

12th April 2016

Food retailing

Tesco

Price 193.50p

FY 2015/16 (first take): apart from FCF, nothing that surprising to us

Fair Value 166p (-14%)

NEUTRAL

Bloomberg	TSCO LN
Reuters	TSCO.L
12-month High / Low (p)	246.9 / 139.2
Market Cap (GBPm)	15,753
Ev (BG Estimates) (GBPm)	23,278
Avg. 6m daily volume (000)	26 907
3y EPS CAGR	0.3%

	1 M	3 M	6 M	31/12/15
Absolute perf.	0.7%	33.0%	-5.5%	29.4%
Food Retailing	1.2%	8.1%	-2.1%	3.4%
DJ Stoxx 600	-2.7%	-2.2%	-8.3%	-9.0%

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	26.6x	56.1x	34.1x	26.4x
FCF yield (%)	NM	0.0%	0.1%	0.1%
Dividends (p)	1.16	0.00	0.85	2.20
Div yield (%)	0.6%	NM	0.4%	1.1%
EV/Sales	0.4x	0.4x	0.4x	0.4x
EV/EBITDA	9.5x	10.4x	10.1x	8.9x
EV/EBIT	NS	25.8x	21.5x	17.7x

FY group trading profit worked out at GBP944m (vs GBP935m expected by the consensus). Once again, at this stage, today's statement does not allow us to amend our conviction according to which other catalysts can only be considered once the Tesco has restored strong LFL rates in the UK&ROI (in Q4, UK&ROI LFL sales excl. VAT is up +0.9% vs +0.6%e). Hence, at this stage, ahead of the conference call, we maintain our Neutral rating.

Overseas (29% of EBIT), sales performances remain in a good momentum with a +3.8% LFL rate (vs +3.5% e / +2.9% in Q3, +2.3% in Q2 and -0.2% in Q1), which breaks down into a +3.5% LFL rate in Asia (vs +2.4% in Q3, flat in Q2 and -3.4% in Q1) and +4.1% LFL rate in Europe (vs +3.3% in Q3, +4.0% in Q2 and +2.2% in Q1).

In the UK (53% of EBIT), Q4 LFL sales growth excl. fuel and VAT (main kpi) works out at +0.9% vs (+0.6% e / -1.5% in Q3, -1.0% in Q2 and -1.5% in Q1). Admittedly, this is a sequential improvement (driven by volumes and transactions up +3.3% and +2.8% respectively in Q4) which, at this stage and ahead of the conference call, is not sufficient to definitely wipe out operating concerns.

As a reminder, *ceteris paribus*, lfl need to be well above the current levels to amortize the natural cost inflation (~2.5%) and the emergence operating leverage. Growth is at a standstill (a disruptive factor in a fixed-cost industry, as Tesco's CEO hinted at when he spoke of a "lethal cocktail of costs" in the UK).

Bottom line, FY trading profit worked out at GBP505m (vs GBP505m expected by the consensus) in UK & ROI (i.e. +4bp improvement in margin / +176 bp in H2); GBP277m (vs GBP264m e) for international activities (i.e. flat margin / +52bp in H2); GBP162m (vs GBP170m e) at Tesco Bank (i.e. -140bp decline in margin / -176 bp in H2).

The net debt came in at GBP5.1bn (in line with the consensus). Note that FCF worked out at GBP1.3bn which is obviously well above expectations (a point we need to look into detail, but obviously, WCR was better than expected while tax were below estimates).

ANALYSIS

Tesco's balance sheet is all the more 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).

Yet, the improvement in the major balances is dependent on a recovery in lfl figures in the UK. As such, *ceteris paribus*, we believe that lfl growth rates of more than 2% are necessary to amortise the natural inflation in costs (~2.5%) and the emergence of convincing operating leverage.

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).

VALUATION

- NM

NEXT CATALYSTS

- Significant improvement of LFL sales growth in UK&ROI

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