J Sainsbury plc

Third Quarter Trading Statement

Wednesday 8th January 2014

Justin King, Chief Executive

Hello everyone, thank you for coming on the line. I'm joined by John Rogers and Mike Coupe. As you all know today is the announcement of our Third Quarter Trading Statement, that's the 14 weeks to the 4 January. And as you will have seen we've delivered good sales performance in what has been a tough market.

Total sales for the third quarter up 2½% or 2.7% if you exclude fuel reflecting the fact that fuel prices are much reduced year-on-year. And like-for-like sales for the third quarter flat but excluding fuel up 0.2%.

The quarter overall was characterised by a very tough sales environment for the market in October and November, already widely reported based on market data. And indeed probably why expectations for our sales have been declined for the whole quarter. But we're reporting for the full quarter today, the 14 weeks, and demonstrating therefore that recent trading weeks, the six weeks over Christmas have seen strong sales as we've helped our customers *Live Well for Less*. And that's delivered the slight sales growth over the quarter; and of course with the extra sales coming from new space it has indeed been our best Christmas ever.

Many records set over the Christmas period: 28 million customer transactions during our busiest trading week. Our busiest trading day ever on 23rd December and our busiest hour, £17m taken in one hour. And our top store, Stanway in Essex, on 23rd, became the first Sainsbury's store ever to take £1m in a day.

A key part of our success over Christmas is customers engaging with Nectar, our loyalty scheme, breaking new records: £120m worth of Nectar points redeemed in the Christmas period. That's a 9% increase year-on-year, which shows customers are really engaged with how loyalty points can help spread the cost of their Christmas shop.

It's been a big Christmas for own label. Of course the story for Sainsbury's for many years has been for own label leading the charge. *Taste the Difference* grew at over 10% in the quarter. And some of the products featured in the various TV programmes last year did well: 100,000 *Taste the Difference* turkeys, of which over half were the Sainsbury's Norfolk Black.

And our Christmas ordering service, which offers really top-end products to our customers, grew 24% year-on-year with over 100,000 orders.

The growth story of our business in recent years has been driven at least in part by strong convenience and online sales; and that has continued, as you would expect, during the quarter. Convenience up 18%, with their own record day on Christmas Eve of £7m, and online up 10% with their own record day on 22nd December of £5m.

General merchandise and clothing throughout the quarter has achieved new record levels of market share. We're now the sixth largest retailer of Homeware, by value that is, and we're the eleventh largest retailer of clothing by value – notable achievements. And very strong

growth within some elements of our offer, particularly focused on helping our customers enjoy Christmas. So, Tableware up 25% year-on-year and Gifting up 30% year-on-year.

We've continued to invest for the future, as you would expect: 555,000 square feet of new space, six supermarkets, four extensions, and 19 convenience stores. And of course we're investing in refurbishing the existing estate: five supermarkets and 11 convenience stores. And we remain on track to deliver 1m square feet for the year.

So as we look forward to the final quarter we expect customers to continue to spend cautiously as they rebalance household finances post enjoying their Christmas. The economic backdrop, inflation still ahead of average wage rises, means that many families still see less money at the end of the week. And we'll continue to focus on helping them to *Live Well for Less*. And by continuing to invest in our point of difference we can continue to deliver our market outperformance.

And with that I'll hand over to questions.

Question and Answer Session

Question 1

Edouard Aubin – Morgan Stanley

Good morning, just two questions from me. First of all, the grocery online growth slowdown during the quarter as you relaunched your website is everything now up and running and are you expecting online sales to re-accelerate during the fourth quarter?

And my second question is: mid-November you very slightly raised your margin guidance for the full year. Now assuming that the competitive landscape and your top line performance in Q4 in line with Q3, which you seem to be assuming, would it still make sense to expect a margin increase?

And I guess related to that, since November what has changed the most? What is impacting you the most; is it A, the competitive landscape or B, the consumer spending environment, or just both?

Answer: Justin King

I think that ended up as three questions. I'll top and tail and then I'll get John to give you it's a trading statement we don't comment on margins answer.

In terms of the website yes, slowed a little to just above 10%. Big changes from a customer point of view on the website in the quarter. We were reasonably cautious on our marketing spend on the quarter to make sure that we only had the volume that we were confident we had the capacity to deal with. We're confident we got that right. Our customer service levels were, by our measurements, at new record levels. But actually interestingly just this week there has been an independent survey published which shows that others externally are measuring our service as being high.

The conversion process of the website hasn't finished. We're through a big slug of it but there are lots more to go. So I can't really answer the question about quarter four and beyond without getting into too much detail about how much we intend to invest in marketing

on the online site. But suffice to say we will continue to balance how hard we drive it with how robust we believe our service and availability levels will be.

One small point of note it is only 10,000 customers, but it is 10,000 customers. We were able to launch at the back end of the quarter our own delivery pass – because that is one of the things that the changes have allowed us to do – and already 10,000 customers signed up to that.

In terms of the last half question that you asked, I think the big issue if you take the quarter as a whole – and of course we're reporting a full quarter of 14 weeks today – is robust and strong though the Christmas period itself was, averaging within the quarter for us so two very soft months for the market. I think you can see from the market data we were still front-running in the market during October and November but those were some of the softest months for the market.

Mike's keen to add colour.

Answer: Mike Coupe, Group Commercial Director

Just on online it's just worth commenting the transfer of all the backend happened before Christmas; which is clearly where quite a lot of the risk occurs when you're making these kinds of transformations. You can see from what other people have done in the past that there is quite a lot of risk involved in these things.

The frontend conversions, actually the store facing part of the conversions, happens during the course of this calendar year right the way through to the middle of summer. Again it's a reason why we're reasonably cautious in making sure that we maintain our customer service during that transitional period.

Answer: John Rogers

Edouard, Justin has teed me up nicely for the guidance point. I'll start, if I may, with like-for-like. Obviously we guided at the interims, we said we expected like-for-likes to fall within the 1% to 1½% range, albeit perhaps towards the lower end of that range. Given the performance in Q3, the 0.2% that we're reporting today, we'd expect a similar performance coming through into Q4. So if you do the maths on that we'd expect the full-year like-for-like just to dip below the 1%. So we're updating guidance on that today.

In relation to operating margin, of course we set out at the beginning of the year to say we expected it to be flat year-on-year. And at the interims we updated that guidance; we delivered 7bps improvement in the first half, and we said that we expected a similar performance in the second half. To date I'm comfortable with that guidance. There's still a quarter to play obviously, and it's always a very competitive quarter, but we still feel reasonably comfortable with that guidance as it stands.

<u>Question 2</u>

Andrew Gwynn – Exane

Two questions if I can. The first is on the Q4 period. You said just then that you expected it to be similar to Q3 but it's a very difficult comparative – I think 3.6 from memory, against 0.9. And obviously as Justin mentioned we've got that rebalancing of household budgets and so

forth. So why the confidence? It does still strike us that it is still extremely competitive out there.

And the second is a longer question which is: obviously there is some suggestion that Tesco may push a little bit harder; are you confident that you've got enough tricks in the bag, as it were, to carry on outperforming? Or do we need to see something a little bit new almost from you?

Answer: John Rogers

You're right to highlight obviously the step-up in comparators Q3 to Q4, the 0.9 to 3.6. That is clearly the case. But actually if you look at the two-year wrap on the like-for-like you'll see that like-for-like in the order of somewhere between 0.0 and 0.5. You don't get that dissimilar a two-year wrap between Q3 and Q4. So that can give us some confidence that we can deliver the numbers that we're talking about. Of course, as ever, it depends entirely on what the competitors do. We are the first to report this Christmas period. A lot of it will depend on how competitive the market remains over the coming quarter. We anticipate it will remain as competitive as ever but we feel we've got all the tools in our toolkit to compete aggressively and outperform.

Answer: Mike Coupe

And of course if I told you about any tricks we have up our sleeve I'd have to shoot you, so I cannot possibly comment on what we may or may not do in the future.

I guess you could characterise this quarter as one of the most competitive we've seen ever. So it's been a very aggressive quarter. And as we've reported today, our performance has been ahead of the market. So I think we're pretty confident that our overall trading strategy, investing in the places that are growing, convenience, online, non-food, our continuing drive to improve the quality of the food products that we sell has held us in good stead, and we'll continue to push very hard in those areas.

Further question

But it's a funny period almost because you say it's one of the most competitive periods ever and yet your margin is still up. So I'm just wondering what's happening. Why is it so competitive and yet the margin is going up?

Answer: Justin King

John just touched on the guidance provided at half-year. I suppose the deeper point of your question, Andrew, is what is it that enables us to outperform consistently over a long period of time. Of course we're pleased that we're reporting growth today but we're very confident that when everyone else has revealed their figures it will also demonstrate a good market outperformance across the whole quarter and particularly over Christmas.

So you have to come back to the unique advantages that we have, and they're strategic and long term. We believe we run the business well tactically too and much of what we achieve in the next quarter will be about the tactics, the cut and thrust of trading from one week to the next over the next ten weeks. But strategically our focus on fresh food, our focus on own brand, clearly driving own brand hard as we have done again in this quarter, actually deflates our top line in the short term, but it helps customers get more for less. And

ultimately that makes them more loyal, we believe, and of course can be therefore margin enhancing.

But also using data to target our marketing and promotions more effectively means that we get better bang for our buck in our marketing spend. Another part of how we're able to protect and sometimes increase margins when those around us are not able to is because of the way we're able to invest money is more cost effective – for want of a better way of describing it.

So there are lots of good reasons why we can achieve that. But fundamentally at its core outperforming the market on average is what gives you the ability to keep margins moving in the right direction, or at least hold them whilst others are declining.

Answer: Mike Coupe

It's something in the shape of the business as well. If you look at our performance in *Taste the Difference*, 10% growth in *Taste the Difference*, and a continuing outperformance of our non-food business – both of which are reasonable margin enhancing businesses.

Further comment

Well, it looks like you won Christmas either way, certainly from the big four. Thank you very much anyway.

<u>Question 3</u>

James Tracey – Redburn Partners

Two questions from me. The first one is: what was the inflation in the quarter and what's your outlook for food price inflation going forward?

And the second question is on the contributions from the extensions that come to zero versus 0.3% in the last quarter yet there were more extensions than in the previous quarter so could you explain that? Thank you.

Answer: Justin King

Yeah I'll get John to pick up inflation but if I just pick the extension point. This quarter we had a number of very disruptive extensions and store relocations reach their conclusion so the net figure as you say is nil. The gross figure was still around 0.3% but obviously we net off the disruption of the closure period, so a particularly disruptive period of closures because of the nature of the particular extensions we were doing.

Answer: John Rogers

Yeah and just to build on that if you look over the last year we'd done eight extensions year to date and this year we've done six extensions year to date, so clearly there's a drop off there which explains that smaller contribution from extensions in the quarter.

In terms of inflation I think roughly speaking we've probably entered the quarter at around 3% and I think we've exited the quarter at around 2%, so an average of 2.5% for the quarter but the trend that you see there is a downward trend, very difficult to predict where it's going

to be in the next quarter, I suspect we'll see it at around 2% but generally speaking it's been a downward trend through the quarter.

Question 4

Caroline Gulliver – Jefferies International

I just had a question on the general merchandise and clothing growth rate actually. You said you've achieved record levels for market share but I just wondered if you could comment on the absolute growth or the relative growth for the total group?

And also if you could just talk about Click and Collect trends that you've seen over the quarter?

Answer: Justin King

Well I'll get Mike to pick up Click and Collect. We're always a bit wary because it depends lots of people have different definitions of general merchandise and clothing; but our definition of general merchandise and clothing nudging towards 10%, a little bit less than 10%. So that's why we've had record market shares in those areas because that's a massive beat to what's been on average in the market in those areas. But of course on the tighter definition they're a little bit less than 15% of our total turnover, so just to be a bit careful on your definition of what you mean by general merchandise when people talk about it.

Click and Collect, Mike?

Mike Coupe, Group Commercial Director

Yeah Click and Collect on non-food is running about 60% so it's similar to the trends that we've seen in the past, no real change.

Question 5

Jaime Vazquez – JP Morgan

I would like to come back to two questions. The first one is: on what basis do you expect Q4 to be in line with Q3 considering the fact that the base of comparison gets 270 basis points tougher in an environment of falling inflation? Sorry that was not very clear to me.

And the second one is: the EBITDA margin went up by 20bps in the first half with like-for-likes of 1.4. On what basis do you expect to repeat that performance with like-for-likes of around zero actually? Is it more cost savings or is it a bigger gross margin expansion?

Answer: Justin King

Well I'll ask John to come back and see if he can provide any more colour on the challenge of Quarter 4, you're right it's a challenge, the comparatives are tougher but the key point John was making is if you were to look at a two year wrap, the two year wrap would be about the same as in Quarter 3. I mean in terms of the margin point your ability to widen margins or, indeed, not decline them if others are declining, is first and foremost driven by the sales delta rather than absolute sales because clearly if we're achieving a good sales delta to our competitors and they're making sure their P&Ls add up, our ability therefore is through the delta to either have more money to invest in driving sales still further or to deliver some

margin accretion and of course that's what we did in the first half. So the absolute sales are not the key here; the key is whether that absolute sales level represents a good delta to the competition. And we're confident that when all the numbers are in and people are looking at whole quarters that 0.2% like-for-like for the whole quarter will be a good delta to all of our key competitors.

Jaime Vazquez

But the sales delta is positive certainly to the other big three, but is it still positive to the market as a whole? I mean should you look at deltas versus losers or deltas versus winners or versus the market as a whole? It's not so clear that the delta is positive versus the market or just tell me if I'm wrong?

Answer: Justin King

Well I think if you look at 12 week data you'll see that with the exception of the last 12 week data which of course included the October/November period, we've consistently delta'd versus the market as a whole as well. Of course one has to be careful, there is a clue in the name big three, they are the big three. If you take say the big five, include the Coop of course which is a significant business too, you're still talking about well in excess of 80% of all the sales in the market; so a good delta to them is still by far the key dynamic in terms of the competitive context. That's not to say that discounters and the smaller retailers aren't part of the competitive mix, they are, they're growing strongly but as I said in my preamble our smaller stores are growing strongly too - 18% in the quarter. So there's lots of stuff going on but ultimately your ability to grow margins comes from absolute sales, of course, it always makes life easier if you've got great absolute sales growth. The sales delta, because that's in the end what drives your ability to compete, and of course you alluded to it in your question, tight and efficient cost management, and we think we've demonstrated over many years an ability to keep a tight rein on our costs while still delivering the very best customer service levels. And we, by our own measures, continue to have the best levels of service and availability that we've ever had and every independent industry measure of those things says so too. So we're confident that as we manage and control cost in our business we're doing it productively i.e. not at the expense of the consumer.

Answer: John Rogers

I don't think I can add much more colour in terms of the Q4 projection other than to say we've been clearly aware of the comparator for some time now. So dare I say it you might have expected us to plan ahead. It's difficult to be certain and confident in what remains a very, very competitive market, but as we see it today we would be expecting in Q4 a similar like for like that we've seen in Q3.

Answer: Mike Coupe

And we shouldn't underestimate, going back to the sales mix, *Taste the Difference* is growing, our own label share is growing, our non-food businesses are growing, they're all effectively margin enhancing and the other point that we constantly make is that our use of money and our overall marketing mix is far more efficient than our competitors. We are much more smart, if that's the right way of putting it, of using our Nectar data to target our customers and that again is the more efficient way of using our marketing cash.

<u>Question 6</u>

David McCarthy – HSBC

Could you tell us what the like-for-likes are within the convenience business? You've given us a total sales growth but can you give us a clearer steer on that please?

Answer: John Rogers

Yes I mean we saw like for like within convenience of around, just north of 4% so very strong performance in the business reflecting the fact that people continue to use convenience as a top up to their main shop, particularly as we said in the statement around these busy times of the year.

Further question

So when we try and then break down the underlying performance of your business and we start looking at the core estate and we exclude convenience, we exclude maturing stores, you have got this ongoing decline in like-for-likes of the larger stores, the traditional part of your business. Do you think that that is an ongoing problem for the industry or do you think it's just a one quarter issue for yourselves and it's all going to be all right going forward? Clearly you think it's a problem for Q4 but what's the structural issue here? Do you see one or do you just think it's a short term thing?

Answer: Justin King

Well I think if you look at the market as a whole and particularly now because of the step up in footage being added by discounters we've not actually seen in the market as a whole yet the much mooted decline in total footage being added. It's clear, as we've discussed many times, David, that the market's adding more footage than the underlying growth in the market. I think what we've demonstrated over a long period of time is that even if you do all of those things that you've just described and indeed did it for all of our competitors, that the performance of our underlying estate also has a good delta to the market. And I suppose it goes back to my answer to the previous question which is in absolute terms we would always shoot to be positive, and for the majority of the quarters we've reported in the last four or five years our core estate has been positive. But if we can't be positive the second prize is always to make sure that we're less negative in our core estate than our major grocery competitors. And I think that when the numbers are all in, and you've done the maths, we can confidently say that our core estate had a more robust performance, albeit that it will be in decline, than that of our grocery competitors and that's a key part of our ability to address that margin issue that we discussed earlier.

Further question

I mean there's no question really you are doing best out of certainly the 'quoted three' as I prefer to call them. But what's the long term implications for your business and cost structures if you've got ongoing declines in the core estate? And you talked about the delta and I'm 100% behind you on that, the delta's the important thing, not the absolute sales; but you've got the likes of Aldi who've driven their sales densities up by over 50% in the last two years, the profit delta, given operational gearing, is funding big improvements in quality and funding lower pricing, so you've got that as a dynamic and you've got the dynamic of ongoing, underlying declines in your core estate; where's that going to take us over the next couple of years?

Answer: Justin King

To some extent I'm going to treat the question as rhetorical, David, because I think you've articulated your view of where that takes us. I think we've many times articulated ours which

is we believe that we've demonstrated, not just of the quoted three but if you look at the bigger retailers more widely, consistent levels of outperformance over the long term, clearly a core estate with sales density declines is an extra challenge for us, but it’s one that we think we've addressed better than most. Of course a lot of these things depend on the length of time that you take. As far as discounters are concerned Aldi massively restructured their business three or four years ago and changed the focus of where they’re investing, they’re running a higher margin business today than they were five years ago, focused on a very different format than pure limited line discounting. You mentioned that they’ve increased their sales densities by 50% in the last two years, they’ve increased their stocking points by 100% in the last two years too. So I think there are lots of things going on, you've discussed them at great length, as have we, it’s a trading statement today, I think what we've demonstrated is our further outperformance, and it’s been part of a consistent and long term story for our business.

Question 7

Niamh McSherry – Deutsche Bank

Hello I had three questions actually. The first one was on vouchering. Maybe if you could describe the level of vouchering activity that you did versus competitors and versus last year?

The second one was actually going back to online grocery growth of 10%. I understand that was to ensure good quality of service, but do you think that means you lost market share in online over Christmas? And how soon is the frontend conversion going to be complete to enable you to grow faster if there was demand?

And then the third question was just on the sizes of the convenience and online business if you could remind us the relative sizes of those businesses that would be great? Thank you.

Answer: Justin King

Okay well I'll do the first, I'll ask Mike to talk about online and John to clarify the numbers.

Answer: Justin King

We’re not going to get into the detail of vouchering because we believe that’s competitively confidential, and we have today, as we always do, reported our sales figures on a fully compliant vouchers adjusted basis. We’ve always done that because we don’t think that it’s in the interest of our shareholders to reveal to our competitors what we’re doing with vouchering, how much money we’re spending and where we’re targeting it. All I can tell you is that in general across the marketplace at large the level of vouchering over the last 12 weeks has been at unprecedented levels, a very significant step up on historical trends, a very significant step up year-on-year. But obviously our vouchers, as Mike touched on earlier, we believe are more customer facing, better targeted, and more efficient use of money than our competitors are able to achieve. But beyond that I’m afraid I can’t provide any colour. Mike?

Answer: Mike Coupe

Online, just going back around the process we’ve been through, we effectively changed the back-end pre-Christmas. As you would have seen from other people going through these kinds of exercise that’s not without risk, and our IT team did a fantastic job of managing our

way through Christmas, but we had to be very careful to make sure that we didn't impact customer service levels during that period of time. We've converted about 25 stores so far on the frontend, so we're in a sort of trial period, and we'll be running that through – fingers crossed – in the next six months or so, you'll see that conversion, that conversion will happen on a store-by-store basis reasonably aggressively into the new year. Now as we've already said, our number one priority is to maintain and preserve the service levels we give to our customers, so we'll take that as we go. We know that we can market effectively when we need to and we'll continue to monitor that transfer as we go through.

I guess the other point to make in the quarter is we also launched the delivery pass. That was a little bit later than our competitors, mainly again driven by the changes that we've made, but that's done pretty well and we're already up to 10,000 sold, so we're seeing quite a good take up of the delivery pass.

Answer: John Rogers

And just in terms of your question on the relative sizes of convenience and online, convenience is around a £1.5bn sales business, and online is currently annualising at about £1bn or so, so the two together would make up about 12% of our overall business sales.

Question 8

Frank Walding – Goldman Sachs

It was just really a follow up to the conversation on the back of Dave's question. You mentioned, Justin, that the discounters have changed their business model profoundly, and I'd suggest that we're going to see a reasonably big shift from a geographic perspective certainly at Aldi over the next couple of years as they move towards London and the South East. In that context, how have you found now with the better part of a year and a Christmas trading period competing against them in, I guess in Kilburn specifically, and what are the key learnings from going head-to-head in the London convenience market?

Answer: Justin King

There's sort of an urban myth in the question Frank because if you look at the data we bump up against the discounters proportionately as much as Tesco do, and have done for as long as we've been looking at that metric. It's true that Asda and Morrisons proportionally bump up against them a notch more than that, but actually we're not underexposed to the discounters and never have been.

The specific point about London and South East raises a slightly wider question about real estate costs. One of the reasons they've profoundly changed their business model is to put their stores where all customers can reach them, as opposed to just sticking them where the most hard pressed of customers can reach them. But that brings with it incremental costs that have meant they've had to adjust their gross margin model. Of course by degree as you move into the South East property costs get much more expensive still. So in a way the question that you ask is a question for them, which is whether they have a gross margin model that can sustain the property costs they'll need to incur to operate in the South East.

Now clearly what Kilburn is for them, and one or two other locations too, is to see whether they can find a smaller footprint model that has higher sales density so they can make sense of maintaining a single price file and therefore their national gross margin approach. That's why I say it's essentially a question for them because that's as yet unproven. But if your question is what are you going to do to compete with them when they arrive on your turf, the

answer is we already are and always have been, and we've been competing with them pretty well, we think.

Further question

I guess also specifically, have you seen any changes from them moving in the way that your convenience stores have traded against them in London?

Answer: Justin King

Nothing that we would comment on now, no, because the very fact that you pick out an individual store means you're talking about very small numbers of their new change format.

<u>Question 9</u>

Sreedhar Mahamkali – Macquarie Securities Group

Good morning. Three short questions please. Firstly non-food like-for-like, I'm not sure if you've commented on, and if you haven't if could give us a steer of that.

Secondly, overall private label, what is it now as a percentage of sales please?

And finally again – and sorry if I've missed this – you've talked about shape of trading October/November being tough and December was a little bit better. Was that a comment on the industry or just your outperformance in December was greater? If you just could clarify that a little, thank you.

Answer: Justin King

I'll talk to the last one and then ask John to pick up and see if he can provide any more colour on non-food, and Mike likewise on private label. Most of our commentary about October/November and indeed the Christmas weeks being bouncier is a market commentary. Obviously you haven't seen the full market data yet through measures like Kantar, Nielsen and others, you will do over the next week or two; and I think what that will show quite clearly is a very tough market in October/November, but 12 week figures looking slightly better than perhaps it seemed likely only four weeks ago as a result of the strong four week period. But nonetheless I think if you look at the 12 week we're reporting for, one of the weakest periods for the market overall that we will have seen.

Within that we're confident that our outperformance has remained across the quarter as strong as it's been for the last several quarters. But it's fair to say that the shape of our outperformance is biased towards the Christmas weeks, and that's what we set out our store to do. We felt that to chase what we consider to be, to some extent, both unprofitable sales but also sales which customers kind of begrudgingly give you, there's lots of things you can sell customers in October and November on a fantastic deal but they'd really rather not be forced to buy them at that time. So we took the view that we'd give customers the offers they wanted on the products that they wanted to buy when they wanted to buy them; and that did mean that our outperformance was less during those tough months, but we've been rewarded during the key Christmas trading period, and that's why net net across the quarter we've out-traded quite strongly. John, do you want to give any colour?

Answer: John Rogers

Yeah, just in terms of non-food like-for-like. Okay we don't want to disaggregate sales to too great an extent, but a like-for-like of around 6% or so for non-food overall, and a total sales growth of just north of 9%. So again reflecting what we think is very strong performance across the non-food business.

Answer: Mike Coupe

Own label penetration is roughly 50% and that's up over a percentage point year-on-year, which of course although it doesn't have a huge effect, it does have some effect on the underlying like-for-like because clearly the average value is lower than the branded equivalent.

<u>Question 10</u>

Clive Black – Shore Capital

Morning gentleman and hope you have a good year collectively. Just going back to Dave's question again please. I can't actually remember, Justin, the last time that the big four/big five, whichever number you want to take, all lost market share at the same time, and I just wondered we spoke a year or two ago about hypermarkets being square pegs in round holes, whether superstores come into that category now; and whether you believe it's plausible for you to sustain the strategy of the last year or two with respect to your superstores; or whether you see something more different will change in the current year to make superstores more competitive? And perhaps in that respect, could I just ask you where you think promotions are going to feature in the next year or so given that superstores tend to be a bit more promotionally dependent than those who seem to be gaining market share at the minute?

Answer: Justin King

Well I guess if you mean by superstores, supermarkets in the kind of 40-80,000 square foot range, then my answer would be will they come off some of the peaks of the past where they have been absolutely the top performing format in the industry, absolutely, they already have to some extent. Will they remain right up there as some of the best performing retail stores and great investments which when we can find fantastic locations we'll still make those investments, absolutely too. I've been consistent, I think, for a very long time that I never saw the hypermarket model being the right model for Sainsbury's, or indeed the right model for customers. They had lost sight, in my view, that food was the core reason for the weekly shop, and it had become harder and harder to do a fresh food focused weekly shop in many of the hypermarkets that were being built, and ultimately they have reaped what they've sown. But the vast majority of customers for as far forward as I can see, will continue to do the vast majority of their shopping in well located, well invested superstores in the 40-60/70,000 square foot range. They will however continue to disaggregate their shopping, and the growth again for the next number of years will be very focused on online and on convenience and on format development more widely.

The legacy stores that create problems in terms of underlying like-for-like is much more about location specific. We have some legacy stores which five years ago if you'd asked the question I'd have said I wish we didn't have a lot of the town centre stores that we've still got but we do, and now I'd say actually many of them have just turned into super convenience stores in town centres where people are shopping, so it's amazing how quickly your view of these things can change. So I guess that's probably as much colour as I can add on that, Clive.

Further question

I guess my point is, over the last quarter we've seen all the big players losing share – I've never actually seen that happen before – and if that continues do you not have to think about changing trading tactics as well? That's where I was trying to allude to the dependence that a lot of superstores seem to have had on promotions as their main method to express value. Maybe customers are tired of that and that's why retailers with less promotional participation are actually gaining share?

Answer: Justin King

I commented earlier on we're as geographically exposed to the discounters as Tesco, and clearly if you look at the market data have been less impacted. As I said, the urban myth that we've been less impacted because we haven't had to compete with them is not true. I would argue that a less promotional – which our offer is – more fresh food and own label focused offer, is the core of the competitive strength you need to have to compete with discounters. I think if you look at the two more northern biased retailers, Morrisons and Asda, who are more geographically exposed to the discounters, it's clear that Morrisons have taken a bigger impact than Asda. And again I'd argue that the less promotional approach in Asda has been key to their ability to compete. So I agree, I think a less promotional offer more focused on something approximating to EDLP, because no-one's doing EDLP and no-one ever will do it pure I don't think, focused on fresh food, focused on the quality of own label, will be the keys to competing successfully. As it happens they're the keys to competing successfully with all of our competitors because they're the core strength of our business.

<u>**Question 11**</u>

John Kershaw – Exane

Happy New Year guys. Just two following on really from Clive's point. First, it's how does the industry detox from a mid-30s promotional intensity to perhaps down to the more normal historical levels of mid-20s, and do you think that is a pre-requisite to solve some of the issues we're worrying about?

Secondly, what will it take for you to reduce your space opening because you've alluded to that the industry's opening more than the industry's growing. Yes individually you've got perhaps an outperforming strategy but whilst you persist in doing that it's sort of perpetuates the others growing as well; so what is it that's going to change that and get the industry into a more focused cash generative position?

Answer: Justin King

Well from a headline view on the detox but I'll ask Mike to comment further, is that of course I've said many times that the vast majority of promotional activity is being driven by investments coming from branded suppliers who are operating notional retail prices which are not reflecting properly the cost of the goods that they sell. And therefore they're having to offer real value for money by supporting promotional activity. That's a massive long term issue for brand equity for those brands. And, ultimately, when they stop writing the cheques and start pricing their products properly we'll start to see that come off. Meanwhile, we're investing, as has been commented, category by category and getting more stable pricing in our business, and of course the fact we have a higher own label penetration helps with that. Mike?

Answer: Mike Coupe

Yes I think just commenting on the market generally I think we might have seen some people experiencing a law of diminishing returns at the very extreme end of the promotional scale. We will and continue to need to promote aggressively against our competitors at particular times of year and will continue to do that. But meanwhile, below the radar, as we've already commented on, we're doing lots of work around our overall value positioning, we're continuing to invest in our own label proposition, we're continuing to invest in non-food and in the mix, in the round, that makes us a more stable and more efficient business in the way that we target our promotional and marketing expenditure.

Answer: Justin King

To pick up the second half of your question; again I'll ask John to add flavour. There's a kind of implication in your question that we are irrationally making investments just to be part of a collective stupidity for as long as everybody else does it too. That's not what we're doing. Every individual investment that we make is subject to very tough hurdles and makes absolute sense in and of themselves to be made in our business. We've talked in the past about the relative accretive nature of the different investments, convenience being the most accretive, at least in part because of the largely leasehold nature of the stores, but they remain rational. We have provided guidance, and I am sure John will comment on it further, to reduce the level of capital. The clear implication of that is that we've raised the bar still further, the hurdle still further, that we measure every capital investment by.

Answer: John Rogers

The reality is, as you well know, we have come off quite significantly from the heady heights of a few years back when we were adding 1.4/1.5 million square feet of space. And as we've said many times in the past we are comfortable for the foreseeable future adding between 900,000 and a million square feet per annum. What's really important to highlight is of course that the mix of that space will change over time. The proportion of convenience space that we add will increase, and as shown indeed by the growth figures that we've announced today, that the convenience sector is doing exceptionally well. Equally, we will also, of course, add extensions so the majority of that 900 to a million square feet will come from convenience and extensions. And as we know extensions predominantly are non-food and I've just told you that the growth in our non-food sales was at 9%, the like-for-like was circa 6%, so again a fantastically performing part of our business and one that we're prepared to invest behind. So as Justin says we're very comfortable with where we are, all the investments that we make on a standalone basis deliver the returns that we're expecting, and for the foreseeable future 900 to a million square feet is where we'll stick.

Justin King

And I think, John, the other point I'd add is the implication in your question is that we haven't done anything; at the half year we announced a significant write-down on a good number of sites that, to use that parlance, were absolutely exposed to that collective madness, because they were essentially edge of town sites exposed by virtue of the planning environment changing such that we could no longer be as confident as we once were in the cash flows of those sites, and we took a write-down. So I think you can see in that announcement at the half year absolutely us clearly demonstrating that we're not blind on this issue.

John Rogers

I think that's an important point to make: in terms of our property pipeline, if you look at our property pipeline today compared to where it was three or four years ago we significantly streamlined that pipeline. We've got of the order of 40 or so, 40/50 schemes in that pipeline,

two/three years ago that number would have almost been double that. So we have significantly streamlined our pipeline, but that still gives us sufficient space to add 900 to a million over the foreseeable future and we think that's the right thing to do. One thing we've also done in streamlining that pipeline is to make our investment hurdle returns higher. We've increased those progressively year-on-year-on-year to make it tougher and tougher for stores to pass that test.

Further question

I suppose there's a five year view and there's a 20 year view I can understand online isn't going to be that big on a five year view but arguably stores on a 20 year view shouldn't be built. So why build freehold stores at all on that basis unless you think online is only going to reach a certain level of penetration in grocery?

Answer: Justin King

Give me a figure that you think it's going to be in 20 years' time and then we'll discuss it in 20 years. I think where we are at the moment is that online is between 4 and 5% of the market, growing strongly in the mid-teens and we expect it to do that as far forward as we can see. If you take yourself out to 2020 on that basis online would still be less than 10% of the market. And as John said we have two of the most vibrant growth businesses in online and convenience between them today they're 12% of our business and likely to make up, as they have done in recent years, 30 to 50% of all of the growth in our business.

Question 12

James Anstead – Barclays

I noted with interest John's comment that you've been aware of that tough fourth quarter comparative for some time and it would be fair to assume that you've planned ahead. Is it fair to conclude you've, to some extent, held back your promotional investment during the third quarter in order to become more aggressive in the final quarter?

Answer: Justin King

Couldn't possibly comment.

James Anstead

Okay.

Justin King

John's already got a slap on the wrist for saying that in the first place.

Further question

And obviously your press release makes rightly proud kind of comments about your very long track record in terms of positive like-for-like record you've got. How important is it that you deliver plus 0.1 rather than minus 0.1 in terms of like-for-like or is that just whatever drops out?

Answer: Justin King

Our press release doesn't actually and I think you'd have to go back quite a long way.

James Anstead

Sorry, yes now I read it. You're right but in conversations with you.

Justin King

For that very reason. We run the business for the long term and there may well be a quarter where we have to report like-for-like decline, and you'll always be a hostage to fortune when you've delivered such a long track record as we have. But we're not emotionally attached to it, it's the right thing to do for the business in the long term is to trade a quarter slightly down and we're not going to spend money that we shouldn't be spending just to have the pyrrhic victory of a positive if it's not there to be achieved keeping doing the right thing for the long term in the business.

<u>Question 13</u>

Andrew Porteous – Agency Partners

Morning guys and a Happy New Year.

Justin King

You get the last question, Andrew, you'll be pleased to know.

Andrew Porteous

You alluded to this topic of back-solving margins in the industry; the message of this conference call seems to be that you're downgrading your sales guidance and you're going to solve it somehow at the margin level. And I just wondered while the big four continue to lose market share to the smaller players how long you feel that's sustainable?

Answer: Justin King

Gosh I'm not even sure the route to come at that question. It's clear the central point of your question which is that we're losing market share, the big retailers in aggregate, to the smaller players is true. And I think it was Clive earlier that said that's unprecedented in the history of our industry. I also commented in the answer to the earlier question, pointed towards the fact that Aldi in particular, Lidl increasingly, have reinvented their businesses to a larger gross margin business model; and they liberated themselves to do that, particularly in the case of Aldi, with a massive restructuring three or four years ago. And so I think it's wrong, if you like, to characterise it that here are these discounters with a fixed gross margin idea and we're somehow drifting away from it. I think if you were making a general comment which is the whole industry has had to have either better gross margin or tighter cost control to cope with a sustained period of underlying top line growth being behind underlying cost growth, that's true for everybody in the industry. And it comes therefore full circle back to relative sales performance. Clearly the relative sales performance of the discounters and others means that they have good gearing in their P&Ls at the moment. But I think Aldi recorded a loss four years ago so they're coming back from quite a low base. The ability to spend money effectively, which Mike touched on earlier, in a world where if you look down the schedule of targeted marketing investment what we're able to do with Nectar data combined with our coupon-at-till technology is by far the most precise investment available to anybody.

At the other end of the spectrum you've got untargeted branded promotions and all points in between. The key to success, we believe, is spending more and more of the money you invest in helping *Live Well for Less* in a targeted way. And if you're able to do that you don't have to widen gross margins away from the industry and therefore reduce the competitiveness of your underlying offer. And we believe the competitiveness of our underlying offer before we start spending the discretionary money that's available to us is better than it's ever been; and then we have the benefit of the ability to spend that discretionary money better than others.

Concluding comments: Justin King

We take that as the last question. Thank you to all of you for coming on the line. We're conscious of course we're the first to break and understand, therefore, the very lively and long list of questions. So thank you for that. We'll be speaking to you in three months' time.

Thank you.