Students of Bath Investment Club

Ocado PLC

Equity Research Report – 01/10/2013

Ocado – Equity Research Report

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Louis Ash
Mridul Gupta
Udaivir Anand

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Executive Summary

- The online food market continues to grow steadily, and will pose significant challenges for the store-based food retailers
- Ocado operate a unique business model and have central warehousing advantages. This provides Ocado an economic advantage versus its larger, store-based competitors
- IP monetisiation adds significant value to Ocado
- Morrison deals fetches Ocado £180m

Company Background

Ocado, founded in 2000 by three Goldman Sachs traders is the only online only grocery retailer. It operates a central distribution process, whereby all supplies and orders are processed through large Customer Fulfilment Centres (CFCs). The firm had long been operating close to maximum capacity with only one CFC. The recent addition of CFC2 in Dordon, Warwickshire provides the largest single grocery store in the world (replacing CFC1 for that title).

The firms' statement that it is a 'technology company with a retail focus' gives reference to the pivotal role of technology in giving the firm a competitive edge. All operating software for the warehouse is developed in-house, since no other programming was deemed capable of coping with the complex operations. The firm is continually exploiting technology to provide efficiency improvements and to improve the customer interface and user experience.

The firm has a contract, due to expire in 2020, with Waitrose to supply their products. The firm is also increasing the range of own label products, which have seen substantial like-for-like growth and allow for higher operating margins. The range of non food products and speciality goods are further being increased to transform the company from a supermarket to a hypermarket, and enable more product competition vis-à-vis its' larger competitors.

Sector: Online Retailer

Market Capitalisation: £2.30bn

Share Price: 396 GBX

EBITDA: £31.2m

Revenue: £726.50m

EV/EBITDA: 7.28

P/E: Industry: NA; Industry (22.3)

Recommendation: Buy

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The On-Line Grocery Market

The UK online grocery market constitutes about 3.4% of the entire £163.2 billion grocery market, with the online grocery market growing c15% annually. IGD, the leading independent information provider on the grocery market, expects this growth to continue till 2017. Assuming the growth rate for the online market persists, it would account for more than 8% of the total grocery market by 2020. With the online food and grocery market in the UK set to double in value over the next five years, 12% of shoppers anticipate using online grocery websites more during 2013.

Despite this growth, however, there are a number of reasons why the market is still its relative infancy:

- **Distribution Network**

Most grocery products are perishable and need to be stored under one of three different temperatures (ambient, chilled and frozen). Since existing postage/courier networks can't be relied upon for the delivery, the grocer must develop their own infrastructure.

- **Consumer Reluctance**

Consumers are often still wary about buying perishable goods without actually seeing them. Moreover, there is a high degree of sensitivity to the delivery charge.

- **Availability**

Most online retailers pick orders locally, from an existing store or purpose built dark store. Orders are received on the basis of what should be in-store, rather than what is. Substitutions can be a nuisance especially when volumes are hard to predict. (Note: this problem is naturally mitigated by the Ocado model, as discussed later.)

- **Constrained Capacity**

Internet grocery shopping is more popular in urban areas, where grocery space is already constrained.

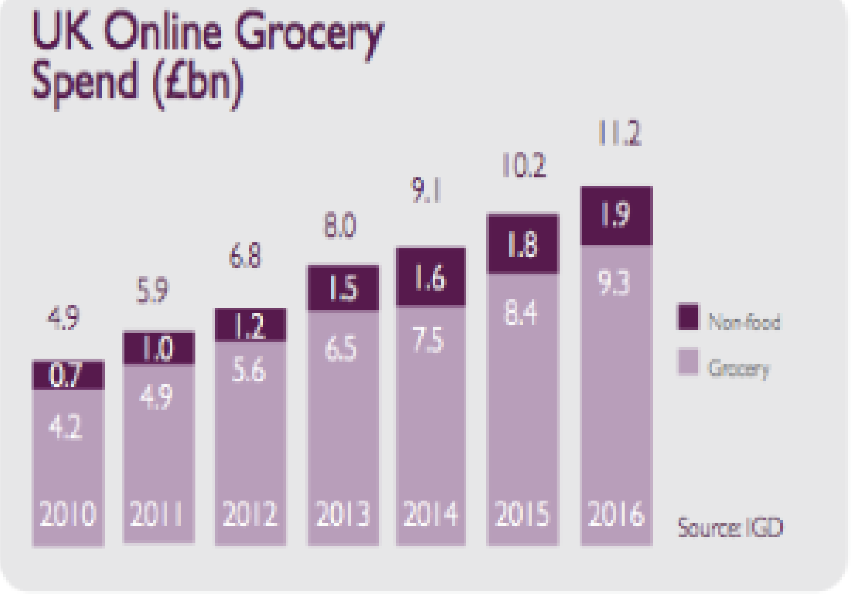
- **Population Density**

We observe that this model is particularly successful in areas with high population densities. London is an important example when analyzing the model. With a high population density and possibly lower levels of car ownership, online grocery shopping has risen to 25% in the city in comparison to 19% for the rest of the country.

Market Potential

The changing market structure is an underlying strength for the company's business model: IGD forecasts that the UK online grocery market will be worth £11.1bn by 2017, almost double its current value of £5.6bn; growing at 14.6% on a compound annual basis between 2012 and 2017. The UK online grocery market is currently 3.3% of the total £151bn UK grocery market. This proportion is set to rise to 6.1% by 2016. The total UK grocery market is growing at 3.2% per annum, with the online market accounting for c20% of this growth. The online grocery sector more than doubled in size between 2007 and 2012. And Mintel forecasts sector sales to increase by a further 79% on 2012 levels by 2017. The time-saving, reduced hassle, ease of use and integration with the digital revolution provide obvious benefits supporting the online grocery shopping transformation.

The firm is incredibly well placed to take advantage of the structural shifts taking place within the industry. It operates a significantly more efficient online business model vis-à-vis its competitors. As its competitors attempt to shift customers online, it becomes more beneficial for Ocado. The firm has found it is 5-10 times more likely to take online customers from competitors than their bricks and mortar counterparts. The firm is hence a beneficiary of competitors' marketing and drive to promote their own online grocery services. Further, for Ocados' rivals additional online customers gained are most likely at the expense of bricks and mortar customers, and hence the shift isn't revenue generating. Ocado however doesn't suffer this problem.



The Business Model

Ocado is an online food and goods retailer operating a business model underpinned by proprietary technology, which provides customer's economic advantages versus store-based competitors.

- **Industry Advantage**

Ocado, as the UK's only online-only grocery retailer, has an edge over it's competitors. Owing to the unique business model, they are able to generate significant cost savings. While most competitors running B+M (Bricks & Mortar) stores average retail costs of 7-8% of sales, for Ocado the figure is less than 2%. With the opening of CFC2, the company roughly targets a sales figure of £1.8bn with £1bn coming from CFC2. We expect a notable reduction in Admin and Technology costs as they will be covered by a significantly larger sales base.

- **Advantages of Central Warehouse Model**

The group operates a centralized distribution center to pick products and has its own network of vans to deliver them. What really sets Ocado apart from the competition are the two large CFCs they operate. 85-90% of stock is delivered directly to the Ocado CFC, with about 10-15% being sourced through wholesalers. For most competitors, in-store labour costs amount to about 9-10% of sales. Automated stock picking and sorting in the Ocado CFC reduces costs to about 70 bps.

- **Improved Freshness and Wastage**

Due to aggregation and the scale through operating out of a centralized location, the stock wastage costs for Ocado, which for most competitors are about 300-400 bps, amount to about 70 bps. Costs relating to energy wastage figure into our analysis as well. Open freezers and chilled food sections in B+M stores, coupled with hot air conditioning required to create an ambient environment for the consumer translate into high costs. Ocado, by eliminating picking costs and such energy costs, maintains a delta of 18-22%.

- **Non-food Segment**

Ocado has expanded into non food categories over the past 18 months. With about 9,000 non food lines, the company plans on further expansion. By opening a new non-food centre in Hertfordshire next year, Ocado should be able to continue with this planned expansion.

- **Economical**

For most of the competition operating B+M stores, retail costs (rent, rates etc.) are approximately 7-8% of sales. By operating out of a centralized and automated location, these costs for Ocado amount to a figure of 2% of sales.
It is encouraging to see the group have learned some major lessons over the twelve years since incorporation and have been able to apply these in their practices. CFC2, which opened in February 2013, not only cost less to build (cGBP210m versus probably cGBP350m for CFC1) but is also more efficient in it's operations.

Marketplace

CFC1
Ocado's original CFC processed all customer orders. A series of improvements were implemented during 2012 which have enhanced both capacity and efficiency in CFC1. Currently they are peaking their order capacity at 150,000 orders per week.

CFC2
Ocado's second CFC, located in Warwickshire delivered it's first order February 2013. At £210m, the new warehouse boasts a size of nearly thirty to forty Waitrose stores. Initial capacity of 120-130,000 orders per week is scalable to 180,000 per week on further investments.

With the two CFC's in place, Ocado covers 70% of the UK population.

Non-food and spokes
The company continually plans to invest in their fast growing non-food business and delivery spokes. A new non-food distribution center at Welwyn Garden City, Hertfordshire is set to open early in 2014 that will allow Ocado to expand their non food lines.

Value Drivers

• Strength of Management

The firms' management structure appears very strong, with capable leaders and a desirable alignment of managements' interests. Two of the three founders still hold influential positions within the company (Tim Steiner, CEO and Jason Gissing, Commercial Director). The company has recently appointed a new Non-Executive Chairman, Stuart Rose. His wealth of experience and contacts within the retailing space will undoubtedly aid the company's longer term ambitions. Solely holding a non-executive position, his influence should be limited. To that extent, this shouldn't signal intent that the company is being prepared for a takeover or his dual position of CEO and Chairman at M&S, which disgruntled investors, should be an issue. (These are two concerns being voiced by the Ocado bears). More significantly, the management have a clear, focused direction for the company and the correct incentives appear in place for that to be achieved, and for this to subsequently benefit equity holders.

• Own Range Products and Bespoke Offerings

As the company transforms from a supermarket to a hypermarket, the product choice it offers its customers is ever increasing. It boasts the largest supermarket 'Free-From' range. It is offering substantially more non food lines and is increasingly launching destination stores. Destination stores direct customers to related supplier websites, and the purchases are packaged separately yet billed and delivered together. For example, the company is allowing customers to purchase specialist pet food, otherwise only available from vets. Importantly, whilst Tesco currently offers customers more product lines, Ocado's business model allows greater product offerings and there is hence significant potential here. Tesco, is constrained by the size of its retail outlets, whilst the boundaries constraining Ocado aren't as rigid. Ocado's recently launched French, Spanish and Swedish destination stores have seen very strong growth. Further, Ocado has recently invested £4 million in a new non-food fulfilment centre to cater for the increasing range of products it is offering customers. Ocado's unique model provides a further benefit for customers, in that it is able to offer fresher food, supported by a guarantee. Since the food departs straight from the factory to the customer it arrives a lot fresher than the supermarket alternative, whereby the food is transported to and then selected from the supermarket shelf. Ocado is ever increasing the selection of its own label range. This is pivotal in rivaling its competitors, and offering customers an alternative to higher priced branded goods. As this selection increases, the more price competitive the company becomes and the higher operating margins it achieves. Purchases of Ocado own label products increased 70% in the six trading weeks to 6 January 2013. Ocado's own range products are now found in 80% of all orders.

- **Revolutionising the Digital Age**

Whilst many of the statistics differ, the trend in undisputed: the digital revolution is taking hold with increasing numbers of tablets and smartphones in use. The importance of utilising the online platform as an interface to market and sell products is paramount. Ocado, whilst a retailer, is an incredibly technology centric firm. It was the first company worldwide to launch a mobile application through which customers could purchase groceries. The company is continually improving the website and application capabilities to optimise the user experience. 28% of orders are currently through applications, with a total of 40% coming from mobile and tablet devices. The company is catering for people on-the-go and it's shopping model saves people time. Further, the company is deeply incorporating its presence through digital advertising and utilising the viral nature of social networking. It is continually deepening connections with Facebook, aspiring to ultimately allow customers to shop through the social media site.

"New services allow customers to login to Ocado using their Facebook accounts, and to start shopping with Ocado through the BBC Good Food recipe website."

- *Tim Steiner*

  Chief Executive Officer

- **Environmental Benefits**

Traditionally, in most B+M stores, the energy required to power chilled food sections and large open freezers, combined with the hot air conditioning energy requirements necessary to create an ambient environment for the customer, the energy wastage and the costs thus incurred are high. Ocado, by eliminating such costs gain a considerable advantage as one of the more 'green' market players. The usage of 'Green Van' slots- delivery time slots which make it possible to deliver the maximum number of orders in a designated area- also allow Ocado to cut down on delivery costs and reduce their carbon footprint.

- **Unique Business Model**

The firm operates a unique business model. It's operations are incredibly efficient, with the customer ultimately benefiting. At the CFC all software is developed in-house, with a continual optimisation and efficiency drive. CFC2 was launched encompassing 12 years of efficiency improvements at Hatfield CFC1, yet on a larger scale and employing more advanced technology. Further there are large economies of scale the business experiences as it grows in size. As the number of spokes rise, the servicing possibilities rise more than proportionally.

- **New Customer Growth**

New customer growth has been incredibly strong, whilst marketing hasn't eroded profit margins. New customer growth through 2012 was up 20%, bringing the total of active customers to 355,000. Increasingly new customers are coming from lower income demographics. In 2006, 21% of new customers had joint household income less than 40,000. In 2012 this has risen to 38%. New customers are increasingly coming away from London and the south east; a trend that should be propelled through the Northern location of CFC2. Currently, close to 50% of the group sales are from postcodes within the M25.

Value Inhibitors

- ### Still Yet To Be Profitable

Since the firms' launch in 2000, the firm has only recently been able to generate a positive net income before tax figure (£1.8 million in 2012). The concept is unique and most certainly revolutionary at the time. Consequently time has to be allowed for customer awareness to establish and brand image to build. Further, the firm is highly capital intensive. The two large CFCs have required substantial CAPEX, as has the development of the spokes and the fleet of vans. However, twelve years on, it's incredibly concerning the firm is yet to generate a profit. As the development of CFC2 finalises, CAPEX should fall substantially (It peaked at £114m in 2011). In addition, the firm's delivery costs are a questionable area of the company's business model. Since the company only delivers from 10 centers, as opposed to around 200 for most of its competitors, it is difficult for the firm to compete on and generate profit through delivery costs. The company argues that the efficiency gains elsewhere through the process more than compensate for this. Further, the company is seeing increased efficiency towards it's long term target of 175 deliveries per van per week (it experienced growth of 4.7% to 151 deliveries per van per week in 2012) which will be aided as the customer base grows and economies of scale materialise. The increasing popularity of the Ocado delivery pass will further assist delivery efficiency.

- ### Customers Uneducated

Despite the firm being in operation for twelve years, it has been unable to portray it's strong brand identity and direction coherently to the public. The company is consistently working to change it's market perception as an 'expensive retailer'. Back in 2009 the company was the first to launch a 'Price match promise' scheme, which nearly all supermarkets followed. The group recently launched it's own 'lower-price' promise which guarantees that a basket bought at Ocado would be cheaper than one bought at a competitor, such as Tesco. It is encouraging to see that the customer retention rates, which stand at 20%, are highest in the industry. Ocado's market share and perception will be critical in determining their success, and to a large extent, will depend on the advantages given to customers and how convincingly these are communicated. This task will continually become more challenging as its larger rivals increase their online operations and improve their customer offerings.

- ### Logistics

Ocado loses on outbound delivery costs as CFCs are remotely placed. However in the long run it should make up for this through a better wastage ratio compared to the industry and by reducing stock loss through smooth order fulfillment. Further the business model may struggle in regions of low consumer density as delivery costs are forced to rise and efficiency reduces.

• Oversees Expansion Plans Appear Unrealistic

The management have made clear that oversees expansion plans are a longer term objective. Yet, struggling to prove the business model can be profitable domestically, these aspirations appear currently beyond possibility. The firm holds a 0.5% market share in the UK market (Montague-Jones 2012) while some analysts, notably Philip Dorgan from Panmure Gordon, comment that the company's market share has over the last year been falling. Such a small, unstable position in an extremely competitive, low margin, oligopolistic market presents Ocado with certain survival questions. Maintaining a foothold in the large, cost intensive industry might not be easy for the firm. Furthermore, part of the Ocado bull story is founded on the basis of the online grocery market seeing strong growth. Whilst the most prominent research in the market suggests this will materialise (from the independent body IDG), there is little collaborating, or contradictory, research on the market to aid the debate. Structural consumer patterns are notoriously difficult to predict.

• Promotional Activity

The company's promotional activity will play a pivotal role in influencing it's customer retention rates and new customer growth. Previously, flier advertising was found to be successful but they stopped this approach as its success rate gradually reduced. The firm is planning to restart it and have previously approached this method through companies such as 'The White Company' and 'Boden'. Interestingly they used to distribute fliers through Amazon, but Amazon have recently denied them of this service, presumably because they felt they were in direct competition. Further Ocado has recently re-launched it's 'Tesco price promise' through increasing the scope of the deal which has consequently resulted in stronger new customer growth. Fall in basket size can significantly impact profit margins.

• Click & Collect

Retailers are capitalizing on the digital revolution through their bricks and mortar presence. Tesco has been the first to launch a 'Click & Collect' service, whereby the customer shops online and collects from the store. The model is most popular in France due to low density of consumers and the service being offered for free. In the UK it is widely seen as a desperate attempt to make use of the vast amounts of retail space the supermarkets possess. The Click & Collect or 'half way house' model reduces the effort of shopping but does not deliver the product to the door. The model is not complex and is cost effective. Click & Collect could pose a challenge to Ocado if the order is processed at a lower cost than the online retailer can achieve or if the retailers are able to transfer the benefit of cost to suppliers.

Click & Collect is likely to complement online shopping for groceries instead of replacing it. Ocado operates as a niche operator as of now and can always explore the opportunity of a Click & Collect service in the longer term.

Morrison's Deal

The 25-year licensing deal between Morrisons and Ocado announced in May 2013 has seen Ocado agree to undertake Morrison's picking, packing and delivery in return for £170m up-front and fees and recharges later. The deal is worth at least £300m to Ocado. This also provides Ocado an advertising platform for monetising it's Intellectual Property (IP) and business model to retailers. According to the provisions of the Morrisons deal, Ocado is permitted to sign up with one other grocer in the UK. At present the other grocer is Ocado itself.

• Financial Position Strengthened

Ocado has benefitted from the asset sales to Morrisons. This benefit can be expected in future CFC's, as Morrisons strong agreement will enable a less capital intensive, higher ROCE operations.

• Improved Scalability of Ocado's Model

The Morrisons deal has improved the scalability of Ocado's model by sharing capex between the two parties and the scalability of spoke network which will also benefit from the sharing of capex and fixed costs. The earlier earnings pressure from under-utilisation of a new CFC, will now be significantly reduced.

• Increase in R&D Spend

As per the Morrison deal, £8m per annum will be provided to Ocado to enable a significantly enhanced focus on R&D.

• Endorsement of the Model

For a long time there have been questions raised concerning Ocado's profitability and the success of their model. With the average basket size not considered big enough to benefit Ocado, the store pick up model was being termed more efficient and profitable. Ultimately Morrisons went with Ocado after much scrutiny of online grocery models and Dalton Philips', and Morrisons', conclusion was that Ocado has the 'best-in- class technology, logistics and delivery platform – the most efficient in the business'.

• Dependence on Waitrose Reduced

Ocado sources about 80% of it's product through it's supply agreement with Waitrose. The deal with Waitrose which runs till 2020 has a potential break in 2017. Given the recent deal with Morrisons, Ocado now has a much broader range of options available to it.

Monetising the Intellectual Property

Technology lies at the core of Ocado's business model. From the fully automated CFC's to the user interface for the mobile applications, the company's technological base is it's biggest asset. Over a 12 year period the company has built a wealth of intellectual property knowledge, which they seek to leverage in order to add value to their business.

- **Business Fundamentals**

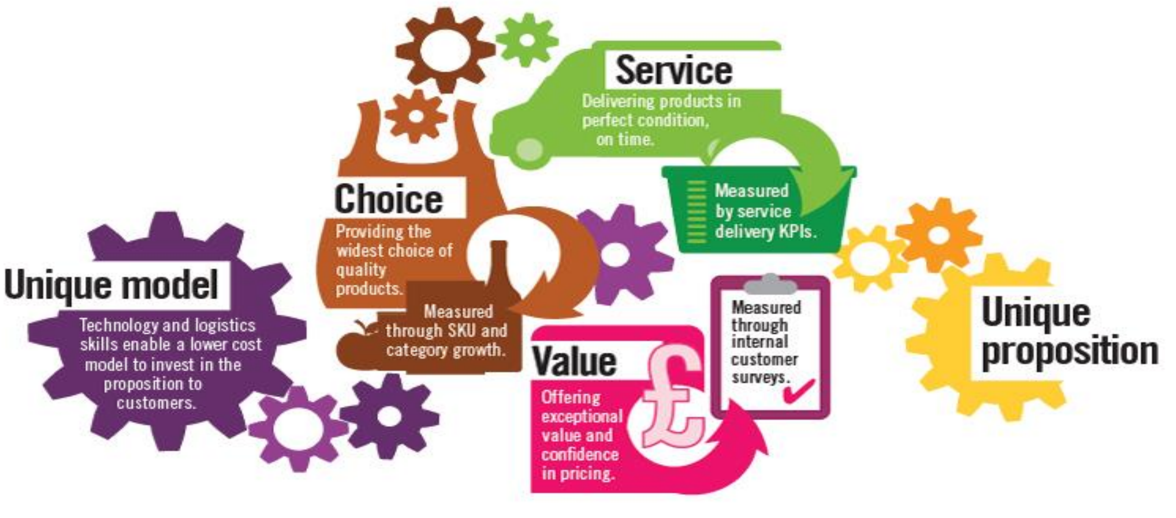
Ocado's fundamental business remains strong – the online grocery market continues to grow steadily, posing challenges for the store based retailers. Ocado's central warehouse model offers clear customer service and economic advantages.

- **The Business Continues to Grow**

Ocado has continued to sharpen it's pricing position, developing an increasingly attractive non-food line and significantly increased customer recruitment. Ocado is uniquely positioned to benefit from the inexorable shift of grocery shopping online by leveraging it's highly developed IP to support the company and it's partnerships with global grocery retailers seeking the best grocery fulfilment solution.

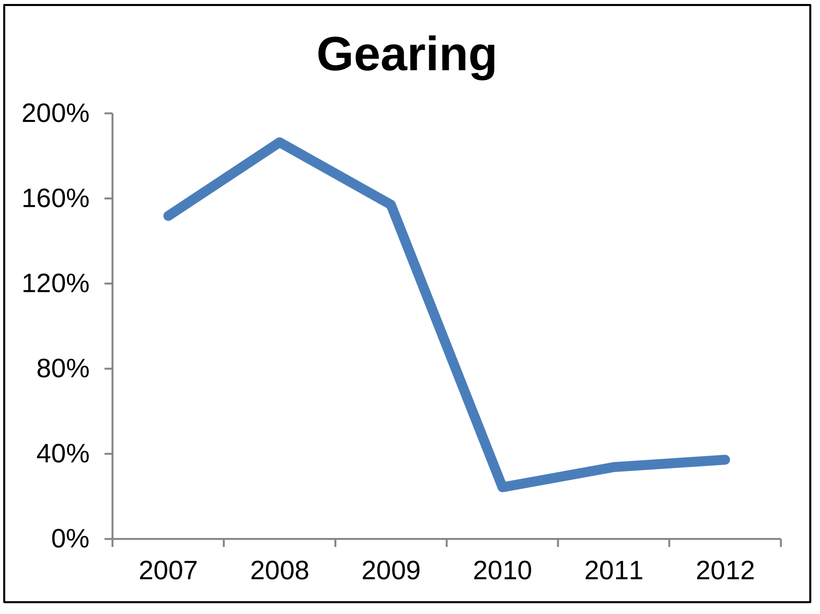
- **Another Morrisons Type Deal**

According to the Morrisons deal, Ocado is permitted to provide an online grocery service to another grocer in the UK. Though at present Ocado is itself the other grocer. However there is scope for Ocado to close it's online retail business and sign another Morrison type deal with another supermarket and turn itself entirely into an IP licensing business.
Ocado's CEO Tim Steiner believes that Ocado has the opportunity to be the price disruptor in the grocery market and will continue with it's online operations.

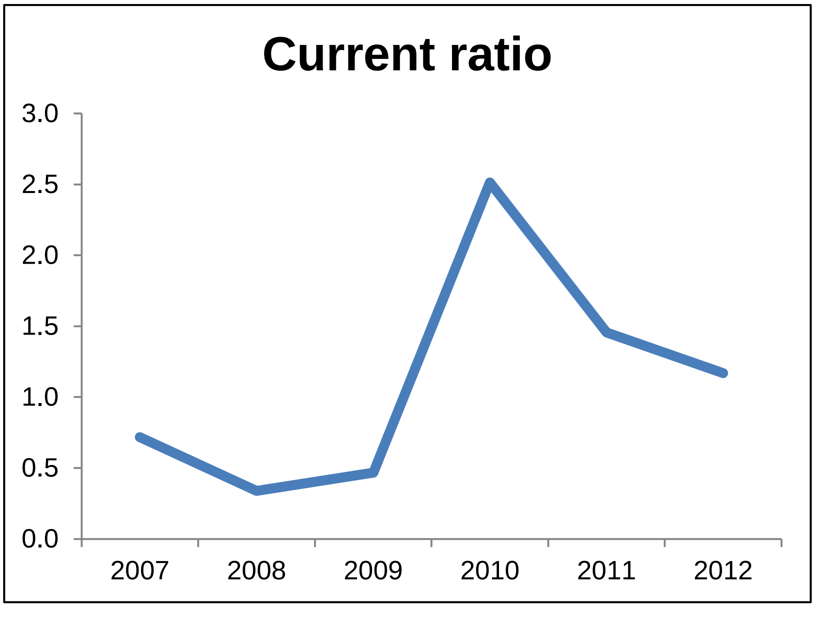


Group Financial Ratio Analysis

Financial ratios have been analysed in isolation due to the unique nature of the business model and the lack of direct competitors for comparison.

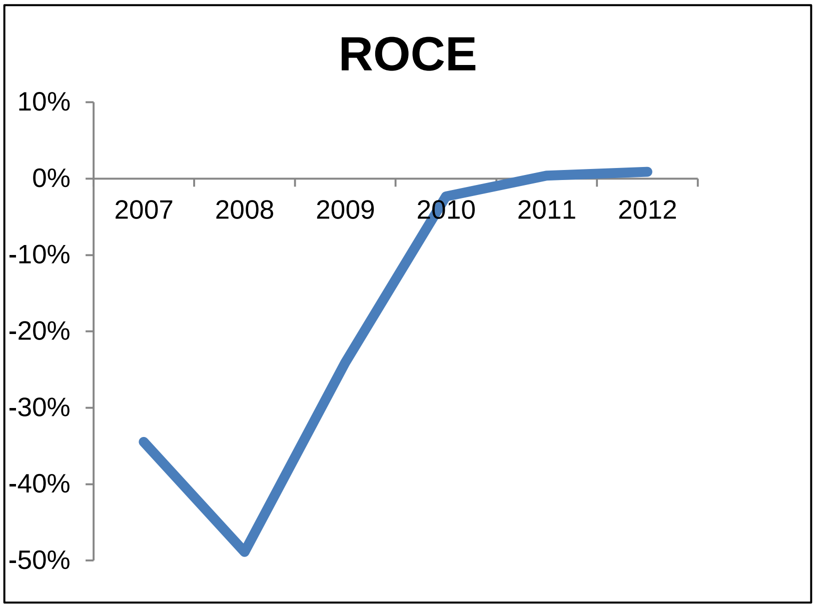


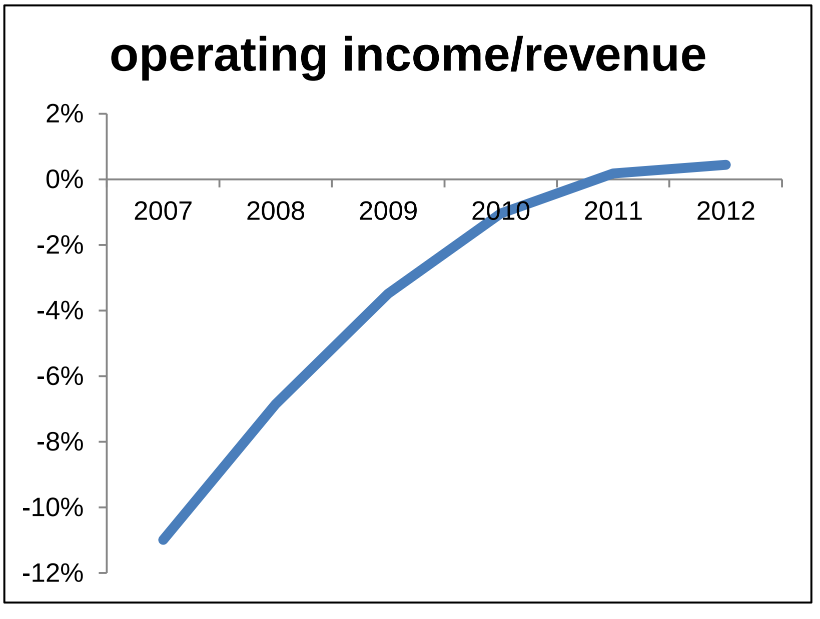
Despite the firms' large capital investment spending its been promising to see the firms' financial structure stabilising at low debt/equity levels

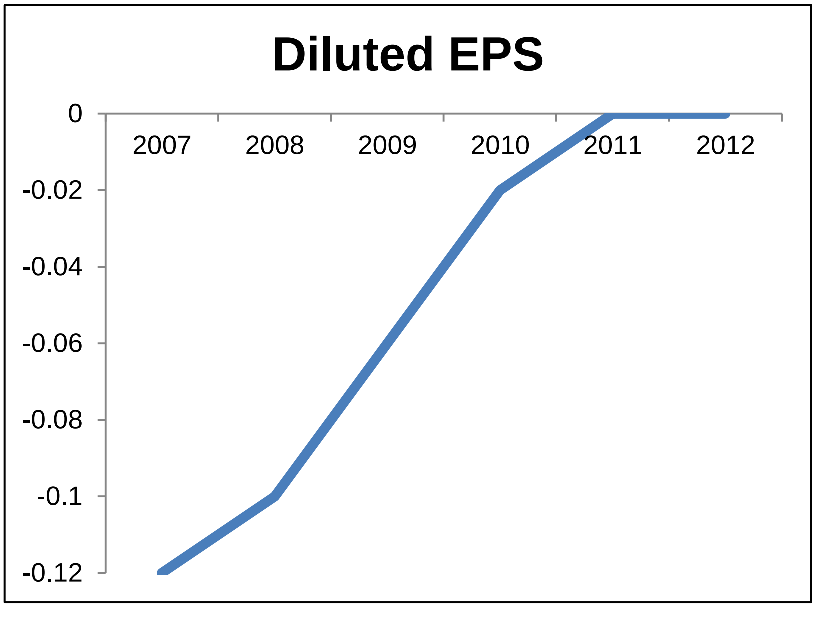


Post 2009 the firm's liquidity has substantially improved and the firm remains in a safe position

The three graphs below demonstrate the changing and improving profitability of the firm. Whilst it's yet to be profitable, there is a clear upward trajectory.







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www.sobic.co.uk | chairman@sobic.co.uk

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