Ocado Group PLC

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Why does Ocado need more money - and does it matter?

Ocado Group PLC (LON:OCDO) may not have surprised many investors when it unveiled its latest fundraising this week, but it raised some familiar questions about the gap between its poor financial performance and sky-high valuation.

While the online grocery company's shares have rocketed around 400% since mid-2017 since delivering a series of overseas contracts for its technology, many see the stock yet to prove the economics of its core business.

One such critic is Clive Black, head of research at Shore Capital.

Bagging some bonds

After raising £324mln in equity issues last year, receiving £750mln from M&S in exchange for half of its UK retail business, Ocado announcing a £500mln convertible bond issue was questioned by Black in light of the "sustained erosion" of the company's financial forecasts over the years and "frankly poor cash flow generation, earnings profile and RoCE".

"Ocado, remarkably, as a FTSE-100 company, is one where few others match the persistent downgrades by its house brokers," says long-time bear Black in a note to clients, noting that such timely downgrades preventing earnings warnings by the company.

"Indeed, we do not know of a major stock that has been more consistently downgraded, especially where it is normally met by a mark-up in the share price."

In fact, a few more analysts have trimmed their numbers of late, including JPMorgan, while the shares continued to notch up gains.

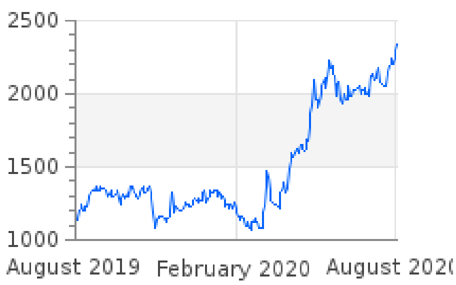
How analysts treat the convertible bond will be important, says Black, as on a fully diluted basis with all the bonds converted into equity, "this could lead to a major downgrade to ongoing EPS".

Furthermore, as convertible equity capital, group return on capital equity "should be notably depleted", says Black, admitting his "surprise" at Ocado's need for the capital, which the company said was largely relating to its Solutions business

Price: 2340

Market Cap: £17.5 billion

1 Year Share Price Graph



Share Information

Code:		OCDO
Listing:		LSE
52 week	**High**	**Low**
	2348	**994.012**
Sector:		**Retail**
Website:		**www.ocado.com**

Company Synopsis:

Ocado was launched in partnership with Waitrose in January 2002, and delivers quality groceries across selected areas of England and Wales. Our business was conceived with one simple objective in mind: to offer busy people a true alternative to going to the supermarket every week. By doing this, we created a totally new shopping experience, built entirely around our customers' needs.

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"What this suggests to us is that Ocado remains very ambitious but also highly cash consumptive. The group simply does not fund its ambitions from anywhere near its operating cash flow after approaching twenty years of trading, which depletes RoCE, an important measure of how management earns from its assets."

Whether the convertible bond issue ends up being dilutive to metrics such as RoCE and EPS will depend on the success of Ocado's various overseas deals and the extra earnings they may bring, counters Richard Hunter of broker

Interactive Investor.

Rates of return

Return on capital employed, or RoCE, connects the profit and loss account to the balance sheet, in other words the level of assets needed to generate profitability

It is a metric beloved of many investors, including star fund manager Terry Smith, as a measure of a management team's capability in converting assets into returns for shareholders.

By capitalising research and development costs, companies' costs are treated as capital expenditures, or 'capex' for short, and so will be accounted on the balance sheet as an asset, rather than expensed, which would see them accounted on the income statement as a negative to reduce profits or extend losses. Assets that are capitalised are then amortised over a period of years.

On the side of defence, companies developing their product or technology such as Ocado need to spend heavily on research and development as a prime part of their long-term progress, but as many analysts and investors focus on headline figures, such as earnings before interest, tax, depreciation and amortisation (EBITDA), this amortisation figure is therefore largely overlooked.

'Ave Ocado

Launched in 2002 by three former Goldman Sachs bankers, including fast-talking ex bond trader Tim Steiner as chief executive, and joining the market in 2010, Ocado ascended to blue chip status within less than a decade.

(Black says he gives "great credit" to Steiner for his "largely singlehanded creation of a FTSE 100 company", which "is no mean feat and deserves proper recognition and congratulation".)

For many years Ocado was losing money as it poured many millions in its robots, software and other delivery technology and when it did turn a profit in 2014 it was thanks to a money-spinning deal with Morrison's.

"Ocado has always been a capital hungry business," as Black notes, with its heavy R&D costs tending to be capitalised.

"Such an accounting practice is ordinary and permissible, but it is important to keep in mind that capitalised costs flatter the near-term pre-tax profit/(loss) figure, as a proportion of the outlay moves to the balance sheet with P&L costs subsequently booked over the amortisation period, which most analysts ignore.

"Additionally, the impairment of capitalised costs needs close attention too, as such activity tends to be below the line and, again, ignored by analysts but flatters the P&L," he says.

Returns from its UK business to date have been less than impressive so far, but Ocado sold 50% of this to M&S this year and as it migrated from being a proprietary retailer to a technology solutions provider to the online grocery market, it has sought to reduce the capital outlay on CFCs through smaller units, Black acknowledges.

Still, the group remains a heavily capital-intensive as part of its overseas contracts, needing to spend up front on fixed assets and technological development before it gains revenues from with its international retailer clients.

How important is profitability?

Almost a decade on from its IPO and Ocado remains largely unprofitable, but "does that matter?" Black wonders.

He notes the success that the company has achieved in generating value for shareholders in the last couple of years and its long-term ambition, but says next year is an important one for Steiner to deliver on his promises.

Needing to deliver a seamless switch of supply from Waitrose to M&S products for the UK retail business by

September, operational delivery of the first international CFCs in Paris for Group Casino, in Canada for Sobeys, in the US for Kroger and in Sweden with IC, this needs to be done in a "flawless" manner, says Black, given a that the equity is valued against "minimal earnings [and] seems to be priced for perfection".

He is not the only analyst with a bearish stance, with the market consensus recently downgraded to a 'sell' rating.

JPMorgan Cazenove said a few weeks back that Ocado's £9bn valuation was "stretched", with around around £4bn of it coming from the Retail joint venture and the overseas projects.

This means the rest of the market's valuation is "ascribed to potential new signings (i.e. m,ore clients/more CFCs with existing clients) and suggests at least additional 126 CFCs will be contracted" compared to 38 announced at that state and just three operational.

Ocado has since signed up Japan's largest grocery chain but it's fair to say many long-time bears will keep growling for some time yet.

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