EDISON

Greggs

AGM trading statement

Growth moderates, but strategy on plan

Retail

Greggs' management has been open in recognising that despite the Beast from the East and other extraordinary weather patterns, there is an underlying softening of demand. We have reduced forecasts, but see earnings growth continuing from a combination of like-for-like sales, shop expansion, and investment in the estate and manufacturing and fulfilment infrastructure. Greggs' value positioning should place it well in a tight consumer market, and at these levels the valuation is attractive.

Year end	Revenue (£m)	PBT* (£m)	EPS* (p)	DPS (p)	P/E (x)	Yield (%)
12/16	894.2	80.3	62.0	31.0	17.4	2.9
12/17	960.0	81.8	64.5	32.3	16.7	3.0
12/18e	1,012.2	81.9	63.7	31.8	16.9	3.0
12/19e	1,083.6	83.8	65.9	32.9	16.4	3.1

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

18-week trading: Spring storms mask weaker demand

Eighteen-week sales were +4.7% year-on-year, and managed like-for-like sales +1.3%. Against +6.2% and +3.2% respectively at eight weeks, that implies intervening declines, with lower transaction numbers despite higher average spend. It is no surprise that extreme March and April conditions affected trading, with footfall down across the retail sector. Management estimates that weather affected the period by up to 1%, implying that ex-weather, like-for-like growth would have been c 2%. That is not a bad result, although it does imply some overall demand flattening.

Openings and manufacturing consolidation on plan

Like-for-like sales are back in growth in the first days of May, and the strategy is on track. Net openings of 29 stores are comparable with the 28 at 19 weeks last year, although the back-ended openings phasing is likely to be more pronounced in 2018. The manufacturing consolidation process is going to plan.

Forecasts: We build in caution on sales and openings

Management is now more cautious in its outlook, and we reduce our forecast like-for-like sales growth assumption for H218 from 1% to 0.5%. We also cut our net openings forecast from 120 to 110 with later phasing. Our 2018 PBT forecast of £81.9m represents a 4% downgrade. In 2019 we soften forecast like-for-like sales growth from 2% to 1.5% which, on the lower base for a full year, means that we downgrade PBT by 8%. By 2020 we forecast a return to more normal PBT growth of 8%.

Valuation: EV/EBITDA discount looks unsustainable

Our blended valuation of 1,360p is around c 5% down on our previous 1,436p, with reductions in our DCF valuation compensated by increases in the market rating of peers since March 2018. It is notable that Greggs trades on a 2019e EV/EBITDA multiple of only 6.6x, compared with peers at 11.6x, a level of discount that looks unsustainable for any length of time. Meanwhile, 2018 year-end net cash, which we forecast at £35.7m, underpins the 3% yield.

10 May 2018

Price	**1,076p**
Market cap	**£1,091m**

Net cash (£m) at December 2017	54.5
Shares in issue	101.2m
Free float	100%
Code	GRG
Primary exchange	LSE
Secondary exchange	N/A

Share price performance

%	1m	3m	12m
Abs	(13.4)	(15.2)	(0.5)
Rel (local)	(18.6)	(21.4)	(4.7)
52-week high/low		1399.0p	1056.0p

Business description

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

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Interim results	31 July 2018

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Edison profile page

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18-week trading: Spring storms mask softer demand

At 18 weeks, total sales were up 4.7% year-on-year, with like-for-like sales in managed shops up 1.3%. That compares with eight-week growth reported with preliminary results, of 6.2% and 3.2% respectively. By implication, the intervening 10 weeks saw actual declines. Those were the product of lower transaction numbers despite higher average spend per transaction.

It is hardly a surprise that unseasonal weather conditions in March and April affected trading, with some shops actually unable to open in the worst days. The so-called Beast from the East, combined with Storm Emma in early March and the "mini Beast from the East" in mid-March, affected retail as a whole in the month, with total retail footfall down 6% year-on-year, according to data from the BRC-KPMG monitor quoted in the press. April comparative sales were affected by the early date of Easter and by variable weather, but underlying consumer weakness also appears to have been an element in the BRC's like-for-like, year-on-year sales decline of 4.2% for the month.

Although such analysis can never be precise, management estimates that adverse weather affected the 18-week numbers by up to 1%, implying that ex-weather, like-for-like growth would have been c 2%. That is not a bad result, although it does imply some overall flattening in demand growth. Notable areas of growth nonetheless have been innovative ranges such as the £2 breakfast offer, hot food products and healthier options such as salads and dips.

Estate strategy: Progress similar to a year ago

Net openings of 29 stores are comparable with the 19-week position of 28 last year. Then, openings were significantly back-ended, and that is likely to be more pronounced in 2018:

Exhibit 1: Shop openings and closures

	2017 week 19	2017 FY	2018 week 18	2018 FY guidance
Managed openings	22	86	27	90-100
Franchised openings	20	45	14	70
Total openings	42	131	41	160-170
Closures	(14)	(41)	(12)	(40-50)
Net openings	28	90	29	110-130

Source: Greggs

Greggs is reaching out into new locations, with recent openings in Westminster tube station, Birmingham New Street station, Glasgow Buchanan bus terminal and East Midlands airport. Such locations are part of a deliberate strategy to move up to 40% of the estate away from the high street in the medium term, providing insulation from secular declines and a more direct connection to customers whose lifestyles fit the on-the-go model. The strategy does mean that increased numbers of openings are dependent on third parties such as Euro Garages, where Greggs already has 125 franchised units. This does increase the risk around openings and management is indicating that it may be more realistic to expect net openings at the lower end of its guidance range.

Supply chain investment programme: Well on plan

2018 is the peak year for investment in the project to consolidate manufacturing operations in Greggs' nine centres and extend distribution capacity. Progress is on plan, with work underway in Leeds, Newcastle and Manchester. Planning is also well advanced for work commencing in H2 at other sites. The quality of production from new manufacturing lines now operational in Glasgow and Leeds has been excellent.

Forecasts: We build in more caution on sales and openings

Exhibit 2: Changes to forecasts

	EPS (p)				PBT (£m)				EBITDA (£m)			
	Old	New	% chg.	% growth	Old	New	% chg.	% growth	Old	New	% chg.	% growth
2018e	66.5	63.7	(4.2)	(1.2)	85.5	81.9	(4.2)	1.3%	142.0	138.3	(2.6)	2.0
2019e	71.6	65.9	(8.0)	3.5	91.0	83.8	(8.0)	2.4%	153.3	146.1	(4.7)	5.6
2020e	77.8	72.1	(7.4)	9.3	98.1	90.8	(7.5)	8.3%	164.0	156.7	(4.5)	7.3

Source: Edison Investment Research

Sales in the first five days have been stronger than over the entire March to April period. However, that is likely to have been a function of the equally unusual warm weather, which in any case is too short a period on which to base expectations. We are therefore reducing our forecast like-for-like sales growth assumption for the second half from 1% to 0.5%. We also reduce our forecast net openings from 120 to 110, and assume that the shape of openings will be phased later in the year.

Management has not changed its view of the cost environment in 2018. Inflationary pressures are starting to ease in line with expectations of ingredient inflation at 3-4% compared with 6.5% in 2017. People costs are expected to rise by 3.6% against 3.1% in 2017, including the impact of the National Living Wage, while workplace pension costs are expected to bring a slight increase compared with the 2017 impact of the Apprenticeship Levy in 2017. As a result, we continue to estimate that these factors net out to a c 0.5% cost benefit for the year as a whole, and we retain our gross margin assumptions.

Our resulting 2018 PBT forecast of £81.9m fits new guidance of profit at around the same level as 2017 representing a 4% downgrade for the year.

For 2019 we also soften our like-for-like sales assumption from 2% to 1.5%. We assume that underlying conditions for the consumer will show little change in the first half at least, but that the extraordinary weather-related weakness of March and April will provide soft comparatives. By the second half of 2019 we assume that consumer pressures will ameliorate slightly, besides which, in a price-conscious environment Greggs' value offer is likely to benefit on a relative basis. However, the combination of the weaker overall demand environment, now over a full year, and the lower base of sales and of store numbers in 2019, means that our PBT forecast reduces by 8% to £83.8m, representing 2.4% year-on-year growth. By 2020, with the benefits of efficiencies from the supply consolidation process, we forecast a return to more normal PBT growth of 8%. As we also explained in our March outlook note, Value discovery, we believe that Greggs' brand transformation will take time to be fully reflected in sales terms, meaning that it should have a relatively long and sustained return.

Our forecast of net cash is still substantial, although reduced by £5m to £35.7m, which underpins the 3% yield.

Valuation: EV/EBITDA discount looks unsustainable

We consider valuation on both a DCF and a peer valuation basis. In terms of peers, we take into account a range of multi-site consumer companies. There is no exact peer in the space, although the recent announcement of Whitbread's intention to spin off Costa provides the conditions for greater investor attention to be focused on the subsector, with a search underway for valuation templates for the new plc.

DCF: Undemanding forecasts

We apply a 6.9% cost of equity based on an assumed risk-free rate of 2%, an equity risk premium of 7% and beta of 0.7. In extending our published forecast to a 10-year cash projection, we assume revenue growth fading from 5% to 2% and EBITDA margin rising from 13.8% to 14.2% between 2020 and 2027, which should be realistically achievable on the strategy of increased scale combined with business efficiencies. We have reduced our near-term free cash flow forecast to more fully reflect project capex.

As a result of these assumptions, we define a valuation of 1,265p per share (previously 1,536p). Varying the discount and terminal growth assumptions would affect the valuation as follows:

Exhibit 3: Sensitivity of valuation to discount rate and terminal growth rate

	Discount rate (%)					
Terminal growth (%)	5.0%	5.0%	6.9%	8.0%	9.0%	10.0%
1.0%	1,680	1,680	1,119	935	813	718
1.5%	1,857	1,857	1,186	978	842	739
2.0%	2,093	2,093	1,265	1,027	876	763
2.5%	2,424	2,424	1,363	1,086	915	791
3.0%	2,921	2,921	1,487	1,156	961	822

Source: Edison Investment Research

Peer comparisons: The discount becomes unsustainable

In terms of peers, we take into account a range of multi-site consumer companies. Although there is no exact peer within the group, we think that in the fast-changing, out-of-home space a range of different offers is as relevant to investors as it is for consumers. Our selection of approximate peers shows a wide range of valuations:

Exhibit 4: Peer comparison

	Market cap (local, m)	Year end	Reporting currency	P/E (x)		EV/EBITDA (x)		EV/Sales (x)	
				Dec-18	Dec-19	Dec-18	Dec-19	Dec-18	Dec-19
Wetherspoon	1,795	07/2017	£	15.9	15.6	9.4	9.2	1.0	1.0
SSP Group	3,376	09/2017	£	27.6	25.0	11.6	10.8	1.3	1.2
Marston's	1,885	09/2017	£	7.5	7.2	9.2	8.9	1.8	1.7
Patisserie Holdings	452	09/2017	£	23.6	21.6	14.7	13.5	3.5	3.2
McColl's	315	11/2017	£	11.6	10.2	8.2	7.4	0.3	0.2
Dunkin' Brands	6,956	12/2017	US$	23.8	21.8	17.6	16.5	*	*
Domino's Pizza	1,733	12/2017	£	22.0	19.8	16.4	14.8	*	*
Average				**18.9**	**17.3**	**12.4**	**11.6**	**1.6**	**1.5**
Greggs	1,076	12/2016	£	16.2	15.0	7.2	6.6	0.9	0.9
Premium/(discount)				**(14.0%)**	**(13.2%)**	**(42.3%)**	**(42.9%)**	**(40.1%)**	**(39.6%)**

Source: Bloomberg, Edison. Note: *Non-comparable as franchised revenue: excluded. Annualised to December. Prices as at 9 May 2018.

Following the lower profit guidance, Greggs' shares trade at a discount of c 14% to the group on a P/E basis, and c 40% on an EV/EBITDA and EV/Sales basis, although arguably the latter is distorted by the outlying sales multiple of Patisserie Holdings, without which it would be c 15%. It is notable that Greggs trades on a 2019e EV/EBITDA multiple of only 6.6x, compared with peers at 11.6%, suggesting that the market is not recognising the value in this near-cash forecast. We suggest that this discount is unlikely to be sustained for any length of time.

Adjusting to peer group averages for both forecast years would produce a valuation of 1,172p on a P/E basis, and 1,741p on an EV/EBITDA basis. These in turn average to 1,456p. This is 9% higher than our previous valuation of 1,335p in March 2018, which is principally the result of higher market ratings, although the exit of Conviviality Retail has a 4% effect on the peer valuation average.

On a blend of DCF and peer-comparison metrics, we derive a valuation of 1,360p (previously 1,436p).

Exhibit 5: Financial summary

£m	2013	2014	2015	2016	2017	2018e	2019e	2020e
Dec	IFRS	IFRS	IFRS	IFRS	IFRS	IFRS	IFRS	IFRS
PROFIT & LOSS								
Revenue	762.4	806.1	835.7	894.2	960.0	1,012.2	1,083.6	1,153.1
Cost of Sales	(305.9)	(304.8)	(305.1)	(324.3)	(348.1)	(367.0)	(392.9)	(416.9)
Gross Profit	456.5	501.3	530.6	569.9	611.9	645.2	690.7	736.1
EBITDA	74.9	95.6	113.3	125.9	135.7	138.3	146.1	156.7
Operating Profit (before amort. and except.)	41.5	58.1	73.1	80.3	82.2	82.1	83.6	90.6
Intangible Amortisation	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Exceptionals	(8.1)	(8.5)	0.0	(5.2)	(9.9)	(6.0)	(3.8)	(3.0)
Other	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Operating Profit	33.4	49.6	73.1	75.2	72.3	76.1	79.8	87.6
Net Interest	(0.2)	0.2	(0.1)	(0.0)	(0.4)	(0.2)	0.2	0.2
Profit Before Tax (norm)	41.3	58.3	73.0	80.3	81.8	81.9	83.8	90.8
Profit Before Tax (FRS 3)	33.2	49.7	73.0	75.1	71.9	75.9	80.0	87.8
Tax	(10.3)	(14.0)	(15.4)	(18.1)	(16.9)	(17.4)	(17.6)	(18.4)
Profit After Tax (norm)	30.9	44.3	57.6	62.3	64.9	64.5	66.2	72.4
Profit After Tax (FRS 3)	24.2	37.6	57.6	58.0	56.9	59.7	63.2	70.0
Average Number of Shares Outstanding (m)	100.4	100.5	100.6	100.4	100.6	101.2	100.4	100.4
EPS - normalised (p)	30.8	44.0	57.3	62.0	64.5	63.7	65.9	72.1
EPS - (IFRS) (p)	24.1	37.4	57.3	57.7	56.5	59.0	62.9	69.7
Dividend per share (p)	19.5	22.0	28.6	31.0	32.3	31.8	32.9	36.0
Gross Margin (%)	59.9	62.2	63.5	63.7	63.7	63.7	63.7	63.8
EBITDA Margin (%)	9.8	11.9	13.6	14.1	14.1	13.7	13.5	13.6
Operating Margin (before GW and except.) (%)	5.4	7.2	8.7	9.0	8.6	8.1	7.7	7.9
BALANCE SHEET								
Fixed Assets	268.9	267.4	298.2	323.4	334.7	373.4	405.9	417.8
Intangible Assets	1.0	4.7	10.2	14.3	14.7	18.0	20.5	20.6
Tangible Assets	267.8	262.7	284.2	307.4	319.2	354.6	384.7	396.4
Investments	0.1	0.0	3.8	1.8	0.8	0.8	0.8	0.8
Current Assets	65.0	101.5	86.0	92.6	106.6	90.2	93.0	113.0
Stocks	15.4	15.3	15.4	15.9	18.7	19.7	21.0	23.5
Debtors	25.0	26.1	27.6	30.7	33.4	34.7	37.0	39.3
Cash	21.6	43.6	42.9	46.0	54.5	35.7	35.0	50.2
Other	3.0	16.5	0.0	0.0	0.0	0.0	0.0	0.0
Current Liabilities	(80.7)	(102.1)	(106.0)	(121.4)	(127.9)	(135.7)	(141.4)	(137.4)
Creditors	(80.7)	(102.1)	(106.0)	(121.4)	(127.9)	(135.7)	(141.4)	(137.4)
Short term borrowings	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Long Term Liabilities	(17.0)	(20.1)	(11.9)	(29.9)	(14.0)	(12.9)	(12.8)	(12.7)
Long term borrowings	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Other long term liabilities	(17.0)	(20.1)	(11.9)	(29.9)	(14.0)	(12.9)	(12.8)	(12.7)
Net Assets	236.2	246.7	266.3	264.7	299.4	314.9	344.8	380.7
CASH FLOW								
Operating Cash Flow	82.5	108.6	119.6	133.8	134.5	139.4	146.2	146.8
Net Interest	(0.0)	0.2	0.2	0.1	0.2	(0.2)	0.2	0.2
Tax	(13.2)	(11.5)	(15.9)	(16.2)	(17.6)	(16.1)	(16.8)	(17.8)
Capex	(48.6)	(48.3)	(71.8)	(80.1)	(72.6)	(95.0)	(95.0)	(78.0)
Acquisitions/disposals	0.2	(4.8)	18.1	4.7	2.2	(12.5)	(3.5)	(3.0)
Financing	0.9	(2.6)	(7.2)	(8.3)	(6.0)	0.0	(0.0)	(0.0)
Dividends	(19.6)	(19.6)	(43.7)	(30.9)	(32.2)	(34.4)	(31.8)	(33.0)
Net Cash Flow	2.2	22.0	(0.7)	3.0	8.5	(18.8)	(0.7)	15.1
Opening net debt/(cash)	(19.4)	(21.6)	(43.6)	(42.9)	(46.0)	(54.5)	(35.7)	(35.0)
HP finance leases initiated	0.0	0.0	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	0.0	0.0
Closing net debt/(cash)	(21.6)	(43.6)	(42.9)	(46.0)	(54.5)	(35.7)	(35.0)	(50.2)

Source: Greggs, Edison Investment Research