J Sainsbury plc

Third Quarter Trading Statement 2015-16

Wednesday 13 January 2016

Mike Coupe, Chief Executive

Good morning everybody and Happy New Year, and thank you for joining us this morning. I'm joined by our CFO, as usual, John Rogers, and we're here today to talk about our Quarter 3 results and trading over the Christmas period. But we'd also like to take this opportunity to update you following the announcement we made last week regarding a possible offer for the Home Retail Group plc.

So I hope that you have received our normal Quarter 3 Trading Statement by email or online this morning, and also if you refer to our website, if you haven't seen it already, there is a copy of a presentation relating to the possible offer for the Home Retail Group plc. So you can find that on our Investor website, j-sainsburys.co.uk. If you haven't been able to reference, as I say, by email, then you can move through to our website.

After we've run through the update we'll take questions. We have extended the time today, we imagine there will be quite a few questions, we've allowed 90 minutes for questions, the presentation will take about 15 to 20 minutes. John will talk through our Quarter 3 Trading Statement, and then I will take you through the presentation regarding the Home Retail Group.

So John, over to you.

John Rogers, Chief Financial Officer

Morning everyone. Thanks Mike. So I'll just take you through the highlights of the Trading Statement. We traded well this quarter in what was clearly a highly competitive market. Like-for-like ex-fuel sales down 0.4% represented a beat to the consensus, and of course we're the only big four supermarket to grow our market share in the quarter.

Like-for-like transactions and volumes both increased year-on-year and we delivered a number of records during the quarter. We broke through the 30 million mark for customer transactions in the week before Christmas, that was up 2.6% on the prior year; our convenience business saw its biggest ever Christmas Eve; and we delivered a record week in groceries online delivering over 289,000 orders.

Of course finally, we were delighted with the success of our Christmas advert 'Mog the cat', it attracted nearly 37 million online views, and the campaign enabled us and our partners to donate over £1.5m to a very worthwhile cause in Save the Children. So that really covers very quickly the headlines.

I'll hand over back to Mike now to talk you through the Home Retail Group presentation.

Mike Coupe

So I'll be referring to the presentation, as I've already said, which has been posted online, and I will endeavour to remember the slide numbers as we go through. The first couple of slides are actually a preamble and disclaimer so if I move to Slide 3 this just reiterates the fact that we made a statement on 5 January that we'd made an approach to Home Retail Group during the course of November and made an offer in the form of shares and cash, and that we're currently considering our position, and that we have a deadline, which is 2nd February, put up or shut up deadline, and of course this may be extended by mutual consent but there is no certainty that this transaction, that any formal offer will actually happen. So I just wanted to reiterate that point up front.

But if I then talk on Slide 4 a little bit more about how customers are changing. And the main rationale for this deal is to accept and understand that our customers are changing very rapidly. Their expectations are changing very rapidly. Our customers, particularly through the use of mobile phones, through digital technology, have very different expectations for a retailer like Sainsbury's over the next period of time.

And I can characterise this by thinking about my mother and my daughter. My mother is 78 years old, she lives in rural Sussex, she sees grocery shopping as a social experience, she visits the shops pretty frequently, she buys relatively small amounts of grocery and she likes to talk to lots of people when she does this. If I characterise my daughter, she uses her iPhone, her mobile phone, as a remote control shopping device, and she lives her life through her mobile phone, and she characterises the market that we're seeing develop over the next period of time.

The use of digital technology and the fact that a large number of transactions are precursored by somebody looking online, and ultimately even if they're buying in a shop researching the products that they're buying online. And we know through the sort of virtuous circle that we have in our business that our food business fuels our non-food business, and indeed the growth of our non-food has allowed us to sell more groceries as well, so that we know there's an iterate effect, there's a benefit, of offering more products and services, and that leading to greater loyalty.

So if I then characterise that in terms of our overall strategic plan, the next slide, which is Slide 5, shows the strategy that we outlined in November of 2014, and to a large extent this is actually a reiteration of many of things that Sainsbury's has been famous for over generations. At the heart of the strategy it's selling great products at fair prices, and that's been the case throughout our 147 year history. But of course the kinds of products we are selling has changed quite significantly over the last period of time. We have a very successful clothing business, we have a very successful general merchandise business, and indeed the purchase of the other half of the Bank has enabled us and will enable us to develop our financial services' business over the next period of time. So again, you can see how our business has developed to make sure that we are offering our customers a wider range of products and services.

But at the heart of our strategy was also the idea of being there for our customers, and we made that a very overt change because as we look forward our customers will expect us to deliver to them as and when they want. We use the words ‘whenever’ and ‘wherever’ they want. Whether it's in a big shop, whether it's in a small shop, whether it's online, and indeed whether that online offer is either delivered to people's homes or, increasing actually, through Click & Collect. So it's important to remember that around 50% of non-food transactions online are actually Click & Collect transactions.

And that's reflected in the shape of our business. So when I joined Sainsbury's in 2004 it was almost an exclusively food supermarket business. Now we are approaching 20% of our sales being delivered through convenience and online, and our general merchandise and clothing business now accounts for about 10% of our sales and is growing fast. So this opportunity is entirely consistent with our overall strategy and it gives us the opportunity to accelerate that strategy.

And so that comes onto Slide 6, a business like ours is always looking at opportunities for how we might make these things go quicker and we've been talking to the Home Retail Group for about 18 months, and that's manifested itself in the trials that we've been running in our shops. So we already have ten, in effect, concessions, Argos concessions in our shops and that's given us an opportunity to really assess how the two businesses might come together. And we believe this opportunity is a great opportunity for the two businesses, and we believe it's possible to create more value for shareholders by bringing the two businesses together.

What would we create? We'd create a business that would sell a round about 100,000 general merchandise products and non-food products, so that's about 50,000 Argos products and around 50,000 Sainsbury's products, which create a significantly scaled business in non-food. It would be one of the biggest non-food retailers in the UK, bigger than John Lewis, bigger than Amazon, and bigger than M&S if you take their clothing and general merchandise business. It would create a business that had unique capabilities across a wide range of channels, whether that's in-store, online or mobile, and it would create a business that had a unique capability in terms of how products were delivered, whether that's through bricks and mortar, on shelf, through collection and through home delivery. Of course, all of the competitors I've mentioned have some capabilities in some of these areas, but none of them have all of the capabilities that I'm talking about.

So now on Slide 7, and this slide just repeats what we put in our announcement on January 5th, and highlights what we believe to be the six areas of potential value creation in this transaction. So if I talk more specifically about these particular points hopefully it will give a bit more colour around where we see the value creation coming from.

In the first slide, which is Slide 8, it talks about the overlap between our customers. And we're both mass market retailers in the end. Sainsbury's serves roughly two-thirds of the UK households in any given year, and Argos serves roughly two-thirds of UK households in any given year, and there's a significant overlap between the two businesses. Over 40% of UK households shop both brands in any given year, and of course that says that there's a high level of resonance between the two brands, we know that through our customer research, but it also says that there's an opportunity to bring Sainsbury's as a brand to those Argos customers that don't currently shop in Sainsbury's, and of course vice-versa, to bring Argos as a brand to Sainsbury shoppers who currently don't shop in Argos. So it represents both a challenge to some of language that's been put out there that they're somehow exclusive customer groups, there's already a high level of overlap, but there's also an opportunity to increase the penetration of both organisations.

And we know through the trials that we've run through our existing business experience that if we're successful in food we fuel our non-food business, and vice-versa. So it does create a virtuous circle if we can make the offer easier and more compelling for our customers overall. But of course, as you can see on the right hand side of the chart, there's a high level of similarity between both the demographics and segment by age of the customer base of both organisations.

If we then look at the range. Actually the product portfolio's remarkably complementary. Sainsbury's clearly has strength in food, it's the core of our business and remains so for the future, but we also have developed a very successful clothing business literally from scratch ten years ago. We have a design-led own label presence in homewares and kitchen wares, so we're very strong in homeware products, we're very strong in categories like home textiles. Argos are strong in electricals, in toys, in large appliances and furniture, and they also have exclusive brands in the form of Chad Valley in toys and Habitat in housewares, which we think play well with Sainsbury's customers and again could be stocked in Sainsbury stores. So we think there's a high degree of complementality [sic] in the two product portfolios and would represent a range of around 100,000 products overall.

Equally, if we combine the two store estates we would end up with 2,000 stores, 2,000 locations, and that would represent the most easy to pick up offer that customers would be able to enjoy in the marketplace overall, and I'll come back to what we would see in terms of the shape of the store portfolio going forward.

And of course for customers it would offer the opportunity of multiple delivery options. They would see the ease of being able to Click & Collect, have delivered to home, or indeed ultimately potentially delivered on our grocery home delivery vans with speed and with confidence with two trusted brands coming together.

And if you look at the retail estate, we believe that there is a significant opportunity to combine the retail space in a way that optimises both store estates. We've already acknowledged in our presentation, November 2014, that we have around 6% excess space, that's about 1.5 million square feet. Nevertheless, we believe we have an advantaged store portfolio: we’re in good locations, our stores are in affluent locations and geographically advantaged. We could make those stores more compelling.

And if we owned the Argos business we would have the opportunity to optimise the space by relocating existing Argos stores into our Sainsbury shops, but also to extend the reach of Argos by rolling out into more Sainsbury shops overall. So we would expect that there would be net more Argos locations.

Argos, Home Retail Group themselves, have talked about the fact that over 50% of their leases come up in the next five years, and we believe the opportunity to consolidate that space is significant. And of course we'd be able to put Click & Collect in the vast majority of our shops, not just our big shops, but also our convenience shops, so we believe virtually every Sainsbury store could have some kind of Click & Collect online presence that would allow customers to pick up products from those shops. So it would give Sainsbury customers access to a wider range of general merchandise products, give Argos customers access to Sainsbury's products, and, of course, in our shops, parking and indeed longer trading hours.

Again, if we combine the businesses together we believe we would have an industry-leading distribution platform both to-store and to-home across a wide range of products. We're experts in distribution in large volumes of products to-store, we have leading food availability, and we have a large and efficient online grocery operation.

Argos are experts in distributing a wide range of GM products efficiently, and we believe they have an almost unique capability in terms of their ability to deliver single units quickly and to where customers want them. So from a customer point of view they can pick up in-store, they can have delivered to home in hours, and of course they can have larger products by appointment at an appointed time.

Of course the financial services' products, I’m now on Slide 12, does give the opportunity of looking at the businesses in the round, and we believe there's a complementary financial services' proposition. As we've said, we already own our Bank and that gives us significant opportunities in the future,

And we believe there’s an ability for us to be able to leverage the Argos Consumer Credit business. And of course just another simple example of where the synergies might come together, we could rollout our ATMs’ estate more widely through the Argos stores as we look forward. So there’s an opportunity to strengthen financial services and to cross-sell.

I’m now moving on to slide 13, and this is a summary of where we see the synergies are coming from. And we believe that the synergies are compelling. We can’t talk specifically about numbers but we believe that there is an opportunity to leverage the rollout of Argos concessions’ relocations. And because we have the ten trial stores operating in our shops, we’ve got a pretty good understanding of where the opportunity is to rollout, and the benefits of cross-selling food and non-food between our business and the Argos business. And it would, of course, give us the opportunity of extending the Sainsbury’s product range into the Argos distribution network, whether that’s clothing, kitchen, homewares.

And there are clear cost synergies as well. So there’s clearly an opportunity, as I’ve described already, to consolidate the store network overall, our operational efficiencies and, of course, both organisations, giving the scale of the non-food business, would have enhanced buying scale through the combination of the businesses.

The businesses are very culturally aligned and we’ve experienced that through the work that we’ve done together over the last period of time, over the last 18 months, and we believe that there’s an opportunity to share back best practice across a number of areas, whether that’s buying or, indeed, operations more generally.

So in summary, we believe this transaction has the potential to be great for our customers, and not just our customers, but actually customers more generally. It would accelerate our strategy, it’s completely in line with the strategy that we articulated in November 2014. We believe it is strategically compelling in a rapidly changing market. We believe that we have understanding through our existing Argos concessions around how we can deliver the revenue synergies and the operational synergies. And actually it plays at the sweet spot of what we believe we’re brilliant at as a business, which is it’s largely based around how we look at the property portfolio overall. And most importantly, we believe it will create value for our shareholders and, indeed, for both companies’ shareholders.

So that’s the presentation in summary. I’ve finished on slide 14, and I will now hand over to questions and John and I will take questions. As I say, we’ve set aside a fair amount of time for questions, so over to you.

Question and Answer session

<u>Question 1</u>

Arnaud Joly, Société Générale

Good morning Mike and John, I have three questions, but very quick questions. The first one. What is your internal deflation in Q3 and if you can remind us the level in Q2?

And secondly on the Home Retail potential deal an integration would require your time and your energy, does it mean that today you are more confident to secure stabilisation of the UK food retail market?

And the last one, a general question regarding your own view on Amazon to efficiently compete versus Amazon, and I would say for both food and non-food, what is the real key to success in your view? Is it price? Is it the level of services? Is the multi-format approach and pick-up points? I would like to have more flavour on this key topic. Thank you.

Mike Coupe

Perhaps if I give John deflation and I'll try and answer the other two questions.

John Rogers

Yeah, sure. So on deflation for Q3, we would call out deflation between 1.5% and 2%. And I guess probably exiting the quarter, closer to 1.5%. And you asked for a reminder of the Q2 position again I think we gave a similar range at Q2, 1.5% to 2%.

Mike Coupe

And on the point of distraction and integration, the first point I would make is of course this transaction would mean that there would be some things that we wouldn't need to do ourselves, so it actually brings forward some things, and I could argue that, in and of itself, reduces the level of distraction rather than increases it.

Of course we have a very experienced management team, so we have a lot of continuity in our management team, and I stress the point that the value creation comes about through things that we think we're pretty good at and we have lots of experience at. A good example of our property expertise is where we had a store in Carlisle that was under five foot of water three weeks before Christmas, and in 20 days we effectively managed to strip out, clean out and refit that store and trade for the three days before Christmas. So this is the sweet spot of what we, as a business, are very good at.

And of course we would take a best of both approach to management, so we shouldn't underestimate that there is a team of people that we've got to know and that we're culturally aligned to, as I've already said, that we've worked with, where they clearly have expertise and we would benefit from that expertise.

So I would push back on the point about management distraction. I think I could almost turn it on its head and say the opposite and actually it would forego the need for us to do certain things in the future.

As far as the general landscape is concerned, I would stress the point that the start point for how we think about this is the way that customers' behaviour is changing, and the way that customers will expect us to serve them in the future. And that is changing incredibly rapidly and we have to recognise that, and we did in our November 2014 strategic update, and we very deliberately put the words in, 'whenever and wherever our customers want' because our customers will demand of us that we'll serve them through shops, conventionally, through big shops, through little shops, online, online delivered to home, online delivered to a convenient location, and that will be increasingly served through an interaction on digital and mobile technology.

And of course Amazon have some of these capabilities, actually you could look at the other end of the spectrum and people like John Lewis have these capabilities. It's quite interesting, if you look at the John Lewis statement, I think they refer to the fact that 35% of the John Lewis Click & Collect transactions were served through Waitrose stores, just to put some flavour on how you can see this playing out over time.

We would argue very strongly that you can't point at a business that is doing this, doing what we're suggesting, comprehensively in the UK. Yes, the business is doing different elements of it, but if you take Amazon as an example, they wouldn't have the 2,000 shops points of distribution that would be facilitated through this transaction.

And you can see, if you look around the world, whether it's Ahold in Holland, they certainly have developed a non-food capability, an online non-food capability. And, indeed, Walmart in the US or Aeon in Japan and the Far East. So I would point at a number of businesses who will be talking around these types of initiatives, not just in the UK but in the world overall. So to just fixate on Amazon I think is wrong.

<u>Question 2</u>

James Collins, Stifel

Hello, morning, so my two, so one specific on Q3. What's the non-food growth rate been like in Q3? And within that, and I know you don't give the absolute number, but how does it compare to Q2? And was clothing a drag on non-food in Q3?

And then my second question is on the deal do you think that it's realistic to be able to deliver GM products, so a full combined Argos/Sainsbury's GM offer, on Sainsbury's vans with one-hour delivery slots because I know that Tesco have talked about that before and basically said that they weren't in a position to do it, and equally, Ocado don't do the same from the same distribution centres? Thank you.

Mike Coupe

John can do the non-food piece and I'll talk more specifically about the second part of the question.

John Rogers

So, James, on non-food growth for Q3, we were just below 5%, and of course we mention in the face of our statement, growth of our general merchandise business is 5% and growth of clothing is nearly 6%, so a pretty strong performance against a tough market backdrop. And that compares to the overall growth in Q2 of just above 6%, so a little bit down, but actually we were pretty encouraged by both our performance in general merchandise and clothing, of course, and I hate to say it, despite the unseasonal weather impact, so a 6% growth in clothing we thought was relatively strong. Not as good as Q2, but pretty good in the context of the market backdrop, we would suggest.

Mike Coupe

Yeah, and I'd just reiterate the point that's John made it was a truly unhelpful season to be selling clothing and I think the telling stat was that the shortest day was actually warmer than the longest day this year, which I think has never happened. So that characterises the challenge and I think our clothing performance against that backdrop is truly remarkable.

We can talk about speed as a currency in the market and there's absolutely no doubt that speed of delivery is increasingly something that our customers will demand of us, whether that's, in effect, same day deliveries on groceries or tighter delivery slots, whether it's the currency that's in the non-food business of delivering within, let's say, four hour delivery slots or, indeed, one hour deliver slots.

And of course as part of that, there is a journey that you would go on if this transaction, and of course it's all caveated by it may not take place, but if this transaction was to take place, clearly the first step of that opportunity is to think about the wide range of products that we both sell and how we would optimise that through the Argos and Sainsbury's networks. But you could certainly envisage a moment in time when, given the distribution capabilities of both businesses, you could imagine non-food deliveries piggy-backing on the food deliveries, on the food delivery infrastructure.

But that would be a bit of time down the road and I think the most obvious and immediate opportunity is just looking at the portfolio of products overall and asking the question of which bits you want to serve through which networks?

The particular expertise in perishable fresh foods would almost certainly have to be through the grocery network, but once you get out of that particular product area, in effect, you could serve virtually any ambient grocery product, any non-food product, any clothing product, through either of the networks.

<u>Question 3</u>

Bruno Monteyne, Sanford C. Bernstein

Just two questions from me. I can sort of see the rationale you lay out for the strategy for Sainsbury's so it all accelerates that, plenty to be admired. However, there's also a way of looking at it from the Argos point of view, and clearly Argos is a challenged business, loads of its categories under threat by Amazon and others, so forget Sainsbury's for a second, and therefore there's probably more restructuring for that business to be done to adjust in the landscape the way Amazon andAO are growing. So how much restructuring costs therefore would you anticipate to have to do to potentially downsize Argos and obviously still keep the network and the capability for your own growth?

The second question is, I notice, quite remarkably, in your release today that there isn't much mention any more of the price investment and the price is way more focused on quality, growth and strategy is this something we can start looking forward now, more Sainsbury's on the front foot and which way it is better, rather than talking about all the pricing activity? Thank you.

Mike Coupe

I'll have a go at both but I'm sure John will chip in as well. I mean we can't talk, for obvious reasons, about any specific costs, or, indeed, synergy numbers, we're precluded from doing that, and of course in the fullness of time, if we were to go ahead with any offer on an agreed basis, then we'd be able to put more flesh on that particular point, or those particular points.

We would emphasise the point that we will only do this if it makes financial sense to our shareholders and to our business. And so I would reiterate the point that we've stressed, that we won't overpay for this business and that whenever we would think about any transaction, we would fully take into account any costs associated with that transaction and any costs of implementation when considering the synergy benefits and ultimately the creation of shareholder value. So I think that's an important point to reiterate, because there have been some numbers put out there which are widely wide of the mark.

In terms of price investment, we haven't made reference to it on the face of the statement, because I think we covered the ground pretty comprehensively during the course of Q2 and our interim update. The price environment continues to be challenging, as we've said before, we think the difference between the big four grocers is as narrow as it's ever been and our price position, we believe, is as strong as it's ever been. But equally, the pricing landscape is not just about the big four grocers, it's also about the discounters, and it's important to stress that. And that we've said, and we will continue to look at making targeted pricing investments relative to the discounters, and we'll do that in a thoughtful and strategic way. And we believe that that's the sort of next stage of the pricing journey, without being specific about the details.

John Rogers

Bruno, just an interesting statistic for you, because I think a lot has been made of the complementarity of the product portfolios between ourselves and Argos, and in particular the challenges, I think as you've raised yourself, particularly in the electricals category, which is a strong percentage of Argos' overall portfolio. What's actually interesting, if you look at John Lewis they actually have a similar level of electricals as a percentage of their overall sales and I don't think you necessarily see that same challenge being raised against John Lewis.

So we do see this as being an interesting opportunity to bring these two product portfolios together, and we believe, you know, you've highlighted some of the external challenges to Argos on a standalone basis, we do believe these businesses are better together, but as Mike has highlighted we've argued why it makes strategic sense, it will only make financial sense at the right price and we're not going to overpay for this transaction.

Bruno Monteyne

Sorry John and Mike, if I can just probe a bit more. So even if I accept the growth opportunity for Sainsbury's itself and its stores, you don't think the current as is Argos business needs to shrink because of the comparative pressures? You don't have an immediate worry about that?

Mike Coupe

As I say, I'm not going to be drawn on the specifics of the detail and I think we've given as much colour as we can. We would anticipate over a period of time, if the transaction was to go ahead, that we would consolidate existing Argos stores into Sainsbury's real estate and put more points of presence of Argos in our existing real estate, and that would be through a combination of concessions and Click & Collect points in our smaller shops. And we think that if you imagine the store portfolio it would be around 2,000 shops, plus or minus a few and the vast majority of those 2,000 shops would have access to a range of Click & Collect of a combined non-food business.

And that's largely actually a property play, that absolutely sits at the sweet spot of what we think we're pretty good at to the point about management distraction, and we think that that's reasonably quick to execute, but we don't think it's possible to execute in quite the same way if the businesses are apart. So that's the fundamental rationale in the short term, at least from a financial point of view, for why you might want this transaction to take place. But as John says, we know what those numbers look like, we've got a very strong sense of where the opportunities lie, simply because we have ten trial stores that we can pretty easily extrapolate the performance across our estate and we can see from the Argos statement that a significant number of their store leases are coming up for renewal over the next period of time and that represents an opportunity.

<u>Question 4</u>

Mike Dennis, Cantor Fitzgerald

Yes good morning. On a sort of similar note on Argos, could you just make it clear, on the concession part of the business if the deal doesn't go ahead how many of your 40,000 to 60,000 square foot stores would take a concession? Would all of them in time take a concession? And if that's the case, and you've just mentioned Click & Collect in your convenience stores, doesn't that sort of diminish the rationale for paying a premium for the whole of Home Retail Group if you can get say some or a lot of the benefits to your customers and to your food business just by rolling out Argos within Sainsbury's? I just want to understand that part.

And on your Taste the Difference, what was the growth in that business as a whole? You mentioned beers, wines and spirits but you don't mention the whole premium brand. What was the growth rate?

Mike Coupe

I'll ask John, he's just looking at the cheat sheet of numbers, I'll ask John to come back on the second point in a second. We're not in a position to lay out the full financial rationale for obvious reasons, so it's difficult to paint much more colour than we've already painted, all I can say with a high degree of conviction that the synergy benefits that we see are far greater through the combination of the two businesses than through some kind of commercial arrangements between the organisations. And it's difficult to go much further than that at this point in time, you'll have to trust me, but believe me, the numbers are more compelling by bringing the businesses together and it creates more value, we would argue, for both sets of shareholders because of course if the deal was on some kind of shares and cash basis which is what we've said already their shareholders would also be shareholders in the Group overall potentially.

So we cannot go any further, and clearly if the transaction wasn't to go ahead which is a possibility then we would clearly review our options at that point of time, not just with Argos as far as the concessions opportunity is concerned but also with other operators, as we've already done. So it's not just that we're working on concessions with Argos, Jessops is another example, we have Timpsons, and indeed within our existing real estate we can roll out things like Travel Money into more of our shops etc. etc. So there's a whole bunch of other options that we have, but at the heart of the rationale for this, and as I say it's difficult because we can't talk about specifics of numbers, there is much more value creation through the combination of the two businesses than is possible to extract through any kind of conventional commercial arrangement.

John Rogers

I think, Mike, just to provide just a little bit more colour on that because obviously we can't go into the details of numbers, but if you look at the face of the statement that we issued and the sources of synergies that we identified and you go through those somewhat in turn, things like the cost synergies, the rationalisation of scale benefits, the operational efficiencies, clearly you don't tap into those through a simple commercial arrangement. If you look at how the two financial services properties may combine going forwards, clearly you don't access those benefits through a commercial relationship. And again, as Mike has already highlighted, the key synergy is the ability to optimise the use of the combined retail space across these two portfolios.

It would be very difficult to tap into just through a simple commercial relationship alone, so look, you're absolutely right, there remains, notwithstanding whether a deal does or doesn't happen a very sensible commercial opportunity to grow our partnership with Home Retail Group over time, but we're absolutely confident, having done the analysis, having had the experience of the ten trial sites that we've operated, that the synergies that are available to us for a potential transaction are significantly higher than we could tap into through a commercial relationship.

Mike Dennis

Is there any way that you can tell me that the ten concessions you've got, something about them that gives us a base case in which to judge a billion plus deal with Home Retail Group? That's what I'm trying to get at. Is there something you can tell us? You know, why is Argos as concession to you so much better than the other concessions you've got, or is there something that you can give us about Argos being in Sainsbury's that makes it so compelling?

Mike Coupe

Mike, we can't go any further than we've already gone, I think we've gone as far as we can. You just have to trust that we have line of sight on the numbers, we have ten concessions that give us a pretty good handle on how it works and we've tried to describe both the property opportunity, in effect the cross-sell opportunity, we know we sell more food and we know we can sell more non-food when we have more footfall into our shops, so we can also give you a very strong, as we have done I hope, consumer rationale, how is the customer changing, how does this play into the changing landscape in the future.

And we have been crystal clear I hope that we would only undertake this transaction if it created the right level of shareholder value and we won't go through with any transaction if that wasn't the case and that we'll apply a high level of financial discipline and properly attribute the costs associated with any transaction as well as the synergistic upside, so I'd reiterate that point. And when it comes to it, if it gets that far, we believe that we'd be able to demonstrate a compelling financial case for why we think this would be the right thing to do, and in the context of what the alternatives are.

John Rogers

And Mike, just to give you an anecdotal story, I was in our Haywards Heath store a couple of days before Christmas which has an Argos implant in it and there was a queue of people at the various Argos desks looking to pick up items that they'd predominantly ordered through Click & Collect and speaking to those customers, and almost every single one of those customers had in their hand a basket that contained Sainsbury's products. So that's just an anecdotal piece of evidence but I think if you were to go into any of our Argos stores today you could see that for yourself.

You asked a very specific question around Taste the Difference, so I just will come back to that. We saw Taste the Difference sales grow by just below 2% in the quarter, not dissimilar to what we'd seen in Q2 and actually better than we'd seen in Q1 and obviously Christmas is a period where Taste the Difference has done tremendously well over the last few years and so we always see strong participation in that particular sub brand over the Christmas period, and again we saw that come through loud and clear this Christmas.

<u>Question 5</u>

Clive Black, Shore Capital

Morning to you, thanks for giving us something to talk about in the New Year.

Mike Coupe

It's a pleasure.

John Rogers

That wasn't the primary driver, Clive.

Clive Black

Ah, I thought those love and kisses you sent me before Christmas meant something. A couple of questions I'll stick to you. First of all would you go hostile on this if you really want it?

And secondly, maybe one for John, can you give us a feel for the financial headroom you've got in terms of access to revolving credit facilities and whatever from a debt perspective at the moment as freestanding business?

And just to be clear, would you be envisaging offering Sainsbury's shares to Home Retail shareholders or would you be envisaging raising equity to pay those shareholders in cash?

John Rogers

Shall I answer the two financial questions?

Mike Coupe

Yes, I'm insulted that you didn't think I could answer the two financial questions, Clive, but hey I'm not going to I'm going to hand it over to John.

Clive Black

I was just giving you a rest, Mike.

Mike Coupe

Thank you. So John can do the first bit and then I'll have a go at the second bit.

John Rogers

Just on the headroom piece, we talked at the interims about we've got just about £1.1bn/£1.2bn of undrawn facilities within the business so plenty of financial capacity. We've often talked in the past about our financial liquidity position which we believe is very strong, and I will take the opportunity to highlight again of course that we have no financial governance against those facilities. So I think we're in a very strong financial position.

And then in relation to your question on the funding of the deal, clearly we can't be drawn today because there is no deal to discuss in detail and a deal may not be forthcoming of course, but what we have said is that we would fund it through a combination of shares and cash, and unfortunately obviously I can't be drawn in any more detail on that on the call today.

Mike Coupe

And on your first question, again it's very difficult to be drawn, I'm not sure I could give you a lot more flavour than what we've already given and in any of these situations you'd always review whatever options you had at any particular moment in time and I don't think you'd expect me to say much more than that.

What I would say however is that we've got on well with the Home Retail Group over the last 18 months, we have talked at various levels of the organisation about the trial stores that we've got, the concessions, the implants, and we believe the organisations are pretty well culturally aligned and we believe that they have expertise to bring to the table just as we believe we've got expertise to bring to the table. So we think, as I've said already, the sort of best of both would be the world that we could envisage should, and if, the transaction went through. So all of the conversations we've had at any level at any time have been conducted in a cordial and friendly and culturally aligned way.

Clive Black

Guys, could I just ask a supplementary thing quickly on the back of my second question? In your summary pack you put in I think, is it just over four times the suggested net debt EBITDA is there a ratio, Mike and John, that you feel most comfortable with strategically going forward, regardless of Home Retail or any other deal you might do?

Mike Coupe

I'll ask John to pick that one up Clive.

John Rogers

Again, I'd just say what we've said in the past which is we're comfortable with the current leverage of the business, we're very much minded to our balance sheet position, we always have been, and actually if you look at our track record over the last four or five years we have maintained the most stable balance sheet I would suggest in the food retail sector. So we're very mindful of the overall balance sheet within the business, it's something that we focus on obviously as the finance team but also more broadly as a Board, and we're comfortable with that position.

And we wouldn't do anything, we wouldn't make any transactions that would in any way put that position of strength in jeopardy. And again I would just highlight the comments that Mike has already made that this is a very interesting transaction, strategically compelling for us, and at the right price financially compelling but it does have to be at the right price, this is not a must do deal, it accelerates our strategy probably over the order of two to three years, but it's not a must do deal for us and we'll only do this transaction at the right price.

Question 6

Edouard Aubin, Morgan Stanley

Yes good morning Mike and John. Just one question for me so it's going to be quick. So just to come back on the grocery market dynamics and specifically deflation, would you mind elaborating on why you expect food deflation to last longer than what you thought mid-2015 and if you could please break it down in terms of the input cost component and the market dynamics component?

Mike Coupe

Oh that's a big question. You see the thing is we've been focusing on the HRG and the Quarter 3 Trading Statement hasn't had a lot of air time but perhaps I'll have a go and then maybe if John can put some colour on it as well.

The key drivers which we've highlighted before are a combination of commodity price movements where it doesn't look like there's any particular inflationary pressures; exchange rate movements as well, particularly the euro/pound exchange rate; and of course the continuing closure of the borders with the Russians and the Chinese, particularly to exports from Western Europe. So we did signal actually in the early part of the summer you might expect one or some of those things to change over time, but as we sit here today broadly speaking they haven't and therefore we would expect the deflationary pressures to continue through the next period of time.

Having said that, as we also indicated or I think John's about to indicate, we have seen a slight relief, if that's the right way of putting it, a slight reduction in the level of deflation over the quarter. And as price investments get annualised you might expect that trend to continue; but of course that's against the competitive backdrop where there continues to be pricing pressures across the market overall. And again, we've been pretty straightforward in the way that we've thought about that and that we've talked about it both in our Quarter 2 Trading Statement and in our Interims in November.

I don't know if there's any colour you'd like to bring to that, John?

John Rogers

I think Mike's covered it all. What I would say, in the interests of time, I think we did cover this extensively at our Interims Statement; we talked about this at length. And just to reiterate, our position hasn't changed since then. So, all that we said at the Interims remains valid today in terms of our expectations going forward. So, in the interests of time I suggest you refer back to the transcript of that call because I think we've covered it in a lot of detail already.

Edouard Aubin

Right business just to follow up, and it's difficult but your guess would be that the environment should remain deflationary for most of the current calendar year, would that be fair or not?

Mike Coupe

We're not in the business of guessing so the current trends would suggest that deflation will continue, and I think in the past we've signalled through the back-end of our financial year and into the early part of next year. I'm not sure we can go much beyond that because of the volatility around, particularly the commodity and exchange rate movements add some topspin to that, and to go much beyond that in terms of predicting I think is almost impossible.

John Rogers

And what we said is deflation will continue into the new financial year, but we're not going to be drawn beyond the early part of the new financial year, the least part of which because of course a lot of these things do depend on the harvest, and at that time we'll have a better indication as to whether it will be a bumper harvest or not. And that in itself has quite a big impact on future inflation/deflation in the market.

Mike Coupe

Yes, if I had the degree of prescience that you're indicating I would probably be sitting on a Caribbean island, would probably own a Caribbean island actually, because the degree of volatility in commodity markets overall is unprecedented, and that's not just in the food sector, that's in commodity markets more generally.

<u>Question 7</u>

John Kershaw, Exane BNP

I'm going to be cheeky on three quick ones. First of all, on the food business, if my calculation is correct, given you've done well in non-food, food is a tad disappointing. It looks down maybe minus 2%, minus 2.5% like for like. So, perhaps you can correct my maths or explain why?

Just coming back to Home Retail, what else can you give us on the ten implants? We know that all refits start well and end badly, so buying the business after ten implants you could argue is quite courageous.

So what's, particularly on this sales dynamic, the uplift, the cross sale and also what Argos has lost in its surrounding stores? Anything you can give us there would be very helpful for investors.

And finally, I understand you don't want to overpay, but you used to look at store returns on a 25-year IRR. What are we looking at: are we looking at a sort of post-tax return on capital over a three to four-year period? Or how are you thinking about this from a returns parameter?

Mike Coupe

I'll have a go at the implants question and John can prepare himself for the food business and the IRR calculation question.

John, again there's an element of 'trust me I'm a doctor' on this: we think we've got enough understanding. These things are never perfect, I'd absolutely agree with that, and there's always a degree of executional risk in any major transaction, and of course we would always factor that into our calculations and we would always take a prudent and conservative view of extrapolating the experience of ten shops into 100 or 200 or 400 or however many shops that you might surmise that we might be thinking about. So we will be very prudent, very thoughtful and will not overpay.

However, there are some direct experiences we have even before we had the Argos implants in terms of the synergistic benefits: the virtual circle of food versus non-food; we already had experience of if you attract more customers to your shops that you wouldn't necessarily get through other means what sort of spend we can attach to those customers. So, we've got pretty good models that already exist that would allow us to make fairly robust assumptions that can then be discounted for some prudence around how you might extrapolate those, given your point that in the end most trials start well and then settle down at a particular level.

But of course the other point I would make is that these implants have been running for a period of time now. So, having got through a Christmas we've got pretty good line of sight of the overall benefit, and there's plenty of anecdotes and plenty of hard data that backs the customer resonance around this particular opportunity. So, it's very difficult to go any further.

John Kershaw

If you look at Waitrose, because you made a good point on Waitrose in the click and collect, but there's very little cross-sell that Waitrose experience from John Lewis. So, perhaps give us a bit more flavour why you think you sell a lot more food to Argos customers in those ten implants, or something to help us there?

Mike Coupe

Let's assume for a moment, and I'm not going through any numbers, but broadly speaking lets break customers who come to Argos implants in Sainsbury stores into three categories: firstly, people who come and shop in Sainsbury's anyway; people who wouldn't have necessarily had a grocery shop with Sainsbury's at that moment in time but have come to pick up a particular item at Argos; and then exclusive Argos customers who have come to Sainsbury's because it's a convenient location.

If you break those customer types down you can attribute, in effect, incremental spend to customers who wouldn't have come at all; incremental spend to customers who might have come for a grocery shop but have basically come for a particular item that they've ordered from Argos; and then of course people that have come anyway you could argue is a footfall opportunity that is afforded to the Argos concession that wouldn't necessarily have been there in a standalone location.

And time and time again – and you can do this: just go and ask customers; just go and talk to them in our shops – they absolutely get it: they just see it as it as being a really convenient way of doing their shopping.

Now, I'm not going to go any further than that. But we have a pretty good handle on, first of all, the proportion of customers that sit in each of those buckets. And that's not least because we've got the Nectar database and we can look directly at that and we can see the read through. And secondly, the benefits and the spend attributed to those customers. And that's the basis of the financial case. And ultimately if we're able to get to some kind of agreement, and it's a big if, we will paint that picture to the marketplace, and we will put hard numbers on it.

John Rogers

And John, just coming back to your other question, you commented about food. Actually I think we had a strong performance on our food business in the Christmas quarter. We saw food volumes on a like for like basis increase by between 1% and 1.5%, so we think that's a pretty strong performance. And obviously the deflation number of between 1.5% and 2% as we've already mentioned. So, we're actually very pleased with the performance of the food business.

And then your third question of how we're going to look at this transaction, what financial parameters will we consider, again we're not going to be drawn on this call today on the details of what that would look like, other than to say of course in any transaction of this nature we're going to look at a multitude of different drivers, performance ratios etc.

If and when, and as I say if and when we get to a position where we make an offer then of course at that time we will take you through what will be a very financially compelling case for doing a transaction. But there's no guarantee of course that we'll ever get there; that's because, as we've said repeatedly and I'll keep saying it, we will simply not overpay for this transaction. It's very important to remember that before we made this announcement the HRG share price was below £1. And I'd make no further comment than that.

Question 8

Rob Joyce, Goldman Sachs

A couple from me, first one just on Homebase: no mention of DIY or Homebase in any of the presentation; what are your intentions there? And given there are around 100 Argos concessions already in Homebase should we be taking those out of our calculations for any kind of incremental concessions you can add?

The second one is just on you made a lot of reference to Waitrose and John Lewis; if I look at Waitrose's operating margin over the period they've kind of integrated John Lewis and the collection from those stores, we've seen quite a material deceleration in the Waitrose margin, much more material than your own over that period. Why shouldn't we expect a similar or expect some margin erosion when Sainsbury's try to integrate the Argos collection opportunities across its estate? Thanks a lot.

Mike Coupe

I'll have a go at both and again John might want to add some colour to it. We cannot say anything and won't say anything about Homebase, just to be crystal clear, we can go no further than what we said or not said in our statement. So, I can't offer any other colour and I can't offer any colour around what may or may not happen to the 100 concessions. And clearly we just can't say anything.

Rob Joyce

Just out of interest, given the site crossover, do you have an idea for how many of those 100 Argos concessions in Homebase basically sit in a Homebase opposite a Sainsbury's already?

Mike Coupe

We do, but I can't comment any further and I won't comment any further. I'm sorry but it's something that we're absolutely precluded from talking about.

As far as Waitrose JLP is concerned, I think you're getting two things mixed up. I suspect if you look at the underlying numbers, the Waitrose business one way or another will be challenged in exactly the same way as the supermarket sector more generally is being challenged, which is there's been a large level of price investment, particularly in commodity pricing, and that's ultimately had an impact on the margins of the industry overall. And I don't know enough about the Waitrose P&L, you'd have to ask them the question, but I suspect that's the key dynamic that's driven the compression of their gross margins and also ultimately their net margins.

The only point that we're trying to make is that if you look at the market generally around 50% of transactions in non-food are click and collect. Broadly speaking the more points of distribution you have, and points of distribution primarily being shops, the more attractive and convenient that is for customers, because in the end retailing generally is driven by proximity: the biggest factor that drives where somebody shops is how near the shop is that they want to go to. And that we would only reference the fact that Waitrose JLP talked about 35% of Click & Collect transactions that John Lewis executed went through a Click & Collect transaction in a Waitrose store.

We're just referencing the fact that is just an example, although not a direct read through, as to the kinds of dynamics that you're seeing developing in the market overall.

Rob Joyce

In your thinking do you have any margin pressure from integrating an Argos offer in the Sainsbury's core business from integrating an Argos sort of Click & Collect across all of your stores?

John Rogers

I don't think we want to be drawn on the specifics of that as this point; but clearly we're not going to be recommending a deal that we don't think makes financial sense. So as and when we're in a position where we can take you through that detail we will do so. But any deal that we will do will have a strong financially compelling case that will support it. And if and when we get to that position we'll take you through that detail.

The one observation I will make, and I think it's a very important one, and we've made this many times in the past but it's one of the key things that underpins the rationale for the deal, which is we do see the more customers shop with us through multiple channels the more loyal those customers become to us, and you capture a disproportionate share of their overall spend. So it's not just a case of one plus one making two, but the one plus one makes three argument. It's the Velcro effect that we've talked about in the past; the loyalty effect, as we might describe it.

And we very much see the opportunity by bringing these two businesses together of achieving that: having customers shopping through multiple channels, multiple products and services will create a connection and a relationship with that customer that will cause them to spend a disproportionate share of their overall spend with us. And that's evidenced we've seen over the last 18 months; and of course we've seen that already in part through the ten trial stores we've talked about where we've seen customers come in who pick up an Argos order, Click & Collect online, and do a Sainsbury's shop at the same time. So, we're confident that that dynamic is a key thing that underpins the rationale.

<u>Question 9</u>

David McCarthy, HSBC

I've got a question regarding Slide 8 in your presentation, the one where you talk about two thirds of households shopped at Sainsbury's and so on. You haven't given a source for the data on the right hand side, the customer segmentation by type. Because my initial thoughts looking at this, two thirds of households shopped in Sainsbury's over the last year, great, you know most companies have a similar figure to that. Your market share is according to Nielson 16%, so most people who go into your stores don't spend a lot of money there. The same as everyone else, there's no criticism there. So what I'm really interested in is if you took your core customer base, your loyal customer base, that 20%, who account for 80% of your sales, and we took that for Argos, what would be the real overlap then?

Mike Coupe

I'm looking at the footnotes which I can't read because my glasses aren't strong enough.

David McCarthy

The footnote relate to the data on the left hand side, which says you've done a survey of 2,000 people. So that's why I'm interested on what the data on the right, where that's from.

Mike Coupe

That's the same source.

John Rogers

I think it's all sourced from the HPI customer survey.

Mike Coupe

I'm looking in the top right hand corner after age there's a (2) and then there's a reference to the footnote. The point we're trying to make, Dave, is that there's been a lot of talk of they're somehow mutually exclusive customers, and that an Argos customer would never cross the doors of a Sainsbury's shop and vice-versa. That is just not true, there is a high degree of overlap. We're both mass market retailers, we both serve roughly two thirds of the population across any given year, and there is a high degree of cross shopping already, and we've referenced 40%.

Just as an anecdote, I did a show of hands yesterday at our Leadership Group, and within the Sainsbury's Leadership Team something like 65% of the audience put their hands up and said they'd shopped with Argos is the last period of time. So that's just a piece of anecdote but it gives you a sense of it.

And I would just ask you to go to our shops, go and talk to real customers and you'll have Sainsbury's customers saying, "Oh, I think this is a really good idea because I can buy X, Y or Z through the Argos concession", and indeed you'll get Argos customers saying, "Oh, I've never been to a Sainsbury's store before, I think this is a really good idea" too. And Argos customers find our locations, because of the car parking, because of the convenience, because of the hours, a very convenient place to pick up products, and as we've said already, 50% of online transactions are Click & Collect in the market overall.

So I'm not getting away from the fact that clearly there are customers who shop at Argos that don't shop at Sainsbury's and vice-versa, but actually the idea that there's a dissonance between the brands is just not true, you cannot find that in any research, you cannot find it in any anecdote, and it's not borne out by the high level stats.

The 40% penetration of course also represents an opportunity. Let's not get away from the fact that that means that 60% of customers or households in the UK could shop at a combined Argos/Sainsbury's Group, which in and of itself represents part of the opportunity that we're describing.

John Rogers

And just to reiterate the point, Dave, this is not just a top down market piece of analysis, we've got 10 trial concessions already in our stores and those obviously are located in different parts of the country, and based on the analysis that we've done you can extrapolate the performance that we've seen in those stores across other potential opportunities. And what we have evidenced in those stores is that customers do come in, Argos customers as you might label them, come in to pick up something that they might have ordered through click and collect, and they do a Sainsbury shop. Whichever way you look at this market analysis, whether it's top down or whether you look at individual customer behaviour in the trials, it supports the view that there's a much greater overlap of these customers than perhaps some external observers have commented on.

Mike Coupe

And I cannot stress this point enough. I mean it's a really frustrating thing that people are writing up that somehow there's mutually exclusive customer bases, it's just not true. I would just reference first of all some of the press commentary, so one of the journalists at The Times I think it was, ran quite an interesting article where he clearly went to talk to customers and asked some real customers in real time what they thought, and they didn't find anybody that didn't think it was a good idea. Similarly, there have been some TV interviews that have referenced the same thing. And actually, I've not come across a single customer that has visited one of the Argos concessions in one of our shops that hasn't said anything other than, “I think this is a really, really good idea,” and I would just challenge you to go and do that, Dave.

David McCarthy

Okay, fair point. But just going back to that data, so you're happy that that sample of 1,200 people and the breakdown of sales reflects what your real business is, that we can use that data to talk about your business?

Mike Coupe

Well, it's one source of data and we wouldn’t have given it to you unless we could back it up. However, there are many, many other sources of data that we haven't talked about today which help reference and emphasise the point, whether that's subjective research, listening groups and all the rest of it, or whether it's objective measurement through things like Nectar database where we can absolutely nail literally at an item by item transactional level the behaviour of our customers.

We won't go through that today for obvious reasons, this just gives you one reference point, but if you characterise it as the only reference point, Dave, that's not reasonable, we have a lot more data that backs up, and of course we can't talk about that data today for obvious reasons.

David McCarthy

Okay. And then just very quickly, there's been no comment on Netto today. Any comment on the joint venture there, and does this have any implication for that?

John Rogers

No, nothing to update on, Dave, at this stage. Obviously we said that we would come back to Netto at our prelim statement and give you an update at that point. So what we said at the interims holds true, which is we'll do the 15 stores through this financial year and then we'll take a step back and look at how we might want to take things forward, and we'll give you an update at our prelim statement.

David McCarthy

So the press reports that you've got an extra ten sites, is that correct or not?

John Rogers

Well, the press reports, the planning consents that we've achieved for additional ten sites. Of course, that's what you'd expect us to be doing in preparing potentially for the future. But just because we've got a planning consent for a site doesn't mean we're necessarily going to build it out. So I think what we said at the interim holds which is we'll do the 15, we'll take a step back and look at the business at that point and decide how we want to take things forward. In potential preparation if we did decide to take it forward it just seems a sensible measure to look at additional sites and get planning permission. But as I said, just because we've got planning permission it doesn't necessarily mean we'll roll those out.

Mike Coupe

We have planning consent on about 70 sites at the moment, Dave, and we're not planning to roll those out either.

<u>Question 10</u>

Bruce Hubbard, Odey

I've listened to you articulating your vision for synergies for financial services for customers very clearly. I really don't understand what your vision is for the footprint of Argos. You talk about inserts which must be incremental sales, you talk about lease expiry at Argos, and I'm not clear whether your vision for this business is for it to be bigger in two or three years in revenue terms, or smaller?

Mike Coupe

I have to be slightly careful, I won't talk specific numbers, we would envisage that the combined businesses would be bigger overall, and as part of that the Argos business would also be bigger overall, otherwise we wouldn't be articulating the case that we are making. In terms of the specifics, you might expect let's say in three/five years' time that there would be less standalone Argos stores, and we make reference to the financial implications of that, not least the fact that they have a high number of their leases running out over the next five years and you've seen some press speculation around those stores are adjacent to each other, quite often on the same retail park or just down the road, and it's not beyond the realms of possibility/probability to imagine that some of those stores might fit in some existing Sainsbury stores. So that's the first part.

So it's basically it a replacement of existing shops, and secondly we believe that there's an opportunity of having more Argos concessions in existing Sainsbury stores above and beyond just the replacements that I've talked about. So I would expect, over time, that first of all there would be more Argos - for want of a better term - points of distribution, mainly concessions in larger Sainsbury stores, so there would be more Argos points of distribution. And secondly, and actually not insignificant, is the fact that we also have a pretty large convenience estate, and we have already got three stores that are Click & Collect Argos products through our convenience stores, and the convenience angle works very well for customers, and so that opportunity also exists.

So if you take the combined estate, you can imagine that there's going to be, let's say, for the sake of this argument, 2,000 shops, real shops, plus or minus, including a significant number of Argos concessions in Sainsbury's stores, and an element of that would be facilitated through Click & Collect in our Convenience shops.

John Rogers

I mean it's worth highlighting, Bruce, that based on the previous conversation we just had, that obviously we think the overlap between the two customer bases is material at 40%, but equally, that's not 100%. And so, by definition, there's the opportunity to sell Argos' products to existing Sainsbury's customers and the opportunity to sell Sainsbury's products to existing Argos' customers. And so we do believe there's an opportunity, a revenue synergy, if you like, by joining these two businesses together, as Mike's highlighted.

Bruce Hubbard

And thank you, that's a clear answer. And so, therefore, just to be absolutely clear, by implication, therefore, your proposition is that Argos has a cost problem, that there are not significant markets which are fundamentally unattractive and uneconomic?

Mike Coupe

Let me try and answer the question slightly differently. We've been asked the question about, why can't you get at this through a commercial arrangement? and we don't think there is as much benefit and as much synergy through that particular route as there is through combining the two businesses.

Now the reason for that is it gives us much more control over the property portfolio, and therefore allows us to make decisions that would make sense for a group rather than for any individual company. And in that scenario, the people who would win, if it was just a purely commercial arrangement, would be landlords, to be blunt.

So where does the value creation come? The value creation comes from rent that landlords might have got from one or other of the partners, particularly from Argos, which, in effect, is space that Sainsbury's has that can be relatively easily given over to Argos concessions. So that's where the money is.

Now whether you characterise that as Argos overpaying for space, I guess you could ultimately dress it up in that way, but that's not the way that we would characterise it.

John Rogers

And I think one of the things, Bruce, that you may be trying to get at in your question is perhaps some of the commentary around the percentage of the Electricals' category within the overall Argos sales at around 40% or so. And I think there's been some suggestion, of course, that that category, it's obviously an incredibly tough category and under significant competitive pressure.

I'll just make the observation, actually, and it's one worth noting, that if you look at John Lewis, actually in terms of their percentage of sales, it's not of a dissimilar nature, it's about 40%, and yet I've not heard the same criticism levied at them. And excepting the fact that clearly Electricals is a challenged category, we believe that we've got a better competitive position through the combination of these two businesses together.

<u>Question 11</u>

Tony Shiret, Haitong

Good morning gents. Re the implants, I know you're limited in what you can say, but before, presumably, Home Retail went radio silent on you, when they knew you were potentially bidding for them, did you actually have access to the sales data from Argos about what the impact of sales in nearby stores were?

John Rogers

Tony, I don't think we'd want to be drawn specifically on what information we had access to, other than the fact that we've got a very positive working relationship with HRG at all levels, and to say that clearly we talked about the synergies in the face of the announcements that we've made, and that's been informed by the experience that we've had through the ten store trials, but I wouldn't want to get drawn on these.

Tony Shiret

But these store trials were only open for a very short of space of time before you made the offer. You had two open in the second quarter of the year and another eight opened in the third quarter. And now you're proposing to go from 850-odd Argos stores to 2,000 units, which are selling these products. So cannibalisation is a bit of a key issue, yeah?

Mike Coupe

Well, we can't be drawn on the specifics and I think John's gone as far as we can do.

Just to try and give maybe a subjective feel, if you characterise an Argos' store versus a Sainsbury's store, generally speaking, our stores are in more convenient locations. Generally speaking, they have, effectively, free car parking, and generally speaking, they have longer hours, and generally speaking, they have a much higher footfall on a continuous basis. And so extrapolating the ten store trial, we believe it's perfectly possible, from our experience to date, and we think we have more than enough data to back up our case.

Now clearly there's an execution risk, there always is, and clearly we live in an imperfect world that can change, but I don't think there will be many transactions of this nature where there is a direct experience of what would happen in certain scenarios, and I think that's a very important point to stress. And, of course, extrapolating ten stores has an element of risk associated with it. Remember, of course, we have also three Click & Collect convenience stores, so we have a bit of experience of that as well, but we think we have enough data to put together a compelling case. But we emphasise the point that we've already made, that would be to a certain price and a price beyond which we wouldn't go.

Tony Shiret

But the cannibalisation issue, Argos has got an EBIT margin of between 2% and 3%, so it's not going to take a lot of cannibalisation to make the existing Argos' estate look pretty unprofitable before the benefit of any sort of cost savings. So have you had any data from Argos about their sales experience in the locations you've been in? A straight question. Have you or not?

John Rogers

And again, just to reiterate my first comment, we're not going to be drawn on the specifics of what data that we've got access to at this point.

Tony Shiret

Just the generality.

John Rogers

We've got sufficient data and we've got specific enough data to be comfortable, in if we were to progress with an offer, that we would be able to support any offer with a financially compelling case based on the data that we have available. But I'm not going to get drawn into the detail on this call as to specifically what data we have or haven't got, other than to say we believe we've got line of sight of what data we require, if an offer were forthcoming, to put forward a financially compelling case, albeit, as Mike says, at the right price.

And your point about cannibalisation, we made the observation in the slides themselves that actually when you look at the product portfolios, in many ways they are complementary. So we see the opportunity there, as I've already described, to sell our products to Argos' customers and vice versa.

And to your point around all this is before you have the opportunity to consolidate the space, well, Mike's already highlighted the significant opportunity that would be available to consolidate that very space. So we wouldn't ever put anything forward to shareholders that we didn't think was financially compelling, and we believe we've got access to the data that, if we were forthcoming with an offer, would support that position.

<u>Question 12</u>

Niamh McSherry, Deutsche Bank

Good morning, I have two. One is just going back to the Q3 results and whether you can comment on the shape of Christmas trading. So, for example, whether we did see an even greater concentration of customer spend in the week or so before Christmas than last year. Or any other market dynamics in the quarter that were they the same or different to Q2. That's the first one.

Mike Coupe

Okay, do you want to give us the second one as well so we can just divvy it out.

Niamh McSherry

The second one is a quick one.

I saw a Reuters' headline that basically said if the deal didn't work you would look for other acquisitions, and I was wondering if maybe you could elaborate on that?

Mike Coupe

Did you? Okay, well that's a headline I haven't seen, so I'm not sure I can comment on what may or not have been written, so I don't think we can comment on the second point at all.

I think it's already been referenced by a number of competitors and we would just reiterate, whether it's because of the distortion because of weather, whether it's just a distortion of Black Friday and the impact that it has more generally on the market, particularly non-food, it is undoubtedly the case that trade came through quite late, and certainly the 23rd was a very, very, very busy day for us, as was the 24th.

So I think it's a fair reflection, and you can see this played out in some people's trading statements, or at least the people that have gone public so far, that when it did come, it came big, and actually we're in great shape to take the money. So we're very proud of the fact that our stores are incredibly well set up, we've got the profile of stock pretty much spot on. And of course this year, although we had quite significant floods and we had a few stores which were disrupted by that, there wasn't any sort of major incident, particularly snow, which is what generally causes distortions in trade, this year compared with perhaps previous years. So I think that's a fair reflection of how trade worked out.

Niamh McSherry

Okay, but the implication is that that is purely a Christmas phenomenon that across the market there's no signs of consumers spending more on grocery or anything like that?

Mike Coupe

Well, you've seen the Kantar data, you can draw your own conclusions, it says very clearly that the market continues to be challenged. If you look at the shape of our business we're pretty pleased, we had like for like item growth, we had like for like item growth in our food business so we're selling more volume, we had like for like transaction growth but that's underpinned by the continuing challenge of deflation which we, as we've already said on this call, think will continue through the backend of this financial year and into the early summer.

Niamh McSherry

And I don't know if you clarified this already, you talked about minus one to minus two deflation, the same as last quarter, but do you think that that was similar to the market this quarter or not?

Mike Coupe

Yes, I suspect there'll be very few differences between us and our competitors.

John Rogers

Yes, I mean if you look at our relative position over the quarter based on our internal data that hasn't particularly shifted versus the competition, I mean we remain as price competitive as we've ever been, so I think we would argue that underlying deflation in the market is not dissimilar. So we talked about minus one and a half to two in Q2, see similar range in Q3 and as we've said already on the call, we'd expect that deflation to continue, at least into the first part of the new financial year but we wouldn't want to comment much beyond that.

And just to your point on the piece about acquisitions and so forth, just to be very clear, we've articulated very clear strategy, we've delivered against that strategy to date, we see the potential HRG transaction as a means of accelerating against that strategy but if that doesn't happen because we can't agree the right price or whatever then we'll move back to delivering against the strategy that we've been doing a good job against over the last 18 months or so. And that's not at all dependent on any other transactions or acquisitions for that matter, just to be clear.

Niamh McSherry

No, that makes sense, I was surprised by the headline. Thanks.

Mike Coupe

So were we! We're coming up to the 90 minutes but in light of the level of interest we'll keep going as long as we can. I suspect we will run out of time at some point so I apologise in advance if we're not able to answer your questions and as always you can come back to our investor relations team and talk to them if we don't get to you. So we'll do our best.

<u>Question 13</u>

Sreedhar Mahamkali, MacQuarie

Yes good morning all. A couple of questions then just on synergies, cost synergies specifically. The first one, you've talked about operation distribution synergies in the slides, slide 12 or 13, can you give us an idea how will the combined distribution network look? If you can expand on that that would be helpful.

Secondly, scale. Again, you've enhanced buying scale, are you able to give an idea in terms of the overlapping spend, how big is it? Thank you.

John Rogers

Shall I pick up both of those? I mean again, to save Mike answering the question, I think in reality we're not going to be able to provide any more colour than we've already given on the call in relation to the detail of those synergies, save to say that you've clearly identified two areas where we believe there to be synergies available. At this stage we can't break out that detail, if and when we get to a position of an offer.

Sreedhar Mahamkali

Sorry John, I'm not looking for numbers, just theoretically or conceptually what will the distribution look like, what are your thoughts exactly? And again, I'm not looking for a specific synergy number, are you able to give the combined buy? How big is the buy?

Mike Coupe

So as John's already said, we can't talk specifics. I guess maybe one way of characterising it is sort of short, medium, long term. The short term synergistic benefits, clearly in terms of rationalising the buying book that is something that you'd look at pretty quickly and you could get at pretty quickly. We can't go into specific numbers, we won't go into specific numbers. Actually we talked about the sort of level of crossover or otherwise, you can probably have a go yourself at looking at market data and trying to work it out for yourselves.

Secondly, sort of short to medium term, the rent roll, and that's where there's a significant synergistic benefit, we've referenced that at length on this call and that's something we think we can get at pretty quickly. You take a longer and more circumspect view of distribution because it's much, much more complex in terms of how you think about integrating the networks and that will be longer term and by longer term I mean let's say two, three, four years down the track. So the big ticket numbers are buying book and obvious cost synergies and rent roll.

John Rogers

But I think I would make the comment about the distribution networks, that they are very complementary to the extent that obviously our food network is great at shifting large volumes around within very tight time windows, delivering great availability across a very large skew count. And that contrasts with Argos' distribution network which is very much a hub and spoke network focused on delivering much smaller units around very flexibly and very rapidly.

So one can see that when you bring those two things together you're able to offer customers the full suite of options in relation to delivery times and so on and so forth. So we see there being an opportunity over time to combine those together in a way that really enhances our customer offer. In the first instance that's just putting those two networks side by side, in the longer term it revolves around greater integration of those two networks but again, we wouldn't want to be drawn today on the specifics of how that would work, other than to say we think it presents an opportunity to deliver value to shareholders.

Sreedhar Mahamkali

So one quick follow up. Would your non-food distribution capability be sufficient to service Argos as of today?

Mike Coupe

As in could you exclusively serve the Argos business through Sainsbury's existing GM network?

Sreedhar Mahamkali

Yes.

Mike Coupe

Almost certainly not.

John Rogers

I mean just in terms of the volumes, we wouldn't have the capacity to be able to do that, but could you over time merge the networks in a way that creates a more compelling customer proposition and also allows you to deliver efficiencies and savings, then the answer to that question is yes, but we're not going to be drawn today on the detail of that for obvious reasons.

Mike Coupe

I'll just refer back to the relative scales of the business. In the end the combined business as we've said already would to all intents and purposes be one of the largest, if not the largest non-food business in the UK, but it's roughly a third us and two thirds them so the idea that somehow you could push that sort of proportion of the stock through our existing network is not realistic, but we would equally as we've already said expect in the medium to long term, and it would be that kind of timescale, it wouldn't be the initial focus of the organisations by any stretch of the imagination, you could imagine integrating the networks.

So going back to the sort of management distraction/things we wouldn't necessarily do if this transaction were to go through, clearly we'd have plans in our own network given the growth of our non-food business to be looking at extending our distribution capacity, clothing being an obvious example where that business has grown like Topsy and clearly the opportunity that would be afforded to us is look more holistically at the combination of the two distribution networks that might forego some capital investments that we'd have to make ourselves.

Question 14

Borja Olcese, J P Morgan Cazenove

Hi guys and thank you. A very quick one. Are there any plans to update on long term incentive plans regardless of the transaction happening or not?

Mike Coupe

Well, I don't think I can answer that question directly, other than to say that our incentive plans are in the public domain in the form of our annual report and I would suggest that I would point you at that. I wouldn't directly reference it now.

Question 15

Nick Coulter, Citi Research

Hi, good morning, thanks for taking my question. Just to quickly clarify on deflation in Q3, I mean others are giving higher figures, so I guess a simple question is whether you're investing less in your offer or whether that's an issue of mix? I guess allied to that what's changed from your expectations when you gave the guidance for likes for likes down around 1.6 in the second half?

And then just on Home, I know you can't talk about Homebase but could you just reiterate any costs or de-synergies of the transaction that would be taken into account in a potential offer for the whole of Home Retail Group? And to be clear, you are talking about a bid for the whole of Home? Thank you.

Mike Coupe

I'll answer the second question and John can have a go at the first question.

We cannot talk, and we've said again and I'll reiterate, we cannot talk about Homebase and we won't talk about Homebase.

On the more general point you make, we are fully aware of the potential costs and opportunities, otherwise we wouldn't be proposing and going down the route that we've talked about. So, any nature, anything that involved any dissynergies [sic] or otherwise would clearly be taking into account in any proposition that we'd make to ours and their shareholders. But I cannot go any further than that.

John Rogers

Just in relation to your comments on deflation and what others have said in the market, of course I can't comment on how others have derived their numbers, but what I can say is that the detailed analysis of our numbers that shows that deflation in the quarter was between 1.5% and 2%, and that's done across a multitude of products of course, and what I can also say is again against a very detailed analysis on a skew by skew basis that our price position versus our competition hasn't changed.

So, you can draw your own conclusions from that. I can't comment on the numbers that others have put out there in the market, other than to suggest that perhaps some of that deflation others are talking about has been particularly focused on certain categories, and you might want to look at that in a bit more detail. But at the headline level we're comfortable with the guidance that we've given.

You also asked why we'd changed position on registered like-for-likes for the second half, what had changed; well, in reality we delivered a better performance than we expected through Christmas. We had a very strong Christmas; that's self-evident in the numbers we've shown in the face of the statement, and hence why we've just update the guidance on a like-for-like basis for the Full Half. Simple as that.

Nick Coulter

But is that because you're trading better? Because you've done something differently? Because the backdrop in the market is different? Because the deflation is different? I'm just trying to get at the reasons.

John Rogers

I don't think there's anything we would note has been done particularly different; other than to say it's a continuation of the trading strategy that we've been talking about now for some time. So, we comment in the statement about our reduced promotional activity. Obviously we had much fewer, for example, multi-buys during the quarter; a lot of that was invested back into underlying price. So, it's a continuation of what we've been talking about now for the last six to 12 months, and it's continued recognition and what gives us a degree of comfort that we can continue to perform well in this market going forward.

So, better than expected, hence why we're changing the guidance today to talk about better like for likes in the second half than we saw in the first.

Mike Coupe

Maybe you'd like to ask one of our competitors of the deflation of Bombay Sapphire in their particular organisation.

Nick Coulter

Okay, thanks very much. I'll leave it there.

<u>Question 16</u>

James Grzinic, Jefferies

I just want to ask a very specific question actually: how many shared locations do you have with Argos? Can you maybe discuss how many of those leases will expire over the next three and five years? Thank you.

Mike Coupe

Again, we can't give specifics, but we have a very good line of sight on both store portfolios, for obviously reasons, and therefore we have a pretty comprehensive understanding of where the opportunities lie. And that's, as I said already, one of the primary drivers of the value creation as we see it. We can't go into the specifics and unless and until any transaction went ahead we wouldn't be able to present that case to both sets of shareholders. But, as I've said already, it is the key underpinning of the most obvious and most realisable immediate synergistic benefits. It's at the sweet spot of what we think we're pretty good at as an organisation.

John Rogers

What we can say James, and it's in the public domain, is that around 55% of Argos' total estate comes up for renewal within the next five years, and that's in the public domain. And if you think about it logically in the context of the size of those two trading estates and the overlap of those two trading estates, given the size of those you can draw your own conclusions about what that might look like in terms of the overlap stores. But 55% of Argos' overall estate comes up for renewal within the next five years.

James Grzinic

Sure, given that it's probably the last opportunity you'll have to talk publicly on this ahead of taking a view, I'm just surprised is all because of Stock Exchange regulations you can talk or you cannot talk about specifics, given that it's really the crux of the question and understand the dynamic? But you cannot even tell us what the overlap is in total?

John Rogers

Well, it's the Stock Exchange regulations, and also from a commercial perspective in terms of where we are. In terms of as and when, if and when we have an offer forthcoming at the right time we'll be able to talk you through some of these details. But for commercial reasons and for Stock Exchange restrictions at this point we've given as much colour as we can.

<u>Question 17</u>

Andrew Gwynne, UBS AG

Let’s go for tradition, it’s a Trading Update, consensus PBT, where are we? What’s happening?

Mike Coupe

I’ll let John, answer that one; he can have the last word.

John Rogers

And let’s just maintain with tradition: obviously today is a Trading Statement and we’re obviously not going to comment on profitability.

Mike Coupe

Thanks everybody; thank you very much for coming on the call. And I’m sure I’ll look forward to seeing some of you in the not too distant future.