J Sainsbury plc

First Quarter Trading Statement

Wednesday 10th June 2015, 08:30 BST

Mike Coupe – Chief Executive

Good morning everyone and welcome to the Quarter 1 Sainsbury's conference call. It's Mike Coupe speaking and I'm joined by John Rogers, our CFO. John will begin by giving a very brief summary and then we'll open up to questions. John.

John Rogers – Chief Financial Officer

Good morning everyone. So I'll draw your attention to the key figure of like-for-like Retail sales down 2.1% in line with consensus. The market continues to be impacted by strong levels of food price deflation and a tough pricing environment. We, of course, outlined in November some key actions that we were taking as part of our strategy going forward, so, for example, £150m of price investment, the investment in quality of over 3,000 SKUs, and, of course, investment in our store service levels.

I'm pleased to say actually last night we won the *Grocer 33* Annual Awards for Service and Availability, so a great positive external endorsement of our store standards. So as a result of our strategy we're starting to see some encouraging early trends in our key trading and operating metrics.

With that, I'll hand over to Q&A.

Question and Answer session

Question 1

Bruno Monteyne – Sanford Bernstein

Good morning John and Mike, a few questions.

You were talking about volumes of 1% to 2% growth, I think, just in the press conversation you had, with the overall like-for-like you've managed -2.1% so are you really talking that you've seen your internal price deflation therefore -3% to -4%? Do I see that correctly?

The second question is on convenience, clearly a slowdown; I think you've got about 11% slowing down. Is that because of the availability of space and that it's just harder to find the sites that are giving you the higher returns, or are there any other explanations?

And the third one is on, given the growth you have in general merchandising, clothing, what kind of margin table do you expect this year from these kind of segments still rapidly growing versus the rest of your food business? Thank you.

John Rogers

So in terms of the volume question, we're seeing sort of volume growth of 1%-2% across the entire business, so the like-for-like level, I'd say volumes that are broadly flat. We've seen price deflation roughly between -2% and -2.5% for the quarter. So we talked about, in Q4, an exit deflation of about -2.5%, and it's come off slightly, probably -2%, -2.5% for this quarter, so hopefully that answers your first question on volume and deflation.

In relation to convenience, I think it's just circumstance. I mean it is getting tougher to find the right sites, and I've said for some time that as competition in this market place hots up, then returns will come under pressure on new sites, and we just simply won't play the game of accepting lower returns, and so by definition, that means it will be tougher to find the sites that we're looking for.

We still believe we're on track to open the one to two stores per week that we talked about at our prelims, so we're comfortable with the rate of progress. It just so happens that for Q1 it was a relatively slow start to the year but we've got a very good pipeline, so, for example, last week we opened five new convenience stores, this week we'll open two, so we're pretty comfortable with the guidance that we gave at the prelims.

And I think the last question was on margin, what would be the impact of clothing growth and GM growth be on margin? I mean I wouldn't want to say at this point and obviously it's a trading statement so we won't comment on profit and profit measures, but we can provide a bit more colour on these things, of course, at our interims.

Mike Coupe

Yeah, I would have thought the effect on the sales mix would be pretty negligible even with reasonably substantial growth rates.

<u>Question 2</u>

Arnaud Joly – Societe Generale

Good morning all, I have three questions.

The first one on your price investment. Where will you cut prices in priority for this year and what is the volume trend on products whose prices are cut?

The second question, you mentioned a 6% sales growth online for this quarter and can you remind us what was the trend in Q4 of last year?

And the last question on the hard discounters. I would like to have your view on the slowdown of sales growth for hard discounters over the last few months. In your view, it is mainly driven by, I would say, a less ambitious store opening programme, and you mentioned stronger difficulties to find good locations for Convenience. Or is it linked to early signs of cannibalisation or linked to the traditional players' reaction? If you can give us your feeling on this slowdown of sales growth for hard discounters. Thanks.

Mike Coupe

On the second one, broadly speaking, it's a continuation of the trend that we saw in the first quarter. I think, actually, the numbers, the volumes are up very, very slightly.

John Rogers

It's a slightly better performance this quarter than last quarter, but not by much.

Mike Coupe

As far as the price investments are concerned, we talked in our prelim statement around a 6% volume increase on the lines where we've made the price investments, so roughly 1,100 lines. We've already talked about the fact that we're also seeing volume increases more generally across the business, which we are pleased with. And we won't talk specifically about our headline pricing strategy. However, we will talk about the fact that we would match our competitors toe-to-toe. Of course, there's a basket of competitors to look at, so not everybody behaves in the same way, but we will maintain our overall price position, we're comfortable where we are, and we certainly know our prices are sharper year-on-year, and we'll maintain that relative position going forward.

So we'll look at what others do, and there are certainly lots of ups and downs in the marketplace at the moment, like there always are, and we will continue to make sure that we do the right things for our customers.

As far as the hard discounters are concerned, I mean it's a matter of fact, in terms of the reported data, that we've seen a slowdown, and I suspect all of the underlying reasons play for the question that you've asked, so the combination of overtrading in existing stores. Actually in terms of rate of store openings, I'm not sure we're seeing a significant slowdown, so they still open lots of stores, but there has also been a significant closing down in the relative price gaps. So if you're looking at price differentials of maybe 20% - 25% a year ago, those differentials have come down, we reckon, in our business by about 10% year-on-year on the products that we stock, which the discounters stock, and I suspect there's a little bit more to go.

John Rogers

Yeah, I think there's evidence and if you look at the trend that happened a couple of years ago of customers basically deciding to effectively split their shop, so becoming more promiscuous and doing a shop at the discounters and then topping up at Sainsbury's or, frankly, any other supermarket, that behaviour was principally driven, we think, by the pricing differential that the discounters had at that time. So we talk about this time/value arbitrage, and it's a bit of a convoluted description, but the idea is that it makes sense for customers to split their shop because of the relative pricing differential between the supermarket sector and the discounters.

Now that pricing differential has reduced, I think customers are now just reconsidering that decision and perhaps, for some customers at least, customers are deciding, 'Look, actually it's more convenient and it's easier if I get all my shop under one roof.' That's clearly something that they can't do at discounters and, therefore, there may be some customers starting to revert back to previous behaviour. I think it's too early to call just yet but there's some evidence of that's the case.

And I think what will be interesting over time, in our view, that that pricing differential versus the discounters will close further over time, so if it's 10%-15% today, we suspect that the supermarket sector will close that differential to maybe 5%-10% going forwards, leading to perhaps a further continuation of the trends that we're starting to see over the last few months or so with the discounter growth slowing down.

Mike Coupe

And if you unpick the numbers a little bit, we referred to it on the press call, John referred to it, we've seen a long-term decline in the size of the basket in larger supermarkets, and actually we've seen that flatten out over the last quarter, which you could argue is perhaps an early indicator, albeit only one quarter, so it's never good to call a trend on the basis of one data point, but nevertheless, that's something that appears to be going on, that sort of flattening out of the underlying decline in basket size, which is a good indicator as far as our supermarket business is concerned.

Question 3

Rob Joyce – Goldman Sachs

Morning guys, a couple from me.

Just quickly, on that volume number and the comment you just made there, Mike, on the basket, in terms of how do we think about this longer term? If you're investing 2%-2.5% in price, would we not expect to see some kind of volume response just on an elasticity basis? I'm not sure how we should think about that and if you could give us some colour on that, that would be great?

And the second one is just on the discounter comment you made there, John. Why would the price gap close to 5%-10% and have we seen any response from the discounters yet on the lines where you've closed that gap? Thanks very much.

John Rogers

If I pick up the discounter comment:

Look, there's a lot of uncertainty in this market and therefore trying to project anything going forward needs to be covered by caveats! But I think what we'll see over the next period of time is an investment in price, in those products that the discounters sell, by the supermarket sector. So if you look at, for example, some of Asda's recent announcements in relation to where they're targeting price investments, they tend to be targeted at those products that the discounters are selling, and I think we will see that trend continue over the coming months. So we'll see what is today perhaps a 10%-15% pricing differential come down to 5%-10% over time.

Now our personal view is I don't think that will be a net-net price investment by the supermarket sector, we think that the vast majority of that margin investment will be recovered in those products that the discounters don't sell. And to be fair, we are seeing already some evidence of that in the market to date. So when our competitors talk about price investment, there's often also price increases in other products across the portfolio where margin is being recovered. We're seeing reasonably positive margins, for example, on fuel today.

So, so far in this market, what we're seeing is a targeted investment versus the discounters, an element of what we might describe as rationality across the rest of the portfolio. That reduced price differential versus the discounters, I think, will contribute to the continued slowdown of the discounters, but they could respond, so we have to be very wary of that and it remains a very, very tough market.

But we would characterise the market today as being quite rational and it's entirely sensible for the supermarket sector, as a whole, to be investing in its price position versus the discounters. We would argue that actually in terms of the pricing environment today, the pricing position between the respective supermarkets, certainly, for the last couple of months, has been relatively stable. That could change overnight, of course, and we're very mindful of that, but at the moment it seems to be that most price investment seems to be targeted at the discounters.

Mike Coupe

And on volume, we are seeing in the market more generally some levels of volume growth, and we've seen that now for the last six months, and that's against a backdrop for the last, broadly speaking, five years, where volumes have either been flat or declining, despite the fact that there's actually a growing population. So I think there are some signs to your point of volume elasticity in the marketplace but, of course, to some extent that's offset by the sort of eating out versus eating in trend, which we see when customers have a little bit more money in their pockets.

So there is an ongoing trend that shows some signs of life in terms of volume and we will see, at some point, the deflationary cycle annualise and I suspect we'll see positive inflation, certainly by this time next year.

Rob Joyce

I guess my question, Mike, just very quickly, do you think volume is a response to the fact that you're just charging people less, and does that mean it potentially goes away when inflation comes back, because I guess the reason you haven't seen volume for the last five years is because the industry has been passing through a lot of inflation to people, that would be one of the reasons that you could conclude from that? Are there any thoughts on that, on how we think about that?

Mike Coupe

Yeah, I would argue that if you went back five or six years ago, the response of customers is entirely rational, that they had their income squeezed and that they started to, in effect, waste less, they used the inventory in their cupboards, they shopped more frequently, and when they shopped they tended to buy less and consequently waste less.

It's quite unusual, if you look at the industry over a decade, that broadly speaking volumes grow in line with population growth, and what we're seeing is a return to that trend. So it's really difficult to unpick the elasticity as you put it. There is no doubt if you look at our business where we have made price investments we've seen a more buoyant volume response, a higher volume response than where we haven't made price investments, but nevertheless across our entire business we're seeing volume growth. I suspect it's very difficult to unpick because the other variable is customer disposable income and we are seeing a rise in that, and if that trend continues I suspect the volume trend will continue as well.

<u>Question 4</u>

Edouard Aubin – Morgan Stanley

Just two quick ones for me. You mention in the release that reduced promotional participation helps you reduce waste. Was this reduction in waste above your budget, and how material could it be to your margin this year?

And we had adverse weather this year in the UK during Q1, so to what extent did that impact your non-food sales this quarter?

John Rogers

So on the margin question, obviously a very astute question but obviously not going to respond to our relative positioning vis-à-vis waste and budget, other than to say that we've absolutely seen the correlation between our reduced promotional participation, which is now around 30% from highs of perhaps close to 40%. So we've seen over time significant reduction in our promotional participation as a result of the pricing changes that we've made. We think that's a very positive sign, we've worked very closely with our suppliers to get to that position, and we think at the moment that is industry leading in terms of that relative movement, so we're very pleased with that performance. That has very much resulted in reduced waste in our stores, again as a result of us moving out of the supply chain.

Edouard Aubin

Was it a positive surprise or was it expected, the waste reduction?

John Rogers

I think we'll just say at this point, Edouard, that we're pleased with the performance. We're pleased with the results that we've seen in terms of that reduction in waste.

Mike Coupe

Not only a reduction in waste, but also improvements in availability, which is the other part of the equation. It sounds a bit like you're making excuses when you start talking about the weather, but we had already had the warmest week of the year this time last year. So there were certainly some seasonal weather effects in the quarter. Perhaps the other two kind of slight headwinds were the timing of Easter, particularly around the timing of Mother's Day, and also this time last year, for those that remember it, there was a very brief World Cup campaign and that had some influence on the backend of the quarter when it came to big ticket electricals and things like that. So there's a few underlying factors in the numbers at which are probably on balance unhelpful, but as I say, blaming the weather is the last refuge of scoundrel so we won't do that this time!

<u>Question 5</u>

James Grzinic – Jefferies International

I just have a quick one really. Can you perhaps put into context the promotional reduction for the rest of the grocers, that 40%-30% you've travelled, where is it for the industry as a whole?

And perhaps another quick one on Nectar, can you perhaps talk through seems to be quite a smooth transition to having those Nectar Points? Is it fair to assume that it's been smooth?

Mike Coupe

Yeah we're just trying to find some statistics. I suspect if you looked at the headline promotional participation for the industry it's probably flat year-on-year if not slightly increasing. I'm just looking at a graph.

John Rogers

You can look at the Kantar data, it's there in terms of spend on deal, you can definitely see a reduction in our promotional participation over the last couple of periods. For the rest of the sector, just eyeballing the data, it does look as though it is relatively flat for most of the supermarket peers. There are some ups and downs within that, but you'll see that yourself, you can get that from the Kantar data. So we see our particular move, as you say from a longer-term trend of around just below the 40% participation level to just north of the 30% participation level, as being a very positive sign.

Mike Coupe

And yes, you're right in your observation, we've made a very smooth transition. We've made sure that we gave our customers plenty of notice of the change, and actually we're giving away as many Nectar Points but in different ways, so we're true to what we said we would do. So our customers are still seeing Nectar Points coming through in similar quantities to what they were before but in different ways. So for instance, we ran a large-scale fuel promotion using Nectar Points in the early part of the quarter. We've seen no change in customer behaviour.

<u>Question 6</u>

Stewart McGuire – Credit Suisse

I was wondering if you could give us a little bit of colour on your promotional or your price investment activities between formats. For instance, the same item that's in a Sainsbury's Local versus a supermarket, what kind of investment are you putting into that particular item and are we seeing any relative difference in that investment?

John Rogers

I think the pricing differential between our convenience format and our supermarket format has always sat at around 4%-5% differential, and in fact that differential has maintained itself, if you like, over the last 3-6 months. So whilst we've been making the price investments that we've made in our supermarket sector, we've made the corresponding price investments in our convenience estate, such that the differential between the two has broadly remained the same.

<u>Question 7</u>

John Kershaw – Exane

Obviously a lot of them have been asked already. Encouraging to hear that you're seeing some sort of stabilisation in basket in the core stores, but what's happening to overall volume trends there, because clearly with the shift away from the core store that has been negative? So if you can talk through the shape of volume trends or traffic trends, obviously the blend of the two, that would be helpful?

And then more broadly just in terms of customer trust and managing price architectures. I understand it makes economic sense to be sharp on the products that the discounters sell and less so on the ones that they don't, but obviously there's quite a lot of lines of substitution in product and in the end they sell the volume lines. So can you really effectively do a net no investment and close the price gap to the discounters by 5-10 percentage points? I suppose that's a bigger picture question, is that really feasible or will it require more margin investment?

John Rogers

Just to pick up on the volume pieces. As I've already said, the items per basket historically have been going backwards, reflecting the trends that we've talked about many times over the last 18 months or so. In the quarter we did see those items per basket stabilise, so broadly flat in the quarter. As Mike highlighted on our previous wires' call actually, it's one quarter so we wouldn't want to call any turn in the market just yet. It's a very volatile market, there's lot of uncertainty in this market going forwards, but it may be the early sign of a change in trends.

In terms of your specific question on volume trends, volume trends again are moving in right direction, so continue to be negative in the supermarket estate, as they have been for some time vis-à-vis all the calls that we've had over the last 18 months or so, but they are in line with the stabilisation in the basket size, those volume trends are moving in the right direction again. So perhaps early signs of a change in shape of the market, but too early to tell at this stage.

Mike Coupe

And at the heart of the value simplicity philosophy that we've talked about a lot, is to make sure that we maintain what customers would view as the right hierarchies so that we make sure that we have the right good-better-best pricing architecture, and we're very conscious of that.

But we're also learning as we're going along, so we're experimenting all the time with the balance between promotions, pricing architecture within individual categories, and they do respond in slightly different ways.

But our underlying sort of headline analysis, in answer to the balancing of margins' question, is that ultimately the market will behave rationally, and that would mean investing in the prices which directly impact on the discounters, and to a large extent that is what we're seeing in the marketplace.

That's what we've seen in the last year. Although we didn't do it specifically, the 1,100 products that we invested in price broadly speaking overlapped quite heavily with the products that were stocked by the discounters, and we would expect over time that there will be a rebalancing.

Now, how that happens and when it happens time will tell, but that's what we believe to be a sensible and rational response to the competitive environment. And indeed, if you look at what's happened in other countries, that's tended to be where the market's got to. So I suspect that will happen over time, but we think it will happen.

John Kershaw

One follow up. I remember asking you, or you saying that you had to tread very carefully in detoxing from promotions. A drop from 40% to 30% is an absolute gallop. So have you surprised yourselves, or did you misspeak or I mishear you before? Because I find it extraordinary to have such a degree of reduction in a relatively smooth transition versus the market.

John Rogers

Just to be clear, John, when I talk about that drop from 40% to 30%, I am talking about from the high to the low, and that's over a period of a year or so, I'm not talking about in the last quarter. We've been talking about this trend now for some time in relation to ...

John Kershaw

I appreciate that. It's a three or four year trend you were referring to.

Mike Coupe

Absolutely. I think when we first spoke about it you're probably talking about three or four years ago, so the very first work that we did on value simplicity was in a very limited number of categories, and as we've learnt we've got more confident. We've now got something like 80% of our volume now working within the value simplicity rule that we have established.

Every category is unique so the reality is that you learn as you go along, but you can surmise from what we've said and the degree of change in our business over the last year, that we have more confidence in that underlying strategy rather than less confidence, so we certainly have been, and aggressive is probably too strong a way of putting of it, but we've certainly been rolling out reasonably quickly across the business.

And actually, just one bit of colour, the categories where we have been using value simplicity for the longest are actually the best performing categories within our business. So that's one of the things that gives us confidence. It's just not a short-term trend, it's actually a long-term trend. And it makes a huge difference to the operational metrics of the business, which we've also talked about, so our service, our availability, and indeed our underlying waste have all improved pretty significantly.

<u>Question 8</u>

James Anstead – Barclays Capital

Good morning everyone, I only really had one question and John pretty much answered it, but just to follow up on one point. Roughly what proportion of your grocery volume would you say can be bought effectively substitutable from a discounter? What proportion is kind of unique to you or the larger retailers, and what proportion can be substituted quite easily?

Mike Coupe

We reckon it's roughly 20/80. So in terms of SKUs that we carry, not necessarily the volumes but the SKUs that we carry, it's roughly 20%/80%. Of course it's notoriously difficult to match the products, so you could have a very long argument about exactly which part of our range we should match the discounters, whether it should be our Basics' range or our standard Own Label. But nevertheless, on a product-for-product basis as far as you can go, we reckon it's about 20% of the overall mix.

James Anstead

Okay. But presumably much higher from a volume perspective?

Mike Coupe

Yeah, not much higher but a bit higher.

<u>Question 9</u>

Xavier Le Mené – Bank of America

Good morning. Two questions if I may actually. The first one, you mention a pretty quiet market, I will say, you have been actually losing a bit of market share in the recent period. So can you give us a bit of colour of who you’re losing to and who potentially you're winning to, market share?

And the second one, just also back to your comment on competition within the big four, which is pretty quiet, as you said, but can change in one night. What are your expectations there, or in other words are you pretty in line with what you were expecting, or were you expecting a tougher competition actually in Q1?

Mike Coupe

Yeah I mean we’ve lost a tiny bit of market share, it’s pretty marginal actually, it’s a slightly improving trend quarter-on-quarter. I don’t think we would historically comment on the relative position of our competitors, you can read it in the Kantar data and you can draw your own conclusions. I would just suggest that there’s a continuation of the trends that we’ve seen historically. But as I say, you can pick through the data.

John Rogers

I think to Mike’s point on the Kantar data, the Kantar data shows us flat year-on-year in terms of market share, so I’m not quite sure where you get your market share reduction from.

In relation to comments on competition Mike says we’re not going to go into details but I think what we would say and we have said this is that when we set out our strategy back in November we had a clear view as to how the market was going to evolve and indeed we outlined some of that when we talked you through the relative market share movements across the different channels.

What we’ve seen over the last few months or so is basically the market evolving pretty much as we expected it to, so in line with our plans. And indeed in terms of our strategic execution we would say that we’re slightly ahead of the curve compared to where we thought we would be.

So the market, if anything, has perhaps been a little bit more benign than we would have expected – I hate using that word in the context of the food retailing sector because it’s anything but benign – but it’s probably been a little bit better than we would have expected and our progress against our strategic plan has been a little bit better than we would have expected.

But I would just highlight that this is a very, very tough competitive market. As you highlighted it changes overnight, there continues to be lots of uncertainty. It is entirely possible that there could be more price investment to come. The point that we would make is we’re absolutely ready for that. Our price position has never been better. We will compete toe-to-toe in this market.

We’ve set the business up, we’ve conserved cash in a way that allows us to do that so we’re confident we can compete in this market whatever the market should choose to throw at us but as we sit here today we're slightly ahead of the curve against our strategic plans and the market probably if anything is a little bit better than perhaps we might have expected.

Question 10

Sreedhar Mahamkali – Macquarie Securities Group

Good morning all. Just a couple of questions. One was actually followed from James' question earlier on, I don't know if you answered but I might have missed it, what is the industry level of participation at this time in terms of promotional participation? You mentioned lower 30s for you, just above 30 I think you said, where is the industry now John?

John Rogers

I think it's difficult to say, I'm actually eyeballing the Kantar data and I don't have the actual average number but it looks like it's about 35, 36 or something of that level if you looked across the board but if you like I'll get Duncan to do the maths and actually work out the average and we can get that to you.

Mike Coupe

Mid to high 30s I think.

Sreedhar Mahamkali

Okay the second one is again, and apologies if I missed it, did you mention a particular deflation number or a range for deflation in the quarter within the like-for-like? Sorry if I missed it.

John Roger

Yeah I said that earlier on in the call it's between -2% and -2.5% for this quarter. So we said for the Q4 that we were exiting at about deflation levels of -2.5%, we've seen across the quarter deflation land at between -2% and -2.5%.

Sreedhar Mahamkali

And the key categories driving this John and to what extent it's driven by fresh and perishables and so on?

John Rogers

Hugely weighted towards fresh and produce, we've seen big deflation across those areas and of course that's part of the market that we typically over-index and so we've seen a lot in the chilled and the produce segments, the meat, fish and poultry, we've seen significant deflation across those areas.

Mike Coupe

The fresher the product the higher the deflation basically.

Sreedhar Mahamkali

And what sort of deflation are we talking, 10%, 15%, 20% deflation in some of these areas?

John Rogers

I wouldn't go that high, to give you a bit of a broad range 5% to 10% deflation across some of our fresh categories.

Sreedhar Mahamkali

And this is one where you have a reasonable amount of visibility how quickly can this sort itself out? Do you have any views here?

Mike Coupe

It’s largely driven by Northern hemisphere harvests, well there’s three factors, exchange rates, which your guess is as good as mine; there's the effect of Russia closing its borders to Western imports, so that’s brought product back into Western Europe that would have been going East; and thirdly the most significant factor will be the effect of Northern hemisphere harvests and until we know what they look like, which we won't really know until the back end of the summer, it will be really difficult to call.

We've said on balance we think that it will annualise towards the back end of this calendar year and into next year and so if you were trying to make an intelligent guess you would be saying that perhaps we’ll go through zero at some point in the early part of the next calendar year but it will be that, it wouldn’t be based on any kind of hard facts as we sit here today.

Closing Comments – Mike Coupe

I think we’ve run out of questions so thank you very much to everybody and we’ll see you actually at the back end of the summer I think so look forward to our Quarter 2 trading statement in September.