McColl’s is the second largest multiple convenience store business in the UK and the largest independent operator of Post Offices. Its growth strategy is focused around upgrading the store portfolio to higher value, better performing convenience formats. McColl’s is looking to have 1,000 convenience stores by the end of 2016.

- **Good recent profit growth but like-for-likes hit by wider industry issues**
  Over the financial years ended November 2011 to 2014 McColl’s grew underlying operating profits at a CAGR of 10.2%. Total sales growth for 2015 was 3.1% but like-for-like sales fell by 1.9%. However, the rate of the falls are slowing, down from 2.3% in Q3 to 1.8% in Q4.

- **Supermarket sector growth is slow but convenience is king**
  The convenience market is one of the fastest growing subsets of the grocery market, driven by consumers moving from large shopping trips at out of town locations to smaller trips at more local venues. Industry analysts IGD forecast convenience sales growth of 17% between 2015 and 2020, putting McColl’s in a good position to grow given its specialised focus.

- **Low valuation and sector beating yield**
  McColl’s shares have performed poorly since IPO in February 2014. They currently trade at a discount to the wider supermarket sector, on a forecast 2015 PE of 8.6. The shares also offer a top of the sector yield of 7.43%.

**Table: Financial overview**

<table>
<thead>
<tr>
<th>Year to end Nov</th>
<th>2013A</th>
<th>2014A</th>
<th>2015E</th>
<th>2016E</th>
</tr>
</thead>
<tbody>
<tr>
<td>Revenue (£m)</td>
<td>869.42</td>
<td>922.42</td>
<td>934</td>
<td>971.4</td>
</tr>
<tr>
<td>PBT (£m)</td>
<td>4.39</td>
<td>12.64</td>
<td>21.3</td>
<td>20.5</td>
</tr>
<tr>
<td>EPS (p)</td>
<td>12.6</td>
<td>15.6</td>
<td>15.8</td>
<td>15.4</td>
</tr>
<tr>
<td>Dividend (p)</td>
<td>0</td>
<td>8.5</td>
<td>10.1</td>
<td>10.1</td>
</tr>
<tr>
<td>PE ratio</td>
<td>10.8</td>
<td>8.7</td>
<td>8.6</td>
<td>8.8</td>
</tr>
<tr>
<td>Yield (%)</td>
<td>0</td>
<td>6.25</td>
<td>7.43</td>
<td>7.43</td>
</tr>
</tbody>
</table>

*Source: Market consensus forecasts.*

[Important: Disclaimer information can be found on the last page of this document]
The Business

Founded by current CEO John Lancaster in 1973 as a vending machine operator, McColl’s is now the second largest multiple convenience store business in the UK and the largest independent operator of Post Offices. With a focus on local neighbourhood locations (as opposed to high streets) at the end of November this year the company had a total store base of 1,352, with 893 of these being convenience stores. In November Lancaster announced his decision to resign as CEO and will move to the Non-Exec Chairman role until the AGM in April 2017. The search for a replacement CEO is ongoing.

For reporting purposes the company divides its stores into several categories:

**Premium Convenience** – operating under the McColl’s brand name these are larger convenience stores which offer a wider range of groceries, including chilled and fresh products.

**Standard Convenience** – traditional convenience outlets which are typically larger than the (below) Food and Wine stores and stock a larger range of convenience products.

**Food and Wine** – newsagents that have been converted to convenience stores by introducing a grocery and alcohol range, longer trading hours and other improvements.

**Newsagents** – primarily trading under the Martin’s brand the newsagent portfolio contains smaller stores which sell the traditional confectionery, tobacco and news related products, along with services such as Post Office counters and Paypoint.

The company’s growth strategy is focussed around upgrading its stores to the higher value, better performing convenience formats. McColl’s is looking to have 1,000 convenience stores by the end of 2016 by converting newsagents into food & wine stores, upgrading standard stores to premium stores and via acquisitions, while also expanding the product range and maintaining a profitable newsagent operation.
Recent trading

Over the financial years ended November 2011 to 2014 McColl’s grew revenues from £805 million to £922.4 million – a compound annual rate (CAGR) of 4.65%. Underlying operating profits grew over the same period by a CAGR of 10.2% to £25.5 million.

Upon listing on the Main Market in February 2014 McColl’s raised a net £44.7 million and used this to pay down borrowings. In 2014 this helped net interest costs before exceptionals (mainly associated with the IPO and non-cash share based payments) to more than halve, from £12.5 million to £6.2 million and pre-tax profits to almost double to £19.2 million.

Interims for the 26 weeks to May showed a much cleaner set of numbers

Total revenues for the period rose by 3.4% to £459.3 million; however a 1.9% fall in like-for-like sales spooked the market and saw the shares fall by 2.5% on the day of results. Net profits were strong at £5.9 million but even stronger was operating cash flow at £9.84 million. As a result the dividend was doubled to 3.4p per share, covered 1.8 times by adjusted earnings of 6.1p per share.

The most recent set of numbers were for the quarter to (and year ended) 29th November 2015. Total sales for the quarter grew by 2.7%, driven by new store acquisitions, taking total growth for the year to 3.1%. Continuing the like-for-like slippage LFL sales were down by 1.8% in Q4 but improved from a 2.3% fall in Q3. This resulted in full year LFL sales being down by 1.9%.

By business segment the LFL figures were worst in the standard convenience and newsagents areas, falling by 4%. However, in the premium convenience and food and wine businesses LFL figures only fell by 0.6%, validating the company’s strategy to focus on these areas.

Operational highlights of the year included the acquisition of 60 new convenience stores acquired and 45 food and wine conversions completed. Alcohol was introduced to 100 newsagents and Post Office services were increased to 520. Results for the full year will be in line with the expectations and McColl’s remains on track to for its target of 1,000 convenience stores by end of 2016.

McColl’s is also exploring additional income generating activities, with an agreement signed with sandwich giant Subway to trial a franchise operation in an existing petrol forecourt site in Tamworth. Early results are said to be “encouraging”.

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Risks & Opportunities

Recent numbers from industry analysts Kantar showed that sales growth in the wider supermarket sector is slow, lagging the overall economy at 0.8% in the 12 weeks to 11th October. Consumers have seen falling prices for over a year now.

While convenience operators tend to be less price sensitive, recent numbers from McColl’s have shown that like-for-like figures have also been falling, hit by strong competition and price deflation. McColl’s largest fall in like-for-like sales is being seen in the newsagents and standard convenience sector, so it is encouraging that the company has a strategy to upgrade these to the better performing convenience category stores.

Convenience is king

Furthermore, the convenience market is one of the fastest growing subsets of the grocery market, driven by consumers moving from large shopping trips at out of town locations to smaller trips at more local venues. Recent figures from industry analysts at IGD suggest that in the 12 months to April 2015 the UK convenience market grew by 5.1% to £37.7 billion. It forecasts further sales growth of 17% between 2015 and 2020, putting McColl’s in a good position to grow given its specialised focus.

Long-term incentives

Management are incentivised to deliver growth, with the most recent long-term incentive plan awarding the directors with a combined £700,000 worth of shares at today’s price, should targets be met over the three years to November 2017. Most of the incentive plan is earnings based, with the full awards only given if cumulative earnings of at least 61.5p per share are achieved over the three years – quite a challenge given that it assumes a CAGR of around 14.3%. The remainder of the awards are based on total shareholder returns being in the top quartile of certain peers over the three years and there is a two year lock in period after vesting.

Further risks

Other notable risks include the planned 10.8% rise in the UK minimum wage, from £6.50 to £7.20 for over-25s, from April next year, which will hit many retailers including McColl’s. In the longer term the National Living Wage, to be phased in between 2016-2020, is also a threat to profit margins.

In reaction, the most recent trading statement confirmed that the company has reviewed opportunities to improve efficiency and reduce costs resulting in restructuring some support services within head office and field operations. Interest costs should also fall going forward. August saw the company agree new terms for its £100 million total banking facilities, extending the expiration date by two years to August 2010 and reducing the interest paid by a minimum of 0.5 percentage points.

While the firm’s net debt remains relatively high at £35.3 million this is entirely manageable, with the company seeing strong cash flow and interest cover for the first half of this year being comfortable at 6.4 times.
Valuation

Since listing at a price of 191p in February last year McColl’s shares have underperformed the FTSE Small Cap Index. At the current 136p they trade at an all-time low.

Performance against the wider sector has been better due to the more dramatic falls seen at the major supermarket groups, Tesco, Morrisons and Sainsburys, which have a higher index weighting.
The current price puts the shares on a multiple of just 8.6 times market forecasts for the full year to November 2015. McColl’s is also an attractive income play, it targeting a payout of around 60% of profits before exceptional gains and after tax. With an expected dividend of around 10.1p per share for 2015 the current yield is a highly attractive 7.34%.

These valuation figures compare very favourably with other food retail sector peers – see table.

<table>
<thead>
<tr>
<th>Company</th>
<th>Share price</th>
<th>EPS current year</th>
<th>PE</th>
<th>Dividend (p)</th>
<th>Yield</th>
</tr>
</thead>
<tbody>
<tr>
<td>McColl’s Retail</td>
<td>136</td>
<td>15.8</td>
<td>8.61</td>
<td>10.1</td>
<td>7.43%</td>
</tr>
<tr>
<td>Conviviality Retail</td>
<td>212.5</td>
<td>13.6</td>
<td>15.6</td>
<td>8.55</td>
<td>4.02%</td>
</tr>
<tr>
<td>Greggs</td>
<td>1301</td>
<td>54.1</td>
<td>24</td>
<td>31.05</td>
<td>2.39%</td>
</tr>
<tr>
<td>Morrisons</td>
<td>148.6</td>
<td>9.13</td>
<td>16.3</td>
<td>5.15</td>
<td>3.47%</td>
</tr>
<tr>
<td>Tesco</td>
<td>160.1</td>
<td>5.17</td>
<td>31</td>
<td>0.49</td>
<td>0.31%</td>
</tr>
<tr>
<td>Sainsburys</td>
<td>247</td>
<td>22.07</td>
<td>11.2</td>
<td>10.74</td>
<td>4.35%</td>
</tr>
</tbody>
</table>

Data source: Digital Look

Overall, we believe that McColl’s Retail shares look like a decent value bet on the growth of the convenience sector, with a high and sustainable yield as a bonus.
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