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FT Money

Investors ignored warning signs at Tesco

Terry Smith

Since starting Fundsmith, my fund management company, the stock which I have most frequently been asked about, and implored to buy, is Tesco. Yes, the same Tesco which has just issued two profit warnings within six weeks, which has cut its interim dividend by 75 per cent and has a share price which has fallen to its 2003 level.

I was even asked about it at one of the fund's annual meetings, and a member of the audience tweeted afterwards of his incredulity that I had not been pressed further on the subject.

Superficially it is easy to see why. We are talking not just about the UK's most powerful retailer which has underperformed the market for several years, thereby attracting investors who rely on the theory that what goes down must come up (ignoring the fact that Sir Isaac Newton popularised a theory which proclaims the opposite) and so might present a buying opportunity. Furthermore, this is a UK stock owned by Warren Buffett, the "Sage of Omaha". In the face of such endorsement, how could I resist owning this gem?

There are many reasons why I am unlikely ever to own a retailer in the Fundsmith Equity Fund, but when it comes to Tesco, a single lesson from the Sage himself was enough to put me off.

In his 1979 annual letter to shareholders, Mr Buffett stated: "The primary test of managerial economic performance is the achievement of a high earnings rate on equity capital employed (without undue leverage, accounting gimmickry, etc) and not the achievement of consistent gains in earnings per share."

This makes it all the more surprising to me that both Mr Buffett and the many acolytes who have seemingly followed him to the gates of hell in Tesco, ignored this chart (right).

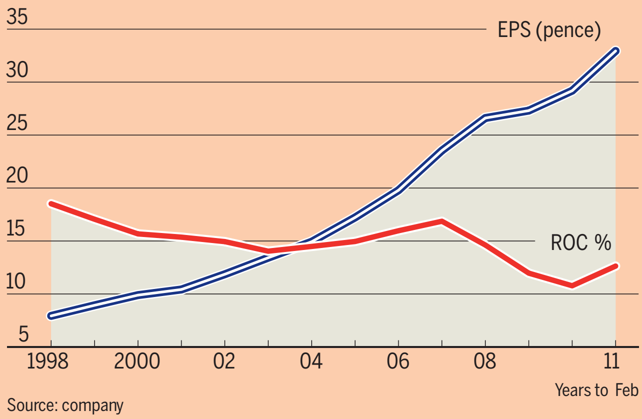
This is not the first such chart that I have come across in which a company reports steadily rising earnings per share (EPS), on which most analysts and "investors" focus. For them, the rise in EPS seems to have a mesmeric effect such as that employed by Kaa the snake in Disney's *The Jungle Book*. But they ignore the point that more capital is being employed to generate those earnings at ever lower returns.

> Tesco has changed its definition of return on capital employed eight times in those years

Add in the fact that Tesco has changed its definition of return on capital employed (ROCE) eight times during those years, and there's more than enough material to send investors running for cover – even those who have less aversion than I do to retailers.

Yet much of the commentary about what has gone wrong at Tesco focuses on Philip Clarke, who took over as chief executive from Sir Terry Leahy in 2011, as if everything was going swimmingly until then.

Tesco: the Leahy years



Source: company

Looking at the ROCE line in the chart it is clear that this was not the case. Moreover, one thing to bear in mind is that if Tesco's ROCE during the Leahy years fell from a very good 19 per cent to a less than adequate 10 per cent, this is an average of returns on capital employed, which includes both capital invested years ago and more recent commitments.

To drag the average ROCE down so dramatically it is likely that returns on new investments in those years were not just inadequate, but in some cases negative – as the ill-starred US expansion proved to be.

Even if return on capital employed does not have the same importance for you as it does for me, or the Sage (at least in 1979), consider this: in 14 of the past 18 years (taking us back to 1997 when Sir Terry became chief executive) Tesco's free cash flow less its dividend (with free cash defined as operating cash flow less gross capital expenditure) was a negative number. In plain English, Tesco was not generating enough cash both to invest and to pay its dividend. In half of those 14 years, the proceeds of fixed asset disposals took the numbers back into the black, but that is not exactly a sustainable source of financing.

So guess what they did instead? Yes, they borrowed it. Tesco's gross debt, which was £894m when Sir Terry took over, peaked at nearly £15.9bn in 2009.

The company spent much of its free cash on fixed-asset investment and raised debt to help pay the dividend. This is neither healthy nor sustainable, as investors in Tesco have now come to realise.

The concept that this might not be sustainable hardly requires much thought. Neither does charting the ROCE versus the growth in EPS. Yet it is evident that many investors, including it seems the Sage of Omaha (who has been trimming his Tesco stake in recent years) either didn't do this or ignored the results if they did. It makes me wonder what else they are ignoring.

Terry Smith is chief executive of Fundsmith LLP