Tesco PLC

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Look past Tesco's window dressing and its pandemic profits are clear

Tesco PLC (LON:TSCO) at the bottom line is doing very well from the coronavirus pandemic and on course to continue generating plentiful levels of cash in the coming years.

What's more, with the sale of its last remaining Asian businesses on track to kick off a £5bn return of capital to shareholders by early next year, dividends are soon going to be coming out of its ears.

Results for the six months since the start of March had some 'window dressing', including flagging that the UK supermarket business is winning market share from Aldi for the first time in a decade, but at the statutory level profits before tax were up 29% to £551mln and the half year dividend was hiked almost 21% to 3.2p per share.

The group also highlighted that, if excluding exceptional items and amortisation, underlying operating profits for its retail business were up 4.4% to £1.192bn.

'Core' operating profits were down 16% to £1.037bn, which includes the impact of a £155mln loss from Tesco Bank.

The effect of COVID-19 has had, as analysts at Shore Capital said, a significant distorting effect on the group's performance this year, but on the whole it has been positive.

Tesco said COVID-19 led to £533mln of extra costs in the UK in the half year, but sales volumes were driven much higher as the British public ate out less, which the government provision of a 12-month holiday from paying business rates was worth £249mln in the period.

READ: Should Tesco pay a dividend when it expects government support?

Management said their latest estimate for COVID costs for the full-year is around £725mln, versus its previous indication of £840mln.

This implies there will be around £244mln of extra COVID costs in the second half versus rates relief that is expected to be around £284mln, which points to a positive impact on full-year profits.

In fact, the new profit guidance from new chief executive Ken Murphy, who has been in charge since the start of the month, was for retail operating profit of "at least the same level as 2019/20", updated from his predecessor's guidance of "likely to be at a similar level to 2019".

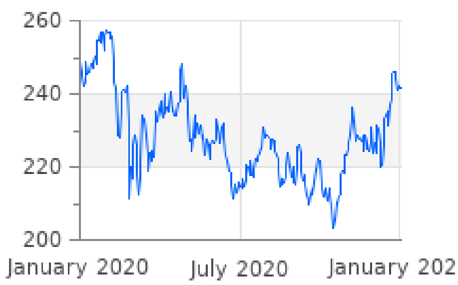
Balancing this, Tesco Bank is projected to make an operating loss of £175-200mln due to bad debt provisions.

Analysts at UBS said this suggests the City consensus will see "modest low single digit" upgrades today, "especially

Price: 241.6

Market Cap: £23.66 billion

1 Year Share Price Graph



Share Information

Code:		TSCO
Listing:		LSE
52 week	**High**	**Low**
	260	**202**
Sector:		**Retail**
Website:		**www.tesco.com**

Company Synopsis:
Tesco - the leading supermarket in Britain With small grocery stores under the Tesco Metro brand name, big supermarkets outside cities (Tesco Extra) and 24-hour stores.

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given the substantially lower COVID-19 costs in 2H".

Shore Capital analyst Clive Black was even more effusive on the longer-term case, saying he believes Tesco "can be a sound growth and highly free cash flow generating business with much if not all of that cash flow being deployed to shareholder benefit from measured organic growth, rising dividends and share buy-backs".

The dividend hike, said Richard Hunter at Interactive Investor, is "a breath of fresh air to income-deprived investors", implying a dividend yield of over 4.5%.

UBS said the doubling of online delivery capacity to 1.5mln orders per week, resulting in a 69% spike in sales for the period, and better than expected retail profits, "reassure investors on key concerns on online and show that there is operating leverage in the business".

"Given how poorly Tesco shares traded through the numbers and a substantial beat in retail profit, we believe reassurance on the Asia deal and capital returns could mean that the shares outperform today," the analysts said.

Lingering issues

Tesco Bank is "becoming a headache and needs to be offloaded", said Neil Wilson at Markets.com, with sales slipping a third and losses continuing.

"Shifting the financial division on to some other party seems like one of the first things for Ken Murphy. Having already offloaded the mortgage book, Tesco has one foot out the door already," he added.

There was not much note by analysts of debt, where non-lease net debt was up almost £240mln to just over £3bn, with total indebtedness, including £9.5bn of lease liabilitiesies and a £3.3bn pension deficit, was up over £980mln to £15.85bn.

Shore Cap did note that around £2.5bn of the Asia proceeds are set to be deployed to reducing pension responsibilities.

Julie Palmer, partner at Begbies Traynor, said in spite of the positive results, the group will still have concerns after its valuation dropped below Ocado.

"This was not just a great achievement for Ocado, but a sign of the competition Tesco is up against in today's market. And even though Dave Lewis has left a well-oiled machine behind him, it will not be an easy ride for new CEO Ken Murphy."

External concerns seem to be the main issues for Tesco, with the pandemic and associated recession, plus the UK's exit from the EU all at once, as well as new online competition as well as Ocado's new partnership with Marks & Spencer, including a new click and collect service from discounter Aldi, and the looming juggernaut of Amazon entering the field.

As Quilter Cheviot analyst Amisha Chohan puts it: "The last decade was all about the growth in discounters such as Aldi and Lidl. This decade, we believe it will be about the growth in online grocery."

Tesco will need to continue its focus on improving efficiencies to enhance margins as online margins are lower than in store.

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