London Business School

Tesco PLC

Edward Dearing, MBA 2013
Date: 16-10-2011
Symbol: TSCO
Exchange: LSE
Price: £4.09
Market Cap: £32.85bn
PE: 12.36
Avg Daily Liquidity: 17,832,900

Background
Tesco is a global grocery and general merchandise retailer headquartered in the UK. It is the third-largest retailer in the world measured by revenues (after Wal-Mart and Carrefour) and the second-largest measured by profits (after Wal-Mart). It has stores in 14 countries across Asia, Europe and North America and is the grocery market leader in the UK (where it has a market share of around 30%), Malaysia, the Republic of Ireland and Thailand. It is currently expanding its UK operations to offer retail banking, and is investing heavily in China and other Asian economies with a view to driving growth through dominance in rapidly expanding economies.

Business Strength
Power through innovation: Tesco has achieved 30 years of unrivalled success in the UK food retail business. It has consistently driven earnings through innovation, pioneering approaches to consumer loyalty programmes, local/express store positioning, distribution, supply chain management, in-store product placement and countless other measures. Tesco's economies of scale and dominant position in the UK retail food market provide it with unparalleled supplier bargaining power, enabling it to control input costs and maintain superior margins to its competitors. Strong cash flow and a sophisticated advisory team has meant that Tesco has consistently been able to drive growth through raising debt on very favourable terms.
Back a (consistent) winner: Tesco weathered the financial crisis unscathed, achieving significant EPS growth every year, while at the same time investing heavily in China, South Korea and other target markets. It has grown dividends every year for 27 years. It has the endorsement of Warren Buffett (who recently purchased 34m shares, raising his stake in Tesco to 3.64% of the company).
Dynamic Repositioning: Given Tesco's strong ties to the UK it is understandable that attention focuses on its struggle to grow UK like-for-like sales and to gain further market share in its home market. However, while maintaining dominance at home is important, Tesco is increasingly becoming a global company. UK sales make up only 68% of revenue; Asian sales are growing strongly and already make up 15% of revenue. Tesco's huge investments in South Korea and China (where it hopes to grow revenue to £4bn per annum by February 2015) mean that in ten years' time it may derive the majority of its profits from the larger Asian economies. This 10-year view of the company differs radically from the one that currently drives valuations.

Financial Assessment
Given Tesco's array of operations across multiple countries, building a single-company DCF model has real limitations. Such problems are compounded by the fact that Tesco's accounts do not separate out investment CAPEX from maintenance CAPEX, meaning it's difficult to determine a true sense of what cash flows would look like without the significant current investment programme. For that reason, any DCF model should project cash flow for around 10 years (to reflect both the full cost of CAPEX and the future impact of such CAPEX on earnings). My model assumes CAPEX of 5.5% of Revenue to 2014, and then a YOY decline of 20% per year thereafter. I've assumed conservative revenue growth of 6.5% from 2015-2022 (figures to 2014 are based on analyst estimates), with margins remaining around current levels. My model discounts cash flows from 2022 to the beginning of 2012 assuming a 9% WACC (again, very conservative relative to Tesco's cost of debt, equity beta, and general analyst WACC estimates for the company). Terminal value has been determined using a conservative growing perpetuity (C = FCF at 2023; r = 9%; g = 4%), discounted back to today.

Risks and Mitigants
The stability of the business together with the track record of success mean that the risks are principally macro (e.g. another financial crisis, recession in China, significant global food price inflation etc.). Tesco has faced these problems before and grown in spite of them. The biggest balance sheet risk is that Tesco has overpaid for new real estate (given China's property bubble), however (given the long term investment in China) this is unlikely to severely impact the company's growth prospects.

Valuation

	2011	2012	2013	2014	2022
Revenue	60,931	64,963	69,851	75299	124620
Growth	*7.00%*	*6.60%*	*7.50%*	*7.80%*	*6.50%*
EBITDA	5,141	5,419	5,935	6,439	10593
Net Interest	-333	-265	-270	-240	-50
Tax*	-864	-877	-1,021	-1,184	-2108
Capex	-3,700	-3,573	-3,842	-4,141	-694.8
WC (Change)	357	311	-61	179	-50
Free Cash Flow	601	1015	741.195	1052.6	7689
Discount Rate		9%	9%	9%	9%
Years		1	2	3	11
PV FCF		931.22	623.849	812.77	2979.8
PV of FCF to 2022	22142				
Shares	7985				
PV (ignoring TV)	2.773				
PV Terminal Value	17035				
PV Shares (Total)	4.906				

Conclusion
At present the tough climate facing retailers in Western economies is depressing the value of many companies associated with those economies. However, it's important to value Tesco on the basis that, in ten years' time, it will derive the majority of revenues from larger economies with strong growing markets. Even taking a very conservative approach to a ten year DCF we can determine a PV significantly in excess of the current share price of £4.09.