EDISON

Greggs

Trading statement

Greggs passes the scorch test

Retail

Greggs' sales growth has accelerated through each quarter, in defiance of the summer 2018 heatwave conditions that turned many retailers' performances on their heads. Greggs has passed the scorch test, thanks to the change strategy that the brand has quietly achieved: a change in its locations, its value menus, its customers and its trading dayparts. This result is significant and should help challenge out-of-date assumptions about Greggs. We retain our 1,360p valuation.

Year end	Revenue (£m)	PBT* (£m)	EPS* (p)	DPS (p)	P/E (x)	Yield (%)
12/16	894.2	80.3	62.0	31.0	16.2	3.1
12/17	960.0	81.8	64.5	32.3	15.6	3.2
12/18e	1,012.4	81.3	64.0	31.5	15.7	3.1
12/19e	1,084.2	83.4	65.6	32.8	15.3	3.3

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

Revenue growth rate accelerates

Total revenue grew 7.3% y-o-y in Q3, an acceleration of growth against H1's 5.2%. Similarly, managed store like-for-like sales growth was 3.2%, higher than Q2's 1.8%, which in turn was higher than Q1's 1.1%. Remarkably, the improvement in all three quarters' like-for-like growth took place against increasingly strengthening comparative growth in the equivalent three quarters of 2017.

Scorch test passed convincingly

The scorching conditions of summer 2018 made many retailers modify their trading expectations. For Greggs they were a test, passed convincingly, of brand transformation on several dimensions: more food-on-the-go locations attracted new customers such as motorists; many customers in existing retail locations are now workers rather than shoppers; the brand has expanded into new dayparts such as breakfast and late afternoon, which were cooler; and menu development meant cold, lighter products were available.

Forecast: No change

The company is on course to meet expectations. The swing to lower-margin, bought-in products such as cold drinks and pasta salads during the heatwave depressed margins slightly. However, this was temporary and was countered by like-for-like sales, above our H2 forecast of 1.3%.

Valuation: We retain our 1,360p valuation

With no change to our forecast, we retain our valuation of 1,360p. This represents a 30% premium to the current share price. However, we believe this is justified on a blend of DCF and peer group analysis. The shares trade on a 15.3x 2019e P/E and 6.6x EV/EBITDA multiple. The latter represents a 37% discount to the peer group, which we do not believe is sustainable. We also note that it is a 60% discount to the 16.4x EBITDA based valuation at which Costa has been bought by Coca-Cola.

9 October 2018

Price	**1,006.0p**
Market cap	**£1,018m**

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	(4.5)	2.3	(20.5)
Rel (local)	(3.5)	7.7	(17.5)
52-week high/low		1399.0p	942.0p

Business description

With over 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

Q4 trading update	9 January 2019
2018 preliminary results	7 March 2019

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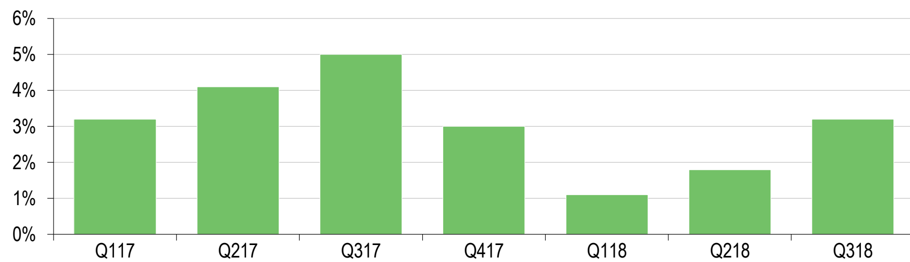
Third quarter trading: Unexpectedly strong

Sales performance: Improving growth against rising comps

Total revenue grew 7.3% in Q3, an improved result against 4.7% growth in Q1 and 5.2% for H1. The growth was powered by a steady rise in like-for-like sales growth in managed units, up 3.2%. As shown in Exhibit 1, what is remarkable about all three quarters' like-for-like growth is that it took place against increasingly strong comparative growth in the equivalent three quarters of 2017.

Exhibit 1: Quarterly like-for-like managed sales growth, %



Source: Greggs

It is equally clear from the chart that Q417, up 3.0%, presents a weaker comparative.

Sales adapt in drought conditions

The strength of trading at Greggs in a period when a wide range of retailers blamed scorching weather for declines is remarkable. How did the company succeed in countering the widespread, heat-induced languor of the retail consumer, exacerbated by prolonged weak confidence?

- The transformation of the shops over the last five years to food-on-the-go formats means that, increasingly, customers are visiting the stores because they work nearby or are passing them in the course of work, not because they are necessarily shoppers in non-retail outlets.
- The development of non-traditional locations such as garages and stations, now around 35% of the total estate, is also helping to pull in a new customer cohort at different occasions.
- Sales were supported during the heatwave by the success of Greggs' strategy to spread its trading period into non-traditional dayparts such as breakfast and later afternoon.
- Menu development has allowed Greggs to flex with the demand for an increasing proportion of cold and light food and drink products during the heat. As the company states, the difficulty was to predict sales patterns correctly. The successful satisfaction of that demand is a quiet success of in-store stock management, supported by the central ordering system introduced last year.
- The period, running from 2 July to 29 September, included two exceptionally hot months and one with more normal conditions. Sales were under some pressure during July and August, although it was already the end of July when we forecast the second half, assuming 1.3% like-for-like growth across the whole period. So, while the length of the heatwave was unexpected, the conditions were to some extent known and allowed for.

Margin performance: Gross margin pressure countered by volume

Gross margin came under some pressure during the hot weather for two reasons:

1. lighter food and drink such as pasta salads and soft drinks are bought-in products, while Greggs' own manufacturing facilities are dedicated to its core baked products. As a result, such products earn a lower gross margin; and

2. while it was possible to predict lower demand for traditional products, it was still necessary to present a certain number for sale, and as a result food wastage increased.

These factors corrected once normal trading conditions were restored, but second-half margins were slightly affected, according to management. However, that effect has been effectively compensated by higher volumes, leaving contribution on track. Separately, increases in potato and onion prices have neutralised any expectations of margin over-performance in H218.

Store openings: A way to go

Despite net openings standing at 58 to the end of Q3, management reiterates its target of around 100 at the full year. We set out below a scenario of how this may be achieved:

Exhibit 2: 2018 store openings – target implications

	Managed	Franchised	Gross	Closures	Net
H1	40	19	59	(25)	34
Q3	18	16	34	(10)	24
Q1-3	**58**	**35**	**93**	**(35)**	58
Q4e	27	25	52	(10)	42
FY18e	54	60	145	(45)	100

Source: Greggs, Edison Investment Research

We understand that some 25 franchised units are scheduled to open in Q4. At the same time, around 10 managed sites should relocate, entailing an equal number of openings and closures. Logically, that leaves 17 new managed openings in the final quarter. This should be achievable, although it will require a high rate of activity, especially as the later part of December will not be a practical time to manage openings.

Valuation: We reiterate our 1,360p

Our forecasts are unchanged, and we leave any finessing of Q3 gross margins against sales volume to the final results. Although we do not expect over-performance on gross margin, there may be grounds for optimism on revenue. Greggs has not disclosed month,-by-month like-for-like sales, but the implication of pressure in July and August is that September like-for-like sales grew above the 3.2% for the quarter. A lower comparative also augurs well for Q4 like-for-like performance.

We retain our existing valuation of 1,360p per share, based on a blended average of both DCF and peer group analysis, as detailed in our note, *Growth moderates, but strategy on plan*, published in May 2018.

Greggs' share price has changed little in the last three months. The shares trade on a 15.3x 2019e P/E and 6.6x EV/EBITDA multiple. The latter represents a 37% discount to the peer group, which we do not believe to be sustainable for any length of time.

Sector transaction: Costa

On 31 August, Whitbread announced that it had reached agreement, subject to shareholder approval, for the sale of Costa to The Coca-Cola Company. The cash consideration of £3.9bn represented a multiple of 16.4x trailing EBITDA.

We would not seek to draw excessive parallels between Costa and Greggs. In particular, Costa has over one-third of its outlets outside the UK and is perceived by its purchaser to have worldwide brand potential, while Greggs is a purely UK brand, implying a substantial discount. However, there are few comparators in the sector, and a discount of 60% looks excessive.

Exhibit 3: 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: Company accounts, Edison Investment Research

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