HollAnd
Advisors

Holland Views – Tesco PLC – Price: 187p; MCap: £15,251m

Mission Possible

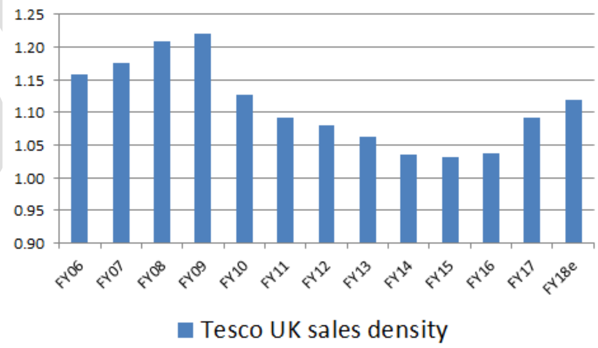
Tesco is written about at length by a great many observers. We have also competed for our fair share of pages on it over the years. As a result, we think we have covered the idea of what Tesco's business model once was and again today is trying to be. All we wish to assert today is our enthusiasm for the shares in the light of the seeming approval by the CMA for the Booker takeover. Combining this regulatory approval with our further reading into the rationale for the deal in the first place results in us having far greater conviction now that Tesco can recover its EBIT margins as per management's plan. As a result, we think the shares offer great self-help value to investors.

The hard way but the right way

In our Tesco piece of the summer – '*the hard way but the right way*' we outlined why we thought by returning to the root of its past successes, Tesco Managers could perhaps deliver on their plan to rise EBIT margin to targeted levels (3.5-4.0%). Since this piece we have studied the results and statements Tesco have released and read the commentary on them by others. What strikes us is that a great number of observers do not seem to understand the re-investment model they are trying to apply for a second time. Perhaps we are naïve to think as such or maybe as we have seen it successfully implemented in so many other sectors we take the idea of its powerful model for granted (see appendix chart). Yet, therein we think lies the opportunity. The driving factor behind the success of such a model is Sales Density, which for many many years rose at the likes of Costco and Tesco (pre 2009).

That this business model at a run rate UK EBIT margin of 6% could not be sustained under the combined attack of low cost and online competition is now well known. That does not mean it does not work in other industries (see JDW and Ryan Air for details) or in fact in the same industry (food retailing) maybe from a different starting point in the capacity cycle and profit margins.

Fig.1: Tesco UK Sales Density



Source: Tesco, Holland Advisors

What kept us away from Tesco shares for 4 years – until our May 17 note was the knowledge that its store estate was likely too big and that this was the elephant in the room that would take an awfully long time to shift. However, we observed in May that not only were Mr Lewis and his team outlining how to use their greatest advantage (scale) once again but they were doing so extremely competently.

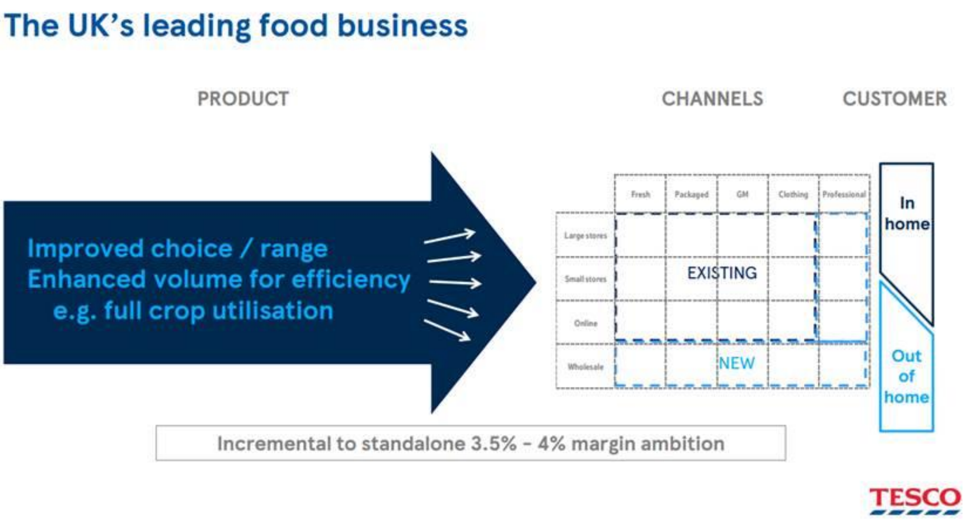
In turn, they were then giving the benefits of this scale to customers whose loyalty was returning on finding greater consistent value on offer in store. In short, the re-investment model was again being used to drive up sales density. However, in order for efficiency gains to be kept by shareholders, they have to be function of greater scale throughput, rather than just one-off cost savings. Hence a price investment was required by the company up-front to win back customer loyalty (occurring now) before improved shareholders margins can be enjoyed (hopefully coming soon). Such deferred gratification many find hard to wait for. The chart above shows sales density once again recovering in FY17. Also, our estimate of its level in FY18 assuming a stable store estate and 2.5% higher sales.

The Tipping Point

These encouraging signs resulted in a little more enthusiasm from us on Tesco this Spring as we felt it logical and right that the resulting EBIT margin of the largest player should recover to at least match its peers. Additionally, that its assets should be able to earn their cost of capital (i.e. what is implied by 3.5-4% EBIT margins). That said, Amazon's expansion of Fresh and the seemingly relentless determination of the likes of Aldi and Lidl to keep expanding despite recently lower margins suggested to us that the industry backdrop was far from clear.

The tipping point in our enthusiasm was however reached this week. Whilst we had not looked at the issue in any detail we had in truth assumed that Tesco/Booker might have had a harder time with regulatory approval than now seems to be the case. An approval without conditions we think is a game changer. Why, because it gives the group so much more flexibility on how to manage and solve our key metric – asset utilisation. Many who have listened to Tesco discuss the rationale for the Booker deal will have seen the chart below. Whilst we agree that post the deal there is a wider growth market available to the company in food, it is the improved efficiency of the existing assets that most excites us as it provides many more options to address this issue.

Fig.2: Booker gives "*enhanced volume for efficiency*"



Source: Tesco 2017

To view the remainder of this in-depth report, please contact Andrew Hollingworth, Andrew@hollandadvisors.co.uk for a complete PDF copy.

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