Greggs

Interim results

More than just the vegan-friendly sausage roll

Retail

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.

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

%	1m	3m	12m
Abs	(10.0)	(18.6)	108
Rel (local)	(5.9)	(21.7)	121.8
52-week high/low		2,476p	1,006p

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

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Edison profile page

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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	EPS (p) *				PBT (£m)				EBITDA (£m)			
December	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

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