EDISON

Greggs

Post-IMS update

Savouring the taste of success

Food & beverages

Greggs' recovery story is bearing fruit. A confluence of improving like-for-like (lfl) sales growth, benign commodity price deflation, cost-cutting initiatives, successful product enhancements as well as store refurbishments has yielded an accelerated recovery in margins. This prompted the company to bring forward its Q3 IMS, reporting ytd lfl sales up 3.9% and the anticipation of full year profits ahead of expectations. We raise our estimates and adjust our fair value to 655p.

Year end	Revenue (£m)	EBITDA* (£m)	EPS* (p)	EV/EBITDA (x)	P/E (x)	Yield (%)
12/12	734.5	84.6	38.3	6.7	15.5	3.3
12/13	762.4	75.5	30.5	7.5	19.5	3.3
12/14e	789.1	86.4	37.8	6.6	15.7	3.3
12/15e	811.2	90.8	41.2	6.1	14.4	3.3
12/16e	838.9	94.2	43.5	5.7	13.7	3.4

Note: *EBITDA and EPS are normalised, excluding intangible amortisation, exceptional items and share-based payments.

Lfl sales recovery: 5.4% for 11 weeks to 13 September

Greggs has reported impressive lfl sales growth, partly due improvements in the product range, as well as uncontrollable factors such as favourable weather conditions. After a negative result last year of -0.8% lfl sales growth, we now forecast 3.5% lfl growth for FY14e and expect incremental sales growth to be key in driving margin expansion due to the operationally geared nature of the business.

Gross margin surprises on the upside

Greggs reported higher gross margins at the half year stage (60.7%), citing lower commodity costs. Management also expects a £1m saving in H214, given the good harvest and lower protein costs. Gross margins have also benefited from the new product initiatives (healthier sandwiches) and inclusion of coffee into the lunchtime meal deal (leading to double-digit sales growth of coffee).

Operating margin: Improvements ahead of schedule

Closure of in-store bakeries as well as underperforming stores will benefit operating margins earlier than we had expected. We also expect improvements in margins both from lfl sales and the company's change initiatives.

Valuation

Given Greggs' net cash position we value the company on an EV/EBITDA basis. In the absence of direct peers, we choose to compare Greggs to supermarkets. We feel a 15% premium to the sector is justified and on FY15e estimates, this gives us a target EBITDA multiple of 7.2x. Averaging this with our base-case DCF yields a fair value of 655p, 11% upside to the current share price. We highlight the 28% discount to the FTSE 250 Index (ex-Investment Trusts) on FY15e EV/EBITDA, which is unjustified in our view given the company's forecast earnings growth.

25 September 2014

Price	592p
Valuation	655p
Difference	11%
Market cap	£602m
Net cash (£m)	17
Shares in issue	101.2m
Free float	91%
Code	GRG
Primary exchange	LSE

Share price performance

%	1m	3m	12m
Abs	8.7	12.4	36.7
Rel (local)	10.0	13.5	33.7
52-week high/low		604.0p	415.0p

Business description

Greggs is the UK's leading bakery food-on-the-go retailer, made up of almost 1,700 shops, nine regional bakeries and 20,000 employees. It sells a range of baked goods, sandwiches and drinks in its shops.

Next event

Christmas update	January 2015

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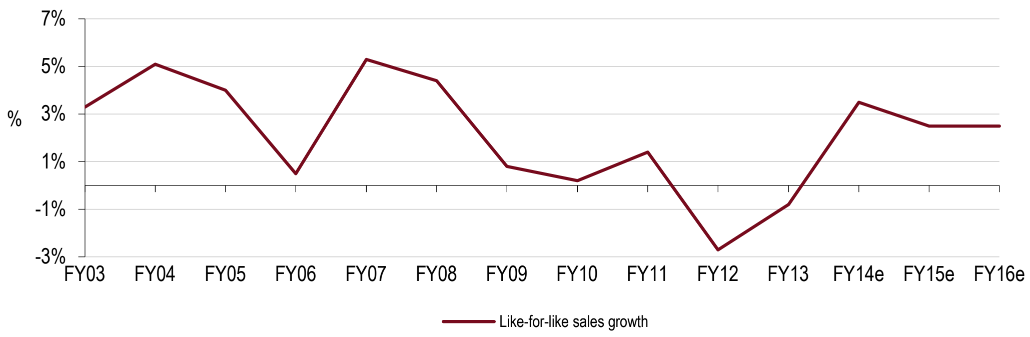
Key driver – Like-for-like sales recovery

Greggs' Q3 IMS recorded 5.4% lfl sales growth for the 11 weeks to 13 September. This sustained the momentum generated by the interim results, which recorded lfl sales growth of 3.2% compared to a 2.9% decline last year. As such ytd lfl sales are up 3.9% compared to last year. The principal drivers of this are:

- Robust macroeconomic conditions
- Favourable weather conditions – warmer weather increases footfall
- Improved take up of product range and meal deals (including coffee and a wider range of sandwiches in the lunchtime meal deal)
- Successful new product initiatives such as relaunched sandwich range
- Positive contribution from store refurbishment programme and faster closure of weaker stores

Although management noted the softer comparatives for H114 and the period reported for the IMS, we think the results can also be attributed to early signs of the success of the turnaround programme. While the comparatives for Q4 will be tougher (as Q413 was the start of the lfl recovery) we have revised our lfl estimates for this year, expecting Greggs to deliver 3.5% for FY14e. We also update our assumptions for both FY15e and FY16e to 2.5%. We think this is feasible given the company's new bakery food-on-the-go strategy, new more relevant product offering and the improving macroeconomic outlook.

Exhibit 1: Greggs' historical and forecast lfl sales growth – sharp recovery this year



Source: Company data, Edison Investment Research estimates

Gross margin improvement

Greggs' gross margin has benefited from a number of factors: increased (higher-margin) coffee sales, better operational control (less waste) and most importantly commodity price deflation. Protein costs have come down over the past year, and management has guided that it expects a benign input cost environment for Q414 and Q115 as it has locked in pricing reflecting a good harvest for flour. We model a 40bps improvement for this year.

Exhibit 2: Greggs' gross margin progression

	H112	H212	2012	H113	H213	2013	H114	2014e	2015e	2016e
Gross margin (ex-exceptionals)	60.6%	61.2%	60.9%	59.0%	60.6%	59.9%	60.7%	**60.3%**	**60.3%**	**60.2%**

Source: Company data, Edison Investment Research

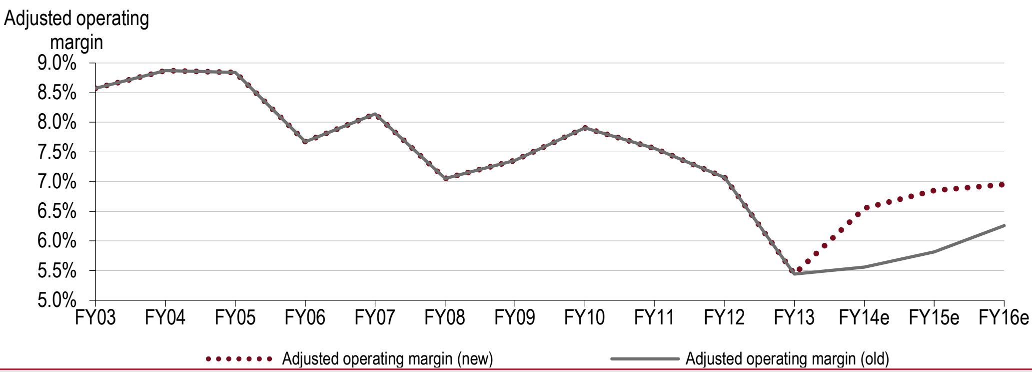
Operating leverage and cost savings materialising

As we argued in our note dated 11 April 2014, Greggs' high operational gearing means that improvement in lfl sales has a meaningful impact on operating profits. This has taken place with positive results. We would also highlight some key operational improvements:

- Closing of in-store bakeries (annualised benefit of £6m) faster than anticipated (programme should be completed by October, resulting in a c £1m cost saving this year)
- Closure of poorly performing stores more quickly than planned
- Refit programme (153 stores of a target 200 for this year completed) with positive results to date

We think the company will continue to benefit from a leaner structure as well as its significant investments in IT and systems (including an SAP ERP system), which should yield benefits over time. Given the above factors, and the improving lfl sales growth outlook, we raise our margin expectations and now expect a 111bps improvement to 6.6% for FY14e and a 30bps improvement for FY15e and 10bps for FY16e.

Exhibit 3: Greggs' adjusted operating margin progression 2003-16e



Source: Company data, Edison Investment Research estimates

Financial summary

For the reasons detailed above, we have revised our estimates. We expect Greggs to deliver three-year EPS CAGR of 13% based on its improved product range and cost efficiencies, as well as the benefit from macroeconomic and commodity tailwinds.

Exhibit 4: Greggs estimate updates – double-digit revisions for FY14e and FY15e

	EPS (p)			EBITDA (£m)		
	Old	New	% chg.	Old	New	% chg.
2013	30.5	30.5	0	75	75	0
2014e	32.0	37.8	18%	78	86	10%
2015e	35.2	41.2	17%	83	91	10%
2016e	39.8	43.5	9%	89	94	5%

Source: Company data, Edison Investment Research. Note EBITDA is normalised. EPS is normalised and fully diluted.

We expect modest contributions from new shops in FY15 and FY16, along with a 2.5% lfl sales growth, which we think is conservative but appropriate given the company's recent strong performance, but acknowledging it is going to face tougher comparatives from now on. Our EPS estimates are in line with consensus for FY14e and 3% ahead for FY15e and FY16e.

Exhibit 5: P&L summary table

£m	FY12	FY13	FY14e	FY15e	FY16e
Sales	734.5	762.4	789.1	811.2	838.9
Growth	4.8%	3.8%	3.5%	2.8%	3.4%
Like-for-like sales growth	(2.7%)	(0.8%)	3.5%	2.5%	2.5%
Operating profit (normalised)	51.9	41.5	51.7	55.6	58.3
Operating margin	7.1%	5.4%	6.6%	6.8%	7.0%
EPS (normalised and fully diluted) (p)	38.3	30.5	37.8	41.2	43.5

Source: Company data, Edison Investment Research estimates. Note: Normalised adjusts for exceptional items and share-based payments.

Valuation

We highlight Greggs' valuation based on comparable companies, a DCF methodology as well as its historical discount on an EV/EBITDA basis relative to the FTSE 250 Index (ex-Investment Trusts).

Exhibit 6: Peer valuation table

	P/E (FY1)	P/E (FY2)	EV/EBITDA (FY1)	EV/EBITDA (FY2)	Interim lfl sales	EBITDA margin (FY1)	EBITDA margin (FY2)	EBITDA (3 yr CAGR)	EPS (3 yr CAGR)
Franchises									
McDonald's	17.5	16.0	10.3	9.8	0%	36%	37%	2%	5%
Burger King	31.9	27.3	18.5	16.8	1%	67%	69%	13%	16%
Dunkin' Brands	26.7	23.1	17.1	15.5	2%	51%	52%	11%	17%
Domino's Pizza (UK)	23.3	19.8	15.9	14.0	11%	21%	22%	12%	12%
Franchises average	**24.8**	**21.6**	**15.4**	**14.1**	**4%**	**44%**	**45%**	**10%**	**12%**
Coffee shops/food on the go									
Starbucks	28.0	23.8	15.2	13.3	6%	23%	24%	14%	19%
Krispy Kreme Doughnuts	24.3	20.1	16.4	13.2	0%	12%	12%	12%	18%
Average	**26.1**	**22.0**	**15.8**	**13.3**	**3%**	**18%**	**18%**	**13%**	**18%**
Supermarkets									
Tesco	10.4	10.9	6.4	6.5	-4%	7%	6%	5%	2%
Sainsbury's	9.6	9.7	4.7	4.8	1%	6%	6%	-6%	-8%
WM Morrison	14.4	12.6	7.8	7.4	-7%	5%	5%	-11%	-4%
Supermarkets average	**11.5**	**11.0**	**6.3**	**6.2**	**-3%**	**6%**	**6%**	**-4%**	**-3%**
Greggs	**15.7**	**14.9**	**6.6**	**6.1**	**3%**	**11%**	**11%**	**12%**	**13%**

Source: Bloomberg estimates, Edison Investment Research. Notes: KKD, TSCO, SBRY, MRW are in FY15. Interim lfls are last reported 6 months, except SBUX (9M), TSCO and SBRY (3M). EBITDA CAGR is 2 years for SBUX. EPS CAGR is 2 years for KKD.

Looking at the peer group, we think that a comparison with franchises is not effective given Greggs derives a large proportion of its cash flows from operating shops. We would note, however, that Greggs does have a franchise partnership with MOTO (30 stores) and recently began a trial concept with Blakemore Retail (the owner of SPAR, which has previously partnered with Subway). We will see how this develops over time and if Greggs can generate meaningful results from this segment.

In the food on the go market, while comparables offer similar growth, Starbucks and Krispy Kreme are companies that are much larger, global and, in the case of Starbucks, much higher margin.

As closer peers in the food-on-the-go market such as Subway, Pret-A-Manger and Eat are privately held, we think supermarkets are the most appropriate publicly traded comparables. This is especially true given Greggs competes with them in the "£3 meal deal" lunch offer.

Greggs trades at a slight discount to supermarkets (on our EBITDA estimates) despite having much higher EBITDA margins, a (now) meaningfully positive lfl outlook and the prospect of double-digit earnings growth. The company has delivered positive lfl since H213 and with its interim results a 110bps improvement in operating margins, as well as a material upgrade in its Q3 IMS.

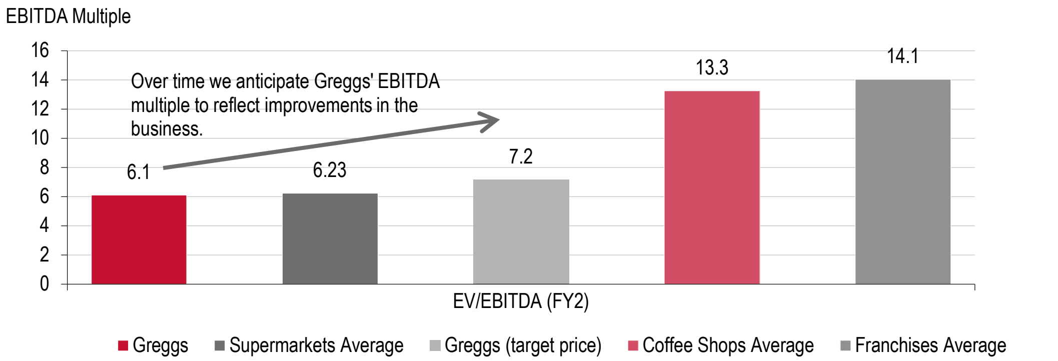
As such we think a modest premium (15%) to the supermarket sector is justified. At our target multiple of 7.2x, Greggs' fair value would be 660p, for 11% upside to the current share price.

Exhibit 7: Greggs target EV/EBITDA multiple – 7.2x EV/EBITDA

	EBITDA margin (FY2)	EBITDA growth (3 year)	EV/EBITDA (x)
Supermarkets average	5.7%	-4%	6.2x
Greggs	11.2%	12%	6.1x
Greggs discount			2%
Greggs EV/EBITDA at 15% premium to supermarkets			7.2x
Greggs EBITDA 2015e			90.8m
Greggs EV at target multiple			651m
Share price at 7.2x 15e EV/EBITDA			**660p**

Source: Bloomberg estimates, Edison Investment Research estimates

Exhibit 8: Greggs FY1 EBITDA multiple comparison



Source: Bloomberg estimates, Edison Investment Research estimates

We introduce our DCF valuation, which supports our EV/EBITDA valuation with implied upside of 10%. We have assumed revenue growth returns to its prior trajectory in the long term as well as margin recovery (highest EBITDA margin in recent years has been 13% in 2011, lowest 8.8% in 2013). We fade capex by 25bps per year reflecting future maintenance capex needs being less as the company is currently spending large sums in its store refurbishment programme. We have assumed a WACC of 10% and a terminal growth rate of 2%.

Exhibit 9: DCF – implies 10% upside

Greggs	2009-14 (five-year average)	2014e-16e (three year average)	2017e-24e
Net revenue growth (CAGR)	3.9%	**3.2%**	**4%**
EBITDA margin	11.5%	**11.1%**	**12.5%**
Changes in WC/Sales	+0.3%	**0%**	**0%**
Tax rate	27%	**24%**	**23.5%**
Capex/Sales (average)	-6.2%	**-5.8%**	**-4.4%**
Cumulative PV of cash flows (£m)			296
PV of terminal cash flows (£m)			346
Implied enterprise value (£m)			642
Net cash (H114) (£m)			17
Implied share price (p)			651
Current share price (p)			592
Upside			10%

Source: Company data, Edison Investment Research estimates. Note: Current share price on 22 September 2014.

A share price sensitivity of our key assumptions is provided below.

Exhibit 10: Terminal growth rate and WACC assumptions

		Terminal growth rate				
		-2%	-1%	0%	1%	2%
WACC	8.0%	711	749	797	858	939
	8.5%	670	703	743	794	861
	9.0%	633	661	695	738	794
	9.5%	599	624	653	690	736
	10.0%	569	590	616	647	685
	10.5%	541	560	582	608	641
	11.0%	516	532	551	574	602
	11.5%	492	507	523	543	567
	12.0%	471	483	498	515	536
	12.5%	451	462	475	490	508

Source: Company data, Edison Investment Research estimates. Note: Red = under current share price; grey = above.

Exhibit 11: Revenue growth and margin assumptions (FY15e-24e)

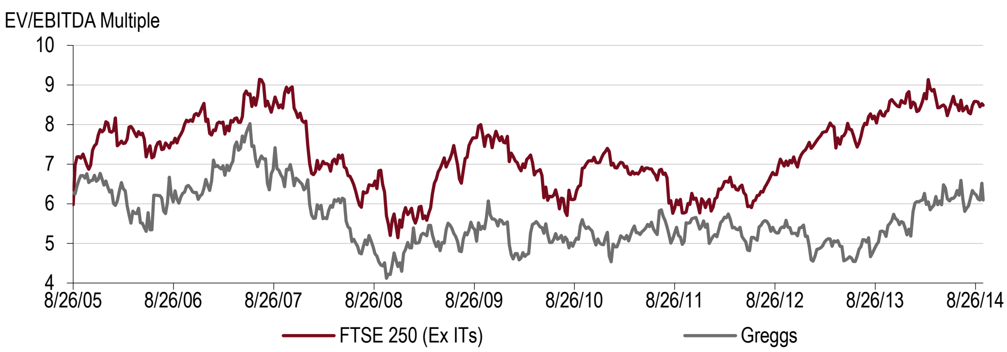
		Revenue growth					
		0%	1%	2%	3%	4%	5%
EBITDA margin	9.0%	291	315	341	369	400	433
	9.5%	322	348	376	407	441	477
	10.0%	352	380	411	445	482	521
	10.5%	382	413	446	483	522	565
	11.0%	412	445	481	521	563	609
	11.5%	442	478	516	558	604	653
	12.0%	473	510	551	596	645	697
	12.5%	503	543	587	634	685	741
	13.0%	533	576	622	672	726	785
	13.5%	563	608	657	709	767	829

Source: Company data, Edison Investment Research estimates. Note: Red = under current share price; grey = above.

Taking the average of our valuation methodologies we arrive at a fair value of 655p. This gives 11% upside to the current share price.

Greggs stands at a 28% discount to the FTSE 250 Mid Cap Index (on an FY15e EV/EBITDA basis). Over the past 10 years, the historical discount has been 25%. We think that given Greggs' growth profile and positive lfl momentum, this is unjustified. We would highlight that FTSE 250 Mid Cap consensus two-year EBITDA growth is 5%, and at our fair value Greggs would be at a 15% discount to the index, which we think is reasonable.

Exhibit 12: FTSE 250 (ex-Investment Trusts) and Greggs FY2 EV/EBITDA



Source: Bloomberg data, Edison Investment Research

Exhibit 13: Financial summary

£m	2009	2010	2011	2012	2013	2014e	2015e	2016e
Year end 31 December	IFRS	IFRS	IFRS	IFRS	IFRS	IFRS	IFRS	IFRS
PROFIT & LOSS								
Revenue	658	662	701	735	762	789	811	839
EBITDA	77	82	85	85	75	86	91	94
Operating Profit (before amort. and except.)	48	52	53	51	41	52	56	60
Intangible Amortisation	0	0	0	0	0	0	0	0
Exceptionals	0	0	7	0	(8)	(9)	0	0
Other	0	0	0	0	0	0	0	0
Operating Profit	48	52	60	51	33	43	56	58
Net Interest	0	0	0	(0)	(0)	(0)	(0)	(0)
Profit Before Tax (norm)	49	53	53	51	41	52	56	58
Profit Before Tax (FRS 3)	49	53	61	51	33	43	56	58
Tax	(14)	(15)	(16)	(13)	(9)	(13)	(13)	(14)
Profit After Tax (norm)	34	38	39	38	32	39	42	45
Profit After Tax (FRS 3)	34	38	45	38	24	30	42	45
Average Number of Shares Outstanding (m)	100.8	100.3	99.0	99.6	100.4	101.2	101.2	101.2
EPS - normalised (p)	34.1	37.8	39.4	38.9	30.8	38.2	41.6	43.9
EPS - normalised and fully diluted (p)	34.0	37.3	38.8	38.3	30.5	37.8	41.2	43.5
EPS - (IFRS) (p)	34.0	37.3	44.3	39.4	23.9	29.0	41.2	43.5
Dividend per share (p)	16.6	18.2	19.3	19.5	19.5	19.5	19.5	20.1
EBITDA Margin (%)	11.7	12.4	12.1	11.5	9.9	10.9	11.2	11.2
Operating Margin (before GW and except.) (%)	7.4	7.9	7.6	7.0	5.4	6.6	6.8	7.1
BALANCE SHEET								
Fixed Assets	212	227	254	264	269	281	291	299
Intangible Assets	1	0	0	0	1	1	1	0
Tangible Assets	211	226	253	264	268	280	290	299
Investments	0	0	0	0	0	0	0	0
Current Assets	68	58	55	64	65	65	79	97
Stocks	12	12	14	18	15	17	18	19
Debtors	21	22	21	27	25	27	28	29
Cash	35	21	20	19	22	20	33	50
Other	0	3	1	0	3	2	1	0
Current Liabilities	(81)	(78)	(81)	(79)	(81)	(82)	(82)	(83)
Creditors	(72)	(70)	(74)	(72)	(72)	(73)	(74)	(75)
Short term borrowings	0	0	0	0	0	0	0	0
Long Term Liabilities	(34)	(31)	(30)	(22)	(17)	(18)	(18)	(18)
Long term borrowings	0	0	0	0	0	0	0	0
Other long term liabilities	(34)	(31)	(30)	(22)	(17)	(18)	(18)	(18)
Net Assets	164	176	198	227	236	247	270	295
CASH FLOW								
Operating Cash Flow	90	79	89	71	79	76	89	93
Net Interest	(0)	(0)	(0)	0	0	0	0	0
Tax	(15)	(16)	(14)	(13)	(13)	(13)	(13)	(14)
Capex	(30)	(45)	(63)	(46)	(48)	(50)	(48)	(47)
Acquisitions/disposals	0	0	0	0	0	0	0	0
Financing	1	(12)	3	4	1	0	0	0
Dividends	(15)	(17)	(18)	(19)	(20)	(20)	(20)	(21)
Net Cash Flow	33	(14)	(1)	(1)	3	(2)	13	17
Opening net debt/(cash)	(2)	(35)	(21)	(20)	(19)	(22)	(20)	(33)
HP finance leases initiated	0	0	0	0	0	0	0	0
Other	(0)	0	0	1	(1)	(0)	0	0
Closing net debt/(cash)	(35)	(21)	(20)	(19)	(22)	(20)	(33)	(50)

Source: Company data, Edison Investment Research estimates. Note: Normalised figures exclude intangible amortisation, exceptional items and share-based payments.

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