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SharePad's **Phil Oakley** scrutinises the financial performance of the major supermarkets to see if the shares are worth buying again

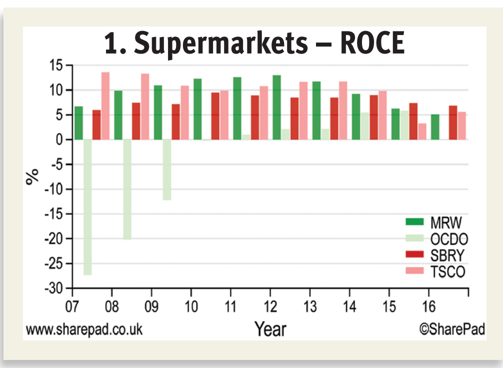
Shares in the UK's big supermarkets have not been very good long-term investments. Their fortunes have taken a massive battering over the past few years, but during the past 12 months they have – with the exception of **Ocado (OCDO)** – actually made investors some money.

This, of course, begs the question: have the bad times passed and are the shares now good investments? To try to answer this question, it helps to understand why the supermarkets got into such a mess in the first place. By analysing the financial performance of the companies concerned, it is possible to gain an insight into what has gone on in the past and what the future might bring. You can then look at what share prices might be implying about future profits and see if the odds are in your favour or not.

In this article, we are going to scrutinise the financial performances of the bricks and mortar supermarket companies: Tesco, Sainsbury's and Morrisons. We will also separately look at internet supermarket Ocado to see whether selling food online makes financial sense.

Have supermarkets ever been quality companies?

High-quality companies consistently earn a high rate of return on the money they invest in their businesses. In financial jargon, they earn a high return on capital employed (ROCE). ROCE compares a company's trading (operating) profits with the money (capital) employed.



'The higher the rate of interest (ROCE), the better a company's financial performance is'

ROCE rather than earnings per share (EPS) is arguably the best measure of a company's profitability. This is because it takes into account all the money used to make a profit, which EPS doesn't.

The best way to think about ROCE is that it's like the rate of interest you get on a savings account. The higher the rate of interest (ROCE), the better a company's financial performance is. Good companies consistently produce ROCEs of 15 per cent or more.

As you can see in chart 1 (below, left), Tesco (pink) got close to meeting that quality threshold back in 2007, but it and the others have not done so since then. What the chart is telling you is that the profitability of the sector has collapsed. ROCE is now in the mid single digits.

Just to give you a bit more of a historical perspective, Tesco's and Sainsbury's ROCE in the mid to late 1990s was in the mid teens. Before it bought Safeway in 2004, Morrisons was making 20 per cent ROCE. So why has profitability declined so much?

From what I can see there are three main reasons:

1. The supermarkets spent too much money on opening new stores.
2. They failed to adapt to the rise of the discount supermarkets such as Aldi and Lidl and the increasing number of people doing their weekly grocery shopping over the internet.
3. Selling grocery goods over the internet might not be very profitable.

How the supermarkets spent too much

If you want to make more money from your investments there are two things that you can do. The first is to try to get a higher return on what you already have invested (generate a higher ROCE) or you can invest more money. For most of the past decade, supermarkets took the second option.

From big out-of-town hypermarkets, to regular supermarkets and convenience stores, the big

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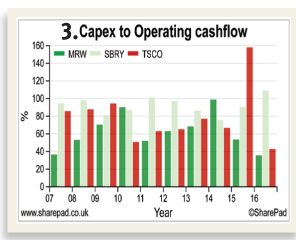
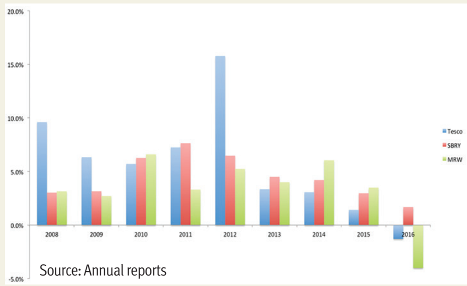


supermarket companies opened up a lot of new selling space, as shown in chart 2 below.

2. Annual change in selling space



Source: Annual reports

As you can see, **Morrisons (MRW)** (green) and **Tesco (TSCO)** (blue) have been shrinking their selling space during the past year in an effort to improve returns, whereas **J Sainsbury (SBRY)** has kept on adding space. That said, all the supermarkets have a lot more stores and selling space than they did a decade ago.

The supermarket space race

	UK stores		Selling space 000 sq ft		
Company	2007	2016	2007	2016	% change
Tesco	1,988	3,743	27,785	45,253	63%
Sainsbury's	788	1,374	15,715	23,202	48%
Morrisons	368	498	10,505	14,142	35%

The problem has been that all this new space has not made enough money in return. This means a lot of this money spent has been effectively wasted and has done considerable damage to the finances of the supermarket companies. Sales are higher, but profit margins have either stayed low – in the case of Sainsbury's – or collapsed.

How the supermarkets compare

	UK sales (£m)		Trading profits (£m)		Profit margins	
Company	2007	2016	2007	2016	2007	2016
Tesco	32,665	45,062	2,083	498	6.4%	1.11%
Sainsbury	16,860	25,829	429	635	2.5%	2.46%
Morrisons	12,461	16,122	385	341	3.1%	2.12%

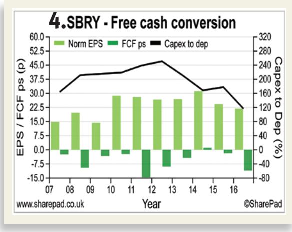
To put this spending into some kind of perspective, the supermarkets were spending very large proportions of their trading or operating cash flow (the cash that comes into the business from selling goods) on capital expenditure – opening new stores and fitting them out, as well as keeping their existing stores in good condition. As you can see from chart 3 (below left), Sainsbury's (light green) has consistently spent almost all of its trading cash flow on capital expenditure.

This has meant that the companies' cash flow performances were dire. The amount of money left over after capital expenditure, tax and interest was paid – known as free cash flow – has been considerably less than the companies' reported profits. In fact, you

Tesco, Sainsbury's and Morrisons shares have taken a battering over the past few years

could be forgiven for asking yourself what the true profitability of supermarkets actually was.

Sainsbury's free cash flow per share, shown in chart 4, has been negative for every year of the past decade due to its high capital spending. As the cash spent on new assets has been considerably more than the depreciation expense in the income statement (a dubious proxy for the amount of money needed to maintain a company's existing assets) there has been a big gap between free cash flow per share and earnings per share (EPS).



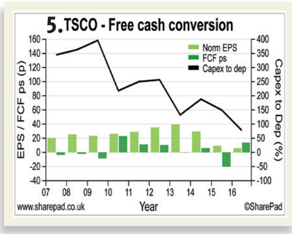
Tesco and Morrisons (charts 5 and 6, below right) have not fared much better on this key test of profit quality for similar reasons. It should have been no surprise to investors that dividends eventually had to be cut or scrapped entirely in recent years.

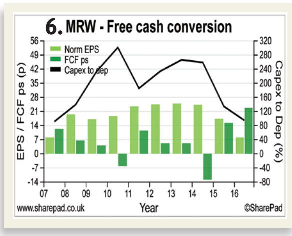
That said, both companies have seen a recent improvement in their free cash flow performance as they have slashed investment in new assets (the black line in the chart).

A note of caution is needed here. Tesco's spending is now below its depreciation expense, which could be a sign that it has moved from overinvesting to underinvesting in its assets.

This level of spending cannot continue for long before stores start to look tatty and tired. Tesco needs to improve its free cash flow by increasing its profits, not by underinvesting in its stores.

As well as seeing their cash flows deteriorate, Tesco and Sainsbury's also sold off many stores to property companies to raise cash to invest in their businesses. At the same time, they agreed to long-term ▶





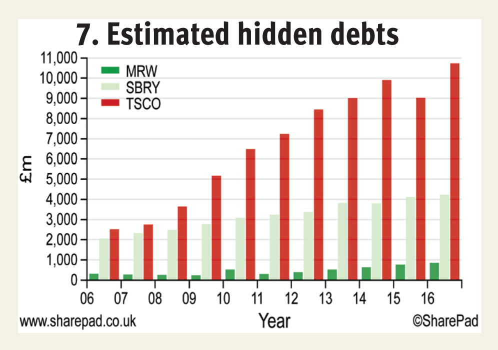
Supermarket borrowings

Company	Fxd charge cover	Interest cover	Debt to net OPCF	Total borrowing (£m)	Est Hidden debts (£m)
Morrison (Wm)	2	3.2	2.2	2,204	854
Sainsbury (J)	1.7	4.9	4.8	2,413	4,235
Tesco	1.4	2.5	5.3	13,537	10,738

Source: SharePad

▶ commitments to rent them back in what is known as sale and leaseback transactions. These transactions created a big increase in hidden, off-balance sheet liabilities for Tesco and Sainsbury's, and with it the financial risks for their shareholders, as shown in chart 7 (below). The higher rent bills increased the cash fixed costs of their businesses and therefore made their profits more sensitive to changes in sales.

In financial jargon, they increased their operational gearing. This is not a smart thing to do in the face of increased competition. Morrisons did fewer sale and leasebacks and looks to have much stronger finances than its larger peers.

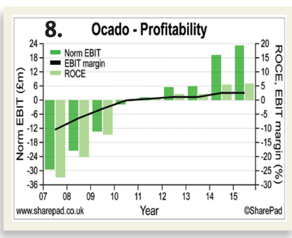


Arguably, the key measure of a company's financial strength is a ratio called 'fixed charge cover'. It measures how many times a company's trading profits can cover the annual rent bill and the interest payments on borrowings. Morrisons has the highest fixed charge cover of the big three quoted supermarkets. Tesco is close to the danger zone (see table below).

Morrisons also has the lowest debt to net operating cash flow (OPCF) ratio. Put simply, its after-tax trading cash flow could repay its debts in just over two years. It also has the lowest total borrowings and hidden debts.

The poor profitability of selling groceries over the internet

Internet grocery shopping has been growing fast, but whether it has contributed much to the supermarkets' profits is debatable. Tesco and Sainsbury's pick customer orders from in their stores. This is very labour-intensive, and delivering to households adds on extra costs.



'Cash-strapped consumers have been able to save lots of money doing their weekly grocery shop at Aldi or Lidl, which have offered much cheaper prices'

The supermarkets do disclose their sales from internet grocery shopping, but do not disclose how much money they are making or losing. This suggests that it has been nothing to shout about and that it is more about holding on to customers.

Ocado is a specialised internet grocer, which also looks after Morrisons' online business. This business has struggled to make money, has wafer-thin profit margins and a very low ROCE, as you can see in chart 8 (below left).

Is the worst over for supermarket shares?

Investors have been warming to the sector in 2016. The exception is Ocado, as City analysts seem to have grave concerns about whether it can make significant profits, especially in such a competitive marketplace. However, it could be that the increases in share prices are explained by a relief that things aren't getting worse rather than evidence of a strong recovery in the sector's fortunes.

Tesco looks as though it has stopped the rot in terms of its sales performance. Its closely watched like-for-like sales figure (sales from stores that have been open at least a year) has started growing again, but only just. It must be remembered that growth of 0.3 per cent during the first quarter of its 2016-17 financial year is by no means stellar.

Morrisons' recent half-year results showed that its rate of growth in like-for-like sales was accelerating (2 per cent growth in the second quarter). Its cash flow performance was good and there was a good reduction in debt, which led it to be cautiously optimistic about its prospects.

Yet it seems that there is still a lot of danger out there for investors. The competition for market share ▶

UK grocery market share

%	Sep 2015	Sep 2016	Change
Tesco	28.2	28.1	-0.1
Sainsbury's	16.2	15.9	-0.3
Asda	16.7	15.7	-1.0
Morrisons	10.7	10.4	-0.3
Aldi	5.6	6.2	+0.6
Waitrose	5.2	5.3	+0.1
Lidl	4.2	4.6	+0.4

Source: Kantar Worldpanel

The rise of the discounters

The chief reason for the collapse in profit margins and ROCE of the big supermarkets has been the rise of discount supermarkets such as Aldi and Lidl. These companies have attracted more and more customers since the recession of 2008. Cash-strapped consumers have been able to save lots of money doing their weekly grocery shop at Aldi or Lidl, which have offered much cheaper prices. This has forced the big supermarkets to cut their prices in order to be more competitive, but it has come at the cost of much lower profitability.

According to Kantar Worldpanel, Aldi and Lidl have a combined share of the UK grocery market of 10.8 per cent in September 2016, which makes them slightly bigger than Morrisons (10.4 per cent). They have been growing their market share at a rapid rate by opening lots of new stores.

It seems that the secret to their success has been a very simple and effective business model based on three key areas:

1. Smaller stores with less overhead costs than big supermarkets.
2. Ruthless in-store efficiency and logistics, which generates better profits.
3. A limited range of products in store compared with the big supermarkets. This allows them to significantly concentrate their buying power and get lower prices, which can be passed on to customers. For example, there might be one or two choices of a product in Aldi and Lidl compared with six elsewhere.

The key threat to the big supermarkets going forward is just how big a slice of the grocery market the discounters can grab and how long it will take them.

Supermarket valuations

Company	Close	Forecast PE	Forecast yield	P/NAV	P/FCF	EBIT yield	Forecast norm EPS % chg
Morrison (Wm)	216.4p	20.6	2.5	1.3	9.5	5	29.6
Ocado Group	254p	282.2	-	6.5	-196.7	1.3	-59.1
Sainsbury (J)	248.7p	11.1	4.7	0.8	-22.6	9.6	2.8
Tesco	176.45p	29.4	-	1.7	12.7	4.6	2.6

Source: SharePad 26/9/2016

▶ remains cut-throat. Even the discounters are not doing as well as they were. Aldi's 2015 results released this week revealed that its sales have still been growing strongly, but that its profits fell slightly. The company stated that it intended to remain the country's cheapest supermarket and seemed to suggest that profits might not grow because of this strategy.

Of more worry to investors is what is going on at Asda. The company is losing customers and sales at an alarming rate as evidenced by the latest market share data. It will be looking to fight back and this is likely to mean more price cuts to woo shoppers.

Given this backdrop, how are supermarkets going to improve their profitability and ROCE? They can only cut costs so much and trying to meaningfully grow sales while cutting prices looks as though it will be very hard to do.

The UK supermarket sector looks like a classic case study of too many shops chasing too few shoppers. The country is oversupplied with supermarkets and this can only continue to put downward pressure on profits and returns. City analysts certainly aren't forecasting strong sales growth and a big recovery in profit margins.

A bullish sign would be to see supermarkets closing. Morrisons and Tesco have made some small steps in shrinking their selling space, but might be reluctant to do more for fear of losing market share.

Market share is a major determinant of a company's buying power with suppliers. The more it has, the more price competitive it can be, which then allows it to take more market share. This is the game that Aldi and Lidl seem to be playing.

The big advantage they have is that they are not quoted on the stock exchange and aren't heavily scrutinised by lots of shareholders. Tesco, Sainsbury's, Morrisons and Ocado don't have that luxury. This means that the quest to gain and hang on to market share might still have the potential to wreak havoc with company profits and cash flows.

The valuation of supermarket shares

Supermarket companies are going to have to work hard to grow their profits. If that is the case, then it's hard to argue that their shares are attractive right now.

Ocado shares trade on very high multiples of profits and assets, which reflect either a big increase in profits or that it will be taken over. Neither is guaranteed to happen. Tesco's shares trade on nearly 30 times forecast earnings, which is telling investors that a lot of profit recovery is already baked in to its share price. Sainsbury's looks cheapest on a forecast PE of just over 11, while also trading below its net asset value and offering a big dividend yield. Potential drawbacks are its consistently poor free cash flow performance and low ROCE.

Morrisons may be the share for investors to look at if they are feeling brave. By no means cheap on a forecast PE ratio of over 20, it looks better value on a cash flow basis. Its financial position is strong and improving, while its prices and ranges look to be finding favour with shoppers.

Housebuilding: room for cautious optimism

The IC's property sector expert, Jonas Crosland, responds to last week's financial dissection of the housebuilding sector – and argues that the cycle has some way to run yet

Never say never, but the UK housing market has weathered the first few months following the EU referendum result in reasonable style. However, it's important to remember that there is a big difference between the performance of the housebuilding sector and the health of the existing housing stock.

Major housebuilders recently released results for the period ending in June, and the consistent theme running through the numbers is that everything worked well before the referendum. But, crucially, early indications show that, aside from the usual seasonal lull, the buyers have not deserted the market. The truth is that nothing much has changed other than people's perceptions of what might happen next.

Maybe it's time to put to rest some of the more ridiculous hyperbole dreamt up around the time of the referendum. House prices have not collapsed and are unlikely to. Mortgage rates are not about to spike higher, and unemployment is falling, not rising. Of course, house prices at the top end of the market in prime central London have come down, but this was happening long before the referendum, as overseas buyers took a step back in the wake of higher property-related taxes.

Taking the secondary, or existing housing market, homeowners naturally took fright in the wake of the referendum, and transactional volumes suffered as a result. This created a kind of stopper in the housing chain because people looking to move to a more expensive property or even downsize into a smaller one stayed put, restricting the number of properties coming on to the market. This had two effects. In a perverse way, a shortage of property coming on to the market helped to underpin prices, and here we're talking about the real world outside prime central London. As one regional developer observed, we're not looking for a collapse in house prices because we're still waiting for the so-called boom (as experienced in the London hotspots).

House price inflation has certainly slowed. This is good – unless you are a seller – because it makes the cycle that much more sustainable. For housebuilders, the situation is fairly clear. Mortgages are cheaper than ever, while demand is higher than ever at a time when there remains a chronic undersupply of new homes.

Government policy

We have great faith that there will be positive measures announced in this year's autumn statement. Reading between the lines suggests that the fiscal reins may be loosened a little in a way that will stimulate growth. For the housing market, there is considerable room for manoeuvre, especially in the wake of the ill-disguised attack through legislation introduced in the past year. The bottom line here is that badly conceived taxation has done little other than to expose the gap between political objectives and housebuilding aspirations.

Lobby groups such as the British Property Federation have done a good job of highlighting the basic requirements to solve the housing shortage. However, there remains a huge gap between what needs to be done and what is being done. Building one million homes by 2020 is a laudable aspiration, but a recent survey of interested parties revealed that 83 per cent see this as little more than a political posture that has little basis in reality.

There are other potential storm clouds on the horizon that the government's policies on Help to Buy will have to address. At the moment, you can use a Help to Buy individual savings account (Isa) for houses costing £250,000 or less outside London and £450,000 inside London. The problem here is that, if average valuation increases continue even at a moderate pace, nearly half of all districts in England will be ineligible by March 2017, and that includes 26 London boroughs, some of which already have average prices exceeding the limit. Northern England (with the exception of Harrogate), Wales and Scotland are expected to have average prices low enough for buyers to be able to afford a home using the scheme. Since the Isa's introduction in December last year, Tower Hamlets and Harrow have since seen average prices rise above the threshold. The Help to Buy equity loan scheme provides more flexibility, but even here the scheme is restricted to purchase prices of £600,000 or less.

Planning and red tape

Housebuilders complain, with justification, about the constraints within the current planning system. A chronic lack of resources in local planning offices, objections to new developments (everyone wants more new houses, as long as we can't see them from where we live) and objections to building on greenbelt land. Smaller builders have also had to contend with the restricted availability of finance from banks; lending on speculative developments is hard, if not impossible to come by. However, a new measure passing through the parliamentary hoops is expected to provide finance for small and medium-sized developers, with emphasis on reducing red tape.

Much attention has been paid to the housing market in the London area; this was already under pressure before the referendum as both house prices and potential buyers were hit by the increase in stamp duty imposed in April. In the wake of the June vote, there was every expectation that the rental market would suffer the same fate, but there is mounting evidence that this has not been the case, although there appears to have been a shift in the type of property that renters are looking for.

London-focused estate agent Douglas & Gordon revealed that August was its strongest ever month for lettings, up by nearly a third on a year-on-year basis, with a 20 per cent jump in enquiries from relocation letting agents working on behalf of large international companies with bases in London. Much of the demand is centred on emerging prime areas where the

Rising high: demand is higher than ever at a time when there remains a chronic undersupply of new homes

rental rates are lower, with a greater tendency to rent apartments rather than houses. It's also interesting to note that most of the new enquiries are coming from France, Germany and Italy, which stands the idea of a post-referendum exodus on its head.

The future for the sector

It's probably still too early to say whether the post-referendum bounceback is sustainable. What we do know is that the housing market is a cyclical beast; the problem is that no one knows how long the current cycle will last, and whether the housing sector will be put to the sword as in 2008, or simply slip towards a more benign retrenchment.

The latest post-referendum data suggests that the underlying picture remains bright. According to the Council of Mortgage Lenders, gross mortgage lending in August was the highest August since 2007 and was 7.1 per cent higher than in July. Transaction volume is lower but also recovering. And a recent survey by estate agent Knight Frank showed that confidence in the housing market is now virtually back to where it was before the referendum. Expectations for price rises are also consistent with further data from the Royal Institution of Chartered Surveyors highlighting a sharp recovery in price expectations among surveyors. So whereas nearly half of all regions in the UK were expected to see prices falling in the immediate aftermath of the referendum, research now suggests that every region is expected to see price gains over the next year. The icing on the cake comes from government figures that showed non-seasonally-adjusted housing transactions of 110,000 in August, the same as recorded a year earlier.

So what can upset the apple cart? The principle influence is the economy, as this affects potential buyers' and sellers' perceptions about whether or not to make a move. So far, the economy has held up well, helped along by more funding from the Bank of England and the prospect of another cut in interest rates. Mortgage availability remains good, and repayments have never been cheaper, but a rise in interest rates could have a major impact on affordability. But we see the prospect of a significant rise in interest rates as remote.

Employment is another key consideration. But, despite the harbingers of doom, the number of people in work is at a record high. Affordability could be another key factor as house prices have been rising faster than wages. The effects have been mitigated to some extent by lenders extending earnings multiples on loans, but there is a limit to how far this can be stretched. On the plus side, slowing house price inflation will help to ease the pressure.

Ultimately, we get back to the same problem. Private housebuilders will not and never have built enough houses to meet demand. The answer is to build more affordable homes, inevitably renting out a bulk of these to those unable to afford a deposit and mortgage payment. In the old days, these were called council houses; the trouble is that councils aren't building houses, while housing associations have struggled against a tide of barriers, and are not filling the gap. More needs to be done to address this problem, but that means money. And while the solution is obvious and clear to see, politicians with good eyesight are another matter.