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GLOBAL IDEAS

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Tesco - Finding its way again

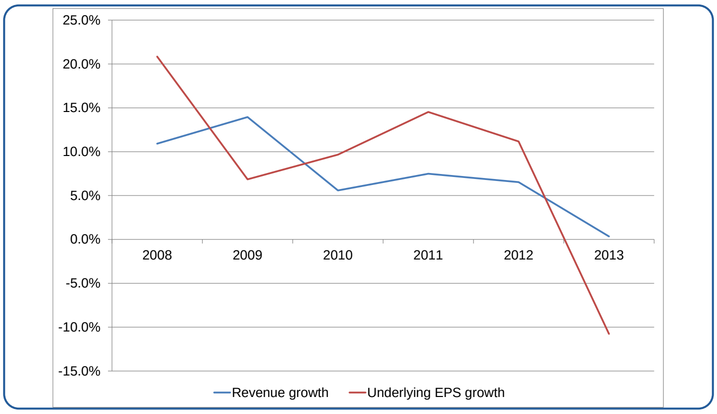
Tesco is the largest grocer in the UK and third-largest in the world. For the first time in many years Tesco lost some market share in 2012 as the other three majors (Asda, J Sainsbury and Wm Morrisons) collectively gained ground. Asda is the next biggest competitor but still lags Tesco by a full 10 ppts while, with its recent share price gains, Sainsbury is almost the same size as Asda. Tesco has traditionally been a very good business with attractive returns on capital and a reasonable growth profile. However, since FY11 Tesco has been rattled by some changes in the retail market which has resulted in a decline in earnings in FY13 and a modest outlook for the company.

Figure 1: Tesco's metrics are as follows:

Spot (GBP)	355.50
Mkt Cap GBPbn	28.7
12M Trailing P/E	20.4
Fwd P/E to Feb 2014	9.7
10-year average P/E	15.3
FYE	28-Feb
P/Book ratio	1.71
12M Fwd DY	4.4

Source: Bloomberg, Anchor Capital

Figure 2: Tesco revenue and earnings growth (2008-2013):



Source: Bloomberg, Anchor Capital

For many years Tesco aggressively grew store space in the UK and elsewhere and earnings grew accordingly. Investors loved the Tesco story. However, over the past few years this formula has stopped working. Weak economies in the UK and Europe, as well as legislative changes in Asia are partly to blame, but other factors also impacted the company.

- First, the Internet has played havoc with Tesco's large stores where the company sells a lot of non-food items (like electrical goods) and this means that significant space in these stores is now wasted and needs to be used to sell something else (non-food sales were 21% of total Tesco sales in FY10 and a large part of this is now under pressure). In addition, online grocery shopping has become quite popular in the UK but this is possibly neutral to favourable for Tesco because it still keeps the sales although we are not sure of the level of profitability. The problem we see is that because the UK has a very high population density, good broadband, high credit card usage etc., it has also become the leading market for online retail per capita globally! For Tesco this is very disruptive, in our view.

Global Ideas is a newsletter published four times a week (Monday, Wednesday-Friday) and available only to clients of Investor Campus and Anchor Capital. The key objective of this newsletter is to provide ideas for investment in the global investment universe.

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

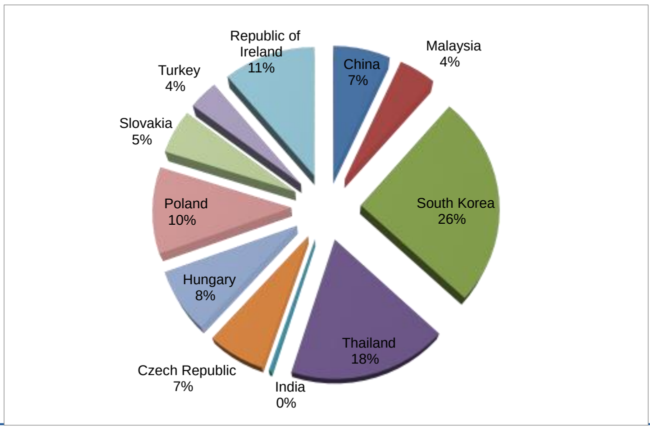
Anchor Capital reception	**011 591 0677**	**Trading Desk**	**012 665 3461**
Investment/ Sales	mnyoung@anchorcapital.co.za	General Enquiries	info@anchorcapital.co.za
Brokerage/ Trading	fswart@anchorcapital.co.za	Newsletter Enquiries	newsletters@anchorcapital.co.za

- Second, shoppers are moving away from the very big stores and shifting their spending to the smaller convenience stores that are closer to home (in the UK and other demographically challenged countries) i.e. the old hypermarket is losing market share in developed markets to convenience. In response, Tesco has had to make some big decisions. The company is cutting its losses on its venture in the US. Tesco is also vastly scaling back the space race in the UK, and in other very competitive markets like China. Capex to sales ratios are also set to drop materially. The new focus in the UK is on multi-channel retailing (i.e. including Internet), smaller store formats and trying to reinvent the large stores so that people will still shop there.

Management now believe that we can expect mid-single digit trading profit growth. Capex/sales will drop to 3.5%-4% because of the slowdown in space growth. Management have also set a level for the UK operating margin of 5.2% but we don't know how reliable this figure is. Also how big will the impact be on the company's large stores?

The remainder of the company's portfolio is very promising in parts of the globe including South Korea, Thailand and Malaysia (48% of international sales). However, the rest are either ok (Hungary, Slovakia, Ireland [24% of sales]), tough (Poland and the Czech Republic [17%]) or loss-making (Turkey, China and India [11%]).

Figure 3: International revenue by country (FY12)

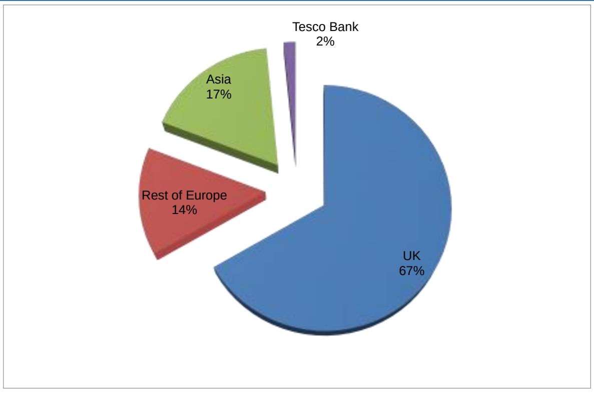


Source: Company data, Anchor Capital calculations

We believe the company's performance will improve as all these changes begin to show results. Although Tesco's growth will still be limited it may improve when the UK economy picks up. Structurally the businesses in South Korea, Thailand and Malaysia are good with long-term growth expected from the modern grocery segment (vs the traditional segment), as are the lower growth regions of Slovakia and Hungary. The rest however is a long shot, in our opinion.

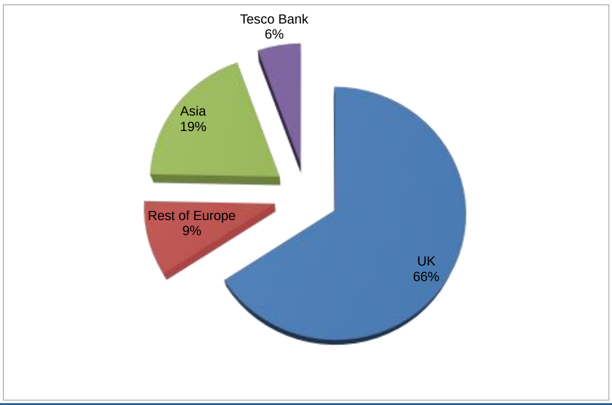
For this, we calculate a discounted cash flow (DCF) value for Tesco of GBP412. This will come down if the company's UK margin goes below 5.2%. We also need its Asia portfolio to perform well again to add to this value. There is no sign of a pick-up in market share in the UK yet although we do believe there is still value in the UK business assuming that the Internet doesn't hurt the company even more. The UK has felt the impact from Internet sales more than any of the other countries in which Tesco operates. The P/E to February 2014 is 9.7x and the 12M fwd dividend yield is 4.4%. This looks fair to us assuming that Tesco's earnings don't decline any further.

Figure 4: Revenue split (FY13)



Source: Company data; Anchor Capital

Figure 5: Operating profit (FY13)



Source: Company data; Anchor Capital

Food retail has traditionally been a high-quality business in most parts of the world – especially for those companies that are market leaders. Although Tesco may have lost its way slightly in the UK by not being run well enough we nevertheless believe the company will get this right. The big question in our view is whether the economics of food retail will become unfavourable if grocers are unable to make up for the loss of higher margin general merchandise (GM) sales in their larger stores. Grocers will also have to deal with some overcapacity in these large format stores. We rate Tesco a *BUY* although we caution potential investors that at current price levels it may still be too early to jump in.

David Gibb

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