

14th April 2016

Food retailing

# Tesco

Price 181.00p

Postview: a return to commercial reality

Fair Value 166p (-8%)

SELL vs. NEUTRAL

Bloomberg	TSCO LN
Reuters	TSCO.L
12-month High / Low (p)	246.9 / 139.2
Market Cap (GBPm)	14,735
Ev (BG Estimates) (GBPm)	22,664
Avg. 6m daily volume (000)	27 410
3y EPS CAGR	103.4%

	1 M	3 M	6 M	31/12/15
Absolute perf.	-5.8%	14.3%	-6.7%	21.1%
Food Retailing	0.8%	4.7%	0.3%	3.0%
DJ Stoxx 600	0.2%	-0.5%	-4.3%	-6.2%

YEnd Feb. (GBPm)	02/16	02/17e	02/18e	02/19e
Sales	54,433	56,245	57,696	58,948
% change		3.3%	2.6%	2.2%
EBITDA	2,278	2,225	2,437	2,581
EBIT	1,046	1,069	1,252	1,370
% change		2.2%	17.1%	9.4%
Net income	103.5	473.0	606.7	866.2
% change		NM	28.3%	42.8%

	02/16	02/17e	02/18e	02/19e
Operating margin	1.7	1.9	2.2	2.3
Net margin	0.2	0.8	1.1	1.5
ROE	NM	NM	NM	NM
ROCE	4.5	5.2	6.1	6.8
Gearing	59.3	48.5	38.5	30.6

(p)	02/16	02/17e	02/18e	02/19e
EPS	1.27	5.83	7.48	10.68
% change	-	NM	28.3%	42.8%
P/E	NS	31.0x	24.2x	16.9x
FCF yield (%)	0.1%	0.1%	0.1%	0.1%
Dividends (p)	0.00	0.88	2.24	4.27
Div yield (%)	NM	0.5%	1.2%	2.4%
EV/Sales	0.4x	0.4x	0.4x	0.3x
EV/EBITDA	10.3x	10.2x	9.0x	6.6x
EV/EBIT	22.5x	21.2x	17.6x	12.5x

The improvement in the major balances (adjusted ND/EBITDA ratio of ~5.0x) is dependent on a recovery in lfl figures in the UK (+0.9% LFL currently vs ~2% needed to cover natural cost inflation). And 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 when he spoke of a "lethal cocktail of costs" in the UK). Ultimately, CEO said it would be "a significant, significant achievement" to meet analysts' estimates for operating profit of 1.25 billion pounds this year. In the end, we stick to our cautious stance and downgrade to Sell vs Neutral given a FV of 166p implying a -8% downside potential.

- Sector growth is at a standstill (a disruptive factor in a fixed-cost industry, as Tesco's CEO hinted when he spoke of a "lethal cocktail of costs" in the UK). As a reminder, *ceteris paribus*, lfl need to be well above the current levels in the UK (i.e. +0.9%) to amortize the natural cost inflation (~2.5%) and the emergence operating leverage. So even before yesterday publication, we were much less optimistic that the consensus as to Tesco's ability to deliver a very strong cash margin as soon as 2016/17.
- We do not question the ongoing commercial recovery (i.e. obvious sequential improvement in LFL). But our point is to say that there is a timescale specific to the sector (already evidenced by Géant Casino, the repositioning of which brought visible benefits more than two years after the initiative was launched) and that there is excessive optimism about how quickly improving commercial trends at Tesco might translate into meaningful cash margin increase.
- Ultimately, CEO said it would be "a significant, significant achievement" to meet analysts' estimates for operating profit of 1.25 billion pounds this year. Profit growth "won't be smooth; we are in a turnaround". Before yesterday publication, we were already well below the consensus estimates for FY 16/17 current operating profit (i.e. 16% below). So today, more than ever, we stick to this estimate. (the +3% average adjustment to our estimates is very symbolic given the very low visibility we have on EPS).
- As a reminder for Q4 15/16: 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).
- 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).



## VALUATION

- NM

## NEXT CATALYSTS

- Significant improvement of LFL sales growth in UK&ROI

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**Analyst :**  
Antoine Parison  
33(0) 1 70 36 57 03  
aparison@bryangarnier.com

**Sector Team :**  
Nikolaas Faes  
Loïc Morvan  
Cédric Rossi  
Virginie Roumage

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NEUTRAL ratings 35,3%

SELL ratings 7,9%

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15 St. Botolph Street	75008 Paris	New York, NY 10022	80538 Munich	New Delhi 110 001
London EC3A 7BB	Tel: +33 (0) 1 56 68 75 00	Tel: +1 (0) 212 337 7000	Germany	Tel +91 11 4132 6062
Tel: +44 (0) 207 332 2500	Fax: +33 (0) 1 56 68 75 01	Fax: +1 (0) 212 337 7002	+49 89 2422 62 11	+91 98 1111 5119
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	resolution (ACPR)			CP 2113
				Genève 1, CH 1211
				Tel +4122 731 3263
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