

Greggs

In balance

Interim results

Greggs' interims show a company in balance in several ways. First, operational and site development initiatives are driving consistent sales growth despite a challenging market. Second, the balance between low-price value and perceived quality is allowing it to cover peak input cost increases without a serious impact on margins. Third, the financial model is operating to support the dividend with a stable balance sheet.

Year end	Revenue (£m)	PBT* (£m)	EPS* (p)	DPS (p)	P/E (x)	Yield (%)
12/15	835.7	73.0	57.3	28.6	19.5	2.6
12/16	894.2	80.3	62.0	31.0	18.0	2.8
12/17e	959.4	80.8	63.6	32.8	17.6	2.9
12/18e	1,028.4	83.9	66.6	34.8	16.8	3.1

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

Reassuringly good trading in the first half

Total sales grew 7.3%, and like-for-like sales grew 3.4%, comparing well against FY16. Operating profit pre-exceptionals and property profit, at £27.6m, was slightly ahead of H116, against flat guidance for FY17. Gross margin improved 10bp over a year ago, reflecting successful pricing and menu mix action counteracting peak ingredient inflation of 7%. Overall, pre-exceptional operating profit was only down 5% at £27.9m because of last year's abnormal property gains.

Food on the go finds acceptance

Greggs' continued sales growth suggests its blend of quality and value is going down well with price-conscious consumers. The company reports increasing demand for its hot sandwich, breakfast and coffee offers, as well as its traditional ranges of savoury foods.

Operational activity continues

In the half, another planned bakery closure was completed and a consolidated production initiative was initiated. But the period was dominated by Greggs' biggest operational change ever, the system-wide roll-out of its central stock forecasting and replenishment system. Despite some initial costs, stock availability benefits are already being seen.

Food on the go has legs

Greggs has opportunities in new locations, including areas of the country where it is not represented. It is progressing in moving its location base off the high street, and is now being invited into shopping developments by landlords. In terms of dayparts, with new formats such as drive-through and transport hubs, there is no reason why Greggs should not eventually expand into the evening market.

Valuation: No change

Guidance is unchanged for the year, and we are not materially changing our forecasts. Consistent with that, we retain our valuation of 1,226p per share.

Retail

9 August 2017

Price 1,118p
Market cap £1,131m

Net cash (£m) at end June 2017	19.9
Shares in issue	101.2m
Free float	100%
Code	GRG
Primary exchange	LSE
Secondary exchange	N/A

Share price performance



%	1m	3m	12m
Abs	4.5	3.5	6.7
Rel (local)	1.8	0.6	(4.4)
52-week high/low	1,129.0p	901.5p	

Business description

With over 1,800 shops, nine regional bakeries and 19,500 employees, Greggs is the UK's leading 'bakery food-on-the-go' retailer. It utilises vertical integration to offer differentiated products at competitive prices.

Next events

Trading update	3 October 2017 (provisional)
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Interim results: Growth and development continue

Greggs has reported good trading progress in the first half year, indicating that its strategy is working successfully.

Total sales of £452.9m grew by 7.3%, which compares well against 2016 full-year growth of 7.0%, and like-for-like sales grew 3.4% against 4.2% in FY16. Management feels that, with the majority of its stores now trading under a food-on-the-go format, underlying sales growth has settled into a range of between 3% and 4%, with external conditions including weather responsible for variations within that.

The company reports continuing development of its chosen market of food-on-the-go, and is progressively less dependent on traditional shopping locations, giving it the potential to decouple from general retail weakness. Greggs reports increasing demand for its hot sandwich range and continued growth in its breakfast and coffee offers, as well as in its traditional ranges of savoury foods.

Operating profit before exceptionals and property gains, at £27.6m, was slightly ahead of last year. This is better than guidance for FY17 as a whole, which was for a flat performance.

Exhibit 1: Group sales and profit			
£m	H117	H116	Change
Sales	452.9	422.0	7.3%
Operating profit before property and exceptional items	27.6	27.2	1.8%
Property disposal gains	0.3	2.2	
EBIT before exceptionals	27.9	29.4	-5.1%
Net exceptional charge	(8.3)	(4.0)	
Finance income	(0.1)	0.0	
Profit before taxation	19.4	25.4	-23.7%
Source: Greggs			

Despite that slight over performance, management regards trading as being on expectation and the outlook for the year is unchanged.

Greggs' continued sales growth suggests that its blend of quality and value is going down well with price-conscious consumers. In addition, gross margin has improved 10bp over a year ago, which reflects some pricing and menu mix action to counteract ingredient costs, which increased 7% in the first half. That increase was driven by dairy and protein products and is likely to be a peak, with forward cover over food costs giving visibility of food inflation for the full year of between 6% and 7%.

Distribution and selling costs as a percentage of sales rose by 70bp, with wage inflation running at 3.3% and the Apprenticeship Levy, introduced in April, adding around a further 0.3% to the wage bill, we estimate. After some reductions in administrative costs, which rose in H116 on systems implementations, EBIT margin before property and exceptionals was down 30bp at 6.1%.

Exhibit 2: Margin analysis		
	H117	H116
Sales, £m	452.9	422.0
Gross margin	63.3%	63.2%
Distribution & selling costs	-51.5%	-50.8%
Admin expenses	-5.7%	-6.0%
EBIT before property and exceptional items	6.1%	6.4%
Property disposal gains	0.1%	0.5%
EBIT pre-exceptional items, £m	27.9	29.4
Operating margin	6.2%	6.9%
Source: Greggs		

Property disposal gains of £2.2m in H116, which were abnormally large, were the main reason for pre-exceptional EBIT of £27.9m being 5% lower than last year.

Exceptionals and restructuring

Net exceptionals amounted to £8.3m in the first half. These form part of the previously flagged £100m multi-year change programme to reshape the manufacturing and logistics operations within Greggs. The major element of that consisted of unavoidable redundancy costs of £7.4m with asset-related and other costs and credits forming the balance. The planned closure of the Edinburgh bakery site was completed in April, with production and logistics activities transferred to Glasgow. Greggs has invested in the Glasgow site with additional work being located there, including the first consolidated manufacturing platform for the production of Yum Yums. In the second half a further consolidated manufacturing operation for cakes and muffins is planned to open in Leeds.

Cash flow and balance sheet

Net cash from operating activities was £34.0m, down from £44.8m at the same stage last year, the main factor being a £13m increase in working capital. This was mainly a result of changes to the supply chain in FY16. Capex of £36.4m was £5m higher than H116 on increased supply chain investment and an increased number of shop refits. Payment of the 2016 final dividend absorbed £21.6m, resulting in net cash at June being £19.9m against £46.0m at the year end. However, the company continues to target a year-end position of £40m as we discuss below.

Central ordering and replenishment system

A highlight of the first half was the completion of the roll-out of the company's central stock forecasting and replenishment system. This is the biggest operational change the company has ever had, and it is already showing benefits in availability of the right products at the right time of day, while retaining the quality advantages of food freshly prepared on the premises. Additional costs of implementing the system and initial higher wastage had a negative effect on the first half net margin, but efficiency gains should close that difference in the second half with shop staff freed up to focus on serving customers. Additionally, reduced costs following the May closure of the Edinburgh bakery are likely to benefit the second half.

Future expansion potential

Greggs is not short of market opportunities. These exist over a number of areas:

- New locations:
 - Geographical: Greggs is opening its first units in areas of the country it has not previously traded in at all, such as Devon and Northern Ireland.
 - The company is progressing in moving its location base off the high street. It now stands at 70:30 high street to non-high street, down from 80:20 against a target of 60:40.
 - As Greggs' brand shakes off its downmarket image, it is noticing that it is being invited into shopping developments by landlords who would previously have regarded it as unattractive.
 - With early examples of new formats, such as its first drive-through and a presence at airports, the company is expanding the scope of its market.
- New dayparts:
 - It is clear that Greggs' initiatives in the breakfast and coffee markets have been a success. Eventually there is no reason why the company should not expand into the evening market, which would represent a major advance in utilising its asset. Not all

locations would be suitable, but for example McDonalds already occupies a market in selective locations in the evening market, and similar locations could be suitable for the Greggs brand. The company is already progressing along this road with current menu developments, particularly in hot food. The operating structure can already handle units that trade at non-standard trading hours, for example at airports, or at Victoria Coach Station where it trades to 11pm. There is, however, a bigger job of transition to do in terms of market perceptions, and this should not be seen as a short-term development.

Forecasts

We are leaving our forecasts materially unchanged:

Exhibit 3: No material forecast changes									
	EPS (p)			PBT (£m)			EBITDA (£m)		
	Old	New	% chg.	Old	New	% chg.	Old	New	% chg.
2017	63.4	63.6	0.3%	80.8	80.8	0.0%	131.4	133.3	1.4%
2018	66.6	66.6	0.0%	83.9	83.9	0.0%	138.3	136.8	-1.1%
Source: Edison Investment Research									

Our forecasts assume continuation of H2 like-for-like growth of 3.3%, which is marginally lower than the 3.4% actually achieved in H1. Following a review of refurbishment activity, Greggs has decided to limit refurbishments in the next three years to c 130 sites, to maximise the returns on capex and avoid refitting units that are already trading in the food-on-the-go format. It takes a week out of trading to refurbish a store and, as a result, with 107 stores refurbishments completed in H1, the number of disrupted units in H2 will be heavily reduced, which should help like-for-like sales. In addition the sales benefits of the new stock forecasting and replenishment system should become more apparent in terms of avoiding stock-outs of items that customers want and resulting missed sales.

Gross margins should be under slightly less pressure than in H1 as a result of food purchase cover that gives visibility of full year inflation of 6-7% rather than 7% in H1. The successful implementation of the forecasting and replenishment system should also have margin benefits in H2. Staff in all units had to be trained on operating the new system in H1, and its implementation created some initial stock wastage. While the cost of training is a definite one-off cost, the margin effect of wastage will be progressively reduced as operators learn how to fine-tune the system.

Balance sheet and cash flow

We expect that the company will end the year with £40m of net cash. We forecast second half net profit of £40m, comparable with H216's £38m, resulting in £56m for the year. That should translate into cash from operating activities of £133.7m, close to last year's figure. Planned capex of £80m is reduced from the previous target of £85m on the lower number of shop refurbishments, and after total dividend payments of £32m, with other smaller items, we forecast net cash to reduce by £6m on the year.

Valuation: No change

Our valuation of Greggs' shares is based on a DCF projection, the basis of which was fully explained in our March 2017 note, [Successful strategy offers further potential](#). Since currently our forecasts are unchanged, we make no change to our existing valuation of 1,226p per share.

Exhibit 4: Financial summary

	£m	2013	2014	2015	2016	2017e	2018e
Year end 31 December		IFRS	IFRS	IFRS	IFRS	IFRS	IFRS
PROFIT & LOSS							
Revenue		762.4	806.1	835.7	894.2	959.4	1,028.4
Cost of Sales		(305.9)	(304.8)	(305.1)	(324.3)	(346.3)	(368.1)
Gross Profit		456.5	501.3	530.6	569.9	613.1	660.3
EBITDA		74.9	95.6	113.3	125.9	133.3	136.8
Operating Profit (before amort. and except.)		41.5	58.1	73.1	80.3	81.1	83.9
Intangible Amortisation		0.0	0.0	0.0	0.0	0.0	0.0
Exceptionals		(8.1)	(8.5)	0.0	(5.2)	(9.5)	(6.6)
Other		0.0	0.0	0.0	0.0	0.0	0.0
Operating Profit		33.4	49.6	73.1	75.2	71.6	77.3
Net Interest		(0.2)	0.2	(0.1)	(0.0)	(0.3)	0.0
Profit Before Tax (norm)		41.3	58.3	73.0	80.3	80.8	83.9
Profit Before Tax (FRS 3)		33.2	49.7	73.0	75.1	71.3	77.3
Tax		(10.3)	(14.0)	(15.4)	(18.1)	(17.0)	(17.0)
Profit After Tax (norm)		30.9	44.3	57.6	62.3	63.9	66.9
Profit After Tax (FRS 3)		24.2	37.6	57.6	58.0	56.2	61.6
Average Number of Shares Outstanding (m)		100.4	100.5	100.6	100.4	100.4	100.4
EPS - normalised (p)		30.8	44.0	57.3	62.0	63.6	66.6
EPS - normalised and fully diluted (p)		30.5	43.4	55.8	60.8	62.4	65.4
EPS - (IFRS) (p)		24.1	37.4	57.3	57.7	56.0	61.4
Dividend per share (p)		19.5	22.0	28.6	31.0	32.8	34.8
Gross Margin (%)		59.9	62.2	63.5	63.7	63.9	64.2
EBITDA Margin (%)		9.8	11.9	13.6	14.1	13.9	13.3
Operating Margin (before GW and except.) (%)		5.4	7.2	8.7	9.0	8.5	8.2
BALANCE SHEET							
Fixed Assets		268.9	267.4	298.2	323.4	349.1	366.2
Intangible Assets		1.0	4.7	10.2	14.3	14.6	18.1
Tangible Assets		267.8	262.7	284.2	307.4	332.7	346.3
Investments		0.1	0.0	3.8	1.8	1.8	1.8
Current Assets		65.0	101.5	86.0	92.6	87.7	105.7
Stocks		15.4	15.3	15.4	15.9	17.0	18.1
Debtors		25.0	26.1	27.6	30.7	30.6	32.8
Cash		21.6	43.6	42.9	46.0	40.1	54.9
Other		3.0	16.5	0.0	0.0	0.0	0.0
Current Liabilities		(80.7)	(102.1)	(106.0)	(121.4)	(119.9)	(125.2)
Creditors		(80.7)	(102.1)	(106.0)	(121.4)	(119.9)	(125.2)
Short term borrowings		0.0	0.0	0.0	0.0	0.0	0.0
Long Term Liabilities		(17.0)	(20.1)	(11.9)	(29.9)	(29.1)	(28.7)
Long term borrowings		0.0	0.0	0.0	0.0	0.0	0.0
Other long term liabilities		(17.0)	(20.1)	(11.9)	(29.9)	(29.1)	(28.7)
Net Assets		236.2	246.7	266.3	264.7	287.8	317.9
CASH FLOW							
Operating Cash Flow		82.5	108.6	119.6	133.8	133.7	134.0
Net Interest		(0.0)	0.2	0.2	0.1	0.0	0.0
Tax		(13.2)	(11.5)	(15.9)	(16.2)	(19.5)	(15.7)
Capex		(48.6)	(48.3)	(71.8)	(80.1)	(83.7)	(70.0)
Acquisitions/disposals		0.2	(4.8)	18.1	4.7	2.4	0.0
Financing		0.9	(2.6)	(7.2)	(8.3)	(6.6)	0.0
Dividends		(19.6)	(19.6)	(43.7)	(30.9)	(32.1)	(33.5)
Net Cash Flow		2.2	22.0	(0.7)	3.0	(5.9)	14.8
Opening net debt/(cash)		(19.4)	(21.6)	(43.6)	(42.9)	(46.0)	(40.1)
HP finance leases initiated		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
Closing net debt/(cash)		(21.6)	(43.6)	(42.9)	(46.0)	(40.1)	(54.9)

Source: Greggs accounts, Edison Investment Research

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