EDISON

Greggs

Transformation taking shape

Interim results

Retail

Greggs' interim results, against a backdrop of extreme weather conditions, reinforce progress with the strategic transformation of the brand into a leading 'food-on-the-go' format. Innovative new product ranges, a reduced dependence on high street footfall and a major overhaul of the supply chain are creating a solid platform for the next stage of the journey. We forecast strong cash generation and a return to earnings growth in 2019.

Year end	Revenue (£m)	PBT* (£m)	EPS* (p)	DPS (p)	P/E (x)	Yield (%)
12/16	894.2	80.3	62.0	31.0	16.4	3.0
12/17	960.0	81.8	64.5	32.3	15.8	3.2
12/18e	1012.4	81.3	64.0	31.5	15.9	3.1
12/19e	1,084.2	83.4	65.6	32.8	15.5	3.2

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

Encouraging recovery in the second quarter

Greggs' revamped summer menu and a wider choice of value meal deals appear to have caught the eye of the cost-conscious consumer in the relentless heat. Following on from the heavy snow disruption earlier in the year, the company reported first half like-for-like sales growth of 1.5%, implying a stronger second quarter at around 1.8% compared with 1.3% in the first quarter. Total sales rose by 5.2% to £476m, while underlying operating profit of £25.7m declined by 7% year-on-year, largely attributable to the adverse winter weather. Strong operating cash flows resulted in a net cash position of £43.5m (H117: £19.9m).

Decoupling from high street trade

The company has adjusted its guidance for store openings, down from 110-130 to about 100 net new stores this year. The emphasis for new outlets remains focused on locations that capture work, travel and leisure-related footfall, thus reducing the chain's high street exposure. 35% of stores now service non-retail trade and the company expects that proportion to rise to approximately 50% over the longer term.

The digital opportunity

As the brand transformation continues to gather momentum, a next logical step would be to develop the digital platform, both in store and for customers to place advance orders for delivery or collection. The fact that Greggs prepares much of its food freshly on site each day and has the ability to tailor orders to meet individual customer requirements is a clear differentiator. Plans are underway to trial the first 'click-and-collect' store towards the end of the year.

Valuation: No change

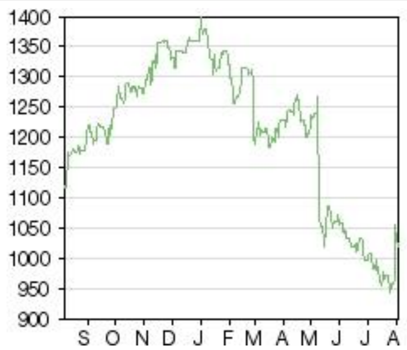
Despite an improved sales performance in the second quarter, we are mindful of the general weakness in consumer sentiment and ongoing inflationary cost pressures. As such, we are not materially changing our 2018 forecast for broadly flat underlying profit growth year-on-year, consistent with company guidance. We retain our valuation of 1,360p per share.

3 August 2018

Price	**1,019p**
Market cap	**£1,031m**

Net cash (£m) at H118	43.5
Shares in issue	101.2m
Free float	100%
Code	GRG
Primary exchange	LSE
Secondary exchange	N/A

Share price performance



%	1m	3m	12m
Abs	1.4	(17.2)	(9.1)
Rel (local)	1.2	(17.5)	(11.3)
52-week high/low		1399p	942p

Business description

With nearly 1,900 shops, eight manufacturing and distribution centres and 22,000 employees, Greggs is the UK's leading 'food-on-the-go' retailer. It utilises vertical integration to offer differentiated products at competitive prices.

Next events

Trading update	October 2018

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Edison profile page

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Interims: Resilience despite challenging conditions

In a period that has largely been governed by long spells of extreme weather - ‘the Beast from the East’ in April/May, followed by an on-going heatwave - Greggs’ resilient sales performance reinforces the progress it is making with the brand’s strategic transformation.

Exhibit 1: Group sales and profit

£m	H118	H117	Change
Sales	476.3	452.9	5.2%
Operating profit (before property and exceptional items)	25.7	27.6	-6.9%
Property disposal gains	(0.1)	0.3	
EBIT (before exceptional items)	25.9	27.9	-7.2%
Net exceptional charge	(1.9)	(8.3)	
Finance income	0.0	(0.1)	
Profit before taxation	24.1	19.4	+24.2%

Source: Greggs

Total sales in the first half rose by 5.2% year-on-year to £476m and like-for-like sales increased by 1.5%, with stronger transaction numbers and average transaction values driving an encouraging recovery in like-for-like sales in the second quarter, despite the unusually hot weather. Second quarter like-for-like sales increased by 1.8% compared with 1.3% in the first quarter.

This has been, in part, attributable to the diversification of ranges away from traditional bakery products. Customers now have a wider choice of hot and cold food and beverages, and the value meal deals have been expanded. The ‘growth categories’, which encompass hot drinks, breakfasts, healthier choices and hot food, now represent 30% of the sales mix compared with just 15% five years ago. Greggs is now number four for coffee in the UK.

Further, the repositioning of the store portfolio to capture work, travel and leisure-related trade is increasingly insulating the company against challenging high street conditions. Key openings in the period include the chain’s first Underground store at Westminster tube station, in addition to stores at Birmingham New Street station and Glasgow Buchanan bus terminal. 35% of stores now service non-retail trade and that proportion is expected to reach approximately 50% over the longer term.

Underlying operating profit, excluding property profits and exceptional items, declined by 7% compared with the prior period, to £25.7m. This reduction was largely attributable to the disruption to trading caused by the Beast from the East, and was flagged in the company’s May trading update. Stripping out this anomaly, management has indicated that profits would have moved slightly ahead year-on-year.

Exhibit 2: Margin analysis

	H118	H117
Sales (£m)	476.3	452.9
Gross margin	63.0%	63.3%
Distribution & selling costs as a percentage of sales	-52.3%	-51.5%
Admin expenses as a percentage of sales	-5.3%	-5.7%
Operating margin (before property and exceptional items)	5.4%	6.1%
Property disposal gains as a percentage of sales	0.1%	0.1%
EBIT margin (before exceptional items)	5.4%	6.2%

Source: Greggs

Input cost pressures remained broadly consistent with management’s expectations during the period. Ingredient price inflation is now running at 3-4% compared with 6-7% in 2017, albeit with the hot weather increasing pressure on grain and milk yields. Wage and salary inflation has increased by 40bp year-on-year and is now running at 3.6%. The main change in recent months has been the double-digit acceleration in energy costs, although these only represent approximately 4% of the total cost base compared with ingredients and people costs, which account for approximately 65% of total costs when combined.

The resulting impact has been a 30bp reduction in the gross margin. The 80bp increase in distribution and selling costs as a percentage of sales not only reflects cost pressures but, more significantly, the negative impact of operational gearing in the business when set against lower like-for-like sales. In contrast, admin costs as a percentage of sales improved by 40bp due to tight cost control and lower incentive costs. Overall, these combined factors resulted in an 80bp reduction in the operating margin to 5.4%.

Exceptional charges peaked and now declining

As previously flagged, the £100m investment programme to reshape manufacturing and logistics operations is expected to generate £30m of exceptional one-off charges over the five-year period to 2020. Including the first half net exceptional charge of £1.9m, total charges to date have amounted to £18.8m. Over the balance of the programme a further £11m of exceptional items are expected to be charged to the P&L.

Exhibit 3: Exceptional phasing 2016-20e

£m	FY16 & FY17	H118	H218e	2019e	2020e	Total
Cash change costs	13.7	1.4	3.7	3.2	3.0	25.0
Non-cash (asset-related) charges	3.2	0.5	0.5	0.8	-	5.0
Exceptional P&L charge	**16.9**	**1.9**	**4.2**	**4.0**	**3.0**	**30.0**
Expected cash cost phasing	5.7	2.6	8.7	5.0	3.0	25.0
	£19m charged to date		**£11m expected through to 2020**			

Source: Greggs

Major projects include the consolidation of manufacturing lines across multiple sites into single ‘centres of excellence’, a recent example being the installation of a doughnut-manufacturing platform in Newcastle to supply the entire stores network. To date three of Greggs’ 11 traditional bakeries have been closed, with one further closure of a facility in Norwich scheduled for the end of the year. The seven remaining sites will combine manufacturing operations with an increased capacity for distribution. Planning is underway for the opening of a new distribution centre in Wiltshire in 2019, which will service stores in the south.

On completion of the programme, the supply chain is expected to provide capacity to grow the estate to approximately 2,500 stores that, at the current rate of 100 planned openings per annum, would be achieved by 2024. Although Greggs has not committed to an optimal number of outlets, this scale is comparable with ‘out-of-home’ peers such as Costa’s UK store portfolio.

Strong cash generation and net cash position

The company has continued to generate robust cash flows. In the first half the net cash inflow from operating activities was £39.0m (H117: £34.0m), leading to a net cash balance of £43.5m at the end of the period (H117: £19.9m). This is consistent with the company’s target net cash position of approximately £40m. Given the on-going higher levels of investment, it does not expect to return capital to shareholders ahead of the completion of the transformation programme in 2020.

The digital opportunity

Greggs has already made significant progress in its transformation from a traditional high street bakery chain to a well-diversified value ‘food-on-the-go’ format.

Looking ahead, a next logical step would be to develop the digital platform, both in store and for customers to place online orders in advance, via the internet or an app, for delivery or collection.

Within the sector McDonald's has pioneered touch screen order and payment technology in store. This not only mitigates bottlenecks of customers waiting to place orders and collect food at the tills, but has also increased the average basket size, as the technology is able to suggest special offers and meal accompaniments as the customer moves through the ordering process.

The 'click-and-collect' opportunity is also significant and Greggs expects to trial its first store towards the end of the year. The fact that Greggs makes its sandwiches and a number of other products freshly on site each day is a clear differentiator. Customers ordering remotely would not only be able to ensure their food choice is in stock, but also tailor it to some extent to their personal requirements. The greatest obstacle is likely to be in ensuring stock availability and management anticipates that trials may last up to two years before the concept can be rolled out more widely.

Forecasts

Our forecasts remain materially unchanged.

Exhibit 4: Changes to forecasts

	Normalised EPS (p)				Normalised PBT (£m)				EBITDA (£m)			
	Old	New	% chg.	% growth y-o-y	Old	New	% chg.	% growth y-o-y	Old	New	% chg.	% growth y-o-y
2018e	63.7	64.0	0.5	(0.7)	81.9	81.3	(0.7)	(0.7)	138.3	136.7	(1.2)	0.7
2019e	65.9	65.6	(0.5)	2.5	83.8	83.4	(0.5)	2.2	146.1	145.6	(0.3)	6.6
2020e	72.1	72.4	0.4	10.4	90.8	91.2	0.4	10.4	156.7	157.4	0.4	8.1

Source: Edison Investment Research

Based on the stronger performance in second quarter we have raised our like-for-like sales growth assumption from 0.5% to 1.3% for the second half of the year, against a challenging prior year comparative. Across the full year we expect like-for-like sales growth of 1.4%. In line with revised company guidance, we have reduced our forecast net openings from 110 to 100 stores in 2018e, weighted towards the back end of the year.

Based on the inflationary cost pressures outlined on pages 2-3, we now assume a 40bp reduction in the 2018 gross margin. We would expect this to be recovered over the following two years as benefits from the supply chain investment programme start to take effect.

Consistent with the trend seen in the first half, we expect to see sustained pressure on distribution and selling costs as a percentage of sales across the full year, partially offset by tighter cost controls. We forecast a profit before tax, before property gains and exceptional items, of £81.3m (previously £81.9m) for 2018. In subsequent years, we forecast a return to earnings growth and a profit before tax, before property gains and exceptional items, of £83.4m and £91.2m in 2019 and 2020, respectively.

Capital expenditure and net cash

We have adjusted our capex assumptions over the three years to 2020e to reflect revised guidance on the timings of expenditure. In 2018e we have reduced capex from £95m to £90m, with a further £95m and £85m of expenditure in 2019e and 2020e respectively. Total expenditure of £270m over the three-year period remains unchanged. We are forecasting a 2018 year-end net cash position of £41.1m (previously £35.7m).

Valuation

Our forecasts have not materially changed and we therefore retain our existing valuation of 1,360p per share. Our valuation is based on a blended average of both DCF and peer group analysis, as detailed in our note, Growth moderates, but strategy on plan, published on 10 May 2018.

Factoring in a post-results rally, Greggs' share price has declined by approximately 25% year to date. The company trades on a 15.5x 2019e P/E and 7.3x EV/EBITDA multiple. The latter represents a 35% discount to the peer group, which we do not believe to be sustainable for any length of time.

Exhibit 5: Financial summary

£m	2016	2017	2018e	2019e	2020e
Dec	IFRS	IFRS	IFRS	IFRS	IFRS
PROFIT & LOSS					
Revenue	894.2	960.0	1,012.4	1,084.2	1,154.0
Cost of Sales	(324.3)	(348.1)	(371.3)	(395.1)	(418.2)
Gross Profit	569.9	611.9	641.1	689.1	735.8
EBITDA	125.9	135.7	136.7	145.6	157.4
Operating Profit (before amort. and except.)	80.3	82.2	81.4	83.2	91.0
Intangible Amortisation	0.0	0.0	0.0	0.0	0.0
Exceptionals	(5.2)	(9.9)	(6.0)	(4.0)	(3.0)
Other	0.0	0.0	0.0	0.0	0.0
Operating Profit	75.2	72.3	75.4	79.2	88.0
Net Interest	(0.0)	(0.4)	(0.1)	0.2	0.2
Profit Before Tax (norm)	80.3	81.8	81.3	83.4	91.2
Profit Before Tax (FRS 3)	75.1	71.9	75.3	79.4	88.2
Tax	(18.1)	(16.9)	(16.8)	(17.5)	(18.5)
Profit After Tax (norm)	62.3	64.9	64.4	65.9	72.7
Profit After Tax (FRS 3)	58.0	56.9	59.6	62.7	70.3
Average Number of Shares Outstanding (m)	100.4	100.6	100.7	100.4	100.4
EPS - normalised (p)	62.0	64.5	64.0	65.6	72.4
EPS - (IFRS) (p)	57.7	56.5	59.2	62.4	70.0
Dividend per share (p)	31.0	32.3	31.5	32.8	36.2
Gross Margin (%)	63.7	63.7	63.3	63.6	63.8
EBITDA Margin (%)	14.1	14.1	13.5	13.4	13.6
Operating Margin (before GW and except.) (%)	9.0	8.6	8.0	7.7	7.9
BALANCE SHEET					
Fixed Assets	323.4	334.7	376.0	408.5	427.1
Intangible Assets	14.3	14.7	18.3	20.7	20.7
Tangible Assets	307.4	319.2	354.2	384.3	402.8
Investments	1.8	0.8	3.6	3.6	3.6
Current Assets	92.6	106.6	95.7	101.3	119.1
Stocks	15.9	18.7	19.5	20.8	23.2
Debtors	30.7	33.4	35.1	37.4	39.8
Cash	46.0	54.5	41.1	43.1	56.2
Other	0.0	0.0	0.0	0.0	0.0
Current Liabilities	(121.4)	(127.9)	(134.8)	(141.6)	(138.2)
Creditors	(121.4)	(127.9)	(134.8)	(141.6)	(138.2)
Short term borrowings	0.0	0.0	0.0	0.0	0.0
Long Term Liabilities	(29.9)	(14.0)	(8.1)	(7.0)	(6.6)
Long term borrowings	0.0	0.0	0.0	0.0	0.0
Other long term liabilities	(29.9)	(14.0)	(8.1)	(7.0)	(6.6)
Net Assets	264.7	299.4	328.8	361.1	401.5
CASH FLOW					
Operating Cash Flow	133.8	134.5	133.2	145.8	147.7
Net Interest	0.1	0.2	(0.1)	0.2	0.2
Tax	(16.2)	(17.6)	(18.2)	(16.7)	(17.9)
Capex	(80.1)	(72.6)	(90.0)	(95.0)	(85.0)
Acquisitions/disposals	4.7	2.2	(4.1)	(1.0)	0.0
Financing	(8.3)	(6.0)	(1.2)	(0.0)	(0.0)
Dividends	(30.9)	(32.2)	(33.1)	(31.4)	(32.0)
Net Cash Flow	3.0	8.5	(13.4)	1.9	13.1
Opening net debt/(cash)	(42.9)	(46.0)	(54.5)	(41.1)	(43.1)
HP finance leases initiated	0.0	0.0	0.0	0.0	0.0
Other	0.0	0.0	0.0	0.0	0.0
Closing net debt/(cash)	(46.0)	(54.5)	(41.1)	(43.1)	(56.2)

Source: Greggs, Edison Investment Research

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