Poor old Sainsbury’s. Its share price is currently lower than at any time over the last 25 years and as I type, it appears to be in freefall. But how can this be? Surely Sainsbury’s is a defensive dividend payer with a long record of unbroken dividend payments and a core supermarket business which is about as dependable as they come?

Well, perhaps not. The big UK supermarkets have had problems ever since the financial crisis made consumers far more cost conscious than they were before. The market effectively fell into the laps of Aldi and Lidl, and Sainsbury’s has been playing catch up ever since.

To build greater economies of scale it proposed a merger with ASDA in 2018, but that was recently blocked by the Competition and Markets Authority. Sainsbury’s shares are now about 40% below where they were last summer. As a dividend-focused value investor, that sort of decline sparks my interest, so I thought I’d take a closer look at whether Sainsbury’s is finally good value or not.

Has Sainsbury’s grown its dividend consistently?

At 210p per share, Sainsbury’s 5.2% dividend yield is attractive, but if that dividend goes down rather than up, then shareholders will be disappointed rather than pleased. What we want to see, of course, is a dividend which goes up over time, enough to grow the income ahead of inflation and to give us a satisfactory total return (10% per year from income and growth is my ballpark target).

Sainsbury’s has a long history of dividend payments, but has it consistently grown that dividend in recent years?

The answer is no. Sainsbury’s has cut its dividend on several occasions and the 2019 full-year dividend of 11p is below where it was in 1993. This lack of performance stands in

“SAINSBURY’S HAS CUT ITS DIVIDEND ON SEVERAL OCCASIONS AND THE 2019 FULL-YEAR DIVIDEND OF 11P IS BELOW WHERE IT WAS IN 1993.”
stark contrast to the company's record of 23% annualised growth over the 20 years to 1992.

Back then, Sainsbury's and Tesco had little serious competition as they plastered towns and cities up and down the UK with huge supermarkets, the likes of which had never been seen before. It was the golden age of the supermarket giants.

Unfortunately for them, things are very different now. Every city and town has about as many supermarkets as it can profitably support, and it seems that every supermarket niche (from big to small and cheap to expensive) has already been filled to overflowing. In this sort of mature market, above average growth is hard to come by unless you can offer something radically different.

This market maturity began to show up in the company's results around the turn of the millennium. After 1999 the dividend stalled at 14.3p for a few years while management invested heavily in new distribution centres and other infrastructure. After that the dividend started to creep up again, but in hindsight that was a mistake. In 2005 the dividend was cut from 15.7p to 7.8p and the annual report of that year asked: "what will it take to make Sainsbury's great again?"

We may still be waiting for an answer to that question. After the 2005 dividend cut, the dividend was raised progressively for a few years only to be cut repeatedly, until finally settling at a low of 10.2p in 2017.

This most recent dividend cut was largely caused by the aggressive discount prices of Aldi and Lidl, but the true cause has long remained the same: Sainsbury's is a major player in a mature market, so growing by expanding the market or expanding market share is virtually impossible unless you offer something radically different (like the incredibly low prices of Aldi and Lidl), and Sainsbury's does not.

So that's the up and down story of Sainsbury's dividend. Of course, there's much more to a company than just its dividend, so let's have a look at the company's recent results in a broader context.

Has Sainsbury's grown anything consistently?

Let's start with two major sources of funds which the company can try to extract a profit from: revenues and capital.

Starting with revenues, these are paid into the company by customers and profits are what's left over after all expenses are paid – so if revenues don't grow over the long term, profits can't grow over the long term either.

In 2010, Sainsbury's revenues were just shy of £20 billion, or 1,066p per share. In 2019 revenues per share were 1,175p, so they'd grown, but not by much. In fact, the growth rate of revenues per share for the last ten years is less than 1% per year, so Sainsbury's isn't growing its revenues fast enough to keep up with inflation.

Let's turn to capital. These are funds raised from shareholders and debtholders which are typically used to buy assets such as stores, distribution centres and the equipment that fills them. The combination of shareholder and debtholder capital is known as capital employed.

In 2010, Sainsbury's revenues were just shy of £22 billion, or 1,066p per share. In 2019 revenues per share were 1,175p, so they'd grown, but not by much. In fact, the growth rate of revenues per share for the last ten years is less than 1% per year, so Sainsbury's isn't growing its revenues fast enough to keep up with inflation.

In 2010, shareholder capital (i.e. shareholder equity) stood at £5 billion and the company had total borrowings of £2.4 billion. So capital employed was £7.4 billion, or 395p per share. In 2019, Sainsbury's capital employed per share
had grown to 411p, an increase of just 4% over ten years.

So it seems that even if we look beyond dividends and measure growth across revenues and capital employed, which are the sources of cash from which profits ultimately flow, Sainsbury’s has basically not grown at all in ten years. This doesn’t necessarily mean it’s a bad company, but it does suggest (as I’ve already said) that it’s operating in a highly competitive and mature market.

**Does Sainsbury’s have any competitive advantages?**

Capitalism is all about competition. If a company operates in a competitive market but doesn’t have any competitive advantages, other companies will come along and take its profits.

For truly uncompetitive businesses the result is bankruptcy, administration or some other form of total failure. For middlingly competitive companies the result is profits which are, at the very least, driven down to the point where returns on shareholder equity are no better than the average returns of the market. In the UK, that means something in the region of seven to ten percent.

Sainsbury’s ten-year average return on equity is 7%, so by that measure it appears to be about as competitive as the average UK company. That’s not bad, but it’s not great either. However, a company’s return on equity can be boosted by taking on lots of debt. The borrowed funds can be used to invest in stores, distribution centres and so on. As long as those assets generate returns greater than the interest on the debt, the remainder goes back to shareholders in the form of boosted returns on equity.

But taking on lots of debt to boost returns on shareholder equity is a very risky strategy. That’s why I prefer to look at net returns on capital employed, because it takes all borrowings into account.

If we take Sainsbury’s average borrowings of £2.4 billion into account, its net return on total capital employed (rather than just equity) falls to a very meagre 5.2%. This suggests that Sainsbury’s has no meaningful competitive advantages, and it therefore has to battle with other supermarkets primarily on price and location. As a general rule, competing on a price-first basis is usually a very bad idea, unless your whole business is designed from the ground up with that in mind (which Sainsbury’s isn’t).

As well as weak returns on capital employed, Sainsbury’s also has low returns on sales. Its net profit margins over the last ten years have averaged an incredibly weak 1.9%, which really is exceptionally low. This combination of thin profit margins and weak returns on capital are both signs of a company that is in a very weak competitive position.

One common consequence of weak returns on capital is that the company in question has to borrow lots of money to fund any necessary capital investments, such as upgrading stores, distribution centres, etc. This is because profits are too low to cover these necessary expenses, and so debt is the only remaining source of funds.

**Are Sainsbury’s debts too high?**

Today, Sainsbury’s has total borrowings of £1.7 billion. It generated net profits over the last ten years averaging £440 million, so the ratio of debt to ten-year average profits is currently 3.8. This is quite high in my experience, although not excessively high for a defensive sector company such as a supermarket.

Debts are also heading in the right direction – i.e. down. Last year Sains-
Fortunately, the company's current management agree. Debt reduction is now a high-profile priority and the recent 2019 results announced a new plan to reduce net debt by £600 million over the next three years.

So debts aren't a major problem; but what about defined benefit pension liabilities? These have been instrumental in some catastrophic corporate collapses in recent years, so they're well worth looking at.

Is Sainsbury's pension liability dangerously large?

Sainsbury's has a total defined benefit pension liability of just over £10 billion, which is over 20-times the company's £440 million average net profits. That's a lot and it's way above my preferred pension ceiling of ten-times average profits.

Thankfully, the company's pension scheme only has a relatively small £260 million deficit. However, just a year ago the deficit was £850 million, which is effectively a form of debt. If the deficit returned to that level (which is not an unlikely scenario) then Sainsbury's debts, including the deficit, would be almost six-times its average profits, which is an uncomfortably high debt burden for a company with no clear competitive advantages.

Given that context, it's no wonder that Sainsbury's management are so keen to aggressively reduce its debts over the next few years.

Is Sainsbury's investible?

In general, I try to invest in above-average companies because they're more likely to prosper over my preferred five- to ten-year holding period. Mediocre companies are, on the other hand, far more likely to suffer at the hands of competitors and disappoint shareholders over that sort of multi-year period. So what do we have with Sainsbury's?

We have a company that has no sustained track record of dividend growth over the last 25 years or so. We have a company that has very weak profitability and therefore is unlikely to have any meaningful competitive advantages. We have a company that has used significant amounts of debt in the past to boost shareholder returns, but which has at least seen the folly of that approach and is trying to repair its balance sheet. We have a company with an extremely large pension liability where there is real potential for a dangerously large deficit.

This is not the sort of background I like to see before investing in a company. In many ways it reminds me of several other high profile, major UK companies that have floureded in recent years.
“MY CONCERN IS THAT TESCO OR AMAZON OR ALDI WILL SUCK AWAY SAINSBURY’S CUSTOMERS, LEAVING THE COMPANY ON A LONG DOWNWARD SLOPE FROM MEDIOCRITY TO IRRELEVANCE.”

Marks & Spencer is one example. It’s a giant of the high street, but one which is very much into the mature phase of its life. It has grown consistently for years, it has weak profitability and non-trivial debts. Or look at Centrica, the company behind British Gas. It’s also very mature and was once a monopoly supplier, but it now has no sustained growth, no significant competitive advantages and an enormous mountain of debt.

This is why I advise people to be wary of the idea that you should "invest in what you know". If you invest in what you really know very well, perhaps focusing on and analysing insurance companies if you work in the insurance industry, then yes, that makes sense. But if you invest in companies like Sainsbury’s just because you’ve heard of them and used their services, I think that’s a very bad idea, regardless of how attractive their dividend yield.

**What price would I pay for Sainsbury’s?**

As you’ve probably guessed, I’m not a massive fan of Sainsbury’s as an investment. It has no sustained track record of success (in recent decades at least) and no obvious competitive advantages, so my concern is that Tesco or Amazon or Aldi will suck away Sainsbury’s customers, leaving the company on a long downward slope from mediocrity to irrelevance.

Of course, its future might not be that bad and Sainsbury’s could well limp along, going nowhere for another twenty years. But that’s not exactly what most dividend investors are after. And while the company could turn things around and perform exceptionally well, I don’t think that’s the most likely outcome.

So I’m not looking to invest in Sainsbury’s. But if I were, what price would I pay? Well, assuming I was happy to ignore its weak profitability, lack of growth and enormous pension liabilities (which I’m not), the price would have to be significantly lower than it is today.

Given the company’s lack of sustained growth, the dividend would have to make up virtually all of my expected return. In other words, I would want the dividend yield to be above 7% before I’d even think about investing. That would require a price of no more than 157p, so I think a target buy price of below 150p is reasonable for a long-term income investor, but only if you’re willing to ignore the company’s various problems.