

Greggs

Promising performance, strengthened proposition

Greggs has traded strongly for the first 19 weeks, and self-help measures such as refurbishments, openings, manufacturing rationalisation and product development continue to offer potential. Whether switching customers would be a net benefit in a consumer squeeze is uncertain, but the proposition is considerably stronger than when real wages were last negative. We retain our forecasts and valuation.

Year end	Revenue (£m)	PBT* (£m)	EPS* (p)	DPS (p)	P/E (x)	Yield (%)
12/15	835.7	73.0	57.3	28.6	18.7	2.7
12/16	894.2	80.3	62.0	31.0	17.3	2.9
12/17e	944.2	80.8	63.4	32.2	16.9	3.0
12/18e	1,000.9	83.9	66.6	34.2	16.1	3.2

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

Trading statement: Promising results at 19 weeks

Trading progress for the first 19 weeks was promising with buoyant like-for-like sales growth of 3.6%. The good performance was attributable to favourable conditions, a late Easter, the c 50% adoption of the central stock forecasting and replenishment system, and the continuing success of the value product offer.

Estate improvements and strategic rationalisation

There was substantial estate development, with 87 refurbishments and net openings of 28 stores, which management regards as on track for the planned 100 for the year. The consultation process for the proposed rationalisation of manufacturing sites has concluded, while investment in the supply chain is continuing on plan.

First-half cost bias

Management estimates food cost inflation at 6-7%, while the new stock forecasting and replenishment system is temporarily increasing training and wastage costs. These factors are likely to add c £1m to first-half costs, which could take interim PBT lower than in 2016. However, in the second half there is forward cover over c 50% of food and energy costs, and initial costs of the stock system should fall away, while savings are extended. Savings on the manufacturing rationalisation should also start to flow within the year. As a result, we hold our forecasts.

Negative real wages for the March quarter confirms our lacklustre view of the retail environment in 2017. If the trend continues, we do not assume that Greggs will derive a net benefit from customers trading down from higher-priced offers. However, further progress on refurbishments and product development has strengthened the prospects.

Valuation: No change

As our valuation is based on a DCF projection, extending our forecasts, which are unchanged, we make no change to our existing valuation of 1,226p per share.

AGM trading statement

Retail

22 May 2017

Price 1,072.00p
Market cap £1,084m

Net cash (£m) at 31 December 2016	46.0
Shares in issue	101.2m
Free float	100%
Code	GRG
Primary exchange	LSE
Secondary exchange	N/A

Share price performance



%	1m	3m	12m
Abs	(1.8)	4.5	(2.5)
Rel (local)	(6.0)	1.5	(20.4)
52-week high/low	1139.0p	884.0p	

Business description

With over 1,790 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

Interim results	August 2017
Interim management statement	September 2017

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AGM trading statement: Good progress at 19 weeks

In its first trading statement of the year, Greggs has reported promising progress for the initial 19 weeks. Total sales grew by 7.5%, stronger than at the same stage last year (5.7%), and like-for-like sales growth was comparable at a buoyant 3.6% (2016: 3.7%). Given that the first eight weeks (reported with prelims) saw like-for-like sales growth of 2.0%, this implies growth in the following 11 weeks of close to 5%.

Factors behind the good performance were:

- **Favourable conditions:** the generally calm and dry weather in March and April resulted in more customer footfall than at the same stage in 2016.
- **Date of Easter:** the relatively late date of Easter in mid-April also meant that more people were out and about in warmer temperatures with time to shop. In fact, Easter 2016 also corresponded with some unusually wet weather.
- **Forecasting and replenishment system:** Greggs is progressing on the introduction of its central order replenishment system driven by store stock counts, which now operates in c 50% of stores. This is proving to be more effective than the previous procedure at store level, resulting in greater availability of product lines at the right times, and is therefore driving sales.
- **Product offer:** increasingly, the food-on-the-go focus of Greggs' offer is resonating with customers interested in value. The attraction to workers, as opposed to shoppers, is evident from the fact that sales before 9am are growing in double digits year-on-year. Costa has recently introduced an offer of a £1 bacon roll with a coffee, but given that its coffee is typically priced at c £2.50, this package does not compete on price with Greggs' £2 breakfast package offer.

While there was inevitably a price component to the like-for-like performance, we understand that volume growth remains a significant element of the total.

Estate investment: Continuing on course

There were 87 store refurbishments in the first 19 weeks. The company opened 22 managed stores, which suggests later phasing of the balance of the 110 planned for the year. However, with 20 franchised openings and 14 closures, management is confident of reaching its planned 100 net openings for the year.

Strategic changes show good progress

Good progress has been made, with the conclusion of the consultation process involving staff affected by the proposed rationalisation of manufacturing sites. When complete, these will see the number of bakeries reduce from nine to two. Investment in the supply chain is continuing on plan: for example, all Greggs' Yum Yums are now distributed from Glasgow, and similar manufacturing platforms will be rolled out for other products.

Cost management

In common with all food retail operations, Greggs faces input cost pressures, in part currency driven. In February management guided these at 6-7% of food cost for 2017, driven mainly by dairy, meat and fish, with c 3% wage inflation.

In addition, the introduction of the new stock forecasting and replenishment system is having two one-off effects in the first half:

- there is a disproportionate training cost, which we expect to reduce as sites using the system accelerate to 100%; and
- introduction of the system, while driving higher sales through better planned stocking, has increased end-of-day wastage. It should be possible to fine-tune stock management to achieve the best of both elements.

In total, we estimate that these factors are likely to add c £1m to first-half costs, which could mean that first-half PBT is lower than in 2016. However, in the second half there is contractual cover extending to c 50% of food and energy costs, and additional costs relating to the stock forecasting and replenishment system should fall away, while resulting cost savings are extended. With the good progress on bakery closures, we can also expect resulting cost savings to begin to come through within the year.

Forecasts: No change, but value proposition could do well

As a result of the above, we are not changing our profit forecasts. However, we remain vigilant on disposable income given that average wages in the UK for the three months to March were up 2.1%, less than UK inflation of 2.7% in April (source: ONS), meaning that real wage inflation is negative for the first time since 2014.

Whether the continuation of such a trend is likely to be negative for Greggs' revenue line is a moot question. On the downside, the pyramidal shape of markets means that any consumer multi-site operation whose market becomes challenged logically has more customers trading down from it than to it. Customer reactions could be to visit the stores less frequently, relying for instance on home-prepared sandwiches, or to spend less during each visit, foregoing treats such as desserts or drinks.

On the other hand, the progress of transforming the estate is now much further advanced than the last period when real wages were negative, which spanned the years 2009-14. During the years 2012-14, around 30% of the stores were refurbished using food-on-the-go templates, and like-for-like managed store sales turned round from 0.8% negative in 2013 to 4.5% positive in 2014.

Up to the present, approaching 60% of the estate has been refurbished on those lines, excluding new openings, which have also been on the contemporary formats. In addition, significant progress has been made on making customer choices more attractive, including the development of the Balanced Choice range with healthy wraps and salads, cold-pressed juice drinks and the breakfast offer. Therefore we believe that the proposition as a whole represents a much more attractive offer to the cost-conscious customer than it did three to four years ago.

Valuation: No change

Our valuation of Greggs' shares is based on a DCF projection, the basis of which was fully explained in our March 2017 note [Successful strategy offers further potential](#). Since currently our forecasts are unchanged, we make no change to our existing valuation of 1,226p per share.

Exhibit 1: Financial summary

	£m	2013	2014	2015	2016	2017e	2018e
Dec		IFRS	IFRS	IFRS	IFRS	IFRS	IFRS
PROFIT & LOSS							
Revenue		762.4	806.1	835.7	894.2	944.2	1,000.9
Cost of Sales		(305.9)	(304.8)	(305.1)	(324.3)	(346.2)	(367.0)
Gross Profit		456.5	501.3	530.6	569.9	598.0	633.9
EBITDA		74.9	95.6	113.3	125.9	131.4	138.3
Operating Profit (before amort. and except.)		41.5	58.1	73.1	80.3	81.4	84.0
Intangible Amortisation		0.0	0.0	0.0	0.0	0.0	0.0
Exceptionals		(8.1)	(8.5)	0.0	(5.2)	(12.0)	(6.6)
Other		0.0	0.0	0.0	0.0	0.0	0.0
Operating Profit		33.4	49.6	73.1	75.2	69.4	77.4
Net Interest		(0.2)	0.2	(0.1)	(0.0)	(0.6)	(0.0)
Profit Before Tax (norm)		41.3	58.3	73.0	80.3	80.8	83.9
Profit Before Tax (FRS 3)		33.2	49.7	73.0	75.1	68.8	77.3
Tax		(10.3)	(14.0)	(15.4)	(18.1)	(17.2)	(17.0)
Profit After Tax (norm)		30.9	44.3	57.6	62.3	63.6	66.9
Profit After Tax (FRS 3)		24.2	37.6	57.6	58.0	54.2	61.7
Average Number of Shares Outstanding (m)		100.4	100.5	100.6	100.4	100.4	100.4
EPS - normalised (p)		30.8	44.0	57.3	62.0	63.4	66.6
EPS - normalised and fully diluted (p)		30.5	43.4	55.8	60.8	62.2	65.4
EPS - (IFRS) (p)		24.1	37.4	57.3	57.7	54.0	61.4
Dividend per share (p)		19.5	22.0	28.6	31.0	32.2	34.2
Gross Margin (%)		59.9	62.2	63.5	63.7	63.3	63.3
EBITDA Margin (%)		9.8	11.9	13.6	14.1	13.9	13.8
Operating Margin (before GW and except.) (%)		5.4	7.2	8.7	9.0	8.6	8.4
BALANCE SHEET							
Fixed Assets		268.9	267.4	298.2	323.4	358.4	374.1
Intangible Assets		1.0	4.7	10.2	14.3	17.5	20.5
Tangible Assets		267.8	262.7	284.2	307.4	339.2	351.8
Investments		0.1	0.0	3.8	1.8	1.8	1.8
Current Assets		65.0	101.5	86.0	92.6	88.3	108.9
Stocks		15.4	15.3	15.4	15.9	17.0	18.0
Debtors		25.0	26.1	27.6	30.7	30.1	31.9
Cash		21.6	43.6	42.9	46.0	41.2	58.9
Other		3.0	16.5	0.0	0.0	0.0	0.0
Current Liabilities		(80.7)	(102.1)	(106.0)	(121.4)	(128.8)	(134.4)
Creditors		(80.7)	(102.1)	(106.0)	(121.4)	(128.8)	(134.4)
Short term borrowings		0.0	0.0	0.0	0.0	0.0	0.0
Long Term Liabilities		(17.0)	(20.1)	(11.9)	(29.9)	(29.1)	(28.7)
Long term borrowings		0.0	0.0	0.0	0.0	0.0	0.0
Other long term liabilities		(17.0)	(20.1)	(11.9)	(29.9)	(29.1)	(28.7)
Net Assets		236.2	246.7	266.3	264.7	288.9	319.8
CASH FLOW							
Operating Cash Flow		82.5	108.6	119.6	133.8	127.4	136.2
Net Interest		(0.0)	0.2	0.2	0.1	(0.6)	(0.0)
Tax		(13.2)	(11.5)	(15.9)	(16.2)	(14.6)	(15.7)
Capex		(48.6)	(48.3)	(71.8)	(80.1)	(85.0)	(70.0)
Acquisitions/disposals		0.2	(4.8)	18.1	4.7	0.0	0.0
Financing		0.9	(2.6)	(7.2)	(8.3)	0.0	0.0
Dividends		(19.6)	(19.6)	(43.7)	(30.9)	(32.0)	(32.7)
Net Cash Flow		2.2	22.0	(0.7)	3.0	(4.8)	17.7
Opening net debt/(cash)		(19.4)	(21.6)	(43.6)	(42.9)	(46.0)	(41.2)
HP finance leases initiated		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
Closing net debt/(cash)		(21.6)	(43.6)	(42.9)	(46.0)	(41.2)	(58.9)

Source: Company accounts, Edison Investment Research

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