

Tesco

Price 155.20p

Q3 trading statement (first take): encouraging signs, but we remain timorous

Fair Value 166p (+7%)

NEUTRAL

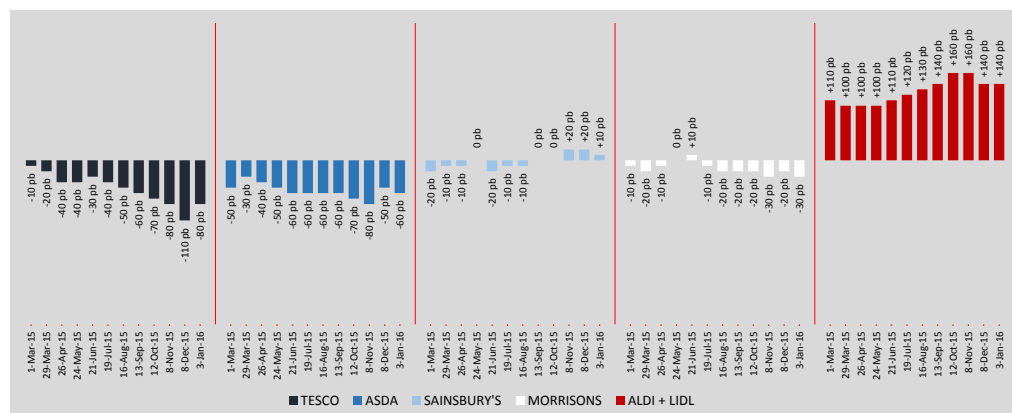
At this stage, today's statement has nothing to change our conviction that other catalysts can only be considered once Tesco has regained strong LFLs in the UK. Hence, at this stage, we maintain our Neutral rating.

Q3 LFL sales growth excl. fuel and VAT (main kpi) came in at -1.5% (vs -1.0% in Q2 and -1.3% in Q1) in the UK. The quarter was notably impacted by strong comps with expensive voucher promotions in 2014. The performance was more encouraging during the Christmas period, with a +1.3% LFL rate (rather encouraging but "one swallow does not a summer make").

Overseas, sales performances are maintaining decent momentum with +2.9% LFL (vs +2.3% in Q2 and -0.2% in Q1), +2.4% rate in Asia (vs flat in Q2) and +3.3% in Europe (vs +4.0% in Q2). Nevertheless, today's statement has nothing to change our conviction that other catalysts can only be considered once Tesco has regained respectable LFLs in the UK.

Given the sluggishness specific to the sector, Tesco's commercial resolutions could take time to produce their effects. Growth is at a standstill (a disruptive factor in a fixed-cost industry, as Tesco's CEO Dave Lewis hinted at when he spoke of a "lethal cocktail of costs" in the UK). This is the reason why, at this stage, we maintain our Neutral rating.

Change in market share in the UK (12 weeks sliding)



Source: Kantar, BG's estimates

Reminder of our investment case

Tesco's balance sheet looks pretty precarious (adjusted ND/EBITDA ratio of 5.3x e before disposal of Korea) in that that even the sale of Homeplus only prompted a modest improvement in the ratio (i.e. an estimated 25bp).

Given the cut in capex and the recent asset disposals, we calculate a ratio of 5.0x, which we consider insufficient to secure the balance sheet (below 4.0x would be reassuring). Abandoning activities in eastern Europe (an option that seems to have been ruled out at this stage), assuming an attractive multiple (i.e. 50% x sales), would only have a limited impact (i.e. ~30bp).

At the end of the day, the improvement in the major balances is dependent on a recovery in lfl figures in the UK. As such, we believe that lfl growth rates of more than 2% are necessary to offset the natural inflation in costs and the emergence of convincing operating leverage. We are not yet convinced by earnings and are therefore initiating the stock with a Neutral recommendation.

NEXT CATALYSTS

- Strong LFL and market share gains in the UK

Bloomberg	TSCO LN
Reuters	TSCO.L
12-month High / Low (p)	251.0 / 139.2
Market Cap (GBPm)	12,635
Ev (BG Estimates) (GBPm)	20,160
Avg. 6m daily volume (000)	23 645
3y EPS CAGR	0.3%

	1 M	3 M	6 M	31/12/14
Absolute perf.	7.5%	-23.1%	-25.3%	-17.9%
Food Retailing	0.1%	-7.0%	-8.1%	6.1%
DJ Stoxx 600	-3.5%	-5.1%	-11.7%	0.2%

YEnd Feb. (GBPm)	02/15	02/16e	02/17e	02/18e
Sales	62,284	55,691	56,710	58,156
% change		-10.6%	1.8%	2.6%
EBITDA	2,942	2,240	2,236	2,450
EBIT	-5,792	903.4	1,051	1,235
% change		NS	16.3%	17.5%
Net income	589.3	279.6	460.3	594.7
% change		-52.5%	64.6%	29.2%

	02/15	02/16e	02/17e	02/18e
Operating margin	2.2	1.6	1.9	2.1
Net margin	0.9	0.5	0.8	1.0
ROE	NM	NM	NM	NM
ROCE	5.5	4.2	5.0	6.0
Gearing	119.9	54.7	42.5	30.6

(p)	02/15	02/16e	02/17e	02/18e
EPS	7.27	3.45	5.68	7.34
% change	-	-52.5%	64.6%	29.2%
P/E	21.4x	45.0x	27.3x	21.2x
FCF yield (%)	NM	0.0%	0.1%	0.1%
Dividends (p)	1.16	0.00	0.85	2.20
Div yield (%)	0.7%	NM	0.5%	1.4%
EV/Sales	0.4x	0.4x	0.3x	0.3x
EV/EBITDA	8.4x	9.0x	8.7x	7.7x
EV/EBIT	NS	22.3x	18.5x	15.2x



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