5th October 2016

Food retailing

Tesco

Price 185.30p

Interim results (first take): positive but reading between the lines…

Fair Value 166p (-10%) **SELL**

Bloomberg	TSCO LN
Reuters	TSCO.L
12-month High / Low (p)	204.8 / 139.2
Market Cap (GBPm)	15,147
Ev (BG Estimates) (GBPm)	23,075
Avg. 6m daily volume (000)	27 624
3y EPS CAGR	103.4%

	1 M	3 M	6 M	31/12/15
Absolute perf.	8.0%	4.6%	-2.5%	23.9%
Food Retailing	-2.8%	0.0%	-4.2%	-2.9%
DJ Stoxx 600	-2.1%	3.3%	3.0%	-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	31.8x	24.8x	17.3x
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%	2.3%
EV/Sales	0.4x	0.4x	0.4x	0.3x
EV/EBITDA	10.5x	10.4x	9.2x	6.8x
EV/EBIT	22.8x	21.6x	17.9x	12.8x

1/ The group's CEO stated in April that it would be "a significant, significant achievement" to meet analysts' estimates for operating profit of GBP1.25bn this year. Today, management indicated that Tesco is on track to deliver GBP1.2bn in group operating profit before exceptional items over the FY (good news which, however, implies a flat H2 vs a +80bp H1…). 2/ Management also shared its aim to deliver group operating margin of between 3.5% and 4.0% by 2019/20, a fairly ambitious assumption regarding the current consensus level of 2.8% for 2018/19 (however, its seems that the effects should be back-end loaded…). 3/ The update on the group's pension deficit, which increased by GBP3.2bn is the main negative point of the publication.

Q2 LFL performances

In the UK (~76% of revenues), Q2 LFL sales growth excl. fuel and VAT (main kpi) came in at 0.9% (+0.3% in Q1, +0.9% in Q4 and -1.5% Q3 LY) vs +0.6% expected by the consensus. Beyond the figures, management indicated that new exclusive fresh food brands are performing well in the UK (confirmation of the trend already seen in Q1). **In ROI** (~4% of revenues), Q2 LFL sales growth excl. fuel and VAT worked out to 0.1% (+0.3% in Q1, +1.0% in Q4 and -1.2% Q3 LY) vs +1.5%e. **Overseas** (~20% of revenues), sales momentum remained healthy with a 2.1% LFL rate (+3.0% in Q1, +3.8% in Q4 and +2.7% in Q3 LY). In detail concerning international activities, LFL sales growth worked out to +3.0% in Asia (~9% of revenues) vs +2.1%e and +1.3% in Europe (~11% of revenues) vs +2.3%e.

H1 operating margin

Bottom line, considering rather good commercial trends H1 trading profit worked out to GBP389m (vs GBP310m expected by the consensus) in UK & ROI (i.e. +104bp improvement in margin); GBP118m (vs GBP134m e) for international activities (i.e. +22bp improvement in margin); GBP89m (vs GBP79m e) at Tesco Bank (i.e. -30bp decline in margin). At first sight, the margin improvement was rather impressive considering the huge investment in Farm Brands in 1H.

Salient point regarding the balance sheet

Net debt came in at GBP8.6bn, given cash generated from operations of GBP0.8bn (vs GBP1bn in the LY). **The update on the group's pension deficit, which increased by GBP3.2bn was the main negative point of the publication**, even if it comes as no real surprise since it was flagged by the consensus ahead of the results.

ANALYSIS

- Note that the CEO stated in April that it would be "a significant, significant achievement" to meet analysts' estimates for operating profit of GBP1.25bn). Today, management indicated that Tesco is on track to deliver GBP1.2bn in group operating profit before exceptional items for the full year (which implies a flat margin in H2 vs +80bp in H1).
- Management also shared its ambition to deliver group operating margin of between 3.5% and 4.0% by 2019/20, a rather strong assumption regarding the current consensus level of 2.8% for 2018/19.
- However, "some of these initiatives will require investment and as a result we expect our total capital expenditure to average £1.4bn per annum over the period to 2019/20. The benefits of the initiatives should start to become evident over the coming months, however given their nature and profile, the margin improvement will likely be more weighted towards the end of the plan"…
- We need to assess these new assumptions. At this stage, ahead of the conference call, we stick to our conviction. As a reminder, *ceteris paribus*, lfl growth needs to be well above current levels in the UK (i.e. +0.9%) to amortise natural cost inflation (~2.5%) and provide operating leverage.

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