

Greggs

Interim results

More than just the vegan-friendly sausage roll

Greggs' interim results highlighted that the consumer is responding well to the company's transition to a leading food-on-the-go retailer. This has led to record revenue growth and a step change in gross margin, as well as enabling further investment to fund future growth initiatives, while funding a special dividend as expected. Our forecasts are broadly unchanged following four upgrades in six months.

Year end	Revenue (£m)	PBT* (£m)	EPS* (p)	DPS (p)	P/E (x)	Yield (%)
12/17	960.0	81.8	63.5	32.3	34.0	1.5
12/18	1,029.3	89.8	70.3	35.7	30.7	1.6
12/19e	1,156.9	107.9	84.0	44.4	25.7	2.0
12/22e	1,236.3	115.8	91.7	48.7	23.5	2.3

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

H119: Record revenue growth and operating leverage

Greggs has delivered strong interim results with record revenue growth, which has led to a good improvement in the operating margin, driven by mostly sustainable gross margin improvements and good control of other operating costs. H119 like-for-like (LFL) revenue growth was 10.5%, the gross margin improved by 230bp, and the clean operating margin improved from 5.4% in H118 to 8.0% in H119. These produced y-o-y growth of 57% in clean PBT and 59% in clean EPS.

Marketing and new products driving footfall

The interims benefited from growth across all product categories as footfall and transactions increase in response to Greggs' marketing initiatives and new product launches. Ongoing space growth, extended opening hours, new product launches and further trials of initiatives such as click and collect should help sustain this trend.

Forecasts: Unchanged following four upgrades

Our forecasts for FY19 and FY20 are broadly unchanged, which reflects assumptions for higher LFL growth in FY19, some modest gross margin pressure in H219 and a lower tax rate (20.4% from 21.0%). We raise our LFL assumption for FY19 to 7.9% from 7.3% given the performance in H1 and the 'strong' current trading indicated in the outlook statement. We factor in a 30bp deterioration in gross margin in H219, versus our previous estimate, given increasing commodity price inflation, which is solely due to pork prices given the swine flu epidemic in China. We make no significant changes to our FY20 assumptions beyond the flow through and annualisation of the H219 gross margin reduction and lower tax rate.

Valuation: No significant change

Our DCF-based valuation has reduced modestly from 2,059p to 2,028p given the change in timing of corporate tax cash outflows (see page 4). Our forecasts continue to assume revenue growth beyond FY21 of 6%, cautiously fading to 2%, and a perpetuity EBITDA margin of 16% (FY21e 15%). Greggs is highly cash generative as evidenced by the special dividend announced with the H119 results.

Retail

6 August 2019

Price 2,132p
Market cap £2,147m

Net cash (£m) at 30 June 2019	85.9
Shares in issue	100.7m
Free float	100%
Code	GRG
Primary exchange	LSE
Secondary exchange	N/A

Share price performance



Business description

With 1,984 shops, eight manufacturing and distribution centres and 23,000 employees, Greggs is the UK's leading 'food-on-the-go' retailer. It uses vertical integration to offer differentiated products at competitive prices.

Next events

Q3 trading update	October 2019
-------------------	--------------

Analysts

Russell Pointon	+44 (0)20 3077 5757
Kate Heseltine	+44 (0)20 3077 5700

consumer@edisongroup.com
[Edison profile page](#)

**Greggs is a research client of
Edison Investment Research
Limited**

H119 results: Strong growth and operating leverage

Following strong trading updates through the first half, Greggs has reported record revenue growth, which fed through to a higher operating margin, driven by gross margin improvements and good control of other operating costs, while investing in new initiatives to drive future growth.

Exhibit 1: Group revenue and profit

(£m)	H119	H118	Change (%)
Revenue	546.3	476.3	14.7%
Gross profit	356.6	300.2	18.8%
Gross margin	65.3%	63.0%	230bp
Operating profit (before property gains and exceptional items)	44.5	27.0	64.9%
Margin (%)	8.1%	5.7%	240bp
Loss on sale of PPE	(0.6)	(1.1)	
Operating profit (before exceptional items)	43.9	25.9	69.3%
Margin (%)	8.0%	5.4%	260bp
Exceptionals	(4.0)	(1.9)	
Financial expense	(3.2)	(0.0)	
Clean PBT	40.7	25.9	57.1%

Source: Greggs

Sales benefiting from marketing and new product initiatives

Total sales in the first half increased by 14.7% year-on-year to £546m and like-for-like sales increased by 10.5%. The performance is described as 'broadly-based' and reflects the coming together of the many initiatives, including marketing and new product introductions, to broaden Greggs' appeal in the growing food-on-the-go market. These have resulted in increased customer visits and number of transactions in more day parts as intended. The message from management is that the consumer is catching up with the innovations in the product offer, store environment and extended opening hours that have been under way for a number of years. While there is strong growth at breakfast, the fastest growing part of the trading day, there is good growth towards the end of the day too, due to offers such as the post-4pm offer of a slice of pizza and a drink for £2. The hot food cabinets required to help service these new day parts will be available in 500 locations by the autumn, versus the current 100, so these should help to maintain momentum in growing footfall through the trading day.

An interesting side effect of the increased footfall, from new and returning customers attracted by the new product offers, has been a resurgence in demand for the traditional sweet and savoury products. The vegan-friendly sausage roll has helped to drive growth in the broader savoury category.

The LFL growth moderated from the 11.1% growth reported at the AGM, which covered the 19 weeks to 11 May. H118 saw significant variations in weather, which affected the sales performance through the period. The net result was that Greggs' comparators strengthened towards the end of the period (H118 1.3%, H218 1.8%), therefore a moderation towards the end of H119 was expected. It is encouraging that management expects the two-year growth rate towards the end of the first half of c 10% to continue into the second half as comparatives strengthen. Management expects LFL growth to normalise through H219 with the two-year rate of growth to continue in Q319, and then for the two-year growth rate to fade by one percentage point in Q419, post the current deadline for Brexit.

During the first half a net 31 new shops were added to the portfolio to bring the total to 1,984. The target for 100 net new shops for FY19 remains, implying a similar H2 skew of new space as in FY18.

The trend towards repositioning the store portfolio to capture work, travel and leisure-related trade continues as 38% of the estate now services these customers, from 35% last year. The availability of these locations can be a challenge given restricted supply and a high level of interest from competitors. Management continues to be surprised by the success of new formats eg drive-through locations in what previously may have been considered as already-saturated towns. The investment in marketing and new products is feeding through to an improvement in the brand perception, such that Greggs is now being invited into locations such as the Trafford Centre in Manchester.

The click and collect pilot has been expanded to a seventh city and Greggs is now available on the Just Eat delivery platform, as well as Deliveroo, having come off Uber Eats. The key challenge for management is fulfilling the two 'new' customers ie click and collect and delivery from a store that typically has a relatively small footprint, while not frustrating the core walk-in customer.

Gross margin: Step change

The gross margin increased by 230bp from 63% in H118 to 65.3% in H119. The key drivers to this were:

- volume growth due to increased footfall noted above;
- cost benefits emerging from the reengineering of the infrastructure;
- modest cost inflation of ingredients and energy; and
- mix benefits driven by changes in the weather plus changes in consumer demand.

The first two bullet points should be considered as sustainable, and, therefore are a step change in gross margin. With respect to the third point, management is indicating greater input cost inflation in H219 (it is now expecting 4% inflation versus 3–4% previously), due to the price of pork as a result of the swine flu epidemic in China. The last bullet point refers to more own-sourced/higher margin products sold this year (eg a return to favour of the traditional baked goods) versus more externally sourced products sold last year (cold drinks given the warm weather) so is likely to vary depending on the weather.

The clean operating profit increased from £25.9m in H118 to £43.9m in H119, the operating margin increased from 5.4% to 8%. Therefore, in addition to the gross margin increase, good cost control of other operating expenses enhanced the operating margin further, albeit there was a modest enhancement from the adoption of IFRS 16 as discussed below.

IFRS 16

The company has adopted IFRS 16 from 30 December 2018, using the modified transition approach, and comparatives for H118 have not been restated. As a result, comparison of individual line items between H119 and H118 can be a little misleading. In H119, the net additional cost to PBT was £2.1m, with a benefit to operating profit of £1.2m offset by an £3.3m incremental financial expense. For the full year, the net impact is as previously guided with a net cost to PBT of £4.2m. At the end of June 2019 the balance sheet reflects right-of-use assets of £276m with a similar offsetting lease liability.

Cash returns and net cash

In line with the policy of distributing excess cash on the balance sheet, defined as a net cash position of more than c £40m at the year-end, a special dividend of 35p per share was declared. This is in addition to the interim dividend of 11.9p, which grew by 11.2%. Both dividends will be paid on 3 October 2019 with a record date of 6 September 2019. The cash cost of the dividend of £35m will take our forecast net cash position at the year-end down to c £60m. Heading into 2020, management wishes to retain an incremental £20m net cash above this 'buffer' in order to fund

incremental corporate tax cash payments in 2020. It is a transition year for cash tax as UK corporation tax payments are being brought forward so that payments are made in the year they were earned rather than with a lag as at present. Therefore, in FY20 roughly half of FY19's corporation tax will be paid as well as all of FY20's corporation tax, with the greatest impact to cash flow in the first half.

Given the increased scale and potential further investment requirements of the business, management believes the £40m 'buffer' may be too low so may consider raising the floor in future years.

Forecasts: Summary of changes

Our net forecasts for FY19 and FY20 are broadly unchanged albeit the assumptions for key line items, notably LFL sales growth and gross margin, have changed as discussed below.

Exhibit 2: Changes to forecasts

Year end December	EPS (p) *				PBT (£m)				EBITDA (£m)			
	Old	New	% chg.	% growth	Old	New	% chg.	% growth	Old	New	% chg.	% growth
2019e	83.8	84.0	0.0	19.0	107.7	107.9	0.0	20.2%	223.5	226.8	1.4	N/M
2020e	91.6	91.7	0.0	9.2	116.6	115.8	(0.7)	7.2%	240.8	241.0	0.0	6.2

Source: Edison Investment Research, * EPS normalised and fully diluted

Based on the strong H119 performance we raise our FY19 forecast for LFL growth to 7.9% from 7.3%. We assume the current two-year growth rate is sustained through Q319 and fades by one percentage point in Q419. These assumptions produce LFL growth of 6.5% in Q319, 4% in Q419 and 5.3% for H219.

We model a slight deterioration in gross margin in H219 of 30bp from 64.3% in H218 to 64% in H219, which we rationalise as a one percentage point increase in food inflation and which represents c 30% of the cost base. In aggregate, this produces a gross margin for FY19 of 64.6% versus 63.7% in FY18.

The normalised tax rate for the FY19 is now expected to be 20.4%, down from our previous assumption of 21%. The lower rate reflects disallowable expenditure for tax representing a smaller proportion of profits given the strong trading performance. Beyond FY19 the normalised tax rate is expected to be 1.75% above the headline corporate tax rate.

Our assumptions for revenue growth in FY20 are unchanged, gross margin increases from 64.0% in FY19 to 64.8% due to the gains made in FY19, and the normalised tax rate falls to 19% from 20.3%.

Valuation

Our DCF-based valuation of 2,028p has reduced modestly from our prior valuation of 2,059p. As highlighted above, our earnings forecasts are broadly unchanged but the timing of cash outflows for corporation tax have been brought forward. After FY21, our assumptions include a conservative fade in revenue growth from 6% to 2% and a perpetuity EBITDA margin of 16% versus 15% in FY21. Therefore, we believe the share price is discounting more optimistic revenue growth and/or operating margins.

Exhibit 3: Financial summary

Year end 31 December (£m)	2017	2018	2019e	2020e
	IFRS	IFRS	IFRS	IFRS
PROFIT & LOSS				
Revenue	960.0	1,029.3	1,156.9	1,236.3
Cost of Sales	(348.1)	(373.4)	(409.4)	(434.8)
Gross Profit	611.9	655.9	747.6	801.6
EBITDA	135.7	145.7	226.8	241.0
Operating Profit (before amort. and except.)	82.2	89.8	114.7	123.7
Intangible Amortisation	0.0	0.0	0.0	0.0
Exceptionals	(9.9)	(7.2)	(7.0)	(2.2)
Other	0.0	0.0	0.0	0.0
Operating Profit	72.3	82.6	107.7	121.5
Net Interest	(0.4)	(0.0)	(6.8)	(7.9)
Profit Before Tax (norm)	81.8	89.8	107.9	115.8
Profit Before Tax (FRS 3)	71.9	82.6	100.9	113.6
Tax	(16.9)	(18.2)	(22.0)	(21.9)
Profit After Tax (norm)	64.9	71.6	85.9	93.8
Profit After Tax (FRS 3)	56.9	65.7	80.2	94.0
Average Number of Shares Outstanding (m)	100.6	100.7	100.7	100.8
EPS - normalised and fully diluted (p)	63.5	70.3	84.0	91.7
EPS (IFRS) (p)	56.5	65.3	79.7	93.3
Dividend per share (p)	32.3	35.7	44.4	48.7
Gross Margin (%)	63.7	63.7	64.6	64.8
EBITDA Margin (%)	14.1	14.2	19.6	19.5
Operating Margin (before GW and except.) (%)	8.6	8.7	9.9	10.0
BALANCE SHEET				
Fixed Assets	334.7	347.5	661.6	706.1
Intangible Assets	14.7	16.9	18.1	18.7
Tangible Assets	319.2	330.5	643.4	687.2
Investments	0.8	0.2	0.2	0.2
Current Assets	106.6	140.6	120.5	136.0
Stocks	18.7	20.8	22.7	24.8
Debtors	33.4	31.6	38.0	42.3
Cash	54.5	88.2	59.8	68.8
Other	0.0	0.0	0.0	0.0
Current Liabilities	(127.9)	(145.1)	(201.7)	(204.1)
Creditors	(127.9)	(145.1)	(201.7)	(204.1)
Short term borrowings	0.0	0.0	0.0	0.0
Long Term Liabilities	(14.0)	(13.8)	(237.8)	(257.3)
Long term borrowings	0.0	0.0	0.0	0.0
Other long term liabilities	(14.0)	(13.8)	(237.8)	(257.3)
Net Assets	299.4	329.2	342.7	380.8
CASH FLOW				
Operating Cash Flow	134.5	152.2	164.4	174.6
Net Interest	0.2	0.2	0.0	0.0
Tax	(17.6)	(16.1)	(20.7)	(29.9)
Capex	(72.6)	(66.6)	(100.0)	(88.0)
Acquisitions/disposals	2.2	1.7	0.0	0.0
Financing	(6.0)	(4.7)	0.0	0.0
Dividends	(32.2)	(33.1)	(72.1)	(47.7)
Net Cash Flow	8.5	33.7	(28.4)	9.1
Opening net debt/(cash)	(46.0)	(54.5)	(88.2)	(59.8)
HP finance leases initiated	0.0	0.0	0.0	0.0
Other	0.0	0.0	0.0	0.0
Closing net debt/(cash)	(54.5)	(88.2)	(59.8)	(68.8)

Source: Greggs, Edison Investment Research

General disclaimer and copyright

This report has been commissioned by Greggs and prepared and issued by Edison, in consideration of a fee payable by Greggs. Edison Investment Research standard fees are £49,500 pa for the production and broad dissemination of a detailed note (Outlook) following by regular (typically quarterly) update notes. Fees are paid upfront in cash without recourse. Edison may seek additional fees for the provision of roadshows and related IR services for the client but does not get remunerated for any investment banking services. We never take payment in stock, options or warrants for any of our services.

Accuracy of content: All information used in the publication of this report has been compiled from publicly available sources that are believed to be reliable, however we do not guarantee the accuracy or completeness of this report and have not sought for this information to be independently verified. Opinions contained in this report represent those of the research department of Edison at the time of publication. Forward-looking information or statements in this report contain information that is based on assumptions, forecasts of future results, estimates of amounts not yet determinable, and therefore involve known and unknown risks, uncertainties and other factors which may cause the actual results, performance or achievements of their subject matter to be materially different from current expectations.

Exclusion of Liability: To the fullest extent allowed by law, Edison shall not be liable for any direct, indirect or consequential losses, loss of profits, damages, costs or expenses incurred or suffered by you arising out of or in connection with the access to, use of or reliance on any information contained on this note.

No personalised advice: The information that we provide should not be construed in any manner whatsoever as, personalised advice. Also, the information provided by us should not be construed by any subscriber or prospective subscriber as Edison's solicitation to effect, or attempt to effect, any transaction in a security. The securities described in the report may not be eligible for sale in all jurisdictions or to certain categories of investors.

Investment in securities mentioned: Edison has a restrictive policy relating to personal dealing and conflicts of interest. Edison Group does not conduct any investment business and, accordingly, does not itself hold any positions in the securities mentioned in this report. However, the respective directors, officers, employees and contractors of Edison may have a position in any or related securities mentioned in this report, subject to Edison's policies on personal dealing and conflicts of interest.

Copyright: Copyright 2019 Edison Investment Research Limited (Edison). All rights reserved FTSE International Limited ("FTSE") © FTSE 2019. "FTSE®" is a trade mark of the London Stock Exchange Group companies and is used by FTSE International Limited under license. All rights in the FTSE indices and/or FTSE ratings vest in FTSE and/or its licensors. Neither FTSE nor its licensors accept any liability for any errors or omissions in the FTSE indices and/or FTSE ratings or underlying data. No further distribution of FTSE Data is permitted without FTSE's express written consent.

Australia

Edison Investment Research Pty Ltd (Edison AU) is the Australian subsidiary of Edison. Edison AU is a Corporate Authorised Representative (1252501) of Crown Wealth Group Pty Ltd who holds an Australian Financial Services Licence (Number: 494274). This research is issued in Australia by Edison AU and any access to it, is intended only for "wholesale clients" within the meaning of the Corporations Act 2001 of Australia. Any advice given by Edison AU is general advice only and does not take into account your personal circumstances, needs or objectives. You should, before acting on this advice, consider the appropriateness of the advice, having regard to your objectives, financial situation and needs. If our advice relates to the acquisition, or possible acquisition, of a particular financial product you should read any relevant Product Disclosure Statement or like instrument.

New Zealand

The research in this document is intended for New Zealand resident professional financial advisers or brokers (for use in their roles as financial advisers or brokers) and habitual investors who are "wholesale clients" for the purpose of the Financial Advisers Act 2008 (FAA) (as described in sections 5(c) (1)(a), (b) and (c) of the FAA). This is not a solicitation or inducement to buy, sell, subscribe, or underwrite any securities mentioned or in the topic of this document. For the purpose of the FAA, the content of this report is of a general nature, is intended as a source of general information only and is not intended to constitute a recommendation or opinion in relation to acquiring or disposing (including refraining from acquiring or disposing) of securities. The distribution of this document is not a "personalised service" and, to the extent that it contains any financial advice, is intended only as a "class service" provided by Edison within the meaning of the FAA (i.e. without taking into account the particular financial situation or goals of any person). As such, it should not be relied upon in making an investment decision.

United Kingdom

This document is prepared and provided by Edison for information purposes only and should not be construed as an offer or solicitation for investment in any securities mentioned or in the topic of this document. A marketing communication under FCA Rules, this document has not been prepared in accordance with the legal requirements designed to promote the independence of investment research and is not subject to any prohibition on dealing ahead of the dissemination of investment research.

This Communication is being distributed in the United Kingdom and is directed only at (i) persons having professional experience in matters relating to investments, i.e. investment professionals within the meaning of Article 19(5) of the Financial Services and Markets Act 2000 (Financial Promotion) Order 2005, as amended (the "FPO") (ii) high net-worth companies, unincorporated associations or other bodies within the meaning of Article 49 of the FPO and (iii) persons to whom it is otherwise lawful to distribute it. The investment or investment activity to which this document relates is available only to such persons. It is not intended that this document be distributed or passed on, directly or indirectly, to any other class of persons and in any event and under no circumstances should persons of any other description rely on or act upon the contents of this document.

This Communication is being supplied to you solely for your information and may not be reproduced by, further distributed to or published in whole or in part by, any other person.

United States

The Investment Research is a publication distributed in the United States by Edison Investment Research, Inc. Edison Investment Research, Inc. is registered as an investment adviser with the Securities and Exchange Commission. Edison relies upon the "publishers' exclusion" from the definition of investment adviser under Section 202(a)(11) of the Investment Advisers Act of 1940 and corresponding state securities laws. This report is a bona fide publication of general and regular circulation offering impersonal investment-related advice, not tailored to a specific investment portfolio or the needs of current and/or prospective subscribers. As such, Edison does not offer or provide personal advice and the research provided is for informational purposes only. No mention of a particular security in this report constitutes a recommendation to buy, sell or hold that or any security, or that any particular security, portfolio of securities, transaction or investment strategy is suitable for any specific person.

Frankfurt +49 (0)69 78 8076 960
Schumannstrasse 34b
60325 Frankfurt
Germany

London +44 (0)20 3077 5700
280 High Holborn
London, WC1V 7EE
United Kingdom

New York +1 646 653 7026
1,185 Avenue of the Americas
3rd Floor, New York, NY 10036
United States of America

Sydney +61 (0)2 8249 8342
Level 4, Office 1205
95 Pitt Street, Sydney
NSW 2000, Australia