April 8, 2011

Dear clients and colleagues,

As people work longer hours and travel more, food on the go has become a huge market in some countries….

This week we shall profile Greggs plc, a current holding in our portfolios. We recently meet with one director of Greggs and were impressed by the operational initiatives they have undertaken in their locations.

Business overview and history

Founded as a family bakery business in 1930 and headquartered in Newcastle, England, Greggs has been baking for over 80 years. It is the leading bakery retailer in UK, operating in two markets: the traditional bakery and the food-to-go market. It serves fresh sandwiches, hot savory snacks, sweets and beverages to a million customers each day, with over 1,487 stores. It has positioned itself as the leading freshly-baked shop in the UK with the best value proposition for its customers.

The market

The "food on-the-go" market has gone through major changes. Now competitors come from different areas: Supermarket chains, convenience stores, up market coffee shop chains, craft bakers and sandwich shops. The Food-to-Go (FTG) market has benefited from changes in habits like erosion of fixed regulated meal times with more and more people eating on the move. Due to the increase in working hours and increased travel time this segment has experienced robust growth. Estimating the exact size of the FTG market is difficult since at one end of the spectrum it could include convenience stores and the other end branded coffee shops.

The European bread & rolls category is a €70B plus market. Euromonitor forecasts the core bakery market to grow at 2% p.a. and estimates that the bakery market was valued at £8.8B in 2010, and has grown at an annual rate of 2.7% over the past five years.

Competitive advantages and competition

Greggs operates in a fragmented market and competes against grocery stores such as Tesco, sandwich shops such as Subways and up market coffee shops like Pret a Manger or Costa.

Greggs is the dominant independent baker on the UK high street with 10 times more stores than its closest direct competitor. The majority of products sold in its shops are produced by one of its ten bakeries across the UK. Greggs products are superior to grocery store products given that they are freshly baked. It differentiates itself from other coffee or sandwich shops by its value proposition, selling its product at a 5%-10% discount to other specialty shops.

Growth strategy

Store expansion can be done through regional expansion. It has a strong presence in the Northeast and Midlands and can expand into Scotland, the South West and South East. Management estimates that the UK has capacity for another 600 Greggs shops (1,487 shops at present), based on expansion into regions where the Group is currently under-represented, in particular East Anglia, the Southwest and Kent. Also, management started to diversify its shop locations by expanding into non-traditional sites such as industrial estates, retail parks, train stations and airports. These locations are normally far from their existing high street stores so cannibalization will be minimal.

Greggs is intensifying the refurbishment of its London shops. An additional 60 stores will be converted to the new concept shop format this year. The new concept is much more appealing in our view and drives better sales performance than the older format. In total, 170 shops will be refitted in 2011.

On the product mix side, Greggs has the opportunity to scale up and broaden its sandwich, beverage and take home food offering. Recently it has made strategic investments in its equipment which should positively impact sales volume and margins of those categories. It has begun the introduction of new hot sandwich machines in its shops and should be at 50% completion by year end. Hot sandwiches have a higher selling price and customers' reception has been good so far. Greggs is also in the middle of important upgrades of its coffee machines. Considering that coffee sales are only 5% of total sales, the new coffee machines should drive up the number of cups served. By year end, all locations will be equipped with the new machine.

With a strong balance sheet and strong free cash flow generation, it has the means and the expertise to acquire smaller regional chains. In 1994 Greggs acquired, and successfully integrated, 424 Bakers Oven shops.

Management

Kennedy McMeikan joined the board in June 2008 and was promoted to the role of CEO the same year. Prior to his appointment at Greggs, Kennedy had worked as Retail Director for J Sainsbury and CEO of Tesco Japan. Insiders and employees own close to 5% of shares outstanding.

Risks

A weak consumer and employment environment in the UK is negative for the retail industry overall. The defensive nature of food companies should be less impacted by a sluggish economy. Consumer scaling down on their purchases has a neutral to positive effect on Greggs.

Rising commodity prices will have an impact on margins in the very short term before stabilizing in six months. Greggs has already increased its prices and intend to continue at least four times during the year

Market data

Market Cap £518M, net cash £23.7M, P/E (2012) 11.4x, EV/EBITDA (2012) 5.2x, dividend yield 3.7%, gross margin 61.8% and profit margin 5.7%. http://www.greggs.co.uk

Valuation

We use a DCF model and derived a target price of 710 pence.

Have a good weekend.

Regards,
The Global Alpha Team