

## **Second Half Trading Update, 14 April 2005**

Analyst conference call transcript

### **David Tyler, Group Finance Director, GUS plc**

#### **1. Introduction**

Good afternoon and good morning, everybody. With me today is Fay Dodds, our Director of Investor Relations, and Peg Smith, from Experian, and we will talk today about the second half trading update. I hope that most of you have already had the chance to read this morning's statement, which I will now summarise, before moving on to take your questions.

#### **2. Overview**

GUS has completed another successful year in the year to March 2005, with profits at least in line with expectations for the group, with our retail businesses again delivering above-market performance for the year, and with Experian delivering its third consecutive year of growth well into double-digit percentages, demonstrating the benefits of its wide product range and its global reach.

The UK retail environment has become much more difficult, but we are confident that GUS will continue to deliver further progress in the new financial year. Our businesses have strong competitive positions and clear strategies for growth, and they are benefiting from the investment in ongoing initiatives to drive this growth, particularly in the area of supply chain.

#### **3. Argos**

##### **Sales**

Sales at Argos grew by 5% in the half-year, all from new space. New stores performed above plan. Like-for-like sales were, therefore, unchanged in the second half. There was modest growth in like-for-sales in the third quarter, and a modest decline in the fourth quarter. We continued to see double-digit increases in the second half in areas such as consumer electronics, digital cameras, and leisure, where we are taking market share. However, total retail demand definitely weakened during this period, which was reflected in a slowing in the rate of growth experienced by Argos in other areas such as furniture and white goods.

##### **Gross margin**

In the second half, in addition to growing total sales, and reducing prices to consumers in the current catalogue by about 6%, Argos was able to continue to slightly improve its gross margin. It is the sixth consecutive year in which Argos has continued to outperform the market in terms of sales and, at the same time, improve its gross margin.

## **Outlook**

Looking forward, Argos continues to invest in initiatives to drive growth around choice, such as Argos Extra, around value, such as the recently launched non-stop price drop campaign, and around convenience, including our programmes to improve service in stores, the benefits of the Internet, and our in-store kiosks.

### **4. Homebase**

#### **Sales**

Sales at Homebase were up in the second half by 6%, of which 4% came from new stores. Like-for-like growth was 2% for the five months to 28 February, and the underlying rate of change was broadly the same in both quarters. We continue to be pleased with the sales progress we are making at Homebase against a difficult background, which comes from the improvements in our customer service, good sales uplifts from the new core DIY ranges, and the mezzanine formats – particularly the latest ones.

#### **Gross margin**

We are also pleased with the progress being made in leveraging the scale advantages of Homebase since it became part of ARG. Gross margin in the second half was slightly ahead of the same period last year, aided in part by the supply chain savings that we are achieving.

#### **Summary**

In the current market, most retailers are facing pressures from sales and costs; although Argos and Homebase are not immune to these pressures, they have ongoing initiatives that will drive sustainable growth, underpinned by our supply chain investment, which is continuing to generate substantial savings.

### **5. Experian**

#### **Growth**

The Experian business grew its sales by 20% at constant exchange rates in the half-year. Indeed, it was the sixth consecutive half-year period during which we have had double-digit sales growth. We have achieved growth consistently and strongly across business units around the world. Experian benefited from the continuing investment it has made in product innovation, expansion into new vertical and geographic markets, and its successful programme of in-fill acquisitions.

## **6. Experian North America**

In North America, sales were up by 22% in dollars, including the benefit of 8% from acquisitions. There were numerous contract wins around the business in America in the half-year, reflecting the strength of its market position. For example, we saw good volume growth in our core credit information, reflecting share gains in markets as widespread as credit unions and mid-tier banks. Our marketing business in North America also won three multi-year, multi-million-dollar deals in the last quarter alone – two with major multi-channel retailers and one with a consumer packaged goods company.

FARES, our real estate information joint venture, had a strong second half, resulting from synergies from last year's major acquisition of the Transamerica business.

The business also coped well with the impact of recent regulatory changes, specifically the FACT Act, although this had a modest negative impact on profits in the year just ended.

Once again, we saw exceptional growth in Consumer Direct, which now has 2.4 million subscribers – up by 700,000 since this time last year. This has been driven by increasing consumer awareness of the product, by our very strong relationships with our major portal partners, and by the success of a number of new product launches, particularly the recent Triple Advantage launch. MetaReward, our Internet lead generation business, also saw exceptional growth, especially in credit card marketing. As we have noted before, this business has margins below the average for Experian in North America.

Overall, in North America, we are building strong market positions in connecting companies via the Internet with those consumers most likely to buy their products. We see this as a key growth opportunity going forward, and we have done well in the past year in Consumer Direct and MetaReward.

## **7. Experian International**

In Experian International, we grew our sales by 18%, 13% of which came from acquisitions. The growth was well-spread between credit, marketing and outsourcing. Highlights in the half-year include the extension until 2010 of the contracts we have with Spanish banks covering our Spanish consumer credit bureau. This reflects how we have now become a very well-trusted partner. Another highlight was the further deepening of our relationship with a number of leading UK banks, and good growth from the recently-acquired QAS business, which has just launched its first joint product with Experian's marketing business, only four or five months after joining the group.

### **Summary**

Globally, with the new management structure now in place, we believe Experian is well-placed to deliver further attractive growth in the new financial year.

## **8. Burberry**

Burberry yesterday reported 6% sales growth at constant exchange rates. It had solid progress in each of its distribution channels, and profit growth in the year just ended was a little ahead of expectations.

## **Conclusion**

We have completed another successful year in all of our major businesses and, although we have a cautious outlook for retail demand in the year ahead, we believe that we will continue to make further progress in the coming year.

## **Questions and Answers**

### **Philip Mitchell, JPMorgan**

First, you said that third quarter gross margins at Homebase were flat, and that those for the fourth quarter were up slightly; was this entirely related to the promotion being brought forward into the third quarter? Second, it sounds like you are being slightly more cautious in terms of the outlook; have you made any changes to your expansion plans in terms of UK retail?

### **David Tyler**

The improvement in Homebase margins in the half-year had nothing to do with that promotional change, but was due to the benefits of our supply chain programme, which brought, and will continue to bring, benefits. In November, we talked about the annual benefits during the coming year being around £40 million for Homebase, as well as synergies from the acquisition, and you are seeing some of those coming through in the second half of the year just ended.

As far as plans for expansion going forward are concerned, these are certainly not being affected by the current consumer slowdown in the UK. We look at our expansion programmes over the medium to long term; clearly, from time to time, the market has a downturn, but that does not affect the way we think about developing our businesses. Over the next year, we see the number of Argos shops increasing by about 35 – roughly the same as this year – and the number of additional Homebase stores will be rather more than this year – up to 15, versus last year's net nine.

### **Philip Mitchell**

Returning to my first question, it is slightly surprising that, given that your sales growth was stronger in the third quarter, the gross margin was, effectively, flat, whereas it was up in the fourth quarter. Could you explain the difference between those two quarters?

### **David Tyler**

It is partly to do with the normal contracts we have with suppliers, where we receive rebates at the end of the financial year, depending on the volume of business we have done during the year. One would have to make assumptions about that during the year; we are fairly conservative, so we take quite a high proportion of those rebates in the last quarter of the year. That is the major reason for the slight improvement in fourth quarter sales.

**Fraser Ramszan, Lehman Brothers**

Could you say how much Consumer Direct now accounts for within the North American business? Growth there was pretty exceptional. Second, you mentioned the core credit business seeing volume growth; are you seeing any particular pricing pressure there?

**Peg Smith, President, Experian North America**

In terms of core consumer credit volume growth, we are seeing volume growth and attribute it to market share gains, particularly in the mid-tier market among banks, credit unions and auto dealers, where we have a focused sales effort. It is not so much the market growing itself, but rather us taking share in that particular tier.

**Fraser Ramszan**

Is there any pricing pressure? I assume there always is, but is it particularly acute at the moment?

**Peg Smith**

Due to the fact that we are targeting that particular part of the market, there is not as much pricing pressure there. It is no more or less on the total core consumer credit business than what we have experienced in the past.

**Fraser Ramszan**

In terms of the FACT Act, you said there was a small impact on profits in the year just ended; how much are you expecting that to impact your profits by in the coming year?

**Peg Smith**

In the coming year, it reverses itself. In fiscal year 2005, we had to invest ahead of our opportunity to recover costs from clients. In fact, we have been investing since the bill was signed into law in 2003.

**Fraser Ramszan**

In the international business, has there been any evidence of a slowdown in your UK credit numbers as a result of what we have seen in the consumer markets here?

**Peg Smith**

We have seen a very slight slowdown in the credit reference side of the UK business, but we also believe that that is temporary. It may simply be caught up in the noise around consumer sentiment and consumer spending. We will need to return to your

question about the percentage of Consumer Direct as a whole. I think it is about 17% of North America.

**Christian Koefoed-Nielsen, Goldman Sachs**

You made the point that MetaReward margins were below the Experian North America average, yet it was growing strongly. Is that a signal that we will see margin pressure from lower-margin businesses doing well within the group here?

**David Tyler**

It is only a small part of the group, so we are simply flagging that it has lower margins than the average and that, therefore, it will have some impact on the mix. It is very good business and the return we are making on the investment in that acquisition, which was completed about 15 months ago, is very satisfactory. Clearly, we do not make a judgment about whether or not to buy a business just on the basis of its EBIT margin; one of the most important factors is the return on capital, and this particular investment looks like it is giving shareholders a very good return on capital.

**Christian Koefoed-Nielsen**

Would you share what that return on capital is?

**David Tyler**

I am afraid that I cannot; that information is too sensitive.

**Christian Koefoed-Nielsen**

What is the situation with the buy-in of the affiliates?

**Peg Smith**

We completed 32 deals through to the end of the fiscal year and spent about \$191 million doing so. There are 38 in total, so we have a few more to clean up in this fiscal year and, frankly, all of them are performing ahead of plan, so we are very pleased with that effort. In this fiscal year, because we did not buy any major bureaux, it only contributed less than 1% to revenue.

**Mark Bacurin, Robert W Baird**

You mentioned in the press release that sales at Experian dropped by a few hundred basis points due to the cost recovery charge for the FACT Act; what kind of response are you seeing from your customers in terms of their acceptance of that increased surcharge?

**Peg Smith**

About 2% of total sales in the first half were related to the FACT Act cost recovery. This means that, in quarter three, about 1% of revenue came from FACT Act cost recovery, due to the fact that we were only recovering at about half the rate. During October-December, cost recovery was implemented at half the rate in order to ease clients into paying for this charge, and the full rate was introduced in January. Quarter four sales represented about 3%.

## **Mark Bacurin**

In terms of client acceptance of that surcharge, have they been fairly comfortable with the new charges?

## **Peg Smith**

I am not sure that clients are ever comfortable with a cost increase, so there is always some risk, but I must say that the conversations, while difficult, went reasonably well, and we have been billing and collecting since October.

## **Mark Bacurin**

In terms of disputes related to the free credit reports that are being issued, it looks like, overall, there has been a fairly low level of disputed information being sent out, which seems to suggest that the costs that you need to recover may ultimately be lower, which could warrant a reduction in surcharges.

## **Peg Smith**

I wish I knew what the costs were going to be when we roll it out across the country. We are not going to discuss the specifics around the mechanics of this at this point, because we are only halfway across the country. Typically, disputes on free reports are lower than our normal transactions in the consumer assistance centre, because those reports are being requested simply out of curiosity. They are not normally disputed at quite the same level as those who have been denied credit. It is very much consistent with what we have modelled in terms of the cost of FACT.

## **Mark Bacurin**

You had very strong sales on the Consumer Direct side, at about 33%; is there a way to strip out what sales lift you may have seen in the geographic territories where the free reports have already been sent out? Seemingly, that is increasing awareness, so you may see some sales lift, as consumers become more aware of product in those areas.

## **Peg Smith**

We have not seen a material change geographically. There is an overall awareness in the United States, since there has been so much media attention, both around the free credit report available to consumers and now, more recently, around data breaches. Those two, in combination, have definitely spurred volume on the FACT Act central source and on our consumer assistance operations.

## **Mal Patel, HSBC**

Can you give us some idea of where you think price deflation is headed in Argos' key categories over the next 12 months?

## **David Tyler**

In terms of reincluded lines, our current catalogue is about 6% lower in price than the same time last year. We anticipate pricing in the autumn/winter catalogue to be lower than the same period last year, but I do not want to get ahead of ourselves by estimating what that might be. Our supply chain programme has been very

successful in generating benefits, and we will still have a 'following wind', when pricing in sterling, from the weaker US dollar, when comparing like-for-like figures during that period. There will be further price deflation, but I do not want to put a figure on it at this point.

**Mal Patel**

What do you think the scope is to vary costs in the delivery infrastructure through the next year, or even longer, as volumes decline?

**David Tyler**

I am not sure that I quite understand your question.

**Mal Patel**

Presumably, there is a level of cost, for example, within the two-man delivery infrastructure, that you might be able to vary if volumes do not come through as anticipated.

**David Tyler**

You are asking, therefore, what opportunity we have to cut costs. Clearly, an element of our business model is variable and we can take costs out in a number of different ways. I do not want to discuss that particularly in terms of distribution as opposed to other parts of our model; clearly, it is a significant element of the Argos model where costs are fixed, but we have a choice as to how much distribution we want and how many trucks we hire in. We also have a choice around how much additional staffing we choose to hire in during peak periods, in terms of warehousing and truck drivers. There is an element of flexibility, therefore, that will allow us to deal, to some degree, with any volume reductions, if that is what you are predicting.

**Mal Patel**

Have you had to exercise any of that flexibility so far?

**David Tyler**

Not in any significant way in the distribution system; however, we have been quite careful about our costs during the last three months through the whole of Argos, given what we saw was happening with consumer demand. We will continue to exercise caution and ensure that we are achieving value for money right across our cost base during the next six months.

**Mal Patel**

You talked about a small impact from the growth in MetaReward because it is a low-margin business; is that a net impact after you take into account the beneficial impact of the growth in Consumer Direct margins, or is it a gross impact?

**Peg Smith**

Against the group as a whole?

## **Mal Patel**

The growth in Consumer Direct, which is a higher-margin business, should offset the impact of the growth in MetaReward, which is a lower-margin business.

## **David Tyler**

Consumer Direct is a good margin business, and we have indicated that it is now ahead of the average for the whole of North America, so that is a positive on average margin. A negative is MetaReward, albeit that it is providing very good profits for us, so it is very useful. We have additional costs in the credit services business, due to the FACT Act. We are also very cautious and prudent in the way we account for our Consumer Direct business, and the acquisition costs of customers are taken upfront. Therefore, with the large growth we have had in that business during the last six months, we have absorbed the costs incurred as a result. There are a number of elements in the mix and we are not trying to suggest to you that there is a significant change in the EBIT margins of Experian North America; we are simply pointing out that there are some elements of the business which, naturally, have different margins, including lower margins in MetaReward.

## **Nick Bubb, Evolution Securities**

Do you know why consumer demand has fallen so much in the UK during the last two months? Does it have something to do with the election?

## **David Tyler**

I do not think it has much to do with the electoral cycle, although the electoral cycle may not be entirely independent of what is happening to consumer demand; I guess you would have to ask Tony Blair and Gordon Brown about that. I think what we are seeing is the continuing impact of a number of factors, such as increases in tax and National Insurance, and a significant increase in petrol prices. I think there is a factor associated with the value of houses and the ability of people to use the value of their house to withdraw equity from mortgages. Those factors have also certainly had an impact in recent months.

## **Nick Bubb**

Why has that slowdown affected your business at Argos in furniture and white goods, but not in brand goods and electronics?

## **David Tyler**

To some extent, it is a 'big ticket/small ticket' issue, in that we have seen slow growth in some of the big ticket areas. However, we have seen a slowdown in growth in this half-year compared to the previous half-year in consumer electronics as well, although we continue to see very good growth in that area. The price deflation effect is also much more significant in consumer electronics and, when we bring down prices in certain areas such as plasma screens, there is an offsetting effect, since the customer is suddenly obtaining something which is perceived as really good value at a particular price. It is not always the case in furniture, where there are fewer standout items. We are also seeing strong growth in some of our entry price products in consumer electronics such as digital cameras and DVD players. Furniture is still growing within Argos' sales, but at a much lower rate than it was.

## **Bruce Hubbard, Citigroup**

Your rate of like-for-like from your Argos stores has narrowed quite substantially relative to BRC and non-food. Do you think that is likely to be a relationship that would carry forward through 2005 and, potentially, into 2006? Do you think something has changed in the relationship of your same-store revenue growth?

## **David Tyler**

The mix is probably changing. Going back to the previous question, we were outperforming significantly in furniture, whereas market growth in furniture has now entered negative territory. It is a big part of our mix, but probably a smaller part of the overall non-food/non-clothing mix. I think mix effects, therefore, will be significant within that. The jewellery market is another where we are not a significant player and which is in decline, as we have seen from other retailers' figures recently.

It will depend on the mix, but Argos' service and convenience levels and pricing are improving. We think this will continue to allow it to outperform against its competitors. There may be periods when that does not happen and when mix effects of market growth have adverse effects on us, but Argos is in a very good position overall and we believe that it will exit this consumer slowdown in a better competitive position in relation to other retailers.

## **Bruce Hubbard**

Can you reassure us that there will be no more non-recurring trading charges, either in Homebase or in other areas where you have made acquisitions recently, such as Experian?

## **David Tyler**

I am not aware of anything that will hit us. There is one element still pending, which is the outstanding decision by the OFT appeal tribunal as to what it will charge us on an outstanding fine. I am not aware of anything else, but we will take these things 'on the chin', as we have done this year with the decision – which is going to earn a good return – to take those Homebase employees involved in merchandising, marketing and buying out of Wallington and move them to Milton Keynes, alongside our Argos staff.

Within Experian, I am not aware of anything pending. I cannot promise that there will be nothing in the future, but our accounts always take these things 'on the chin', and you will see, through the profit growth of the business in the last three years, good double-digit growth each year, and current analyst forecasts for the year just ended suggest the same.

## **Fraser Ramszan**

You mentioned the non-stop price drops at Argos; what are they and how do they differ from previous promotions? Second, Peg mentioned the Triple Advantage product; what is it and how does it work relative to other previous Consumer Direct products?

## **Peg Smith**

Triple Advantage was launched in January this year. It is a product subscription

service that monitors all three bureaux on a daily basis. Customers are sent email or SMS messages about changes at any of the three bureaux and we have had very good reactions from consumers.

**Fraser Ramszan**

Are there other competitive products like that in the market?

**Peg Smith**

To date, I believe it is the only one that has been launched, but I suspect that we will see others following. However, we are a market-leader in that regard.

**David Tyler**

The non-stop price drop is really a branding concept that we have been involved with. For several years, we have dropped our prices during the course of a catalogue. Very often, they are in the promotional leaflets that are sent out every month associated with the promotional period, but quite often they are not something that we tend to publicise. We tend to do them quite quickly, in response to others, or because we want to focus on certain areas. This is an attempt to encourage the consumer to think that prices may continually be falling in our Argos shops, which they are.

**Fraser Ramszan**

It is, therefore, enabling you to be more tactical in terms of your pricing.

**David Tyler**

We have already been doing it for several years, so it provides a marketing 'banner' for that programme.

**Robert Miller, Dresdner Kleinwort Wasserstein**

The MBNA contract that you lost falls out of the comparatives in May; what should we expect the uplift to be on the run-rate for the International business once you pass that anniversary?

**David Tyler**

The impact of that in the last two quarters has been about 3%. Instead of having a headwind from that, after May, we will not. All things being equal, therefore, figures will be 3% better.

**Robert Miller**

I think that you said, during the January call, that you are aiming for Experian revenue to grow, in this new financial year, by more than 10%, even though there is much less of a tailwind from acquisitions. Do you still stand by that?

**David Tyler**

We are still aiming for that. The performance of the business in the last 12 months – and particularly the last six months – underpins our confidence that that is a reasonable target to aim for.

**Robert Miller**

I know that you do not consolidate the revenue from FARES into these numbers, but what is the revenue trend in the FARES business in this last quarter?

**David Tyler**

All we do is consolidate profits when they reach the P&L. We will update you on that in May when we make our preliminary announcement, but I can give you some guidance, in that the business was stronger than we thought. As I mentioned in my remarks, the acquisition of Transamerica has gone well, and the business as a whole has probably also taken share. However, I cannot tell you the absolute revenue numbers.

**Robert Miller**

In the statement, you said that the marketing information and solutions area has done well; can you be more specific in terms of how it has done relative to the group, and what are the particular product areas where it has been making most progress?

**Peg Smith**

The credit side of the business tends to have stronger growth rates than the marketing side. We are seeing good growth in marketing information, which is broader than just the consumer marketing side; it includes our business-to-business marketing file and our auto history marketing information that is included within that category, and it is growing well.

In solutions, we have had some contract wins in the quarter that are very encouraging to us in terms of the database solutions area. However, as we have said in the past, because there has been a slowdown in the typical list processing that we do for cataloguers, you will see revenue for these new databases offsetting a softening in the catalogue industry and list processing. However, we are convinced that we are on track for the multi-channel marketing solutions side of the business, which is evidenced in its biggest form by the growth in our email delivery business. All told, a pretty strong story is coming out of the marketing side.

**Andrew Hughes, UBS**

In terms of Argos, do you think that you have lost market share in any of the durables areas, particularly in white goods? Second, in terms of Experian, you said that Fair Credit issues would swing from a small loss last year to a small profit this year. Does that exclude the growth you are seeing from Consumer Direct?

**Peg Smith**

We are taking a new region every quarter in terms of rollout, so we believe that, late in the second half of 2006, you will see some improvement in terms of the cost structure, because we will have rolled out free reports nationwide. In terms of the Consumer Direct side of the business, we account for that separately. The credit services piece of the business is the one responsible for FACTA delivery and surcharge

recovery. Although Consumer Direct has had increased sales, we believe that they are due directly to awareness, rather than to conversion of consumers who are requesting their free report.

### **Andrew Hughes**

You will, therefore, in 2005-06, see a P&L benefit from the growth in Consumer Direct and the fact that many of the startup or recruitment costs were taken last year. Additionally, you will see some benefit from the surcharge recovery swinging from loss to profit.

### **Peg Smith**

That is correct.

### **David Tyler**

With more clients taking our service from Consumer Direct at the beginning of the year, you can anticipate higher revenue, because the clients are already there. In terms of your question on durables and white goods, we are gaining market share and have been doing so consistently ever since we entered the market in 2000. The latest figures still show a gain in market share. However, we are suggesting that our sales growth has slowed in light of the current consumer environment, and I am sure that it has for many of our competitors too.

### **Andrew Hughes**

Everyone is concerned about hypermarket encroachment into non-food; in those categories where you may overlap with hypermarkets, you seem to have performed better. When you benchmark your prices against hypermarkets in those categories, do you think your 6% decline still puts you in a better position than them?

### **David Tyler**

I will not discuss our competitor price surveys, but we are competitive. Not only do we have competitive prices because we can source as well as they can, most of the time, with our supply chain programme in particular assisting us on that, but also because we have the range, and it is very difficult for competitors such as hypermarkets to carry the very wide range of consumer electronic products that we are talking about. Sometimes, that gives us an advantage.

### **John Baillie, Société Générale**

How have UK financial services built this period and what is the size of the book at the period-end?

### **David Tyler**

The book, as a whole, is just below £100 million higher than it was last year. Growth continues well in our storecard businesses in Argos and Homebase. On the personal loans side, we have been unhappy about the competitive pricing in that arena, and we have pulled back significantly from acquiring new customers.

### **Fay Dodds, Director of Investor Relations**

The storecards and loans book will end the year at about £460 million, compared to just over £350 million the year before.

**John Baillie**

Do you feel that there is increasing margin pressure in that area?

**David Tyler**

Certainly in personal loans, but not necessarily in storecards. It is a great promotional tool for Argos to have and, indeed, increasingly for Homebase. However, a lot of money from the financial services industry has been chasing the personal loans market.

**John Baillie**

Looking forward, are you still happy to achieve this sort of rate of growth on storecards over the next 12-18 months?

**David Tyler**

We certainly expect storecards to go on growing, which provides benefits to merchandise sales at Argos and Homebase.

**David Tyler**

Thank you very much for attending this call. We will announce our preliminary results on 25 May and we look forward to seeing most of you then. Goodbye.