J Sainsbury plc

J Sainsbury plc Interim Results 2014

Wednesday 12 November 2014

David Tyler, Chairman

Good morning and welcome to this presentation on Sainsbury's Interim Results for the 28 weeks to 27th September 2014. I'll just say a few words then I'll pass on to John and Mike for the great bulk of this presentation.

So underlying profit before tax in the six month period was £375m, that's down 6% on the first half last year. As you know, this result has been recorded in a grocery sector which has become increasingly challenging during this period.

We recognise now that we operate in a fundamentally different market from that which was there three years or more ago. It has become clearer that this is not a cyclical change, essentially it's a structural one. As a result we've carried out a careful strategic review, and our updated review is a natural evolution of what has gone before, building on what this business is and its real strengths; in food, in non-food, in stores, in Convenience stores, in digital, and indeed, in new businesses as well.

Mike and John will take you through this strategy shortly, an emphasis on our quality differentiation, on simpler pricing and on lower pricing, and all that funded by lower costs and by reduced capital expenditure.

We believe that this will allow us to continue to be a winner in this marketplace. The strategy has been put together by what I believe, and indeed what the Board believes, is the very best management team in this sector. We benefit from the huge experience of Mike and John and many other senior colleagues, and we also benefit from the vigour and the new thinking of younger colleagues and those who've joined us from other industries. No one in this sector understands better the customers in this market than our team; ditto on suppliers, our supply chain, shops, the digital offer too. So we start from a good place.

Let me also just briefly speak about the dividend. Although we're making no change to our interim dividend today, which is 5.0p, we are announcing an updated dividend policy. Our policy will now simply be to have a full year dividend cover of two times underlying earnings, in other words we will simply pay out half our underlying earnings per share. And given our expected profitability this year we therefore expect our full year dividend will be lower than that of last year.

Now, we have given this matter a huge amount of thought before coming to this decision, we believe it's in the interest of shareholders for us to make this cut because it will free up capital and cash for us to invest in our customer proposition and to look after our balance sheet, and we have to get those things right to underpin the future of this business for shareholders.

So that's all I wanted to say by way of introduction, let me now pass you on to John to take you through the financials. John.

John Rogers, Chief Financial Officer

Thank you, David. Morning everyone. Okay, I think you've got all the usual slides in your pack that we normally go through, but I'm going to take you through the edited highlights so that we can get on to the Strategic Review as quick as possible.

Just taking you through the numbers for the first half, reporting retail sales, down 1.4% to just below £13.8bn and that's delivered a retail operating profit of £388m, so down 11.8% reflecting of course the negative like-for-likes that we've seen in the first half and also the price investments that we've made.

Strong performance from the Bank here of £35m, and of course you'll see that now on a fully consolidated basis, and the adjustment of course has now come out of the joint venture line numbers.

Net finance costs of £54m, slightly better than we expected, delivering a profit before tax of £375m, and that's a beat to consensus, so consensus for the first half was around £350m or so.

A tax rate of 26.4%, slightly higher than we guided to at the prelims, and I'll go on to explain later on why that's the case, delivering a basic underlying earnings per share of 14.5p and as David's already confirmed, the same interim dividend as we paid last year.

Coming on now to items outside of underlying, a charge of £665m in total, which is predominantly an impairment on a combination of some of our trading stores and also some of our property pipeline going forward, and again I'll break that out in more detail later, and that of course results in a loss before tax of £290m.

Coming on now to the sales, these numbers will be familiar to you, this is what we reported at our Q2 trading statement, so like-for-like sales a decline of 2.1%, offset by 2.1% coming through from our new space, such that total sales growth flat year-on-year. Of course a contribution from our extensions of 0.2%, and we reiterate the guidance that we gave at the Q2 trading statement, we expect second half like-for-likes to be similar to the first half, and again, a contribution from new space of around 2%, so no change in our guidance there for the full year.

Coming on now to margins, margins clearly under pressure given the challenges the sector's facing, Retail underlying EBITDAR down 1.4% to 982 and at the margin level constant fuel prices down five bps again reflecting the investment in price and the negative like-for-likes I've just mentioned, and at the operating profit level we've seen margin decline of around 40 bps and of course we've been able to offset that decline in part through the cost savings that we've delivered, and I'll talk about those later on as well.

Really good performance from the Bank, really pleased with the performance in the first half, a step up in expectations to where we thought we would be, total income has increased, we've increased our loan book and our credit card book, and indeed our profit has gone up 30%, reflecting the growth in the business and also a change in our funding. We've been moving away from savings balances, we've got access to the government's Funding for Lending scheme which has lowered our overall funding costs and with a good bad debt position we've been able to deliver 30% growth year-on-year in profit, so a really strong performance from the Bank.

And in fact we guided at the prelims to broadly flat profit year-on-year, we're now updating that guidance today reflecting the strong performance we've seen in the Bank in the first

half to guidance to expect a 10% to 15% growth in underlying profit for the Bank for the full year.

Coming on now to the items excluded from underlying, you'll see here the impairment charge of £628m. As part of our strategic review we've done a really sort of deep dive exercise looking at our entire store estates, we've projected forward where we think the sector is going in terms of volumes and like-for-likes and as a consequence of that we've taken a decision to impair some of our property pipeline, so some stores that we no longer foresee ourselves building out and also to impair an element of our trading estate as well, about 40 schemes in total for each branch, so 40 schemes in our pipeline and about 40 of our existing stores in our business.

You'll see there the transition costs in relation to Sainsbury's Bank of £23m, again that's part of our programme to move on to a new banking platform, and indeed we anticipate we'll spend £50m in the full year to date, that's a slight increase from where we guided to of £45m reflecting the acceleration of the delivery of that programme going forwards.

Coming on now to interest costs, interest costs slightly better than we expected at £54m, reflecting the low inflation rate on our index linked debt and also very good working capital management in the half, so we've kept debt levels down and therefore we've been able to deliver a lower than expected interest rate charge at £54m, capitalised interest of £12m, again down year-on-year, reflecting the slowdown in our property pipeline build out of new stores.

So as a consequence of that good performance in the first half we're changing our guidance for the full year, the previous guidance at the prelims was as we expected flat interest charge year-on-year, last year was £111m, we're now changing that guidance to expect interest costs of around £105m for the full year. Capitalised interest remains the same, guidance at £20m.

Coming on now to the tax rate, 26.5%, a slight increase to the guidance that we gave at the prelims and that's really as a result of clearly the deductibles that you make on depreciation are fixed and because of the reduced lower profitability, therefore the implicit tax rate goes up and we've also reduced some of our future tax assets as well which have resulted in that effective tax rate going up to 26.5%, and indeed, we're guiding for that same rate for the full year.

Cost savings, we talked about cost savings at the prelims of between £120m and £130m, we've had a really good half in terms of cost savings, and these cost savings have been delivered across the business through Retail, through Logistics, through our centralised operation, so really good performance right across the board. We've delivered £75m of cost savings in the first half and we are therefore updating our guidance for the full year to deliver £140m of cost savings.

Capex, again capex in line with our plan, a total of £562m. We've accelerated our capital plan this year into the first half of the year compared to previous years but the guidance for the full year remains the same, so we expect to spend in the order of £900m or so on capex for the full year.

And cash flow, again cash flow from operations down slightly because of the reduced profitability, but what's really pleasing, we've been able to release a significant quantum through better working capital management in the Retail business and that's as a result of a number of exercises that we've undertaken in the half. Of course that's offset by increased working capital within the Bank and then you'll see the various adjustments flowing through

including the capital spend charge of course, so that's at net debt, from the prelims has only moved on £2m or so, so it's pretty much flat from the prelims.

And coming on now to the balance sheet. Property valuations, £11.9bn, so down slightly on the £12bn that we've previously reported. That's partly as a result of a slight improvement in yields offset of course by the impact of the impairment charge that we've made, so that brings that number down to £11.9bn and net debt we've already just discussed. Facilities in place of £3.6bn, this remains well funded, and a pension deficit that's actually reduced from the half to £634m, reflecting actually an outperformance on our assets in part offset by a reduction in the discount rate, but net, net we've seen an improvement in our pension deficit as a consequence. Guidance for the full year remains the same, so we expect our net debt for the full year to be around the £2.4bn level.

And actually coming on now to some of the balance sheet metrics that we make reference to, again very stable metrics across the board, across the last five years, both in terms of the lease adjusted net debt to EBITDAR, a very stable performance and indeed a fixed charge cover that hasn't actually moved at all over the last five years, so we're maintaining a very stable balance sheet strength.

So to summarise quickly, obviously we've seen the impact of deflation and the accelerating trends that we've seen in the industry, that's impacted our performance in the first half, but we still believe it's a relatively strong performance given the challenging industry environment reflected in the beat to consensus that we announced today. Yes, we've still got great growth opportunities in our business in the non-food, Online, Convenience and the Bank, great performance in the Bank we're reporting today, resulting in a very strong multichannel offer and of course very much underpinned by our quality and our own brand, and of course our strong values within the business.

Key financial measures you'll see there, the like-for-likes, the profit of course and the charge in relation to the impairment on both the property pipeline on our stores and of course very stable balance sheet metrics. Really good improvement in working capital, really pleased about that performance and property values just down slightly, pension deficit reduced and net debt in line with our expectations.

In terms of guidance for the full year, clearly Mike's going to come and talk about later on the investment that we're making in price in the second half of, effectively it'll be an annualised investment of £150m, but about half of that investment will take place in the second half of this year so you'll have to adjust your numbers to reflect that. We're also saying that the outperformance that we've seen in the Bank in the first half and indeed the outperformance that we're seeing in relation to delivering cost savings in the first half, we don't necessarily expect to replicate that performance in the second half, so again you'd have to adjust your numbers slightly, and as a consequence of those adjustments of course we're expecting profitability in the second half to be lower than the first.

And with that I'll hand you over to Mike to take you through the strategic review.

Mike Coupe, Chief Executive

Morning. So I've been in this industry for 30 years and I have to say it's probably the most challenging time that I've seen in those 30 years and actually there's probably nothing that we haven't seen before, but what's different is that all of the things have come together, so all of the challenges of the market have come together in what I would call a perfect storm. So we've looked at our strategy, we've talked to our customers, we've talked to our colleagues, and broadly speaking what they say is that they want us to be a better version

of Sainsbury's; they want us to evolve rather than create a revolution. So what I'm going to talk about today is how we make a better Sainsbury's, how we evolve to win.

We've also made sure that we've got the cash resources to be able to execute the strategy, so we're talking about reducing our capex, revising our dividend policy, but also making sure that we take the cost savings in the business to ensure that we've got the cash to execute the strategy and also to deal with the market conditions that we think we're going to be facing over the next period of time.

And the last point David's already made, which is we have a fantastic management team. In the end, a lot of retailing is about strategy, but in the end it does come down to execution and leadership, so I'm confident we've got the team in place, we've got the continuity of the team in place, they've helped me develop the plan over the last period of time to make sure that we execute well in the future.

So I want to talk a little bit about the market conditions. This chart reflects the market performance over the last period of time. And of course the first thing to notice broadly speaking despite the fact that the population of the UK has grown by about three quarters of a percent in the last year, the last five years year-on-year, volumes have stayed static and during that period of time the industry has added about 3% more space. So almost an inevitable consequence of that is that the supply and demand equation has changed. That's a structural effect.

Secondly, for the first time in probably about ten years we are seeing deflation in our industry, or certainly no inflation, and that's as a direct result of some of the price investments that have been made in the industry, but also because in the end commodity prices have fallen. So from a customer point of view that's great news if you look at fuel prices. Petrol, customers are paying about 20p a litre less than they were this time last year, so that's about £4 or £5 a week in their pocket week in, week out. But the way that money's being spent if you look at other industries is on non consumable durables, cars, maybe a little slightly better holiday, maybe replacing the barbeque that they haven't replaced in the last three or four years, those kind of things. So we're seeing growth in other consumer areas of the industry but that money's not coming back to the grocery sector. So again I believe a cyclical effect but that's another pressure on our industry.

If we project forward, my own view, our view, is that if you look at commodity price inflation or deflation, harvests this year have been pretty good so you would expect that deflation environment would exist for at least the next 12, probably the next 18 months. You would expect over the period of time that inflation will return to food prices, it won't be a flat 2%, almost certainly it'll be spikey, it'll go up and down, but I would expect in maybe 18 months, two years' time you would expect inflation to return to the market. And you'd also expect at some point, I've been saying this for three or four, five years, at some point, volume growth will return to the market in the sense that there is a population growth in the UK, there will continue to be a population growth in the UK and in the end that's a driver of our industry.

And the structural change, the fundamental structural change that we've talked about before, but is the key dynamic that's driving our industry is the fact that customers are choosing to shop more frequently, when they shop they tend to buy less. And they have even more outlets available to them than they've ever had so if you went back five years on average, the average customer would have had three, four shopping outlets that they could shop in. If you take today, it's probably more like four or five. So the additional outlets have given customers even more choice in where they shop, and they are shopping around, they are more savvy in the way that they shop. That is the primary structural change in our industry and we would expect that to continue into the foreseeable future.

This chart kind of throws out those market predictions for the next almost ten years, certainly seven or eight years. There are a few things I'd pick out from this chart. The realist is despite the fact that lots of people are writing about the death of the superstore, the reality is the majority of the customers the majority of the time for the foreseeable future will be doing their grocery shopping in large out of town superstores. It will be the bulk of the market, more than 50% of the market for the foreseeable future. However, you can't get away from the fact that the discounters will grow. You can take a point of view. Our point of view is that they'll probably get to around 15% of the market. Historically if you went back to the early 1990s that's broadly speaking where it got to, Kwik Save got to somewhere around 10-11% of the market, for those of you who were around in the early 90s, so we will see growth in discounters. And if you look at continental Europe again, it's around somewhere between 12% and 15% of the market, in the most mature markets.

But interestingly, the biggest chunk of the market is actually Convenience shops, so Convenience still represents a significant opportunity into the foreseeable future, and we believe that channel will grow, as will Online. So we will see a shift in the way that customers spend their money and shop, and if anything that will drive the trend towards little and often shopping because they'll have even more outlets available to them.

So this is a way that we're thinking about the market. I'm going to explain this chart because it's slightly complex, but hopefully it gives you an idea of the sort of depth of thinking that we've gone into in our business, and perhaps it drives some of our thinking going forward. Along the bottom axis, broadly speaking that describes the consumption occasion for the products that customers are buying. So if you go that way, the 'for now' bit, that's sandwiches, I'm going to buy and eat it almost immediately. The other corner, that's things like toilet rolls, something I buy and consume over a reasonable period of time. Up the other axis are things that I really care about, so they really matter to me. The example I give of something in the top right hand corner is our peak trading hour for Valentine's Day products is actually between 5.00 and 6.00 on the evening of Valentine's Day itself. So you can imagine all of those desperate males, they fall in the 'for now', and for most of them at least I believe it will be a special event! So you will basically pay anything to get your 12 red roses for that particular purchase occasion. That's an extreme version of it. But you have to think of the products in the top right hand corner as being absolutely special occasions, things that really, really drive people to want quality necessarily over price.

But if you take a category like pet food, for a lot of people pet food would sit absolutely in the bottom left hand corner of this chart, but actually some people really, really care about their pets and will pay a premium for pet food. For them it's a special product, it's something that I care about, it's a product that matters. So that will push that product up the left hand side of that chart.

You can also think about the structure of the industry by using this chart, and it does explain some of the dynamics in our industry. So broadly speaking supermarkets cater for the majority of shopping occasions. If you think about Online, actually Online over-trades in the bottom left hand side of that chart by a factor of about two. But as Online develops it's becoming more and more convenient, things like delivery passes, things like click and collect, so it's moving more and more to the right hand side of the chart as you look at it.

It also explains the growth of categories like Taste the Difference and indeed some of our competitors, M&S, because they very clearly reside in the top right hand side of the chart. And the colours on the chart reflect the relative growth in the individual sector. So bottom left hand corner relatively low levels of growth, top right hand corner relatively high levels of growth. And of the course the discounters tend to sit sort of in the bottom centre, and Convenience stores tend to sit on the right hand side of the chart.

So hopefully that gives you some flavour for how we thought about the structure of the industry. The size of the individual boxes reflect the size of each of the individual sectors, and as I've said already the colours reflect the growth opportunities in the chart. So it's enabled us to be really thoughtful about how we develop our business going forward from a product, from a category, and also from a format point-of-view, and we've used a lot of customer data to get to the supporting evidence to drive our business going forward.

Sainsbury's has lots of strengths. We're building from a platform where we are recognised by our customers on a number of dimensions to be ahead of our major competitors. I'm not going to go through the whole of this chart, I won't drain the slide as they say, I won't go through all nine of them, but the reality is that we're recognised for the values that we have within our organisation. I'm not going to spend a huge amount of time on talking about our values, but you can take it as read that we will continue to invest in our values where it makes a difference to our customers, and we will do the right things for our customers and we will do the right things for our colleagues in the future.

The middle box, we have a competitively advantaged set of stores, a store portfolio. Generally speaking we have the right size stores in the right locations, and we believe that gives us a source of competitive advantage in the future. We're also recognised for delivering great service to our customers, so our store standards are very, very high and have improved year-on-year-on-year-on-year. We're rated by our customers and we're rated by the industry in general for having the best store standards, and we want to maintain and improve those standards into the future. In the bottom right hand corner, we would argue that we know our customers better than anyone else, and that's driven our thinking in terms of how we develop our business in the future.

So this builds on the chart earlier, and really there are three chunks. It's a continuum of products, but again it expresses some of our thinking in terms of how we want to invest in our business going forward. Along the bottom, the importance of quality. Up the left hand side, how much does it mean to me as a customer? To give the example of toilet tissue, commodity product and not a huge amount of engagement in toilet tissue as far as customers are concerned. If you go to the top right hand side of the chart, something like a roast joint for Sunday lunch. Quality really, really matters to customers. It really matters because it's a centrepiece of a meal occasion. It's a centrepiece of a meal occasion where you're going to be judged on the quality of that product. So that really matters. In the top left hand side of the chart, brands, and by definition brands have to have some level of emotional quality otherwise they're just straightforward commodities.

So if you think about the way that we're thinking about the business broadly speaking, not entirely but broadly speaking, you want to invest in quality in the stuff in the top right hand side of the chart, you want to invest in price in the stuff in the bottom left hand side of the chart, and you want to make sure that you're competitive in the stuff in the top left hand side of the chart on brands. That's our strategy in a nutshell, and I'll talk a little bit more in detail about how we're going to do that in the future.

I'll give you a couple of examples. Strawberries, a very emotionally engaging product, one of our biggest selling products actually during the summer. In fact *the* biggest selling product during the summer. We've done a lot of work on creating exclusive varieties with our suppliers. We have the best quality strawberries in the marketplace. It wasn't that long ago that actually the UK strawberry season was only 10 weeks long. Now there's only 10 weeks of the year when you *can't* get UK strawberries. We've invested in developing the technology to use LED lighting to be able to produce strawberries all year round from the UK. We have a better product. We have lower waste because we've improved the date quality, the date codes of those products. We've reduced the packaging in those products.

From the customer point-of-view we have the best quality strawberries in the marketplace. We will continue to invest in the right way in product quality, and we're saying today that we're going to invest in the quality of 3,000 products over the next 12-18 months.

At the other end of the spectrum, nappies. A good example of an area that we're going to invest in price, and we're saying today that we're going to invest £150m in targeted price investment. So nappies we have an under-trade, we only have 13% of the market against a market share of roughly 17%, so it's an area of opportunity for us. We know if you buy nappies you will buy a broader range of baby products in our stores. We have a fantastic quality product developed through a long-term relationship with a particular supplier. So we've reduced the price of nappies – we've done that already – and actually we now have the cheapest own label nappies in the marketplace. This is a really good example of what we would consider to be a targeted price investment. So we'll be spending that £150m on products where we know for our customers it makes a difference, and that we believe that there's an opportunity to drive our business in the future.

We've talked a lot about pricing and promotions. We've simplified our pricing, we've simplified our promotions. We've done a lot of work, which we've discussed before, over the last two or three years, and we have much, much more stable pricing in our business on a week-to-week/day-to-day basis. We made brand match more focused, and we've talked and made an announcement that we're halving the number of Nectar Points we're giving away. It's been slightly misreported, we didn't do that last week, we're actually not doing it until April, so you still get the same number of Nectar Points until April, but we're taking that money and reinvesting it in targeted promotions for our customers, whether that's through the Nectar scheme or through other forms of direct marketing. So we're giving exactly the same amount of money back to our customers, we're just doing it in a fundamentally different way. That's a big change for us and it gives us a great opportunity of targeting our customers in the way that they want to be targeted.

Let's just talk a little bit about the growth opportunity in non-food. When I joined Sainsbury's our clothing business was virtually non-existent, and now it's grown like Topsy, it's doubled in the last five years, and it still represents a significant opportunity, and I'll talk a little bit later on about the opportunity in our space for clothing and indeed general merchandise. We've have a knockout year and we continue to grow those businesses, and they still represent a significant opportunity for us to grow in the future. Our clothing business, for instance, has grown by 13% year-on-year.

Of course we have other growth opportunities in our business going forward. John's already talked about the performance of the Bank. A fantastic business. We've now taken full ownership. The number one priority for the Bank is to make sure that we get through the systems transition that we're going through, that's still going to take another 12-18 months, but we believe that that represents a significant opportunity for this business into the future. And indeed there are other investments that we've made, like Mobile by Sainsbury's, and indeed the Sainsbury's energy business. So these are opportunities for us to develop our business and indeed utilise our space potentially differently in the future.

So we're investing in quality, we're investing in price, we're continuing to invest in simplifying our pricing. We've also done a detailed review of our store portfolio, every single one of our shops, and we've stress tested them against a series of potential market scenarios. The good news is that 75% of our shops under any circumstances that we can think of are in the right locations, brilliantly located, and for the foreseeable future will be great trading assets, and we believe our portfolio is competitively advantage in the scenario that we're describing. We're also aware of and need to address the fact that around 25% of our estate not necessarily today but over the next five years is over-space, and therefore

we need to utilise that space differently and we need to think of creative ways of taking those businesses forward in the future.

There's also an important point about our large out of town superstores generally. We have a challenge to make them more convenient. So again today we're talking about how we might go about doing that. We need to make our large out of town superstores generally more convenient for our shoppers to get around, get in and out of, improve the layouts, improve the ranges, and indeed use technology to help them work through our stores. That's a general point about superstores and that's something that we'll be working on hard over the next period of time, but we also need to make sure that we utilise our space differently in the stores which are over-space. The good news is we've got lots of opportunities to do that, so clothing and general merchandise only a third of our shops/customers actually have access to our full clothing and general merchandise offer. So that represents an opportunity in the future.

We've got an opportunity to roll out Travelex, the Bank, in more shops. We have an opportunity within Mobile by Sainsbury's. We only have a relatively small number of shops that has a mobile phone shop in, we'll roll that out in the future. We've talked a little bit about utilising that space with other third parties, so an example of that is Jessops or indeed the Timpson's concessions that we have in our stores. We were asked the question this morning, I'm not anticipating that we're going to turn our stores into department stores, I don't think that's the right thing to do. But I think we have the right assets to be able to utilise our space differently, and that's one of the things that we'll be working on hard in the future.

So that's the big shops. Equally the little shops represent a fantastic opportunity for us. We're opening 100 a year. We'll anticipate opening 100 a year into the foreseeable future. We believe there's an opportunity in smaller shops. Again if you like at continental Europe, 750ft^2 shops do represent an opportunity for us, so we'll be trialling smaller shops particularly in larger urban conurbations. We have some fantastic examples of very successful convenience shops which are also larger format. So we won't be restricted to just the 3,000ft^2 model, we will roll out larger Convenience shops and smaller Convenience shops, and we think that'll open up a wealth of opportunities into the future. Of course, as John often reminds me, they're very accretive capital investments so they're great investments for this business to be making into the future.

Of course Online continues to grow. I just want to emphasise the point for us, Online is about serving our customers. We're not going to chase volume for the sake of chasing volume. We know for our customers, if they shop with us in our shops and they become an online shopper, they will buy more stuff overall. So 1 plus 1 doesn't just equal 2, it equals 2½ to 3. It's very important that we address our online offer to our customers. So we'll continue to work on making sure that we improve the performance metrics, that we improve our website, that we improve freshness, that we improve substitutions, but we'll also continue to roll out and develop click and collect. We accept that that's where the market is going to go over time, and if I went back to my chart earlier, the online offer is moving more and more towards the convenience end of the spectrum. And we'll continue broadly speaking to pick out of our larger out of town superstores, which we think is a source of competitive advantage because it's another way that we can utilise our space for our business in the future. However, we are capacity constrained in London, so we will build out a dark store in London over the next period of time. We've also got a clothing online trial which has proved to be pretty successful, so we'll be rolling out clothing online over the next period of time.

We thought we'd have to put a Netto slide in. Five trial stores, one last week, three this week. Heaton Park opened this morning. We'll repeat what we've said already, this is very much at the trial stage. So far so good. The fact that we've opened five stores before Christmas starting from scratch is a brilliant achievement by all of the teams involved. I'm sure some of you have seen the shops. I'm sure some of you have also commented on the shops. We're very pleased by what we've seen on the ground and by the customer reaction. So we will roll out the remainder of the stores, so we're committed to roll out 15 over the course of the year, and we'll see how it goes. But it hasn't escaped your attention, it certainly hasn't escaped our attention, it is the one of the opportunities that we have to utilise our excess space differently. The first store that we opened was co-located with one of our shops on the same site. The store we're opening this morning is actually in the same building, different entrance but the same building.

If you look at continental Europe again, if we talk to our partners Dansk, their large out of town superstores and their discount stores can co-exist, and it creates a more powerful offer for customers overall. Without giving too much away, the early indications are that it's new business to us, so that's a good thing, we believe in the end it will make our sites more powerful.

The last thing about Netto is actually there's a huge amount of shared learning. I have to say for all of us, for both them and us it's been a voyage of discovery, and by the two businesses working really closely together we've certainly had a chance to examine and understand their business model, and of course they've had the opportunity of doing the same with us. There are lots of things, lots of insights that we've learned from the Netto joint venture that we can roll back into our larger shops.

I talked about customer service already. We believe, we've said before, that we run the best shops in the industry. We've reduced our gaps, increased our on-shelf availability dramatically over the last five years. Whichever metrics you look at and whichever objective measures you look at within the industry we're generally rated as delivering the best customer service. But we're not resting on our laurels we know we have to continue to step on. So we're reintroducing a new on-shelf availability system which will allow us to do a better job for our customers in the future: a real-time analysis of where we have gaps. And we're continuing to invest in customer service so we have a new EPOS system going into our stores. It's on trial now in five or six stores, and during the course of the next year we'll expect to roll that out. It will allow us to do a better job serving our customers.

We're rated as number one by our suppliers for retail execution, so we do what we say we're going to do from our suppliers' point of view. We'll continue to build on those strengths it's a very important part of our overall proposition.

The last piece I wanted to talk about, and this is very much gazing into the future, is how we're starting to think about how we join up our customer knowledge, and how we do a better job through the use of technology of serving our customers' needs into the future.

So on the left-hand side of the chart we have lots of data sources in our organisation and we're gradually putting those together in a single view of our customers. And we believe that will give us the opportunity of serving our customers' needs better in the future, so helping them manage their budgets, helping them to manage their shopping lists, if you want to buy healthier products helping them to do that.

So on one side of the equation we're joining our data sources together. But on the other side of the equation we're providing more and more different ways of our customers shopping with us. By providing them with a single sign on and access to their own personal

shopping list they can start to think about how they might buy their products differently in the future in the various parts of our business. We believe this technology is very powerful, and we believe over time this will allow us to compete even more with our competitors in the market overall. Because we have this data it's unique to us. The power of joining it together and helping our customers in the future is one of the key differentiators as we look forward – not today, but maybe over the next two or three years, we'll start to see developments in this area and we'll start to see things coming through in a very different way.

A few examples of where we're already doing some of this stuff. I've talked about clothing online, we've developed that over the last nine to 12 months; we're in trial; we're now thinking about rolling it out. For those of you thinking about order Christmas products we have set up an app to make Christmas ordering dead easy. So if you want to get your turkeys, brilliant, download it onto your mobile phone. We now have entertainment on demand. We believe we can join that together to our overall position, a different way to perhaps the way that some of our competitors do.

And perhaps most powerfully is the in-store shopping app; which at one level is utilitarian, it allows customers to scan products as they go round the shops and to see how much they spend and to manage their shopping list. But we believe that ultimately is a very powerful mechanism for the way that we communicate with our customers. We are in trial with the latest version of this in our Wandsworth store. And again, if successful we'll be thinking about how we roll that out in the future.

The point I wanted to make on technology generally is that all this technology is focused on making our customers' lives better, on helping them live well for less. Not a load of superfluous stuff over here but very much focused on driving helping our customers live their lives better.

So we have a new strategy wheel. It's very straightforward; there are five elements to it: We know our customers better than anybody else. We'll invest in great quality products; we're talking about investing in 3,000 products over the next 12 to 18 months and upping the benchmark in the quality of the products that we see. We're also making sure that we target our price investment, that £150m, in the right products and the right categories. We need to be there for our customers. We need to join together our offer in a fundamentally different way, but we need to make sure that all of the places that we serve our customers are convenient and easy to get round and that we recognise the fact that our customers will be shopping very differently in the future.

Our colleagues make the difference. Our customer service is absolutely paramount. We're not going to compromise our customer service through reducing our costs. We must, must, must make sure that we deliver customer service week in, week out, and we're doing all the things that we need to do to make sure that we enhance our on-shelf availably and our customer service metrics.

At the heart of our business are our values. Our colleagues make the difference, our values make us different.

We have underpinned our plan by making the right choices about financing. So we will lower our costs by £500m over the next three years. We have reduced our capital expenditure. And, as the Chairman has already alluded to, we've amended our dividend policy in a way which we think is fair to shareholders to make sure that they receive the benefits and they get half of our overall earnings over the foreseeable future.

At this point I'm going to hand back to John.

John Rogers

Thank you Mike. So Mike has taken you through our outputs of our strategic review. What I'd like to do now is just take you through a few slides to help you in terms of guidance for your models as to what all that means.

We've talked about the £150m of price investment. We've said that half of that price investment will take place in the second half of this financial year, so roughly speaking £75m or so. The remainder will take place in the first half of financial year 2015/16, such that the annualised investment in 2015/16 will be £150m. And of course that will carry that forward for the following two years. Of course when you add all that together number you get to a number of about £500m of overall price investment over the next three years; but we think it's more intellectually honest to talk about as an annualised investment of £150m.

We will work with our suppliers. Mike talked us through a great example earlier on, the strawberry example, where we've worked with our suppliers to recover cost savings across our supply chain. And we will do more of that work over the next three years to recover that investment in price through the cogs line. Now that will be phased later than the price investment itself, and you will see the respective phasing of that over the next three years. But by 2017/18 we will have recovered the investment in price that we've made through savings in our cogs line through working with our suppliers.

Coming on now to capital investment. This chart here shows the investment in capital over time. You will have seen that over the last couple of years we have stepped off our capital investment overall year-on-year. Indeed what we're announcing today is a further step down in capital per annum. So between £500 to £550m capital spend going forward for each year over the next three years. And indeed our core capex to sales ratio will be around 2% from 2015/16 onwards.

What is important to note as well is the shape of that capital spend, it's changing markedly over the next three years. So you'll see the proportion that is dedicated towards new space, supermarkets, Convenience and extensions you'll see that falling quite significantly from where we are today towards the next three years. But clearly we're maintaining our investment in areas like IT and technology, logistics and commercial initiatives, so that we can provide a better service to our customers to make our stores easier to shop.

Here is the summary of new space. We've talked about capital spend on new space but in terms of what does that mean for the square footage that we're putting down over the next few years you can clearly see that outlined in the slides. So in practice we'll be adding about 500,000 sq. ft. for the next two years, and then just above 300,000 sq. ft. for 2017/2018. So, a significant cutback in the amount of new space that we'll be adding going forward. Again, you'll see that actually most of that cutback is clearly taking place in supermarkets. So, more than half of the space that we add over the next three years will be in the Convenience space, which is of course where we see the most accretive returns. In fact if you look at the first half of this year we've added less supermarket space than all of our major supermarket peers; demonstrating to you the step-back that we've made progressively over the years in adding supermarket space.

We will be doing four replacement schemes. And these are schemes that three of those four are actually mixed use developments. Some of you will have seen perhaps the developments happening for our Nine Elms store, for example, our Fulham store. These are opportunities where we'll be unlocking significant property profits over the next three years. So, they're great returning schemes for our investors. And we'll maintain our Convenience pipeline of roughly 100 stores per year.

Coming on now to cost savings going forward. We're talking today of cost savings of £500m over the next three years, and roughly between £150m and £175m of cost savings per annum over the next three years. That is a significant step on from the £120m, £130m or so that we've done historically. Indeed I said this morning we're stepping up this financial year to £140m. So, you can see the natural progression that we're making in terms of delivering cost saving in our business.

I've often said to you before as well that we generally have line of sight of our cost savings stretching out about 12, possibly 18 months or so. The exercise that we've undertaken in the last three to four months has been a really detailed analysis of our business. And we've now got line of sight over the next three to five years of the cost savings we'll be making going forward. So, for this £500m we're very clear as to where those cost saving opportunities lie in our business, certainly for the next three years.

As you can see from the chart, they are very much spread across the business, central operations, marketing costs etc, in our retail business, procurement – we continue to deliver good savings for our procurement function. And of course we've got a very good track record of delivery in this respect.

We talked a little bit about the balance sheet. We will retain our balance sheet strength over the next three years. We've talked today about how we manage the cash in the business. So, we've sensibly cut back our capital spend; we're driving cost savings through the business; and of course we've announced the changes to the dividend policy today, again which I think reflects a sensible balance between rewarding our shareholders for owning our shares at the same time as making sure we can conserve cash within the business to maintain our balance sheet going forward.

We expect all these metrics to remain stable over time. We've had really good progress made in working capital management. There may be a little bit more to go for. So, we saw £300m improvement in the first half. Some of that is temporal; but some of that is real underlying working capital improvement. And we can expect to see a little bit more coming through over the next 12 months or so.

So, in summary we do expect supermarket like-for-like sales to be negative for the next few years. It is a very tough industry environment; but we think we've outlined the strategy to you today that demonstrates we've got robust plans to address the challenge. We want to maintain and enhance our differentiated offer through our investments in price, the £150m; through our investments in quality, the 3,000 products; and through our investment in service, making it easier for customers to navigate and shop our stores. We've got fantastic investment opportunities to continue to grow our business, whether it's Online, Convenience, the bank; great, great opportunities for us. And of course we'll fund all of that investment through sensible management of our cash: so cutting back capex over the next three years; reducing our cost base; and also delivering the cog savings that I made reference to.

So, we will continue to pay the dividend. We will maintain our balance sheet strength. And we'll fix the cover on the dividend at two times over the next three years, so paying our roughly half our earnings to our shareholders.

And with that I'll just hand you very quickly back to Mike.

Mike Coupe

I think we've covered the main bases. I'll just end up repeating what we already said: this is about evolution and not revolution. It's about being a better us. We believe that we're structurally advantaged; if we look forward the next couple of years undoubtedly is going to be challenging for our business; there is no doubt of that. But actually we believe in the medium to long term we can build on our strengths and create shareholder value into the future.

As John has already said, we've made sure that we've made the right choices about financing the business, not just to execute our strategy, but actually we've stress tested the business against potential scenarios in the future to make sure that we've got the financial capacity to deal with whatever the marketplace throws at us.

The last point I would make is to repeat what I said at the very beginning, which is in the end my experience of retailing is it's as much about execution, if not more about execution and leadership than it is about strategy. We do have continuity in our management team, a team that has bought into the plan, a great set of 161,000 colleagues, and we can execute this plan over the next three to five years.

Thank you very much for listening and we'll go back to Q&A.

Question 1

Bruno Monteyne, Sanford Bernstein

With the solid numbers this morning, the measures taken to improve the balance sheet strength, do you feel you've done enough to take a rights issue off the table for the next six months at least?

John Rogers

As Mike says, we've clearly looked at the business going forward. We've cast forward a number of different scenarios for the business, upside and downside cases reflecting what could happen in the sector going forwards, and we're confident today that we certainly don't foresee the need for a rights issue going forward.

Question 2

John Kershaw, Exane

Just putting together some of your slides, and my maths is a bit simple, but it strikes me that we're struggling to get into positive like-for-like territory for the foreseeable future. Perhaps comment on that? Because perhaps Convenience can pull out where you're making comment on the superstore estate.

But if I look at your slides for guidance it looks like you've got over the next couple of years £300m to £400m into price that you only gradually get back. So, if we look out a couple of years at the gross profit level you're telling us maybe we've invested £200m. You've got your cost savings; but if there's no like-for-like then basically you're scoring the draw against inflation.

So, if I read your slides right you're telling us that profitability could go down substantially from say high 600s to high 400s in the next couple of years.

Mike Coupe

I'll ask John to comment more specifically on it. But we're recognising the fact that the market will be very challenging for the next 18 months to two years. There are some market scenarios that you could play out that would be more optimistic; and indeed there are some market scenarios that you can play out which are less optimistic. But the reality is it's going to be a challenge for the next couple of years. And we're trying to strike the right balance between making sure that we've got the financial resources, but also are investing in the things for our future.

Maybe John can comment on the specifics?

John Rogers

Just in terms of the specific guidance hopefully we've been very clear in the guidance we've set out today in relation to the price investment that we're making. I think we've been remarkably transparent actually in terms of the £150m, how that's phased; how we anticipate recovering an element of that over time, albeit with a slight lag; and we've been equally very clear on what we expect in terms of our cost savings year-on-year: so £150m to £175m of cost savings each year for the next three years.

So, hopefully with that quite detailed guidance going forward you can build all of that into your models and clearly come up with the consensus numbers that you'll come up with. But I think the guidance tells you the story.

Question 3

Charlotte Edgar, Jeffries

John, could you just confirm the level of bonus accrual in the first half for this year and also what it was last year, and any expectation for that for the full year?

And then just on that 25% of the store estate, could you talk a little bit about the geographic locations of those stores and the size of those stores please?

John Rogers

I'll pick the bonus accrual piece up. I think it would be wrong of me to talk at this stage of the year to talk about the bonus accrual on behalf of our colleagues. What I can say though is that clearly last year's bonus was set for the business at around £80m or so. Clearly, given where consensus is this year vis-à-vis profitability for the business at 677, I think it wouldn't be any surprise to say that we're going to be paying a lower bonus this year than we paid last year. But I think it would be wrong of me at this point to give details to that detail of what we've accrued for the first half.

Clearly what underlines your question of course is your quality of earnings piece. We will clearly see benefit year-on-year in that context of a reduced bonus payment to our colleagues.

Mike Coupe

As far as the store portfolio is concerned it is reasonably geographically spread. It's a slight simplification to put it this way, but broadly speaking, and I think this is probably true across

the industry, the larger the shop the more challenge it is from a space point of view. As I say, that's a gross simplification because there are other dynamics in play. But as I say, it's broadly speaking across our entire portfolio; it's not any particular geography.

<u>Question 4</u>

Mike Dennis, Cantor Fitzgerald

Just on costs I've got three questions. Could you tell us what the first-half cost growth was, because you gave guidance of 2% to 3%?

I'm just also trying to read your charts; the £500m it looks like half of it is retail. Given your comments on service what are those retail cost savings that you're actually making within that I guess £250m?

And given that Tesco gave us their head office cost to sales ratio at 1.9%, which was an incredible increase, what is your cost to sales in central head office costs?

John Rogers

The cost inflation in the first half we would set at around 2%, so the lower end of our 2% to 3% range. That equates to cost inflation of around £50m or so in the first half.

I'll comment on the head office costs in a way by not commenting. So we're not going to break out that ratio for you.

Mike Coupe

We're very passionate and conscious of maintaining our customer service, so that's our number one priority. As I've already said, we'll make sure that we improve our on-shelf availability and maintain our service metrics.

The savings are across a broad portfolio, which I'm not going to go into now in any great detail. But it's not just around labour management; things like energy savings would be a good example where we've invested an enormous amount of money in lowering our energy costs over the last few years. Again we've commented before that we actually have the largest solar array in Europe on the tops of our shops. And we'll continue to do those kinds of things.

To John's point, it's a very detailed plan and we know where the money is going to come from. Actually it's a lot of little things rather than one particular big thing.

John Rogers

Probably just to throw light on it a little bit more. In core savings if you look at our track record over the last three years as to where our cost savings have come from, £120m or so a year that we've delivered, you'll see from our analysis historically that quite a high proportion has come from the retail business. And yet at the same time I would argue that we have improved our in-store standards, we've improved our service levels in our stores – and that remains a differentiated part of our offer compared to our supermarket peers. So I think in a way we feel confident that we can continue to take costs out of our business in the right way as we have done historically, and indeed maintain and enhance the customer service in our stores.

Question 5

Niamh McSherry, Deutsche Bank

On the slide you've presented, the longer-term grocery market growth, volume and inflation, it would suggest that you've got another two years or you're expecting another two years of flat volumes and then volumes to recover. I know you've talked many times about wastage taking volume out of the market, do you still think that it's wastage that has volumes below normal? And what is it that gives you the confidence to expect volume to return?

John Rogers

Yes, I gave an overall view. I've said personally for a number of years that I would expect volume growth to come back to the market, and I've been woefully wide of the mark. So the reality is I'm not calling it any time soon because I've been proved wrong on numerous occasions. You have to believe, if you look at the historical norms, if you look at the fact that there comes a point where it's quite difficult to save waste generally, that volume growth will return to the market, and it will return broadly speaking in line with population growth.

Again, if you look at the historical norms as grocery markets come out of recession again you see two effects: one is a return to volume growth, and secondly a general movement of uptrading, so people buy more expensive stuff.

As far as inflation is concerned I think it's a cyclical effect in the sense that we are seeing last year high inflation followed by a very good crop, and therefore against the previous year deflation. The harvest this year, as I've said, will probably be quite good looking at the weather. But you would expect, in the end food resources are scarce in the world and we have a population that is growing, you would expect inflation over time to return to the market. Now, I don't think it's a flat 2% I think it will be volatile. But again, if you look at the historical norms over a 25-year period it's kind of 2% or 3%.

Niamh McSherry

The second question was actually about the H2 like-for-like guidance and price investment. So the £75m price investment in H2 can you give us an idea of how that compares to H1 in terms of price investment? And does that imply that you expect volumes to improve in H2 simply because your guidance for like-for-like is flat?

Mike Coupe

You assume that the price investment for H1 is in the base profitability. So it's probably easier to explain it that way. And effectively the £75m you're talking about will be in H2 and will be a material investment from a product and price point of view. And you can assume therefore that our guidance would imply some level of underlying volume recovery, because the arithmetic doesn't work unless you work that through.

John Rogers

And actually it's probably important to point out that as we sit here today our price position versus our peers is the best that it's ever been. I think that is even confirmed by a number of your pricing surveys that have been published over the last few months or so. So the announcement of the £150m investment in price today is a further step on in improving that overall price performance.

Question 6

James Anstead, Barclays

To follow up on that comment by John about the price positioning being as good as it's ever been. Do you think your price perception is as good as it's ever been?

You've been very specific about the £150m price investment, but you've also got a kind of catch-all in your guidance saying that you will remain competitive on price. I guess those two things could be incompatible at some point if other people do move. And clearly there is at least one player that might be thinking about that right now. So to what extent have you taken a view of what other people might do in that £150m number?

And a small follow up. I'm not talking in lease backs but in terms of asset divestments in the next couple of years, what kind of inflow should we expecting from some of the stores or sites you might not be developing, or these mixed use schemes that could be quite profitable? What should we expect in the cashflow?

Mike Coupe

On the first point, our price perception relative to our grocery peers has never been better, so the pricing reality and the pricing perception are correlated. We're very well aware that there might be somebody limbering up in the changing room at the moment, and therefore our thinking does take into account making sure that we've got the resources to deal with that. But at the moment we don't know what they may or may not choose to do. What we're focusing on today is making the right investment choices for our customers. And in the end we know the places that we need to make those price investments. It's very specific: it's at a product level it's not at a category level, it's not scattergun. So we're making the right choices for our customers.

It's impossible to predict what is going to happen in the market. If I asked you 12 months ago to predict what's happened in the last 12 months you would have said I was completely bonkers. So the reality is that none of us know what's going to play out in the next period of time; but we'll focus on doing the best job that we can for our customers.

John Rogers

Just to build on Mike's comments on price perception he's absolutely spot on that our price perception has never been better in the market. That said though, I think there is still a small gap between our price perception and our price reality. And that presents, in my mind at least, a fantastic opportunity to close that gap, because of course you get that for free. So I think there is still opportunity to move our price perception over time. We've done a really good job of proving our price perception, particularly through dynamics such as Brand Match. But there is still more to go, and that opportunity comes free.

In relation to your question on asset divestments and property profits through mixed use developments, I think you could assume roughly a £40m, £50m cash benefit through asset divestments over the next two to three years per annum as an indication. And in relation to property profits for the mixed use developments, again you could assume about £150m of property profits over 2015/16 and 2016/17 from the various mixed use schemes that I talked about earlier on: so Vauxhall, Fulham, Greenwich etc.

Question 7

Clive Black, Shore Capital

If you are expecting negative like-for-likes for a few years, which I take is more than two, and a declining contribution from new space and for your costs to be broadly matched in time by your initiatives, firstly there's likely to be no earnings growth for the foreseeable future from the Group. But what scope should we have to have confidence in the present carrying values of your assets? Will you be sitting there in two years' time writing them down even further?

And secondly, Mike, I was interested in your comment about strawberries. Unfortunately I don't eat enough strawberries and drink too much. But in terms of your supply chain I'd be interested to know where you see costs coming from your supply chain.

And in terms of your competitiveness to what extent do you think the limited assortment discounters piggy-back of your supply chain? And what, if anything, can you do about that?

Mike Coupe

I think we've commented, and I'll ask John to comment more specifically on earnings growth. We are facing the reality of the market that we're in. We've described it already the next couple of years are going to be extremely tough, and we have to make sure that we put in place the right investment programme to do the right things to make sure that we're on the winning side as we look forward.

I'll ask John to comment on the carrying values of assets. On strawberries specifically it's a great example where we're able to reach through our supply chains. And we are very conscious of protecting our intellectual property. So certainly one of the things that we have changed in our thinking over the last period of time is making sure that we've got our arms around the supply chains that really count in our business. And they are in broadly speaking the added value fresh food areas, if you want to be straightforward about it. And if we take the strawberry relationship as a good example it's an area where we have a one on one relationship with the suppliers in that sector; that we've invested in technology, which is effectively our technology, our intellectual property, to make sure that we can do a better and better job of providing great quality products and reduce the costs in our supply chain.

In the end the cost of goods benefit that John has referred to in the guidance are derived from those added value, one on one style supply chains.

John Rogers

Just to build on that slightly. I think we've been very clear on the guidance going forwards. So we do expect it to be challenging like-for-likes. Whether it's for two or three years who knows. But it's certainly for the next 18 months, two years or so in our supermarket estate.

But we've also got to remember that we've got some fantastic investment opportunities in things like Online, in Convenience, in our non-food offer, in the bank; and of course growth in those areas will help offset some of that challenge that we see within our supermarket business. You talked about cost inflation, I think our cost savings over time will outstrip cost inflation, so the step up from the £120m to £130m of savings a year to £150m to £175m will outstrip the cost inflation that we see in our business, so that will help again, but again I think we've been very detailed, very specific in the guidance to allow your models to project forward the future earnings of the business.

In terms of your question around the sort of carrying value of our assets, clearly when we've made the impairments that we're announcing today we have cast forward where we think the industry will go over the next five or ten years in making that impairment, and I think we've taken a very sensible, a very prudent view as to what's going to happen in this marketplace over the next five or ten years. Of course if things got significantly worse than where we are projecting things today then we would have to revisit that analysis, but the analysis that we've done, the fact that we are factoring in the challenging like-for-likes in the supermarket sector going forwards I think sensibly reflects where the market is going, and it's sensibly already factored in to the numbers that we're announcing today. So I'm not foreseeing the need to have a drip feed of asset write downs going forward.

Mike Coupe

Can I just reinforce that point? Throughout this process in the last three or four months we've absolutely held the mirror up to ourselves to make sure that we're facing the reality of the market that we're in and that we're making the right choices today. And of course that then leads to actually you could view those under spaced stores or over spaced stores as opportunities, so there's both sides to argue the case.

<u>Question 8</u>

Jaime Vazquez, JP Morgan

Jaime Vazquez from JP Morgan. Just coming back on the costs, I mean you have savings of 75, you have the inflation of 50, but then you have separately the costs attached to the new space. Can you tell us if the absolute cost base increased in the first half or was it flat or what was it? And whether this cost definition includes depreciation and rent or is it before those two lines. So that's the first question.

The second one, talking about depreciation, can you provide the depreciation of the Bank in the first half and the depreciation savings from the write down going forward in next year's depreciation charge?

And finally, the percentage of your selling area, that is freehold please, an update on that, including the convenience stores in the total selling area and also excluding any store that you pay rent on, so for example the Scottish partnership assets and also the JV assets. Thank you.

Mike Coupe

I'm very happy for John to answer all of those questions.

John Rogers

You might have to repeat them.

Mike Coupe

I was going to say, you might not be able to answer all those questions.

John Rogers

I've been trying to write those down, so you might have to just repeat some of them, I think I've got most of them. So in relation to whether our costs that I made reference to includes the rent or the depreciation, it includes the rents but not the depreciation and we've seen rental inflation in the first half of around 2%. I think you asked a specific question about depreciation at the Bank, is that right?

Jaime Vazquez

Yes.

John Rogers

So I'm not going to break that detail out for you today. You asked a question on the benefit that we would see through the asset impairment on depreciation going forwards and I would put in your models an annualised benefit of the order of £15m or so as a consequence of the impairment that we've made and I'm really sorry, but I didn't pick up your last question.

Mike Coupe

Scottish partnership.

Jaime Vazquez

The percentage of your selling area that is truly freehold, truly meaning no rental payment of any sort, you know, Scottish partnership and JV's kind of.

John Rogers

Yes, so it you looked at it, we've reported in the past a freehold leasehold split of 60%, well we always say we want to be between 60% and 65%; the current ratio is set at 61%. Now that treats the joint ventures as 50/50, so we assume effectively half freehold, half leasehold in that analysis. If you stripped out those joint ventures from that 61% you would get to 57%.

Jaime Vazquez

And that excludes the Sainsbury's local estate?

John Rogers

That's correct, that's just purely the supermarket estate, so the Sainsbury's local estate clearly is predominantly leasehold so would be about 95% leasehold, 5% freehold, so that should give you a bit of a flavour. So the Convenience 95%, 5%, the supermarket business 61% if you include the joint ventures, 57% if you split out the joint ventures.

Jaime Vazquez

And that includes the Scottish partnership?

John Rogers

Correct.

Jaime Vazquez

So sorry, coming back to the cost question, did costs go up or down in absolute terms in the first half, including space related cost additions?

John Rogers

Yes, so costs obviously would have inflated by 2% as we talked about and we saved overall 75%, but cost net, net would have gone up slightly.

Question 9

Sreedhar Mahamkali, Macquarie Securities Group

Starting on Jaime's point about depreciation on rent. If you look at first half movement it looked like to me 30, 40 basis points decline in margins is all due to asset costs, depreciation and rent. I hear you in terms of you will probably save a bit of depreciation going forward with the capex ramping down, but should we be expecting 20, 30 basis points headwind just purely from leverage, from these two fixed costs for the second half and perhaps into next year on top of the price investments that you're talking about? That's the first one.

And secondly, the £150m you're talking about, why is it the right number? So if you can just talk us through the thinking behind it, how many skus were involved in getting to £150m? Are you able to give us any sense of what that does to your pricing versus market or versus where you are perhaps?

And the third one, just coming back to the estate and impairments today, you've talked about 25% of your larger stores potentially being over spaced and yet you've taken only impairments on probably about 40 odd sites. Agreed there is probably not necessarily a direct correlation between the two but just explain the thinking of the big gap between the two.

And finally, just on the estate, a very small question, the age of these stores, the 40 stores that you've taken impairment on, are they recently built? Within the last five years? Ten to 15 years etc? That would be helpful, thank you.

Mike Coupe

Well John can start on depreciation and rent and then I'll come back on price investment and then he can cover off the last two, how about that?

John Rogers

So in terms of depreciation and rent, just to hopefully give you a little bit of a flavour, so we'd expect for the full year a depreciation charge in the order of 550, that's a depreciation amortisation of around 550, 560, so 550 depreciation, ten roughly on amortisation. And for '15, '16 we'd expect the depreciation amortisation charge of around 570, so that will give you a bit of a flavour as to where we expect to see depreciation go over the next few years.

In terms of rent inflation, again I think we've consistently seen rent inflation in the order of 2% or so per annum, and I think that type of inflation level going forwards is a sensible number. What I would say is I think going forwards we will rely less on sale and leasebacks

going forward so I don't think you'll necessarily see an uplift in rent as a consequence of significant sale and leaseback activity. I think we may see a little bit of sale and leaseback activity in the second half of the year, but going out into future years I think you will see less and less, so hopefully that will give you a bit of a flavour as to how to project forward your depreciation and your rents.

Mike Coupe

I mean arithmetically you can do the sums yourself, it's roughly 1% reduction in prices, so it's pretty straightforward in that sense. I obviously didn't do a good enough job of explaining the side, broadly speaking we're talking about investments in the commodity areas within our business because we believe that's where customers care most about price and those investments will be targeted. So we're not going to go into any great detail today because clearly it has a level of commercial sensitivity but I did try and use nappies as a good example of an area that we've made an investment.

Areas that we under trade would be a good way of thinking about it, areas where we believe that investment in specific products will bring more of a basket with them and nappies is absolutely in that sweet spot, if you're able to bring the nappy purchase then customers will come and buy other things, whether it's baby clothes, whether it's baby wipes or baby food, so it's not just about that single product, it's about other things coming with it.

So we've been very thoughtful about it and there is a detailed plan that underpins it but I'm by no means going to say what the products are because I'd be giving far too much away.

Sreedhar Mahamkali

Could you give us an idea of how much skus it involves? Is it 2,000, 10,000?

Mike Coupe

We're not going to talk about a number of products, but as I say if you go back to my charts generally speaking the bottom left hand side of the box, generally speaking in categories where we under trade, but not just blanket investments specific skus.

John Rogers

In terms of your question around the overlap of the 40 or so impaired stores and the 25% of our estate where there's underutilised space going forwards potentially, obviously that represents about 150 stores, clearly there's going to be an element of overlap and correlation between those so within 150 most of those 40 sites you'd expect to see but it's not a direct correlation because one's an accounting exercise looking at marking down the carrying value of those assets in our books, the other one's a very commercial exercise looking at how we're going to deal with the challenges that the supermarket estate faces going forwards.

In relation to the aging of the stores, the 40 odd stores in the impairment analysis, so there were 40 sites, around ten of those, give or take, were investments that were made in the last five years, but actually in practice if you look at that impairment across our stores it is a fair reflection across our store estate in terms of both size, geographic location and of course age of our estate.

Question 10

Rob Joyce, Goldman Sachs

Just to carry on Sreedhar's final question on the impaired stores, focusing on the 40 sites you chose not to develop can you give us a comment on the average age of those sites?

Also can you also comment on what's the alternate use you're valuing them under now instead of to be developed as a supermarket, and what kind of value per square foot that gives you for those sites?

The other one is just in terms of the depreciation of the capex going forward, how do you square some growth going forward with investing below depreciation over the longer term? Thanks very much.

Mike Coupe

I'll let John answer all of those questions, thank you.

John Rogers

So on the 40 impaired property pipeline sites what is the age of those, I mean the reality is they will vary from two to three years to ten years. I mean the one thing that obviously you guys will be familiar with, that many stores in our pipeline take ten years to come to fruition and indeed that's one reason I think why the industry has taken a while to slow down its new space, because you can't turn these pipelines off overnight.

So when you look at those sites that we've impaired, some of them will be things that we worked on within the last couple of years, other stuff will be stuff that's been in our pipeline for years and years, ten, sometimes even more than ten years. I mean a great example actually is a store that we've opened this year, Wolverhampton, which was a decision that we took probably 12, 13 years ago and it's taken us that long to get it to a point where we can open the store, so that's just the nature of the property sector.

In terms of alternative use value, so if you look at the pipeline stores that we've written down, pre-impairment they would sit in our books at around £380-390m or so, so you can see we've written off circa 290 or so. Most of that's been written down. That gives you a bit of an indication as to the alternative use value for those sites.

I think your last question was on how can you justify paying or spending less capex than you would appreciate. I understand that's one way of looking at the analysis, but the reality is we look at capital spend on a very commercial basis, so what opportunities are there to deliver return enhancing investments for our shareholders? If we identify those opportunities like Convenience and like the Bank, then we'll make those investments. At the same time we refurb our estates in a way that we maintain our service levels to our customers. So going forwards we have a very sensible reinvestment back into our estate to ensure that we can maintain those service levels.

Rob Joyce

On the property freehold, how much of the freehold stuff is left within the M25?

John Rogers

We wouldn't want to break that out in detail. Obviously we over-index in our stores in the south and south-east and therefore we benefit from perhaps higher property values in that part of the country, but we wouldn't want to break out that level of detail in terms of valuation.

Mike Coupe

Just a comment. If you looked at the historical average gestation period for our store it's about five years. So that gives you a flavour, that's how long it takes to go from sign-off to ultimately build out and opening. So I would suspect that would answer your first question.

Question 11

Bruce Hubbard, Odey Asset Management

It's no surprise that your quoted competitors haven't shown us any switching data for ages. As you say, it's all about execution. The figures for you roughly show you gaining about a percentage point funded by Morrisons and Tesco, and losing a bit more to Aldi and Lidl combined. I've got two questions. The first is, does your play book that you've been articulating here for the next two/three years include the assumption of continued losses by Tesco and Morrisons and continued outperformance on execution?

And two, do you think about 100 bps a year is enough to stop those flows into the discounters, and is that your ambition?

Mike Coupe

We assume that we will continue to outperform the market, so by definition that means our big four peers, and in effect that's what we've achieved over certainly eight of the ten years I've been in this company. So the short answer to your question is yes. Of course we wouldn't be proposing the actions that we're taking today if we didn't believe in the round that would be the case, and indeed to use your analogy, would not stem the flow from us to the discounters. The reality is we would look to outperform the market for the foreseeable future and making the right choices to be able to do that.

I think the switching data per se is quite dangerous. It is based on a relatively small base, so you just have to be slightly careful to read too much into it. We have commented before on what we believe to be the accuracy or otherwise of the Kantar data. So just be slightly careful in the way that you treat it.

Bruce Hubbard

Thank you. I think I heard you say that about a percentage point price cut per annum is enough for you to fulfil your ambition to stop the flows to discounters. Is that correct?

Mike Coupe

It's a combination of all of the things that we're talking about. It's not just about price cuts, it's about investing in quality, it's about making our shops more convenient. So it's a balance of all of those things, and we believe in the medium to long-term that will allow us to outperform the market.

Question 12

David McCarthy, HSBC

I just want to carry on from Bruce there and a point talked about earlier. You've been winning market share and outperforming your quoted competitors, and you've also talked about your price position never being better. You talk to your customers a lot. So how much of your outperformance has been due to your improved price position; and if you were to lose some of that price position, would it be a strategic concern to you, i.e., are you going to defend your sales or defend your margin if you come under attack?

The second question goes back to leasehold/freehold. You're changing your opening programme and you're opening more convenience stores, which I think tend to be more leasehold than freehold. So over time your freehold participation is going to come down and it's going to come below that 60-65% figure you've talked about. What are you going to do about that? Are you going to say to us actually 55-65% is the new figure, or are you going to back and try and buy some of your leases back?

John Rogers

In relation to the 60-65% freehold/leasehold mix, we've always been very clear that that only represents supermarkets, and so we've always been very clear that excludes our convenience business, which as you rightly highlight, Dave, is predominantly leasehold, and that's always been the case. In relation to the metric of freehold/leasehold on supermarkets, as I've said it's currently at 61%, and if you project that forward, based on our assumptions over the next four to five year, on the grounds that I've just said, that we don't anticipate doing a great deal of sale and lease back over the next four or five years, that measure will remain broadly between 60-61% over the next five years or so. Clearly you're absolutely right though, that if we continue to add convenience space which is predominantly leasehold, then if you looked at the measure in totality – and we never provided this figure by the way in terms of freehold/leasehold split including convenience – then clearly that measure would increase over time.

What's relevant here though is actually more importantly the balance sheet strength. The measure that we focus on is the lease adjusted net debt to EBITDAR. So that measure will reflect any leases that we have on our books, and what we've said very clearly today is we expect that measure over time to remain stable. That's as a consequence of striking the right balance between capex, cost savings, dividend and so forth. So hopefully that will give you a little bit of a flavour in answering your question.

Mike Coupe

The answer to your question is yes we will maintain our price position. We think it's very important. So we're making the price investments that we're talking about today, and we will continue to fight toe-to-toe with whatever comes to us in the marketplace, and we have deliberately set out, as we've described earlier, to make sure that we've got the cash resources to be able to do that.

Of course also implied in your question, and to some extent the question before, is on outperformance, and actually relatively speaking our outperformance relative to our other quoted peers has never been wider. So in reality our ability to invest against them, and our ability to maintain our overall price position, is as good as it's ever been. We accept the other dynamics that have already been discussed in the room, but as I say we will maintain our price position, we will fight toe-to-toe and make sure that we've got the cash resources to do that.

Question 13

John Kershaw

Just to be clear, have you already made some of the £75m of investment as part of your new marketing programme that you've released about three/four weeks ago now, or is this money still to be spent?

Second, just a view. If it takes five years on average in a pipeline, how much store estate have you got left that hasn't been written down? If you've got 40 in the pipeline you've written down, how many are still there of superstore nature?

And finally, back on my first question at the beginning. On the one hand it sounds like you've got enough to protect market share and gain from custom to protect profit. Then if I look back at your slides and the bridge of incremental £150m price investment per annum and the delay in offsetting that in your cost of goods sold, it still feels to me that your profitability will be going down sequentially for the next few years. Have I misunderstood those slides, or not?

Mike Coupe

The reality is I've given one specific example. We have made a little bit of price investment so far, but not a lot, and it won't be material in any of the numbers we're talking about today, it would have happened after the end of the financial half. So this is all new money to be spent in the balance of the half.

John Kershaw

As in-store today? If we went round store today would we see ...?

Mike Coupe

No, not as in in-store today, as in to come.

John Rogers

I think just to be clear, that £75m is all new money, that is all to come in our stores. On the store estate, what's left in the property pipeline, we've probably got in the order of 30-odd schemes in the pipeline today. Of course that includes the eight supermarkets that will roll out over the next few years or so. So that'll give you a bit of an indication as to where we are. It's important to point out that that's a significant step down from where we would have been three to four years ago. If you'd asked me that same question three to four years ago, we would have had about 140/150 schemes in our pipeline. We have responded very proactively over the last few years in taking some of those schemes out of our pipeline. We're left with around 30-odd schemes today including the eight that we're going to roll out in the next three years or so.

I'm not sure there's a lot more we could say about profitability. I think it would be wrong at this stage to provide absolute profit guidance over the next two to three years because there are so many uncertainties in the market going forward, least of which we've already discussed is what competition do vis-à-vis pricing in the market. What we have done though today is be absolutely crystal clear in relation to clear guidance on price investment of £150m, clear guidance on our cost savings, clear guidance on our capital savings, and

clear guidance on our dividend, which I think – dare I say it – does stand us out from the crowd in relation to the detail of that guidance, and I'll leave it up to you to work that through your models.

Mike Coupe: concluding comments

Okay, I think that is it so thank you very much.