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Tesco interim results - Green shoots appearing

As highlighted in Wednesday's Global Ideas, Tesco released interim results this week. The results to August 2013 were lower than expected primarily because of weak performances in Ireland, Poland and Turkey. Continuing EPS was down 7%. The expectation for the full year to February 2014 was for flat earnings. In our view this will probably be revised slightly lower but not materially so because, for various reasons, we expect 2H will be much better than 1H and the comparatives (i.e. 2H in the prior year) were more depressed. We believe forecasts for FY15, however, are unlikely to be revised downwards and, if anything, could be revised upwards. We think the past six months could be the low point in Tesco's recovery cycle.

Tesco is making good progress with the refresh of their UK business which remains roughly two-thirds of the Group. Tesco UK has faced three problems – the rise of e-tailing (affecting, primarily, general merchandise e.g. consumer electronics), the decline in popularity of large format hypermarket type stores (with a shift towards local, convenience stores), and the weak UK consumer. The first two problems are related. Over the past 18 months just over 1/4 of Tesco's UK store space has been refreshed with a revived food and, most recently, general merchandise (GM) offering. The signs are positive. The problematic consumer electronics range is being cut back and modified. We are likely to begin to see the full benefits of the UK store refresh cycle by the second half of calendar 2014, in our view. However, the test will be whether the company can restore the profitability of the broader GM range and improve sales densities in the large stores. This remains a question for all big box European retailers.

During the past six months Tesco management have made some important strategic decisions. They have exited the US market and they have also merged their struggling Chinese business with the largest food retailer in China, China Resources Enterprise's (CRE's) Vanguard, for a 20% stake in the combined entity.

Anchor Capital recommended a purchase of Tesco in July 2013 with the share price at GBP3.47. We suggested that we may be too early. We also felt that Tesco wasn't dramatically undervalued but that you would be paying a fair price for a good business. Our thinking has not changed - in fact the signs of improvement in Tesco UK have become more encouraging. Our value for the business is GBP4.10 representing 15% potential upside. We believe this upside could improve in a stronger UK economy.

David Gibb

Global Ideas is a newsletter published three times a week (Monday, Wednesday and Friday) and available only to clients of Investor Campus and Anchor Capital. The key objective of this newsletter is to provide ideas for investment in the global investment universe.

We scan the globe looking for good opportunities. We provide our model portfolios, as well as news and views on our watchlist, which is continually reviewed and updated.

Contacts

Anchor Capital reception	**011 591 0677**	**Trading Desk**	**012 665 3461**
Investment/ Sales	mnyoung@anchorcapital.co.za	General Enquiries	info@anchorcapital.co.za
Brokerage/ Trading	fswart@anchorcapital.co.za	Newsletter Enquiries	newsletters@anchorcapital.co.za

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