1st April 2016

Food retailing

Metro AG

Price EUR27.23

The positive buzz surrounding the spin-off could limit downside

Fair Value EUR26 vs. EUR24 (-5%) **NEUTRAL vs. UNDER REVIEW**

Bloomberg	MEO GY
Reuters	MEOG.DE
12-month High / Low (EUR)	34.6 / 21.9
Market Cap (EURm)	8,825
Ev (BG Estimates) (EURm)	11,704
Avg. 6m daily volume (000)	1 229
3y EPS CAGR	12.3%

	1 M	3 M	6 M	31/12/15
Absolute perf.	20.0%	-7.9%	10.3%	-7.9%
Food Retailing	2.5%	2.0%	3.1%	2.0%
DJ Stoxx 600	1.1%	-7.7%	-2.9%	-7.7%

YEnd Sept. (EURm)	09/15	09/16e	09/17e	09/18e
Sales	59,220	58,320	59,835	61,396
% change		*-1.5%*	*2.6%*	*2.6%*
EBITDA	2,457	2,460	2,544	2,631
EBIT	711.0	1,497	1,557	1,618
% change		*110.6%*	*4.0%*	*3.9%*
Net income	502.3	597.5	652.5	711.0
% change		*18.9%*	*9.2%*	*9.0%*

	09/15	09/16e	09/17e	09/18e
Operating margin	2.6	2.6	2.6	2.6
Net margin	0.8	1.0	1.1	1.2
ROE	NM	NM	NM	NM
ROCE	10.5	10.2	9.8	9.6
Gearing	48.9	44.4	45.9	46.4

(EUR)	09/15	09/16e	09/17e	09/18e
EPS	1.54	1.83	2.00	2.18
% change	-	*18.9%*	*9.2%*	*9.0%*
P/E	17.7x	14.9x	13.6x	12.5x
FCF yield (%)	NM	NM	NM	NM
Dividends (EUR)	1.00	0.98	1.02	1.05
Div yield (%)	3.7%	3.6%	3.7%	3.9%
EV/Sales	0.2x	0.2x	0.2x	0.2x
EV/EBITDA	4.8x	4.8x	4.7x	4.7x
EV/EBIT	16.5x	7.8x	7.7x	7.6x

We have upgraded our recommendation to Neutral vs Sell because: 1/ we believe that the spin-off makes sense from a strategic point of view; 2/ seperate listings would probably help gain operational flexibility going forward; 3/ we believe a pure player is far more valuable than a patchwork of very different business units; 4/ the post spin-off structure may inspire some attractive scenarios (the impact of which will notably depend on MMS's status as a prey or predator). Anyway, we guess the positive buzz surrounding this spin-off could limit immediate downside potential. Neutral.

Metro announced its intention to split into two entities: Media Saturn on the one hand and Real/Cash & Carry on the other. As a reminder, once appoved by the AGM, the plan is to split the Media Saturn and Food businesses by mid 2017 when Metro's shareholders will receive a proportionate stake in both seperatly listed entities (Media Saturn will remain in the Metro AG listed entity). Because we were travelling the day of the news, we initially put both our recommendation and our Fair Value under review. Once we were back in Paris, we were able to carefully assess the consequences of this deal.

We have finally upgrade our recommendation to Neutral vs Sell because: **1/** we believe that the deal makes sense from a strategic point of view, since there are very few synergies between the divisions; **2/** seperate listings would probably help gain operational flexibility going forward; **3/** we believe a pure player is indeed far more valuable than a patchwork of very different business units; on paper, **4/** the post spin-off structure may inspire some attractive scenarios (the impact of which will notably depend on MMS's status as a prey or predator…). Anyway, we guess the positive buzz surrounding this spin-off could limit immediate downside potential.

Nevertheless, **1/** this fairly smart spin-off and the buzz around it will not wipe out all of Metro's (see below). This is the reason why we are not buyers of the stock either. Not to mention the fact that **2/** we are not sure that the proposed new structure will help fully fix governance issues (according to management, under the new structure, Kellerhals could not prevent Media Saturn from undertaking international deals going forward, but we guess there is a counterpart... and in any case, a structural M&A deal won't occur before mid-2017 when the deal is completed). Moreover, **3/** the German retailer will have to show stronger momentum, especially in Real and Cash&Carry, so that valuation multiples can effectively rerate going forward.

As a reminder in terms of our concerns:

- So far, in view of EBIT margin of around 10% (!), and despite the depreciation in the Rouble, Russia accounts for ~25% of EBIT whereas its share of sales only stands at ~8%. In a restricted consumer spending environment, and with the market stigmatising and harshly punishing margin rate policies (see Tesco), a margin rate of this level leaves us somewhat perplexed.
- Since the aim is to rapidly serve shareholder interests, the temptation for retailers to collude over prices is all the more enticing, we think, in that the market has an oligopolistic structure. However, Russian retailing is ultimately dominated by a handful of listed retailers (X5, Magnit, Lenta, Dixy and O'key) who have never really suffered competition from troublesome independents.
- MMS (~30% of the group's profitability) remains at the forefront of the disruptive development of e-commerce in Europe. Indeed, the roll-out of the online offering could eat into sales of the bricks and mortar store network and dilute the banner's profitability. Consequently, at this stage, it is difficult for us to factor in a strong improvement in margins as expected by the consensus.

VALUATION

- Our new FV is the average between a DCF (EUR21) and a SOTP (EUR31)

NEXT CATALYSTS

- Spin-off mid-2017

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