

Ocado: Amazon Hemel Hempstead CFC Visit STRONG BUY @ £2.65

Analyst: **Mark Hiley**

T: +44 (0) 203 2742 1000
E: m.hiley@theanalyst.co.uk



[Ocado – View All Notes and Models](#)

Recommendation: **Strong Buy (No Change)**

Price: **£2.65**

Market Cap: **£1.7bn**

Ticker: **OCDO LN**

3m Average Daily Volume: **\$7m**

2-Year Price Target: **£6.80**

Forecast Return: **157%**

Investment Thesis

- Share price still gives optionality on further growth in the UK beyond CFC1 and CFC2 revenue, and international deals.
- Core business (CFC1, CFC2 and the Morrisons JV) close to £100m free cash flow (2017e), headlines in P&L carry significant costs for platform businesses with no revenue today. Market doesn't understand the business.
- Low-cost supplier of groceries based on superior cost structure against offline players. Best grocery shopping experience for the consumer, can keep driving market share.
- Stock back below fair value of current UK business.

In follow up to [recent Ocado notes](#), we briefly summarise our visit to Amazon's Hemel Hempstead fulfillment center (FC). Amazon offers public tours, hosted by their 'ambassadors' (six of whom escorted us round). Presumably this is part of a public relations exercise to distance themselves from the negative press coverage on companies such as Sports Direct, and other zero hour contractors in the UK.

Exhibit 1: Amazon Public Tour



Source: *The Analyst Lens*; Male Model: Mark Hiley

Key points

- The centre is large, but the complexity and automation is minimal. It is a scale and range game, with a heavy emphasis on customer service.
- Amazon appears to be a good employer with numerous programmes in place to make this a better place to work.
- Amazon are adding capacity in the UK.
- Traditional retail is severely challenged and the high street will disappear in its current form.

- Ocado has much more complexity and is a completely different type of logistics operation.

Details

- Amazon has 100 FCs worldwide, and has 10 FCs in the UK, typically around 500,000 square feet in size. They are adding two more in **Manchester** and **Leicester**.
- The largest FC is in **Dunfermline**, where they have around 1m square feet to handle all the returns processing.
- Most of the UK FCs are 'Generation 7'. The company has two 'Generation 8' FCs at **Dunstable** and **Doncaster**. Generation 8 has more robotics, including the **Kiva system**. Amazon fulfill the '**Pantry**' offer from Doncaster and use the robotics to move heavy products to the pick station, thereby reducing the amount carried and distance walked by the associate. A 'Pantry' order has more items in, often including heavy products such as boxes of washing powder.
- **Grocery** is picked in Bow, East London, for select postcodes – this is a dedicated grocery facility. Our guide did not know whether they had plans to open more grocery or larger grocery facilities.
- **Hemel Hempstead** is fairly typical of an FC (450,000 square feet), employing around 1,000 permanent staff and handling five million items under one roof. Additional staff are hired for peak seasons such as Christmas and Prime Day.
 - We didn't note anything unexpected in the FC. There were many conveyor belts dedicated to moving totes containing items to be packed towards the boxing stations. Packed boxes also move on conveyor belts towards the outbound locations, after sealing and address/barcode stamping. Most of the inventory is held randomly in simple aisles with pigeon holes. Items are placed by hand in empty holes, with the location registered on a handheld scanner.
 - The pictures below give a reasonable overview of the setup of the facility. We did not see significant complexity or unique software and hardware components.

Exhibit 2: Hemel Hempstead FC



Source: The Analyst Lens

Conclusion

Ocado's CFCs are completely different logistics operations to the Amazon FC we toured. It will be difficult for Amazon to transition any of these warehouse configurations to grocery, or to upgrade a Gen 7 to a Gen 8. In fact, they would have to build something large from scratch to get anywhere near the scale and technical aspects of Ocado.

However, Amazon can place 'large fridges and freezers' into these centers in the meantime and offer a limited range of grocery and fresh product that could be picked by hand and packed into a third party courier for rapid delivery to the customer. They can lose money doing this while they test the market and decide on a bigger strategy.

Amazon is fundamentally a different product to Ocado. A typical Amazon order is two-to-three items, non-perishable, packed in a cardboard box and then onto a van for next day delivery, usually by a third party courier. An Ocado order is 50 items across ambient, chilled and frozen areas, packed into plastic bags, and then onto a van for a dedicated one-hour delivery slot by Ocado.

Although Amazon represents a real challenge to Ocado in the online grocery market, we think Amazon's presence may actually accelerate the adoption of online grocery in the UK, and is ultimately a killer product for the offline incumbents, who rely on their local stores for much of their profitability. We are still short [Sainsbury's](#) in the UK.

As discussed in [previous notes](#), Amazon is likely to do £20-40 orders for same day, whereas Ocado is doing £110 weekly family shops – these are different products.

Ocado remains a Strong Buy-rated stock with a £6.80 target share price.

Important Information and Disclaimers

The accompanying documents have been prepared and issued by The Analyst Research LLP ("The Analyst"). The Analyst is a limited liability partnership authorised and regulated by the Financial Conduct Authority ("FCA") of the United Kingdom (firm reference number 605593) and registered as an investment adviser in the United States of America by the U.S. Securities and Exchange Commission (registration number 801-76777). Registered office: Arthur House, Chorlton Street, Manchester, M1 3FH. Trading address: 35 Bedford Road, London, SW4 7EF.

THE ACCOMPANYING DOCUMENTS ARE MARKETING COMMUNICATIONS. The documents are not independent investment research, and have not been prepared in accordance with legal requirements designed to promote the independence of investment research and, in producing these documents, The Analyst is not, and has not been, subject to any prohibition on dealing ahead of the dissemination of these documents.

The accompanying documents are intended only to promote the investment research and related advisory services of The Analyst, by using examples and case-studies to give potential clients of The Analyst a sample of The Analyst's investment research services and how such services will be provided. The examples used may be actual investment research issued previously and/or research in relation to hypothetical situations.

WITHOUT PREJUDICE TO THE FOREGOING, THESE MARKETING DOCUMENTS DO NOT RECOMMEND OR SUGGEST ANY INVESTMENT STRATEGY, DO NOT EXPRESS A CURRENT INVESTMENT RECOMMENDATION, DO NOT EXPRESS THE VIEWS OF THE ANALYST AS TO THE CURRENT OR FUTURE PRICE OF ANY INVESTMENT, AND MUST NOT BE TREATED AS DOING SO BY RECIPIENTS OF THIS DOCUMENT.

The accompanying documents are issued by The Analyst only to and/or are directed only at (and The Analyst's services will be made available only to) persons who are "professional clients" or "eligible counterparties" (as defined in the rules of the FCA). Persons of any other description (including, without limitation, persons who are "retail clients" for the purposes of the FCA Rules) must not act or rely on this material, and the services of The Analyst will not be available to such persons.

All content within these marketing documents (including text, trademarks, illustrations, photographs, graphics, designs, arrangements etc.) are protected by copyright and other protective laws. The marketing documents should not be passed on, duplicated nor reproduced in whole or in part under any circumstances without The Analyst's express written consent.

The information in the accompanying documents is provided for information purposes only and is not comprehensive. These accompanying documents are not directed to, or intended for distribution to or use by, any person or entity who is a citizen or resident of or located in any locality, state, country or other jurisdiction where such distribution, publication, availability or use would be contrary to law or regulation which would subject The Analyst to any registration or licensing requirement within such jurisdiction. The financial instruments described in these accompanying documents research may not be eligible for sale in all jurisdictions or to certain categories of investors.

The Analyst gives no undertaking that it will update any of the information, data and opinions in this document. The Analyst may at its discretion decide to provide you with further data or material, but makes no representation that such further data or material will be calculated or produced on the same basis, or in the same format, as this material.

The Analyst's methodology for determining valuations and price targets may include, but are not restricted to, the following methodologies: analyses of market risk, growth rate, revenue stream, discounted cash flow ("DCF"), earnings before interest, tax, depreciation and amortisation ("EBITDA"), earnings per share ("EPS"), cash flow ("CF"), free cash flow ("FCF"), enterprise value ("EV")/EBITDA, price-earnings ratio ("PE"), PE/growth, price/CF, price/FCF, premium (discount)/average group EV/EBITDA, premium (discount)/average group PE, sum-of-the-parts ("SOTP"), net asset value ("NAV"), dividend returns and return on equity ("ROE").

The investments described in the accompanying documents place an investor's capital at risk (i.e. an investor might lose some or all of the amount invested). Past performance is not necessarily a guide to future performance and an investor may not get back the amount originally invested. The price, value of, and income from, any of the financial instruments mentioned can rise as well as fall and may be affected by changes in economic, financial and political factors. The accompanying documents do not seek to provide an exhaustive statement of the risks associated with the investments or types of investments referred to. All information is provided AS IS with no warranties, and confers no rights. If a financial instrument is denominated in a currency other than the investor's home currency, a change in exchange rates may adversely affect the price of, value of, or income derived from the financial instrument described in this report. In addition, investors in securities such as American Depositary Receipts ("ADR's"), whose values are affected by the currency of the underlying security, effectively assume currency risk. Please note that in particular the bases and levels of taxation may change.

Any prices stated in this research are for information purposes only and do not represent valuations for individual securities or other instruments. There is no representation that any transaction can or could have been effected at those prices. Different assumptions, made by The Analyst or any other source, may yield substantially different results. The accompanying documents are intended to be for information and marketing purposes only and are not intended to constitute, and should not be construed as, investment advice. These documents have no regard for the specific investment objectives, financial situation or needs of any person. Recipients of these documents should seek their own independent financial advice. They are not and should not be construed as a recommendation, offer or solicitation for the purchase or sale of any financial instrument.

No liability is accepted by The Analyst for the reliability, accuracy or completeness of such information. In no event will The Analyst be liable to any person for any direct, indirect, special or consequential losses or damages of any kind arising out of any use of or reliance on the information in the accompanying documents, including without limitation, any loss of profit, business interruption, loss of programs or data on your equipment or otherwise. This does not exclude or restrict any duty or liability that The Analyst has to its customers under the relevant regulatory systems.