Ocado: Close to Proof

Upgrade to STRONG BUY @ 74p

- **Online grocery will take share. This is a real business with a good product.**
- **The business is cash flow positive excluding growth capex and the ramp-up of the new facility will be very accretive.**
- **We are through the point of maximum pessimism on the balance sheet and at the point of maximum pessimism on the business model.**
- **Price target significantly higher than current share price. Valuation below replacement cost.**

Company	Ocado PLC
Recommendation	STRONG BUY
Price	74p
Price Target	175p
Upside	+136%

THE ANALYST

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Following an extensive review of the company, another site and management visit and an internal debate, we upgrade Ocado to Strong Buy. Ocado is a real business, with the best product in the online grocery space. Online grocery in the UK is still under 5% penetrated and we think, over time, the industry will follow other retail trends in terms of online penetration.

Online delivery can have a fresher product and a lower cost, delivered to your door. Online, like in other industries, is a category killer that can grow for the next decade.

Ocado can offer consumers **low-price products, delivered accurately to your home**. With their inherent **advantages over traditional, physical supermarkets,** they can provide this service and make an 8-10% EBITDA margin themselves.

Investors need to have patience. This is a **completely new approach to selling groceries**. Ocado have ripped up the traditional model. Having seen the investment deployed over the last twelve years and the fully functioning factory delivering 140,000 orders per week, we do not think this is a business put together by investment bankers to win fees and assure a quick exit for management.

The reality is that Ocado's CFC1 is testament to human innovation and hard work. The fact that it has even been built is a tribute to the incentive structures of Western capitalism. It is a real business, employing a lot of people and trying to do something new. **Proof of concept is now appearing** and we argue that in terms of market psychology we are being presented with a compelling opportunity to own a piece of a business that could change an industry and become highly profitable in due course. The **psychology point is compelling** because investor sentiment is extremely negative, short interest very high and there are many question marks and risks still around the stock. By the time some of these questions get answered, the shares will be significantly higher than today's price.

The misperception is that Ocado won't be profitable because customers won't pay for delivery. The reality is that customers don't need to pay for delivery and that Ocado can eat the delivery cost out of the margin because of the cost savings of the model.

Through pinch point on the balance sheet:

- Ocado raised £36m via an equity placing in mid-November. Without this, the company would probably have breached banking covenants (or at least got close enough to trigger an event). Through the placing and extension of the £100m debt facility maturity, we think they are through the point of maximum pain on the balance sheet.

- As of today, the company is covering maintenance capex out of cash from operations. Without the growth capex, the company is self-funding. Capex peaked in H1 2012 and, as the business grows, it generates cash from working capital (which will offset interest payments in the near-term).

- We now expect growth in EBITDA on a quarterly basis, driven by revenue growth and efficiency improvements. Our net debt to EBITDA calculation showed a pinch point pre the equity raise at 3.3x v. the banking test at 3.5x (an effective breach of covenants given the banks want a margin of safety). Now we see ND:EBITDA at 2.3x, dropping to 2.2x in H1 2013 and 1.7x in H2 2013.

- We are **not saying Ocado is totally home and dry** and we cannot categorically rule out a start-up delay in CFC2 or another operational hiccup in CFC1, but we are saying the likelihood of these two risks is diminishing every day and the balance sheet is corrected to accommodate these two risks.

- The overlay for all this is a short interest in the stock around 90 days trading volume of 15-20% of the market cap. To be short the stock today, you would have to believe the company will go bankrupt. We don't think this will be the case.

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Inflection point on operations in CFC1 and incremental efficiency in CFC2 can improve by 40%:

- Ocado's long-term targets are for 'CFC efficiency' of 180 units per hour and 175 deliveries per van per week.

- Currently, they are at 114 and 150 respectively. This translates to a cost per order of £9.32 in the CFC and £12.81 trucking. At the target levels, the company would be picking the order for £6.90 in the CFC and getting it to your

door for £8.20. This is the theory, and at these levels, with a gross margin of 31% (£34 on the average order of £110), the company delivers a 17% EBITDA margin, pre-overheads.

- Clearly, the evidence that investors have to work with since the IPO is serial disappointments on sales growth (which has restricted the efficiency gains of the model) and incremental profit conversion weakness. In particular, CFC efficiency has gone backwards, from 124 in 2009 to 114 in the last interim period. This suggests that as the business has scaled, it has become less efficient.

- However, we are at the inflection point here, where the management has ramped-up the automated picking machines, in particular OSR2, replacing some of the manual picking put in place earlier in the year. Furthermore, they are close to bringing in an automated bagging system, which would cut 10% out of the labour costs of the operation.

- CFC2 will start-up towards the end of February (early March?) 2013. By using their ten years of experience in CFC1, this centre should come on-stream at dramatically better efficiency metrics. By the end of year one, CFC 2 should have a capacity of 120,000 orders per week (CFC1 is peaking at 140,000 per week currently).

- There are some immediate delivery savings of fulfilling the Northern/Central part of Ocado's delivery range from CFC2 and the break-even point for CFC2 would be significantly lower than CFC1 - around £50m-£60m. Importantly, CFC2 will not bear the central overheads of £35m which are carried in the current business.

- Ex-central overheads, CFC1 is doing around £70m of EBITDA (a 10% margin). Therefore, a 10% EBITDA margin should be the worst-case scenario for CFC2 when ramped up. We met the management yesterday (and yes we know the bears' view on management…) and the CFO reiterated the expected efficiency improvements from CFC2. We think CFC2 could operate within 10% of the company's 180 CFC efficiency target, 40-50% better, delivering at least £3-4 per order benefit.

If they don't monetise it, someone else will:

- What would Tesco pay for this? Tesco could easily fill the two CFCs with £2bn of sales per year, making a 10% EBITDA margin and over £100m of net income, valuing it around £1bn (current market cap £400m).

- We believe Tesco are losing money for each online order. Although Tesco is opening a 4th 'dark store' with some automation, the pick rates with humans are at 75-100 at best (items per hour), compared with 280-300 in the dedicated CFC. Tesco has just 5% margins in the store and assuming it costs them £20 to pick and deliver the order, they are clearly losing money to protect market share and get a foothold in online.

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Ocado claims to save 20% of sales in costs in the CFC model:

1. Firstly, suppliers deliver direct (85%+ of the product), thereby eliminating one step in the supply chain in the regional distribution centre – this equates to 300-350bps of cost savings.
2. Secondly, labour is around 10% of sales in a supermarket (1/3 at the checkout and 2/3 on the shop floor). Ocado's decanting operations (direct off the truck into the stock flow), lack of checkouts and absence of employees on a shop floor equates to around 600-900bps of cost savings.
3. Thirdly, the waste savings are staggering. Waitrose waste costs are 400bps, whereas Ocado did 73bps in the last interim period. In addition to this, their food is fresher by missing out the RDC.
4. Fourthly, property costs are around 8% of supermarket sales in costs, compared with Ocado below 2% (including energy savings).
5. This all adds up to around a 20% of sales cost advantage over the traditional, physical supermarket.
6. On the offset, are disadvantages on purchasing due to scale – Ocado purchase at least 5% worse than the peer group, and still buy alongside Waitrose (a risk in the business model).
7. Then we add back the pick and deliver costs which are 8.5% and 11.6% of sales currently. At the current run-rate of £700m of sales, Ocado is break-even and has not yet realised the efficiencies (in terms of bring down pick and deliver costs) to demonstrate the economic advantages of their model.

- Even if Ocado cannot do this itself, it would make sense for Tesco to acquire the centre. Tesco would immediately bring their purchasing advantages to the stock, adding at least 500bps to the gross margin and taking the Ocado EBITDA margin to 10% overnight.

- Additionally, they would cut the corporate overheads (currently £35m+). An acid test on the stock would be the price a trade buyer would pay for the asset and we believe that price is higher than the current Ocado market capitalisation**. If the Ocado management don't monetise what they have built, someone else will.**

- It's a real business which cost over £300m to build and we should consider the intangible value of ten years' engineering development. A price of £500-1bn would not be unreasonable for a trade buyer to pay for this asset.

Valuation and expectations:

- Ocado is at break-even and making around £35m of EBITDA. It is free cash flow negative while expansion capex is put in for CFC2. Therefore, the stock is 'expensive' on earnings multiples. On valuation, we think the key consideration is that Ocado is now at a low multiple on replacement cost and below the price at which a trade buyer would be interested.

- On our modelling assumptions, we get to £125m of EBITDA by 2015, with £55m next year. Ocado therefore trades on 9.4x EV/EBITDA (peak debt at £92m) near-term. With proof of concept, the market is highly likely to afford Ocado a high earnings multiple and our price target of £1.75 is based on 8x EV/EBITDA and 12.5x the 2015 EPS.

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- At this point we dare not talk of CFC3 or a licensing model: we save the economics of this until we have proof of the economics of the current asset!

Risks and Other Considerations:

CFC2's build is complete and they are in physical testing with some supplies running through the centre. The CFO claims they are within £1m of the initial budget and it will be on time. He admitted that **if there is a delay it would be a case of weeks, not months.**

CFC1 has not been a smooth ramp-up and the company has struggled to get to the current 140,000 peak orders per week levels. The implementation of the automatic bagging could be delayed and increasing the number of SKUs brings some increased complexity. **There could be additional problems in CFC1.**

Ocado is a disruptive player in a well-established industry. **Tesco and the other supermarkets will not sit back and let them succeed.** Ocado will have to fight big, strong players to prove the model. Predatory pricing and smear campaigns should be expected (in fact the company is already heavily criticised in the popular and financial press). The other players will have to provide online offerings to customers. Our view is that more online offer is better for Ocado as it drives penetration and changes customer habits faster.

The **company needs to grow around 15% by adding customers.** Customer awareness of Ocado is still low on a national basis and the price perception of the offering is not good. Ocado is associated as Waitrose own delivery and is viewed as expensive. The **company will have to work hard on customer perception to negate this**. They will also need to drive new customer numbers through vouchering, price match offers and first-time customer incentives (e.g. £20 off your first shop). Customer retention is around 20% (the number of first-time customers that reorder within a year). Once a customer reorders, they are usually a customer for many years (the management argue Ocado is a 'subscription model'!). Anecdotally, they claim they are still growing in every postcode (even the core early adopter areas of North and South West London).

The company will **need to invest margin gains in pricing**. We should anticipate that any purchasing benefits gained from scale are reinvested in pricing for the customer. Gross margin expansion will be very limited. Additionally, the expiry of the Waitrose contract (in 2020 with first termination opportunity in 2017) could be negative for Ocado's purchasing costs. We are probably more relaxed than the rest of the market on this as Waitrose benefit from the joint purchasing and by 2017 Ocado will have adequate scale to offset the termination. They are currently constrained in their own-brand offering (capped by the Waitrose agreement at 20% currently, rising to 30% next Easter). Ocado pay Waitrose £10m in sourcing fees per year.

The **non-food offer is being launched,** with a lower level of sophistication (8,500 SKUs). The gross margin is higher on non-food and the offer is obviously complementary to the grocery basket. Non-food could offer upside longer-term but in our modelling we assume it merely offsets a decline in average grocery basket size (we keep average order size flat at £111).

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Conclusion:

We've been wrong on this stock for a long time, but this is not an analytical reason to stop. As the share price has come down and the business has tangibly improved, this has made the investment proposition much more attractive. We have debated the investment case at length internally and reviewed the prospective economics of the business. The only conclusion we can draw is that Ocado is a Strong Buy idea. We recommend investors add to positions and we recommend short sellers cover their positions.

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