J Sainsbury plc

Wednesday 6th May 2015 BST

Preliminary Results 2015

David Tyler – Chairman

Good morning everybody, if you'd like to take your seats and welcome this morning to this announcement of the preliminary results for Sainsbury's for the year to 14th March 2015.

It won't surprise you to hear me say that this has been the most challenging year that any of us can remember in the grocery sector and this has led to our underlying profit of before tax being down 15% to £681m and to our EPS being 26.4 pence for the year compared to 32.8 pence last year.

As far as dividends are concerned, we announced six months ago that our policy is now to pay out half of our earnings as dividends, and this means that our proposed full-year dividend is 13.2 pence, and that's down 24% compared to last year, and the proposed final dividend will be 8.2 pence per share.

Our decline in profit is much less than that experienced by other major players in the market, but this is not of great comfort to me or to the Sainsbury Board. Our job is to grow shareholder value and we've not succeeded in that in the last 12 months. We are confident, however, that we can grow value over the medium and long-term in the years ahead by implementing the strategic review that we carried out last year. We're now following a very clear strategic plan. We're represented in all areas of the market: in supermarkets, in convenience stores and, in a trial, in the discount sector. We're in food and we're in non-food, we're in financial services too, and we're selling online and we're selling offline, and everywhere we operate with the same high Sainsbury values and we drive the benefits of our brand name and our customer data.

We're also investing seriously in the quality of our products; we're cutting our costs significantly; and we're reducing our capital expenditure.

Our business is therefore built on strong foundations and is led by what I believe is the best management team in the sector. And I'd like to thank the whole management team, and, indeed, all of our colleagues, for what they've achieved in what's been a tough year, particularly Mike, who couldn't have taken over as CEO at a more testing time in the sector's history. You'll hear from him in a few minutes, but before that, John, would you like to come up and talk about the financials?

John Rogers – Chief Financial Officer

Thank you David and morning everyone. So let me just take you through the financial highlights for the year.

So retail sales inc. VAT, inc. fuel, down 2% to £25.8bn. That delivers a retail operating profit of £720m, down 17.5%. And of course we've got the full contribution from the Bank in the P&L coming in this year, £62m, a good performance there by the Bank. Net finance costs of

£107m, in line with the guidance that we've given you. And then, of course, joint venture profits of £6m, again reflecting the fact that we've moved the Bank from effectively below the line to above the line. All of which delivered a profit before tax of £681m, down 14.7%, but a good beat to consensus, so consensus was at £659m, and £681m clearly a good beat to that consensus. A tax rate of 25.8%, and again, an increase year-on-year. 13/14 benefited from the adjustment for deferred tax assets through the tax rate and we didn't see that same benefit this year and hence the tax rate is up at 25.8%, in line with the guidance that we gave. As David said, basic earnings per share, 26.4p, down 19.5%, and a dividend of 13.2 pence in line with the two times cover dividend policy that we announced at the interims.

Results outside of underlying, a loss of £753m, and I'll break this out in a little bit more detail later on, but again it's largely reflecting the impairment we made to both our property pipeline and some of our stores at the half-year, so there's no movement there since the half-year, all of which resulted in a loss of £72m on a statutory basis.

Coming on now to sales, these numbers you'll have seen and we talked about these at our Q4 trading statements, so like-for-like growth for the full year of -1.9%. Contribution from net space of 1.7%, all of which delivered a total sales growth of -0.2%. And of course within that, if we break that out in a little bit more detail over here, clearly negative in relation to supermarkets and food, and Mike's going to come and talk about that in more detail later on, how we're going to address that in our supermarket business.

But on the positive side, some really good growth opportunities in our business. Convenience up over 16%, online up over 7%, clothing up just below 12% and general merchandise up over 7%, so some really good growth opportunities for our business going forwards.

In terms of guidance for 15/16, again this is in line with what we talked about our interims, so we expect like-for-like to be negative, driven by the challenging market environment, and, of course, food price deflation; we're seeing food price deflation now at about -2.5%. We expect to see that food price deflation for at least nine months, if not longer. It may start to annualise towards the end of this financial year, but I think it would be too early to call that just yet.

Contributions from net new space will be slightly lower year-on-year, again reflecting the slowdown in the addition of new property, new space to our estate, and again, contributions from extensions expected to be 0.1, we're not doing any additional extensions over the next year or so.

Coming on now to margins. Clearly the margins have been impacted by the price investment that we've made this year, not only in the first half, but perhaps more importantly, stepping on in the second half. So we're seeing underlying EBITDAR margins taking account of changes to fuel prices of -39 bps. We've also seen at the operating margin level a reduction of 62 bps, again reflecting the price investments that we've made particularly in the second half.

You'll note here an enhanced disclosure on commercial income. You'll read through the statement that we break the different chunks out of commercial income in a bit more detail. However, we haven't gone as far as providing the numbers here on either the P&L basis or the balance sheet basis. And the reasoning behind that is we think that from a P&L perspective it's very commercially sensitive information and we wouldn't want to be disclosing that, and from a balance sheet perspective, actually the numbers just simply are not significant. That's why we've chosen not to break out those numbers in detail.

I'm not going to dwell on this slide for too long, and as David said, clearly no board takes any satisfaction whatsoever from reporting a year-on-year profit decline. But I think it is worth

noting that over the last five years we have been able to outperform on both a sales basis and both a profit basis compared to some of our major peers. And the reason it's worth noting is we feel that there are some fundamental underlying reasons behind that which we think are relevant going forwards, particularly in relation to our differentiated offer, and Mike again will come and talk about this in more detail later on, but also our advantaged store portfolio as well. So there are some underlying reasons as to why we believe we have the ability to outperform the market in both sales and profit terms going forwards.

Coming on now to the important area of price investment, it's an important slide for your models. So we talked at our interims about overall price investment on an annualised basis of £150m, and we phased that 50%/50%: the second half of 14/15, 75, the first half of 15/16, 75. Now in practice, we are still going to make that £150m annualised price investment; that number is not changing. However, the change to the guidance is just the phasing of that price investment.

So, in practice, in the first half and the second half of 14/15, on a gross basis – and I'll explain what I mean by that in a second – we actually invested £50m in price, not the £75m that we first envisaged, and that was just due to the phasing of the price investments that we made. What we did also see was we also got some volume uplift as a consequence of that price investment, and if we offset the benefit of that volume uplift then we see actually a net price investment of £40m.

As I said, on annualised basis that will come through as an overall price investment of £150m, but the way that it will hit the P&L is £40m in the second half of 14/15 and £110m on a net basis in the first half of 15/16, simply put. And that means in terms of your models you'll have to make that adjustment there in the phasing of that price investment.

Now of course we've made it very clear, we've talked about price investment of £150m, but that's clearly not a static number, we've made it very clear that we aim to compete toe-to-toe in the market on price. And we believe that today our price position has never been better versus our competitors, and indeed, whether we look at our internal data or indeed look at some of your own external surveys, it absolutely demonstrates a significant movement in our price position, so we now see ourselves bang in line with our competitors in the market and it's our intention to remain so. So further price investment, as required, to remain competitive in the market, depending on how the market moves over the next 12 months or so.

Coming on now to the performance of the Bank, a good performance on an operational basis, so total income up £260m, reflecting a growth in our loans books, the growth in our credit card portfolio, some great opportunities there to grow our business.

From a cost perspective, our bad debt asset ratio has improved. We have one of the best bad debt asset ratios in the industry at 0.7%, all of which has flowed through into an increase in our operating profit of 17%, £62m, so a very good performance from the Bank.

And, indeed, for 15/16, we expect mid single digit growth year-on-year in underlying operating profits, so another step on in the financial year ahead.

From a transitional perspective, we do expect the costs of transition to increase from what we've previously guided. Nonetheless, the business case for the Bank remains, in our views, very attractive. In fact, I think our view on the Bank today versus 12 months ago would be the opportunity is even greater than we first thought in terms of our ability to grow that business in terms of the loan book and the credit cards and savings, etc. So we remain very upbeat about the Bank, but the reality is that the transition costs, we feel will be £80m-120m higher than we previously guided, albeit all of that increase is in capital.

As a consequence of that cost increase, we will make a capital injection into the Bank of circa £80m, that's partly reflecting the additional costs of course, but also a step on in our

investment in the Bank, also reflecting our ability and desire to grow the loan book and our credit card portfolio, which also, of course, would have to put additional capital investments into the Bank in 15/16.

Coming on now to results outside of underlying. Again, we've talked about the £753m I mentioned earlier on. As I said, most of that is the impairment that we talked about at the interims, and I'm not going to spend too much more time on that and I think we talked a lot about that at the time; the transitional costs of the Bank are £53m, and then compensation payments, of course, because we closed our pension scheme to future accrual, and as a consequence we have to make compensation payments to some of the members, and then a few other items, fair value adjustments, restructuring cost, etc. all of which sums to the £753m.

For guidance for 15/16, we expect the transition costs to be circa £50m and £75m of transition capital, and that's in line with what I've just told you on the previous slide. And also something here, which we've talked about in the past, is our property profits. And this is not property profits in relation to sale and leasebacks, but this is property profits in relation to mixed use development schemes - specifically the opportunities that we've talked in the past about at our Fulham store and our Nine Elms store, all of which flows through over the next two years to circa £200m of property profits, so that's again a very positive message in relation to how we're using our property portfolio to unlock value.

Finance costs, £107m, in line with the guidance that we gave. Again, a reduction, good management of our net debt position. Also a reduction in interest rates, particularly on our inflation linked debts has resulted in that slight decline. Capitalised interest of £17m, down from £26m the year earlier, again reflecting the slowdown in our property pipeline. And guidance for next year, we expect costs to increase slightly year-on-year, because again that capitalised interest will slow down again, reflecting the continued slowdown of the addition of new stores, so interest costs for 15/16 slightly higher than the £107m that we see for the last financial year. And an underlying tax rate, again just for completeness, in 15/16 similar to the 25.8 that we've seen in 2014/15, so no update there.

Coming on now to our cash position, we've made some very positive steps over the last two years to improve the overall cash position of our business. So in summary, with cost savings we're talking about £200m in this financial year, 15/16. In 14/15, we delivered £300m of working capital benefits. Capex reducing to £550m. We closed the DB scheme, Defined Benefit pension scheme, to future accrual in 13/14. We set ourselves an affordable dividend at two times cover.

So significant actions over last year and the new financial year to protect our position, which in our minds gives us the full flexibility to compete in this market. It gives a significant flexibility in relation to whatever the market may throw at us going forwards in terms of price investment.

So just breaking that out in a little bit more detail. So cost savings of £140m in line with what we guided at the interims, no change there. For 15/16 we expect cost inflation at the lower end of the range, 2% to 3%, so call it 2%, and efficiency savings of £200m in 15/16. That's in line with the £500m that we talked about when we announced our strategy at the interims, so a slight acceleration of that run rate, so £200m in 15/16 and then obviously £150m, £150m in the following two years to deliver in total the £500m in savings. And we've got a very, very good line of sight, project by project, as to how we're going to deliver those savings, which gives us great confidence in our ability to do so.

And again, all the usual areas where they come from, it's not one big area, there's a multitude of different sources for those cost savings. Energy has always been a big

opportunity for us; I think we have, as we said in the past, the largest multi-site solar array in Europe.

We've obviously announced various changes to our management structures; we've announced changes to the roles, indeed in our store support centres, the outsourcing of parts of our IT. We continue to see good savings through our investment in our real time supply chain systems, so reducing our waste in our stores, and obviously procurement delivering savings as well. So savings from across the board to deliver those savings, both the £140m in 14/15 and the £200m going forwards in 15/16.

Cash flow, again from an operating basis before working capital we've seen the dip year-on-year but reflecting the tough industry environment, reflecting the investments that we've made in price, but really good performance in terms of working capital management in the retail business.

You see on the Bank side an investment in working capital, but it's not a negative, that's really reflecting the growth of our loan book, the growth of our credit card book and the change to our funding structure in the Bank in terms of opening up the opportunity through the Funding for Lending scheme, so this is just the Bank doing what you would expect it to do going forwards.

So overall, cash from operations down slightly, but not significantly year-on-year and of course adjusting for interest tax dividends and a Capex of £900m I should add in cash terms, we were still able to reduce our net debt position year-on-year, so £2.35bn give or take, slightly lower than that that we guided to, the £2.4bn that we guided to, so a good performance in terms of managing our balance sheet.

And for 15/16 we're expecting to deliver another small improvement in our working capital position. I don't foresee that it'll be the same extent as we've delivered in 14/15, the £300m, but we do think we can step on again with another small movement in our working capital position.

So Capex, again Capex of £947m in line with that that we guided to, within that £947m we've always had an element that's contributed from BAU proceeds which relates to bits of land and property that we are selling as we work our way through our land bank, and again, guidance for 15/16 we expect to see another £50m come in through the what we call the 'business as usual' proceeds through selling down, bits of land that we no longer think we need for our pipeline.

And the shape of Capex and the quantum of Capex of course is changing, so the quantum of Capex is year-on-year 15/16 of 550 versus the £947m in 14/15, and the shape of that Capex is changing slightly as well, so reduced amount of course, no surprises, in relation to new supermarkets, a step up in the proportion that we're spending on convenience, a step up in the proportion that we're spending on IT, and of course the rest being the balance in logistics in commercial initiatives and so forth. So again, a reduction of Capex, sensibly managing the balance sheet but also a change in the mix of how we're spending that cash.

Pensions, again just to reinforce, we've closed the scheme now to future accrual, that's actually delivered us a £20m annual saving as a consequence since the '12, '13 costs, so again sensibly managing the pension liability. At the moment the last triennial valuation took place in 2012, we make cash contributions of £49m and also £30m through our property funding partnership, so a total of £79m into that scheme and we're about to enter into the new triennial valuation process as of March 2015.

All of that said, the IAS 19 deficit has improved year-on-year, £679m to £651m, clearly we've seen an uplift as a result of the increase in value of the assets of that scheme, which is in part, but not completely, offset by the increase in liabilities driven of course by the movements in discount rates. But a movement in the right direction in terms of a reduction in that pensions liability from an IAS 19 perspective.

Dividend, again full year dividend, 13.2 p down 23.7%, we've already talked about this, but in line with our cover policy of two times cover. Balance sheets, again property values have decreased slightly since a year ago, so £11.1bn versus the £12bn, that's actually not yield driven, yields have remained broadly static at or around 4.6% across the portfolio. That's actually a reduced expectation on future rental growth in the sector which clearly actually is a good thing for us in the context our leasehold portfolio and as a consequence of that reduced expectation on future rental growth that's reduced that valuation from the £12bn to £11.1bn.

Net debt we've already covered, and we have facilities of £3.8bn, so plenty of funding in this business to deal with whatever the market may throw at us from a price investment perspective, and that funding indeed is quite long dated in some cases, it goes out to 2031, we've got another chunk in 2018 but very sensibly funded on a long-term basis going forwards.

And in fact we have restructured our revolving credit facility, we've had a £1.15bn revolving credit facility, and in line with the journey that we first embarked upon in 2005/6 where we moved towards a secured funding approach we've now moved our revolving credit facility onto a similar basis so secured funding and we are now in a position where there are no financial covenants in this business. Again, we feel that gives us very good flexibility going forwards to be able to compete in this marketplace.

Guidance for 15/16, again consistent with what we said at the interims, we expect the net debt position to reduce year-on-year, we've reduced the net debt position already in the last financial year in 14/15, and we expect to be able to reduce our net debt position in the year ahead, 15/16. And again if you look at some of our balance sheet metrics, consistent balance sheet metrics over the last five years which I would suggest is somewhat unique in our sector, and equally on a fixed charge cover basis we've seen a small dip, but it's only a small dip.

So to summarise, food deflation, pricing pressures impacting on margins, but we've got strong growth in clothing, general merchandise, convenience and online, and the price investment that we're making is actually driving the volume growth, and Mike will talk about this in a little bit more detail. Good progress on cost initiatives, again I won't cover all the key financial measures, we've already covered those in detail, but balance sheet net debt better than we expected, pension deficit down, property values down slightly, good improvement in working capital and as I've just mentioned, the restructuring of the RCF.

Okay, that covers the financial review; I'm going to hand over to Mike to cover the business review. Thank you.

Mike Coupe - Chief Executive

Thank you, John. Morning. You're all very cheerful this morning, on this bright sunny morning. So we announced the outcome of our business review in November. I'd say three things up front, the first thing is that we have a plan and we're executing that plan. The second thing, John's already talked about it, we have the financial resources and if anything we believe that we are in a better shape as far as our finances are concerned compared with

November to execute that plan, and thirdly we have a strong and consistent management team who are getting on with making it happen. So I think it’s very important that we frame where we are upfront.

I want to start by just talking a little bit about the consumer backdrop. The reality is as we stand today our customers should feel better off than they’ve felt for a long time so we’re seeing consumer expenditure, consumer discretionary income actually rising by about £16 a week, and that is actually reflecting itself in, to some extent, grocery volumes in the market which I’ll talk about later.

However, we’re seeing a lot of growth in other sectors so whether it’s in electrical goods, whether it’s in cars, automotive, or indeed whether it’s in things like travel we’re seeing that customer expenditure finding its way into kind of non-discretionary areas, and one of the things that we see in our industry is that when we come out of a recession people tend to eat out more rather than eating in which tends to be a drag on the supermarket industry. But we haven’t seen that necessarily translated directly into consumer confidence, the big increase in consumer confidence happened during the course of last year and it’s kind of flat lined over the last period of time.

In terms of reflecting on the market dynamics the reality is that deflation has been with us since the backend of last financial year, that’s mainly reflective of two things, firstly the lowering of commodity prices, particularly in fresh foods, and secondly the price investments that have been made in our industry overall.

Now, as John’s already said the reality is we don’t think that’s going to change for the next period of time, certainly during the course of this calendar year, and probably into next calendar year as well, However, we are beginning to see some volume recovery in the marketplace, so one of the cyclical factors that we talked about in November is beginning to unwind over the last most recent period of time. Now we’ll see how that plays out over the next period, but certainly the early indications are that there is some volume growth coming back into our industry.

And our view on the shape of the industry hasn’t changed, for the foreseeable future the majority of customers the majority of time will be doing their shopping in large out of town superstores, so the mantra of the superstore being dead we think is grossly exaggerated, our job, our challenge, is to make our superstores more attractive to our customers for the future, and we’ll talk a little bit about some of the things that we’re doing in that space in a minute.

The next biggest sector of the market is convenience shops, we do expect convenience to grow as a percentage of the overall market and that’s driven by the fact that the population is increasingly single and urbanised, customers shopping more frequently and when they shop they tend to buy less, so we would expect that trend to continue for the foreseeable future, as will the growth of online, currently around 5% of the market and we believe over the next five/seven years, that will grow to 10% of the market.

And clearly the discounters will continue to grow, we believe in our analysis that they will grow from around 10% of the UK grocery market to around 15% of the grocery market, and one of the interesting things that we can now reflect on looking back is actually the discounter growth has come off the top, it’s still substantial, it's still at 15% year-on-year so we can’t ignore it, but that growth is now largely driven by new space and maturing space and you can begin to see that perhaps the market is reshaping and rebalancing itself to a slightly more equilibrium state compared with where it’s been over the last few years.

So in that context we talked about the strength of our business and the point that John's made I will reiterate, the reality is that we have outperformed our mainstream grocery peers for the last five years and that's driven by the fact that we believe our offer is differentiated and we highlighted last time that our strategy is all about being a better us, being a better Sainsbury's.

And just to pick out a couple of examples, we are the clear quality leader amongst the big four, we need to continue to invest in the quality of the products that we sell and to make sure that we communicate the quality of the products that we sell to our customers.

We have a competitively advantaged portfolio, we, generally speaking, have smaller shops in more urbanised and demographically advantaged locations, particularly in the southeast of England and we believe in the medium to long-term that's a strategic advantage. And we run great shops, we deliver great customer service and we must never forget that and in terms of our day to day operations we are constantly focussing on how we improve our customer service, and I'll come back and talk a little bit more about that as we go through.

We talked about our strategic plan; there are five key pillars to our strategic plan as we look forward. The first is, that we know more about our customers than anyone else, and we can use that knowledge to really drive many, many multiple facets of our business.

So we can use that knowledge to think about how we range our shops and how we do a better job of ranging our shops for our customers, and we do a better job than our competitors at ranging our shops for our customers. At the other end of the spectrum we can use that customer knowledge to sell them financial services: credit cards; loans. So that base customer knowledge gives us a tremendous source of competitive advantage for the future.

Second part of the strategy, great products and services, starting with food at the core of our business. We now actually play in roughly 60% of the markets where consumers spend their money. Relatively small shares in things like non-food, clothing, general merchandise and the bank, but these represent significant opportunities for us in the future. And that comes onto the next part of our strategy which is about us being there for our customers whenever, wherever they want, whether that's in our big shops, whether it's in our convenience shops, whether it's in our online operation, and it's all about how we interact with our customers in a world where they are demanding more and more flexibility about how they shop within the retail space. We believe that we're well positioned to develop whenever and wherever our customers want us to be.

Our colleagues make a difference. We have 160,000 employees in our business and they do a fantastic job in serving our customers week in/week out, day in/day out, and we run – as I've said already – we believe the best shops in the industry and we want to continue to do that.

And all underpinned by our values. In the end Sainsbury's is a trusted brand and we see that in our research continuously, we are always held up as the most trusted retail brand, and again our values make us different and we need to make sure that we continue to differentiate and do different things in that space.

So to go through the specifics of our plan. As I've said already, our quality perception is actually already differentiated from our mainstream competitors, but we need to keep investing in our quality position. And we talked last time about investing in the quality of 3,000 products, and that's about making sure that we incrementally change lots and lots of products on many, many dimensions. I've just picked out a few examples. Something close

to a few people hearts, certainly my heart, the vanilla cheesecake. We've improved the biscuit base in our vanilla cheesecake and we've increased the percentage of cream that we put in our vanilla cheesecake, and therefore we've made it a better product. And that's the kind of thing we can do across our broader portfolio and range of food products.

Our dishwasher tablets are rated by Which? as the best in the industry and that's as a result of again continuously looking at how we can improve the quality and the delivery of that product. And our Taste the Difference beef burgers, as well as having a better texture as a result of a product improvement, one of the things that our customers increasingly demand is that we make our products allergen free, so we've taken the gluten out of our Taste the Difference beef burgers, which makes them more available to the broader market. Product quality investment does take time so you will see a lot of things coming through over the next 6-12 months, and certainly the Trading Team is committed to literally thousands of products improving in quality over the next 6-12 months.

John's already alluded to our price position. We would say we measure, and certainly the outside commentary would suggest, that our prices have never been sharper, and they are better than they've ever been versus all of our mainstream competitors, whether it's our straightforward big four competition, whether it's people like Waitrose, or indeed whether it's relative to the discounters. This is an independent survey; this is one of the surveys that one of you guys does. Certainly our own internal measures will tell us a similar story that our price position has closed down. And we believe that we have the financial capacity to deal with whatever we need to deal with in the marketplace. We're pretty comfortable about where we've got to, but if the market moves on then we'll move on with the market, and as I say, we believe we've got the resources to be able to do that.

And we've done it in a unique way. We actually started on the value simplicity journey about three years ago, and now we've introduced value simplicity across 80% of the product ranges that we sell. And the volumes that we sell at regular prices has gradually increased, and I'll talk a little bit more about that on a future slide.

And we've seen our promotional participation reduced, so we've gone from around 37% promotional participation, to around 32% over the last period of time. So we've seen a fundamental switch in the way that we're presenting value to our customers. And one of the by-products of that, which we believed would come through and now we can actually demonstrably in our businesses, is that we've improved our store availability and we've actually significantly reduced our waste, because we've got a much flatter supply chain, a much flatter demand curve in our week-to-week, day-to-day business, which is very important.

Where we've specifically invested in price, the 1,100 products, we've seen quite significant volume gains, so a volume gain of roughly 6% across that portfolio of products. And we've seen our total volume improve, as we talked about in our Quarter 4 Trading Statement, and our underlying like-for-like transactions improve as well. So in this current market we're seeing volumes grow in our business for the first time in a while, we're seeing like-for-like transactions grow, we're seeing a downside as far as deflation is concerned, but if you took a long-term view over the next 12-18 months if we see those trends continue, we should see a return to underlying like-for-like sales growth.

And we continue to work with our suppliers on lowering our cost of goods. So we talked again in November we would expect to recover the £150m price investment through working through our supply chains with our suppliers looking at the value chains, looking at where the value leakage actually happens, and to make sure that we work our suppliers to reduce that value leakage and therefore reduce our cost of goods.

A couple of examples are the detergent business, we've concentrated the powder, that means we've got less product going through our supply chain delivering the same functionality. That means less pallets in our supply chain, it means less Lorries on the road, and ultimately a cost saving to our business. We've concentrated our fabric conditioner. Similarly less water in the supply chain, less pallets and again less Lorries. And that's a classic example of how we're looking at our value chains, we're reaching through with our suppliers, cooperating and looking at how we can reduce our cost of goods. And we're pretty confident that we'll recover the £150m of price investment over the next couple of years.

A lot of talk in the industry about range rationalisation. We're certainly looking at our ranges all the time and we believe that through our customer data, through our transaction data, we're uniquely placed to do the best job in the industry of ranging our shops for our customers. We've actually reduced the number of stocking points in our food business on a like-for-like basis by 2.9%, and we believe that that can lead to a substitution in product volumes. However, and there is a big however, we have to be incredibly careful not to take out the products at the tail of the range that determine where customers shop, because time and time again we know from our bitter experience if you take out a product at the tail quite often it will come with a big grocery shop.

I've used the example that was actually given by one of my colleagues, our four mueslis which on the face of it look very similar, and actually if you looked at our range analysis they would come in terms of volume pretty far down the pecking order, they would be typical tail products. I was actually in a store not that long ago, a customer bought the one in the top right-hand corner, the Frusli. I asked the customer why she had bought that particular product and she said, "It's the only place I could buy this particular product. And your shop is the only place I could buy this product". Therefore it determined where she shopped and therefore it came with an overall basket. So, as I say, the mantra of range rationalisation, whilst we can do a better job of ranging our shops, we certainly mustn't get carried away and we must be careful in the way that we range our shops in the future.

Our non-food business has been spectacular this year; we've seen a growth of 12% in clothing, 7% in general merchandise. About one in five of our shops carry the full clothing and general merchandise offer. So there's a still a significant opportunity to utilise our space for our non-food business, and that's certainly one of the things that we talked about last time and one of the things that we will put into our plan in the future.

We're sourcing more and more products from the Far East, so that gives us a margin benefit, a cost of goods benefit, which is coming through in the non-food P&L. and we will be rolling out clothing online. It's already in trial, it's been in trial since February, and we'll be rolling that nationally over the next few weeks and months. So I'm confident by the middle of the summer that we'll have our clothing online business throughout the UK. And interestingly, around 70% of the products sold through clothing online are actually 'click and collect', so they do drive traffic to the shops, and I think that's one of the clues for how we might use our real estate differently and more creatively in the future.

John's already talked about the Bank performance - pretty impressive. We've increased the number of credit cards by 50%, the number of loans by 13%, travel money up by 24%. We've actually in-sourced our travel money business. It's a big opportunity for us. We have currently a market share of around 6% of travel money. I think the Post Office is at 40%. So it goes to show that we could penetrate that market further, and we believe that's a significant opportunity for us.

And we have now close to 1,600 ATMs, so again up 7% year-on-year. And as John has said already, we believe that the Bank represents a bigger upside than perhaps we were thinking

when we first took the half share, so that gives us a big opportunity in the future. We believe that by joining it together with our overall retail proposition, that we can do a better and better job of serving our customers.

Clearly the supermarket industry, the supermarket business, has been challenged in the last year and we're thinking creatively, and I'll come back to talk about how we can do a better job of serving customers in our larger shops. But we've done a pretty good job in the convenience business, growing by 16.3% in the last year. We now have over 700 shops. We opened virtually 100 last year, and we'll continue to open more as we go through this year. Our online business has shown respectable growth as well, 7% sales growth, around 11% order volume growth.

So if we start with the supermarkets. We talked last time about the fact that we believe that we have a structurally advantaged estate, we have less large shops, we have better locations, and we have 75% of our shops with the right space and the right locations. However, that does mean that 25% of our shops have too much space. On average we believe that's around 10,000 square feet, so it's roughly 1.5 million square feet, roughly 6% of our overall store portfolio. So our challenge is to think about how we can better utilise our space in the future and how we can do a better job of making our stores easier for our customers to shop.

So we've got a number of trials that we'll see hitting on the ground over the next six months, so by the time we talk to you in November we'll be able to give you some initial feedback on some of the things that we've done and some of the results of that feedback. However, we know there's a significant opportunity in about 75 of our shops to put clothing and non-food in. So that's one solution. And equally we're already undertaking trials with people like Timpson's and Argos and Jessops looking at how we can offer a broader range of goods and services. And we also have 'click and collect' in a number of our shops where we're serving other third parties. So we will make our shops easier to shop but also better locations from a customer point of view, more convenient locations, to do a broader range of shopping missions, which ultimately will drive our supermarket business.

Convenience, as I said, grown by 16%. I think we run the best convenience shops in the industry. I think they're brilliant. 98 rolled out last year. We'll continue to grow that portfolio. Certainly another three or four years' worth of growth. However, we won't compromise on the quality of the sites. We can see from other people that where you just chase numbers ultimately that will trip you up, so we're very focused on making sure that we get high quality real estate, and if that means we roll out less stores then so be it. We're currently confident we'll rollout between one and two a week, and we'll continue to invest in that area of our business. The investments are very high returning, very accretive investments, and there's still plenty of upside capacity.

And we will develop a smaller format. Our smallest store is currently around 1,200 square feet. We believe we can go below 1,000 square feet, and we'll have some on the ground over the next six months, and that will open up the number of opportunities in the future. But equally at the other end of the scale we've got quite a few shops now trading at around 6,000 square feet. One that's close to my heart, I was brought up in a place called Billingshurst in West Sussex, and I know in the centre of the village there is some big noise because we're about to open a 6,000 square foot shop in the centre of Billingshurst in West Sussex, which again shows our commitment to that format and to the great people of Billingshurst in West Sussex, my brothers!

Groceries online, growth at 7%. Slightly behind the market, but we've talked very openly about the fact that we are not going to chase volume for the sake of chasing volume. So our

groceries' online business is all about serving our customers on a day-to-day week-to-week basis, and actually it represents about an 11% growth in order numbers. We're currently shipping around 0.25 million orders a week and we believe that that will continue to grow in the future. And we're doing lots of things to continually improve the underlying proposition, whether it's the functionality of the website, whether it's the number of substitutions, whether it's the underlying availability, whether it's the quality and the freshness of the products that we sell.

We've got 'click and collect' in about 20 locations currently. We'll roll that out to 100 locations over the next period of time. We'll start trialling 'click and collect' in different locations, so as well in our large out of town superstores over the next period of time we'll also try 'click and collect' on some convenience sites where we've got car parks, which again opens up the online offer to more of our customers. And particularly in our high trading stores we're already seeing that where we have put 'click and collect' in we're getting significant demand, which of course allows the demand in the big shops to fill up again. It releases car parking spaces in stores which are constrained, so it does present an opportunity, particularly in London and the South East where our stores tend to trade more intensely.

We see the penetration of delivery pass increasing, which has the benefit of driving the number of orders, but clearly the value per order is dropping in the industry more generally, and that's as a result of delivery charges broadly speaking gradually being competed down, and delivery pass is a very obvious example of that.

We now offer customers a green van option, so where we are coming to your street you can nominate to have a green van option, that gives you a much more environmentally-friendly and cheaper delivery. And we're anticipating that in London particularly, we'll get to the top end of our capacity over the next 12 months or so. So during the course of 2016 we do anticipate that we'll open a 'dark store' in London particularly.

Now we believe that the business model picking from store is the right model and we still believe that outside London we have the capacity to do that out of our large out of town superstores.

I'm not going to spend a lot of time on Netto, I know there's a lot of interest. We have five stores trading. We've learnt a lot from those five stores, but we're also very focused on making sure that we get the right sites to make sure we conduct the appropriate level of experimentation to understand how the business model can work in the future. So we're not going to just open sites for the sake of opening sites, we want to make sure that we get the right quality real estate. So we'd anticipate that we'll get to 15 shops by the end of our financial year – that's slower than we originally envisaged, about three or four months slower than we originally envisaged, but nevertheless it is a trial and we want to make sure that we get that trial right.

However what we are seeing is, week in/week out the sales line increasing and clearly the acid test of the success of the trial will be whether and when that line continues to grow and when it tops out. So at the moment every week, week in/week out since opening in all of the shops broadly speaking we're seeing the sales improve.

We can't get away from the fact that in the end we're shopkeepers, we are, we run great shops, we believe, and our challenges continue to improve the level of customer service and products availability. And we are very proud of the fact that we are rated by our suppliers, and we're rated by the industry as consistently running the best shops. So through the Advantage Group Survey our suppliers would say our retail execution is the best in the industry.

Our own mystery shopper programme would confirm the fact that we see our customer metrics on our service increasing year-on-year. We're actually still top of the charts for the Grocer 33 – a bit of fun but I think we're now currently three ahead of Waitrose, and we've won it consistently I think now for three years running, so hopefully the fourth year. And actually we've launched our own internal network Yammer which allows our colleagues to feedback to us and also feedback to each other on their customer service initiative which has proved to be a very potent way of communicating within the business, more or less in real time. So a very powerful thing and a step forward into the future.

However, we've also had to make some tough choices during the course of the last period of time and certainly no management team faces into reducing overheads, costs and making people redundant lightly and we've had some difficult choices to make. However we've made those choices and we believe in the medium to long-term that will allow us to service our customers better over a period of time. So as John's already said we anticipate, if anything, our cost-savings next year to be higher than we originally guided in November which is a testament to all the hard work that's been done throughout our organisation.

But we continue to invest in training our colleagues. So we have six training centres around the country and we believe fundamentally in the training of our colleagues, particularly around the differentiated offers that we have in our stores, whether it's our in-store bakeries, whether it's our counters offers, or whether it's our customer service at our frontend. So we will continue to invest in our colleagues, in our shops and throughout the business.

And we also announced that we'll be investing in a digital hub, you can see it being built as you walk into the building, in the basement of this building. And we're anticipating recruiting 480 people over the next period of time, focused on improving our digital capability because we believe over the medium to long-term that's one of the areas that we can significantly improve our offering and overall differentiate relative to our competition.

And at the heart of that idea is the idea of a single sign on, it might sound a statement of the blinding obvious but at the moment if you want to interact with Sainsbury's you kind of have to go through about 20 different methodologies, whether that's the Bank or whether it's our online business, or whether it's our clothing online business. And by focusing our customer proposition through a single identity sign on it actually gives us lots of opportunity for how we might integrate our overall proposition in the future.

So a good example is if you show with us online we already have your address details; if you're applying for a bank product we can populate your application without you having to do the hard work. And there are lots of examples of where a single sign on can add value to our business and ultimately add value to our customers.

Clearly in the last period of time we've announced a change to our Nectar scheme, the way that we reward customers. And we're increasingly moving our reward scheme towards rewarding customers on a personalised basis, so actually taking the points from a single transaction onto a personalised basis and really interacting with our customers in a fundamentally different way. And so again we believe that our customer knowledge enables us to do a better and better job of serving our customers on an individual basis than perhaps they've been served in the past and we believe that's a key point of differentiation in the future.

And last but not least we have Trolley Talk which gives us real time feedback from our customers. We have 4,000 customers on a panel who, day in/day out, give us feedback about what's on their minds and we can react to that and we can therefore flex our proposition to deliver against their needs.

And last but not least our values make us different, our brand is the most trusted in the sector, certainly amongst the listed players and we continue to look for was to differentiate our offer. Big issue at the moment sugar in carbonated drinks – we've reduced the amount of sugar in our carbonated drinks by 2,250 tonnes – as one example.

We've increased the level of sustainable palm oil in our products so now 95% of the palm oil in our products is from sustainable sources.

We actually have a store which is completely off the National Grid and entirely powered by food waste, which has both an environmental and an economic benefit to the business.

Last year we raised £52m for charitable causes. My most proud moment I think in my time running Sainsbury's has been the moment when we handed the £11.5m cheque to Comic Relief in March. And again it's a testament to the values of this business and also the fundraising capabilities of our colleagues who really, really engage with these initiatives.

And last but not least to date we've raised £150m for Active Kids. So again we've written a very large cheque during the course of this year to make sure that we put sports equipment and actually cooking equipment into schools, which again is a very big initiative for us.

So we're doing lots of stuff; we're making our plan happen; we're investing a lot of money in the products that we sell. We're investing a lot of money in the prices that we're selling them for. We're continuing to invest in the things that will drive our business into the future whether it's our non-food business, clothing, and general merchandise; whether it's our convenience business; whether it's our online business. And the Bank is another example. So we believe that we're well-positioned for the future.

And if we start thinking about our business for the future, fundamental to our proposition is the idea that we can know our customers better than anyone else and that we can use that knowledge to anticipate and serve their needs, wherever and whenever they interact with us, whether that's online, in our shops, in our big shops, in our small shops.

And actually if you look at our portfolio of products we currently play in around 60% of consumer expenditure. Clearly at the heart of that is the grocery business and we must never lose sight of that but equally we have opportunities to gain market share in non-food, in financial services, in energy and indeed in telecoms.

So that's a broad portfolio of products and I think we can do a better and better job as we look forward at joining those propositions together and really understanding our customers through our customer data.

So with that we'll open up to a Q&A. Thank you.

Q&A

Question 1

François Halconruy – Morgan Stanley

I have a small question on your price investment and the phasing. So initially you thought you were going to do 75 net and 75 net in the first half of 2016 [sic] but you did not do this and why is that so? Is it because you would say that the market has behaved in a more rational way in terms of pricing compared to your initial expectation? Is it because it has an

impact on the pricing architecture that makes it difficult to do it quickly? If you could just expand a little bit on that.

And then a second question related to your working capital. So £300m is a big improvement on the retail side we shall expect a small improvement. Could you just come back a little bit on the reasons why the improvement is so big and just to check that there's no calendar impact on this working capital benefit?

Mike Coupe

I'll go for the first and I'll ask John to answer the second. On pricing, and it's purely a function of the phasing and the timing, so we effectively announced our price investment in November, that's already two thirds of the way through the financial year so we've effectively invested in three tranches: November, January and then towards the backend of the financial year. So it's about the phasing of the investment, the net investment ends up being the same number at £150m. And of course we can take the learnings from the initial investments – that's one of the reasons why we did it in a series of tranches so that we can make sure that we make the right choices as we look forward.

And we'll continue to refine our overall pricing strategy as we look forward, because we get knowledge as we make the investments, we can see what's happening to the product volumes and we'll adjust our pricing accordingly. The underlying point that we make however is that our prices have never been sharper relative to our mainstream competition and that's certainly borne out by our internal data and I would suggest it's borne out by the data in the market as well.

John Rogers

And just coming to your working capital point, £300m improvement year-on-year, I mean that's principally driven by creditors and improvements in inventory. So we've moved a lot of the suppliers onto standard terms and continue to do so. We've also moved to a weekly payment cycle, rather than a daily payment cycle, and we've made significant improvements particularly in our non-food inventory position. So that will explain away most of the £300m.

There is an element of timing in there which flatters that number slightly. That will in part reverse as we go through the financial year but net/net we would expect a further small improvement in 15/16. So there'll be a little bit of that reverses through timing but overall we expect to see that position improve year-on-year.

<u>Question 2</u>

Niamh McSherry – Deutsche Bank

Thanks. Just the first question was on rents, you talked about reduced expectation for rental growth and I was wondering what factors you consider when you come to that conclusion and what factors are going to drive the growth of your £500m rental growth going forward?

And then the second question was actually just on property and as a clarification you talked about £150m of proceeds I think next year but you also talk about £200m of profits from mixed use development over two years, so presumably the proceeds will be at least as great as the £200m over two years?

John Rogers

So the first question as I understand was on rental growth and we talked about that explaining away a reduction in the property value. So previously a year ago we were assuming, on average, rental growth of 2% to 3% for the sector overall, as a function of the challenges that the sector's gone through over the last 12 months or so the market has now adjusted that future rental growth expectation and we're now looking at roughly 1% rental growth going forward. So that's clearly a positive thing in terms of managing our cost base but does nonetheless have an impact on our property valuation.

In relation to the comments on proceeds and profits, those two are entirely different and let me just explain to you those two different buckets. There's one bucket which is basically us working through our historical pipeline, our pieces of land that we bought historically that we may no longer need, and that constitutes about £50m of cash sales each year. The profit from that typically will be in the single of millions. So that's just a reflection of working through our pipeline and will deliver that £50m benefit in the financial year.

The £200m profits relates purely to mixed use developments, not due to any divestment of land or parcels of land but due to the mixed use development schemes. That in and of itself will have a cash component, but from an accounting perspective as it happens for both Fulham and Nine Elms, that cash component is spread over three to four years, albeit the profit will fall in 15/16 and 16/17.

So we'll see a cash component to that profit of around £140m - £150m, spread over, and we've had some already in from last year, some this year and some next year and the year after, so it's spread effectively over four years – the cash component. The cash component is about £150-160m albeit it delivers a £200m profit and the reason why the profit is slightly larger than the cash component is because there's a fair value adjustment in relation to our Fulham store. Hopefully that's clear.

Mike Coupe

And the good news is for those of you who live in South West London your Fulham store will be coming towards the backend of May. So good news all round.

Niamh McSherry

Okay and just one follow-up on the rents again. The assumption for 1% growth, are there any stores where rents could actually come down? Is that like an average?

John Rogers

Well unfortunately the way that the property market works, at least currently, so we have two types of rent, those that are what we call an 'open market' valuation basis, OMV basis, and they are upwards only rent reviews. So unfortunately they only move in one direction.

And there's a second type of lease that we have is an RPI-based lease, that's not based on open market values but based on RPI. And typically within the construct of those leases we have a cap – so a floor and a ceiling. And that typically depends on the lease; it could be 1% to 4%. So again we typically expect to see, depends what your views are on future RPI, but we typically expect to see that inflation on those types of leases at the lower end of that range, clearly given where RPI is today.

<u>Question 3</u>

Rob Joyce – Goldman Sachs

I've got a few. Firstly just on the guidance for next year can I just clarify what you're saying in terms of the move in the price investment, is it as simple as £35m additional net price investment this year means we should be looking at £35m off our estimates or is there more to it than that? Do we need to work through a bridge on that?

The second one, in terms of the overall long-term margin you talked about the differentiated product and your advantage retail estate do you feel that you should earn a rent-adjusted margin above the space – like a sustainable margin? And how do we think about that in terms of relative scale advantages, or disadvantages versus certain peers?

And then finally just on the cash side, Capex-wise now at £550m, ex-bank, is that where you see we should be looking at that going forward?

And then just to confirm on the property we've got £50m incoming pretty much annually from the working through the estate and then another £40m/£50m from the Nine Elms, Fulham developments.

John Rogers

So in terms of the price investment guidance I think it is simply, all else being equal, simply what you say which is just a change in the phasing. So the £150m hasn't changed, that's absolutely clear, rather than 75/75 it's now 40/110. And therefore it's effectively, this is a number, all else being equal, looks better by 30-odd. And next year's number would look worse by 35. So it's a straightforward adjustment on that basis reflecting the timing and the phasing of that investment.

In relation to long-term margin can we earn an economic rent above and beyond, based on our differentiated offer? Difficult to say. I mean I think what we're talking about now is we've clearly delivered this year an operating margin of just above 3% and I would suggest that the long-term margin in this sector will centre around 3%. The big debate of course in the industry at the moment is how far does it fall from that 3%, in our case, and how quickly does it recover? And that's the debate of course that we have time and time again.

In terms of our ability to deliver above and beyond that, I think at this stage it's very difficult to say, however we do make the point very, very clearly, and I think this is proving to be the case that price as a point of competitive advantage is being eroded. And that's not saying that price is not important, price is incredibly important but if you look at any of the pricing surveys that have come out over the last six months or so you'll see that the differential between players in the market has got smaller and smaller.

So price as a pointer to competitive advantage is eroded and therefore customers will therefore be able to choose on the other components – they're going to choose on the quality, they're going to choose on the service, on the values etc. etc. And that's something that we believe we operate very strongly on. Whether we'll get an economic return above and beyond, time will tell but certainly we feel that's one of the attractions of our business.

Mike Coupe

And on the scale point, I would argue that whatever scale advantages or disadvantages have been with us for the last 5-10 years, so I don't think the relative scale advantage is any different, if indeed you believe there is a relative scale advantage. Of course the relative scales, particularly with our largest competitor, have narrowed quite significantly in the last period of time, they've got a lot smaller basically and we've basically stayed the same size relatively speaking.

So you can argue the case both ways. I would argue that there are certainly some scale disadvantages given the structure of the marketplace, but clearly there are also some economic scale benefits from being a large player. But the relativity of that scale advantage or disadvantage I would suggest is not dissimilar to what it's been for the last five years. So therefore given that we've managed to broadly speaking outperform the industry for that five year period of time in terms of our relative profitability and our relative sales growth, we would argue that we think we're pretty well positioned for the future.

John Rogers

Capex, again no change to the guidance that we gave at the interim, so around 500-550 going forwards. We will see the shape of that spend change, and increasing component as I said on convenience which we see as being high accretive. We are investing more in our IT infrastructure. Mike made the comments about the benefits, for example, of things like that single sign-on and our interaction with our customers on a digital basis, so we will be making more investments there. We will see the new store component of that Capex come down, but no change to the guidance that we've given historically.

In relation to the property, again I'll just repeat probably what I said, but just to be clear. On disposals we would expect to see broadly speaking £50m per annum coming in over this year and the next years going forward, just on what I would call the BAU disposals, parcels of land that we no longer need. And again in relation to mixed use developments, we've been very, very clear that £200m of profit, about £150m of cash spread over three to four years. So again, very clear on the mixed use developments.

And there of course is a third component of property sales, which is sale and leasebacks. You'll notice in this year we made no sale and leasebacks, and I think going forwards I would never say never but I'm not anticipating making huge sale and leasebacks going forward. There may be the odd one here or there, but I'm not anticipating huge property profits coming through sale and leasebacks.

So hopefully that's very clear on those three components, so £50m on the cash disposals, single million profit, mixed use developments £200m of profit, £150 of cash spread over four years, sale and leasebacks do not foresee significant sale and leasebacks going forward.

<u>Question 4</u>

David McCarthy – HSBC

First of all on depreciation when I look at your Capex you're spending £550m, half of that goes on new stores, logistics, IT and so on. There only seems to be something like £75m – trying to read the chart – that is going on, if you like, refreshing your existing store estate, and that just looks very low and doesn't look long-term sustainable.

So you talk about the shape of your Capex changing in the future, but what's that going to look like because that looks a really low depreciation charge for just keeping your stores, repairs and up-to-date and so on.

Secondly, you talked a fair bit about the discounters, and you've talked about price and you've talked about your own quality, but you didn't include on the chart the improvements or the perceived improvements by consumers around the discounter quality aspect. So if you had input that on the chart, how would the discounters perceive quality appear relative to yourself?

Then finally and relative to all this, you talked about the discounters slowing, which as you know is something we share your views on. But when you embarked on the Netto venture, when that was announced some time ago, we hadn't seen this slowdown in the discounters. So with the benefit of hindsight, would you have still started the Netto experiment given the rapid slowdown in the discounters that's underway?

John Rogers

In relation to your point on refurbishment, if you like maintenance Capex, we're actually very confident that we've got sufficient Capex in our plans going forward to ensure the appropriate maintenance of our estate. We've always had a policy of broadly refreshing and refurbing our stores on a 10 year rolling cycle, and I think actually one year we did show you that chart which showed you when we'd last invested in our estate, and that I hope at the time gave you confidence actually that we've made very good progress in relation to the maintenance and refurbishment of not only our supermarket estate but also our convenience estate.

Actually what we can do is perhaps we'll refresh that chart for you to give you that same confidence. We have this rolling programme which gives us confidence that we're maintaining the estate to the right standards. Indeed, at the end of the day the proof of the pudding is in the eating, and when you talk to our customers and you look at all of our customer metrics from a service level, from a store ambiance perspective, from an availability perspective, our customers are telling us that our store standards are better and better. So that gives us confidence that we are maintaining our estate to the right level.

Mike Coupe

I'm going to give you really woolly answer on the quality because it depends on who you ask. So in the end if you did a survey nationwide you would find that the discounters would be below the big four and significantly below us. But if you did a survey of customers who shop in the discounters then you'd get a very different picture. And customers judge quality on the basis of quite often their current need state, so again it depends on when you're asking somebody. You might ask somebody at Christmas and they'll have a very different view of the world compared with, say, the middle of the summer.

So it depends. But if you were do a nationwide survey of customers you would find that the discounters' quality would still be perceived to be below the big four. But absolutely, if you were to ask discounter customers they would perceive the quality to be extremely good and comparable in some cases with the major multiples.

In the end we believe that Netto gives us optionality. And one of the things that we can't call is what the shape of the market will be in the future, but we are confident that discounters will be a bigger proportion of the market. If we were a future management team looking back at the decisions that this management team made looking at the trends within the industry, if the market ended up being 20% discounters or 25% discounters I think we could be accused of "Why didn't you do something about that given the market dynamics and given the market information?".

So it gives us optionality, it's a relatively low cost chip to play. We'll continue to experiment, but we'll only roll it out if we believe that we can make a sensible commercial return.

Question 5

James Tracey – Redburn Partners

Three questions from me. The first one is what is your attitude towards percentage margin and how important is it to you that this goes up?

The second question is what was the change in gross margin year-on-year in basis points? The third one was, do you have a target for range rationalisation and the percentage of skews that you hope to take out longer-term?

Mike Coupe

Well we would view margins in output not in input, so in simple terms we'll maintain our price position, we'll do everything we can to reduce our cost of goods without undermining the quality of the products and the benchmarks that we set. So the way you framed the question I wouldn't necessarily agree with.

We don't comment on our gross margin, as you know, so you wouldn't expect us to say anything about that. You can draw your own conclusions from the data that we've given you.

I don't think there's a right answer to the question you ask. We have reduced our range by approximately 3%, the number of stocking points that we have in our business. We believe that there's probably a bit more that we can do. But some of the rhetoric around a 30% reduction in range or a 20% reduction in range, we just don't get, because in the end if there is a reason for shopping in a large out of town superstore, fairly high up the list will be the range of products that you can buy in that out of town superstore, and time and time again our customers would say to us that we can buy things in your shops that we can't buy elsewhere, including actually our big four competitors.

If you take an example, our 'Free From' range, gluten-free products, we have a very high market share, probably the order of off the top of my head of around 30%. A very high percentage of those products will be at the tail of our range, and by any measure you would be looking at them very hard. But the fact that you've got a proposition which appeals to a particular group of people, and they tend to be customers at the higher end of the income spectrum and therefore likely to spend more with you, does act as a differentiator. So I have to say, I would suggest that one plays with one's ranges at one's peril. And we believe that through our Nectar database, through our transaction database, that we can do a better job of managing our ranges in the round.

Question 6

Clive Black – Shore Capital

A few little questions. First of all, what do you estimate as your attrition rate for the next two or three years given that you're not going to be opening any superstores and others will be opening against you?

John Rogers

Sorry, what do you mean by attrition rate?

Clive Black

Competitor stores opening against you eating into your sales, as opposed to cannibalisation.

Secondly, where do you get the 15% from in terms of discounter market share, what's the assumptions behind that?

And lastly, do you offer national pricing at the moment and would you aspire to have a breakup of national pricing structures in the UK?

John Rogers

In terms of what we call competitor impacts or attrition rates, as you describe, we'd expect that to be about just below 1% like-for-like. That's actually been consistent over the last four or five years at about 0.7%/0.8% level, which I think is the number I've given in the past, and we don't expect that to change in 15/16 so a similar level.

Mike Coupe

And the 15% market share is based on projecting out the number of stores, the sales densities in those stores, and taking a reasonably balanced view of the market. I'm sure one of the guys can take you through the arithmetic if you're interested. It's a balance of probabilities' number but it is based on the hard facts of how many stores you think are going to be opened over the next period of time.

The other factor that we're thinking about is increasingly you see an element of cannibalisation. Whether it's the traditional German discounters or indeed the high street discounters, it's not unusual to go to a high street now where you've got four or five discounters competing head-to-head and not really competing with us. So that's another factor that over the medium-term will play a role.

We currently run two price files in our business: one for the convenience business; one for the mainstream supermarkets. I would anticipate that will be the case for the future. I think it's really difficult to justify to customers why you'd be charged something different in a given shop in any given geography. And I believe that if that were to be the case that the competition authorities would start to take quite a close interest.

So whilst there wasn't a form of undertaking given to the competition authorities last time around in the competition review, they were certainly heavily implied in the submissions given by all of the major players that national pricing was something that they believed was here to stay.

And customers get convenience; they kind of get why they would pay a little bit more of a premium for convenience shops. But I wouldn't anticipate – we certainly wouldn't be looking at our price files overall.

David Tyler

And just to build on Mike's response on the 15%, at the end of the day it's a bit of a guess as to where the market is going. But it's a top down piece of analysis and a bottom up piece of

analysis; and as Mike said, the bottom up piece is literally working out where they're going to put stores and applying a growth curve to that and coming up with a number.

From a top down perspective we've looked at how you benchmark the European markets; the reality is in the European markets you get a penetration anywhere from 6% to north of 50% if you go to some of the Scandinavian countries. So, the answer is a very broad range.

But if you look at the UK market dynamics, if you look at the property markets, the ability to find new sites, in our view – and it is a bit of a guess as to where the discounters will end up to; if you look at what's happened in France, in Canada where the main players have responded to the discounters on price and have caused their market share to slow – in our view, all that taking into account bottom up, top down, 15% seems a sensible point.

Mike Coupe

I think it's probably just worth reflecting more broadly, when we undertook our business review over the summer, we looked at our entire portfolio and we modelled the market. And it does give us a calibration point that we can keep coming back to just to see whether our inherent assumptions were correct for how the market would play out: whether that's a global view of is it 15% discount, is it 20% odd convenience shops.

But actually more important is actually looking at our own store estate to see whether that's behaving in the way we predicted. Because all of the assumptions we made in our plan were based on a model that we can now refine as we look forward.

<u>Question 7</u>

Andrew Gwynn – UBS

Just a quick question from me, and it's quite an out there question maybe but a long view on the balance sheet and cash generation, what sort of timescale do you think you move away from cash preservation mode, shoring up the balance sheet, towards maybe building a dividend or even buying back shares? Where should we think about your long view on the strategy? Maybe even a question for David, perhaps.

John Rogers

I'll take it, and if David wants to add any colour to it that's fine.

It's a very difficult question to answer because fundamentally it refers back to this point about, if the margin is 3% long-term position, when the interim returns to that level of margin on average. But what I can say is if we stick with our current strategy that we have at the moment, and the market evolves in the way that we've outlined – and we've given pretty clear indication of how the market could evolve – then we would expect to see our net debt number, all else being equal, come down year-on-year and, if you like, accelerate in the way it comes down in year three to five of our plan. So, in our sense the options you've outlined may present themselves in years three, four and five.

However, I would heavily caveat the answer to that question on the grounds that today we're in a market where there's a huge degree of uncertainty. And that uncertainty is reflected indeed in the variability of our consensus numbers for next year, which are somewhere between low 400s to mid-600s. And that reflects the uncertainty in the market, given the uncertainty around pricing. And all of those things clearly impact on your question as to

when we'll get to those; what's the long-term view. So, giving any long-term view at the moment on this market is fraught with jeopardy.

But if things transpire as we have outlined then I see the ability of this business to generate cash and pay down debt being a good position over the five years of our plan.

Mike Coupe

And then we'll be into a different conversation about, as you say, where you allocate the funds. In effect we have foregone some accretive investments, particularly store extensions, in order to maintain our cash position. And clearly in the future those opportunities may well give us the opportunity to invest in the future. But I'm sure John and I will have some fairly healthy conversations around as and when and <u>if</u> that time arises.

<u>Question 8</u>

Charlie Storey – Macquarie

Three from me please. You mentioned you're confident you'll recover the £150m price investment over the next couple of years, in the same breath as talking about reducing the amount of water in your washing softener. Just to clarify what you mean by recovering this £150m; is it in addition to the £500m cost savings you've talked about or is this from an uptick in volumes?

Which relates to my second question: you mentioned £40m offset to price investments this year from increased sales. On my maths that's about a 0.5% uptick in like-for-like next year because of your price investments. Is that just the cost of doing business? Do you see that offsetting deflation in the market and competitors? Or is that incremental potential like-for-like? Or does that allow you a steady state environment?

Lastly, you referenced a price gap chart there that's in the market. What do you think your price gap is versus the main competitors and versus the discounters as well? If you can't give an absolute, direction would be very helpful.

Mike Coupe

I'll go for the first and the third, I think, and I'll let John reflect on the second so he can get his head around the mechanics of the answer.

I did say very clearly in November that we would anticipate recovering the £150m of price investment in our cost of goods, and we're working with our suppliers to do that. And we're doing a lot of work by looking at the value chains that supply our products. I've given you two small examples: 37 lorries off the road is not £150m. But we're doing some very interesting work that we wouldn't want to disclose at this point in time looking at our value chains and working with our supply base.

We believe that we have the unique knowledge. We've been working on a business model for a number of years which allows us to reach to our supply chains right the way through, and in some cases to their primary agricultural end of the supply chain, so the farmer groups. And we believe that unique knowledge gives us the opportunity of lowering our cost of goods in a way that will give us a source of competitive advantage – without going into too much detail.

So, yes you could argue the couple of cases I gave are at a relatively low level, but we believe that we will recover. And we're more confident than ever that we'll recover the £150m of price investment in a differentiated way, which is a critical point: it's a zero sum, gain, you have to be able to do it in a way that other people can't replicate and that's the point.

John Rogers

Your maths is correct, all else being equal. But the reality is all else being equal; this is not a static environment: we're living in a world of deflation of -2.5%; we're living in a world of responding to price as we are responding to price. So, actually it's in the mix, but it's in the mix of a whole bunch of factors that we all have to get our heads round in terms of where like-for-likes will land throughout this new financial year.

But all else being equal, you're right: the maths says the benefits of the price investment that we're making gives us a 0.5% or so like-for-like volume uplift. But then you've got to adjust for the price investment. Competition may respond, which in and of itself impacts on the volumes. So, it's very difficult to unpick it in the way you describe.

That's probably as full an answer as we can give at this point.

Charlie Storey

That £40m doesn't include any of the cost savings in loss of business?

John Rogers

Absolutely correct – to be clear. And just to avoid doubt, because you also asked the question about the £150m, you asked whether that was anything to do with the £500m, and that's clearly a separate pool of savings as well.

Mike Coupe

And I'll give you the same woolly answer I gave to Dave earlier on. There are many ways you can make price surveys: there are lots of independent surveys; there are lots of internal measures. If we took our own internal measures, which of course are based on our volumes and our view of the market; not on other people's volumes. One of the things about price surveys is that everybody can be right; everybody can claim price leadership because they look at it through their own lens. And that's one of the important considerations when you listen to other people talking about these things. But relatively speaking we believe year-on-year we believe we've improved our prices relative to Tesco by, say, the order of 1%. Broadly speaking they're at parity. And I think that's played out in the market data more widely.

Broadly speaking we think we're about 2% better relative to Asda in the round, that order of magnitude. And broadly speaking we reckon we're between 6% to 8% better relative to the discounters. And that's because their focus of investment has been quite a lot of the frontline commodities like milk, bread, eggs, butter etc. So, although there are price gaps the price gaps have dropped quite dramatically. If you take milk as an example: the price gaps is 16% lower than it was this time last year – just one example of an extremely high volume skew. So, that would give you some idea of the relativity.

But also our own data would say against every single competitor, every single competitor, today our prices are better than they were a year ago.

Question 9

James Anstead – Barclays Capital

Just two quick ones. You said in the press release this morning that the sales density of the convenience stores have been depressed somewhat by the newer ones that have been opened. I know in the past you've talked about the likelihood that over time the very good returns from the convenience estate would probably start to converge with the main estate. I just wondered if you think that process has now started with these lower densities from the newer stores?

Secondly, the £200m property profits from the mixed use schemes over the next two years seem very attractive. But I guess Fulham, Nine Elms and Whitechapel, given either very high value locations or transport projects, are slightly atypical. Is that anywhere near a sustainable number going forward? Can you give us any more colour there about what we might expect over a five/ten year view?

John Rogers

Just in relation to convenience stores, the reality is that of course the newer stores are on a build-up; like any new store, whether it's a supermarket or convenience, it does go on a build-up curve. It's slightly quicker for convenience than it would be for supermarkets; but as you add new stores clearly they're on that build up. Therefore, all else being equal, they do dilute the trading intensity slightly. But we would expect that to normalise over time.

Also where we're opening stores versus the costs of opening stores I think we're now, if you look at the mix, there's probably on average a tendency for more sort of suburb/neighbourhood type stores, which typically, as opposed to, say, located to transport links or high density cities. So, the tendency for those stores is they would deliver a slightly lower trading intensity; but of course from a capital perspective and a rental perspective they are better, and therefore we expect to deliver the same returns from those. So, there are two factors that play there in explaining it away.

In relation to the property profits, as much as I would like to think we had £200m property profits every other couple of years in this business, the reality is you're right. I mean, we've talked about two schemes here, which are the Central London schemes. Unfortunately we don't have tens and tens of those opportunities going forward. But we do have a handful; we have probably got up to five to ten schemes or so in our property portfolio that have the opportunity to deliver significant property value profits over time.

A good example of that is we've just put in for planning for an extension at our Whitechapel store. Again, huge amounts of development going on in that area. And that has the opportunity to unlock significant property profits. Our Ladbroke Grove store is another store where we've been looking for the opportunity to unlock profits going forward.

So, there are a handful. But I wouldn't want to suggest for one moment that is something you'd expect to see year-on-year on year. And let's also be clear that these schemes are a long time in the making. We first kicked off, if you like, the Nine Elms store opportunity when I was Property Director seven-odd years ago. So, that gives you an indication of the timeframe it takes to get these to fruition.

Question 10

Caroline Gulliver – Jeffries

Just one quick question from me. Could you comment on the bonus accrual for this year in the light of the PBT 4, perhaps in terms of year-on-year movement? And I ask because we're interested to know what sort of flex there is as we go into probably another difficult year of trading.

Mike Coupe

So last year was 80; this year is 55.

David Tyler

Thank you very much.