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J SAINSBURY (SBRY): 292P
Premium to narrow, questions build:

The supermarket with moats is beginning to look like just another castle built on sand.

Year to end-Aug	PBT (£m)	EPS (p)	PER (x)	DPS (p)	Yield (%)
2014 (A)	898	32.8	9.6	17.30	5.5
2015 (E)*	735	29.7	9.9	16.42	5.7
2016 (E)*	715	29.2	10.1	16.35	5.6

Source: *Company & Broker Estimates, *downgrades possible*

Sainsbury: Where to From Here?

Summary

SBRY's share price has resisted the steep declines of rivals TSCO and MRW over the last five months. The relative share price strength implies structural issues will have less effect on the supermarket due to a stronger balance sheet and customer base.

With difficult short, medium and long term trends going forward, we find it difficult to believe its strong relative performance will continue. Should the company be forced into the same emergency measures as its peers (price cuts, dividend cuts etc.) we would expect its shares to come under significant downward pressure.

Problems are building…

Take a quick glance at the recent share price performance of the UK's supermarket giants and you will know that the powers-that-be have been having a tough time of late. The bears argue that:

- These former FTSE darlings have had it too easy for too long;
- The day of reckoning looks to have come in the form of:
    - Market-poaching European deep discounters;
    - A weak grocery inflation environment, the weakest in almost eight years, according to Kantar;
- Market share competitors have evolved from vulnerable family independents to well-financed European discounters;
- Customers previously captive to the big four supermarkets are leaving in droves.

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Initial responses

This perfect-storm story of structural change is well known by now and the old supermarket business model is fast becoming outdated. The big four have responded to this threat by:

- Retreating from the ‘space race';
- Ramping up roll-out of convenience stores;
- Fast-tracking online businesses and improving multichannel experience; and…
- Making painful dividend cuts and/or cutting capex (with the exception of SBRY) and making management changes.

Where are we now?

Shares in Tesco (TSCO) and Morrisons (MRW) have been battered over the last year, falling 38.6% and 42% from their respective 52-week highs. There is precious little in the short to medium term that might improve sentiment.

Of the publicly listed UK supermarkets, Sainsbury (SBRY) appears to have resisted this slide in share price to some extent. The chart above shows TSCO (orange), MRW (green) and SBRY (blue) all tracing the same unhappy path until mid-March 2014. Here, the market appears to have concluded that Sainsbury has the best chance of steering its business unharmed through these turbulent times.

Sainsbury ‘better’ but everything’s relative

Since mid-March Tesco’s shares have declined by 27%, while shares in Morrisons are down 25%. Sainsbury’s shareholders are sitting (comparatively) pretty with a more modest 11.7% slide. This period of outperformance may be attributed to the following factors:

- Perceived upmarket customer base, less driven by cost and therefore less likely to be tempted by the deep discounters;
- Perceived stronger brand and better management;
- Strong presence in southern England;
- Expansion of convenience stores and online business.
- Some innovation such as the joint venture with Danish discounter Netto (which will see the launch of 15 new Netto stores by end 2015)

We explain below why the SBRY share price premium to its peers overstates these best-in-class traits.

… Mr. Market makes too much of SBRY competitive advantages

Market share falling…

We would classify SBRY's perceived strength in customer base not so much as a defensive moat but perhaps as a dangerous mirage. Even supposing SBRY hangs on to its 16.4% market share (which data suggests is on the slide), the price wars of competitors might force Sainsbury to squeeze its already low margins. If not that then the anaemic rate of food inflation almost certainly will.

The latest grocery shares figures from Kantar Worldpanel for the 12 weeks to 17 August show food price inflation has fallen for the eleventh period in a row and now sits at 0.2% -- its lowest since October 2006. Staple foods are bearing the brunt of the impact.

Whilst the table below shows that Sainsbury's market share has risen on a 12mth view, we would suggest that the group is beginning to feel the strain and its market share is no longer untouchable. Over the 12wk period to August 2014, its share fell for the first time in a number of years by 0.1% to 16.4% compared with the previous Kantar reporting period.

- **Tab.1. Selected food retailer market shares:**

Company	**Market share 12w to Aug 2014 %**	***Market share 12w to Aug 2013 %***
Tesco	**28.8**	*30.2*
Asda	**17.2**	*17.1*
Sainsbury's	**16.4**	*16.5*
Morrison's	**11.0**	*11.3*
Co-op	**6.4**	*6.6*
Waitrose	**4.9**	*4.8*
Aldi	**4.8**	*3.7*
Lidl	**3.6**	*3.1*
Iceland	**2.0**	*2.0*
Other multiples	**2.8**	*2.6*
Total multiples	**97.9**	*97.9*

Source: Kantar WorldPanel:

…and management changed

As for superior management, widely acclaimed CEO of 10 years, Justin King, left his post in July. Before Mike Coupe assumed that mantle, he made sweeping changes to the supermarket's higher management. This may lead to some disruption in these challenging times.

While the Netto joint venture is undoubtedly a good strategic move, it will enter the deep discounting market towards the end of next year as a distant third, behind Aldi and Lidl. This situation typifies the strategic lethargy of the big four in responding to evolving market conditions.

Feeling the squeeze

Some of these trends are beyond the capacity of good management or loyal and affluent shoppers to influence. We propose that the market has not adequately factored in the vulnerability of SBRY to strong, long-term macroeconomic and structural headwinds. If, as we believe, Sainsbury is set to struggle, we expect to see:

- Further market share losses to deep discounters and online specialists;
- Potential market share losses to price-cutting rivals;
- Continued retreat from expansion;

- Potential losses from property write-downs;
- Price cuts and squeezed margins;
- Lower forecasts and a rebasing of dividend, which is already proving hard to maintain.

Revaluing the premium

While the industry is in flux, it remains difficult to value these companies. However, making some reasonable assumptions about the dividend, one can arrive at a target price (deep breath):

SBRY currently has a dividend yield of 5.8%. Rival TSCO pays a 6.3% yield, although this is being cut by almost 75% going forward following an everything-but-the-kitchen-sink trading update. MRW pays out 7.4% but serious questions are being raised about its sustainability and the management's mystifying commitment to a progressive 5% increase p.a.

This analyst assumes that both MRW and SBRY will follow Tesco in implementing dividend cuts as all operators seek to strengthen their balance sheets ahead of the coming period of price cuts, squeezed margins and low food inflation.

While MRW may even exceed Tesco's 72% cut, we believe Sainsbury will not and could end up reducing its annual payments to shareholders by around 40%. The latest figures indicate this implies 10.38p per share (from 17.30p). Furthermore, with the lack of revenue visibility afflicting these shares, we imagine investors would demand a yield of no less than 4%, a level similar to that offered by a number of on-trade retailers, who are currently not involved in a price war and who benefit from greater earnings visibility going forward.

These calculations bring us to a target price of 257.50p, but we will give SBRY a break and call it a round 260p.

With all the above in mind, the structural nature of the challenges facing it indicate that Sainsbury is in for a tough ride despite remaining a good business. We advise to reduce holdings.

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