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**Topic: corporate finance**

## 1. Introduction:

This first part of this paper seeks to prepare a fundamental analysis report of Morrison Supermarkets' equity using either the free cash flow or the economic profit approach. The immediate objective of the report is to make a recommendation whether the stock of Morrison Supermarkets is worth to invest with. In so making a recommendation a qualitative and quantitative analysis of the relevant information about Morrison Supermarkets and its industry forms part of this paper. This paper hence uses also the five- competing forces model By Michael Porter (1980) as basis of industry analysis and financial analysis of at least three years with the year 2005 as latest and at least 2 years for its competitors as additional basis to determine company's strengths and weaknesses.

The second part of the paper discusses and illustrates the use of real options (Brigham, 2000) analysis in strategic investment decisions.

### 1.1 Brief Company Profile and the Supermarket Industry

Supermarkets dominate UK food retailing business, with an increasing number of brands springing up everywhere. With such a situation, consumers are offered with different choices from which to pick from thus increasing their expectation for a good price, quality and customer service. Hence, a battle exists among these supermarkets and

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Wm Morrison Supermarkets has moved up the UK food chain with the acquisition of its larger rival Safeway Plc. The acquisition gave Morrison  increased its store count to about 550 supermarkets from just 125 when it beat out UK supermarket giants Tesco (the UK's #1 food retailer) and Wal-Mart-owned ASDA in a highly contested takeover battle.

The highly competitive and notable players in the industry competing for the same market share offer similar service, which ranges from grocery to health facilities. The UK supermarket industry is very concentrated and highly competitive and its characteristics would be best known in the applying the SWOT analysis

## 2. Analysis and Discussion

**2.1 Question 1a --** Assume that you are an analyst in an investment bank that, amongst other, uses fundamental analysis and valuation methods to select equities for portfolio investments. Using one FTSE100 company of your choice, prepare a fundamental analysis report of its equity using either the free cash flow or the economic profit approach. On the basis of your valuation, make a recommendation to the investment clients of your bank. – 70%

To answer this question a forecast for the years 2006 to 2010 and thereafter will be made and an evaluation using the free cash flow model will be used whether the stocks of Morrison is worth investing with. See Appendix A

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The total value of the firm using the free cash method is £ 5.5 billion pounds .See computation per Appendix A (worksheet: cashflow). For purposed of understanding the elements of the model, please refer to Appendix A (worksheet: formula). The model and its applications are also explained under separate sections of this paper.

In addition, an analysis of the strengths, weakness, opportunities, and threat (SWOT) is made to support the basis of the financial forecast.

## 2.2 SWOT Analysis

**Opportunities:**

Morrison faces the following industry opportunitities using Porte's five forces competing model.

### 2.2.1. Difficulty of entry by competitors

Based on Porter's model, the existing firms in the industry might offer a resistance by having discouraging new entrants. There is thus a high threat of new entrants since the industry is highly concentrated. It is unlikely that new companies enter the market, as there are difficulties in accessing distribution channels. The exceptions are entries through merger and acquisition or purchase of existing real estate.

### 2.2.2 Capability to expand into convenience stores

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Using the Porter's threat of substitutes could affect the industry. Having major competitors from other supermarkets, which include convenience stores, takeaways and restaurants, the said leading supermarket chains have found ways to combat these competitions. Expansion into the convenience sector by Tesco Metro and Sainsbury's Local gave supermarkets' a presence in High Street retailing. The threat of substitutes therefore challenges Morrison to resort to expansion to convenience stores. In the meantime, different luxury own-brand instant foods have been tailored for the high-end market to face a revival of eating out trend.

### 2.2.3. Low bargaining power of customers

There is basis to state that customers have low bargaining powers. This is due to the fact that supermarket shopping is typically "one-trip" shopping. The continued expansion of supermarket outlets also means that consumers are able to choose from a number of different supermarket chains in their immediate locality. In simple language, low switching costs for consumers makers it advantageous to firms in the industry. Leading supermarkets tried to develop loyalty schemes such as Sainsbury's Nectar card to retain loyal customers. This low bargain justifies reason why supermarkets could compete by broadening customer services via banking and Internet shopping.

### 2.2.4. High bargaining power to suppliers

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High bargaining to suppliers enables firms to have more profitability. The market leaders in the supermarkets have long incorporated their supply chains into the vertical integrated networks. This opportunity then gives them high economies of scales to maintain low costs hence low prices.

It is estimated that the supermarket industry will enjoy a continued growth in short to medium terms with the major contributions claimed to be diversifications into a range of non-food products and services, and the expansion into the convenience sector.

**2.2.5 Capability of expanding into financial services**

Two main opportunities await Morrison's in the future if it decides to expand and that include financial services and convenience stores markets. The first one was already discussed. It was reported that during 2002 about 60% of the major supermarket chains in the West moved into financial services. Tesco, Sainsbury have diversified into this sector in recent years and have reaped huge gains. In addition, home ware and clothing can also aid the company to diversify its product range into higher margin goods. Tesco and Sainsbury have entered this market through the introduction of Tesco Metro/Express and Sainsbury's local formats.

**Strengths:**

**2.2.6. Increased supermarket chain as result of acquisition**

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Morrison's strengths may help the firm in attaining its objectives. It is believed that with Wm Morrison having recently acquired Safeway and having thus expanded its presence in southeast England and Scotland in order to increase its market share and to gain synergies through cost savings, more revenues are expected. It had purchased the supermarket chain for only 55% of sales, and it paid an exceptionally low price for the stores. It is submitted that will increase its supermarket chain from the current number of 125 to 550 and provide the group with major strength to compete with its main rivals.

There is also basis to say that management structure in place at Morrison's has been permanent for a long time indicating stability and this has made easier long-term growth and continuity of strategy. Morrison has laid a major emphasis on quality and high service standards, which is communicated to the consumers through its marketing strategy.

Furthermore, Morrison distinguishes itself from its competitors with its commitment to strong customer service as portrayed in the "Market street" initiative in all new stores. Such initiative comprises a relatively high number of service counters, thereby addressing customers' needs in order to increase revenue and customers' loyalty.

**2.2.7 Company has reputation for prudent accounting and best shareholder value creation.**

Using accounting analysis, there no is major discrepancies that exist between the accounting policies used by Wm Morrison and its peers in the industry. In fact, the

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company prides itself for a reputation for prudent accounting and best shareholder value creation. It is not likely that accounting distortions exist in their reporting. In previous years, the company used to have additional depreciation up to a 5% high. However, it has now adopted a standard rate of depreciation on buildings of 2.5%, which puts the company consistent within UK industry peers. This will surely enhance profitability in period covered.

### 2.2.8. Higher gross margin compared to its direct rivals

As per analysis of financial ratios, Morrison and Sainsbury and Tesco, essentially use low pricing competitive strategy. Please find full set of financial ratios per Appendix A.

In 2005, sales of Morrison increased by 59.15% compared to 9.4% in 2004. This growth stemmed from the combination of new stores, increase in average spending per customer by and increase in the average number of customers because of acquisition of Safeway in late fiscal year 2004, whose effect was felt more in 2005. This however did not led to an increase in the company's gross margin because of higher cost incurred in 2005, since said gross profit margin decreased 25.5% from 2005 to 3.27% in 2004. The exceptionally high gross margin compared to its direct rivals up to 2004 did not continue in 2005. This was attributed to the high cost incurred because of acquisition of Safeway, which was not doing well before acquisition. The company offers superior service, top quality products as well as low prices. This policy allows increasing sales from year to year. Morrison sells around 55% of its own brand products. It operates fresh food factories, package capacities and warehouses. Compared with competitors, Morrison's

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net profit margin was better than that Sainsbury in 2005, but Tesco, posted net profit margin of 3.98% had a chance to overtake Morrison, which posted growth rate of .87% in 2005.

### 2.2.9 High asset turnover

In 2005, Morrison had a 1.57 assets turnover compared to 2.24 in 2004. This is higher than Sainsbury than Tesco. On the other hand, Morrison had the highest inventory turnover of 25.68 in 2003. Inventory turnover and receivable turnover were not available for comparison for 2005 because lack of detailed information, hence the turnover comparison is limited to asset in 2005. The high asset turnover for Morrison and its competitors means that assets are fully used and it would indicate efficiency for all the firms.

### 2.2.10 More stable financial leverage than competitors

Morrison's financial leverage was stable over the three financial years 2003 to 2004 and lower than that of its competitors. However debt to equity deteriorated in 2005 indicating increase risk for Morrison. This is caused by more liabilities in 2005 resulting from the acquisition of Safeway. Comparing the three however will show that Morrison is still better off than its rivals since its debt to equity ratio is less than one (1) while its competitors are greater than 1.

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Morrison's financing strategy largely depends on internally generated resources as evident from the very low Total Debt to Common Equity ratio. Prior to 2005 it was five to ten times lower than that of Morrison's nearest competitors.

Liquidity ratios of the company are sa little below industry average. Although quick ratio and current ratio do not reach one, it is accepted all retail food store chains can generate great cash flows and the possibility of going bankrupt is very small.

**Threats to the business:**

**2.2.11 Large and highly efficient supermarket chains dominate the UK supermarket industry.**

Existing players generated great strong rivalry among them and has created a few, large and highly efficient supermarket chains in the UK supermarket industry. Since consumers' major concern is price, price wars among key players are extremely intensive, enabled by high economies of scales. It must be noted however that selling below cost is prohibited in UK. However, new trends in supermarket sector indicate a focus of competition not only on price, but also to some extent on differentiation. As state earlier in the opportunities, this involves the expansion into convenience store sector, non-food sales, financial services and the launch of customer loyalty schemes.

**Weaknesses:**

**2.2.12. Company may be adversely affected by a decline in the economy**

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Lack of diversification characterises the group of firms industry and has all its business placed in the UK. As a necessary result, they are affected by a decline in the economy or the UK food market. The major players have expanded into foreign ventures and will not be affected as hard by a decline in the UK market. Some of them have overlapping strategies in terms of value proposition, image and store locations and these include Morrison and competitor. If said competitors decide to engage into an aggressive price competition this could affect the Morrison terms of sales and profitability.

Lack of clear evidence about the long-term overall success of the merger with Safeway is still there. Success then is then highly unpredictable even though Morrison is expected to achieve synergies in the short-term. The long-term value appears to be exploited only when a major portion of the Safeway chain is successfully converted or integrated. As was seen in the financial report, the less than standard performance in 2005 was mainly attributed to the huge conversion cost recognized in 2005. There was a persistent background of long-term underperformance in Safeway, which necessitated Morrison to take the proper and strategic actions to hasten the benefit synergy.

Morrison, hence, faces a few post-merger problems, with a competitive environment surfacing in the short-term that will cause a higher level of price reinvestments than management has budgeted. Therefore revenue of the synergies accumulated in the shot-term was actually eroded in 2005.

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It was reported that Safeway as a stand-alone business was underachieving and underwent the stewardship of three Chief Executives in a ten-year period. It spent over £4 bn in capital investments without improving profits. This allowed Morrison's with a huge task of reconstructing the chain to create a successful merger. The 427 Safeway stores acquired range from convenience to large-scale stores.

### 2.2.13 Morrison faces a problem of location where Safeway is situated.

Complexity of Morrison's operations could result from transferring the Morrison format into these outlets and selling its brand in larger stores. Unfamiliarity to Morrison's are evident are to the problem of location where Safeway is situated. The Morrison's operation model is significantly more labour intensive than Safeway due to the higher in-store service element in the Morrison's format ("Market Street") .The latter has a feature that is less applicable to Safeway. The recruitment and retention of labour is a potential risk area for the introduction of the Morrison's model into the new stores.

## 3. Valuation Methodology

As required by the problem, the model used is cash free flow method. Please see Appendix A or for the complete model.

Shrieves, R. and Wachowicz, J. (n.d.) provided the formula on free cash low method and saying:

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> Free cash flow to the firm (CFFt) is the sum of cash flow to equity (CFEt) and cash flow to debtholders (CFDt), reduced by the interest-tax-shield benefits from the cash flow to debtholders. Subtracting the interest-taxshield benefits from the cash flow to debtholders produces an after-tax cash flow to debtholders). Since the discount rate to be used later is the after-tax weighted average cost of capital, the appropriate cash flows are before the tax advantage of debt (i.e., we account for the tax advantage of debt financing by reducing the discount rate, rather than by including the interest tax shield in the cash flow to investors). In effect, cash flow to a levered firm is defined as that which would be realized by an otherwise equivalent unlevered firm.

The authors then provided the formulas to compute the cash flow to equity (CFEt) and cash flow to debtholders (CFDt), reduced by the interest-tax-shield benefits from the cash flow to debtholders. Please refer to Appendix A. The authors concluded that conceptually, free cash flow, economic value added, and net present value approaches to valuation and decision-making are equivalent. There is also discounting done under the free cash flow method. The model is applied in the next section.

## 4. Free Cash Flow Valuation of Wm Morrison

Summary of Free Cash Flow Method or Morrison is show below. For complete computation, please refer to Appendix A. (Filename: Corpplan.doc)

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| **Summary: Amounts in £m** | Assumption 1 | Assumption 2 | Assumption 3 |
|---|---|---|---|
| Net present value at 8.5 of cash flows 2005 to 2010 | 2,756.07 | 2,393.37 | 2,721.70 |
| Present value of Morrison at year 2010, assuming a perpetual net cash inflow | 4,184.17 | 2,982.21 | 4,895.44 |
| Present value at year 2005 , current for the future value above, discounted at 8.5% | 2,782.66 | 1,983.30 | 3,255.69 |
| Total present value | 5,538.74 | 4,376.67 | 5,977.39 |
| Net present value at 10% of cash flows 2005 to 2010 | 2,694.16 | 2,346.04 | 2,658.36 |
| Present value of Morrison at year 2010, assuming a perpetual net cash inflow | 3,556.55 | 2,524.90 | 2,524.90 |
| Present value at year 2005 , current for the future value above discounted at 10% Above | 2,208.33 | 1,567.76 | 1,567.76 |
| Total present value | 4,902.49 | 3,913.81 | 4,226.12 |

The free cash flow valuation was prepared under three separate assumptions as a way of preparing a sensitivity analysis (Holmes, 1998) brought about by the uncertainty of the future. Projected figures cover the period 2006 to 2010. However or purposes of discounting the years after year 5 from year 2005 as year 0, it was uniformly assumed that there will be perpetuity (Brigham, 2000) in the amount of net cash inflow from 2011 and onwards.

**Assumption 1**: The turnover increased by 20% in the first year, 7% in the second year, 6% in the third year, 5% in the fourth year, and 4% in the fifth year. Since the net cash low in year five will be the same through out, it was impliedly assumed that the level of revenues for the next sixth up to the succeeding years will be maintained. This may be far from reality but it was intentionally done to have a conservative estimate of the future for purpose of evaluating the investment opportunity. Knowing that the estimate may be conservative, a corresponding adjustment may be made in the

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judgement. Estimated level of expenses came from original relationship of said expenses with turnovers in the past, hence, the degree of efficiency was assumed uniform also in the future. This again might be conservative considering the resulting synergy that will be created because of the merger (Van Horne , 1992).

**Assumption 2:** The turnover will increase annually 5% from year 2006 to year 2010. The increase may actually appear conservative still considering that historical figures exhibited increase of not less than 10% or either Tesco, Sainsbury and Morrison. From 2003 to 2004, Morrison's increase in turnover was 13% while from 2004 to 2005 the increase was 182%. The latter increase coincided with the acquisition of Safeway, hence total revenue appear to have almost doubled with the acquisition of Safeway. Tesco's increase was 92% while Sainsbury's was 10%. The level of expenses is assumed as that in the assumption 1.

**Assumption 3:** The assumptions need not be limited to three but for purposes of making a decision then there a need again to use a certain percentage. It was therefore assumed in the third that all other things equal with the rest, turnover is expected to increase 10 % per for the next five years. However, after year 5, or starting year 6, it was assumed that the year 5 levels would be maintained in perpetuity.

**5. Conclusion and Recommendation:**

Based on financial model, there is a good indication that investing at Morrison's stock should be advised. The result of the SWOT analysis did reveal many industry

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opportunities and little threat. However, the opportunities are clear that the forecasted model may actually appear supported based on a wise analysis on different subject areas. Morrison may then use its strengths like higher gross margin than its competitors may as an advantage to further its strategy of delivering better value to customer. This is considering also the fact that the industry I highly concentrated.

Morison with its more stable financial advantage than competitors has more allowance to address its problems with greater capabilities. It could its low debt to equity to borrow finance future projects or other investment opportunities that may give Morrison rates higher than the cost of capital. It good reputation in its accounting practices may be used to talked advantage of an industry opportunity o low threat to entry. With also its increase chain store from Safeway, it can increase revenues more. It need however to take advantage of the synergy that may have been created by acquiring Safeway. With increase revenues, more profitability is expected if the company maintains a certain level of efficiency where cost

**Appendices**

**1. Appendix A –See Excel file**

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Part 2

**1b. Discuss and illustrate the use of real options analysis in strategic investment decisions. – 30%**

Brigham (2000) defines real options as those involving real, rather than financial assets. He also called the real options managerial, or strategic options. According to him, these options exist when managers can influence the site and riskiness of projects' cash lows by taking different actions during or at the end of a project's life.

The author explained the fact that when we evaluate project we generally assume that the firm will operate assets at their full physical lives. However, as reality will dictate, such is not always the best course of the action. If the firm has the option to abandon (or shut down) a project before the end of expected life, where lowering the risks is an option, then to increase its expected profitability is a well-deserved thing to watch out.

In Appendix B, we have a case where management can decide to abandon a project before the end of the expected life and it is assumed that there is a ready buyer at the end of year 1. The decision tree in Appendix B therefore illustrates a case where the firm can abandon a project in order to lessen the risk and increase the profitability of the project. This kind of reality must be accepted since economic decisions are subject to changing conditions. There are external forces which may not fully be controlled by the manager

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and a good project should offer a chance to quitting the project but that that such quitting decision should at least offer a simpler way-out of the situation considering the unpredictability of things.

It is clear in the illustration that if the option of abandonment is included in the decision tree, a fourth branch is added under the worst-case scenario. Notice also that if the project is sold at book values in Year 2, there will be no capital gain and therefore no tax. As necessary part of abandonment, there will be no expected cash flows after the sale. Notice also that the probability of the worst-case scenario was changed from 25% to zero because of the ready availability of the option to sell the project at the end of year 1.

The real option in strategic management allows managers to make in between decisions to alter a decision made earlier as a result to changing conditions of the uncertain future.

Notice also that if we compare the option to abandon and option not to abandon there is greater freedom in case there is chance of abandonment provided there is a ready market that will buy the project.

The figures in Appendix B tell that by having the choice of abandonment of the project after the first year there seems a net advantage of £ 8,373.61. This should not be surprising in the light of changing inflation, changing political situations and changing technology. Business assumes certain probability and there is allowance for error. Hence

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that the part of unpredictably should not deny a manager to make a good economic decision in order to insure survival of the business

To conclude, changes are inevitable in business and although no person can prevent a badly conceived plan to complete its perdition, a wise manager may actually see the greater wisdom if it can respond to said changing conditions by lending its self to some abandonment if the need arises.

**Appendix B- Decision tree with and without abandonment.**

**Bibliography:**

Brigham, J. (2000), Fundamentals of Financial Management, Ninth Edition, Thomson South-Western, U.K.

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