J SAINSBURY PLC

SBRY:LSE

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EXECUTIVE SUMMARY	**2**
HISTORY OF THE COMPANY	**3**
COMPANY PROFILE	**5**
MANAGEMENT	**6**
ANALYSIS OF OPERATIONS	**9**
RISKS	**11**
FINANCIAL ANALYSIS	**15**
INVESTMENT APPRAISAL	**16**

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Executive Summary

Sainsbury's has existed for almost 150 years and during this period has expanded its offering from the relatively basic groceries outfit first seen in 1869, to the diaspora of business interests that all fall under the Sainsbury's umbrella nowadays. These range from consumer banking to mobile telecommunications in addition to the fundamental groceries business.

Sainsbury's has the third largest share in the groceries sector and its heavy presence online, on the high street but also in larger store formats mean the brand is recognised nationwide. As the dominant groceries industry in which Sainsbury's operates experiences dramatic changes in consumer tastes and spending habits, the large market share that Sainsbury's has historically enjoyed in a relatively comfortable and safe manner is under ever-increasing threat.

The firm does not, however, lack a clear outlook and strategic direction to deal with the changing landscape of its industry. A strong and experienced management team underpin the business and the initiatives focussed on in the firm's strategic plan are designed to overcome areas of weakness exposed by the turbulent state of the groceries sector at the present time.

Ticker:	SBRY	Ratios:	
Shares in issue:	1,914m	Profit Margin:	4.2%
Market capitalisation:	£4.89bn	Return on Assets:	4.9%
Enterprise value:	£6.46bn	Net Gearing:	28.5%
6-month share price range:	£2.21 - £3.83	EV/EBITDA Multiple:	7.42x
Dividend yield:	4.35%	P/E ratio:	11.3
Cash:	1,592m	Current Ratio:	0.66

History of the Company

- 1869 – John Sainsbury and Mary Staples opened the first Sainsbury's store on the 20th April 1869, their wedding day.
- 1882 – By 1882 Sainsbury's was established with 11 stores in and around the London area, at this point they began to produce the first own branded products. Also adopted its first slogan 'Quality Perfect, Prices Lower'
- 1916 – Set up first training centre in Blackfriars, threatened with prosecution for keeping prices too low during the war years
- 1922 – Sainsbury's was incorporated as a private company 'J. Sainsbury Limited' after becoming the UKs largest grocery group
- 1928 – By the time John Sainsbury passed away in 1928 there were 128 Sainsbury's stores. He was succeeded by his eldest son John Benjamin Sainsbury
- 1944 – Halved labels on cans to save paper and help the war effort
- 1946 – First issue of colleague magazine, 'The Journal,' was sold in-store. Now has a print run of 40,000 issues and is distributed every two months
- 1956 – First self-service store (years ahead of competitors) after Alan Sainsbury's trip to the US
- 1969 – Own brand products accounted for 50% of turnover
- 1973 – Listed as a public company, at the time was the largest ever flotation on the London stock market with £495m being offered for 14.5m shares
- 1974 – Set up the first savings related share scheme
- 1986 – First supermarket to offer organic products, "SO" range now contains 250 products

- 1994 – Set up Sainsburys Bank authorised to provide loans and other financial products to consumers
- 1996 – First retailer to offer Fair-trade products, now the world's largest retailer of Fair-trade goods. Sales of £319m in 2013/14
- 1998 – Re-branding centred around the slogan "Making life taste better"
- 2002 – Nectar Loyalty Card scheme launched. Sainsbury's a major founder
- 2004 – Launched the TU fashion range in over 160 stores, now the 7th biggest clothing line by volume in the UK
- 2008 – Established the 'You Can' employment programme in conjunction with Job centre plus and Remploy, over 13,000 people have been employed as a result
- 2011 – Opened its 1000th store
- 2014 – Posted worst performance since 1990 with a 3.1% fall in sales

Company Profile

- J Sainsbury PLC is a UK based company that runs supermarkets, convenience stores, online grocery, banking and general merchandise operations
- The holding company is split into three subsidiaries: Sainsbury's Supermarket Ltd., Sainsbury's Convenience Stores Ltd. and Sainsbury's Bank
- Sainsbury's has 161,000 employees across 592 supermarkets, 611 convenience stores, 22 distribution centres and offices across the country. CEO Mike Coupe runs the firm
- In a joint venture with Dansk (Danish owner of the Netto discount chain in Europe) Sainsbury's has announced 15 new Netto branded stores across the North of England in an attempt to infiltrate the growing discount market
- Currently, Sainsbury's is the third largest chain of supermarkets with a market share of 16.4%, behind Tesco and Asda of 28.7% and 17.2% respectively
- The market is worth £174.5 billion (as of April 2014) accounting for 54.5p of every pound spent in the UK
- Sainsbury's has distinguished itself as a prominent supporter of fitness and health sponsoring the London 2012 Paralympic Games and supporting schemes such as Sainsbury's active kids
- Listed on the FTSE 100 with a market capitalisation of £4.26 billion, Sainsbury's reported annual revenue of £23.95 billion and a net income of £798 million on 15/03/2014
- Currently Sainsbury's shares are priced at 226.7GBp down 41.57% from a year ago as of market close 11/12/2014 and has a market beta value of 0.7089

Management

Board of Directors:

David Alan Tyler (Chairman of the Board of Directors)

- External hire made on the 1st of October 2009
- Tyler has a strong background in retail and was finance director of GUS, the now defunct conglomerate that used to own Argos
- He is also Non-Executive Chairman of Hammerson PLC and a Non-Executive Director of Burberry Group PLC
- He brings a wealth of experience and expertise having previously held senior financial and general management roles with Christie's International PLC (1989-96), County NatWest Limited (1986-89) and Unilever PLC (1974-86)

Mike Coupe (Chief Executive officer)

- Joined Sainsbury's in October 2004 as a Trading Director on the operating board
- In 2007 he was appointed to the board of directors as an Executive Director and in 2010 he became the group's Commercial Director
- During this stint, Mike Coupe has been accredited with the brand's accomplishment in e-commerce and creating Sainsbury's "Brand Match" campaign
- Effective as on 9th July 2014, Mike Coupe succeeded Justin King as the CEO of J Sainsbury's
- Prior to his period at Sainsbury's he was on the board of directors at Big Food Group, the owner of Iceland Food Stores until February 2005. He held the position of Managing Director at Iceland Food Stores from November 2001 to May 2004
- Prior to this, Coupe worked for both Asda and Tesco, where he served in a variety of senior management roles
- He is also a Non-Executive Director at Greene King PLC

John Rogers (Chief Financial Officer)

- Joined Sainsbury's in November 2005 as a Director of Corporate Finance
- Became Director of Group Finance effective from March 2007
- Joined the Sainsbury's Operating Board as Property Director in June 2008
- Appointed To Sainsbury's Board of Directors as Chief Financial Officer in July 2010
- Member of the Board at of J Sainsbury's subsidiaries "Sainsbury's Bank PLC"
- John is also a Non-Executive director at Travis Perkins PLC and co-chair of the Prince's Accounting for Sustainability (A4S) Network
- Previously held a management position with Hanover Acceptances, a private investment group specialising in food manufacturing and Retail

Operating Board:

Roger Burnley (Retail and Operations Director)

- Joined Sainsbury's Operating board in March 2006 as Supply Chain Director
- In 2008 he assumed the role of Retail and Logistics Director
- Became Managing director of General Merchandise, Clothing and Logistics in March 2012
- This role was integrated with Retail and Operations, and thus he became Director of Retail and Logistics as of May 2014 with the responsibility of leading J Sainsbury's Supermarkets, Convenience and Logistics
- Prior to joining Sainsbury's, Burnley was Supply Chain Director at Matalan
- He gained his experience in supply chain management through his time in a number of positions in retail management with Walmart/Asda
- He is the Vice-President of the Chartered Institute of Logistics and Transport (UK) and is a board member at Transport for London

Paul Mills-Hicks (Food Commercial Director)

- Paul joined the operating board in May 2014 as Food Commercial Director
- Prior to this he had spent 10 years at Sainsbury's in various management positions
- Has a wealth of experience having held a variety of roles throughout his career in areas including commercial, strategy and finance
- Notably he was a Business Unit Director for Sainsbury's Grocery
- Specific previous roles include European Controller at Marks and Spencer Group PLC and Managing Director at UBS Warburg
- He is a qualified Electronic Engineer and a Chartered Accountant

Analysis of Operations

Superstores, Convenience, Online and Other

Arguably Sainsbury's most well known operation is that of its supermarkets and convenience stores. In addition to this, it operates in a number of other areas including banking (Sainsbury's Bank), mobile telecommunications (Mobile by Sainsbury's) and Internet retail (Sainsbury's Online). It also has a property portfolio worth an estimated £14bn.

Sainsbury's Petrol is available at many of Sainsbury's supermarket stores across the UK. Sainsbury's Online is the online retailer of non-food goods with a particular focus on entertainment products (e.g. DVDs, CDs, Games) and Sainsbury's also run pharmacies in many of their stores.

Sainsbury's method of reporting performance figures does not allow for close enough analysis to determine which of their divisional operations contribute well to overall business performance. Despite this, there are several details that are interesting to note.

As of Financial Year End 2014:

- Sainsbury's 592 Supermarkets processed, on average, 17.4 million transactions per week and in their 611 convenience stores, (Sainsbury's Local), 6 million transactions per week
- Over £1bn annual online grocery sales (190,000 deliveries per week)
- Sainsbury's Bank has 1.4 million active customer accounts
- Customers in store redeemed Nectar Points to the value of £241m
- In terms of underlying operational profit, Sainsbury's Supermarkets (including convenience stores and online) generated £873m and Sainsbury's Bank generated £6m.

The only reports of performance data that separates that of Sainsbury's Local Sainsbury's Supermarkets is the data that represents sales by store size (in square feet.) Most Sainsbury's Local stores are below 10,000 square feet with only 2 being larger than this. With limited data to distinguish between the two types it is difficult to properly judge the financial impact of each on group performance. In financial statements, all retail operations are reported as a single figure.

The Future: Adapting to Industry Change

The grocery market in the UK has fundamentally changed for two main reasons; firstly the economic conditions and policies adopted by the government and central banks and secondly from changing consumer perceptions. Loose monetary policy adopted by the Bank of England represented through the combination of rates set at a record low of 0.5% and quantitative easing has led to widening income disparity. The people who have benefited most from this monetary stimulus have been the wealthiest as equity prices, whose ownership is skewed heaviest towards the wealthiest in society, have risen. This means that in the grocery sector, the middle has been squeezed as upmarket retailers such as Waitrose and M&S have enjoyed success but at the same time, the lower end discounters such as Aldi and Lidl have also prospered. Secondly the negative consumer perception of shopping at Aldi and Lidl seems to have shifted and it is now deemed more socially acceptable to be seen shopping there.

To respond to this changing landscape Sainsbury's have adopted the following strategies:

Opening of Netto Stores

They have created a joint partnership with Danish discount retailer Netto and have opened 15 stores in the north of England. This strategy means that Sainsbury's can address 2 of its issues. Firstly it is historically weak in the North of England and opening these new stores, as a different brand, will diversify its market. Secondly the rise of discounters has negatively affected its market share. This venture gives it the opportunity to tap into a market worth an estimated £10bn in annual sales and is forecast to double in value to approximately £20bn in the next five years.

Focusing pricing on products that matter

Sainsbury is focusing on reducing prices in the areas most appreciated by consumers. They have removed Tesco from their price-matching scheme. This is linked to the notion that Tesco's size and market share gives it more scope to aggressively lower prices and if it was a competition on price and purely price Tesco would be best equipped to survive.

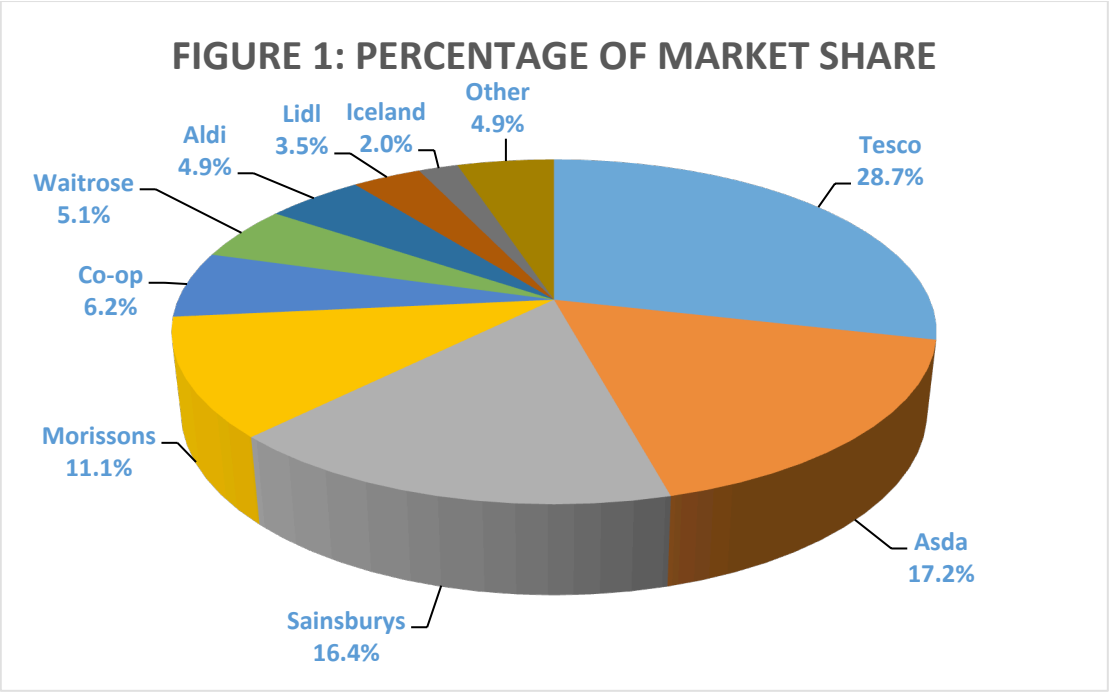
Improving Quality

Sainsburys has announced it is improving the quality of 3000 own brand goods. This differentiates Sainsburys as the other supermarkets are focusing solely on price creating an opportunity to maintain margin.

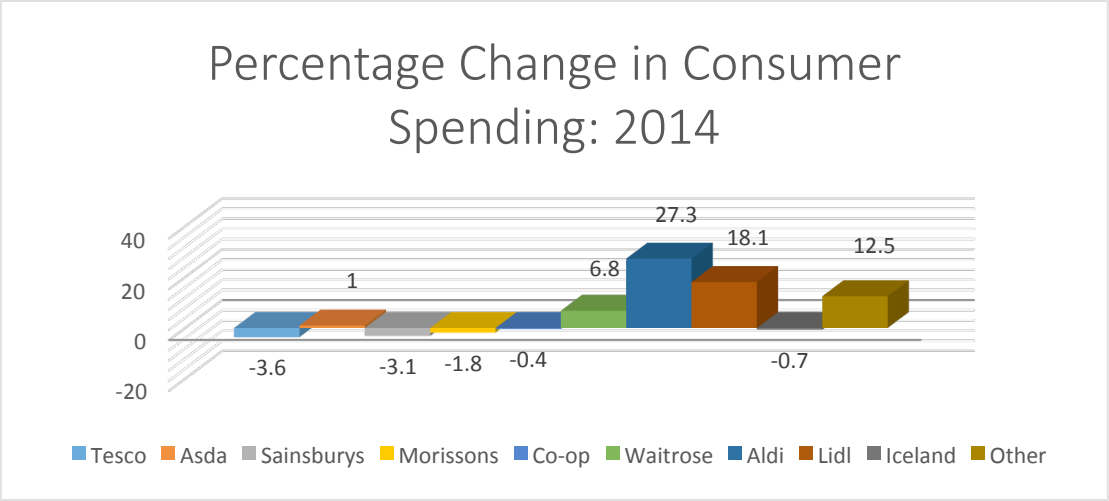
Risks

Competition

As of 9th November 2014 the total grocery market is valued at £174.5 billion in the United Kingdom. The 'big 4' of Tesco, Asda, Sainsbury's and Morrison's have acquired just less than three quarters of the market share (73.4%) as shown in Figure 1 below. However, increasing pressure from German discounters such as Aldi and Lidl and upmarket brands such as Waitrose, are beginning to place firm competitive pressures upon customer loyalty and profit margins for the big 4. This has been reducing their market share over the past few years and is squeezing the 'middle market' suppliers posing a major risk to Sainsbury's as to whether it can retain customers.



Sainsbury's, before the beginning of 2014, had managed to keep profits largely stable because of stronger like for like sales than Tesco or Morrison's. However, since the beginning of 2014 it has seen consumer-spending fall by 3.1% as shown in Figure 2 on the next page. On the other hand Waitrose, Lidl, Aldi and other brands, including Poundland, have seen consumer spending in 2014 increase by 6.8%, 27.3%, 18.1% and 12.5% respectively with Aldi planning to open 60 new stores in 2015.



The movement of customers away from the more traditional middle market brands towards the discount suppliers correlates to the current UK economic climate and poses a key risk to the long-term customer base of Sainsbury's. Since the financial crisis there has been the most persistent fall in consumer real income since the Second World War with inflation rising consistently higher than nominal wage growth. The average worker is now £5000 worse off since 2008 leading to an increasing sensitivity with regards to pricing of every day goods and services[1]. The UK discount sector is currently valued at £10bn annual sales, 8.3% of the total market share (Oct 2014). This is forecasted to increase to £20 billion within the next five years aligning itself with the current European countries' 12 - 15% of the total market share. Sainsbury's has earmarked £150 million for price cuts across its range of products to try and increase its competitive edge in the pricing war that has now encapsulated the market. This, however, seems feeble compared to amount the other firms comprising the big four have set aside with Morrison's, for example, allocating £400 million to its price cutting strategy.

Although cutting prices is key for competitiveness, there are risks that the quality of products may fall victim, and this is a fundamental issue for Sainsbury's. To mitigate these effects further and help adapt to a changing market, Sainsbury's has recently invested in a joint venture with Danish discount chain Netto, as outlined in the previous section. Although this gives Sainsbury's an emergence into the discount sector, there is a risk the Netto deal could undercut its own ranges, actually decrementing its own flagship products. Currently, stores are only present in northern England where Sainsbury's presence is low, so the risk is reduced but expansion of the venture could create its own problems for Sainsbury's.

Sourcing of Products & Foreign Trade Risk

The sourcing of overseas foreign products presents a number of risks to Sainsbury's business strategy:

- GBP fluctuations can lead to a fluctuation in COGS (cost of goods sold) depending on the proportion of goods sourced overseas depending on the terms and conditions agreed between the supplier and Sainsbury's.
- Maintaining and inspecting overseas product quality and facilities is difficult to regulate. The Horse Meat Scandal of 2013, which Sainsbury's managed to avoid, exemplifies this.
- Association of local sourcing and British branded products delivers important impressions to customers about company social values and product quality.

Sainsbury's compared to its competitors has cemented itself as one of the leading British sourcing supermarkets in the UK with over 1900 products in its own brand range, planning to double this figure by 2020. Alongside this, Sainsbury's has supported British farmers for over 143 years supporting initiatives such as the farmer and grower development groups. Sainsbury's is also the world's largest retailer of fair trade products supporting ethical sourcing with integrity.

Accounting Practices

Sainsbury's have experienced increased scrutiny with regards to its accounting standards after recent revelations that close rival Tesco PLC overstated its first half trading profits by as much as £263 million. At issue was how Tesco booked promotional payments and rebates from its suppliers as revenue. This caused turmoil in the UK Grocery Market as a whole, with share prices for all major retailers falling significantly when the news came out.

A significant reason behind Sainsbury's link to this is that once regulators are done checking Tesco's books, there will be investor pressure on Sainsbury's and other big UK supermarkets to do the same to their accounts. If this were to happen, Sainsbury's would be expected to come out of this investigation unscathed, this claim is backed up by CFO John Rogers saying that he is "100% confident" in the company's accounting practices.

Sustainability

Management claims that sustainability and the environment are core to Sainsbury's values. The firm makes all the right noises; it has published an extensive sustainability report (The 2020 Sustainability Plan), and is a leading FTSE 100 firm for carbon management. In comparison to its rivals, we see Sainsbury's as a middle of the road player. It certainly has more sustainability initiatives than Tesco, however has fewer than Morrison's, Waitrose or M&S. Indeed in the most recent annual report the only sustainability figure reported was a drop in water usage thanks to better usage systems.

On the social side of sustainability, management triumphs its £80m bonus to staff in 2013/2014. This may seem generous, however over the period Waitrose paid its staff (50% of Sainsbury's staff), ~£200m. That said by all accounts Sainsbury's is a good long-term employer.

Overall we see Sainsbury's sustainability efforts as largely brand-driven, rather than as driven by long-run business intentions. For an exemplar business that does place sustainability at the heart of business practice, we recommend investors look at Unilever, who aim to double revenue whilst having environmental impact by 2020. Sainsbury's has some good initiatives, but is not game changing in any of its sustainability efforts.

Financial Analysis

Graham Defensive and Enterprising Investor Metrics

Ben Graham, long known as the founder of value investing, counselled investors to apply a number of metrics to potential stock investments in order to evaluate which to buy. These metrics fall into two categories, those for the risk-averse defensive investor, and those for the more risk-keen enterprising investor. We will here analyse the more demanding defensive investor metrics.

	Adequate size of enterprise		Sufficiently Strong Financial Condition		Earnings Stability	Dividend Record	Earnings Growth	Moderate Price to Earnings (3yr avg.) Ratio	Moderate Price to Assets Ratio	Graham Number
Criteria	£310m plus		2 plus	110% or less	100%	100%	33% plus			Under 22.5
	Results	Size (£m)	Current Ratio	LR Debt to NCA	Earnings Stability	Dividend Record	10yr Earnings Growth	Pemg	P/B	Pemg x P/B
Sainsbury's	HY 2014	4670.43	0.65	-125%	100%	100%	54%	7.00	0.90	6.27
Tesco	HY 2014	15181.87	0.69	-203%	100%	100%	94%	7.87	1.60	12.62
Morrison's	FY 2013/14	4261.5	0.50	-210%	80%	100%	98%	22.23	1.01	22.37

As the table above illustrates, none of the major supermarkets pass Graham's defensive investor criteria. Most problematically, long run debt dwarves net working capital for all three grocers, producing negative percentages. Overall, Morrison's is the weakest, scoring 4/7, and we share city views predicting further trouble for this company. Tesco and Sainsbury's score a marginally healthier 5/7. Interestingly Sainsbury's is by far the cheapest (lowest 'Graham Number'), has the 'best' Debt to NCA percentage, and the second 'best' current ratio, so could be the strongest relative play in the industry. In sum however the balance sheet weakness of all three companies make their shares unattractive investments for risk-averse investors.

Investment Appraisal

With competition in the groceries sector increasing rapidly, the long dominant incumbents such as Sainsbury's are being forced to adapt and work to overcome threats to their businesses as a matter of urgency. The main area of competition is, unsurprisingly, price. With consumers feeling the hangover effects of sustained high inflation in addition to the gravity of the recent recession, there is clearly room in the market to offer consumers staple goods at knockdown prices. This is where firms such as Aldi and Lidl are able to pounce on the market share of larger rivals and this they have been doing recently with aplomb. In the 12 weeks to 7 December, Aldi and Lidl took a combined market share of 8.6%. Aldi's sales were up 22.3% and Lidl's by 18.3%.[1]

Despite this, we believe that Sainsbury's is far better positioned going forward to deal with the risks outlined than its competitors. We see the threat posed directly by discounters as being dealt with as more significant and potentially damaging than might actually be case. A particularly interesting area to investigate has been the advertising spends of Sainsbury's compared to the discounters. Aldi, from available data, spent £52.6m on advertising compared to Sainsbury's £53.6m.[2] What is telling, however, is not the size of the figures themselves, but the spend as a proportion of annual turnover; for Aldi this was 1.7% but for Sainsbury's, it was 0.8% of turnover. Evidently, the advertising expenditure of discounters is far higher as a proportion of turnover. This links in with the discounters' aggressive brand promotion attempts that they believe will break the longstanding reputations held by larger rivals and allow their market share to increase and presence to become more disruptive to the status quo.

We are also of the opinion that the size of Sainsbury's market share is largely ignored. Whilst sales figures at discounters are rapidly increasing, the market shares of grocers such as Tesco, Asda and Sainsbury's are still far larger. Despite its competitors' recent woes, we believe that Sainsbury's has an intangible brand value to the customer that is superior to the likes of Tesco. Sainsbury's stable navigation of the recent sector turbulence reflects this. In the improving economic landscape, the spending power of Sainsbury's target customers is likely to increase as inflation slows rapidly thanks to the plummeting price of oil amongst other factors.

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[1] According to Kantar Worldpanel
[2] According to Ebiquity/The Grocer. Most recently available financial accounts to April 2014

In the current environment in which there is not only a vicious price war among established grocers but also an increase in consumer spending power, we see it likely that Sainsbury's customers will stick to historical purchasing habits. There is a requirement for a prolonged period of heavy investment to allow discounters to fully disrupt the reputation and popularity of Sainsbury's and larger grocers. We consider the likelihood of this happening as relatively low given the significant pressure that the required expenditure places on financial performance of discounters.

While none of the firms in our financial analysis met Ben Graham's defensive investor criteria, Sainsbury's passed 5 out of the 7 checks performed and returned the lowest debt to net current assets ratio. In addition to this, market pessimism towards Sainsbury's prospects is reflected through Sainsbury's returning the lowest Graham number of the companies analysed (6.25). Given the significant financial and strategic woes of both Tesco and Morrison's we see this as unduly negative towards Sainsbury's. It is adapting to the necessity for change with conviction and targeting areas in which industry disrupters could cause the most damage, such as the northern England, where Sainsbury's historic presence is low. We feel risk/reward is favourably skewed towards Sainsbury's and see a positive outlook for shares in the company going forward.