ICA GRUPPEN – EXCESSIVE MARGINS, INDUSTRIVARDEN EXITS

«In the short run the market is a voting machine; in the long run it is a weighing machine» (Benjamin Graham). A case in point is the wild SEK 50 rally in ICA following a decent but far from spectacular q3 report last October. As the co only beat revenues by a meager 1pc and the rest is due to margins staying flat after having contracted for six consecutive quarters, the reason for the wild rally is to be found in positioning rather than the numbers themselves. A large short base and underweight Swedish institutions were caught wrong-footed. With valuations as a result driven up to an unwarranted 30pc premium to peers ahead of a likely multi-year structural margin decline, an opportunity has emerged on the short side.

GRAB

ICA SS Equity | Export | Settings | Equity Relative Valuation

Comp Source Analyst Curated (BI) | Name | Curr SEK

vs Comps | Group Dynamics | vs Self

Analysis of ICA SS Multiples - Premium to Comps (3M | 6M | 1Yr | 2Yr | 5Yr)

	Current vs 2Yr Average Historical Premium					2Yr Historical Premium Range		Implied @ Hist Avg	
Metric	Current	Hist Avg	Diff	# SD	3M Trend	Low	High	Multiple	Price (SEK)
Current Price									320.50
11) BF P/E	30%	11%	20%	2.6		-2%	35%	15.1x	272.33
12) BF EV/EBITDA	46%	31%	15%	2.3		20%	50%	9.5x	285.25
13) BF EV/EBIT	22%	12%	11%	2.0		2%	26%	13.2x	291.07
14) BF EV/Rev	34%	20%	14%	2.2		10%	38%	0.5x	285.89
15) LF P/BV	-12%	-33%	22%	2.7		-44%	-8%	1.5x	241.89

9) View All Comps Below

Summary of Current Multiples

Name	2Y Corr	Mkt Cap (SEK)	BF P/E	BF EV/EBITDA	BF EV/EBIT	BF EV/Rev	LF P/BV
1) ICA Gruppen AB		64.49B	17.8x	10.6x	14.4x	0.6x	2.0x
Current Premium to Comps Mean			30%	46%	22%	34%	-12%
Mean (Including ICA SS)		74.96B	13.7x	7.3x	11.8x	0.4x	2.3x
2) Axfood AB	0.32	32.32B	20.6x	11.3x	15.8x	0.6x	8.1x
3) Colruyt SA	0.20	93.28B	23.6x	11.8x	18.1x	1.0x	4.3x
4) Koninklijke Ahold Delhaize NV	0.17	274.51B	13.9x	6.5x	11.0x	0.4x	1.8x
5) Sonae SGPS SA	0.17	16.88B	10.1x	11.7x	20.9x	0.7x	0.8x

Grey values are excluded from group stats. 10) Analyze List

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Source: Bloomberg

The short thesis on ICA is far more than its lofty valuation, though. Swedish food retail seems to have been a protected space with EBIT margins 30-40pc higher than its international peers. For the market leader ICA (36%) the situation is even more dramatic as its franchise model has allowed for an additional 2-300bps fat to have been left with the franchisees. In sum, ICA has been able to operate with margins on a fully integrated basis of 6-700bps – more than twice the level of its more competitive international brethren like Ahold, Carrefour, Tesco et al and even 50pc higher than its fully integrated domestic peer Axfood. As the fat Swedish margins are attracting more competition in a starved European food retailing industry, that premium ought to be eradicated in the next few years. A warning of things to come may be found in the CMD in December, where management guided on flat margins in 2019 after first saying that the weak 1H `18 margins had been «exceptional».

One reason for the Swedish contentment on competition is found in the failures of large players like Lidl to break into Sweden. Pushing German brands to the Kalles Kaviar-loving

Swedes proved a difficult task. As Lidl has regrouped and changed its offering, the fat Swedish margins are about to incur a new and better prepared attack. Speaking to an owner of one of Lidl`s competitors in Sweden underlines this thesis, as the respect for «new» Lidl`s capabilities has grown considerably. 3 trends Lidl have identified as differentiators are sustainability, global food innovation trends and flexitarian lifestyle. Also, the new concept stores with sun-panels, eco-zones and EV-chargers offering a.o delicatessen shops with food service proves Lidl is aiming high not only in number of stores but also in quality. Having achieved an «Outstanding» BREEAM certification for a number of its new stores in Sweden already, it seems Lidl are well underway to revamp its image and reach its target of 200 stores by 2020 (ICA 1300 stores at 36% mrk share).

On top of that, as the industry is gearing up for online sales, management is steadily ratcheting up its capex forecasts for the years to come. Now anticipated at SEK 4bn/yr, after having been firmly set at 2-2,5bn in 2012-16 and 3-3,5bn in 2017/18. With a gross profit level in steady decline and now more than 5pc lower than at the beginning of this period. The clock is ticking. Also, ICA`s franchise model indicates that the co may be more challenged than its competitors as online sales grows, and I am already hearing franchisees reporting stresses in the system as very profitable brick-and-mortar volumes are moved to low-margin online sales. It`s main competitor Axfood ought to see an easier transition with its fully integrated model. With online only 1pc or so of ICA`s volumes today (3-4pc amongst the franchisees that offer it) the situation with the franchisees is highly manageable, but how will this look when online is maybe 10 or 20pc? Given industry trends and ICA`s own capex plans, that is surely where we`re heading. Eventually.

Approx 10pc of ICA`s franchisees are losing money today, according to analysts. Assuming fully integrated margins need to come off at least 200bps on the heels of the changing competitive landscape, and this being shared 50/50 with ICA Wholesale, a dramatic increase in losses and subsequent turnover of franchisees can be expected. Already, the share of unhappy franchisees considering quitting within the next 5 years are up from 26% to 32% in a poll done by ABG last fall. All in, it seems fair to shave 100bps off ICA`s wholesale margins as they will try to keep franchisees in the system and assume a number of stores ending up in ICA`s hands, taking the overall margin down to industry levels of no more than 4pc (probably lower). That would take approx SEK 1,2bn off ICA`s earnings in a «normalized» margin scenario, leaving EPS down 25pc or so at SEK 14 with a major dividend cut to follow. At 23x normalised earnings, that leaves the stock vulnerable for a drop down to the SEK 200 level.

Industrivarden may have seen the writing on the wall, selling 5,5m shares in November and probably exercising its option to sell the remainder before the exchangeable bond expires in May. Worthwhile noting is that Industrivarden has an option to sell to ICA-handlarna before May 17th at 290.52, but it can also sell in the market, of course, if they can achieve a higher price that way. Without being too much of a conspiracy theorist, it is clearly in both parties interest to keep the price as high as possible as ICA-handlarna already controls >50pc of the company and won`t gain anything by moving ownership from 54 to 61pc. In that sense, the q3 halt in the margin slide was convenient.

Other minority shareholders ought better to pay careful attention here, as the main minority shareholder and the protector of their interests exits the company. Leaving the franchisees (ICA-handlarna) to govern the company alone with a 61,5pc ownership, just as the industry is about to embark on structural changes leaving future margin compression as the only certainty. Ie; ICA`s largest customer becomes not only it`s largest owner, but a completely dominant one at that. Will the rumblings amongst the franchisees for better purchasing terms find more acceptance with the board going forward? When Industrivarden leaves, the board will consist of 5 ICA-franchisee friendly members and 4 «neutral» (ie no bindings to any party).

The minority shareholders left in ICA must be crossing their fingers now. Hoping ICA will continue enjoying above industry standard margins thereby keeping the franchisees at bay in the BoD. Hopefully that will all go down well. For any other investor the question surely must be why the clouded strategic situation in ICA trades at a 30pc PREMIUM to peers when surely a large discount looks warranted.

SELL – 250 target on peer pricing when Industrivarden exits, more to come thereafter on margin compression and governance issues.

Source: Bloomberg

Oslo 08012019

Ståle