Stock Market Review

Tesco's profit warning and Warren Buffett

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On January 12, Tesco plc, the UK's largest supermarket chain, announced that sales during the Christmas and New Year period in its stores around Britain dropped by 2.3 per cent. Financial analysts in the UK claim that this was Tesco's worst performance over the Christmas period for decades.

Tesco's chief executive Philip Clarke commented in the statement to the stockmarket entitled "Determined to move faster" that the company experienced "more strain than anticipated on our profitability during the important seasonal trading period". The CEO confirmed that although the company's profit before tax and earnings per share for the 2011/12 financial year ending February 29, 2012 "will be broadly in line with market consensus forecasts, we expect trading profit growth to be around the low end of the current consensus range".

Tesco also revealed that the company's profit for the following financial year to February 28, 2013 would be about £450 million lower than analysts' expectations. International analysts covering Tesco were forecasting a 10 per cent growth in profits. The company's first profit warning in 20 years shocked the stock market with the share price sliding by 16 per cent on the day hitting a 34-month low of £3.11. Tesco's overall market cap dropped by £5 billion on January 12. The last time that Tesco's share price had suffered a similar drop was in October 1987, when the UK market had crashed by 26.5 per cent on what is commonly referred to as "Black Monday".

Tesco's profit warning was given wide prominence across the financial world since it is one of the largest retailers with almost 5,400 stores in 14 countries employing over 490,000 people.

Tesco's leading market share in the UK has been on the decline in part due to the increased internet shopping which is negatively impacting sale of clothing and electronic goods from their hypermarkets and also as a result of the stronger competition emerging from the likes of Wm Morrison, Waitrose, J Sainsbury and Marks & Spencer. In fact, only a few days before Tesco's statement to the market, some of its major competitors announced upbeat/positive results. Sainsbury reported its best Christmas ever with a 2.1 per cent increase in revenue and Waitrose registered a 3.8 per cent increase in turnover helped by a jump of almost 50 per cent in online sales. The subdued economic environment in Britain is also leading to more customers choosing the discount chains such as Aldi and Lidl.

While Tesco's performance in Britain was rather subdued, total international sales during the Christmas and New Year period grew by 8.2 per cent. Tesco reported strong performances in all three regions, i.e Asia, Europe and particularly the United States. However, although the Fresh & Easy supermarket chain in the US continued its strong rate of growth with a sales increase of 41 per cent, Tesco is still seen to be struggling to turn around its loss-making Fresh & Easy concept in the US.

The chief executive also announced that Tesco's plan for the next financial year includes substantial investment to deliver an improved shopping experience for customers, particularly in the UK, and as a result of this, the expectation is of minimal growth in profit for 2012/13. Analysts in the UK indicated that Tesco plans to invest between £300 to £400 million to shake up the UK business which accounts for almost 70 per cent of sales and profits. The strategy involves price cuts, store refurbishment and developing the internet business. The market will be eagerly awaiting the strategy update on April 18, 2012 when Tesco will issue its preliminary set of results for the year ending February 29, 2012.

Tesco was placed under more controversy a few days after the profit warning as it was reported that its UK Chief Operating Officer sold 50,000 shares at £4.04 just before the announcement and the resultant slide in the share price.

So what's the connection between Tesco and the US legendary investor Warren Buffett? Tesco is the only UK company within Buffett's $67 billion investment company Berkshire Hathaway. Prior to this profit warning, Berkshire Hathaway held a 3.2 per cent equity stake in the company and in an interview given last November on a visit to Japan, Warren Buffett had selected Tesco as his "top pick" in Europe and claimed that he would seek to increase this position if the share price were to be at lower levels.

Although Tesco enjoys a market leading position with a market share above 30 per cent, the coming years will show whether it could remain the dominant force in British retailing while enjoying industry-leading margins in challenging trading conditions.

Indeed, as the share price of Tesco skidded on January 12 and 13 in response to the profit warning, Warren Buffett stood by his philosophy to "be fearful when others are greedy and greedy when others are fearful". Media reports last week claimed that as the equity plummeted on January 12 and 13, Warren Buffett bought a total of 150 million Tesco shares worth circa £480 million increasing his position to an equity stake of 5.1 per cent.

> **The company's first profit warning in 20 years shocked the stock market**

Warren Buffett has built up an unrivalled reputation as a long-term value investor and his successful investments over the years positioned him as the third wealthiest person in the world. The show of support by Warren Buffett for Tesco improved market sentiment towards the world's third largest supermarket chain and the share price edged slightly higher following the news despite Tesco's downgrade by the US investment bank Goldman Sachs due to a "significantly worsened outlook".

The legendary investor may have been attracted to Tesco by the fact that the drop in the share price led to an improved estimated dividend yield on Tesco shares of almost five per cent, which is substantially higher than the average dividend yield of the companies forming part of the UK's FTSE 100. Moreover, the dividend cover is estimated at twice the company's profitability which is another important yardstick in the industry implying a sustainable level of dividends.

Changes in the portfolio of Warren Buffett's investment company Berkshire Hathaway are closely monitored by the financial markets. In November 2011, Warren Buffett surprised many when it was revealed that his investment vehicle became one of the largest shareholders of IBM after purchasing $10.7 billion worth of IBM shares. Mr Buffett had always avoided technology companies in the past but he indicated that the company has a competitive advantage in their industry due to the wide range of products and services offered.

Warren Buffett and other investors who have taken the opportunity of the recent sharp drop in the share price to purchase Tesco shares hope that the UK's largest retailer will manage to repeat the strong turnaround in performance it achieved in the early 1990s when despite the recessionary environment, the company managed to surpass Sainsbury as the leader in the industry with a market share increasing from 15 per cent to 25 per cent in the space of a few years. Although Tesco currently enjoys a market leading position with a market share above 30 per cent, the coming years will show whether it could remain the dominant force in British retailing while enjoying industry-leading margins in challenging trading conditions.