, travel agencies, the motor trade and non-food department stores.
In food retailing it operates convenience stores; smaller 'market town' supermarkets; and some superstores.

Also Tesco is planning to create 1,000 jobs by opening up two new supermarkets at Croxteth and Litherland on Merseyside.