EDISON

Greggs

Value discovery

Final results

Retail

Five years into its strategy, there is plenty for Greggs to do. Its shops, which all now look and work like value food-on-the-go outlets, must spread out from their high street origins. Its manufacturing bases are being transformed, at substantial projected returns. But most importantly, its wide-ranging food offer will take time to be known by non-customers, we believe. Their gradual buy-in should provide a tailwind to Greggs' mission to gain share.

Year end	Revenue (£m)	PBT* (£m)	EPS* (p)	DPS (p)	P/E (x)	Yield (%)
12/16	894.2	80.3	62.0	31.0	19.6	2.6
12/17	960.0	81.8	64.5	32.3	18.8	2.7
12/18e	1,027.0	85.5	66.5	33.3	18.3	2.7
12/19e	1,105.5	91.0	71.6	35.8	17.0	2.9

Note: *PBT and EPS are normalised, excluding amortisation of acquired intangibles, exceptional items and share-based payments.

Food-on-the-go strategy goes on

Where next for Greggs' strategy, now that the entire estate has been repurposed on the food-on-the-go operating model? The full answer to this references the fourfold strategy as a whole: not only the shops, but also the food offer, the supply chain project, and the enabling of service through support systems. It is through these enhancements that the brand is aiming to become the customer's favourite for food-on-the-go, with the share gains that implies. The estate is still developing with non-retail locations such as transport hubs; the food offer is pushing boundaries with, for instance hot food, creating the possibility of evening opening, and the supply chain project is entering its heaviest investment phase, with substantial returns to come according to the company's projections.

Supply chain enhances both value and convenience

Greggs' brand is founded on convenience and value, and the rationalisation of its manufacturing bases into product specialisation centres should enhance both by providing a reliable supply of quality products at lower economic cost. Management expects the five-year project to provide annualised returns on investment of 23%. It is just entering its third year with a peak investment of £37m.

Brand transformation that is a slow burn

Greggs is a well-loved national brand, but unlike other brand transformation stories, does not advertise its new identity above the line. As a result, we believe non-customers will be relatively slow to understand the transformation of the brand. In one sense this is an advantage since it implies investment in the brand will have a relatively long and sustained return.

Valuation: Stable growth and yield not fully valued

Our valuation approach adds peer comparison to the DCF metric: comparisons are not exact but, like consumers, investors have a choice in the space. Our DCF values the shares at 1,536p, our peer comparison at 1,335p. Our blended valuation is therefore 1,436p (previously 1,226p), implying a FY18e P/E multiple of 21.6x and EV/EBITDA of 8.6x, undemanding given Greggs' stable growth and yield prospects.

14 March 2018

Price	**1,215p**
Market cap	**£1,230m**

Net cash (£m) at December 2017	54.5
Shares in issue	101.2m
Free float	100%
Code	GRG
Primary exchange	LSE
Secondary exchange	N/A

Share price performance

%	1m	3m	12m
Abs	(4.8)	(9.9)	18.8
Rel (local)	(5.9)	(7.1)	18.9
52-week high/low		1399.0p	1002.0p

Business description

With over 1,800 shops, nine regional bakeries and 19,500 employees, Greggs is the UK's leading 'bakery food-on-the-go' retailer. It utilises vertical integration to offer differentiated products at competitive prices

Next events

AGM trading update	9 May 2018
Interim results	31 July 2018

Analysts

Paul Hickman +44 (0)20 3681 2501

Neil Shah +44 (0)20 3681 5700

consumer@edisongroup.com

Edison profile page

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Investment summary

Company description: Food-on-the-go specialist

Over the past five years Greggs has transformed itself from a national bakery chain into a food-on-the-go retailer with a broad offering. There are four strategic pillars supporting the current aim of **becoming the customers' favourite for food-on-the-go.** These are: (1) great-tasting freshly prepared food; (2) the best customer experience; (3) competitive supply chain; and (4) first-class support teams. Greggs has widened its food range to encompass healthy options such as salads and wraps, as well as its traditional baked products. It has developed competitive hot drinks and is extending its hot food ranges, giving the potential for evening opening. Substantially the whole estate has been repurposed to the food-on-the-go operating model and image, and a modernisation of the supply chain is approaching its peak investment phase. A major SAP development is streamlining support functions, and a central stock ordering system relieves store staff of clerical distraction while reducing cost. Greggs does not advertise above the line, and as a result we believe non-customers will be relatively slow to understand the transformation of the brand. In a way this is an advantage since it implies investment in the brand will have a relatively long and sustained return.

Financials: Solid earnings growth, strong cash and yield

Greggs has a good record of like-for-like sales growth, averaging 3.5% over the last two years. In 2017 our expectations were met with 7.4% revenue growth to £960m and, after successful management of inflationary pressures, 4.7% growth in operating profit to £81.7m. Our trading forecast for 2018 is slightly upgraded by 2% at the PBT level, although higher tax means that our EPS forecast is barely changed. We forecast EPS growth of 3.2%, 7.6% and 8.6% over the next three years. Greggs has a strong balance sheet with £54.5m net cash at December 2017: after a high level of capital investment in the estate and particularly the supply chain in 2018, we still forecast £40m net cash by the end of 2018. The dividend yields 2.7% and there is a progressive dividend policy, with the potential for special dividends to be paid if there is excess cash.

Sensitivities: Consumer economy and retail landscape

We see the main sensitivities as:

- Challenges within the consumer economy.
- Resurgence of input, including currency and regulatory cost pressures.
- Marginalisation of terrestrial retail locations faster than management can act to relocate.
- Execution risk from the supply chain programme, and concentration of supply sites.
- Changes to immigration policy causing labour shortages and cost increases.

Valuation: Peer comparisons and DCF blend to 1,436p

We add a peer comparison to our previous DCF valuation metric. On a DCF basis, we apply a 6.9% cost of equity (previously 5.1%), with a 2% perpetuity growth rate (previously a terminal multiple of 8 times). As a result of these assumptions we now define a valuation of 1,536p per share (previously 1,226p). Against a disparate multi-site retail peer group, Greggs stands at a c 20% premium on a P/E basis, and a c 16% discount on EV/EBITDA and EV/sales measures. Adjusting to peer group averages for both forecast years would produce a valuation of 1,051p on a P/E basis, 1489p on an EV/EBITDA basis and 1,465p on an EV/sales basis. These in turn average to 1,335p. Our blended valuation is therefore 1,436p (previously 1,226p), implying an FY18e P/E multiple of 21.6x and EV/EBITDA of 8.6x.

Company description: Next phase of strategy

With origins in local bakeries, Greggs adopted a strategy in 2013 of transforming itself into a value food-on-the-go retailer. This has now evolved to the current aim of **becoming the customers' favourite for food-on-the-go.**

Greggs' strategy is built on four pillars:

1. **Great-tasting freshly prepared food:** Greggs seeks to differentiate itself by highlighting high-quality and freshly prepared food, which is also competitively priced in the value market.
2. **Best customer experience:** the key elements are service and convenience. Convenience is strongly defined by location as well as format, areas of strong focus. Service needs to be simple and straightforward, and the company focuses on its in-store processes.
3. **Competitive supply chain:** hand-in-hand with the developing estate, Greggs is working to rationalise what used to be a regional bakery estate into centres for national production of its major product lines.
4. **First class support teams:** the support function is largely governed by systems, where the company is implementing SAP throughout the organisation.

We go on to examine where the company is now and where it is going on the main planks of its strategy.

Fresh food offer: Meeting wider consumer needs

Greggs has purposefully evolved its food selection to appeal to a wider range of customers, while retaining existing ones.

Exhibit 1: Examples of current products

Source: Greggs

Non-traditional ranges adopted as part of the strategy include:

- **Healthy ranges:** Greggs aims to be at the forefront of the battle to reduce sugars, salt and fats in food-on-the-go (FOTG) products. The company formalised its Balanced Choice sub brand in mid-2014 representing meals containing less than 400 calories, creating new focus on what had previously been a relatively small range of options. Currently, the store fit-out reflects significant shelf area devoted to Balanced Choice, and the range is seeing high single-digit growth (healthy options more widely defined are growing in double digits).
- **Breakfast:** Greggs has for many years maintained a value meal deal for breakfast, which is competitive against alternative vendors. It has progressively rolled out the options and now for example offers croissants, porridge and wraps, as well as sausage and bacon rolls. The standard offer of a sausage and egg roll and a hot drink recently increased in price from £2 to £2.25, but is still competitive against McDonald's, for example. The development of the breakfast range is a significant step in the move towards relative balance between dayparts.

- **Hot drinks:** the company has targeted coffee shops in its upgrade of coffee and other hot drinks. Significant investment in additional coffee machines has driven speed of service and choice extension. Coffee is an example of a product that can pull in new customers to experience store interiors.
- **Hot food:** while Greggs has always had the equipment to heat traditional baked product such as sausage rolls, bacon and sausages, the extension of the range opens up new sources of business. Examples of range extension have been soups, hot sandwiches, and burritos. While the move into hot food creates challenges in terms of workflows and prompt customer service, these are not insurmountable, and there is a major medium-term opportunity for extension into evening opening when the stores are traditionally closed, creating the potential for transformation in utilisation of the store asset.

The experience: Convenience, location and format

Store repurposing

Greggs has made decisive progress in moving its offer from that of a high street baker to the current food-on-the-go brand. The store refurbishment objective has been emphatically achieved, with substantially all its sites now refurbished on a food-on-the-go format.

Exhibit 2: Greggs pre-2013 – a high street bakery

Source: Greggs

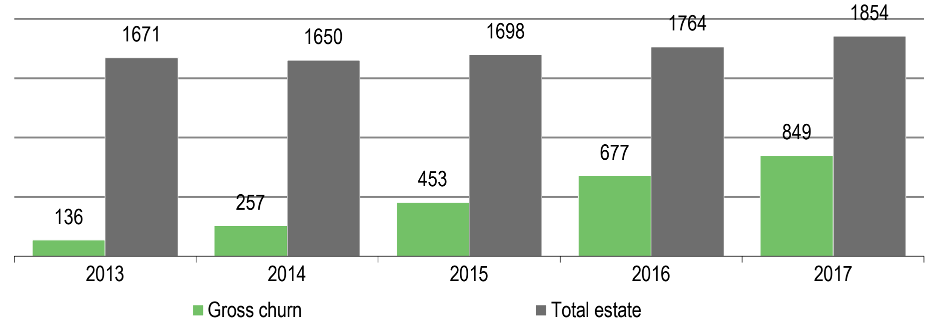
Exhibit 3: Greggs contemporary format – value food-on-the-go

Source: Greggs

Location and market shift

Active estate management has resulted in gross churn of 46% of the estate since 2012:

Exhibit 4: Gross estate churn 2013-17



Source: Greggs

The emphasis within estate development is now shifting to locate the brand in its most appropriate market. This is not necessarily on high streets, and 34% of the estate, some 630 stores, are now located in travel and workplace locations, up from 20% in 2012. These include transport hubs, bus stations, train stations, petrol stations, office developments and drive-thrus. In March 2018 Greggs opened its first shop on the London Tube, at Westminster, and there is scope for this to be followed by others. In addition, the medium-term objective is for 40% of the estate to be in such locations.

Greggs is expanding its geography to new territory such as the county of Devon, and is adding to its footprint in Northern Ireland, currently 10. The business model is evolving, with 202 shops now trading in franchise formats, an increase of 45 in the year. Franchise offers some protection from reduction of footfall in traditional retail locations.

Looking forward, management sees potential in digital order pads of the kind adopted by McDonald's, although these would be subject to appropriate system changes. In addition, delivery trials are underway with Uber, which could result in further revenue opportunities.

Competitive supply chain: Modernisation, rationalisation

In March 2017 Greggs announced a substantial programme to upgrade its national manufacturing and distribution infrastructure. Over five years, the £100m investment programme aims to create additional national manufacturing centres of excellence and increase capacity to serve more than 2,000 outlets. The plan is to create national centres of excellence in specified products, capturing national economies of scale and ensuring consistency of product quality across the brand.

In 2016 Greggs opened a new distribution centre in Enfield, and closed bakeries at Twickenham and Sleaford that were unsuitable for upgrade. In 2017 the company completed the transfer of its Edinburgh operations to its Glasgow bakery, which has been extended to become a centre of excellence for Yum Yum production. The Leeds bakery has been extended to create a centre of excellence for cake and muffin manufacturing. 2018 will be the peak year for investment, including the creation of a centre of excellence for doughnuts at the Gosforth Park bakery.

The following table sets out management's financial assessment of the programme, phased over the five-year period (investment is due to peak in 2018). Although it includes significant capex, it also avoids spend that would have been invested in the previous establishment. On that basis, and including disposal proceeds, the project as a whole produces an annualised net return on investment, after five years, of 23%.

Exhibit 5: Greggs' plan for supply chain programme return on capital

£m	2016	2017	2018e	2019e	2020e	Total
Capital investment	3	17	25	22	8	75
One-off change costs	4	2	12	4	3	25
Expected cash phasing	**7**	**19**	**37**	**26**	**11**	**100**
Expected offset from disposal proceeds						20
One-off change costs	5	9	5	3	3	25
Asset -related charges	2	1	1	1		5
Expected exceptional charges	**7**	**10**	**6**	**4**	**3**	**30**
Cumulative net benefit to P&L	1	2	3	5	7	
Incremental investment			**Net benefit**			
Gross investment	100					
Cost of equivalent expansion of previous model	-50		Ongoing annual cash benefit			10
Expected disposal	-20		Incremental depreciation			3
Net incremental investment	**30**		**Net P/L benefit**			**7**

Source: Greggs

First-class support teams

Greggs' vision of FOTG depends crucially on prompt and efficient service. This is particularly important in Greggs' small physical format. While management is working to even out differential demand between dayparts, queues at busy times such as lunchtime remain common and there is an obvious risk of losing customers as well as causing dissatisfaction. Conversely, an improved rate of service can directly contribute to revenue.

Greggs invests in technology and processes to free staff time to devote to customer service, as well as to reduce absolute cost. The supply chain investments covered above should support progressive improvement in stock availability. Following the deployment of SAP Finance in FY16, the company successfully rolled out its central forecasting and replenishment process in FY17, replacing traditional, shop-based, manual ordering processes. This brings benefits in terms of improved product availability, and management expects lower wastage as staff become more experienced with the system's capabilities. In addition, the system should bring staff efficiency and better customer service by freeing store staff from a regular clerical exercise. In 2018 the remaining SAP support modules, human resources, payroll and property management, are to be implemented.

Brand image: Little-known transformation

Greggs is a national brand: its footprint of 1,854 stores compares well with competitors such as Marks & Spencer (c 1,000), Morrisons (c 500) and MacDonald's (c 1,200). The comparison is not exact, but Greggs management considers its competitive set to be supermarkets, convenience stores, delivery outlets and coffee shops (in that order).

While customers' acceptance of Greggs' wider and more contemporary offer is reflected in its consistently improving like-for-like sales, we think wider awareness of the change in the brand among non-customers is likely to be a slow burn.

Greggs does invest in marketing on social media. It has 685,000 followers on Facebook, 139,000 on Twitter and 15,000 on Instagram. Its social media sites are managed to generate a flow of 'fun' content. They typically publicise product offers, promotions and events, examples being free coffee with a local newspaper, or dinner for two at Greggs on Valentine's Day. They also serve as a channel for customer reaction both negative and positive to the company's products and service, giving a valuable opportunity for dialogue with the customer.

Unlike competitors such as McDonald's, Tesco, and Domino's Pizza, Greggs does not invest in above-the-line advertising. Management takes the view that direct sight, word of mouth and social media channels are a more cost-effective and efficient method. However, these channels are also slower than above-the-line advertising and, like any fast-changing offer, it takes non-customers longer to appreciate that the offer may now be relevant to them. It is also true that increasing frequency of visits among existing customers is a relatively easy target, which it would be inadvisable to ignore.

It is beyond the scope of this note to gauge the effect of direct advertising on a brand repositioning exercise, but logic dictates that there is one, and Burberry, McDonald's and Tesco are among major companies that thought it advisable to communicate brand repositioning using the media. We make three deductions:

1. Greggs' widespread shop presence, communicating the food-on-the-go image, is undoubtedly helpful in showing non-customers as well as customers what the brand represents.
2. The move to new locations is likely to attract the attention of further new customers.

3. However, without above-the line advertising, the message will take longer to percolate into the national consciousness.

This is good and bad for the company's prospects. The benefit of changed market perceptions may take longer to be reflected in the top line. However, the significant costs of above-the-line advertising are avoided.

Management analyses that its shop investments currently pay back in two years for a relocated shop and three years for a new shop (both take an additional year when the supply chain is taken into account). In addition, improving brand perception should pull in new customers over time, enhancing like-for-likes and lengthening investment returns.

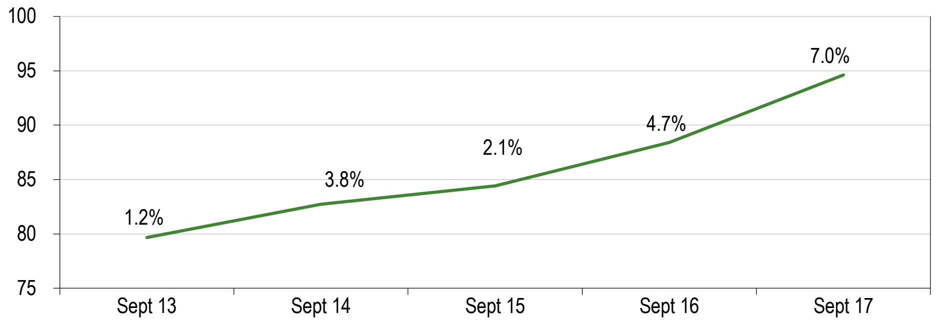
Greggs' market: On-the-go value food

We consider Greggs in the context of the eating out market and also as a value food retailer.

The UK eating out market: Mind the definitions

Eating out in the UK is a £95bn market, which has grown strongly in recent years:

Exhibit 6: Out-of-home food market growth (£bn)



Source: ONS. Note: Year to September, current prices. Annual growth % shown.

However, what was once a well-defined restaurant market has fragmented under the influence of lifestyle changes, time shortage and cost pressures. As the market develops, there is an increasing distinction between three categories: dine-in restaurants, takeaway and delivery.

Dine-in model under threat

Traditional terrestrial, sit-down restaurant models are being threatened by over-supply and at best flat demand, while margins have been threatened by higher food, labour and rent costs. The Restaurant Group, which first signalled trading problems in January 2016, recorded like-for-like sales down 3.9% for that year and 3.0% for 2017. Following a review, the company identified the loss of value-conscious customers as the primary cause, resulting from significant price increases and the removal of popular value offers. Byron, the premium hamburger restaurant, entered a restructuring deal in January 2018 in which 20 of its 67 restaurants will probably close. Jamie's restaurant organisation also announced in January 2018 that 12 of its 37 outlets would close.

Delivery sales model positive

By contrast, Domino's Pizza increased like-for-like sales by 4.8% in 2017. Just Eat's app-based delivery operation recorded 40% UK revenue growth in 2016 and 27% at interim in June 2017. We believe the Just Eat example, while relevant to the sector as a whole, should be treated with caution. Just Eat, like its more premium competitors, Deliveroo and UberEats, is a platform for home delivery, which tends to convert existing takeaway and dine-in restaurants to its model to the extent they participate. This is not necessarily relevant to Greggs, whose customers are already out and about.

Takeaway model is robust

The takeaway sector itself has performed strongly. The number of dedicated takeaway outlets increased by almost 10% between 2013 and 2015, to 36,855. Spending on takeaways grew to £9.9bn in 2016, up 34% since 2009 (according to research commissioned by Just Eat). It is forecast to grow by a CAGR of 2.6% to reach £11.2bn by 2021. On this basis, Greggs would be supplying c 10% of the market, which seems questionable.

Not all commentators reflect the distinction between delivery and food-on-the-go, but MCA has publicised the forecast from its Food-to-go report that this market will grow by 2.8% in 2018, despite the headwinds facing the consumer economy. BFFF, the UK's frozen food association, presented to its conference in June 2017 that food-to-go is growing 16 times faster than grocery, at 6.5%, and is forecast to continue growing at a CAGR of 6.2% to £21.7m in 2021. On that basis, Greggs currently has around 6% of the market.

While Greggs retains some seating, it is predominantly a takeaway operation, as the company's strapline food-on-the-go indicates. In this way it is different from either dine-in or delivery models. Following refurbishments over the last five years, the vast majority of the Greggs shop estate now operates in a food-on-the-go format. To the extent it is represented on high streets it is exposed to declines in terrestrial shopping footfall. However, the company is taking action to address this, with increasing presence in workplace, travel and leisure locations.

In addition, the rebalancing of the offer towards food-on-the-go itself means that revenue is not so dependent on high street shoppers, as the customer base increasingly consists of working people, including those who are on the move in their jobs.

Greggs social media presence

In 2016 the company relaunched Greggs Rewards, its digital loyalty scheme. Greggs Rewards includes an app which customers can scan in the shop to get free coffee and other products. The app extends payment options through a reloadable account. Greggs Rewards has now been upgraded to include satisfaction ratings and is growing rapidly, providing better information on customers and so helping the company meet their needs.

As noted on page 5 above, a trial partnership for 'click and deliver' with Uber is being tested under the name Greggs Delivered. If rolled out, this would expand the scope of social media to Greggs' business model.

Greggs within the value retail market

Another relevant dimension in which to view Greggs' market presence is that of value food retail, its London Stock Exchange sector. With 2018 CPI inflation forecast at 2.4%, real household income growth at 1% (source: BoE), and personal borrowing set for some degree of correction driven by interest rate rises, consumers are increasingly under pressure. While staple food and drink is to some extent insulated from pressures affecting discretionary purchases, even here the consumer faces challenges. It is well known that value food retailers are gaining market share from traditional supermarkets. In the two years to December 2017, a group made up of Aldi, Lidl and Asda increased UK market share by 1.2% to 27.1%, whereas Tesco, Sainsbury's and Waitrose slipped 0.9% to 44.4%, according to Kantar's online indicator.

Management: Energetic and task driven

The team under Roger Whiteside has engaged with the change task with a sense of conviction and urgency. Whiteside is a career retailer originally from Marks & Spencer, where he acquired experience of operating multi-site food retail. He was on the founding team at Ocado, and CEO of Threshers before joining Punch Taverns. On becoming CEO of Greggs in 2013, he set out his vision for the brand's transformation, which has since become his mission.

Sensitivities: Consumer economy and retail landscape

- Greggs is clearly exposed to a challenged consumer economy. Consumer confidence has been on a downward trend since late 2015, and we believe that rises in real disposable income during calendar 2018 will be small, while inflation, though moderating slightly, will still be substantial compared to many consumers' experience of the economy over the last five years. In addition, rising interest rates are deliberately intended to curb consumer borrowing. While Greggs' value offer may mean that it gains market share, this may not be enough to offset macro declines in consumer spend. Operational gearing is high:

Exhibit 7: Greggs' operational leverage (gross/operating margin)

	2014	2015	2016	2017	2018e
Gross margin	62.2%	63.5%	63.7%	63.7%	63.7%
Operating margin	7.2%	8.7%	9.0%	8.6%	8.3%
Operational leverage	8.6	7.3	7.1	7.4	7.6

Source: Greggs, Edison Investment Research

- We assume in our model that FY17 marked the peak of input cost pressures, but it is possible that commodity or currency prices could move against Greggs and, critically, the rest of the sector again in FY18e. Clearly, a recovery in sterling's value or weakness in commodity prices would have the opposite, positive effect.
- Greggs has been focusing its store expansion plans on sites away from traditional shopping locations. Non-high street locations now represent 34% of the estate and Greggs sees this increasing to 40%. This is a necessary reaction to the reality that many traditional retail locations will be marginalised due to terrestrial shopping models becoming uncompetitive. Although Greggs' estate policy as well as the change in its market offer addresses this threat, the risk remains that the market switch could be harder or faster than management assumes. Conversely, these trends may mean less competition for sites, and franchising may be an effective way of avoiding their effects.
- Execution risk is a constant. Greggs is undertaking a major manufacturing consolidation programme. Glitches are inevitable, but we draw considerable comfort from the success that management has enjoyed in its major supply chain investment programme to date. As the programme becomes complete, the supply of certain products from a single source introduces an element of additional risk as the cost of achieving economies of scale.
- Changes to immigration policy may have severe implications for Greggs in common with the wider leisure retailing sector.

Financials: Positive record and prospects

2017 results: Balance of investment effort

Greggs' results improved in the second half, with marginally higher revenue growth and much higher operating margin than in the first. Also, at the operating and pre-tax level, they showed an expected turnaround from a first half that had lagged the previous year.

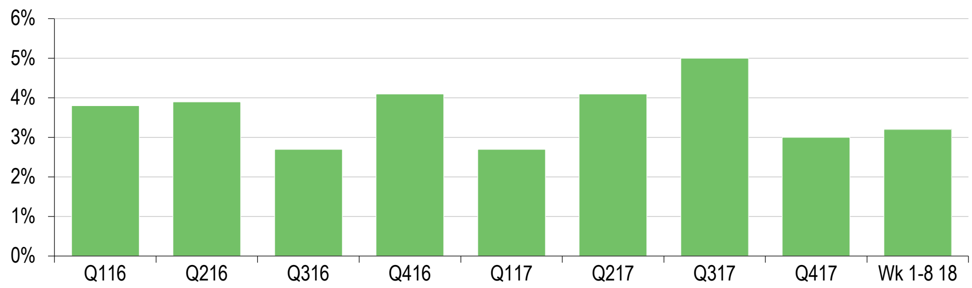
Exhibit 8: Results summary

£m	H116	H216	FY16	H117	H217	FY17	Growth		
							H1	H2	FY
Revenue	422.0	472.2	894.2	452.9	507.2	960.0	7.3%	7.4%	7.4%
Gross margin	63.2%	64.2%	63.7%	63.3%	64.1%	63.7%			
Operating profit pre-property, exceps	27.2	50.9	78.1	27.6	54.3	81.7	1.5%	6.6%	4.6%
Operating margin	6.4%	10.8%	8.7%	6.1%	10.7%	8.6%			
Property disposal gains	2.2	0	2.2	0.3	0.2	0.5			
Finance income	0.0	0.0	0.0	(0.2)	(0.2)	(0.4)			
Pre-tax profit pre exceptionals	**29.4**	**50.9**	**80.3**	**27.7**	**54.1**	**81.8**	**-5.6%**	**6.2%**	**1.9%**
Note: Exceptional charges			(5.2)			(9.9)			

Source: Greggs

Revenue has showed a robust and consistent trading pattern, with sustained like-for-like sales increases averaging around 3.5% over the last two years:

Exhibit 9: Steady underlying LFL sales progression



Source: Greggs. Note: Adjusted for Christmas and New Year trading pattern Q416, Q117. Reported levels were 6.4% and 3.6% respectively.

Gross margins have been held consistent with ingredient cost pressure in the year mitigated by cost reductions, mainly emanating from the supply chain actions:

Exhibit 10: Margin analysis

£m	FY16	FY17
Revenue	894.2	960.0
Gross margin	63.7%	63.7%
Distribution & selling costs	49.5%	49.6%
Admin expenses	5.5%	5.5%
EBIT before property and exceptional items	8.7%	8.6%
Property disposal gains	0.3%	0
EBIT pre-exceptional items	80.3	82.2
Operating margin	9.0%	8.6%

Source: Greggs

Distribution costs as a percentage of sales increased slightly as a result of wage rates contributing to 3.1% overall wage and salary inflation and training costs. Administrative costs are up in absolute terms in line with systems investment.

Property gains were at insignificant levels compared with an unusually high level in FY16.

Outlook and forecasts: Slight underlying upgrade

During the first eight weeks of 2018 sales have moved positively. Managed like-for-like sales grew by 3.2%, and total sales were up 6.2%. At the same time, there is a clearer picture on the level of continuing food and packaging inflationary pressure, and it does show some slight easing, with ingredient inflation at 3-4% compared with 6.5% in 2017. On the other hand, people costs are expected to rise by 3.6%, compared with 3.1% in 2017, including the impact of the National Living Wage, while workplace pension costs bring a slight increase compared with the 2017 impact of the Apprenticeship Levy in 2017. Overall, with ingredient costs at c 25% and people costs c 40% of the cost base, we estimate that these factors net out to a c 0.5% reduction in cost pressures y-o-y.

As a result, we slightly upgrade our FY18 forecast, by 4.7% at EBITDA level, and 5.7% PBT (after reduced finance charges compared with the higher pension financing charge in 2017) although, as a result of higher tax guidance, our EPS forecast is little changed:

Exhibit 11: Changes to forecasts

	EPS (p)				PBT (£m)				EBITDA (£m)			
	Old	New	% chg.	% growth	Old	New	% chg.	% growth	Old	New	% chg.	% growth
2018e	66.6	66.5	(0.1)	3.2	83.9	85.5	1.9	5.7	136.8	142.0	3.8	4.7
2019e		71.6		7.6		91.0		6.5		153.3		8.0
2020e		77.8		8.6		98.1		7.7		164.0		7.0

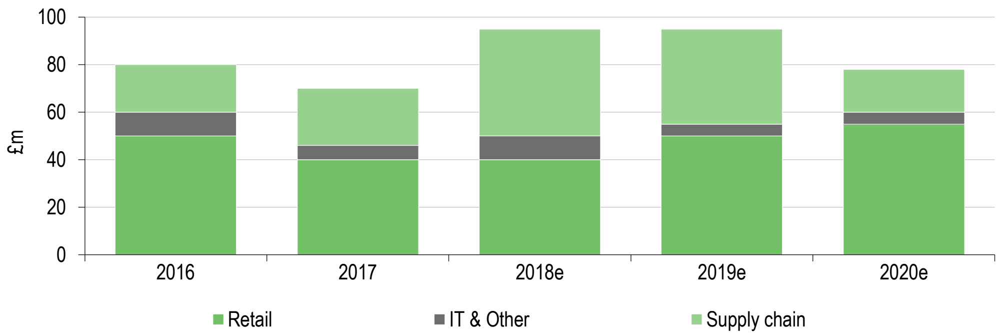
Source: Edison Investment Research

Both our 2019 and 2020 forecasts are new, and we continue to forecast modest growth in earnings as a result of continuing like-for-like positive growth, investment in site expansion, and the benefits of the supply chain improvement programme.

Cash flow and balance sheet: Strong support for investment

Greggs is very cash productive, with cash conversion from EBITDA of 99% in 2017 and 102% for 2018 on our forecast. It finished 2017 with net cash of £54.5m against our previous forecast of £40.1m. This was mainly the result of c £10m of delayed spend on supply chain investment, as well as smaller working capital differences. We do not expect those delays to affect the realisation of project benefits, although they contribute to an expected peak year for investment in the supply chain at £37m. Combined with consistent net investment of c £40m and the next phase of the systems project, this results in a high point for the expected capex total of £95m.

Exhibit 12: Capital investment



Source: Greggs

Management reiterates its guidance of a target of at least £40m of net cash flow, and we forecast that reducing to £43m in 2019.

Valuation: Investors have a choice

We are broadening our approach to valuation. Previously, we valued Greggs purely on a DCF basis, on the premise that there were no realistic comparators. We now value the shares jointly on a DCF and a peer valuation basis. In terms of peers, we take into account a range of multi-site consumer companies. Although there is admittedly no exact competitor within the group, we feel that, like consumers, investors have a choice in the relevant consumer space and that it is more realistic to look at Greggs in context.

DCF: Revised and standardised basis for the valuation

We apply a 6.9% cost of equity based on an assumed risk-free rate of 2%, an equity risk premium of 7% and beta of 0.7. We previously used a 5.1% discount rate. We introduce a terminal value based on this rate and a 2% perpetuity growth rate, which is a more widely used approach than our previous assumed terminal multiple of 8x. In extending our published forecast to a 10-year cash projection we assume revenue growth fading from 5% to 2% and EBITDA margin rising from 14.0% to 14.5% between 2020 and 2027.

As a result of these assumptions, we define a valuation of 1,536p per share (previously 1,226p). Varying the discount and terminal growth assumptions would affect the valuation as follows:

Exhibit 13: Sensitivity of valuation to discount rate and terminal growth rate

	Discount rate (%)					
	4.9%	**5.9%**	**6.9%**	**7.9%**	**8.9%**	**9.9%**
3.0%	3,639	2,397	1,793	1,435	1,198	1,031
2.5%	3,002	2,127	1,650	1,350	1,143	993
2.0%	2,585	1,926	1,536	1,279	1,096	960
1.5%	2,291	1,771	1,444	1,219	1,056	932
1.0%	2,072	1,647	1,367	1,168	1,020	906

Source: Edison Investment Research

Peer comparisons: Valuation method

Compared with the peer group, Greggs stands at a c 20% premium on a P/E basis and a c 16% discount premium on EV/EBITDA and EV/sales measures. Adjusting to peer group averages for both forecast years would produce a valuation of 1,051p on a P/E basis, 1,489p on an EV/EBITDA basis and 1,465p on an EV/sales basis. These in turn average to 1,335p.

Exhibit 14: Peer comparison

	Market cap (m)	Fiscal y/e	CCY	P/E (x)		EV/EBITDA (x)		EV/sales (x)	
				Dec-18	Dec-19	Dec-18	Dec-19	Dec-18	Dec-19
Conviviality	525	04/2016	GBP	12.8	11.9	9.8	9.3	0.7	0.7
Wetherspoon	1,092	07/2016	GBP	16.7	16.3	9.2	8.8	0.9	0.8
SSP Group	2,277	09/2016	GBP	23.8	21.6	10.5	9.8	1.5	1.4
Marston's	789	09/2016	GBP	8.3	7.7	8.9	8.6	0.7	0.7
Patisserie Holdings	343	09/2016	GBP	18.5	17.0	11.5	10.5	3.0	2.7
McColl's	228	11/2016	GBP	8.9	7.9	4.7	4.4	1.8	1.8
Dunkin' Brands	5,051	12/2016	USD	20.6	18.7	14.2	13.3	5.8*	5.5*
Domino's Pizza	1,413	12/2016	GBP	17.4	15.7	12.6	11.3	2.9*	2.7*
Average				**15.9**	**14.6**	**10.2**	**9.5**	**1.4**	**1.4**
Greggs	1,119	12/2016	GBP	19.0	17.6	8.6	8.0	1.2	1.1
Premium/(discount)				**19.6%**	**20.7%**	**(15.6%)**	**(16.1%)**	**(16.7%)**	**(18.3%)**

Source: Bloomberg, Edison Investment Research. Note: Annualised to December. *Non-comparable as franchised revenue: excluded.

Our blended rate between the two metrics we use is therefore 1,436p (previously 1,226p), implying the following multiples:

Exhibit 15: Valuation metrics at 1,436p per share

	P/E (x)	Yield (%)	EV/EBITDA (x)
2018e	21.6	2.3	8.6
2019e	20.0	2.5	8.0
2020e	18.5	2.7	7.5

Source: Greggs, Edison Investment Research

In our view, these ratios appear reasonable for a business with Greggs' track record and strong competitive position.

Exhibit 16: Financial summary

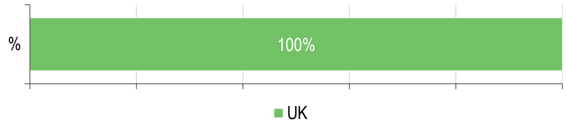
£m	2013	2014	2015	2016	2017	2018e	2019e	2020e
Dec	IFRS	IFRS	IFRS	IFRS	IFRS	IFRS	IFRS	IFRS
PROFIT & LOSS								
Revenue	762.4	806.1	835.7	894.2	960.0	1,027.0	1,105.5	1,175.6
Cost of Sales	(305.9)	(304.8)	(305.1)	(324.3)	(348.1)	(372.4)	(400.9)	(425.1)
Gross Profit	456.5	501.3	530.6	569.9	611.9	654.6	704.7	750.5
EBITDA	74.9	95.6	113.3	125.9	135.7	142.0	153.3	164.0
Operating Profit (before amort. and except.)	41.5	58.1	73.1	80.3	82.2	85.7	90.8	97.9
Intangible Amortisation	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Exceptionals	(8.1)	(8.5)	0.0	(5.2)	(9.9)	(6.0)	(3.8)	(3.0)
Other	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Operating Profit	33.4	49.6	73.1	75.2	72.3	79.7	87.0	94.9
Net Interest	(0.2)	0.2	(0.1)	(0.0)	(0.4)	(0.2)	0.2	0.2
Profit Before Tax (norm)	41.3	58.3	73.0	80.3	81.8	85.5	91.0	98.1
Profit Before Tax (FRS 3)	33.2	49.7	73.0	75.1	71.9	79.5	87.2	95.1
Tax	(10.3)	(14.0)	(15.4)	(18.1)	(16.9)	(18.2)	(19.1)	(19.9)
Profit After Tax (norm)	30.9	44.3	57.6	62.3	64.9	67.3	71.9	78.1
Profit After Tax (FRS 3)	24.2	37.6	57.6	58.0	56.9	62.6	68.9	75.7
Average Number of Shares Outstanding (m)	100.4	100.5	100.6	100.4	100.6	101.2	100.4	100.4
EPS - normalised (p)	30.8	44.0	57.3	62.0	64.5	66.5	71.6	77.8
EPS - (IFRS) (p)	24.1	37.4	57.3	57.7	56.5	61.8	68.6	75.4
Dividend per share (p)	19.5	22.0	28.6	31.0	32.3	33.3	35.8	39.1
Gross Margin (%)	59.9	62.2	63.5	63.7	63.7	63.7	63.7	63.8
EBITDA Margin (%)	9.8	11.9	13.6	14.1	14.1	13.8	13.9	14.0
Operating Margin (before GW and except.) (%)	5.4	7.2	8.7	9.0	8.6	8.3	8.2	8.3
BALANCE SHEET								
Fixed Assets	268.9	267.4	298.2	323.4	334.7	373.4	405.9	417.8
Intangible Assets	1.0	4.7	10.2	14.3	14.7	18.0	20.5	20.6
Tangible Assets	267.8	262.7	284.2	307.4	319.2	354.6	384.7	396.4
Investments	0.1	0.0	3.8	1.8	0.8	0.8	0.8	0.8
Current Assets	65.0	101.5	86.0	92.6	106.6	96.2	103.7	126.8
Stocks	15.4	15.3	15.4	15.9	18.7	20.3	21.7	24.3
Debtors	25.0	26.1	27.6	30.7	33.4	35.7	38.2	40.6
Cash	21.6	43.6	42.9	46.0	54.5	40.3	43.8	61.9
Other	3.0	16.5	0.0	0.0	0.0	0.0	0.0	0.0
Current Liabilities	(80.7)	(102.1)	(106.0)	(121.4)	(127.9)	(138.9)	(145.4)	(141.5)
Creditors	(80.7)	(102.1)	(106.0)	(121.4)	(127.9)	(138.9)	(145.4)	(141.5)
Short term borrowings	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Long Term Liabilities	(17.0)	(20.1)	(11.9)	(29.9)	(14.0)	(12.9)	(12.8)	(12.7)
Long term borrowings	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Other long term liabilities	(17.0)	(20.1)	(11.9)	(29.9)	(14.0)	(12.9)	(12.8)	(12.7)
Net Assets	236.2	246.7	266.3	264.7	299.4	317.8	351.5	390.4
CASH FLOW								
Operating Cash Flow	82.5	108.6	119.6	133.8	134.5	144.8	153.9	154.4
Net Interest	(0.0)	0.2	0.2	0.1	0.2	(0.2)	0.2	0.2
Tax	(13.2)	(11.5)	(15.9)	(16.2)	(17.6)	(16.9)	(18.3)	(19.3)
Capex	(48.6)	(48.3)	(71.8)	(80.1)	(72.6)	(95.0)	(95.0)	(78.0)
Acquisitions/disposals	0.2	(4.8)	18.1	4.7	2.2	(12.5)	(3.5)	(3.0)
Financing	0.9	(2.6)	(7.2)	(8.3)	(6.0)	0.0	(0.0)	0.0
Dividends	(19.6)	(19.6)	(43.7)	(30.9)	(32.2)	(34.4)	(33.7)	(36.2)
Net Cash Flow	2.2	22.0	(0.7)	3.0	8.5	(14.2)	3.5	18.0
Opening net debt/(cash)	(19.4)	(21.6)	(43.6)	(42.9)	(46.0)	(54.5)	(40.3)	(43.8)
HP finance leases initiated	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Other	0.0	(0.0)	0.0	0.0	0.0	0.0	0.0	0.0
Closing net debt/(cash)	(21.6)	(43.6)	(42.9)	(46.0)	(54.5)	(40.3)	(43.8)	(61.9)

Source: Greggs, Edison Investment Research

Contact details

Greggs
Fernwood House
Clayton Road
Newcastle Upon Tyne
NE2 1TL
+44 (0)191 281 7721
https://corporate.greggs.co.uk

Revenue by geography



Management team

CEO: Roger Whiteside

Appointed CEO in February 2013. Roger began his career at Marks & Spencer, where he spent 20 years. He was one of the founding team of Ocado, serving as joint MD from 2000 to 2004. From 2004 to 2007 he was CEO of Threshers before joining Punch Taverns, ultimately becoming chief executive.

Finance Director: Richard Hutton

Richard Hutton qualified as a chartered accountant with KPMG and gained career experience with Procter & Gamble before joining Greggs in 1998. He was appointed FD in May 2006.

Principal shareholders	(%)
Sun Life	5.9%
Standard Life Aberdeen	5.0%
Brewin Dolphin Holdings	4.6%
GCM Collateral Holdings	4.4%
Van Lanschot NV	3.9%
Franklin Resources	3.5%
BlackRock	3.0%

Companies named in this report

Conviviality , Wetherspoon (JDW) SSP Group (SSPG) Marston's (MARS) Patisserie Holdings (CAKE), McColl's Retail Group (MCLS), Dunkin' Brands (DNKN) Domino's Pizza (DOM), McDonald's (MCD), Marks & Spencer (MKS), WM Morrison Supermarkets (MRW), Just Eat (JE), Restaurant Group (RTN), Burberry(BRBY)