6th October 2016

Food retailing

Tesco

Price 207.10p

Guidance already looks priced in

Fair Value 170p vs. 166p (-18%) **SELL**

Bloomberg	TSCO LN
Reuters	TSCO.L
12-month High / Low (p)	207.1 / 139.2
Market Cap (GBP)	16,929
Ev (BG Estimates) (GBP)	28,741
Avg. 6m daily volume (000)	28 924
3y EPS CAGR	103.6%

	1 M	3 M	6 M	31/12/15
Absolute perf.	22.2%	17.8%	10.4%	38.5%
Food Retailing	0.1%	4.6%	-1.0%	-0.1%
DJ Stoxx 600	-1.8%	6.2%	4.9%	-5.9%

YEnd Feb. (GBPm)	02/16	02/17e	02/18e	02/19e
Sales	54,433	55,871	57,023	58,259
% change		*2.6%*	*2.1%*	*2.2%*
EBITDA	2,278	2,378	2,592	2,876
EBIT	1,046	1,140	1,412	1,669
% change		*8.9%*	*23.9%*	*18.3%*
Net income	103.5	550.6	667.5	868.9
% change			*21.2%*	*30.2%*

	02/16	02/17e	02/18e	02/19e
Operating margin	1.7	2.2	2.5	2.9
Net margin	0.2	1.0	1.2	1.5
ROE	NM	NM	NM	NM
ROCE	4.5	5.9	6.8	8.0
Gearing	59.3	111.8	102.3	90.8

(p)	02/16	02/17e	02/18e	02/19e
EPS	1.27	6.79	8.23	10.72
% change	-		*21.2%*	*30.2%*
P/E	NS	30.5x	25.2x	19.3x
FCF yield (%)	0.1%	0.0%	0.0%	0.0%
Dividends (p)	0.00	0.00	2.47	4.29
Div yield (%)	NM	NM	1.2%	2.1%
EV/Sales	0.5x	0.5x	0.5x	0.5x
EV/EBITDA	11.3x	12.1x	11.0x	9.8x
EV/EBIT	24.6x	25.2x	20.2x	16.9x

We were impressed by Tesco's management whose strategic options were fully validated in H1, judging from operating results (+104bp improvment in the UK&ROI margin!). This performance deserves applause! However, until the upcoming investor day (16th November), when the plan will be detailed, it is difficult to form a solid opinion on Tesco's ability to deliver a 3.5-4% group margin by 2019/20. And at this stage, with all due respect, we can only conclude that promises only bind those who believe in them.

There is no denying that Tesco’s management was rather impressive in explaining its mid-term ambitions yesterday. As a reminder, it expects to deliver a group operating margin of between 3.5% and 4.0% by 2019/20, which is a very encouraging assumption when looking at the current consensus level (+2.8% for 2018/19). The guidance is all the more appealing in that it does not seem to take into account any return to inflation in the UK. Hence the very positive share price reaction yesterday (+10%), unhampered by the GBP3bn increase in the pension deficit.

The group's ambition is underpinned by drivers including GBP1.5bn in operating cost reductions to further invest in the offer, offset natural cost inflation and enhance profitability. Alongside these cost reductions, Tesco will be looking to further differentiate its brand, focus on cash generation, optimise the margin mix and maximise the value of property. Some of these initiatives will require investment and hence Tesco expects capex to average GBP1.4bn per annum out to 2019/20.

Management notably expects to reduce operating costs by a further GBP1.5bn through **1/** operational improvements (change in trading hours, single customer service desks, replenishment savings, scan as you shop services…), **2/** logistics and distribution (sales forecasting and lower stock holding, lower fulfilment costs, integration of supply and logistical systems, common international systems…) and **3/** scale (single procurement policy, IT systems…).

ANALYSIS

- We have to admit that we were impressed by Tesco's management whose strategic options (notably in favour of fresh products) were fully validated in H1, judging from operating results (+104bp improvment in the UK&ROI margin!). This performance deserves applause!
- That said, in view of the share price reaction, it seems that the market is also betting on an acceleration in the recovery in a context that remains highly uncertain, especially as regards how competitors (notably discounters and Asda) will behave going forward.
- Whatever the case, management will have to be more specific about the levers set to make its guidance feasible at the analysts' day scheduled for 16th November. Until then, it is difficult to form a solid opinion and we would almost conclude that promises only bind those who believe in them.
- At this stage, we can only assess what a margin ranging from 3.5% to 4.0% implies in terms of valuation (with a 100bp margin gap in favour of international business vs the UK). We base our DCF on a 7.22% WACC (risk free rate of 1.6% and risk premium of 7.0%), growth to infinity of 1.2%, while restating our EV for the pension deficit.
- By doing so, we conclude that a valuation for Tesco could range from 170p per share to 210p per share, which is actually the current share price. Hence we struggle to buy into news which, at this stage, could be considered pretty much as wishful thinking.

VALUATION

- We base our Fair Value (170p) on a DCF with a 3.5% normative margin rate at the low end of the mid-term guidance range.

NEXT CATALYSTS

- Investor day on 16th November.

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