



Overview & Investment Thesis:

- **Tesco PLC is the market leader in the United Kingdom grocery industry**, operating over 2,100 stores. Tesco also is the largest hypermarket grocery retailer in five other countries (Ireland, Hungary, Poland, Slovakia and Thailand) and has significant positions in four other international markets - the Czech Republic, Slovakia, Taiwan and South Korea.
- The Group operates in over 3,700 stores around the world providing a variety of services and products such as Tesco Express, Tesco Metro, Tesco Superstore and Tesco Extra.
- **Tesco operates a number of unique store formats** - from 24-hour Tesco Extra hypermarkets, to traditional Tesco grocery stores, to Tesco Express convenience stores. Tesco.com is one of the few online grocery models that actually turn a profit. The broad variety of formats is supported by an excellent private label program (over 1,200 lines offered) and a very popular loyalty program, which is centred on the 10 million Tesco Clubcard members.
- We believe Tesco is one of the best in class international food retailers. It has pursued an organic expansion story that has driven double digit growth. It is a strong market leader in the U.K. and this provides stability, expertise and cash flows to export to its 11 emerging market businesses and its U.S. start-up.
- **The Group's strong growth has been driven by a "virtuous cycle" strategy** - cutting prices to gain market share and then taking advantage of the higher volumes that result to achieve lower costs of goods sold. In market after market, Tesco's approach has proven tough for competitors to match and has resulted in a steady progression of higher market shares.
- The Group's principal activity is operating food retailing stores but it has moved into clothing, telecommunications, property, garden centres and personal finance.
- As the leading grocer in the U.K., Tesco also features on expanding non-food offer and has the world's largest B2C (Business to Customer) online operation.
- **Tesco Personal Finance** originated as a joint venture 12 years ago with Tesco buying out the Royal Bank of Scotland's 50% share for £950m (US\$1.6 billion) last year. It has offered credit insurance and savings accounts for several years and has experienced a near doubling of deposits from £2.5 billion in mid-October 2008 when trust in banks were at their lowest, to about £4.5 billion at date.
- **Tesco's real differentiator is its strength of management.** CEO Terry Leahy and most of his senior management team has been with the business for over 20 years. Management has pursued careful, profitable expansion outside of their home market while continuing to drive innovative product and service offerings in the core U.K. business.

Business Description:

Tesco is a leading U.K. and international food retailer. It has over 2,100 stores in the U.K. and operates 746 stores in Europe, 814 in Asia and 53 in the U.S.A. The Group's strategy focuses on five elements: (i) be an international retailer; (ii) maintain a strong core U.K. business; (iii) be as strong in non-food as food; (iv) develop retailing services; and (v) put the community at the heart of what Tesco does.

Industry Growth Drivers/Trends:

- We believe the grocery business is a good place to invest. Demand in the industry is very consistent and certain key trends are providing excellent growth opportunities for leading operators. One of the most significant trends is the emergence of the grocery store as the hub of a much broader group of products and services, as time-stretched consumers seek to make more purchases at a single, convenient retail location. Tesco continues to be a true pioneer in this respect, offering a wide variety of general merchandise such as clothing and entertainment products, as well as offering financial services.
- An aggressive competitor, Tesco has responded to the requirements of a more frugal world and introduced in the U.K. its own discount brand products and assorted range/price changes in September 2008 enabling customers to "trade down" while staying in Tesco stores. This deflationary impact has been largely overcome by maintained volume growth with little impact on earnings.
- The leader in a very competitive home market, Tesco is well positioned to enter less-developed international markets. The Group has shown strong success in building leading franchises in Eastern Europe and Asia. We believe Western-style shopping will continue to gain share in these countries.
- In the U.K. Tesco is seeking to capitalize on the public's poor perception of banks and their oligopolistic grip on the market by increasing its in-store financial services. Within the next two years it plans to offer a current account and mortgages as its CEO has pledged to transform the supermarket into the "peoples bank."

Competitive Advantages:

- Scale: results in advantages in procurement, distribution and overheads.
- Strong market positions: clear #1 position in the U.K., leadership in five of eleven international markets.
- Customer loyalty: 10 million member loyalty program.
- Fast growing, profitable international business differentiates Tesco from its peers.
- Strong financial position.

Competitors:

- UK: Asda, Morrison's, Marks & Spencer, Sainsbury, independents.
- Worldwide: Wal-Mart, Ahold, Metro, Carrefour.
- Discounters: Aldi Group and Lidl.

Barriers to Entry:

- **Breadth of Offering:** Tesco's operation around the world share a common strategy, values and business processes that give both economies of scale and creates a sophisticated buying organization which provides scope to deliver new products as business as usual.
- **Real Estate:** Over 25 million square feet of selling space is a strong barrier to new entrants in the U.K.

Customers:

- No single customer accounts for more than 1% of total company revenues.



Officers and Directors:

Leadership team: Non-Executive Chairman, David Reid (61); Non-Executive Deputy Chairman, Rodney Chase (64); Chief Executive Officer, Terry Leahy (51); Commercial & Marketing Director

Corporate Governance:

- **18 member board** – of which 9 are independent directors.
- Chairman of the Nominations Committee, David Reid (61); Chairman of the Audit Committee, Ken Hydon (63); Chairman of the Remuneration Committee, Charles Allen (51) are non-executive and independent.
- **Corporate Governance** - Good corporate governance. In broad compliance with the U.K.'s Combined Code of Best Practice.

Ownership:

Insiders own 2.14% of outstanding shares. Institutions own 59.23% of outstanding shares. Notable holders include: Legal & General 4.91%, Barclays PLC 4.24%, Invesco 3.57%, Capital Research 3.38%, Smith Barney 1.62%, M&G 1.49%, Threadneedle 1.18%.

Capital Allocation/Uses:

- Cash from operations has been used to support the store expansion program, both in the U.K. and internationally. Organic growth has been supplemented by acquisitions in emerging international markets, a start up in the U.S.A. which is loss making pending local management's ability to achieve scale and prove the concept; and the acquisition of Tesco Personal Finance. Net debt has grown to £9.6 billion with management planning to pay down to around £8.5 billion by mid 2010 as capital expenditure is moderated - without meaningfully reducing new space growth rates: 8.2 million square feet of gross space is planned to be added (6.0 million internationally) in contrast to 8.7 million square feet in 2008 (7.0 million internationally). Tesco says the bursting of the construction boom has driven down CAPEX costs 20% per square feet.
- Tesco has increased leverage to pay for expansion but given its £4 billion of operating cash flow we do believe Tesco will strive to lower its debt as planned and that up to approximately £1 billion of asset disposals may be required - thus supporting its high credit rating and dividend payout. However we would not be surprised if Tesco moderated its progressive dividend policy to a flat payout in 2009/2010 and resume progression thereafter.

Tesco's International business portfolio can be divided into 3 broad groups:

Country	Year of Entry	Market Position	Market Share (%)
Established			
UK	N/A	1	30
South Korea	1999	2	7
Ireland	1997	1	26
Thailand	1998	1	10
Hungary	1995	1	16
Developing			
Poland	1996	3	6
Czech Republic	1996	4	9
Slovakia	1996	2	4
Malaysia	2001	2	7
High Potential			
China	2004	4	3.0
Turkey	2003	4	1
Japan	2003	>10	<1
US	2007	N/M	N/M
India	2009	N/M	N/M

Trading Profit by Geography:

	2007	2008	2009
United Kingdom	77%	77%	77%
Rest of Europe	13%	14%	16%
Asia	10%	11%	11%
USA	-	(2%)	(4%)

Financial Statement Summary: (£MM, years ended February 28)

Income Statement	2005	2006	2007	2008	2009
Total Revenue	33,974	39,454	42,641	47,298	54,327
Operating Income	2,002	2,023	2,142	2,603	2,970
Taxes	561	649	772	673	788
Net Income	1,100	1,366	1,580	1,874	2,124
Fully Diluted Earnings per Share	0.18	0.20	0.24	0.27	0.28
Dividend per Share	0.08	0.09	0.10	0.11	0.12
Dividend Payout Ratio	32.8%	28.1%	24.7%	37.3%	40.9%
Balance Sheet					
Net Debt	3,842	3,993	4,550	5,811	11,326
Common Equity	9,006	9,380	10,506	11,815	12,938
Net Debt: Common Equity	0.4	0.4	0.4	0.5	0.9

Key Profitability Ratios and Figures:

Y/E February 28	2007	2008	2009
Operating Margin	5.0%	5.5%	5.5%
Interest Coverage	9x	8x	7x
Return on Equity	19%	19%	17%
S&P Senior Rating of Debt	A+	A	A-

Sourced from 2009 Annual Report.

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