Principal of Financial Market

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Executive Summary

The current report has focused on discussing overall economic environment of Australia and its retail industry through conducting top down analysis. After performing economic and industry analysis, it has been learnt that the Australian economy has been slightly hit, but it is anticipated that it shall improve in future. It is also expected that Australian financial market and retail industry would also become stronger. On the other hand, two retail companies, AMA Group Limited and Woolworths Limited have been considered for this report. Through bottom up analysis, current financial situation of both the organizations have been carried out. It has been found that their performance has degraded, which requires making a change in their approach of doing business in order to sustain in the market or industry.

Introduction

A financial market allows investors or other people to trade commodities, financial securities and other fungible items of value at low cost of transactions and at prices that would reflect demand and supply. It is a broad term which describes any marketplace where securities comprising currencies, equities, bonds and derivatives takes place. In this paper, an industry and two ASX listed organizations from the same industry would be taken in account for conducting fundamental analysis more specifically, top down analysis and bottom up analysis. It would help in understanding and analyzing overall economic environment and financial situation of the companies. Therefore, retail industry of Australia has been considered for this paper. Australian retail industry has shown significant rise over the years. Like other major industries in Australia, retail industry too largely contributes in the economic development of the nation. The retail industry in Australia is driven by technological changes which range from the exercise of plate glass windows to the advent of the internet that effectively offers a similar customer service.

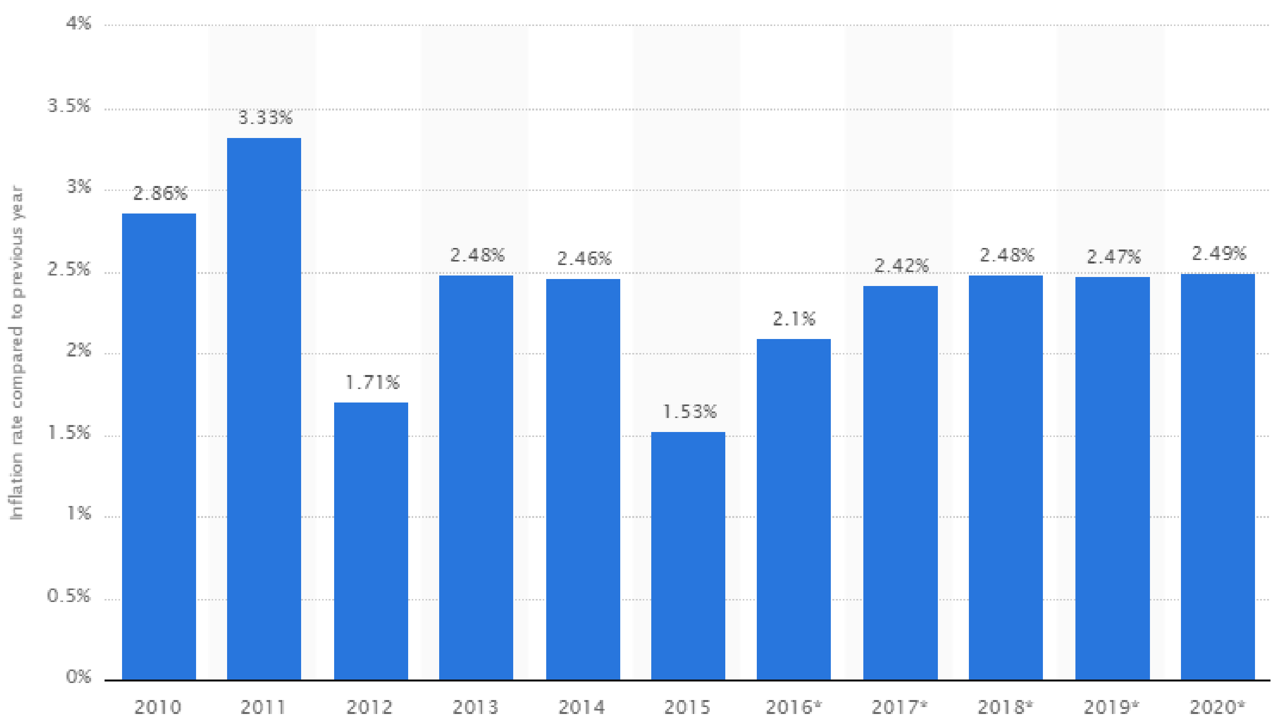
According to the report of Australian Bureau of Statistics Retail Trade figures, the turnover of retail industry has increased by 3.7% between 2014 and 2015 (Editor, 2016). It is also reported that average retail sales year-on-year in Australia attained is 5.97% from 1983 until 2016 (Tradingeconomics, 2016a). Therefore, Australian retail industry is growing at a significant pace. The companies that have been selected from considered industry are Woolworths Limited and AMA Group Limited. The mission Statement of Woolworths Limited is to deliver and offer to the consumers a satisfactory shopping experience (Woolworthslimited, 2016). On the other hand, the mission statement of AMA Group is to give high commitment to excellence in cost effective operations, customer service and sector leading brands. The firm is intensely focused on investing in its customers and people, maintaining focus on shareholder value and delivering growth (Amagroupltd, 2016).

Section A: Top Down Analysis

Economic Analysis

The monetary policy of Australia is formulated and implemented by the Reserve Bank of Australia. Monetary policy entails the management of short-term interest rates for attaining domestic policy objectives in accordance with the floating exchange rates. The bank maintains an inflation target and seeks to hold consumer price inflation in the economy to 2% to 3% so that price stability, economic prosperity, full employment and welfare of people could be maintained (RBA, 2016). On the other hand, the current inflation rate in Australia is 2.1% in 2016 which has slightly increased from 1.53% in 2015. It is also expected that the inflation rate would further increase to 2.49% till 2020.

Figure 1: Australian Inflation Rate



(Source: Statista, 2016a)

However, it could be pointed that the country would be able to maintain the inflation rate within its inflation target standard. Moreover, it could be seen that forecasted inflation rate is almost similar or stable. It indicates that the companies like Woolworths and AMA Group or others would be more optimistic and confident to invest. This in turn could lead to rise in LRAS (Long Run Aggregate Supply) and would facilitate higher rates of economic development in the future. On the other hand, as Australia is able to maintain the inflation target, then it would extensively promote the companies to make efficient utilization of the productive resources. Moreover, the stable inflation would foster investment as it would help in reducing the uncertainty about the financial market (Hall and Lieberman, 2012). Therefore, the organizations would be able to take long-term decisions which could help in contributing to economic development and in national reserve. It could be pointed that inflation rate in Australia is quite normal which would support many investors, shareholders and businesses to avoid financial losses.

Further, the factor that could be considered is GDP (Gross Domestic Product) of the country. The GDP in Australia in 2015 has been reported to be 1339.54 billion US dollars which declined from 1454.68 billion US dollars in 2014 (Tradingeconomics, 2016b). Decreasing GDP indicates that economic condition of the country is going down. Therefore, it can impact on the stock prices, profits of the companies, employment level, wages, etc. It might force the firms to lower down its stock prices which could largely and directly affect their earnings and returns. Moreover, it could be understood from the declining Australian GDP is that the country might not be using the resources economically and productively. This can have long term impact on the overall economic development of financial market or other markets in Australia. However, it is predicted that the GDP of Australia would increase to 1468.69 billion US dollars till 2020 (Statista, 2016b). The basis for such forecast is that the country would be welcoming more foreign direct investment in the financial market and simultaneously in other markets which could significantly contribute in the economic growth. It is also pointed that export of goods and services would also increase in future which shall help in increasing the GDP value. On the other hand, it has been reported that in the final quarter of 2015, GDP has increased by 0.6% which was driven by potency in household final consumption expenditure and with public gross fixed capital arrangement. It has also be noted by ABS (Australian Bureau of Statistics) that the rise in GDP was driven by development in service industries such as arts and recreation services (2.2%), information, communication and media (2.7%) and retail trade (1.0%) (Scutt, 2016).

The value of Australian Dollar is currently lower than developed countries like the US, the UK and other nations but higher than developing economies like India, Mauritius, etc.

Table 1: Australian Dollar Rates Table

Australian Dollar	1.00 AUD	inv. 1.00 AUD
US Dollar	0.758745	1.317966
Euro	0.680760	1.468947
British Pound	0.584602	1.710564
Indian Rupee	50.854235	0.019664
Canadian Dollar	0.999313	1.000688
Singapore Dollar	1.033305	0.967768
Swiss Franc	0.741751	1.348162
Malaysian Ringgit	3.140315	0.318439
Japanese Yen	77.305519	0.012936
Chinese Yuan Renminbi	5.061760	0.197560

(Source: X-rates, 2016a)

It could be clearly observed from the above table that exchange value of Australia is lower in comparison to US Dollar, Euro, Canadian Dollar and Swiss Franc. In context to this, it could be pointed that exports from Australia would be cheaper and on the other hand, imports would become more expensive. Therefore, it could give rise to inflation in the country. However, it could be noticed that there is not much gap between the currency of Australia and developed nations. Due to this, there is not much negative impact on the Australian economy and its market. The exchange rate of Australia is majorly determined by scale of demand and supply on the international markets and by market forces. The lower gap in the currency value indicates that Australia would be able to bear the cost for importing the goods, technology or other materials from countries like the US, unlike developing countries like India, which could be costly for them to import from the US. On the other hand, over the period the exchange value of

Australia has further decline more when compared to the value of 2010. For example, in 2010, 1AUD was equal to 0.947 US Dollar, 0.721 Euro and 0.609 British Pound (X-rates, 2016b). It could be pointed that if AMA Group or Woolworths decide to import materials from these countries, then these companies would have to disburse more amounts which can impact on their profitability. Therefore, from the exchange value of Australia, it could be observed that the performance of the country is going down which requires serious attention.

Industry Analysis

Demand and supply relationship in Australian retail industry is almost at equilibrium level. There has been huge transformation in retail areas with the advent of technology which has supported the organizations to improve their supply and value chain. It has led to product availability whenever there is increase in the demand for the product. Moreover, for meeting the demand of the consumers, many companies in the retail industry has moved to online retailing so that gap between supply and demand could be minimized. As per the data from National Australian Bank, domestic online retailers are now capturing about 75% of total online spending (Ferrierhodgson, 2015). The Australian retail industry has generated $161 billion between 2015 and 2016 and provided employment to more than 734,300 people (Ibisworld, 2016).

On the other hand, both national and international quality control standards are maintained in the retail industry so that accurate and expected value could be provided to the customers, investors or shareholders. Moreover, there is a stiff competition between retail companies present in the retail industry in order to capture more market share and expand its businesses. Further, the retail organizations have more bargaining power than buyers as the number of customers for retail products are more than the availability of companies in the market. Therefore, it gives an edge to the companies to fix price of their products according to them which can attract the customers.

Forecast changes impact companies' performances

The changes in the economic fundamentals could significantly influence the outcome and performance of the organizations. If it is expected that inflation in the country would decrease in future then it would enable both AMA Group and Woolworths to make long term plans as they would know that the purchasing power of their capital shall hold and would not be gradually eroded year after year. Moreover, the companies would be able to borrow finance at lower real interest rates which could help the firms to use it in financing their business or expanding it

(Gagnon and Hinterschweiger, 2011). Further, based on the current situation if the changes in context to GDP are predicted, then GDP would improve in future and it would allow Woolworths and AMA Group to increase their business revenue. Growing GDP forecast would enable the firms to take decisions that required investment could be made in the industry and market which can support in increasing the performance of the companies and arranging the product for the customers. On the other hand, it has been mentioned that exchange value of Australia has weakened to some extent and if it is forecasted that it would further depreciate, then it would become tough for the companies to import any goods or technology that they might require for their business. The low exchange value would make Woolworths and AMA Group to spend more for advertising their business internationally or supplying products. Therefore, it can lower down the total earnings of the companies.

Section 2: Bottom Up Analysis

Current Financial Situation of AMA Group

	2016 (million AUD)	2015 (million AUD)
Net Profit Ratio		
Net Profit after Tax	7.22	9.09
Net Sales	264	93
	2.73485	9.77419

It could be clearly seen that net profit of the company has significantly declined in spite of increase in sales. The main reason behind the drop in net profit is increase in operating expenses. The company majorly increased the selling, general and administrative expenses and depreciation or amortization (Markets.ft, 2016b). This has impacted on the total income of the company. It is important for the company to increase its net profit in order to survive in the retail industry.

Return on Assets	2016 (million AUD)	2015 (million AUD)
Net Income	7.22	9.09
Average Total Assets	169.5	69.5
	4.25959	13.0791

AMA Group has not been able to increase its return on assets and suffered decline. It indicates that the company is not being able to convert its assets into profits efficiently thereby affecting its profitability states. Due to this, the investors would be less likely interested to invest in the company which would further impact the business operation.

Return on Equity	2016 (million AUD)	2015 (million AUD)
Net Income	7.22	9.09
Shareholder's Equity	147	48
	4.91156	18.9375

From the above financial ratio evaluation, it could be viewed that there has been drop in generating return from the shareholders investment. The return on equity has fallen down more than half the value earned in 2015. It shows that the company is lacking the required ability to utilize the investments of shareholders due to which it has faced huge decline. Moreover, it could be assumed that the firm may not be investing in the right project due to which there is fall in return.

Current Ratio	2016 (million AUD)	2015 (million AUD)
Current Assets	63	23
Current Liabilities	59	24
	1.0678	0.95833

The current ratio of the firm is almost stable in 2015 and 2016. It indicates that the company is able to cover at least the value of their short term debt. However, it is expected that the company need to increase the ratio in order to provide additional cushion against any unforeseeable incidents that would take place in the short term.

Quick Ratio	2016 (million AUD)	2015 (million AUD)
Current Assets	63	23
Inventory	15	7.48
Prepaid Expenses	1.69	1.27
Current Liabilities	59	24
	0.78492	0.59375

Quick ratio of AMA Group has slightly improved as well but is often expected that the company shall achieve the ratio of at least 1:1. It would help in meeting the current financial obligations with the available quick finance on hand. However, AMA Group is not being able to invest the resources in the business's working capital which is impacting its profitability. On the other hand, the cash flow of AMA Group is stable which could be the reason for keeping its quick ratio at low level.

Debt to Equity Ratio	2016 (million AUD)	2015 (million AUD)
Total Liabilities	110	35
Total Equity	147	48
	0.7483	0.72917

Considering the debt to equity ratio of 2015 and 2016, the value is almost similar. It shows that AMA Group uses debt financing equal to 72% and 74% in respective years. Moreover, the percent of assets provided by the stockholders is higher in comparison to the percent of assets given by the creditors of the company. The ratio indicates that the company is able to protect its money and seems a financially stable business.

Return on Capital Employed	2016 (million AUD)	2015 (million AUD)
Net Operating Profit	15	13
Total Assets	256	83
Current Liabilities	59	24
	0.07614	0.22034

The return of the company has significantly declined from around 22% in 2015 to 7.6% in 2016. It could be assumed that in spite of accumulating high percent of assets in 2016 in comparison to last year, the company has not been able to convert the investment into return. Therefore, it shows the inability of the company to use the assets or resources effectively.

Current Financial Situation of Woolworths

	2016 (million AUD)	2015 (million AUD)
Net Profit Ratio		

Net Profit after Tax	840	2301
Net Sales	58276	59001
	1.44142	3.899933899

The net profit of Woolworths has also declined in 2016 in comparison to preceding year (Markets.ft, 2016b). The major reason behind the decrease is the fall in the sales of product and services of the company. It is also seen from the income statement of Woolworths that it has made unusual expenses of AUD 959 million which is nearly double than last year which has impacted the profit level.

Return on Assets	2016 (million AUD)	2015 (million AUD)
Net Income	840	2301
Average Total Assets	24419.5	24737
	3.43987	9.30185552

It could be seen from the above valuation of return on assets that Woolworths has faced more than double drop in the return in 2016. It illustrates that the company might not be investing in profitable assets or assets may be remaining idle for most part of the time. Further, the fixed costs of the company would be high due to which the return on assets might have been affected. The company would be lacking efficiency to convert the purchased assets into net income.

Return on Equity	2016 (million AUD)	2015 (million AUD)
Net Income	840	2301
Shareholder's Equity	8471	10834
	9.91618	21.238693

The company has generated less return from the investments done by its shareholders in comparison to return earned in 2015. It could be seen that the shareholders have invested less in 2016 due to continuous decline in the total revenue of the company. On the other hand, it could be pointed that the firm might not be using or investing the capital of shareholders in the profitable venture due to which the return is low.

Current Ratio	2016 (million AUD)	2015 (million AUD)
Current Assets	7427	7661

Current Liabilities	8993	9169
	0.82586	0.835532773

The current ratio of Woolworths is almost stable from the year 2015 to 2016. It indicates that the company might be having problem to able to pay of its short term or current obligations as it does not have significant portion of liquid assets which could be seen on balance sheet. However, maintaining a stable ratio shows that company is able to meet its obligations with the level of liquid assets held by them.

Quick Ratio	2016 (million AUD)	2015 (million AUD)
Current Assets	7427	7661
Inventory	4559	4872
Prepaid Expenses	330	301
Current Liabilities	8993	9169
	0.28222	0.271349111

Quick ratio is almost similar but it is very less which illustrates that Woolworths is facing huge problem or takes more time in paying its bill or other short term obligations. Moreover, it shows that operating efficiency of the company is falling down and is not able to convert its liquid assets into cash. On the other hand, current assets of Woolworths consisting major portion of inventory which is not easily converted due to which the quick ratio is very low.

Debt to Equity Ratio	2016 (million AUD)	2015 (million AUD)
Total Liabilities	15032	14503
Total Equity	8471	10834
	1.77452	1.338656083

It could be viewed that Woolworths has been maintaining a high debt to equity ratio as per data of 2015 and 2016. It means that the company is heavily relying on debt financing which makes it a risky venture for the investors. Moreover, it indicates that the company might not be able to produce sufficient capital for satisfying its debt responsibilities. Therefore, it shows that the company is less dependent on shareholder’s equity for running its business operations.

Return on Capital Employed	2016 (million AUD)	2015 (million AUD)

Net Operating Profit	1605	3550
Total Assets	23502	25337
Current Liabilities	8993	9169
	0.11062	0.21956952

The return on the investment made by Woolworths has also gone down to 11% in 2016 against 21% in 2015. It could be understood that the company is lacking efficiency using the capital in the right areas due to which Woolworths has suffered decline in return. On the other hand, it could be assumed that the long term financing strategies of the company might not be effective due to which the investment in assets or in products or services may not result in increased return.

Comparing need to industry and company history

The need of measuring performance of the companies would be compared by analyzing their current situation with the industry financial/accounting ratios standard. In context to return on assets, it is important for AMA Group and Woolworths to earn more above the investments made in the current and fixed assets. It has been observed that both the firms have generated positive return but less than previous year. Therefore, in order to survive in the retail industry, the companies would have to match up the industry standard. On the other hand, past performance of the firms need to be compared with the current performance to know whether they have grown over the years or gone down (Needles, Powers and Crosson, 2010). Further, the current ratio is usually considering 2:1 as an acceptable standard in the industry. It ensures that the firms are in a comfortable financial position to clear their short term debts. The current ratio of both AMA Group and Woolworths is below the standard level which shows that they do not have enough liquid assets which could be used for meeting the short term obligations. It is important for the companies to check their current ratio history for knowing where are they lacking and what kind of assets they are required to focus upon to quickly achieve the debt requirement. Simultaneously, it is crucial for both the companies to analyze other financial measures considering company history and industry for better future operation.

Summary and Recommendations

From the overall study, it has been understood that economic environment of Australia has been affected to some extent. It would entail the companies to spend more capital for running the business and could also make difficult to survive in the financial market. However, it is expected that Australian economy would rise in future as it is forecasted that there would be increase in the foreign investment in different sectors. On the other hand, it has been found that both AMA Group and Woolworths have witnessed decline in their performance which requires serious attention to maintain their stand in the retail industry.

AMA Group would have to improve its business structure and need to invest in liquid assets so that any short term obligations could be met quickly without relying much on external debt or waiting for assets to get liquefied. Furthermore, in order to improve sales, the company would have to build better marketing strategies and invest in promotion. It would help in making customers aware about the business activities and dealings of the company which can support in increasing the sales.

On the other hand, Woolworths would require to sale the assets that are unproductive which could help in decreasing the holding costs. Therefore, the saved costs could be used in enhancing the product and service quality. Furthermore, the company needs to control its expenses in order to make a right balance between net profit and net sales.

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