Goldman Sachs

Europe: Retail: Supermarkets

Equity Research

Totally addicted to space: overcapacity in UK grocery still needs to be addressed

The only real solution is capacity exit

Our analysis of the UK grocery industry suggests capacity exit is the only viable solution for a return to profitable growth. We believe that any major price investments by MRW, SBRY or Tesco UK can be exceeded by discounters given their now high ROIC (ALDI UK's CY13 lease adj. ROIC of 10% vs. listed 3's 7% in 2014E). At the same time, structural channel shifts to discounters and online implies large stores will see long-term sales declines unless capacity is reduced.

Self-inflicted problems now structural

Catalysed by excessive price increases and compounded by excessive space addition and now deflation, the 'listed 3' (MRW, TSCO, SBRY) are suffering from negative LFLs as consumers shift away from large stores towards convenience, discount and online channels. We believe these channel shifts are structural and our analysis suggests that large stores will see a LFL CAGR to 2020 of -3% if no further competitive/strategic response is made. On our estimates, negative leverage through core assets drives a 60% fall in the listed 3's EBIT through CY13-17E.

Scenario assessment– price war unlikely

We assess the likely outcomes for the UK grocery sector and conclude that further heavy price investments will place too much pressure on P&Ls and are unlikely to stop the trends we discuss. Also, while consolidation at an attractive valuation is ideal, regulation means it is unlikely in the short term; and therefore capacity exit from the largest store operators appears to be the only solution. Alternative use property valuation suggests no support at current share prices.

Sell SBRY & TSCO, relative value in MRW

For SBRY/TSCO we model 54%/75% average dividend cuts in FY14-16 and our FY17 EBIT is 36%/24% below Bloomberg consensus, as we do not believe current strategies address negative operating leverage and high lease adj. leverage levels. We do not see cash flow or asset support at current share prices and remain Sell on both (SBRY on CL). We see value in MRW with dividends covered despite modeling the deepest price cuts and lowest volume growth. Trading at a 7.7% 2014-16E dividend yield vs. SBRY at 3.5%, we see relative value in MRW and upgrade to Buy.

RATINGS AND 12-MONTH PRICE TARGET CHANGES

Company	Curent price (p)	Rating		Price Target (p)		Upside/ Downside
		Old	New	Old	New	
Tesco	191	Sell	Sell	250	155	-19%
Morrisons	177	Sell	Buy	172	207	17%
Sainbury	265	Sell*	Sell*	155	155	-42%

** indicates on Conviction List*

Source: FactSet, Goldman Sachs Global Investment Research.

COVERAGE VIEW: NEUTRAL

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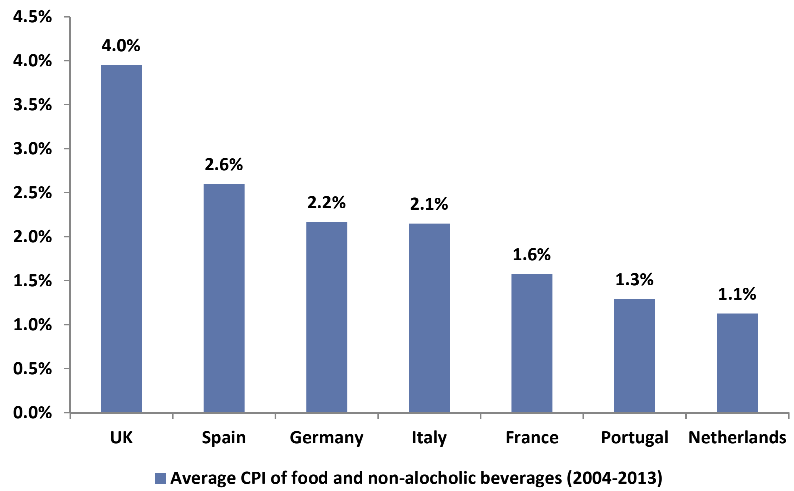
Prices in this report are as of the close on November 14, 2014, unless otherwise noted.

All ROIC calculations in this report are lease adjusted unless otherwise stated

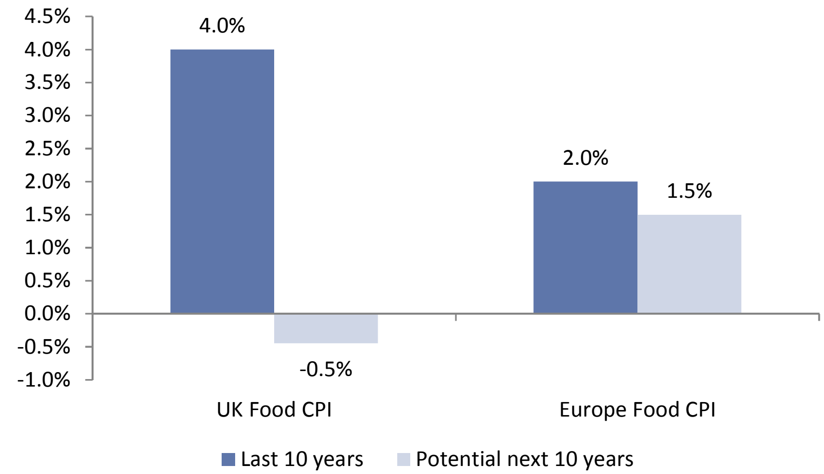
Thesis in charts

Exhibit 1: UK grocers have passed on food inflation well ahead of European peers…
Food CPI, 2004-13



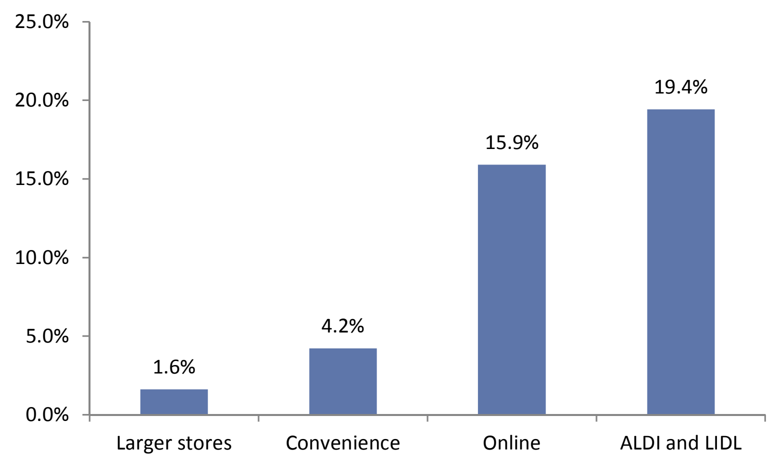
Source: Datastream.

Exhibit 2: …and they would have to put through price deflation of 0.5% pa to 2025 to give it all back
UK implied food CPI over the next 10 years to match Europe over a 20 year period



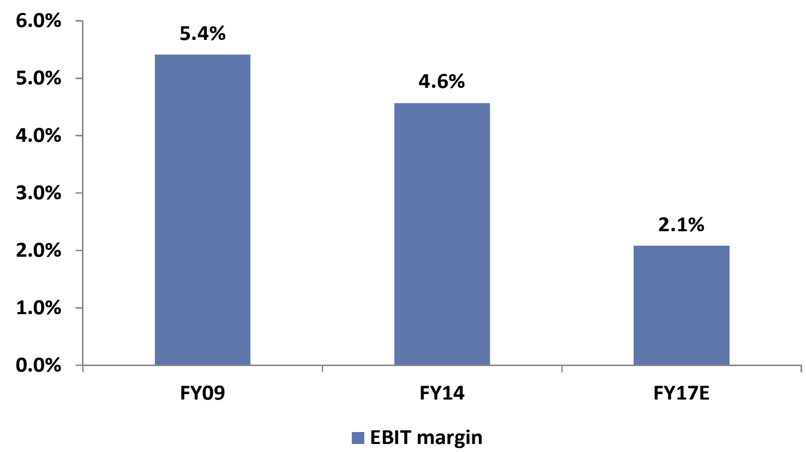
Source: Goldman Sachs Global Investment Research.

Exhibit 3: High prices and behavioural shifts have driven growth of alternate channels…
Sales CAGR by channel (2009-13)



Source: Mintel.

Exhibit 4: …which has driven down profitability for the listed 3
Combined EBIT margin Morrisons, Sainsbury, Tesco UK



Source: Company data, Goldman Sachs Global Investment Research.

Exhibit 5: We forecast that larger stores will see sales fall of c.3% pa to 2020E
Estimated sales growth by channel (CAGR 2013-20E)

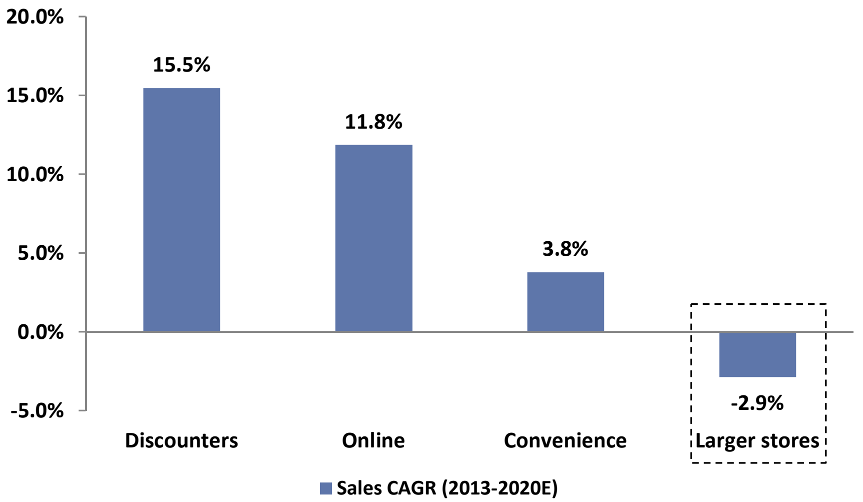


Exhibit 6: Listed 3 UK grocers' returns now well below Aldi UK's
Lease adjusted ROIC of Aldi UK vs. listed 3 (Morrisons, Sainsbury, Tesco UK)

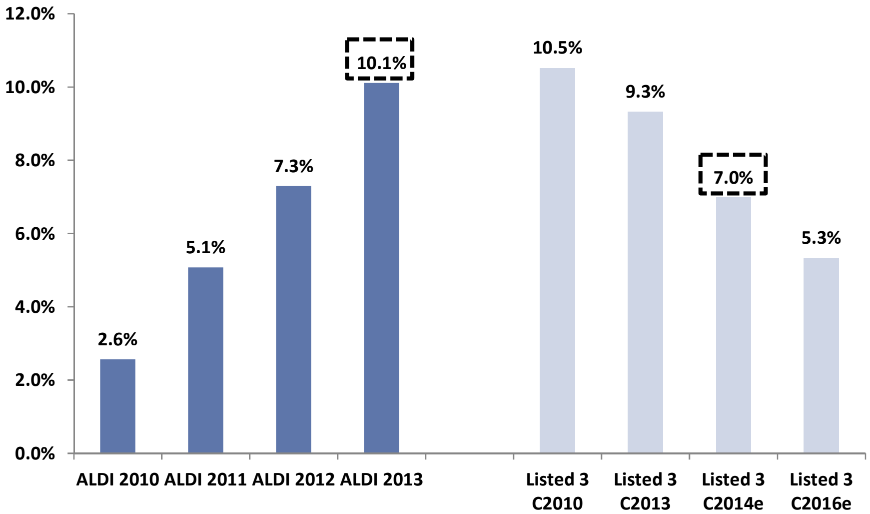
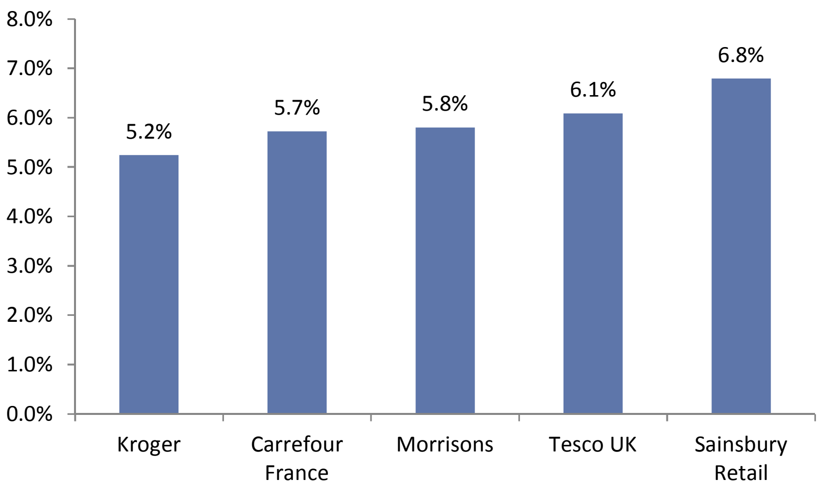
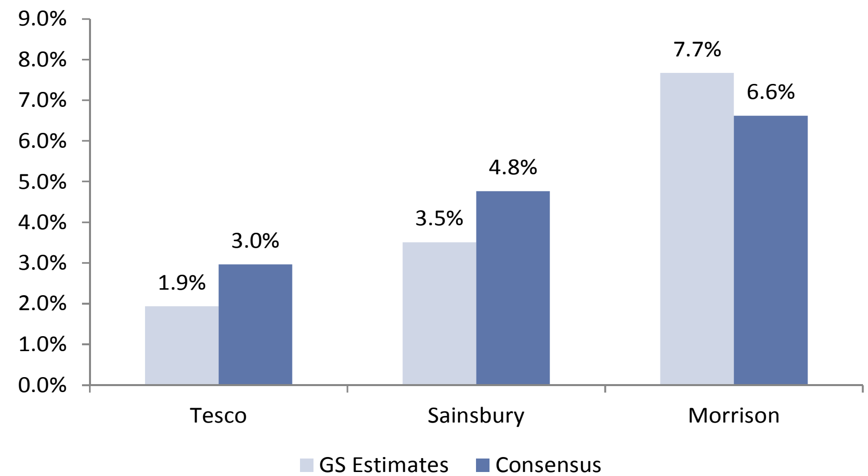


Exhibit 7: International large store peers are making similar EBITDAR margins to those we forecast for the UK grocers
Average forecast EBITDAR margin (forward 3 years)



Source: Goldman Sachs Global Investment Research.

Exhibit 8: Dividend yields on consensus dividend estimates show a large valuation disconnect among the grocers, even greater on GS estimates
Yield on average dividend (FY15-17E); Bloomberg consensus



Source: Bloomberg, Goldman Sachs Global Investment Research.

No easy solutions; capacity needs to exit; price war unlikely; Buy MRW; CL-Sell SBRY

We believe the major decisions that will shape the future of the UK grocery market are yet to be taken. More cost efficient and lower capital models are now setting the price agenda and the industry gross profit pool is contracting and being shared amongst a broader competitor set. This means that in order to generate sustainable high single digit returns on invested capital, the incumbents need to cut their costs and/or invested capital base. While we forecast cost-cutting programmes for all three of the listed players, we still believe invested capital needs to be cut by c.20%. Our space analysis suggests a similar reduction is required.

We have been bearish on the operating trajectory of the major listed UK grocers for the past year (see our November 13, 2013 note, *Disruption from discounters and online to persist in UK grocery; we remain cautious*) and on their balance sheets for even longer (see our January 18, 2013 note on Sainsbury, *Cashflow and balance sheet risks as momentum slows, onto CL Sell*). However, since then the sector has suffered more dramatically than expected with discounter growth rates remaining >20%, two CEO departures, two chairman changes, several profit warnings, the first price matching campaign vs. discounters, serious questions raised about the value of supermarket properties, and most recently concerns over input cost deflation. Since November 2013, Tesco's share price is down 47%; Sainsbury's -35% and Morrisons' -38%. Despite this, our **new target prices imply a further 19% and 42% downside at Tesco and Sainsbury** and 17% upside for Morrisons.

UK grocers have been excellent retailers – but an over-focus on profitability has allowed discounters to get too strong
The UK grocers have been excellent retailers, in our view. They pioneered innovative, high quality private label, developed capabilities to offer high quality service across multiple formats, including home delivery, and cultivated a favourable market structure. However, alongside training their customers to trust private label and teaching them that convenience stores can offer a service almost comparable to larger supermarkets, we think over confidence in the market structure and their own retail models has caused them to increase prices and over-spend on store assets. This in turn catalysed and compounded the structural shifts towards cheaper discounters, as well as more accessible online and convenience channels.

Which means capacity exit is the best solution to protect returns and makes price wars less likely…
Aldis UK's ROIC has increased from 2.6% in 2010 to 10.1% in 2013. By the end of CY14E we believe the listed UK grocers will have seen their ROIC fall from 10.5% in 2010 to just 7.0%. Kantar data shows that Aldi and Lidl have been investing in price ahead of the grocers across 2014 and we believe that these relative ROIC levels mean they can afford to continue to do so. This suggests that any price initiatives will be matched or exceeded by the discounters and is why we believe a broader price war is unlikely. We therefore think the only way to protect returns is to cut invested capital. By exiting underperforming stores, we believe the UK grocers would improve their returns through cutting the asset base while also improving profitability. We believe they need to cut invested capital c.20% to return to the c.9% lease adjusted ROIC they earned in calendar 2013.

… but "alternative use" property valuations do not make this attractive and consolidation is unlikely in the short term
On our estimates, assessing property value based on alternative uses, letting or selling for residential development, indicates a UK property value support level which is still 35%-70% below current market capitalisation. This suggests that any significant capacity exit would not be appealing to the retailers in the short term. And while consolidation at attractive valuations would allow a combined entity to reallocate use of their underperforming stores in a capital effective manner, our assessment of regulatory obstacles concludes that though this is more likely to be allowed than in the past, it is unlikely to provide a short-term solution.

We still remain very bearish on the space, maintaining CL-Sell on Sainsbury and Tesco at Sell. We see deep value potential in Morrisons and upgrade to Buy

Sainsbury, maintain CL-Sell, 42% potential downside – Sainsbury came into this year with the lowest EBIT margins and highest lease-adjusted leverage of the listed 3 UK grocers. This means they have the least strategic flexibility. Further, the last quarter showed a rapid downturn in trading momentum. At last week's strategic update, there were some targeted price investments announced, but largely Sainsbury's strategy will remain the same. As Aldi and Lidl gain increasing traction with the middle classes, and their higher ROICs allow them to continue to lead on price, we believe Sainsbury will struggle to reverse negative sales growth and thus negative leverage. Reflecting the full impact of negative leverage in our forecasts, we are 24%/36% below Bloomberg consensus FY16/17 EBIT estimates and believe dividends will continue to fall beyond FY15E. We remain Sell rated and the shares are on our Conviction List. Our 12-month price target is 155p, implying 42% downside.

Tesco, maintain Sell, 19% potential downside – 56% of Tesco's UK stores are >40k sq ft. We believe structural shifts away from large stores means over-spacing and not price is its biggest problem. We do not expect the company to initiate a price war, but, in the absence of any large-scale grocery space reduction, think negative leverage will continue to drive UK operating profitability down. Our SOTP continues to show downside and we remain Sell rated with a 12- month price target of 155p.

Morrisons, upgrade to Buy, 19% potential upside – Morrisons has the smallest sized supermarkets of the listed 3 grocers and has taken the most aggressive steps to address share losses, matched with the most ambitious programme of cost cuts and asset sales. Its smaller-sized store base means we think MRW is right to focus on price over store space reduction, though it is still unclear whether this will drive sustainable volume improvements. We model the largest price investments and the deepest volume declines at Morrisons, but with cost savings and asset disposals we still believe it will remain the least levered (lease-adjusted) grocer, with the most visibility on cash generation. Despite this, MRW trades on an average 6.6% dividend yield over the next 3 years (Bloomberg consensus) vs. Sainbury on 4.8% and Tesco on 3.0%. It trades on a 7.7% average dividend yield on GS estimates.

We see a deep value opportunity here and as a result upgrade to Buy from Sell on a relative basis with a 12-month price target of 207p. However, we acknowledge there are risks around mis-execution of cost cutting and large-scale price aggression from Tesco.

Risks

The key upside risks to estimates for each of the grocers are: a return of food price inflation that Aldi and Lidl pass through to consumers; if behavioural shifts away from larger stores and weekly shops prove to be cyclical rather than structural, resulting in a return to volume growth through large stores; capacity exit by another major competitor and; any mis-steps or reputation damaging events for Aldi and Lidl.

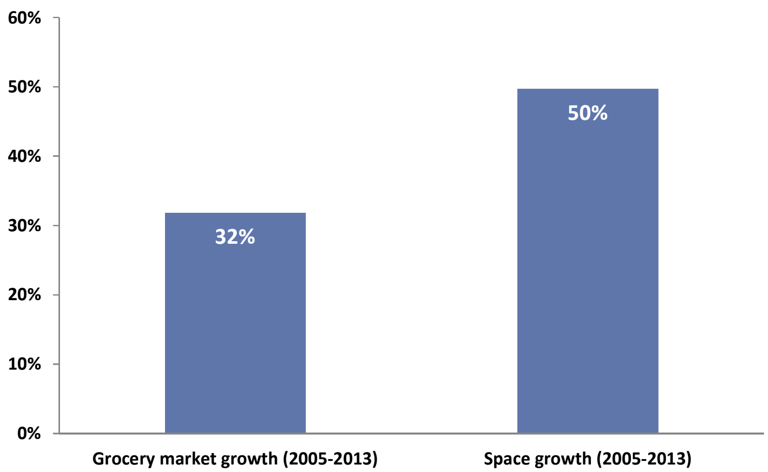
For Tesco, a key upside risk is the monetisation of assets at higher valuations than that assumed in our SOTP.

For Morrisons, the key downside risks are: major price investments announced by a competitor and mis-execution/under delivery of their cost cutting programme.

How a good market goes bad: Over-pricing; over-spacing; over-earning

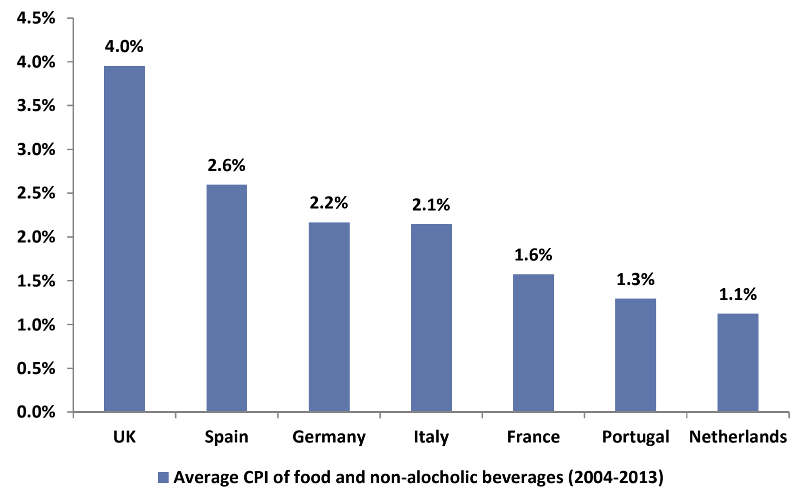
Too much grocery space was added to drive growth in the face of channel shifts, and prices were increased to protect margins. How the UK grocery market arrived at the current situation, with sales and margins falling for the listed incumbents, has been discussed at length and not a point we intend to labour. We believe it is simply due to the pursuit of short-term profit growth in the face of deep structural shifts, underpinned by overconfidence in a previously successful business model and ostensibly favourable market structure. Basically, too much supermarket floor space was added, prices were increased and services cut to support profit margins as sales densities fell. Alongside behavioural shifts to convenience and online channels, this also widened the value gap vs. Aldi and Lidl, which had been improving their own ranges and offer, catalyzing customer shifts to the discount channel. The full implications of this are discussed below, but in a low growth environment, the net impact of these shifts in customer habits is negative sales growth in large stores. These stores essentially have a fixed cost base (we estimate roughly 80%-85% of opex is fixed) rising with inflation, so negative sales growth drives negative leverage and the profit margin contraction we continue to see for the industry's listed players. What is equally interesting, and concerning for the listed 3, is that the Aldi and Lidl have only increased their market share from c.4% to 8% over the last 4 years. Adding the observation that Aldi and Lidl appear to have captured the middle classes in the UK, this suggests the level of disruption is unlikely to abate in the foreseeable future and that the impact of this disruption will continue to be deeply negative.

Exhibit 9: "listed 3" have expanded capacity beyond grocery market growth…
UK grocery market, 2005-13



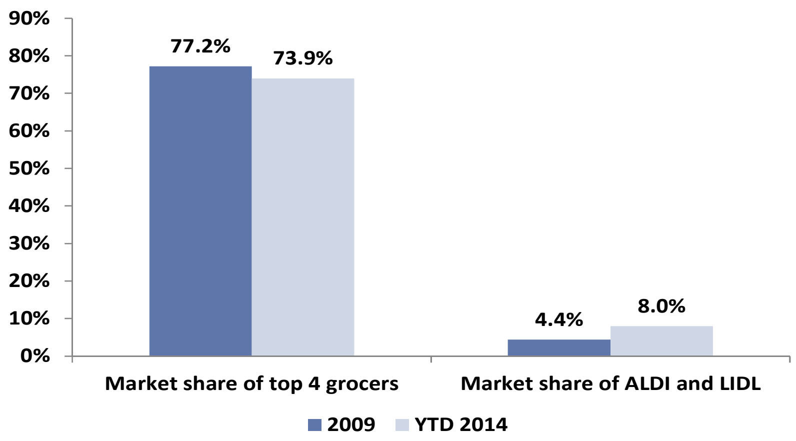
Source: Mintel, Company data.

Exhibit 10: … while increasing prices well ahead of the rest of Europe …
Average CPI (Consumer Price Index) in key European countries; 2004-13



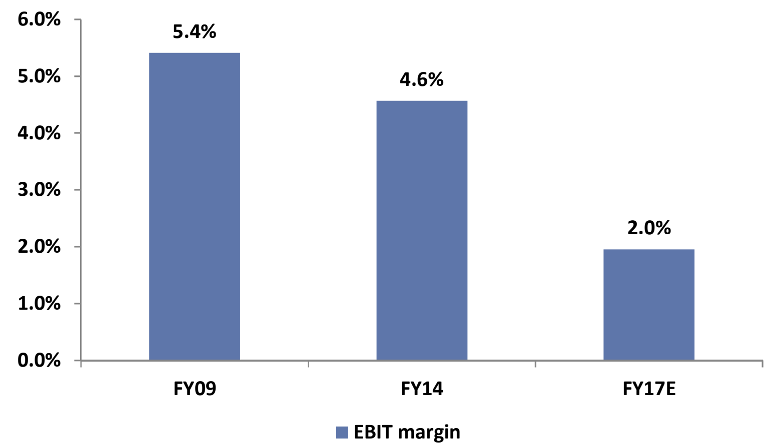
Source: Company data, Datastream.

Exhibit 11: …… which resulted in market share gains for Aldi and Lidl …
UK grocery market share



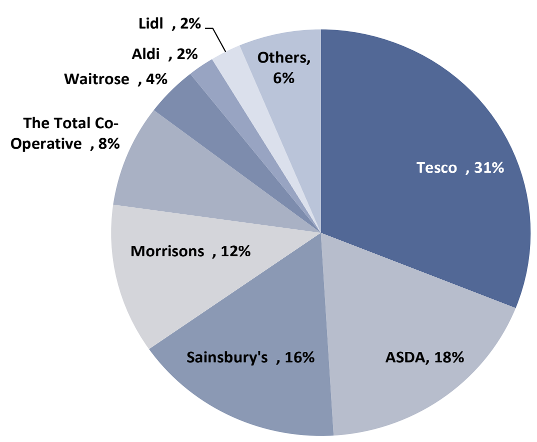
Source: Kantar.

Exhibit 12: … and has caused operating margins to aggressively rebase
Combined EBIT margins - Morrisons, Sainsbury, Tesco UK



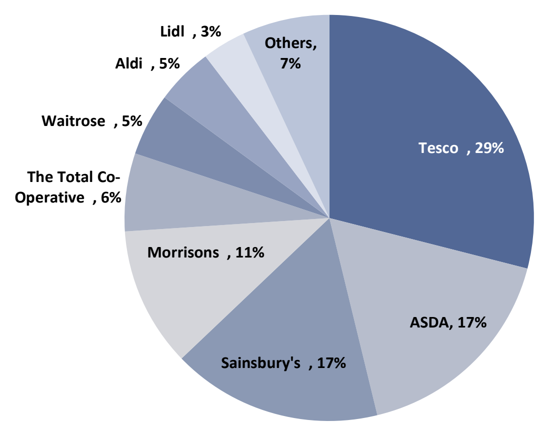
Source: Company data, Goldman Sachs Global Investment Research.

Exhibit 13: Though we note the overall market structure from 2009 …
UK grocery market share 2009



Source: Kantar.

Exhibit 14: … has not changed dramatically
UK grocery market share 52 weeks to October 2014



Source: Kantar.

Large stores expected to see -3% LFL to 2020 if nothing is done about space

If the market continues to develop in the manner we have seen over the last 3 years we think that sales through larger stores (any channel that is not convenience, discount or online) will fall by around 3% per year out to 2020, or around 18% in total. With a predominantly fixed cost base, this will continue to drive negative leverage through the P&Ls of the listed 3 grocers, who, alongside Asda, operate the largest stores in the UK. Over 50% of both Tesco UK and Sainsbury's stores are over 40,000 sqft (Exhibit 17). Our assumptions underlying this are summarised in Exhibit 15, but the main ones are that channel shifts are more structural than cyclical and the market structure is now such that food inflation will not get near its recent 4% pa average. Looking even longer term, we ask the question, "why would today's 15-year olds ever go to a hypermarket?" - simply suggesting that the shift away from large stores is likely to accelerate rather than reverse as Millenials become core grocery shoppers.

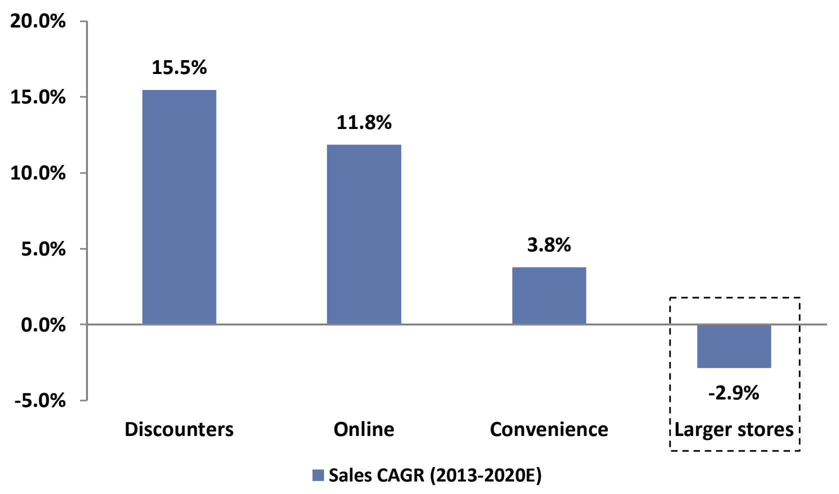
Note we assume that each of the grocers stop opening stores outside of the convenience channel. Meaning the -3% we forecast is all LFL. If grocers return to opening larger stores, this would drive a lower LFL number.

Exhibit 15: Summary of our assumptions that underpin our assessment that large stores will see a -c.3% growth CAGR to 2020

Broader themes impacting the UK Grocery sector	Factors driving trends	Last 3 year trend	GS annual assumption to 2020
Convenience format	- Major grocers have increased the reach and quality of the offer in this channel - Demographic shift to smaller households and older population	Added £1.7bn sales annually (4.8% CAGR)	Add c£1.6bn pa (3.8% CAGR)
Discount format	- Price advantage with quality - Evolution of offer and marketing message to reach and retain the middle classes - Big 4 have trained UK customers to trust private labels	Added £1.3bn sales annually (23.4% CAGR)	Discounters to add £2.1bn pa (15.5% CAGR); 2014e growth £2.1bn
Online	- Structural shift to online shopping continues - Superior customer experience and presence of a cost effective player like Ocado accelerates the channel	Added £0.7bn sales annually (15.5% CAGR)	Online to add £1.1bn pa (11.8% CAGR)
Food and cost inflation	- Food inflation has remained soft in recent quarters, driven by external deflationary pressures and price cuts enforced by share losses to discounters	c4%	Underlying food and cost inflation of 1% pa
Population growth	- Long run trend of c. 0.5% per annum	c0.7% growth	0.8% pa to 2020
Why would today's 15 year olds ever go to a hypermarket?	***Generations that have grown up with a search bar, the expanded range of online and convenience of home delivery will find the idea of getting an Uber to a 100,000 sqft shop, to search for goods themselves, from a range that is smaller than online as strange, in our opinion.***		

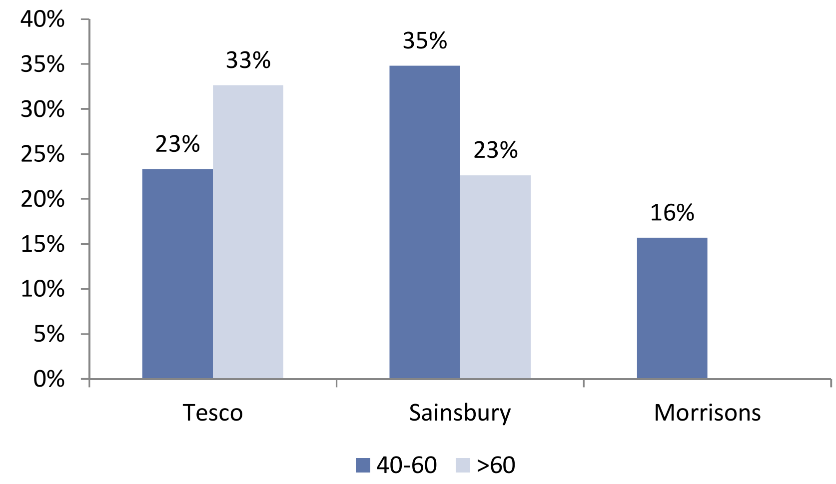
Source: Mintel, ONS, Goldman Sachs Global Investment Research.

Exhibit 16: We estimate the large stores sales CAGR will be -c.3% to 2020…
Channel CAGR (2013-20E)



Source: Mintel, Goldman Sachs Global Investment Research.

Exhibit 17: …and over 50% of Tesco UK and SBRY's space is in stores >40k sqft
% of UK supermarket space in stores of above quoted sqft



Source: Mintel, Goldman Sachs Global Investment Research.

Though the conclusions in Exhibit 16 are stark we do not think the assumptions driving them are overly ambitious. The assumed CAGR of Discounters (15.5% vs. 23.4%), online (11.8% vs. 15.5%) and convenience stores (3.8% vs. 4.8%) is below the last 3-year average, reflecting a continuation of the annual sales growth in £bn we have seen more recently, rather than an extrapolated growth rate.

The converse of all this, is what do you have to assume for the large stores not to lose sales? **For large stores to achieve just 0% growth at the expense of discounters, we estimate the discounters would have to stop growing post 2014 and actually lose market share. We do not believe this is a likely scenario.**

Returns analysis is integral to assessing possible solutions…

In our opinion, the key to finding a solution is looking at the return on invested capital (ROIC) earned by the incumbent grocers, the disrupted, vs. that of the disruptors. We focus on ROIC because we believe this industry has focused too much on profits and not on improving cash returns. Which is why prices were taken too high, and too many stores added. The price increases to protect the numerator in the ROIC calculation (profit) have allowed the discounters to grow, and the heavy capital spent in expanding the invested capital in the denominator (stores) reduces the flexibility to deal with them (Exhibit 18).

In 2010, the average ROIC of Tesco UK, Morrisons, and Sainsbury was 10.5%. With little momentum and limited LFL growth through their P&L's Aldi made an EBIT margin of c.1% and a ROIC of just 2.6%. Three years of discounter disruption later, the average listed 3 ROIC was 9.3% vs. Aldi at 10.1%. By the end of CY14, we believe the Listed 3's UK lease adj. ROIC will be 7%.

As we discuss later, these relative movements in ROIC suggest that price investments by the listed 3 are unlikely to drive sustainable LFL growth as the discounters have the financial capacity to more than match them. Hence we conclude that to improve economic returns the listed grocers must focus on reducing invested capital.

Exhibit 18: ROIC equation
Return on invested capital

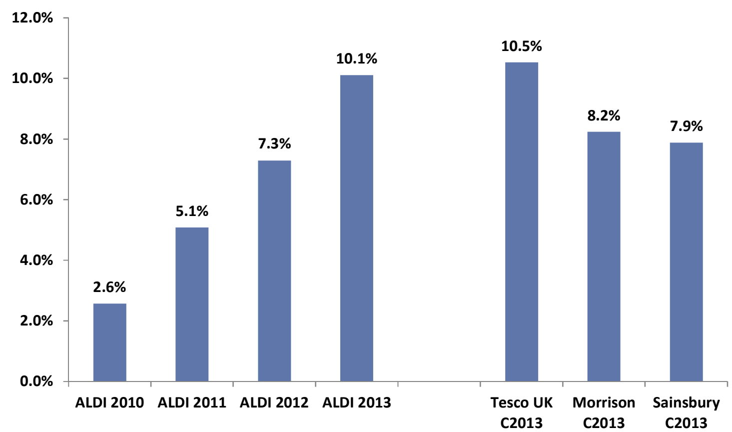
$$\textit{Return on Invested Capital (ROIC)} = \frac{\textit{Net Operating Profit After Tax (NOPAT)}}{\textit{Invested Capital}}$$

$$\sim \frac{\textit{Profit}}{\textit{Stores + Working Capital}}$$

$$\textit{Lease adjusted ROIC} = \frac{\textit{EBITR * (1- tax rate)}}{\textit{Invested Capital + Capitalized leases}}$$

Source: Goldman Sachs Global Investment Research.

Exhibit 19: ALDI's ROIC now exceeds that of the listed grocers, with room for further improvement
Lease adjusted ROIC of Aldi UK vs. listed 3 (Morrisons, Sainsbury, Tesco UK)



Source: Companies House, Company data.

…and returns analysis suggest to us that a price war initiated by the listed 3 is not the answer…

The returns of the discounters are now too high for the listed grocers to beat them on price. Returns analysis suggest to us that heavy price investment by the industry is unlikely to provide the answer to addressing share losses to the discounters as they have the financial capacity to more than match the listed players on price. In fact, Kantar volume/value data demonstrates that in 2014, falling prices at the listed 3 grocers has been met with even larger price cuts at the discounters, which has driven their volume growth. And importantly, price investments from the listed 3 are yet to arrest discounter or online growth. This is important because our analysis suggests that a true price investment by the listed 3 of 100 bp would require a c.400 bp volume response to be margin neutral. So, a grocer needs to be confident that price investments will drive volume gains. Or confident enough that they have cost cutting plans and balance sheet initiatives sufficient to protect the business if a price action results in a price war.

As shown in Exhibit 20, we believe that:

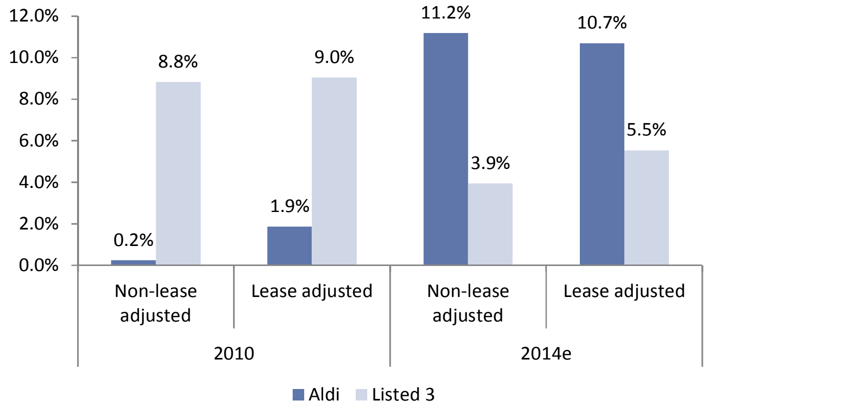
1) **3 years ago, stopping Aldi would have been much easier** as the major players earned returns twice that of Aldi, which was making a very low c.3% lease adj. ROIC. At that point the pressure needed to be applied to Aldi's operating model to keep returns at a level that would have made marginal investment unattractive was much lower than it is now (see Exhibit 20).

2) **Aldi can operate at very low returns –** Until 2013, its lease-adjusted returns had not reached 8%. So the listed 3 have to assume that if they continue to see a long-term market opportunity, as a private company, Aldi can operate at returns levels the stock market may not find acceptable for the listed 3.

As illustrated in Exhibits 19 & 20, we believe Aldi's ability to cut prices is now significantly ahead of the listed 3. Having given the discounters the initiative and allowing the behavioural shift to become structural, the Big 4 UK grocers are no longer in a position to stop discounter growth through price. As the discounters continue to drive this cycle they will likely compound their ability to offer lower prices as the listed 3 see their opportunity weaken.

We believe we are already seeing this in the recent Kantar data, which shows price cuts at the listed 3 players being magnified by Aldi and Lidl (Exhibits 22 and 23).

Exhibit 20: In 2010, a 1% price investment by Aldi would have taken ROIC to 0%, in 2014E, this investment would take ROIC to a still attractive 11%
Implied ROIC post 1% EBIT margin cut (Listed 3 is in addition to forecasts)



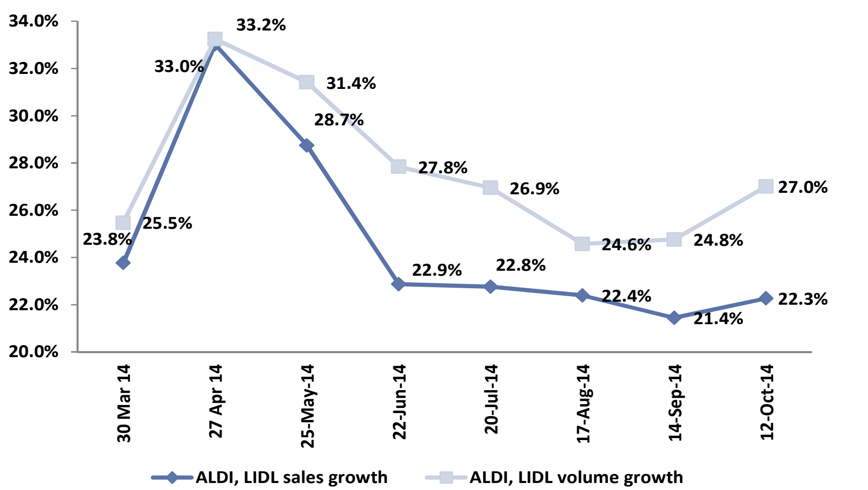
Source: Company data, Goldman Sachs Global Investment Research.

Exhibit 21: While any price investment requires a significant volume uptick
Estimated £mn impact on EBIT of a 1% LFL decline driven by....

	Impact at EBIT		
	Morrisons	Sainsbury	Tesco UK
1% price/service investment	150	200	350
1% deflation	40	50	100
1% volume decline	35	40	90
Volume uplift to recover 1% price investment (multiple of price investment)	4	5	4

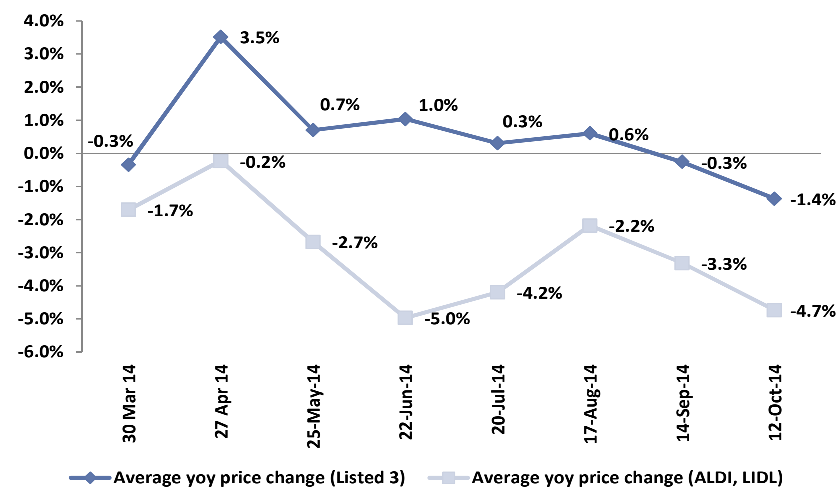
Source: Company data, Goldman Sachs Global Investment Research.

Exhibit 22: ALDI and LIDL have maintained >20% combined sales growth, driven by volume
Year-over-year volume and sales growth



Source: Kantar.

Exhibit 23: Which they have achieved through cutting prices more aggressively than their listed competitors
Year-over-year price change; 4-week grocery data



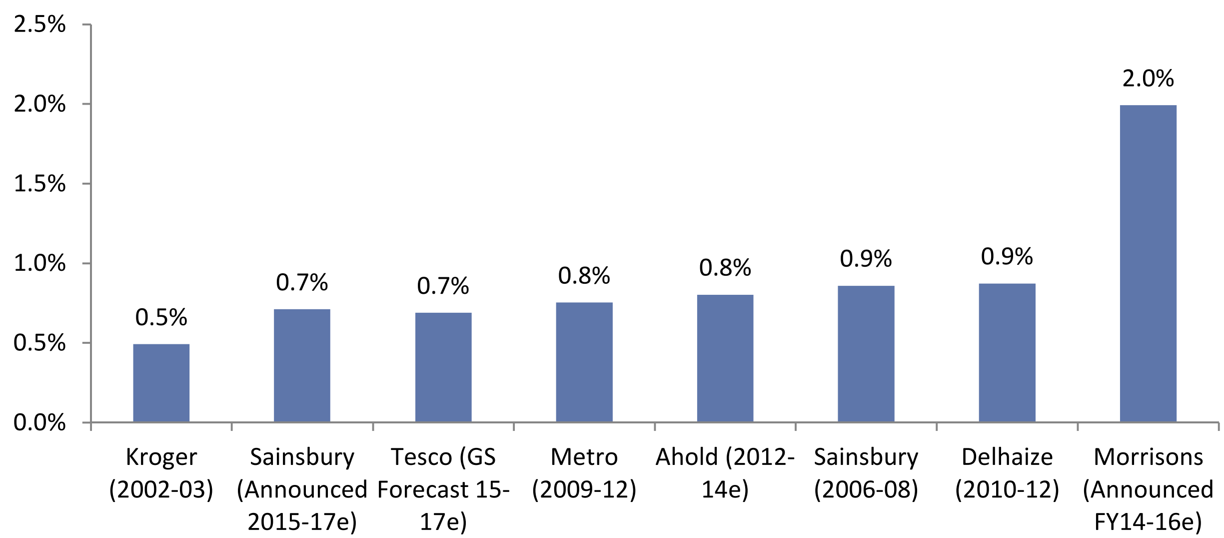
Source: Kantar.

…cost cuts should provide some short-term relief…

We forecast cost cuts, but these are not enough to offset the pressures from negative leverage. The first step for any company facing profitability pressure is normally to look at costs. Morrisons announced a major cost cutting plan which took a year to formulate and will take place over 3 years for a total of £1 bn in savings. Sainsbury announced a £500 mn cost cutting plan over the next 3 years. Tesco has intimated that cost cutting will be a major focus.

Looking across grocers who have announced major cost cutting plans since 2002, Morrisons' announced cuts are more ambitious than any major grocery plan we have identified (Exhibit 24). While Morrisons cuts are equivalent to c.2% of sales per year, the standard amongst peers has been c.0.5%-1%. At c.0.7% of sales per year, Sainsbury's announced cuts fit within this level and is in the region it announced with the strategic review. We forecast Tesco will also announce cost savings of around 0.7% of sales annually. However we point out that with operating costs of c.20%-25% of sales, 2% underlying cost inflation means cost savings equivalent of 0.4%-0.5% of sales need to be achieved each year to stand still in a zero LFL environment. Since we forecast LFL of -c.3% for the listed 3, alongside some price/service investment, we conclude these savings will not be enough to offset the margin pressures that Sainsbury and Tesco are facing. If Morrisons achieves its savings goal there is margin upside potential in outer years if it manages to achieve improved volume growth.

Exhibit 24: Morrisons' costs savings plan well above the average c.0.8% of annual sales peers have announced
Equivalent annual cost savings as a percent of sales (i.e. Morrisons £1 bn over 3 years = 1bn/(FY15E sales + FY16E sales + FY17E sales)



Source: Company data, Goldman Sachs Global Investment Research.

…but cutting capacity c.20% is needed to take the industry back to 2013 ROIC

We believe cutting invested capital, or industry capacity, is the only way to sustainably get the industry back to 2013's 9% lease-adjusted ROIC levels. This is 8% on a non-lease adjusted basis. As discussed, we believe that the momentum, returns profile and well-capitalised position of the discounters means that collective price cuts are likely to be met with even more aggressive cuts from the discounters, with little gain for the major incumbents. As illustrated, we do not believe it is possible to cut costs deep enough for the industry to make solid returns again.

Our analysis implies that to protect returns the invested capital base needs to be cut - this means capacity exit given that land and buildings are c.77% of invested capital of the UK grocers. We believe c.20% of existing capacity needs to be exited.

This estimate is based on the margins we expect the grocers to generate in CY14E. Another year of negative LFLs as implied by the analysis above would mean operating margins are likely to fall another 70 bp in 2015 if underperforming invested capital is not taken out of use in order to avoid the negative leverage we forecast. Under this scenario, by the end of 2016, 37% of invested capital would have to be removed to return to a 9% ROIC (Exhibit 26).

In our opinion, this highlights the imperative to take action. Cost cuts are incorporated into our estimates, demonstrating that the underlying problem of structural shifts away from returns dilutive capital will remain despite cost initiatives.

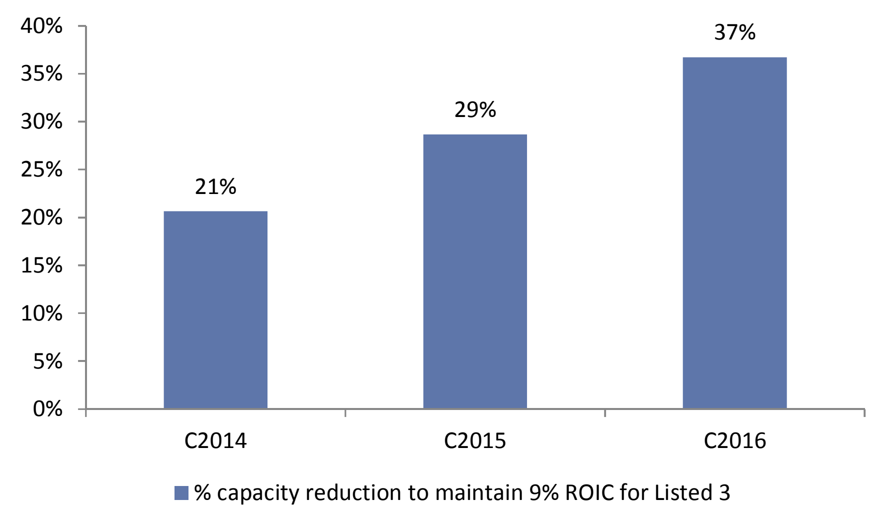
Exhibit 25: To return to 9% ROIC, the big 4 need to cut invested capital by c.20% on CY14E operating margins…
Invested capital reduction required to generate lease adjusted ROIC at given EBITR level

Estimated EBITR margin 2014e listed 3---->

		EBITR margin					
		3.4%	3.9%	4.4%	4.9%	5.4%	5.9%
ROIC	6%	-17%	-5%	7%	19%	31%	43%
	7%	-29%	-19%	-8%	2%	12%	23%
	8%	-38%	-29%	-20%	-11%	-2%	7%
	9%	-45%	-37%	-29%	-21%	-13%	-5%
	10%	-50%	-43%	-36%	-29%	-21%	-14%
	11%	-55%	-48%	-42%	-35%	-28%	-22%

Source: Goldman Sachs Investment Global Research

Exhibit 26: …however, if nothing is done in FY14, then negative leverage through underperforming capital means 37% would need to exit by end 2016
Invested capital reduction required under our published forecasts to return to 9% lease adjusted ROIC



Source: Goldman Sachs Investment Global Research

Our base does not forecast capacity exit

Although we believe capacity exit is the long-term solution, the grocers are yet to announce any large scale space reallocation. We therefore do not include this in our published forecasts. What we do include is our best assessment of what the listed 3 grocers will do and how this will impact performance based on what they have said publicly and the constraints which our forecasts place upon them. We summarise these announcements and our high level assessments of them in Exhibit 27. Further in the note we look at scenarios outside of our base case assumptions.

To summarise our forecasts:

Sainsbury and Tesco – We expect margins to continue to fall due to negative leverage and **dividends to be cut further for both companies**. Any asset disposals at Tesco will likely be focused on deleveraging the balance sheet and not provide dividend support. This is despite cutting capex to deprecation for both.

Morrisons – In our view, Morrisons has the most clearly articulated asset disposal and cost savings programme to offset the effects of price investments and negative leverage. **We do not forecast dividend cuts at Morrisons** despite not forecasting a meaningful pick-up in trading conditions, though this is highly dependent on the success of its announced cost cutting programme.

Exhibit 27: Summary of strategic comments and our forecasts based on the outcomes of those strategies

		Trading	Cost cuts	Margins	Capex	Leverage	Dividend	Additional Capital raise
Morrison	Company guidance/strategy	Aggressive investment in price; service later	£1bn (c2% cumulative sales) over 3 years (FY15-17e)	-	Long term cut back to c£400mn; c1.1x depreciation	Deleverage	Grow dividend 5% in FY15; no further guidance	£1bn asset sales through FY15-17e
	GS high level forecasts	Announced strategy to offset some volume declines, LFL not positive until FY17	£900mn (c2% cumulative sales) over 3 years (FY15-17e)	Flat margins, price investments and negative leverage offset by cost cuts	Fall to £400m pa, in with guidance	Debt paydown of £550mn from FY15-17	Dividend growth of 4.3% in FY15; flat thereafter (FY16-FY18)	£1bn asset sales through FY15-17e
Sainsbury	Company guidance/strategy	Quality leader, strong value proposition	£500mn (c0.7% cumulative sales) over 3 years (FY16-18e)		FY15 c£900mn; £500-550mn thereafter	Maintain leverage levels	Dividend cover of 2x; guidance that FY15 likely to be lower than FY14	£50mn of annual divestments
	GS high level forecasts	No material change to existing strategy, through which they are losing share to discounters still	£500mn (c0.7% cumulative sales) over 3 years (FY16-18e)	Continue to fall, cost cuts not sufficient to offset negative leverage.	FY15 c£900mn; £500-550mn thereafter	No debt paydown assuming no sale of portfolio assets	FY15 dividend cut of 26%; FY16 dividend cut of a further 51% (over FY14)	£50mn of annual divestments
Tesco	Company guidance/strategy	Service, availability, price (in order)	Will be a focus, but not quantified	-	FY15 at most £2.1bn; c1.33x depreciation	Protect and strengthen the balance sheet	FY15 interim dividend cut by 75%; no guidance on FY15	"Significant opportunity to extract value from the portfolio"
	GS high level forecasts	Over-space, not under service is the issue in our view. No marked improvement in volumes	c. £800mn over 3 years (FY16-18e, 0.7% of cumulative sales)	Continue to fall, cost cuts not sufficient to offset negative leverage.	Fall to depreciation level, £1.5bn pa long term	No debt paydown assuming no sale of portfolio assets	FY15 yoy cut of 75%	No capital raise assumed given other avenues of cash raise (sale of portfolio assets)

Source: Company data, Goldman Sachs Global Investment Research.

Exhibit 28: Assumptions and output summary in our base-case scenarios

	Morrisons (Jan YE)				Sainsbury (March YE)				Tesco (Feb. YE)			
	FY14	FY15e	FY16e	FY17e	FY14	FY15e	FY16e	FY17e	FY14	FY15e	FY16e	FY17e
UK Like for like sales growth	**-2.8%**	**-6.5%**	**-5.0%**	**-3.0%**	**0.2%**	**-2.5%**	**-2.5%**	**-2.0%**	**-1.4%**	**-4.5%**	**-4.0%**	**-3.5%**
Cumulative cost cuts (£mn)	0	220	520	820	0	0	115	230	0	0	280	550
UK EBIT margin	4.6%	3.0%	3.0%	3.0%	3.6%	3.1%	2.2%	2.0%	5.1%	2.5%	2.0%	1.5%
Group EBITDA	1,202	904	882	865	1,419	1,310	1,099	1,020	4,751	3,471	3,210	2,968
Capex	835	650	400	400	916	966	620	550	2,774	2,065	1,780	1,500
Dividends	303	316	316	316	326	241	160	129	1,189	297	297	297
Total Cash generated	-12	177	241	256	-201	-204	62	131	1,393	-377	132	221
Net debt to EBITDA	1.1x	1.6x	2.3x	2.6x	1.7x	2.0x	2.3x	2.4x	1.5x	2.2x	2.4x	2.5x
Lease adj. net debt to EBITDAR (inc. pension deficit)	2.7x	3.1x	2.7x	2.4x	3.7x	4.1x	4.5x	4.7x	3.6x	4.3x	4.5x	4.7x
Capex / D&A	2.1x	1.7x	1.1x	1.1x	1.7x	1.7x	1.1x	1.0x	1.8x	1.4x	1.2x	1.1x
Dividend as a % of FCF	-90%	43%	42%	47%	367%	197%	53%	45%	82%	66%	69%	57%
CROCI	6.5%	7.2%	6.7%	6.6%	8.0%	7.4%	6.6%	6.1%	10.3%	7.5%	7.0%	6.5%

Source: Company data, Goldman Sachs Global Investment Research

Key points to note from the above table:

Morrisons – Negative LFL driven by price investments. We assume a stronger volume recovery than at Sainsbury and Tesco. Operating margin stability due to cost cuts.

Sainsbury – no material change in strategy, so no material change in sales trajectory. LFL growth is driven by volume declines and margin contraction is largely due to negative leverage. Dividend halved to try to restrain lease adjusted leverage.

Tesco – focus on service does not address core issues. LFL continues to be driven by volume declines and margin contraction is largely due to negative leverage. We forecast FY dividend will have to be cut by 75% to sustainably keep lease adjusted leverage below 5x.

Valuation – SOTP and near-term cash flows the only option

We do not have clarity on how the long-term cash flows in the UK grocery industry will be distributed. We therefore value the stocks on the higher value of SOTP and the discounted value of next 3 years' free cash flow with a year 4 terminal value at an 8% WACC and -2% terminal growth. We also assess property value, but conclude this is not supportive at current share prices (Exhibits 33 and 34).

Our long-term analysis suggests terminal sales contraction for the listed 3 grocers and resulting profitability falls unless there is capacity exit from the industry. We therefore think it is highly likely that in the long term the industry structure will look materially different to today. We assess some of these potential changes in the scenario analysis below, but think they are more likely to be medium-term events. Hence our focus on near-term cash flows and SOTP break-up value.

We summarise our valuation methodologies below:

Morrisons – 3-year DCF with year 4 terminal growth of -2%. New 12-month target price is 207p, from 172p, implying 17% upside potential. We upgrade to Buy from Sell.

Sainsbury – 3-year DCF with year 4 terminal growth of -2%.. 12-month target price remains 155p implying. 42% potential downside. Reiterate Sell rating. Stock remains on the Conviction List.

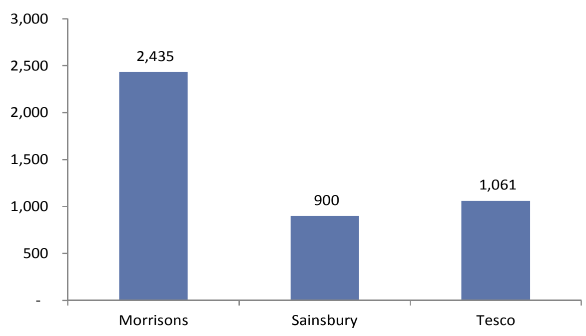
Tesco - SOTP (see Exhibit 32 for full analysis). New 12-month target price is 155p from 250p, implying 19% downside.

Exhibit 29: Implied multiples on current price and target price

		EV/EBITDA			P/E			Dividend Yield		
		FY15	FY16	FY17	FY15	FY16	FY17	FY15	FY16	FY17
Tesco	Target price	6.6x	7.1x	7.6x	8.6x	9.9x	11.6x	2.4%	2.4%	2.4%
	Current price	7.6x	8.1x	8.7x	10.8x	12.5x	14.7x	1.9%	1.9%	1.9%
Sainsbury's	Target price	4.8x	5.7x	6.0x	6.1x	9.2x	11.4x	8.2%	5.4%	4.4%
	Current price	6.5x	7.7x	8.1x	10.6x	16.0x	19.8x	4.7%	3.1%	2.5%
Morrisons	Target price	6.3x	6.5x	6.6x	15.0x	14.8x	14.4x	6.5%	6.5%	6.5%
	Current price	5.6x	5.7x	5.8x	13.0x	12.8x	12.5x	7.6%	7.6%	7.6%

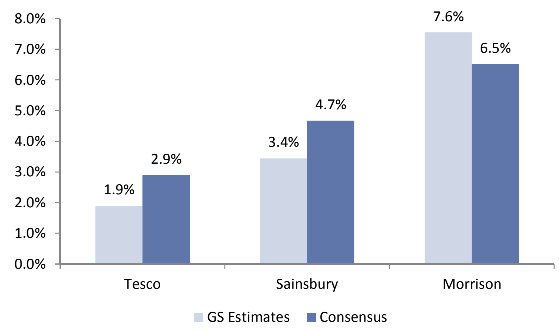
Source: Goldman Sachs Global Investment Research.

Exhibit 30: Despite announcing the largest cash preservation programme…
Sum of announced cost savings, capex cuts, asset disposals and divi cuts (£mn)



Source: Company data.

Exhibit 31: …Morrisons trades on a materially higher dividend yield
Dividend yield, current price on next 3 years average dividend



Source: Bloomberg, Goldman Sachs Global Investment Research.

Exhibit 32: Tesco SOTP gives us a 12-month price target of 155p

Europe				
Country	FY14 sales	Target multiple (EV/Sales)	Target Value (£ mn)	Peers
Ireland	2,279	0.3x	775	Average mature market transaction multiple
Poland	2,259	0.4x	832	Jeronimo Martins, Eurocash
Hungary	1,597	0.3x	543	Average mature market transaction multiple
Czech	1,298	0.3x	441	Average mature market transaction multiple
Slovakia	1,134	0.3x	386	Average mature market transaction multiple
Turkey	679	0.7x	479	Migros
Europe	9,246	0.37x	3,455	
Asia				
Country	FY14 sales	Target multiple (EV/Sales)	Target Value (£ mn)	Peers
Thailand	3,836	1.2x	4,603	Big C Carrefour Acquisition; Cencosud Carrefour
Korea	5,474	0.7x	3,928	E-Mart
Malaysia	931	0.6x	559	Aeon; Carrefour Malaysia sold to Aeon for 0.6x
India	68	0.3x	20	
Asia	10,309	0.88x	9,110	
United Kingdom (ex-Stores)				
Business Unit	FY14 net income/EBITDA	Target multiple (P/E)/ (EV/EBITDA)	Target Value (£ mn)	Peers
Tesco Bank	83	11.1x	918	Lloyds bank; HSBC; RBS
Dunhumby	53	21.1x	1,114	Average of Business Analytics companies
Dobbies*	6	7.5x	104	Kingfisher
UK ex food retail			2,135	
Enterprise value of ex-UK Retail businesses (£mn)			**14,701**	
Enterprise value of ex-UK Retail businesses (p)			**183**	

** EBITDA numbers and EV/EBITDA multiple*

	Per share (p)	£ mn
SOTP derived EV of ex-UK Retail businesses	183	14,701
+		
100% weighted UK Stores valued at 6x FY17E EV/EBITDA	91	7,345
=		
EV per share of Tesco Group	**274**	22,046
+		
Associates	7	566
−		
Net Debt	87	6,984
−		
Pension Deficit	40	3,193
=		
EV of ex-UK food retail	**155**	**12,435**

Source: Bloomberg, Company data, Goldman Sachs Global Investment Research.

What is the true support from UK property? Less than current share prices

We estimate that the true downside protection from grocers' UK property assets is still less than current share prices. As we have said, we believe space needs to fall by c.21% by 2020 to maintain the current margin structure. However, we think that simply selling this property at the values stated in the annual reports will be difficult as:

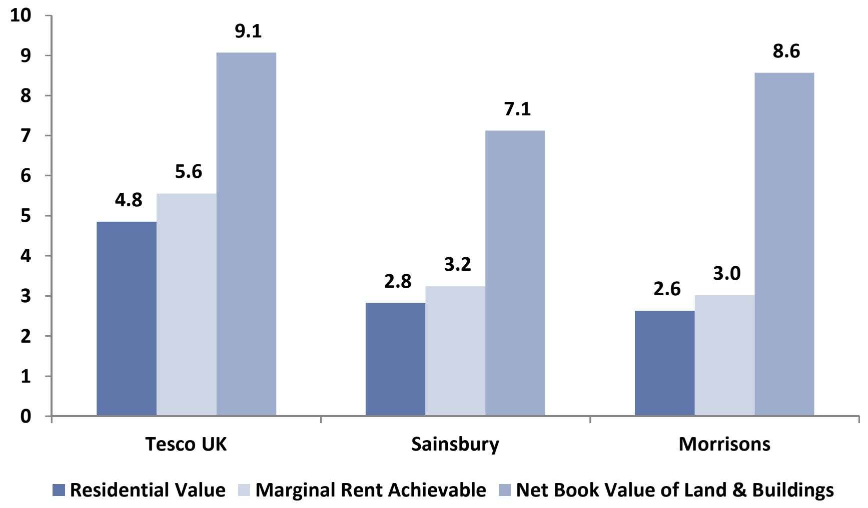
- At the profitability levels we forecast, the rent grocers can afford to pay as part of a sale and leaseback transaction is much lower now. And at a group level, the P&L's will struggle to take much more rental expense.
- Strategically, we believe entering 25 year leases when flexibility is most important makes large scale incremental sale and leasebacks unlikely.
- We do not see any buyers for large areas of retail space, but there are multiple potential sellers..
- The retailers who are taking on space are paying materially lower rents than those entered into by the grocers through sale and leaseback agreements. B&M's average rent per sqft is £12 vs. grocers at c.£50/sqft implied through their rental expenses.

With this in mind, we assess the property value of the grocers' real estate portfolios if:

- They were valued on the marginal rents paid of £12/sqft at a 5% yield.
- If they were to be sold as residential land. We assume residential land value of £36/sqft (based on peak ex-London residential development land values in 2007), with a total site area of c.6x quoted selling space based on data included in Tesco CMBS prospectuses.

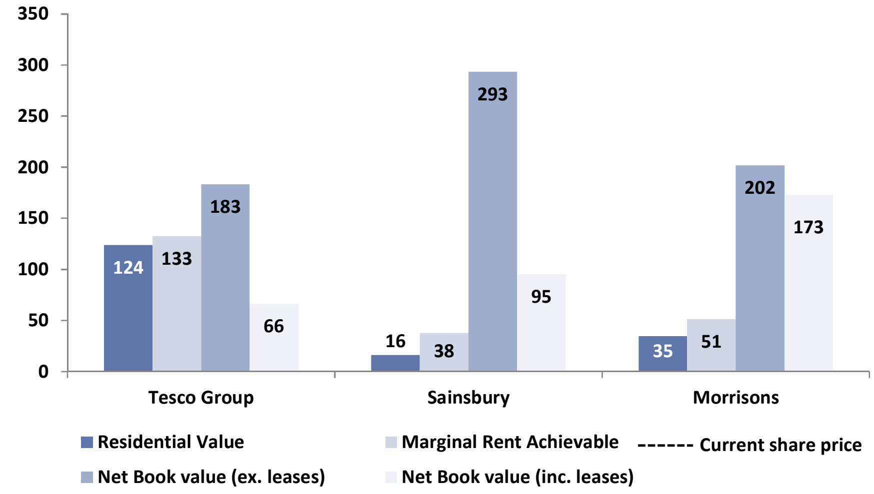
We also show the net book values of land and buildings for context in Exhibit 33, while Exhibit 34 shows the group net book value.

Exhibit 33: Valuing owned real estate as alternative uses suggests a significant discount to net book value of land and buildings
Estimated UK property value (£bn)



Source: Valuation Office Agency, Goldman Sachs Global Investment Research.

Exhibit 34: Valuing UK on its alternative use property valuation and adding back remaining assets/liabilities does not imply upside to current share prices
Equity value per share (p)



Source: Valuation Office Agency, Goldman Sachs Global Investment Research.

What we present above is what we believe is a more realistic way of thinking about the market value of the grocers' property portfolios, and the residential usage puts a floor valuation on this. Clearly, the situation where the entire portfolio of stores needs to be liquidated/have usage reallocated is unlikely, and the ultimate solution could take a number of forms, and will be taking place continuously over many years. Regardless of how it is analysed, our view remains that sales are moving online and towards more convenient (or well invested in the case of non-food retail) locations which means we need less of the existing traditional retail space.

We originally presented our view on this in January 22, 2014 industry note (see *No margin of safety from UK grocery asset values; balance sheets need to delever*), where we used an average rent paid by high street operators as an alternative valuation floor. However, outside of Next, which is looking to develop its own sites and be the anchor tenant in developments, we cannot identify a high street player that is adding meaningful out of town space. Some retailers could be interested in sub-letting part of Tesco's space, though likely on flexible terms. As a result we use B&M, which alongside Aldi, in our view are the largest consumers of additional retail space in the UK to proxy what retailers might be willing to pay at the margin for any space the retailers make available.

Scenario summaries: Capacity exit should be led by Tesco; consolidation a longer-term solution

In the long term we do not believe our base-case scenario is sustainable. Which as we discuss above is why our valuation focuses on short-term cash flows or asset break-up value. However, what we attempt to do here is assess the scenarios that may occur and the key considerations surrounding them. Some of them we have investigated above. Our key conclusions are:

- **No one wins a price war** – With the exception of Aldi and Lidl. See our assessment on pages 11-13
- **Capacity exit is the real answer** – See analysis on page 15. Our analysis highlights that Tesco has the largest amount of store space in the largest stores (Exhibits 36, 37), meaning we believe they are the most likely to benefit from exiting space.
- **Consolidation could be a long-term potential solution** – The UK grocers are still well-run businesses in our view. They have developed strong private labels and some world leading capabilities to operate across multiple formats and channels. With capacity exit the industry should be able to achieve acceptable returns. We think ultimately strategic consolidation is the best solution longer-term, however, it would have to come at a price that would make capacity exit profitable and the regulatory hurdles would mean this is unlikely to be a short-term solution.

Exhibit 35: Summary of broad outcomes under different scenarios – capacity exit and market consolidation our preferred scenarios

Directional impact for current share price in different scenarios and duration

	Base case*		Price War		Capacity exit		Market consolidation	
Impact on "Listed 3" Grocers	Short-term impact	Long-term impact	Short-term impact	Long-term impact	Short-term impact	Long-term impact	Short-term impact	Long-term impact
Directional impact	↘	↓	↓	↓	↔	↑	↗	↑
Rationale for the impact	**Profits need to be reset downwards; further to fall SBRY and TSCO**	**Inaction means perpetual negative leverage through core assets**	**Profitability falls for all; discounters match price investments**	**Prices difficult to bring up; discounters retain price gap**	**Loss of share; realisation of sub-book values for assets**	**Densities, profitability and returns improve**	**Somebody has to lose for rest to win**	**Only if capacity exit part of process**

Source: Goldman Sachs Global Investment Research.

Scenario – Tesco operates the largest stores, should be the driver of space reduction

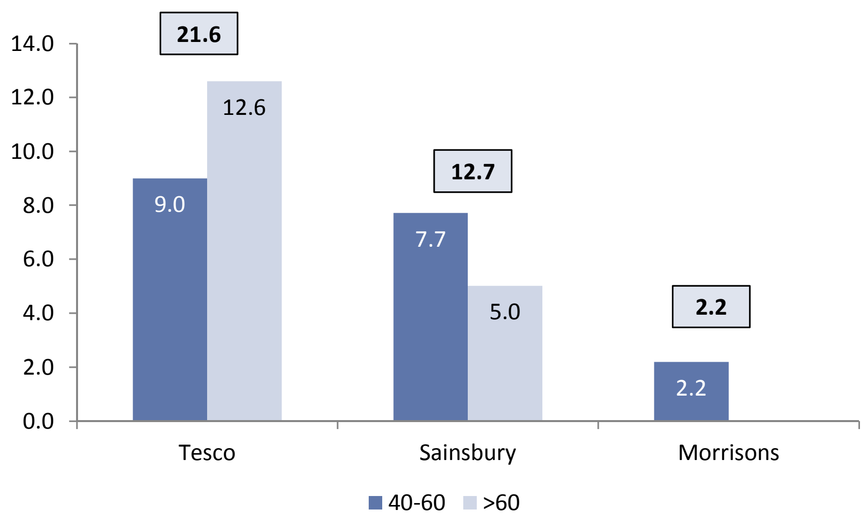
Tesco is most likely to be the driver of industry space reduction in our opinion. Ultimately, whether it comes following consolidation or organically we believe that the long-term solution for this industry to improve its returns and return to a more sustainable profitability level is to exit structurally unproductive space. However, as with price investments, this will mean some pain before the company sees a benefit. Unlike price investments this decision is beneficial to the industry as a whole and will thus benefit competitors - this makes it an even tougher decision for Tesco. Further, we believe to sell UK stores or properties in today's market the grocers will have to realise values materially below those stated in their annual reports as market value, as we discussed.

While we understand that each store will have to be judged on its own merits, we think it is a reasonable assumption that the largest stores are the ones facing the broadest structural issues and therefore need to be considered first in terms of capacity exit. Looking at store exposure by size it is clear that Tesco has the most structurally challenged stores and is why we conclude that it will have to act first.

However, space exit is likely to take various forms (sub-letting, residential sales, retail sale to name a few), which it is beyond the remit of this report to list. Basically we believe that capacity exit needs to happen, there are no easy solutions and Tesco faces the most pressing need to do something.

Exhibit 36: Tesco has more space over 40k sqft than MRW and SBRY combined

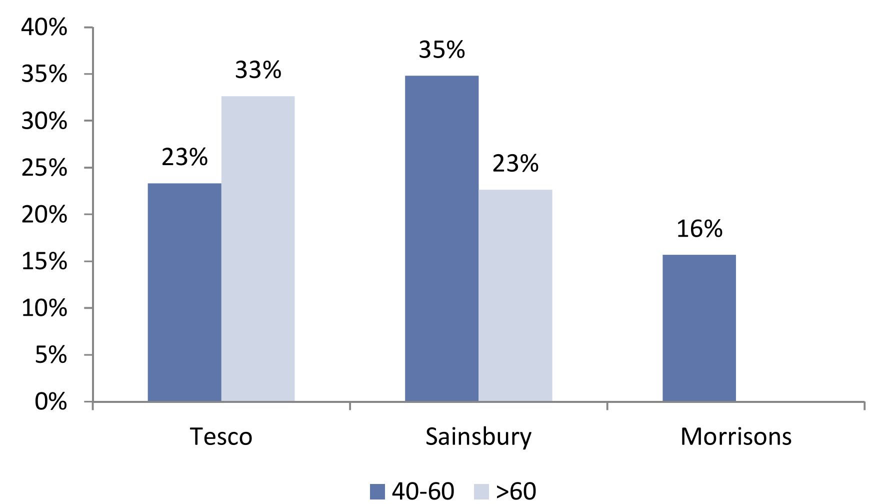
Total UK grocery selling space by size (last reported) (million sqft)



Source: Company data, Goldman Sachs Global Investment Research

Exhibit 37: Both SBRY and TSCO have over 50% of their space in stores > 40k sqft

% UK selling space in store of 40-60k sqft and over 60k sqft



Source: Company data, Goldman Sachs Global Investment Research

Scenario: Consolidation – A realistic long-term solution; unlikely in the short term

We think consolidation is an attractive long-term option. The UK market still has some excellent retailers with strong assets, well developed private labels and multi-channel platforms. However, we think regulatory hurdles mean this is a long-term process and it would have to come alongside capacity exit rather than solely profitability improving synergies. To make it allowable under regulations and attractive as an acquisition, we believe it is likely that a player would have to become loss making, or "a failing firm", which implies much lower share prices before this scenario manifests. We do see some room for re-interpretation of rules previously preventing mergers between the Big 4 grocers, but again see this as a medium-term event.

Why buy a UK supermarket asset?

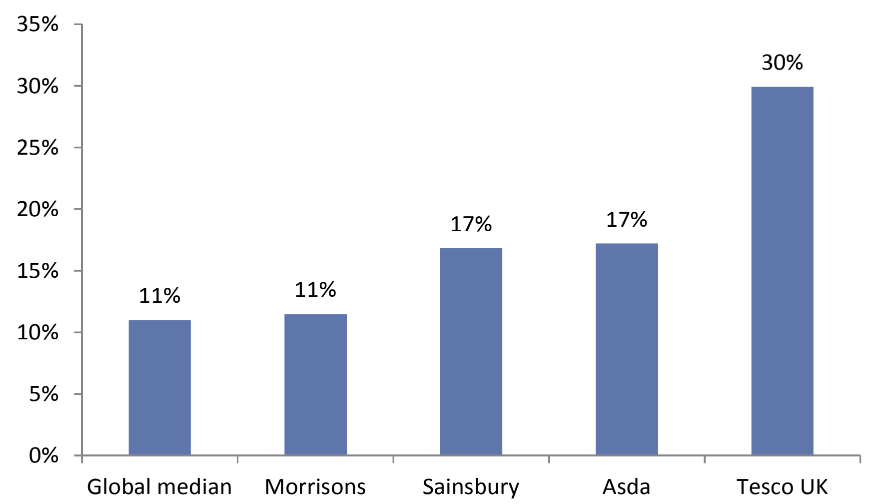
Despite the disruption from channel shifts, when looking at food retail on a global basis, the UK grocery market has a relatively attractive structure and its 3 largest listed players are relatively well positioned businesses given:

1) They all have relatively high market shares in a consolidated market – average share of the 3 largest listed players in the UK is 19% vs. 13% amongst global peers and the top 4 players have c.77% market share.

2) And the incumbents have well developed private labels – average private label penetration amongst UK listed 3 is c.47% of sales vs. a global average of around 17%.

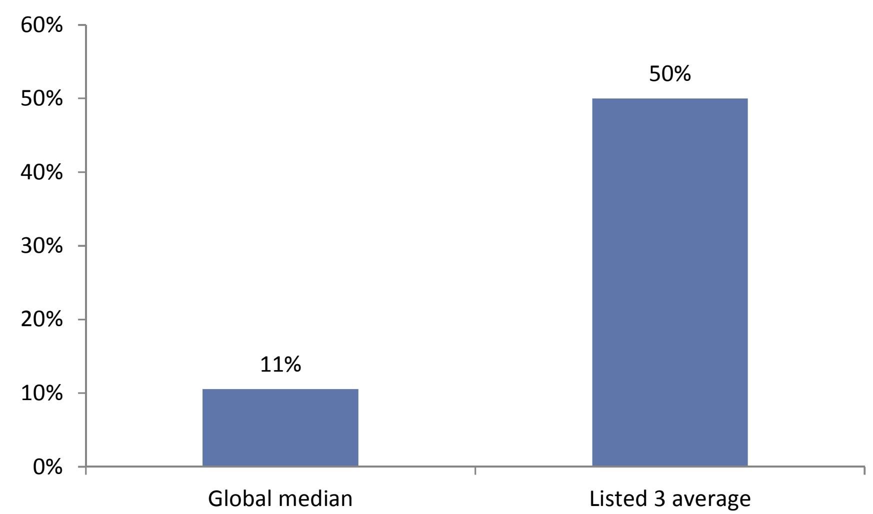
3) And are well developed online as well – Tesco and Sainsbury have very well developed online businesses and, through Ocado, Morrisons has the capability and functionality of a strong online business.

Exhibit 38: UK grocers have higher market share than global average
Market share, 2013 data



Source: Euromonitor, Goldman Sachs Global Investment Research.

Exhibit 39: And far more developed private label
Private label penetration



Source: Company data, Goldman Sachs Global Investment Research.

What are the regulatory hurdles that stand in the way?

There have been several reviews of competition in the UK grocery space and an extensive investigation into the Safeway acquisition by Morrisons in 2003, for which Asda, Sainsbury and Tesco all submitted bids. We think there are two scenarios under which consolidation amongst the big 4 could be allowed, both of which will probably take some time before they could feasibly materialise:

1) **Failing firm defence –** The Competition Commission has to consider that the company to be acquired is loss making and will go out of business before it will allow an acquisition under this criteria. As we highlighted, this is unlikely to happen in our view in the next 3 years for any of the three listed players under current market conditions. A consideration of a major price war therefore could be to push a weaker firm toward a stronger competitor.

2) **Re-interpretation of rationale laid out in the Morrisons/Safeway merger** – During the merger, the key focus was on competition amongst "one-stop" grocery shops (deemed to be stores above 1,400 sqm) and the key conclusion was that moving from 4 to 3 "national players" would result in "co-ordinated behaviour" and that "effective price and non-price competition would be reduced in the UK one-stop grocery market". Basically, 3 national players would mean a market concentration so high that grocers would be aware of the mutually destructive impact of price investments and therefore compete less on price.

   This analysis was carried out in 2003, with various updates since then, but we believe there is some room for re-assessing some of the substance of the above criteria.

   First, it could be argued that discounters of around 1,000 sqm are providing "one-stop" shopping experiences. Also given the 0 sqm online shopping option it could be argued that price competition takes place far beyond the 10 minute drive times previously focused on by the competition commission.

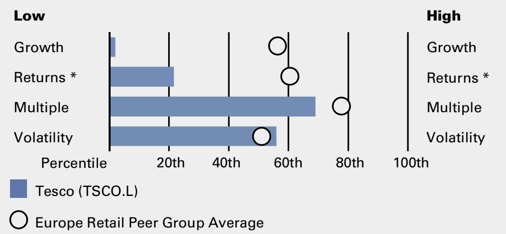
   Secondly, the importance of the "one-stop" shop to the consumer is decreasing, as we have discussed. In our view, this questions whether "one-stop" is an appropriate methodology to assess competing grocers and therefore could be reassessed.

   Finally, Aldi and Lidl would still set the pricing agenda if 4 became 3. Most importantly, we believe that the definition of a "national player" and whether removing one of the 4 largest grocers would create the opportunity for "co-ordinated behaviour", has moved on. Aldi and Lidl are setting the pricing agenda with c.8% combined market share and we would argue that this would not change if there was consolidation amongst the big 4. Also, with 1% market share, Ocado can deliver to c.70% of the UK.

However, the above changes are unlikely to be pushed through rapidly and therefore any consolidation on re-interpretation of the precedents set is unlikely to provide near-term relief to the market.

Tesco (TSCO.L): Investment in service does not address the core issue of large stores; Sell

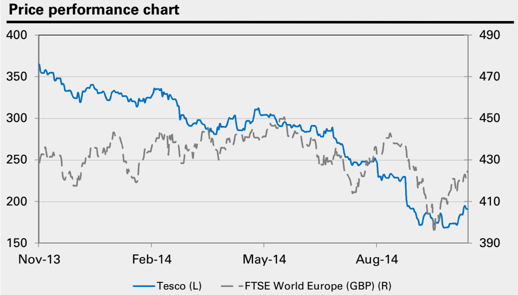
Investment Profile



* Returns = Return on Capital For a complete description of the investment profile measures please refer to the disclosure section of this document.

Key data				Current
Price (p)				191.15
12 month price target (p)				155
Upside/(downside) (%)				(19)
Market cap (£ mn)				15,362.7
Enterprise value (£ mn)				25,909.5
	2/14	2/15E	2/16E	2/17E
Revenue (£ mn) New	**63,636.0**	**61,323.9**	**60,317.5**	**59,426.1**
Revenue revision (%)	0.0	(4.0)	(7.7)	(10.7)
EBIT (£ mn) New	**3,189.0**	**2,019.9**	**1,777.0**	**1,547.2**
EBIT revision (%)	0.0	(27.2)	(38.2)	(47.9)
EPS (p) New	**33.74**	**18.04**	**15.64**	**13.29**
EPS (p) Old	33.59	27.24	28.61	29.59
EV/EBITDA (X)	8.0	7.3	7.9	8.4
P/E (X)	10.6	10.6	12.2	14.4
Dividend yield (%)	4.2	1.9	1.9	1.9
FCF yield (%)	4.3	2.9	2.8	3.4
CROCI (%)	10.3	7.5	7.0	6.5

Price performance chart



Share price performance (%)	3 month	6 month	12 month
Absolute	(21.7)	(35.4)	(47.6)
Rel. to FTSE World Europe (GBP)	(22.1)	(32.5)	(47.1)

Source: Company data, Goldman Sachs Research estimates, FactSet. Price as of 11/13/2014 close.

Source of opportunity

We reiterate our Sell rating on Tesco and believe that the company's high exposure to large stores (56% of total supermarket space above 40k sq. ft.) in the UK will continue to act as a drag on the business amid the structural growth of convenience, online and discounters channels. In our view, the recently announced service investment does not address this core issue and we believe that capacity reduction, through closing or finding alternative uses for large stores is the solution Tesco should pursue in order to sustainably improve profitability and returns.

As a result, we do not expect any significant improvement in its UK trading performance and believe operating margins will continue to fall as unaddressed structural shifts drive negative operating leverage. We note that though our EBIT margin estimates look severe, our FY17E EBITDAR margin estimate of 5.7% is in line with our forecast EBITDAR margin for Carrefour France. Valuing the assets outside of UK grocery at recent transaction multiples does not offer valuation support at the current price and nor does alternative valuations of UK property. We reduce our 12-month price target to 155p and remain Sell rated.

Catalyst

Tesco reports 3QFY15 IMS on November 30, 2014. We forecast UK LFL sales growth (excluding fuel) of -4.5% compared to 2Q of -5.5%. Kantar grocery data will be published on November 18 for the 4 weekly trading to the November 9.

Valuation

Our 12-month price target of 155p is derived using SOTP methodology. We value international assets on average transaction multiples for the last 3 years of comparable assets. UK non-grocery assets are valued on peer multiples. The UK business is valued on 6x trough EBITDA (which reflects the estimated value of Carrefour France currently implied as a multiple of its trough EBITDA). Our group 12-month 155p price target implies a 12-month forward P/E of 10x, EV/EBITDA of 7x and dividend yield of 2.4%.

In terms of finding a floor for the UK business, we use residential development prices as a proxy for valuing the UK property which along with our SOTP valuation of ex-UK retail businesses gives us a floor of 124p/share. While we acknowledge that this scenario is not something we envisage will happen in the near/medium term, we believe that use of Tesco UK property for residential purpose provides a valid floor price for the shares. This is materially below the current share price.

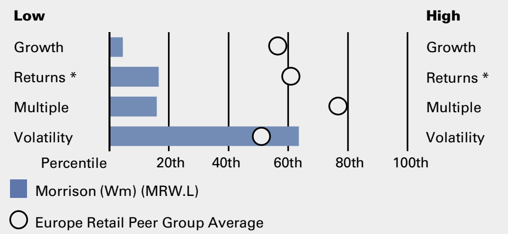
Key risks

Key upside risks to our view and price target include better-than-expected valuation for its ex-UK retail businesses, better than expected LFL sales growth in the UK, and slower growth of discounters.

Source: Company data, Goldman Sachs Global Investment Research, FactSet.

Morrisons (MRW.L): Greater visibility on cash flows offers value opportunity; up to Buy

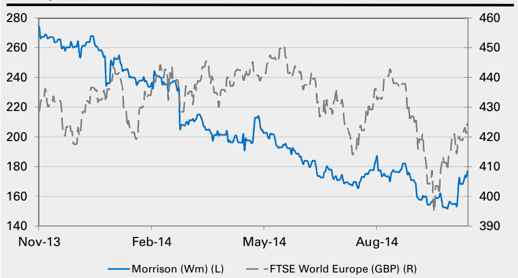
Investment Profile



* Returns = Return on Capital For a complete description of the investment profile measures please refer to the disclosure section of this document.

Key data				Current
Price (p)				176.8
12 month price target (p)				207
Upside/(downside) (%)				17
Market cap (£ mn)				4,573.1
Enterprise value (£ mn)				6,515.8
	1/14	**1/15E**	**1/16E**	**1/17E**
Revenue (£ mn) New	**17,680.0**	**17,163.6**	**16,711.9**	**16,345.8**
Revenue revision (%)	0.0	(2.3)	(5.5)	(9.0)
EBIT (£ mn) New	**808.0**	**518.2**	**506.6**	**497.3**
EBIT revision (%)	(6.6)	6.1	3.1	0.0
EPS (p) New	**22.69**	**13.80**	**14.05**	**14.35**
EPS (p) Old	25.14	12.89	13.18	13.54
EV/EBITDA (X)	7.6	7.2	6.9	6.6
P/E (X)	12.0	12.8	12.6	12.3
Dividend yield (%)	4.8	7.7	7.7	7.7
FCF yield (%)	(1.9)	6.8	11.1	10.2
CROCI (%)	6.5	7.2	6.7	6.6

Price performance chart



Share price performance (%)	3 month	6 month	12 month
Absolute	4.6	(9.7)	(35.5)
Rel. to FTSE World Europe (GBP)	4.1	(5.6)	(34.9)

Source: Company data, Goldman Sachs Research estimates, FactSet. Price as of 11/13/2014 close.

Source of opportunity

We believe there is a value opportunity in Morrisons, as, amongst the listed 3, it offers the clearest visibility on cash flows and dividend sustainability, alongside the lowest lease-adjusted leverage. However, it trades at a materially higher dividend yield than Sainsbury (60% higher on our estimates, 35% on Bloomberg consensus). Morrisons has announced the most aggressive investment strategy to address share losses, supported by the largest cost cutting plan and the largest cash generation through asset disposals programme. Clearly the majority of cost savings will be invested in price, but in absolute terms, the combined value of these, as well as steady state capex cuts is c.£2.4 bn or c.8 years' worth of dividend payments.

Morrisons supermarkets are much smaller on average than Sainsbury and Tesco and therefore we believe are less impacted by the structural issues facing large out-of-town stores and are thus they are correct to focus their investments on price. We do not forecast a return to volume growth in the next 3 years, and are yet to see clear evidence that price investments will be successful. However, with a structurally more favourable store estate, the lowest leverage and the largest cash preservation plan, we believe Morissons' dividend is at the least risk of further cuts of the listed 3 and has the strongest cash flow support to valuation. As a result, we upgrade from Sell to Buy, though acknowledge risks around potential competitor price investment and mis-execution of cost savings. Since being added to the Sell List on August 18, 2011 the shares are down 38% vs. the FTSE World Europe's rise of 33%.

Catalyst

Morrisons report Christmas trading on January 8 for the 6 weeks ending January 4. For the quarter to the end of January we forecast LFL ex fuel of -5%, representing a sequential increase on -6.3% in 3Q. Kantar will report 4 weekly trading to November 9 on November 18.

Valuation

Our new 12-month price target is 207p, implying 17% upside potential. We value Morrisons using a short-dated DCF. This is to reflect the industry uncertainty discussed. We add the discounted value of FY15-17E cash flows (8% discount rate) to a terminal value based on FY18E cash flow at a 10% discount rate (8% with a terminal growth of -2%). Our 12-month price target implies a 14.8x 12-month forward P/E, 7.8x EBITDAR and a 6.5% FY16E dividend yield.

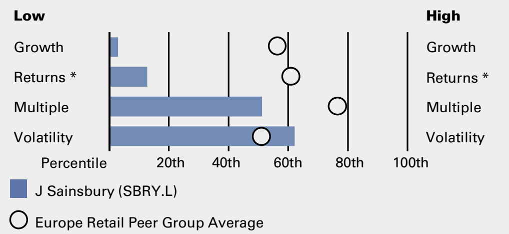
Key risks

The key downside risks to our view and price target are: aggressive price actions by a competitor, the mis-execution of announced cost savings, or failure to raise the £1 bn cash from asset sales it has announced.

Source: Company data, Goldman Sachs Global Investment Research, FactSet.

Sainsbury (SBRY.L): Further dividend cuts to come, operating margins still falling; CL-Sell

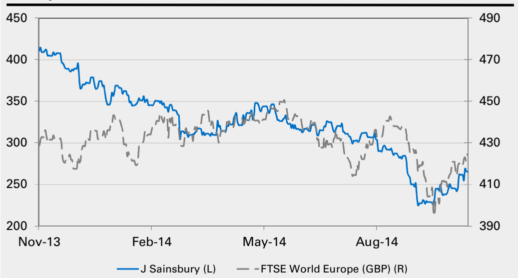
Investment Profile



* Returns = Return on Capital For a complete description of the investment profile measures please refer to the disclosure section of this document.

Key data				Current
Price (p)				265.1
12 month price target (p)				155
Upside/(downside) (%)				(42)
Market cap (£ mn)				4,987.9
Enterprise value (£ mn)				8,386.6
	3/14	3/15E	3/16E	3/17E
Revenue (£ mn) New	**23,949.0**	**23,985.8**	**23,748.3**	**23,472.1**
Revenue revision (%)	0.0	(0.6)	(2.0)	(3.7)
EBIT (£ mn) New	**869.0**	**748.9**	**533.7**	**461.8**
EBIT revision (%)	0.0	12.7	9.9	(5.5)
EPS (p) New	**32.40**	**25.36**	**16.83**	**13.64**
EPS (p) Old	32.40	24.27	16.23	15.97
EV/EBITDA (X)	7.0	6.3	7.5	7.9
P/E (X)	11.6	10.5	15.7	19.4
Dividend yield (%)	4.6	4.8	3.2	2.6
FCF yield (%)	(0.5)	1.4	5.0	4.8
CROCI (%)	8.0	7.4	6.6	6.1

Price performance chart



Share price performance (%)	3 month	6 month	12 month
Absolute	(12.6)	(21.8)	(35.5)
Rel. to FTSE World Europe (GBP)	(13.0)	(18.3)	(34.8)

Source: Company data, Goldman Sachs Research estimates, FactSet. Price as of 11/13/2014 close.

Source of opportunity

We believe negative operating leverage and investments in price, and potentially offer, suggests Bloomberg consensus materially underestimates the risk to Sainsbury's operating margins. We are 30% and 45% below FY16 and FY17 consensus PBT. The decline in recent trading, as well as Kantar switching data illustrates that Sainsbury's is not insulated from the broader behavioural shifts away from large stores and towards discounters. Its recent strategic update offered little in the way of new strategy, the highlights being relatively small price investments (£150 mn vs. Morrisons potentially up to £1 bn) and adding concessions in large stores. We do not know what strategy should be pursued to address the structural issues, and our analysis suggests that heavy price investments are unlikely to yield sustainable profitability increases. However, in the absence of strategic changes, we cannot forecast a reversal of trends we consider structural.

Capex cuts may provide some support to the balance sheet, but even with these we forecast leverage levels continuing to rise and dividends falling further. Our 12-month price target of 155p implies 42% downside potential. The shares remain Sell rated and on our Conviction List.

Catalyst

Sainsbury report 3Q trading update on January 7. We forecast LFL ex fuel of -3.0%. Kantar will report 4 weekly trading to November 9 on November 18.

Valuation

Our unchanged 12-month price target is 155p, implying 42% downside. We reiterate our Sell rating and the company remains on our Conviction List. We value Sainsbury's using a short-dated DCF. This is to reflect the industry uncertainty we discussed. We add the discounted value of FY15-17E cash flows (8% discount rate) to a terminal value based on FY18E cash flow at a 10% discount rate (8% with terminal growth of -2%). Our 12-month price target implies a 9.2x 12-month forward P/E, 5.5x EBITDAR and a 5.4% FY16E dividend yield.

Key risks

Key upside risks to our view and price target include better-than-expected LFL performance, greater cost cuts than we forecast and a slowdown in channel shifts away from large stores. If a significant shareholder decides to increase or reduce its stake it could be an overhang risk.

Source: Company data, Goldman Sachs Global Investment Research, FactSet.

GS vs. Consensus

Exhibit 40: Our estimates are materially below consensus for Sainsbury and Tesco
Summary GS estimates vs. Bloomberg consensus

Sainsbury	GSe			Consensus			GS vs. Consensus		
	FY15	FY16	FY17	FY15	FY16	FY17	FY15	FY16	FY17
Group Sales (£ mn)	23,986	23,748	23,472	24,119	24,278	24,658	-0.6%	-2.2%	-4.8%
Like for Like sales growth (%)	-2.5%	-2.5%	-2.0%	-	-	-	-	-	-
Group EBIT (£ mn)	749	534	462	777	706	725	-3.6%	-24.4%	-36.3%
Group EBIT margin (%)	3.1%	2.2%	2.0%	3.2%	2.9%	2.9%	-10 bp	-66 bp	-97 bp
Capex (£ mn)	966	620	550	885	689	638	9.1%	-10.0%	-13.8%
Dividend per share (p)	12.7	8.4	6.8	13.2	12.0	12.7	-3.9%	-29.9%	-46.3%
EPS (p)	25.4	16.8	13.6	26.6	23.9	24.4	-5%	-30%	-44%

Tesco	GSe			Consensus			GS vs. Consensus		
	FY15	FY16	FY17	FY15	FY16	FY17	FY15	FY16	FY17
Group Sales (£ mn)	61,324	60,317	59,426	61,826	62,222	63,449	-0.8%	-3.1%	-6.3%
UK Like for Like sales growth (%)	-4.5%	-4.0%	-3.5%	-	-	-	-	-	-
EBIT (£ mn)	2,020	1,777	1,547	1,996	1,879	2,040	1.2%	-5.4%	-24.2%
EBIT margin (%)	3.3%	2.9%	2.6%	3.2%	3.0%	3.2%	7 bp	-7 bp	-61 bp
Capex (£ mn)	2,065	1,780	1,500	2,092	1,950	1,952	-1.3%	-8.7%	-23.2%
Dividend per share (p)	3.7	3.7	3.7	5.0	5.8	6.2	-26.0%	-36.2%	-40.3%
EPS (p)	18.0	15.6	13.3	16.4	15.0	16.8	10.0%	4.3%	-20.9%

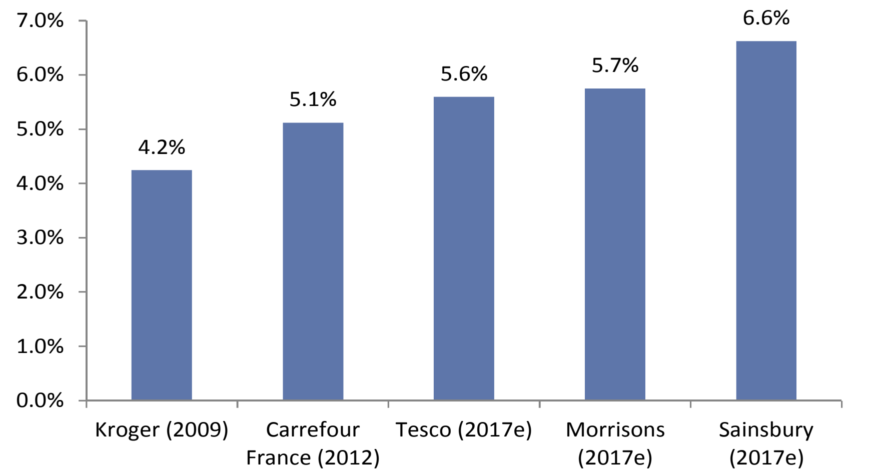
Morrison	GSe			Consensus			GS vs. Consensus		
	FY15	FY16	FY17	FY15	FY16	FY17	FY15	FY16	FY17
Group Sales (£ mn)	17,164	16,712	16,346	17,243	17,283	17,514	-0.5%	-3.3%	-6.7%
Like for Like sales growth (%)	-6.5%	-5.0%	-3.0%	-	-	-	-	-	-
EBIT (£ mn)	518	507	497	482	537	583	7.6%	-5.6%	-14.7%
EBIT margin (%)	3.0%	3.0%	3.0%	2.8%	3.1%	3.3%	23 bp	-7 bp	-29 bp
Capex (£ mn)	650	400	400	544	428	412	19.6%	-6.6%	-2.9%
Dividend per share (p)	13.6	13.6	13.6	13.5	10.8	10.8	0.4%	25.6%	25.6%
EPS (p)	13.8	14.0	14.3	12.3	14.3	15.2	12.2%	-1.8%	-5.6%

Source: Bloomberg, Goldman Sachs Global Investment Research.

Appendix: Interesting charts

Exhibit 41: UK trough EBITDAR margins still higher than trough margins of international peers

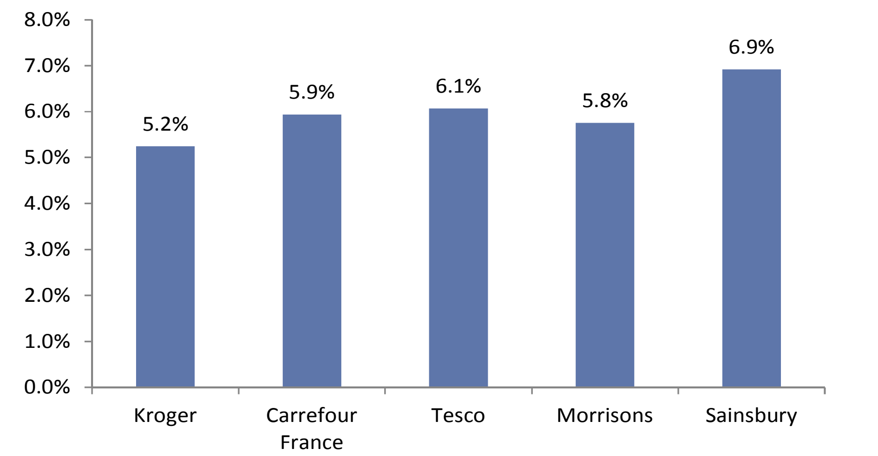
Trough EBITDAR margins



Source: Company data, Goldman Sachs Global Investment Research.

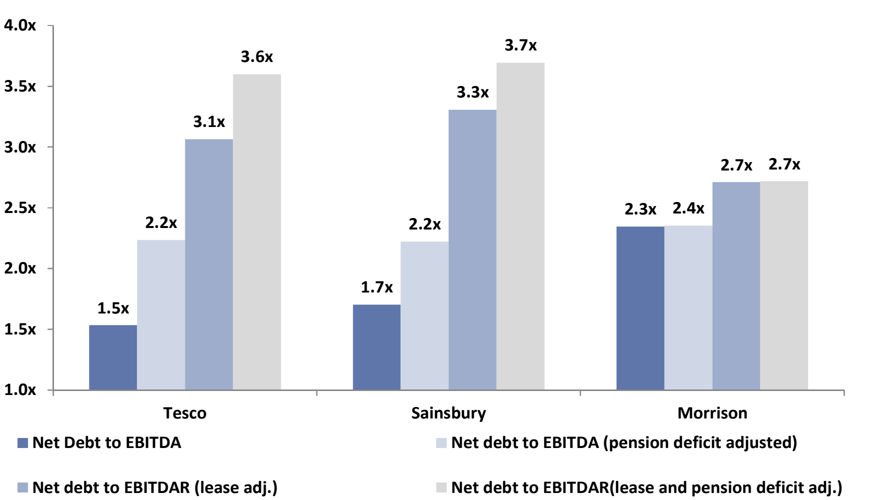
Exhibit 42: And our EBITDAR forecasts are still lower than Carrefour France and Kroger

Next three year forecast EBITDAR margins



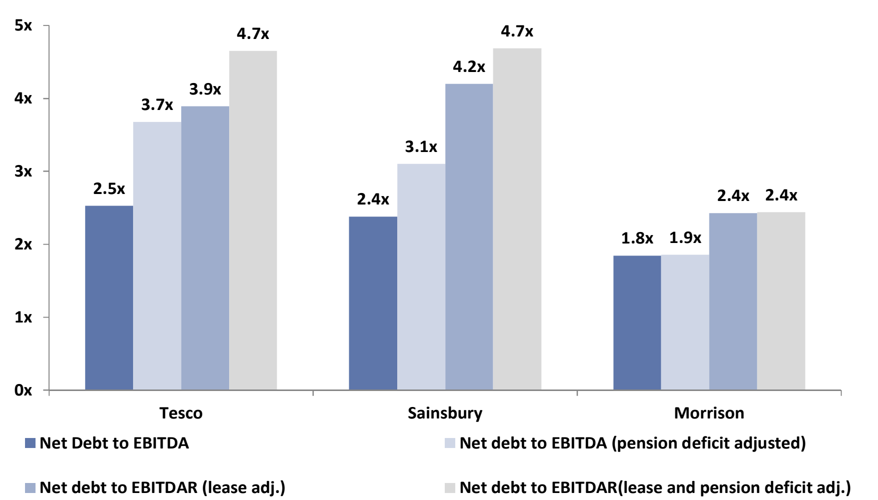
Source: Company data, Goldman Sachs Global Investment Research.

Exhibit 43: Leverage – FY14E



Source: Company data.

Exhibit 44: Leverage – FY18E



Source: Goldman Sachs Global Investment Research.

Financial forecasts

Exhibit 45: Morrisons Income Statement
£ mn

Income statement	2012	2013	2014	2015E	2016E	2017E	2018E	2019E	2020E
Sales	**17,663**	**18,116**	**17,680**	**17,164**	**16,712**	**16,346**	**16,303**	**16,380**	**16,456**
EBITDAR	**1,358**	**1,403**	**1,285**	**990**	**970**	**955**	**956**	**964**	**972**
EBITDAR margin	*7.7%*	*7.7%*	*7.3%*	*5.8%*	*5.8%*	*5.8%*	*5.9%*	*5.9%*	*5.9%*
EBITDA	**1,306**	**1,334**	**1,202**	**904**	**882**	**865**	**863**	**868**	**873**
EBITDA margin	*7.4%*	*7.4%*	*6.8%*	*5.3%*	*5.3%*	*5.3%*	*5.3%*	*5.3%*	*5.3%*
EBIT	**974**	**950**	**808**	**518**	**507**	**497**	**496**	**500**	**503**
EBIT margin	*5.5%*	*5.2%*	*4.6%*	*3.0%*	*3.0%*	*3.0%*	*3.0%*	*3.1%*	*3.1%*
Interest income	8	5	5	7	11	16	21	20	20
Interest expense (ST+LT)	(47)	(75)	(87)	(91)	(81)	(73)	(69)	(69)	(69)
Associate income	-	-	1.0	-	-	-	-	-	-
Others non-operating items	12.0	(1.0)		(70.0)	-	-	-	-	-
EBT	**947**	**879**	**727**	**364**	**436**	**440**	**448**	**451**	**455**
As a % of sales	*5.4%*	*4.9%*	*4.1%*	*2.1%*	*2.6%*	*2.7%*	*2.7%*	*2.8%*	*2.8%*
Underlying EBT (pre exceptionals, amort'i	**935**	**880**	**727**	**434**	**436**	**440**	**448**	**451**	**455**
Taxes	(274)	(232)	(199)	(95)	(110)	(106)	(90)	(90)	(91)
Tax rate	*28.9%*	*26.4%*	*27.4%*	*26.1%*	*25.1%*	*24.1%*	*20.0%*	*20.0%*	*20.0%*
				-40.2%					
Minorities	-	-	-	-	-	-	-	-	-
Post tax exceptionals	(17)	-	(821.0)		-	-	-	-	-
Net income	**656**	**647**	**(293)**	**269**	**327**	**334**	**358**	**361**	**364**
Net income margin	*3.7%*	*3.6%*	*-1.7%*	*1.6%*	*2.0%*	*2.0%*	*2.2%*	*2.2%*	*2.2%*

Per share data	2012	2013	2014	2015E	2016E	2017E	2018E	2019E	2020E
Shares outstanding (weighted avg; in mns)	2,587	2,428	2,327	2,327	2,327	2,327	2,327	2,327	2,327
Fully diluted (weighted avg; in mns)	2,587	2,428	2,327	2,327	2,327	2,327	2,327	2,327	2,327
Year end shares outstanding (in mns)	2,532	2,335	2,327	2,327	2,327	2,327	2,327	2,327	2,327
Earnings per share: basic	**25.4**	**26.6**	**-12.6**	**11.6**	**14.0**	**14.3**	**15.4**	**15.5**	**15.6**
Earnings per share: basic fully diluted	**25.4**	**26.6**	**-12.6**	**11.6**	**14.0**	**14.3**	**15.4**	**15.5**	**15.6**
Earnings per share: underlying	**25.7**	**26.7**	**22.7**	**13.8**	**14.0**	**14.3**	**15.4**	**15.5**	**15.6**
Earnings per share: u'lying fully diluted	**25.7**	**26.7**	**22.7**	**13.8**	**14.0**	**14.3**	**15.4**	**15.5**	**15.6**
Dividends	271	276	303	316	316	316	316	316	316
Dividend per share	**10.7**	**11.8**	**13.0**	**13.6**	**13.6**	**13.6**	**13.6**	**13.6**	**13.6**
Dividend payout ratio	41.7%	44.2%	57.3%	98%	97%	95%	88%	87%	87%

Source: Company data, Goldman Sachs Global Investment Research.

Exhibit 46: Morrisons Balance Sheet and Cash Flow

£ mn

Balance sheet	2012	2013	2014	2015E	2016E	2017E	2018E	2019E	2020E
Assets									
Cash & securities	241	265	261	438	679	935	916	909	906
Receivables, net	320	291	316	296	288	282	281	283	284
Inventories	759	781	852	823	764	713	711	715	718
Total current assets	**1,320**	**1,337**	**1,429**	**1,558**	**1,731**	**1,930**	**1,909**	**1,906**	**1,908**
Long term investments & others	293	159	217	217	217	217	217	217	217
Property, plant & equipment, net	7,943	8,616	8,625	8,495	8,275	8,111	8,198	8,283	8,367
Intangible assets	303	415	458	402	347	293	240	186	132
Total assets	**9,859**	**10,527**	**10,729**	**10,672**	**10,570**	**10,551**	**10,563**	**10,593**	**10,624**
Liabilities									
Short-term debt	115	55	563	563	563	563	563	563	563
Trade payables	1,524	1,603	1,709	1,834	1,923	1,993	1,988	1,997	2,006
Other payables	1,212	1,223	1,238	1,339	1,337	1,330	1,304	1,279	1,253
Total current liabilities	**2,851**	**2,881**	**3,510**	**3,736**	**3,823**	**3,886**	**3,855**	**3,839**	**3,822**
Long-term debt	1,600	2,396	2,516	2,266	2,066	1,966	1,966	1,966	1,966
Pension provisions	11	20	11	11	11	11	11	11	11
Total liabilities	**4,462**	**5,297**	**6,037**	**6,013**	**5,900**	**5,863**	**5,832**	**5,816**	**5,799**
Minority interests		-	-	-	-	-	-	-	-
Undistributable equity	379	379	400	400	400	400	400	400	400
Distributable equity	5,018	4,851	4,292	4,259	4,270	4,289	4,331	4,377	4,425
Total shareholders' equity	**5,397**	**5,230**	**4,692**	**4,659**	**4,670**	**4,689**	**4,731**	**4,777**	**4,825**
Total liabilities & equity	**9,859**	**10,527**	**10,729**	**10,672**	**10,570**	**10,551**	**10,563**	**10,593**	**10,624**

Cash flow	2012	2013	2014	2015E	2016E	2017E	2018E	2019E	2020E
Operating profit	974	950	808	518	507	497	496	500	503
Depreciation & amortization	332	384	394	386	376	367	367	368	370
Receivables, (increase) decrease	(52)	29	(25)	20	8	6	1	(1)	(1)
Inventories, (increase) decrease	(121)	(22)	(71)	29	60	50	2	(3)	(3)
Payables, (decrease) increase	84	79	154	125	89	70	(5)	9	9
Others	47	12	(229)	(70.0)	-	-	-	-	-
Operating free cash flow	**1,264**	**1,432**	**1,031**	**1,007**	**1,039**	**991**	**860**	**873**	**878**
Interest paid	(55)	(85)	(101)	(91)	(81)	(73)	(69)	(69)	(69)
Interest received	6	3	5	7	11	16	21	20	20
Corporation tax paid	(281)	(243)	(220)	6	(112)	(113)	(115)	(116)	(117)
Cashflow before investing activities	**934**	**1,107**	**715**	**930**	**857**	**821**	**697**	**708**	**712**
Sale (purchase) of tangible assets	4	5	(32)	450	300	250	-	-	-
Sale (purchase) of intangible & fin assets	(177)	(170)	(185)		-	-	-	-	-
Maintenance capex	(724)	(846)	(835)	(550)	(400)	(400)	(400)	(400)	(400)
Expansionary capex	-	-	-	(100)	-	-	-	-	-
Property, plant & equipment, net	(724)	(846)	(835)	(650)	(400)	(400)	(400)	(400)	(400)
Cash from investing activities	**(897)**	**(1,011)**	**(1,052)**	**(200)**	**(100)**	**(150)**	**(400)**	**(400)**	**(400)**
Free cash flow	**37**	**96**	**(337)**	**730**	**757**	**671**	**297**	**308**	**312**
				"FCF not less than £2bn over 3 years"					
Short-term debt (decrease) increase	(486)	(81)	(157)	-	-	-	-	-	-
Long-term debt (decrease) increase	1,102	843	790	(250)	(200)	(100)			
Dividends	(301)	(270)	(283)	(303)	(316)	(316)	(316)	(316)	(316)
Share issue / repurchase	(368)	(514)	(53)	-	-	-	-	-	-
Others	-	(23)	28	-	-	-	-	-	-
Cash from financing activities	**(53)**	**(45)**	**325**	**(553)**	**(516)**	**(416)**	**(316)**	**(316)**	**(316)**
Cash flow, inclusive of finance	**(16)**	**51**	**(12)**	**177**	**241**	**256**	**(19)**	**(7)**	**(3)**
Increases (decreases) in cash				177	241	256	(19)	(7)	(3)
Liquid funds at start of year				261	438	679	935	916	909
Liquid funds at end of year				**438**	**679**	**935**	**916**	**909**	**906**

Source: Company data, Goldman Sachs Global Investment Research.

Exhibit 47: Sainsbury's Income Statement
£ mn

Income statement	2012	2013	2014	2015E	2016E	2017E	2018E	2019E	2020E
Sales	**22,294**	**23,303**	**23,949**	**23,986**	**23,748**	**23,472**	**23,196**	**22,904**	**22,614**
EBITDAR	**1,714**	**1,795**	**1,904**	**1,808**	**1,592**	**1,508**	**1,494**	**1,480**	**1,465**
EBITDAR margin	7.69%	7.70%	7.95%	7.54%	6.70%	6.42%	6.44%	6.46%	6.48%
EBITDA	**1,288**	**1,338**	**1,419**	**1,310**	**1,099**	**1,020**	**1,012**	**1,004**	**996**
EBITDA margin	5.8%	5.7%	5.9%	5.5%	4.6%	4.3%	4.4%	4.4%	4.4%
EBIT	**789**	**821**	**869**	**749**	**534**	**462**	**460**	**459**	**458**
EBIT margin	*3.54%*	*3.52%*	*3.63%*	*3.12%*	*2.25%*	*1.97%*	*1.98%*	*2.00%*	*2.02%*
Interest income	18	19	20	10	4	6	10	14	18
Interest expense (ST+LT)	(127)	(130)	(136)	(115)	(125)	(135)	(135)	(135)	(135)
Associate income	28	24	34	10	10	10	10	10	10
Others non-operating items	82	54	52	(50)	(70)	-	-	-	-
EBT	**790**	**788**	**839**	**604**	**353**	**343**	**345**	**348**	**351**
As a % of sales	*3.5%*	*3.4%*	*3.5%*	*2.5%*	*1.5%*	*1.5%*	*1.5%*	*1.5%*	*1.6%*
Underlying EBT (pre exceptionals, amort'n)	**708**	**734**	**787**	**654**	**423**	**343**	**345**	**348**	**351**
Taxes	(206)	(162)	(184)	(159)	(86)	(84)	(84)	(85)	(86)
Tax rate	*26.1%*	*22.1%*	*21.9%*	*26.4%*	*24.5%*	*24.5%*	*24.5%*	*24.5%*	*24.5%*
Minorities	-	-	-	-	-	-	-	-	-
Post tax exceptionals	13.8	(11.8)	60.7	-	-	-	-	-	-
Net income	**598**	**614**	**716**	**444**	**266**	**259**	**260**	**263**	**265**
Net income margin	*2.7%*	*2.6%*	*3.0%*	*1.9%*	*1.1%*	*1.1%*	*1.1%*	*1.1%*	*1.2%*

Per share data	2012	2013	2014	2015E	2016E	2017E	2018E	2019E	2020E
Shares outstanding (weighted avg; in mns)	1,870	1,882	1,897	1,897	1,897	1,897	1,897	1,897	1,897
Fully diluted (weighted avg; in mns)	1,933	1,945	1,960	1,960	1,960	1,960	1,960	1,960	1,960
Year end shares outstanding (in mns)	1,933	1,945	1,960	1,960	1,960	1,960	1,960	1,960	1,960
Earnings per share: basic	**32.0**	**32.6**	**37.7**	**23.4**	**14.0**	**13.6**	**13.7**	**13.8**	**14.0**
Earnings per share: basic fully diluted	**30.9**	**31.6**	**36.5**	**22.7**	**13.6**	**13.2**	**13.3**	**13.4**	**13.5**
Earnings per share: underlying	**28.0**	**30.4**	**32.4**	**25.4**	**16.8**	**13.6**	**13.7**	**13.8**	**14.0**
Earnings per share: u'lying fully diluted	**27.1**	**29.4**	**31.4**	**24.5**	**16.3**	**13.2**	**13.3**	**13.4**	**13.5**
Dividends	301	314	326	241	160	129	130	131	132
Dividend per share	**16.1**	**16.7**	**17.2**	**12.7**	**8.4**	**6.8**	**6.9**	**6.9**	**7.0**
Dividend payout ratio	58%	55%	53%	50%	50%	50%	50%	50%	50%

Source: Company data, Goldman Sachs Global Investment Research.

Exhibit 48: Sainsbury's Balance Sheet and Cash Flow
£ mn

Balance sheet	2012	2013	2014	2015E	2016E	2017E	2018E	2019E	2020E
Assets									
Cash & securities	739	517	367	163	225	356	513	664	810
Receivables, net	286	306	433	434	429	424	419	414	409
Inventories	938	987	1,005	1,016	1,012	1,002	992	980	969
Total current assets	**1,963**	**1,810**	**1,805**	**1,612**	**1,666**	**1,782**	**1,924**	**2,058**	**2,187**
Long term investments & others	888	909	769	779	789	799	809	819	829
Property, plant & equipment, net	9,329	9,804	9,880	10,249	10,268	10,224	10,185	10,154	10,129
Intangible assets	160	171	286	272	258	244	231	217	204
Total assets	**12,340**	**12,694**	**12,740**	**12,912**	**12,981**	**13,049**	**13,149**	**13,249**	**13,350**
Liabilities									
Short-term debt	150	165	534	534	534	534	534	534	534
Trade payables	2,740	2,726	2,692	2,696	2,669	2,638	2,607	2,575	2,542
Other payables	733	687	775	775	775	775	775	775	775
Total current liabilities	**3,623**	**3,578**	**4,001**	**4,005**	**3,978**	**3,947**	**3,916**	**3,884**	**3,851**
Long-term debt	2,617	2,617	2,250	2,250	2,250	2,250	2,250	2,250	2,250
Pension provisions	471	766	737	737	737	737	737	737	737
Total liabilities	**6,711**	**6,961**	**6,988**	**6,992**	**6,965**	**6,934**	**6,903**	**6,871**	**6,838**
Minority interests	-	-	-	-	-	-	-	-	-
Undistributable equity	2,279	2,296	2,316	2,316	2,316	2,316	2,316	2,316	2,316
Distributable equity	3,350	3,437	3,183	3,604	3,700	3,799	3,930	4,062	4,196
Total shareholders' equity	**5,629**	**5,733**	**5,752**	**5,920**	**6,016**	**6,115**	**6,246**	**6,378**	**6,512**
Total liabilities & equity	**12,340**	**12,694**	**12,740**	**12,912**	**12,981**	**13,049**	**13,149**	**13,249**	**13,350**

Cash flow	2012	2013	2014	2015E	2016E	2017E	2018E	2019E	2020E
Operating profit	789	821	869	749	534	462	460	459	458
Depreciation & amortization	499	517	550	561	565	558	552	545	538
Receivables, (increase) decrease	57	(20)	(127)	(1)	4	5	5	5	5
Inventories, (increase) decrease	(126)	(49)	(18)	(11)	4	10	11	11	11
Payables, (decrease) increase	143	(14)	(34)	4	(27)	(31)	(31)	(33)	(33)
Others	(71)	13	(89)	-	-	-	-	-	-
Operating free cash flow	**1,291**	**1,268**	**1,151**	**1,303**	**1,080**	**1,004**	**997**	**988**	**980**
Interest paid	(142)	(143)	(148)	(115)	(125)	(135)	(135)	(135)	(135)
Interest received	18	19	20	10	4	6	10	14	18
Corporation tax paid	(82)	(144)	(140)	(159)	(86)	(84)	(84)	(85)	(86)
Cashflow before investing activities	**1,085**	**1,000**	**883**	**1,038**	**873**	**791**	**787**	**781**	**777**
Sale (purchase) of tangible assets	313	184	335	50	50	50	50	50	50
Sale (purchase) of intangible & fin assets	12.0	15.0	(213.0)	-	-	-	-	-	-
Acquisition of subsidiaries net of cash acquired									
Property, plant & equipment, net	(1,227)	(1,067)	(916)	(966)	(620)	(550)	(550)	(550)	(550)
				1.67	1.00	1.01	1.02	1.04	1.05
Cash from investing activities	**(902)**	**(868)**	**(794)**	**(916)**	**(570)**	**(500)**	**(500)**	**(500)**	**(500)**
Free cash flow	**183**	**132**	**89**	**122**	**303**	**291**	**287**	**281**	**277**
	- 130	- 52	- 246	72					
Short-term debt (decrease) increase	-	(50)	-	-	-	-	-	-	-
Long-term debt (decrease) increase	340	14	44	-	-				
Dividends	(285)	(308)	(320)	(326)	(241)	(160)	(129)	(130)	(131)
Share issue / repurchase	14	17	19	-	-	-	-	-	-
Others	(14)	(27)	(33)	-	-	-	-	-	-
Cash from financing activities	**55**	**(354)**	**(290)**	**(326)**	**(241)**	**(160)**	**(129)**	**(130)**	**(131)**
Cash flow, inclusive of finance	**238**	**(222)**	**(201)**	**(204)**	**62**	**131**	**157**	**151**	**145**
Increases (decreases) in cash	535	450	333	(204)	62	131	157	151	145
Liquid funds at start of year	5,350	4,500	3,330	367	163	225	356	513	664
Liquid funds at end of year				**163**	**225**	**356**	**513**	**664**	**810**

Source: Company data, Goldman Sachs Global Investment Research.

Exhibit 49: Tesco Income Statement
£ mn

Income statement	2011	2012	2013	2014	2015E	2016E	2017E	2018E	2019E	2020E
Sales	**60,931**	**64,616**	**64,907**	**63,636**	**61,324**	**60,317**	**59,426**	**59,246**	**59,164**	**59,135**
EBITDAR	**5,868**	**6,370**	**6,251**	**6,165**	**4,885**	**4,639**	**4,411**	**4,414**	**4,423**	**4,434**
EBITDAR margin	*9.6%*	*9.9%*	*9.6%*	*9.7%*	*8.0%*	*7.7%*	*7.4%*	*7.4%*	*7.5%*	*7.5%*
EBITDA	**4,804**	**5,164**	**4,964**	**4,751**	**3,471**	**3,210**	**2,968**	**2,957**	**2,952**	**2,948**
EBITDA margin	*7.9%*	*8.0%*	*7.6%*	*7.5%*	*5.7%*	*5.3%*	*5.0%*	*5.0%*	*5.0%*	*5.0%*
EBIT	**3,384**	**3,666**	**3,374**	**3,189**	**2,020**	**1,777**	**1,547**	**1,534**	**1,524**	**1,514**
EBIT margin	*5.6%*	*5.7%*	*5.2%*	*5.0%*	*3.3%*	*2.9%*	*2.6%*	*2.6%*	*2.6%*	*2.6%*
Finance Income	150	176	177	132	133	123	127	178	187	196
Interest expense (ST+LT)	(483)	(417)	(459)	(564)	(609)	(600)	(620)	(620)	(620)	(620)
Associate income	57	91	54	60	57	51	64	75	78	82
Others non-operating items	427	394	(287)	278	-	-	-	-	-	-
EBT	**3,535**	**3,910**	**2,859**	**3,095**	**1,600**	**1,351**	**1,118**	**1,166**	**1,169**	**1,172**
As a % of sales	*5.8%*	*6.1%*	*4.4%*	*4.9%*	*2.6%*	*2.2%*	*1.9%*	*2.0%*	*2.0%*	*2.0%*
Underlying EBT (pre exceptionals, amort'n)	**3,303**	**3,710**	**3,378**	**3,048**	**1,820**	**1,568**	**1,332**	**1,379**	**1,381**	**1,383**
Taxes	(864)	(879)	(574)	(347)	(328)	(270)	(224)	(233)	(234)	(234)
Tax rate	*24.4%*	*22.5%*	*20.1%*	*11.2%*	*20.5%*	*20.0%*	*20.0%*	*20.0%*	*20.0%*	*20.0%*
Minorities	(16.0)	(8.0)	4.0	4.0	2.0	2.0	2.0	2.0	2.0	2.0
Post tax exceptionals	-	-	(1,266.0)	(942.0)	(69.0)	-	-	-	-	-
Net income	**2,655**	**3,023**	**1,023**	**1,810**	**1,205**	**1,083**	**896**	**935**	**937**	**939**
Net income margin	*4.4%*	*4.7%*	*1.6%*	*2.8%*	*2.0%*	*1.8%*	*1.5%*	*1.6%*	*1.6%*	*1.6%*

Per share data	2011	2012	2013	2014	2015E	2016E	2017E	2018E	2019E	2020E
Shares outstanding (weighted avg; in mns)	8,020	8,021	8,033	8,033	8,033	8,033	8,033	8,033	8,033	8,033
Fully diluted (weighted avg; in mns)	8,061	8,045	8,037	8,033	8,033	8,033	8,033	8,033	8,033	8,033
Year end shares outstanding (in mns)	8,061	8,045	8,037	8,033	8,033	8,033	8,033	8,033	8,033	8,033
Earnings per share: basic	**33.1**	**37.7**	**12.73**	**22.53**	**15.0**	**13.5**	**11.2**	**11.6**	**11.7**	**11.7**
Earnings per share: basic fully diluted	**32.9**	**37.6**	**12.73**	**22.53**	**15.0**	**13.5**	**11.2**	**11.6**	**11.7**	**11.7**
Earnings per share: underlying	**30.9**	**35.8**	**33.7**	**33.7**	**18.0**	**15.6**	**13.3**	**13.8**	**13.8**	**13.8**
Earnings per share: u'lying fully diluted	**30.8**	**35.6**	**33.6**	**33.7**	**18.0**	**15.6**	**13.3**	**13.8**	**13.8**	**13.8**
Dividends	1160	1184	1186	1189	297	297	297	297	297	297
Dividend per share	**14.5**	**14.8**	**14.8**	**14.8**	**3.7**	**3.7**	**3.7**	**3.7**	**3.7**	**3.7**
Dividend payout ratio	43.7%	39.2%	115.9%	65.7%	20.5%	23.7%	27.8%	45.0%	45.0%	45.0%

Source: Company data, Goldman Sachs Global Investment Research.

Exhibit 50: Tesco Balance Sheet and Cash Flow
£ mn

Balance sheet	2011	2012	2013	2014	2015E	2016E	2017E	2018E	2019E	2020E
Assets										
Cash & securities	4,179	5,315	5,057	5,098	4,721	4,853	5,074	5,336	5,602	5,872
Receivables, net	2,314	2,657	2,525	2,190	2,110	2,076	2,045	2,039	2,036	2,035
Tesco Bank Receivables	5,045	4,403	5,558	6,915	4,544	7,804	4,825	8,086	5,223	8,992
Inventories	3,162	3,598	3,744	3,576	3,371	3,321	3,278	3,265	3,258	3,253
Total current assets	**14,700**	**15,973**	**16,884**	**17,779**	**14,746**	**18,054**	**15,221**	**18,726**	**16,118**	**20,152**
Long term investments & others	3,770	4,480	4,013	4,100	4,422	4,553	4,617	4,692	4,770	4,852
Property, plant & equipment, net	24,398	25,710	24,870	24,490	25,110	25,642	25,963	26,282	26,594	26,900
Intangible assets	4,338	4,618	4,362	3,795	3,575	3,358	3,144	2,932	2,720	2,508
Total assets	**47,206**	**50,781**	**50,129**	**50,164**	**47,853**	**51,607**	**48,946**	**52,631**	**50,202**	**54,413**
Liabilities										
Short-term debt	1,386	1,838	887	2,009	2,009	2,009	2,009	2,009	2,009	2,009
Trade payables	5,782	6,196	6,118	5,843	5,721	5,627	5,544	5,527	5,520	5,517
Other payables	12,370	13,163	13,258	14,324	14,730	15,024	15,334	15,658	15,999	16,357
Total current liabilities	**19,538**	**21,197**	**20,263**	**22,176**	**22,460**	**22,660**	**22,887**	**23,195**	**23,528**	**23,883**
Long-term debt	9,689	9,911	10,827	10,073	10,073	10,073	10,073	10,073	10,073	10,073
Pension provisions	1,356	1,872	2,378	3,193	3,193	3,193	3,193	3,193	3,193	3,193
Total liabilities	**30,583**	**32,980**	**33,468**	**35,442**	**35,726**	**35,926**	**36,153**	**36,461**	**36,794**	**37,149**
Minority interests	**88**	**26**	**18**	**7**	**5**	**3**	**1**	**(1)**	**(3)**	**(5)**
Undistributable equity	402	402	403	405	405	405	405	405	405	405
Distributable equity	16,133	17,373	16,240	14,310	11,717	15,272	12,388	15,766	13,006	16,863
Total shareholders' equity	**16,535**	**17,775**	**16,643**	**14,715**	**12,122**	**15,677**	**12,793**	**16,171**	**13,411**	**17,268**
Total liabilities & equity	**47,206**	**50,781**	**50,129**	**50,164**	**47,853**	**51,607**	**48,946**	**52,631**	**50,202**	**54,413**
Cash flow	**2011**	**2012**	**2013**	**2014**	**2015E**	**2016E**	**2017E**	**2018E**	**2019E**	**2020E**
Operating profit	3,384	3,666	3,374	3,189	1,827	1,581	1,352	1,338	1,328	1,318
Depreciation & amortization	1,420	1,498	1,590	1,562	1,451	1,433	1,421	1,423	1,428	1,434
Receivables, (increase) decrease	(152)	(139)	132	335	80	35	31	6	3	1
Inventories, (increase) decrease	(467)	(461)	(146)	168	205	50	43	13	7	4
Payables, (decrease) increase	976	679	(77)	(275)	(122)	(94)	(83)	(17)	(8)	(3)
Others	360	217	(623)	35	(69)	-	-	-	-	-
Operating free cash flow	**5,521**	**5,460**	**4,250**	**5,014**	**3,372**	**3,005**	**2,764**	**2,764**	**2,759**	**2,754**
Interest paid	(614)	(531)	(457)	(496)	(661)	(649)	(649)	(649)	(649)	(649)
Interest received	128	103	85	121	133	123	127	178	187	196
Corporation tax paid	(760)	(749)	(579)	(635)	(328)	(270)	(224)	(233)	(234)	(234)
Cashflow before investing activities	**4,275**	**4,283**	**3,299**	**4,004**	**2,516**	**2,210**	**2,018**	**2,059**	**2,063**	**2,067**
Sale (purchase) of tangible assets	1,906	1,141	1,419	568						
Sale (purchase) of intangible & fin assets	(612)	(526)	(641)	(356)	-	-	-	-	-	-
Property, plant & equipment, net	(3,178)	(3,374)	(2,619)	(2,774)	(2,065)	(1,780)	(1,500)	(1,500)	(1,500)	(1,500)
Cash from investing activities	**(1,884)**	**(2,759)**	**(1,841)**	**(2,562)**	**(2,065)**	**(1,780)**	**(1,500)**	**(1,500)**	**(1,500)**	**(1,500)**
Free cash flow	**2,391**	**1,524**	**1,458**	**1,442**	**451**	**430**	**518**	**559**	**563**	**567**
Short-term debt (decrease) increase	-	-	-	-	-	-	-	-		-
Long-term debt (decrease) increase	(1,978)	185	(1,202)	1,192	-	-	-	-	-	-
Dividends	(1,081)	(1,180)	(1,184)	(1,189)	(828)	(297)	(297)	(297)	(297)	(297)
Share issue / repurchase	67	(234)	57	62						
Others	(90)	(51)	(10)	(114)						
Cash from financing activities	**(3,082)**	**(1,280)**	**(2,339)**	**(49)**	**(828)**	**(297)**	**(297)**	**(297)**	**(297)**	**(297)**
Cash flow, inclusive of finance	**(691)**	**244**	**(881)**	**1,393**	**(377)**	**132**	**221**	**262**	**266**	**270**
Increases (decreases) in cash					(377)	132	221	262	266	270
Liquid funds at start of year					5,098	4,721	4,853	5,074	5,336	5,602
Liquid funds at end of year					**4,721**	**4,853**	**5,074**	**5,336**	**5,602**	**5,872**

Source: Company data, Goldman Sachs Global Investment Research.

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Reg AC

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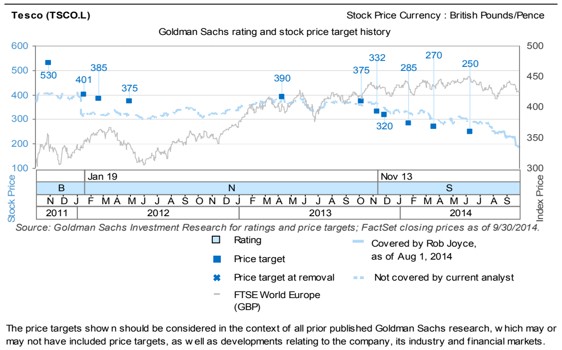

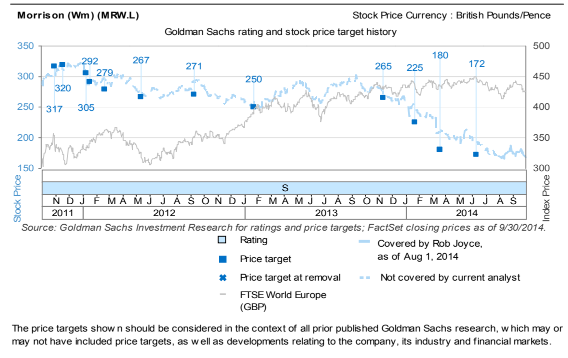

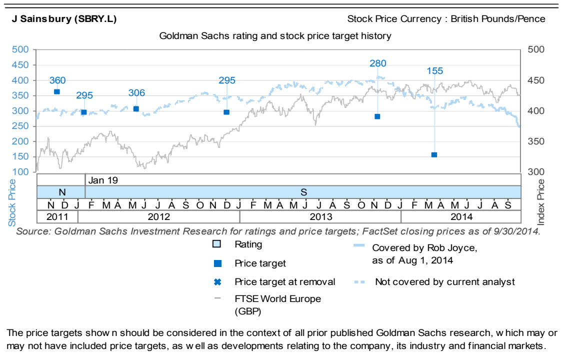

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