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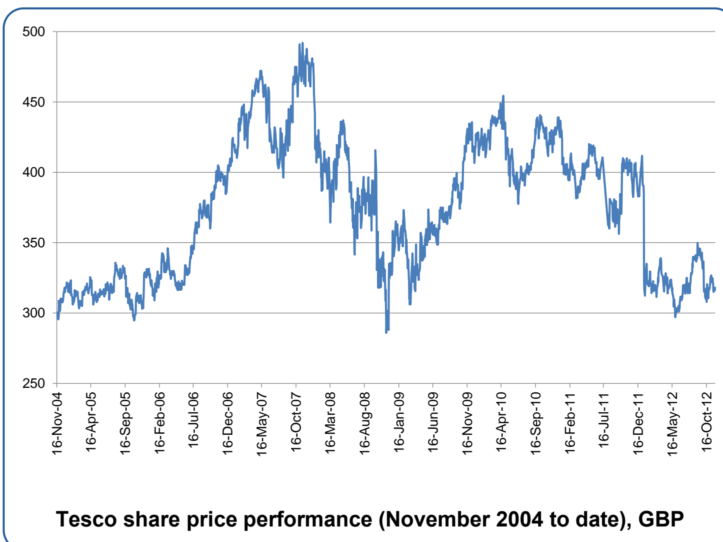
Tesco: Undervalued?

Global food and general merchandise retailer **Tesco (LSE: TSCO)** is the largest retailer in the UK with a market cap of GBP25,829mn. The company also has stores in Ireland, the Czech Republic, Hungary, Poland, Slovakia, Turkey, Japan, Malaysia, South Korea, China, Thailand and the US. Tesco is trading at a current P/E of 9.06x with a dividend yield of 5.18%. Its five-year dividend growth, according to Bloomberg, is 8.03%

Following a poor 2011 Christmas season, after its Big Price Drop campaign failed to attract enough UK Christmas shoppers to offset the lower prices, the company issued its first profit warning in over 20 years in January 2012. Despite saying that underlying pre-tax profits would be broadly in-line with forecasts in the current financial year and that group trading profit growth would be at around the low-end of expectations the announcement alarmed the market resulting in c. GBP5bn (or 15%) being wiped off Tesco's market cap in only one day. The share price plummeted 15.9% (from GBP385/share to GBP323.45/ share). The inherent value in Tesco shares was not lost on everyone and following the sharp share price fall Warren Buffett nearly doubled his stake in the company from 3.21% to 5.08%, spending around GBP480mn on the share purchase.

Tesco's share price had previously taken a hit in November 2008 in the midst of the global financial crisis (GFC) when it traded at GBP285.90/share, and those of other retailers like Sainsbury, also took a significant dip. However, since 2008, Tesco's share price had regained most of its losses before its January profit warning resulted in the significant share price decline. As can be seen from the chart on the next page the Tesco share price traded in line with that of Sainsbury and the FTSE 350 Food and Drug Index up to September 2012, when Sainsbury outperformed the index and Tesco. In May, Tesco fell to levels last seen during the GFC in the midst of renewed concerns over the eurozone debt crisis as further austerity measures loomed on the



Tesco share price performance (November 2004 to date), GBP

Source: TimBukOne, Anchor Capital

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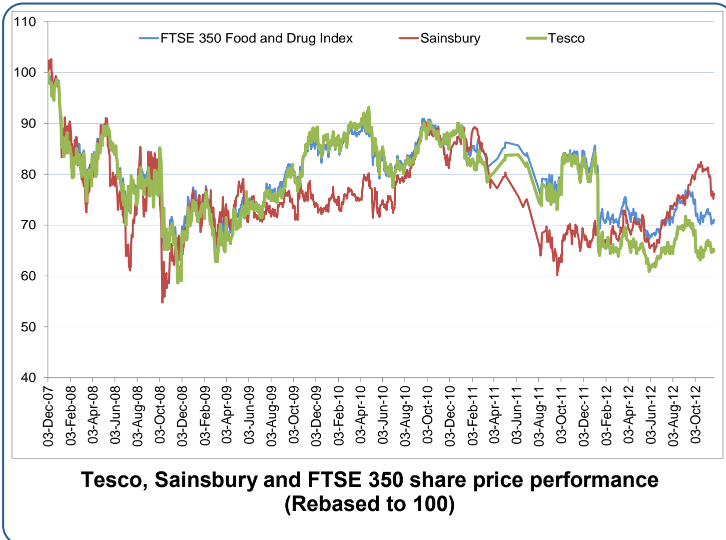
We scan the globe looking for good opportunities. We provide our model portfolios, as well as news and views on our watchlist, which is continually reviewed and updated.

Contacts

Anchor Capital reception	**011 783 4793**	**Trading Desk**	**012 665 3461**
Investment/ Sales	mnyoung@anchorcapital.co.za	General Enquiries	info@anchorcapital.co.za
Brokerage/ Trading	fswart@anchorcapital.co.za	Newsletter Enquiries	newsletters@anchorcapital.co.za



Tesco, Sainsbury and FTSE 350 share price performance (Rebased to 100)

Source: TimBukOne, Anchor Capital

back of bank insolvency fears and a deepening recession in Europe.

In October, Tesco released interim results for the 26 weeks ended 25 August 2012, reporting its first profit decline since 1994. This saw the group's share price again taking a hit (down 3.0%) albeit not as severe as when the profit warning was released in January. YTD Tesco's share price is down 20.4%. Tesco's results showed that profit was down 10.5% due to a slowdown in UK sales, the cost of its GBP1bn turnaround plan in the UK and pressure on its international businesses. The results were basically in line with market expectations with the underlying diluted EPS from continuing operations down 6.7% at actual tax rates. The interim dividend was maintained at GBp4.63/share for a dividend yield of 4.6% for the next 12 months and it is currently trading at a 9.4x, 12-month forward P/E.

Group capital expenditure in the first half was GBP1.6bn and the company expects full-year capital expenditure to be c. GBP3.2bn with net cash flow from retail operating activities at GBP1.3bn (GBP0.6bn lower than last year). Net debt improved GBP0.4bn YoY, while net finance costs rose GBP75mn.

In its results Tesco noted that since January 2012 there has been less space growth, with fewer new, big stores opening and more smaller store openings. In terms of space, the company commented that others have followed its lead of reducing space growth (c. 40% for the full year), which it believed was good for the industry as a whole. Tesco was also redirecting investment into its existing stores.

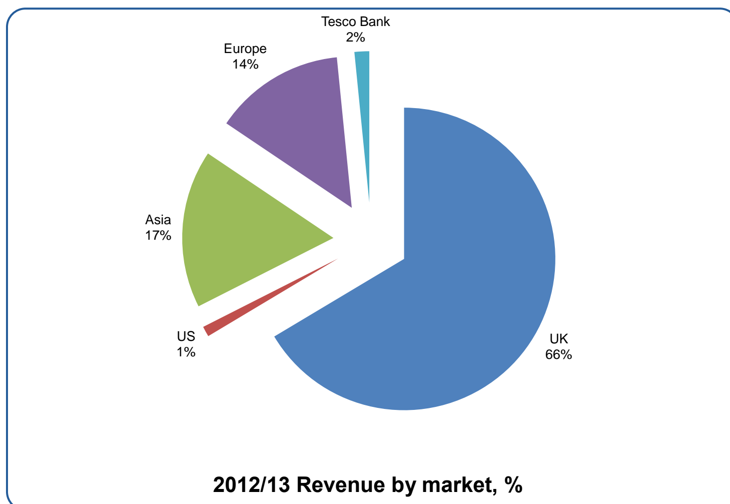
One of the main reasons for the fall in profit was that the company was forced to invest heavily in its struggling UK operations in order to revive its UK businesses. In April, Tesco announced it was investing GBP1bn to return the UK business to a sustained growth path through more staff, changing of its product ranges and cutting prices. Tesco has also had to deal with fierce competition from rivals like Sainsbury and wholly-owned Wal-mart subsidiary, Asda. Its domestic UK chain is crucial for Tesco as it generates two-thirds of the group's profits. Tesco's dependence on non-food sales impacted the group as cash-strapped consumers pulled back in these non-essential areas (electrical and non-food items) or alternatively bought these items cheaper online.

In this regard, chief executive Philip Clarke maintains the UK grocery industry is at a crossroads as the world of physical and online shopping collide. The company is now trying to reinvent its Extra hypermarkets which are becoming increasingly obsolete with its CD,DVD and consumer electronic offerings. Some of the new Extra stores have added bigger food and clothing ranges (and even a Nandos fast-food outlet to the Extra store in Wembley), as debt-burdened consumers move away from electrical and non-food items or buy these items cheaper online. This has resulted in Tesco adopting their "more clicks than bricks" game-plan in terms of general merchandise.

The company believes that in order to win it must be a multi-channel focused company and the way to do this was by opening fewer stores while simultaneously offering customers a greater 'digital connection'. Tesco will effectively start this in its UK home market before spreading to its operations across the globe. The company reiterated its plans to be what it calls "an internet winner".

On top of the GBP1bn investment in its UK chain, some challenges seem to have emerged in the group's international operations.

In **Europe,** continued uncertainty and financial pressure weighed on the group. The region has cash-strapped consumers in weak economies, while VAT increases in the Czech Republic impacted Tesco's operations in that country. Exposure to countries where austerity measures have been implemented (especially in Central Europe) have also affected Tesco's sales. Its usually reliable Central European division saw the eurozone crisis affecting consumers in Poland, the Czech Republic and Hungary, forcing them to also cut back their spending on non-essential goods such as electrical appliances and homeware products.



2012/13 Revenue by market, %

Source: Tesco, Anchor Capital

Tesco expects the tough trading environment in Europe to continue for some time to come with general merchandise and electrical sales particularly impacted. However, the company has noted that its clothing sales have picked up and the launch of its grocery dotcom venture has been successful. Tesco therefore aims to focus on smaller stores and on its online business in Europe as a further deterioration in the European economic environment is expected to hit discretionary spending the hardest. Nevertheless, Tesco gained or held market share in the majority of European countries in which it has a presence despite 20% lower capex, which is a very positive development for the company in the current challenging operating environment.

In **Korea**, Tesco's core Asian (and second-biggest) market, shopping-hour regulations are having a significant impact on the company's profit. The impact of legislation regarding operating hours (24-hour trading is now prohibited) and especially regulations requiring Tesco to close its stores for two Sundays a month could cost it, according to the group, c. GBP100mn in profit in 2012 alone, since Sundays account for 20% of total sales. However, despite this, its Homeplus businesses have remained its most successful and highest-returning venture outside of the UK. Excluding the regulatory impact in Korea, overall profit in Asia would have been up, buoyed by a strong performance in Thailand. Tesco is expected to open its 1,000th Express store soon and its Dotcom grocery business in Bangkok will open later this year.

China has been a difficult market for Tesco to enter with excess capacity in that market and China having the slowest economic growth since the GFC of 2008/09. Nevertheless, Tesco has noted that its more cautious stance was serving it well in China and, although less than initially planned, it would still open c. 16 hypermarkets in the country this year. Although it has scaled back regional and central overheads, China remains strategically important for the group.

In the **US,** Tesco's five-year old Fresh & Easy brand has been under pressure for several years already with a turnaround looking increasingly unlikely in the near-term despite more than GBP1bn already having been ploughed into it. Tesco admitted its interim results performance in the US was not where it wanted it to be despite losses being slightly down, the like-for-like sales performance improving in 2Q and more existing stores crossing into store profitability. Tesco is continuing to focus on store-level profitability and overhead cost reduction. Investment house, Panmure Gordon has suggested that if the US chain was closed or sold Tesco's share price "would rocket".

Tesco Bank's performance was positive. It currently has 7mn customers with new products launching including mortgages. Trading profit increased 114% to GBP94mn although baseline profit was flat.

We believe issues of concern for the company are that in the past its global expansion has been fuelled by its UK profits and if the profits from its UK operations keep falling it will not be able to spend as much on its international expansion plans.

As we saw in 2012 when new regulation in Korea resulted in Tesco's Homeplus stores no longer being allowed to stay open around the clock and having to close two Sundays of a month, there is also political risk which weighs on Tesco in the geographies in which it operates.

However, while it is early days yet, Tesco's turnaround strategy in its underinvested UK business could be starting to bear fruit, albeit slowly, as like-for-like sales for the three months to 25 August 2012 were up 0.1% compared with a 1.5% decline in the previous quarter. Tesco has hired 8,000 extra staff, modernised 230 stores and is expanding its meat, bakery and frozen food ranges. The group is also looking to aggressively expand its online shopping volume.

Tesco maintained its existing dividend pay-out during perceived tough times for the group, the dividend can only improve once the group's turnaround strategy in the UK starts taking full effect. Tesco has effectively been a victim of its own success after reporting 20 years of continually growing earnings and rising dividends. A profit warning, which basically said pre-tax profits would be in-line with expectations, resulted in overly harsh market reaction resulting in a significant share price fall.

One wonders if it had been any other company making the announcement whether the share price drop would have been as severe. In general, investor sentiment turned against Tesco following the profit warning most likely due to the fact that investors are used to the company beating market expectations with almost every results release.

Tesco has in the past seemingly been more dependent on non-food sales (DVDs, CDs, clothing, electronics) than its rivals. However, from the turnaround strategy announced at its results presentation it would appear it has recognised consumers are under pressure and is moving away from non-essential, non-food items in its stores and instead offering these items online.

The current UK operating environment is extremely difficult. Consumer confidence remains low and the economic downturn is affecting spending patterns with the continuing challenging economic backdrop and low general merchandise and electrical sales a drag on Tesco's performance. Investors should focus on Tesco's fundamentals in 'normal' market conditions. The Tesco brand is huge, well-known and diversified, covering groceries, furniture, electrical goods, catalogue sales and financial services in numerous geographies. The share price is also cheap (trading at around GBP321/share), having fallen 20.4% YTD, and offering a good buying opportunity. Tesco also has a high dividend yield—its current forward dividend yield 4.8%.

On the international business front, Tesco's latest results showed its businesses in Malaysia, Thailand, Slovakia and Poland are doing well. Despite the abovementioned GBP100mn impact of new regulations in Korea on profit in 2012, Tesco's Homeplus businesses have nevertheless remained its most successful and highest-returning venture outside of the UK. Tesco gained or held market share in the majority of European countries in which it has a presence despite 20% lower capex, which is a very positive development for the company in the current extremely challenging operating environment. Another positive development is that Tesco has halted new store openings of its loss-making Fresh & Easy US business and selling the business would likely result in a jump in its share price.

Tesco's full-year results are due to be released on 17 April 2013.

Marco de Matos

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