FLASH NOTE – TESCO

JULY 8TH, 2019

Tesco PLC	
Ticker Site BiG	TSCO
Ticker BiGlobal Trade	TSCO
Ticker BT24	TSCO
Ticker BiG Power Trade	TSCO
P/E Ratio 2019E	13,60
P/BV Ratio	1,53
EV/EBITDA	7,28

Source: Company´s data;

Price and Performance (Values in GBP)	
Price	232,50
52 week high	266,80
52 week low	187,05
YTD	22,3%
Average daily volume (un)	20.606.390
Market Capitalization (mn)	22.770
Beta	0,85
Dividend	0,06
EPS	0,14

Source: Company´s data;

Analysts Consensus (last 3 months)	
Buy	16
Hold	5
Sell	1

Source: Company´s data;

Financial Data	
Sales (GBP mn)	63.911
EBITDA (GBP mn)	3.528
Number of Employees	321.490
ROA	2,8%
ROE	10,4%
D/E	0,49
Dividend Yield	2,48%

Source: Company´s data;

Notes:

All quotes were updated in Bloomberg at 09h30 of July 3rd, 2019.

Relevant Information:

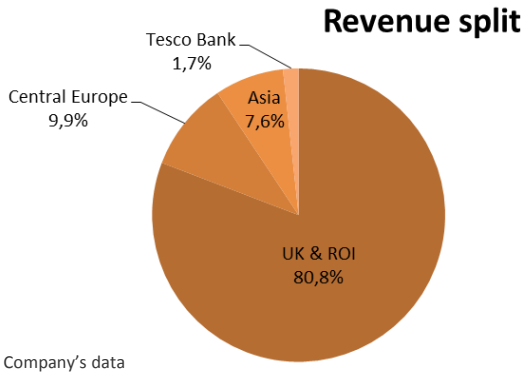
Use the following link to view our most recent publications: https://www.big.pt/InformacaoMercados/TradingIdeas/Index/-1

Use the following link to see our recommendation history: https://www.big.pt/pdf/Newsletters/nld.pdf

Tesco (Ticker: TSCO)

Description

Tesco PLC is a British groceries retailer founded back in 1919 in UK, Welwyn Garden City, where it is currently headquartered. The company operates through hypermarket and convenience store concepts, as well as wholesale business. In addition to groceries retail, Tesco PLC provides retail banking and insurance business services. With the food retail, company operates in UK and Ireland, Central Europe (Poland, Hungary, Slovakia and Czech Republic) and Asia (Malaysia and Thailand). UK and Ireland is the main revenue generating business (70% of sales in 2018). Tesco PLC employs around 321 thousand employees.



Source: Company's data

Investment Points

Tesco PLC delivered an outstanding growth of 11% in the last years due to acquisition of cash & carry business Booker. However, the company is still trying to recover after the financial scandal in 2014, which highly affected company´s reputation, profits and value in the market. In 2015 the company had losses of roughly £6 billion and started delivering profit again in 2017. Currently it trades at P/E of 13.6, which is below the total industry average. However, comparing it with the average of the main competitors (Sainsbury´s and Morrison; 12.2), the P/E ratio is in between the two. Due to downsides of the company it is not recommended to have it as a long-term investment.

Environmental, Social and Governance (ESG)

Tesco PLC is highly engaged in sustainability activities, starting from detailed reporting of environmental impact to having measures of how to reduce the impact. Also, it is involved in many social projects to empower the communities and contribute to UN Sustainability Goals. However, the company was involved in fraudulent activities in 2014 by overstating the profit and horse meat scandal in 2013 (for more information see *page 6*).

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Investment Case

Growth. In 2018 Tesco PLC increased revenue growth to 11% from 3% due to acquisition of cash & carry business Booker. The strategical move to enter the wholesale industry might contribute to the business development in the following years and help Tesco PLC to fully recover after the financial losses. In the last years before the acquisition Booker grew at the rate of 6.7% (lfl 2.8%).

Local regulation and competition. New regulation imposed on Polish retail supermarkets negatively hit the company in the last years. Sunday trading ban decreased trading days by 25 in 2018, also the retail chain finds it difficult to compete with the discount stores, namely Lidl and Biedronka. To fight the Sunday trading ban the competitors increased promotional activity: discounts are reaching up to 70%, also the working hours of personnel increased on Fridays and Saturdays. Discount stores normally have less stuff in the stores; personnel is not interacting with the customers. While Tesco has a different concept, being a more premium brand, ensuring constant support to the customers, thus it finds it difficult to compete in pricing. Due to slowdown in activity, 62 stores were closed in Poland in 2018. During the rest of 2019, Tesco PLC is planning to close four big supermarkets in Poland and three distribution centres, which were providing supplies to 120 Tesco stores.

Shrinking customer base. In the biggest market of UK&ROI the company faces challenging environment, because before it used to take the market share from small grocery stores, however recently such stores are gaining appeal from the customers, because they can offer competitive prices. Tesco PLC finds it more difficult to maintain the margins as operating costs are not decreasing, while to maintain the top line is becoming very challenging.

Fraudulent activity. In 2014 Tesco PLC was involved in fraudulent activity. The company was accused of overstating the profits by £326 million (more information on *page 7*) and had to pay £214 million in fines. The following year (2015) company had losses of £6 billion and lost its market capitalization by roughly 50%. Five years after, the company´s share is trading below the industry average, company is still involved in legal proceedings with shareholders and it is difficult to change the negative reputation towards the company in the industry. Nevertheless, the company managed to recover from losses and in 2018 published nearly £1 billion in profits.

Financial position. Despite the slowdown in Central European market, the company delivered a 11% revenue growth in 2018 mainly driven by the acquisition of wholesaler Booker. Cash flow in 2017 allowed company to increase capital expenditure, decrease the debt and increase dividends to shareholders. 2018 was the first year when company delivered a solid performance after the continuous obstacles to recover after the financial losses. Tesco PLC paid £357 million in dividends after a long period of no payments.

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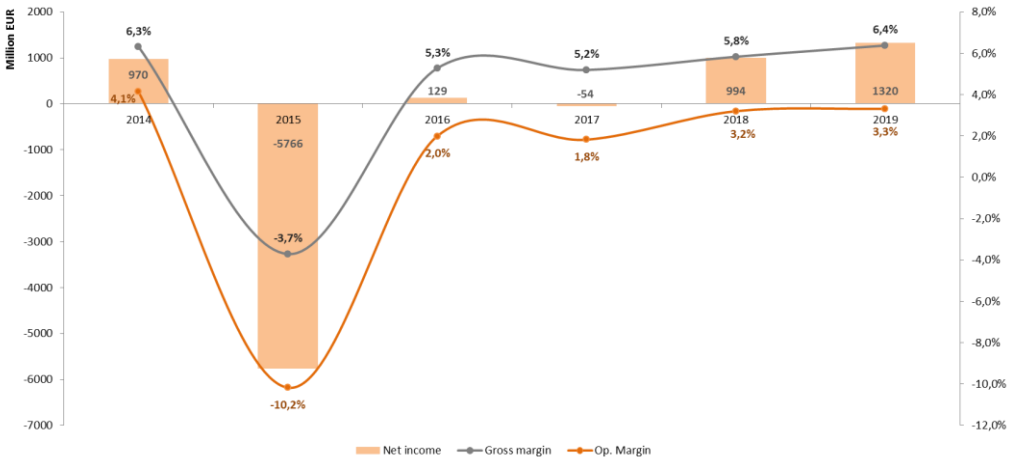
Income Statement (GBP millions)	2018	2017
Revenues	**63.911**	**57.493**
COGS	(59.767)	(54.141)
Administrative costs	(2.075)	(1.633)
Other Expenses/Income	84	120
Operating Expenses	**(61.758)**	**(55.654)**
EBIT	**2.153**	**1.839**
Net Interest	(479)	(539)
EBT	**1.674**	**1.300**
Taxes/benefits	(354)	(306)
Others	0	216
Net Income	**1.320**	**1.210**
Earnings per share	**0,1**	**0,1**

Source: Company´s data

Income statement

Revenues in 2018 increased by 11.2%, UK&ROI being the main revenue generating segment. Revenue growth was driven by the recent acquisition of Booker. Despite of increase in COGS, gross margin increased by 0.7% to 6.5%. COGS increased mainly due to higher inventory write-offs, which have increased by 13% in 2018. Operating margin increased by 0.3% to 2.6%. EPS increased to £0.14 from £0.12.



Source: Company's data

Free Cash Flow (GBP millions)	2018	2017
Operational Cash Flow	**1.966**	**2.805**
Operating Profit	2.153	1.839
D&A, impairments	1.317	1.106
Interest Paid	(306)	(328)
Interest and dividends received	(370)	(176)
NWC: Retail	(438)	480
NWC: Tesco Bank	(258)	110
Others	(132)	(226)
Investment Cash Flow	**(1.143)**	**643**
Capex	(1.006)	(1.384)
Net Treasury Investments Inflow	511	1.935
Acquisitions	(715)	(27)
Disposals	8	66
Others	59	53
Financial Cash Flow	**(1.981)**	**(3.236)**
Debt change	(1.496)	(3.408)
Share buyback	(206)	0
Dividends	(357)	(82)
Others	78	254
Change in free cash flow	**(1.158)**	**212**
Other and forex	**15**	**15**
Cash and equivalents at end	**2.916**	**4.059**

Source: Company´s data

Free Cash Flow

Operational cash flows decreased during the financial year due to changes in working capital in both, retail division and Tesco Bank activities. Investment cash flow mainly changed due to acquisition of Booker. The company paid £766 million in cash and issued additional capital of £3.1 billion in shares. Also, company sold short-term investments, namely money market funds of roughly £1 billion. Tesco PLC again started paying dividends: in 2018 the company paid £357 million or £0.05 per share.

Balance Sheet

Total assets increased by 9% as a result of acquisition of Booker. Consequently goodwill increased by £3.1 billion and intangible assets by £490 million. Other line items of assets changed due to ordinary business activity. Liabilities increased by 8% due to increase in customer deposits and deposits from banks attributable to Tesco Bank activities. 86% of liability makes customer deposits, which increased by 13% and was the main reason of the total increase. Also, during the financial year the company had a tender offer for bonds, therefore the total amount of long term debt was decreased by 4%. Net indebtedness/EBITDAR ratio in 2018 reached 2.8x, a decrease from 3.3x. The company is expecting to maintain the level below the ratio of 3x.

Balance Sheet (GBP millions)	2018	2017
Assets	**49.047**	**44.884**
Cash & Equivalents	2.916	4.059
Short term investments	390	1.029
Goodwill	4.909	1.796
Receivables	1.835	1.690
Loans to customers and banks	12.750	11.522
Inventories	2.617	2.264
Property Plant & Equipment	19.023	18.521
Intangible Assets	1.355	865
Joint Ventures & Associates	704	689
Other Assets	2.548	2.449
Liabilities	**34.213**	**34.404**
Short term Debt	1.599	1.479
Long term Debt	5.673	7.142
Payables	9.738	9.358
Customer deposits and deposits f	12.128	10.784
Other liabilities	5.075	5.641
Total Shareowner's Equity	**14.834**	**10.480**
Total Equity and Liabilities	**49.047**	**44.884**

Source: Company´s data

Guidance

In the first quarter of 2019 Tesco PLC delivered revenue growth of 0.4% (lfl 0.2%), the main driver being UK&ROI (growth +1.3%) due to increased loyalty programs and various campaigns for customers as part of ´100 Years of Great Value´ program. Also, strong Easter performance strongly contributed to the growth, as small stores benefited from the biggest-ever sales day during the Easter Sunday. Booker, acquired in 2018, continues to grow: it contributed to sales by 4.2%. While sales in Central Europe (growth -7.9%, lfl -4.9%) continue to decrease due to slower activity in Poland. Tesco PLC blames colder weather conditions in the Q1, which changed the needs and preferences of customers. Asia delivered growth of 2.6% (lfl 0.1%) mainly driven by expansion in Thailand.

Tesco PLC is expecting to reach operating margin of 3.5-4% by the end of 2019. Also, the

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company continues reducing operating costs, i.e. cut costs by £1.5 billion by the end of the year. Tesco PLC is planning to invest from £1.1 billion to £1.4 billion in CAPEX and reach the dividend ratio of 2x EPS coverage.

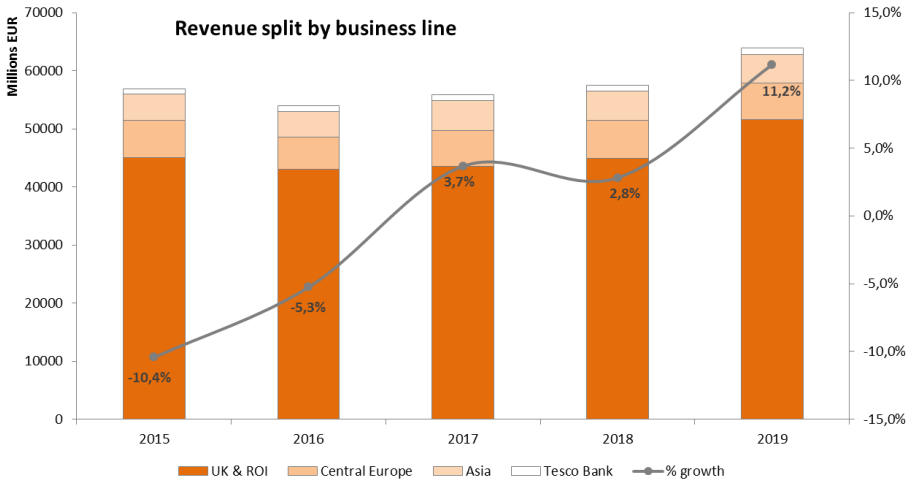
Management

Dave Lewis, CEO of Tesco PLC

Dave Lewis - CEO of Tesco PLC Group, who joined the company in 2014, replacing the former CEO Philip Clarke. Lewis graduated from Nottingham Trent University with BA of Business studies. He has 27-years experience working at Unilever in various management positions. Lewis biggest achievement is the launch of Dove brand, which became the main brand of Unilever. CEO joined Tesco at the difficult times, when the company suffered from accounting scandal; however he is continuously working towards the recovery of the business.

Main Segments

Tesco PLC groceries retail business operates in several regions worldwide, namely UK & ROI, Central Europe and Asia. Banking services are provided just in UK.



Source: Company´s data

UK & ROI (81% of total revenues; lfl growth +2.9%; op. margin 2.98%) represents groceries retail business in United Kingdom and Ireland. It is the biggest revenue generating region, making 80.8% of total sales in 2018. Sales grew by 15% (lfl 2.9%), as the company relaunched 10 thousand of own brand products, which were on demand especially in the Q3. Also, Tesco PLC started realizing the synergies after the acquisition of wholesaler Booker (for more information, see *page 5*). Operating margin increased by 0.62% to 2.9%. Net gain in stores resulted in 4 new stores: 2 in UK and 2 in ROI.

Central Europe (10% of total revenues; lfl growth -2.3%; op. margin 2.95%) represents groceries retail business in Hungary, Poland, Czech Republic and Slovenia. It is the second biggest revenue generating market, which made 9.9% of total sales in 2018; however, it has a much lower share than in UK & ROI. Poland makes the biggest part of revenues generated in Central Europe (32% of total revenues of Central Europe), followed by Hungary (25% of revenues of Central Europe). In 2018 revenues decreased by 4.4% (lfl -2.3%) mainly impacted by the decision not to participate in Black Friday´s promotional activities and due to slowdown in Poland. In total 66 stores were closed in Central Europe and no new stores opened. Operating margin increased by 1.13% to 2.95%, because the company is simplifying the store concept in the region.

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Asia (7.6% of total revenues; lfl growth -6.2%; op. margin 5.87%) represents groceries retail activity in Malaysia and Thailand. Sales decreased by 1.5% (lfl -6.2%) in 2018, mainly driven by the decreased activity in Thailand. Sales in Thailand made 83% of total revenues generated in Asia and sales decreased by 7.4%. The decrease was mainly caused by the company´s decision to stop the cash & carry business in Thailand, which was unprofitable. Also, the government issued a welfare card to support households; however it is not accepted by multinational retailers, which leads to decrease in sales. Even though 56 stores were closed, 70 new stores were opened. Operating margin decreased by 0.17% mainly due to decreased sales and advertising restructuring.

Tesco Bank (1.7% of total revenues; growth 4.7%; op. margin 17.9%) is exclusively available for UK citizens. It is supposed to provide retail banking and insurance services for people who shop at Tesco. For that purpose Tesco PLC offers a credit card and Banking App. During the year of 2018 the main revenue generating segment was retail banking, while insurance business decreased due to strong competition in the market. Out of £1.1 billion revenues in 2018 66.5% are attributable to interest revenue and remaining 33.5% of revenues come from fees and commissions.

M&A

Tesco PLC has made several acquisitions in the past including restaurant services provider Giraffe, online retail platforms developer Mobcast, and several others. However, the most important acquisition was made in 2018, when the company acquired Booker, specialised in cash & carry business.

Booker, providing wholesale in UK, was acquired for £3.7 billion. The main goal of Tesco PLC was to increase the business activity in chain restaurants, where Booker before the merger was growing rapidly. Meanwhile customers of Booker will be able to benefit from the innovative products, which Tesco PLC is providing (gluten-free, vegan meals). Also, the company will be able to reach the broad customer base of Tesco. Before the acquisition, Booker was growing at the rate of 6.7% (financial year of 2017 until March) and generated revenues of £5 billion. The deal is expected to bring synergies of £200 million.

Relative Valuation

Tesco PLC has a P/E ratio of 13.6, which is below the industry average of 15.7. It may imply that the share price is undervalued. However, the share has not recovered since 2014 financial fraud scandal. EBITDA Margin is also slightly lower than the peer average, but it is higher than the main competitors, namely Morrison and Sainsbury. Dividend yield also falls below the industry.

Name	Country	Market Cap (mn)	Currency	P/E 2019E	P/E 2020E	EV/EBITDA	YTD	Div. Yield	1 Yr. Price Δ	NetDebt/ EBITDA	Margin EBITDA
WM MORRISON	BRITAIN	4.906	GBP	14,7	13,9	7,9	-2,0%	6,1%	-16,0%	1,2	4,7%
MAGNIT	RUSSIA	383.136	RUB	11,4	10,2	6,0	7,1%	8,1%	-18,6%	1,7	6,6%
JERONIMO MARTINS	PORTUGAL	8.766	EUR	20,4	18,6	10,3	34,7%	2,3%	16,5%	2,2	6,0%
SAINSBURY	BRITAIN	4.420	GBP	9,7	9,4	5,3	-24,6%	5,5%	-37,3%	0,4	3,8%
ICA GRUPPEN AB	SWEDEN	81.183	SEK	21,8	21,4	13,2	27,4%	2,8%	46,6%	2,7	6,2%
X 5 RETAIL GROUP	RUSSIA	9.619	USD	16,3	14,3	7,8	42,9%	4,0%	38,4%	4,5	8,6%
TESCO PLC	BRITAIN	22.711	GBP	13,6	12,4	7,3	21,9%	2,5%	-10,3%	1,1	5,5%
Average exc. Tesco				15,7	14,6	8,4	14,3%	4,8%	4,9%	2,1	6,0%

Source: Company´s data

Risks

Brexit. Tesco PLC faces a significant risk once the Brexit will be completed. Due to high uncertainty of consequences towards the trading conditions between UK and the rest of Europe, companies may have restrictions or strict regulation imposed on business activity.

Local laws and regulation. As Tesco PLC is operating in Poland, it was negatively affected

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by the new regulation: Sunday trading ban. It took effect in 2018, when retail sector was allowed to trade two Sundays per month; in 2019 sector is allowed to trade only one Sunday per month, followed by the complete ban of trading on Sundays from 2020. It has a direct effect on the revenues, as the total trading days were reduced by 21 in 2018. Tesco PLC has a different concept than the major players in Polish market, namely Biedronka, Lidl, which can fight against the regulation by offering bigger discounts, longer working time on other days. Thus, it is difficult to maintain the market share for Tesco PLC. In recent years the company closed 62 stores in Poland stores to reduce the exposure.

Competition. Food retail sector is highly saturated with the food distributors, offering competitive prices and high quality production. Since the company is operating in various markets, competition is local and international. In UK & ROI the main competitors are ASDA, Sainsbury´s and Morrison´s, all four are leading the groceries market in UK. In addition, the fierce competition is created by discount stores Aldi (market share 6.9%) and Lidl (market share 5%), which are increasing market share rapidly. Since the last financial downturn, customers often prefer discount stores for groceries shopping rather than premium class service.

Customer relationships. During the business activity Tesco PLC was involved in several controversial scandals, both ethical and financial, which negatively affected the company´s reputation and relationship with customers. Due to negative customers´ perception the company is losing market share against the major rivals, namely Morrison and Stansbury in the main market. Also, entry and development of discount stores shapes the customer preferences and might result in further loss of market share.

Environmental, Social and Governance (ESG)

Environment. Tesco PLC is very transparent in disclosing the ratios of the environmental impact: 3.3 million tons of CO_2; 44 thousand tons of food waste; 928 thousand tonnes of packaging were produced by the company in 2018. 860 thousand tonnes of soy and 59 thousand tonnes of palm oil were used during the year. Nevertheless, Tesco PLC is engaged in various activities to reduce the numbers of environment impact. One of the most important is the initiative to use fully recyclable packaging by 2025 in own brands (83% used in UK brand in 2017). Also, Tesco PLC is determined to significantly reduce the food waste with the initiative that no food, which is safe for human consumption, will be wasted in UK retail. In 2019 Feb 81% of food was redistributed in UK.

2006	2009	2010	2013	2016	2017	2018
50% **carbon** reduction target per sq. ft. of store by 2020 Target to reduce **packaging** by 25%	Zero **carbon** business by 2050	CGF 2020 Zero **Deforestation** target adopted	Commitment to publish our own **food waste** data annually	No food safe for human consumption will go to **waste** from our UK retail operations	Launch of **Little Helps Plan** commitments	Announced zero deforestation **soy** transition plan

Source: Company´s data

Social. Tesco PLC engages in development of wellbeing of society through various campaigns. In all Tesco PLC markets over 125 million meals were provided as well as £70 million donated through Bags of Help since 2016. To promote healthy lifestyle the company reduced prices for healthy alternatives and with the partnership with Jamie Oliver educates society about healthy nutrition. Also, the company has identified the key contributions towards the UN Sustainability Goals. Controversially, in 2013 Tesco PLC was involved in horse meat scandal. Tesco PLC together with Aldi, Lidl and Iceland was selling beef burgers, which contained horse meat. The production raised concerns towards the safety and had to be removed from the supermarkets. The scandal was a significant downside for Tesco PLC, which at the time was trying to build the relationship with

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customers by providing the ´high quality´ products.

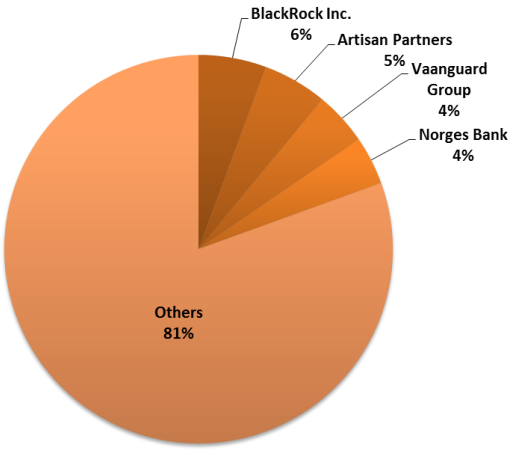
Source: Company's data

Governance. In 2014 was found that Tesco PLC was involved in fraudulent activities by overstating the profits by £326 million. Independent auditors revealed that profits were overstated by £118 million in 2014, £70 million in 2013 and the rest in years before. Due to increased competition, company started losing the market share, however pressure from shareholders didn´t allow to present slowdown in the activity. Therefore, in order to increase profit, the company was recognising the revenues prematurely and struck deals with the suppliers offering them significant benefits in the next financial period to be able to postpone the payments. Tesco PLC had to pay £214 million in fines and compensations, which was followed by £6 billion in losses the year after.

Graph

Source: BiGlobal Trade (partner Saxo Bank); BiG Research

Shareholders



Source: Company's data

Calendar

October 2nd, 2019: 2nd Quarter 2019 Results

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  - Accumulate, expected absolute return between +5% and +15%;
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