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Tesco plc: FY15 loss worse than expected, turnaround risks remain

Bad news has flowed from Tesco's for some time and last week's (22 April) results were no exception with the company reporting a worse-than-expected loss of GBP5.8bn for the year to 28 February 2015. This included once-off charges of GBP7bn (which is half the company's equity before the financial year, leaving only GBP7bn at FY15) of which only GBP0.6bn were cash; the main once-off charge was a GBP4.7bn property impairment. It looks to us as if the company really 'cleaned out the accounting cupboards,' so to speak, with these charges as is often the case when a new CEO takes over. However, accounting earnings even without the charges would've been disappointing: revenues were down 3% YoY (although revenues were up 0.9% in 2H – tentative signs of a turnaround), while cost of sales increased 8% YoY, resulting in a loss at the gross-profit level of GBP2bn (FY14 had a 6% GP margin). The weakness was spread across the business with trading profits down 79% YoY in the UK, 18% lower in Asia and dropping 32% YoY in Europe and revenue contractions in all regions (except for Tesco Bank, but it only contributes c. 1.5% of total revenue).

If an investor were to buy Tesco's shares now that would equate to buying into a "turnaround story." This would involve a higher degree of trust in management than is usually the case because the value to be unlocked depends on the delivery of strategies that deviate significantly from the company's financial track-record to date. So, at this point, one could ask: What would a successful outcome look like? What would failure look like? How long will it take management to deliver and what are their chances of success? Any numbers we put to these questions would be highly preliminary - especially given that Tesco's management have been very cagey about their strategy (which makes sense, for competitive reasons). However, that being said, we would suggest that a bullish 'success' scenario might look something like the GBp37/share earned in the year to February 2012, which would put the share on a P/E of 6x at the current price. Furthermore, given the magnitude of the turnaround being attempted, we think it will probably take a number of years for solid earnings to be delivered (in the 4 to 6-year range).

Tesco is embarking on quite aggressive 'structural reforms' and it is interesting to consider how this might affect its UK competitors, especially given that the company has said it plans to focus on driving volume growth and not, for the time being, on margins. Although this doesn't imply that Tesco's will be profitable in the near future, it does suggest to us fairly imminent margin pressure for the other UK retailers (Sainsbury's, Morrison Supermarkets, etc.).

The 'success' outcome could eventually drive Tesco's back to the front of the pack but the aggressive competition involved will probably also reduce industry margins, at least within the UK, as other retailers are pushed to compete for market share.

Indeed, this kind of contagion effect is already a present reality and the UK retailers have generally been experiencing difficulties for some time: so, while Tesco's is about 42% off its April 2013 share-price highs (having bounced c. 35% off its December 2014 lows), Sainsbury's is down (about 33%) over the past two years, having also bottomed in late 2014 (now being c. 16% off its December 2014 lows); Morrison's is similarly c. 33% down over the past 2 years, also having bottomed in late 2014. All three companies have recently reported losses.

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The company now has a very high debt level with long-term liabilities at GBP17bn, of which GBP10.7bn is debt (vs total equity of only GBP7bn). Thus, we will most likely see asset disposals and there is a risk that Tesco will have to execute a capital raising, as the core business especially (given the present difficulties) will be unable to carry these levels of debt.

Given the risks associated with: (1) a possible structural decline in UK retailer profit margins; (2) a possible (dilutive) capital raising; (3) excess debt and pension deficits, as well as the potentially long timeframe required for the turnaround strategy to be executed, we cannot but wonder if the bull scenario EPS of GBp37/share and the associated 6x P/E multiple are sufficiently attractive to continue holding the stock.

Tesco share price and EPS, GBp/share:

Source: Anchor Capital, Bloomberg

Tesco share price and P/E:

Source: Anchor Capital, Bloomberg

Blake Allen

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