J Sainsbury plc

J Sainsbury plc Second Quarter Trading Statement 2012-13

Wednesday 3rd October 2012

Justin King, Chief Executive

Good morning everyone. Thanks for coming on the line. I'm joined by John Rogers and Mike Coupe. As you know, it's our second quarter trading statement for the 16 weeks ended the 29th September, just last weekend, and you will have seen we delivered good sales and a continued outperformance in the market. Total sales for the quarter, up 4.3%, and the important like-for-like figure, 1.9%, and that closes out the half for us with 4% at the total level, and 1.7% add to the like-for-like.

I think it's fair to say the quarter we're reporting, the 16-week quarter, was somewhat a game of two halves. The start of the quarter, the post-Jubilee period, very unseasonal weather, and of course the finish of the quarter, the special events that were the Olympic and Paralympic games, really lifted the mood of the nation and Sainsbury's were very proud to have played our part with our special sponsorship of the Paralympic games. A good part of our performance being driven by our own-label ranges, as you will have seen, our *by Sainsbury's* range nearing the end of its two year re-launch and our own label penetration now growing faster than any of our major grocery competitors, a great way, of course, for customers to save money without compromising on quality.

And a couple of important anniversaries to note: Brand Match coming up to its first anniversary, it's continuing to reinforce the competitiveness of our prices, and customers tell us that it's by far the simplest price guarantee in the market. And a much older anniversary, the 10th anniversary, indeed, of our partnership with Nectar, celebrated just last weekend with a double Nectar points' event. But Nectar is particularly important in its combination, uniquely with our coupon-at-till technology, allowing us to continue to reward our customers with coupons, vouchers that they really value because they're targeted at the shopping that they want to do.

And pleasing to note is the performance of our non-food business, growing in the quarter, around three times that the rate of food, a good positive stretch of the legs there from our non-food business. The growth areas of our business are delivering in line with our expectations, and as previously communicated to you, 49 convenience stores in the half-28 in the quarter, delivering against that one to two per week, the target that we guided to. And of course our online business continues to beat the market with a growth in excess of 20% year-on-year.

Total space then: 267,000 square feet in the quarter, bringing the year to date to 330,000 square feet: a mixture of extensions, new stores, and, of course, those convenience stores. And whilst, of course, it's largely internal to the industry, we're proud to note that for the fifth time in seven years, the industry voted us Supermarket of the Year, and indeed, for the third time in a row, voted us Convenience Store of the Year, recognising the real gap that we have in the service that we're delivering to our customers.

So looking forward, we don't see a change to the challenging economic backdrop, we think it will persist, but I think we've demonstrated that by helping our customers live well for less, through our competitive pricing, supported and reinforced by Brand Match, as we've targeted promotions, aided by Nectar data, the quality of our own-label products, now reinforced with that Brand Match re-launch, and, of course, that leading customer service recognised by our industry peers, we can continue to perform well in that important Christmas period.

And with that, I'll hand over to questions.

<u>Question and Answer Session</u>

<u>Question 1</u>

Jonathan Pritchard - Oriel Securities

Morning gentlemen. Three, if I may. Firstly, on inflation, was there any particular movement between Q1 and Q2, and what do you foresee for the second half?

Secondly, could you just put a bit more meat on the bones in terms of the non-food performance? Obviously a good acceleration there, just what areas that has particularly been in.

And then finally, on the own-label, as a sort of percentage of sales for you guys, the growth in own-label, does that mean, actually, on the basis the own-label run a better gross margin, that your sort of 'pay to play' is slightly less than everybody else's and you can perhaps reinvest that elsewhere?

Answer: Justin King

I'll pick up the last point and then ask John and Mike to pick up the other two, Jonathan. Just on that own-label, in the margins, of course, the maths of what you've just described is true, but we're only talking about small half or single percentage points in the margins of the mix between total own-label and total brands, so it's not material in the overall mix of things, but it's not unhelpful.

Answer: John Rogers, Chief Financial Officer

Just in terms of the inflation number, we said to the first quarter inflation was about 3 to 3.5%. I think in Q2 we saw inflation come down slightly to about 2.5 to 3%. In terms of looking forward, of course it's a little bit of a guessing game, but I would expect us to exit the year at around 4%.

Answer: Mike Coupe, Group Commercial Director

On non-food, pretty much across the board, but if you were picking out a couple of particular highlights, clothing has been very strong for us, both ladieswear and kidswear. Actually, there's been a bit of a resurgence in large electricals, so certainly we've done well on big ticket items, and Home has been pretty good for us, and that's kind of been offset, on the downside, by seasonal products, particularly the early part of the summer, because it poured with rain for about eight weeks, and I suspect right across the industry there are a lot of people left with barbecues and sun loungers. So, we're pretty pleased, and as I say, it's pretty much across the piece.

Question 2

Andrew Kasoulis - Credit Suisse

Morning guys. Two questions, if I may. Firstly, are you happy with the 2012/13 guidance for operating margin, please?

And secondly, are you going to have to make any changes to Brand Match, given what the ASA decided yesterday?

Answer: Justin King

Well, the ASA decided yesterday to announce their view on the advertising that we ran a year ago. We've long since changed the advertising, we don't really accept that the advertising, anyway, misled, and more importantly, nor do our customers. It was, of course, a complaint from a competitor that led to that ASA ruling, but we've been happy to make changes in line with what they've asked us to do. It's a winning formula for our customers: we've enhanced our communication of what we always thought was clear, which is a minimum of a £20 basket and it is a promise across the basket, not on individual items, and those were the two essences of the ASA's concern which we've been happy to address.

Answer: John Rogers

Andrew, just on operating margin: we guided to flat operating margin for the year, and we maintain that guidance. In terms of underlying PBT, the consensus number is now at 742 for the year and we're not expecting that to change as a result of what we say today. There's a possibility that a couple of the outliers at the top end may come in slightly, but given that the range if pretty tightly bunched, as we see it today, I'm not seeing the number is going to change as a consequence.

Question 3

Richard Cathcart - Espirito Santo

Sorry, my question has already been answered. Thanks guys.

Question 4

James Tracey - Redburn Partners

Good morning guys, it's James Tracey from Redburn. I was wondering if you could give an indication of the level of non-profitable promotions you've seen in the market, even again in the past, that's been higher than usual? And could you also talk about is it getting harder to back-solve margins at the moment? Thanks.

Answer: Justin King

Well, I'm not sure we've ever talked about non-profitable promotions. It's clear that some promotions aren't profitable and others are. The overall level of promotion activity has been pretty flat for a while now, in the high 30s across the industry, nip and tuck from quarter to quarter, but that sort of level. I think the wider question, if by promotion we also sweep in all the vouchering and coupon activity, which I think we probably should in thinking about this, is there's been a lot of debate about whether the level and type of couponing and vouchering is sustainable, and therefore, by definition, profitable. We think that's a question for individual retailers. The point that we would make is that with Nectar data we're very confident that the activity that we're doing is profitable for Sainsbury's; we simply don't recognise the observation that the current level of couponing activity, as far as Sainsbury's is concerned, is unsustainable. Far from it, it's pivotal in our sales success, our ability to identify what customers are doing, the habits that they're changing, reward and incentivise those changes, means we can be very clear about the profitability of the money that we're investing. And of course, that's true of the coupons and vouchers themselves, but of course we can also, through Nectar, observe changes in behaviour more generally from more generic promotions, for example, like fuel, so we can be quite clear as to the profitability. So our level of activity at the moment is sustainable.

And I suppose that's really the answer to the back-solving question, which is that each retailer has to deal with the challenge of investments which they have varying degrees of knowledge of whether they pay back. We are able to manage our margin through very clear understanding of the value of the investment activities that we make, and as John has just said, we're comfortable maintaining our guidance for flat margin with that in mind. Other retailers clearly have not got flat margin at the moment, they're seeing significant declines, and by definition, therefore, not back-solving their margin at the moment, and it may well be that the margins of the activity that they're pursuing therefore is not profitable.

<u>Question 5</u>

David McCarthy - Investec

Good morning. I just wanted to ask you about the profitability of the internet and that you have just seen, previously you've said many times the internet, you've questioned the profitability of it for the industry, and therefore we have to assume it's not as profitable as traditional store retailing. So, I just wanted you to talk a little bit about the rationale about migrating your customers from a more profitable format to a less profitable one, and the fact that you are talking about 'we've got fabulous growth of 20%' when you're throwing even more vouchers at the internet promotions than elsewhere. So, can you just talk us through the rationale behind the strategy for yourselves, and indeed, how you see it within the industry?

Answer: Justin King

Well, I think the answer to the question, in a way, David, is the same as the answer to James' question, but, if you like, with knobs on. The internet, particularly in food, by definition of course, you're incurring an extra cost, because you're picking the product for a customer and delivering it to their home, so there is undoubtedly an extra cost. So what you've got to understand about an online delivery operation is what the benefits are, either in terms of incrementality, or in terms of total shopping that customers do, or the type of shopping that customers do with you, which gives a level of profitability to justify that extra cost. And we're very comfortable with our understanding of why driving our online business is profitable for Sainsbury's. And you may have noticed, and if you haven't I'm happy to draw your attention to the fact, that we actually incentivise customers that shop in our shops, through Nectar and coupon-at-till data, to also shop online, and therefore I think you can take it as absolute read that we're comfortable that actually improves the profitability of our relationship with that customer.

To the general point about vouchering, it is true that there is a very significant level of vouchering in online, largely focused around grabbing new customers, but we would not recognise an observation that there has been a significant increase about ourselves. We're continuing online, as we are in store, to be very targeted, and we’ve not stepped up our vouchering activity either online or in store, we continue to refine how targeted it is, but that’s not quite the same as stepping it up, which clearly has happened elsewhere.

Answer: John Rogers

And David, John just to build on Justin's comments on online. What we're finding is when a customer switches from shopping in our stores to shopping online, as we've said in the past, what they end up spending in store with us goes down very slightly but then on top of that you have the incremental online shop, so overall their total spend with us increases, and it increases quite significantly. And it’s the profit that we get from those additional sales that effectively offset the additional costs that Justin referred to, but net-net it’s a profit accretive activity.

Further question

Okay. The maths still don’t seem to work in my mind so maybe we have a discussion at a different point, but you’ve got all the quoted retailers saying exactly what you’re saying, but of course the quoted sector is now losing share to the unquoted sector. And so a related question is how much longer can your core estate, and if we strip out extensions, inflation and maturing stores, you strip all those out then your core estate, as is common across the industry, remains in firm volume decline. So how much longer can yourselves and the industry carry on seeing volume declines on stores that are more than three years old?

Answer: Justin King

I want to come back to the start of the question before answering the second half, David, because others may be saying what I’ve just said but if they are of course it’s not true, because they don’t actually have the data with the level of precision that we do to be able to make the assertions that I’ve just made with confidence. So I think you have to ask them how they’re so sure, perhaps from the data. And of course one of the quoted retailers doesn’t have an online business and at least historically has been somewhat of a naysayer about online, which I would suggest would be talking their own game.

As far as your wider point, I think it comes back to of course the overall debate, which you’ve been a key proponent of, is the industry adding too much space, what’s happening to the core. But again the answer is, as we’ve given I think many times before, you have to look at it individual retailer by individual retailer, and of course it is important to note that all performance is both relative and absolute and there’s no doubt that there is overall pressure on core space in this industry. It’s self-evident that if the industry is adding in total more space than the total growth in the industry, that core space for the total industry is undergoing that squeeze that you described. Given that, the question is for individual retailers whether your core space is hurting more or less than the rest, because that’s what presents you with the profitability challenge, and self-evidently with our underlying performance even if you strip out all those things our core space is under less pressure than that net the rest of the grocery industry and that’s a competitive advantage, albeit that it’s a competitive advantage of having a lesser negative. And we’re very comfortable with the focus of our investment activities, convenience stores are very accretive for us, extending stores when we do it, leverages existing investments and assets, and of course our new stores are almost entirely in parts of the country where we are not. So I’m not sure how much more colour I can add to what I know are your strongly held views about the market overall.

Question 6

Andrew Gywnn - Exane

Just coming back on the competitive backdrop, obviously things have been tight over Christmas ((sic)), bad weather and so forth, quite a lot of vouchering going on, perhaps a bit of a temporary truce almost at the moment, but as we head towards Christmas do you expect a deterioration in the competitive backdrop? Do you think grocers are going to be fighting much harder for that sadly limited volume growth that Dave speaks of?

Answer: Justin King

I'm not sure I'd say there was that much of a truce at the moment, it's been pretty relentless throughout the summer in terms of vouchering and promotional activity. But I think you could probably find the answer to this question on every conference call that's ever been made in September, which is the most competitive part of the year is always the part that runs in to Christmas. It's important in itself, because there's extra business to be fought over, and it's also important in terms of next year's trajectory, because it is a time of year when customers will change their behaviour, particularly around fresh food and the opportunity is there to secure them, or at least part of their shopping, on an ongoing basis into the new year, so there are two reasons for winning at Christmas. And because of that it tends to be when the competitive activity hots up. Of course the sort of broader market dynamic question is the shape that individual retailers' P&Ls are in entering the period, and therefore how much latitude they have to invest ahead of the curve or whether they can only invest as the sales come through, and in that regard of course today's announcement shows that we're carrying the best momentum into that period. So, you know, carrying momentum is an important part of being able to compete in that kind of environment.

Further question

I don't think anyone would dispute your momentum, it's clearly much better, but I guess, coming back to John's answer earlier, where you said you were expecting around about 4% inflation coming through, clearly that's coming through onto a still very constrained consumer, and obviously onto a backdrop of this relentless competition as you say. Does that make you nervous? Do you think the consumer can absorb 4% inflation?

Answer: Justin King

Well, inflation's not good news for the consumer and therefore it's not good news for the industry, we've been consistent in that over the years because a consumer under pressure has to think hard about what they're spending and where they're spending it. But I think we feel that the changes in behaviour which have been driven by the economic downturn over the last five years and have persisted, because on the whole consumers have found that they like those changes in behaviour, they are here to stay and they're part of how customers will continue to deal with the challenges of more pressure in the grocery shop. So whether it be trading through the ranges of own-label, trading from brands to own-label, buying promotions, seeking out more coupons, responding more positively to targeted coupons, all of those things are things that we think we're equipped to compete on. So a consumer under pressure is something that we don't welcome on their behalf, but from a competitive point of view it's not something that we fear.

Further question

And to coin a phrase you seem to be pointing towards dialling out the inflation through mix effects, do you think there's a volume drag though?

Answer: Justin King

What we're seeing this year so far is a level of volume decline in the market which is greater than we anticipated. We felt that the last couple of years of consumers removing volume probably only had about another year to run its course, because there's only so much volume they can dial out. Actually consumers have proven to be quite innovative in how they've continued to do that. So as we sit here now with an industry with maybe only 1%, 2% depending on which market data you look at, total growth and inflation at 3-ish percent, there's clearly still 1% to 2% volume decline overall. And that looks like that'll be the picture for this year and probably be prudent to assume that that carries forward. But it only leads to all of those things I've talked about and switching and savvy shopping more generally. And we've been able to help our customers with that well, and ultimately they reward the retailers that are helping them solve that problem best with extra business, and that's why we've been growing throughout the economic downturn.

<u>Question 7</u>

James Collins - Deutsche Bank

Firstly, going back to online grocery, I've just seen some things that suggest you're maybe changing the charging structure on online grocery. It might be isolated examples, but I've seen that you're stopping some of the free mid-week deliveries. It might just be one particular area, but I'd be interested in if you are doing something there to manage the costs.

And then my second question, I'm interested in your comments on non-food where you talked about big ticket electricals and Home doing better. Is that something that you've done that's driving that or is the market, do you think, picking up in that area?

Answer: Justin King

I'll get Mike to come back on that. Online delivery charges are a pretty regular part of the mix in terms of changing them. They're the most powerful tool you have to manage when you have volume and when you want to shift volume. There's been commentary from competitors in the past about the challenges of everyone wanting to have their online deliveries on the same day of the week and therefore about placing capacity constraints. So we have changed and will continue to change online delivery charges from time to time to enhance the productivity of the business. It's still possible to get a delivery from Sainsbury's for a good bit of the week for as little at £2.95, and that's a competitive rate. But we are using delivery charges to manage the volume around the mix. And, as we've said, more than 20% growth shows that we're doing that in a way that's acceptable to customers because our business is still growing.

Further question

Just on the free mid-week deliveries, if you're saying that you get as low as £2.95 that's suggesting there's no more free mid-week deliveries for anybody.

Answer: Justin King

As it stands today that's true but I'm not going to be drawn on what might be the case in the weeks and months ahead. I think in a way you've got to view delivery charges just like any other price in the mix, all of us are using them to change where and how much volume we have.

Answer: Mike Coupe

And there is a customer benefit by utilising our fleet a lot better and by getting more deliveries on each van it means we actually are able to open up a lot more slots overall. So one of the things we've done very effectively in the last six to 12 months is improve our fleet utilisation. It's a bit like running EasyJet, turn around as quickly as you possibly can and keep them as full as you possibly can. So that's one of the refinements you can use around pricing.

On the large electricals I think most of the electrical retailers would comment on the fact that the large electricals have been better this year than they were the previous year, but they were pretty dreadful for two years running, so it's not surprising in one sense. But I think it's fair to say we've performed disproportionately well and that's a function of the fact that we've got a great store offer and I think that's true not just of large electricals, that's true right across our non-food business and I think that's reflected in the numbers we've looked at.

<u>Question 8</u>

Pradeep Pratti, Citigroup

One quick question. Can you comment on the space growth for the rest of the year?

Answer: John Rogers

We're not changing our guidance in relation to around a million square feet. I think it probably is important to note that the contribution from extensions, which we're reporting today at being 1%, we would of course expect to see that come off in the second half as a result of the slowing down in extension space that we've embarked upon this year. But we're not changing the guidance in relation to the overall space. So it's one to two convenience stores per week, around a million square feet of additional space, and a contribution from that new space being around 2%.

Concluding comments - Justin King

Okay, it looks like that's it for questions, thank you very much. Obviously we'll be talking to you again fairly soon, face to face at our interim results in November, so look forward to seeing you then. Thank you.

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