

## **Interim Results – 21 November 2006**

### **Chairman's Welcome**

#### **Oliver Stocken**

Good morning, everybody, and welcome to the first results day of Home Retail Group as a separate public company following our separation from the GUS group in October. This is, therefore, a momentous day for Home Retail Group. I was delighted when asked to be Chairman of the group. I had been on the board of GUS since April 2000, and therefore I have worked with Terry Duddy since that time. Richard Ashton joined the group as Finance Director of the then ARG Group in 2001, and so I have known Richard, as well, for over five years.

The group is the UK's largest home and general merchandise retailer, and we have two extremely strong brands in Argos and Homebase. At the time of the separation, we were joined by 30,000 employees who became shareholders in the company; it was a very good tick for the management that so many employees decided to take up the offer of shares given to them at the time of separation.

Terry will take you through the operations for the first half, and Richard will go through the financial results in more detail. I should mention that they are somewhat complicated because of the timing of the split, which came partway through the year, just after the first six months, and they impact very significantly on the six months' results.

### **Operational Review**

#### **Terry Duddy**

#### **Chief Executive Officer**

##### **1. Preamble**

I am pleased to be here for our maiden announcement as a separated company. We will be reporting on the six-month period for which we remained a subsidiary of GUS. To help your understanding of the underlying performance of the business, we have pro formas, which Richard will go through in detail. I will provide a short update on our performance in the first half and some operational background on Argos and Homebase.

##### **2. Further Good Progress in the Half**

Through the demerger we believe we have set out for investors and analysts a clear view of our business, together with strengths, capabilities and clear agenda for growth. Group benchmark operating profit was 2% ahead of last year, with strong sales from Argos. Our approach to the challenging conditions in Homebase has supported an improvement in gross margin. During this half, we have continued to invest in long-term growth in both businesses, pursuing the strategy outlined through demerger.

### **3. Argos**

#### **Sales**

Total sales at Argos were up 11.5%, of which 4.6% was like-for-like and 6.9% was from new space. The like-for-like performance was driven by varied factors throughout the half with a combination of differing one-off factors; the World Cup effect through the first quarter driving flat panel TVs and set top boxes; child safety due to regulation changes; and seasonal products working well with the arrival of warm weather. Although there was an exceptional performance in flat panel TV's in the first quarter, their outperformance continued through the second quarter, albeit at a much lower rate of growth. Together with videogame systems and bedroom furniture, they became consistent outperformers throughout the first half.

The new space performance was a result of 20 store openings through the half, in line with our target of 30 store openings, although new space sales continued to benefit from the Index store openings in the latter part of the previous year. We expect new space sales growth to be around 4%, as we anniversary these openings in the second half of this year.

Argos Extra has now had over 12 months as a national offer and is performing well. It is increasingly difficult to estimate the sales effect of Argos Extra due to lack of control stores. However, a circa 2% contribution of like-for-like is likely, and we believe we will continue to benefit as awareness of the product offer continues to build.

#### **Gross Margin**

The profit impact of the strong sales performance has been substantially offset by lower gross margin percent. The lower margin was driven by product and promotional mix, but the effect reduced in the second quarter. There have been supply chain gains, but not enough to counter the total reduction. Separately, in terms of working capital, there was an increase in domestic-purchased product, as the business responded to sales higher than expectation in order to maintain availability. You should recognise that the Argos performance is driven by the fundamentals of our proposition: value, choice and convenience.

#### **Great Value**

Being recognised by our customers as a leading value retailer is the cornerstone of the Argos proposition. We continue to leverage the combined buying scale of the group, delivering highly competitive everyday prices and creating breakthrough on entry-price products and promotional value. We continue to lower prices through the life of the catalogue, and since the launch of the current catalogue, from July we have lowered over 2,600 prices, ensuring that we move with and ahead of the market. As an example of how we drive these promotions, we typically distribute 60-page brochures to around seven million homes every month.

#### **The Leading Multi-channel Business**

The sales performance in this first half has also been supported by our performance as the leading multi-channel business. This is clearly how customers want to shop, and we deliver this for our customers' convenience. Interestingly, we have been providing a check and reserve service on the internet for over five years, which is now our fastest growing channel segment. Check and reserve – remote orders for later pick up in store – are now over 10% of sales, and growing by over 50%. Total orders over the internet for the first half of the year were 15% of Argos total sales and also grew overall by 50%. Total home delivery is 25%, of which half of those

orders are made in store. Our long-term investment creating seamless order taking through stores and remote channels is working effectively for us and for the customer. And we continue to invest in our infrastructure; for example, this year we have expanded our internet capacity.

### **Great Home Delivery**

Supporting our multi-channel proposition, we have an efficient home delivery operation. We have the advantage of scale of being the largest two-man delivery infrastructure in the UK, which is providing over four million deliveries per annum. For the customer, that means that we have an unmatched offer, providing a choice of three time slots through the day, which are confirmed ahead of delivery and again on the day when the driver will phone ahead. On one-man, we are contracted to the largest one-man delivery in the UK, where our two Argos DCs' deliver into 60 contractor regional depots. Our standard delivery at £4.95 allows the customer to choose a specific day of delivery. This now includes next-day delivery, although in our experience over 50% of customers tend to choose a day to suit them, which is often more than two days ahead. All in all, we have what we consider to be the most convenient multi-channel and home delivery infrastructure in the UK.

### **Ready for Peak**

Although we are not providing any current trading commentary, let me assure you that we are fully ready for the Argos peak season. We launched our 232-page Christmas gift guide at the end of October, which was distributed to over six million homes, as well as in store. We have backed this with a new TV advertising campaign and focussed promotional events.

We expect Christmas to be as competitive as ever, and not surprisingly, the product focus will be on digital products, particularly LCD, plasma TVs and MP3 players. For the less technically concerned, chocolate fountains will be a must have gift. We continue to add to our proposition to make shopping at Argos the most convenient on the high street and have rolled out around one-third more quick-pay kiosks, adding to our multi-channel proposition. We now have over 1,000 kiosks in store.

## **4. Homebase**

### **Sales**

Challenging market conditions have continued throughout this first half. Although overall sales increased by 1.4%, this was off the back of a 2.7% like-for-like decline and new space growing by 4.1%. Sales of furniture and kitchen continue to show strong growth, albeit the core DIY and decorating ranges remain weak. There has been an improvement in like-for-like sales performance towards the latter part of the half, although this has been largely driven by the exceptional warm weather driving specific seasonal categories. Importantly, the reduced promotional stance that we had planned from the beginning of the year has shown a significant improvement in gross margin, predominantly in the first quarter, yet Homebase has been able to hold market share.

### **Gross Margin**

The gross margin improvement has been supported by the benefits of supply chain improvements, specifically group combined purchasing. During this period we have seen no noticeable improvement on the overall competitive nature of the market, but we intend to continue our trading approach through the next promotional period in the new year, dependent on market circumstances.

## **Continuing to Differentiate**

We continue to differentiate the Homebase proposition and position the business as the leading home enhancement retailer. The rollout of Furniture Extra has been key and our brochure is now in all stores. We also have on trial in 100 stores the Homebase home furnishings catalogue. This catalogue incorporates the Furniture Extra offer and presents room settings and design trends, providing style-led coordination across a wide range of Homebase product categories.

### **Create the Look**

We have matched our own-brand paints to provide colour palettes that match with our home accessory products. These are presented in the catalogue and in store to provide room sets in design styles to provide the direction and support for customers completing their home-design projects.

### **Home Enhancement Trials**

The new product ranges in kitchens, bathrooms and furniture, combined with our mezzanine programme, have been delivering sales growth and return on capital above our hurdle rate, and we now have mezzanines in over 150 stores. As importantly, the positive response from customers in all our invested stores continues to give us confidence in the way that we are moving our proposition.

A further 100 stores within the chain have not had any, or minimal, store refurbishment investment for a number of years, even prior to acquisition. Many do not have any presentation of furniture and minimal presentation of kitchens and bathrooms. However, these stores do not have the capacity for a mezzanine.

We have begun trials in a number of stores to reconfigure and provide edited presentations of kitchens, bathrooms and furniture. These trials are necessary to ensure that we get the optimum return on space and investment to drive the sales result. However, the trials are in the initial stages and we will not have completed our assessment until after next Easter. At this early stage, we believe we can expect positive results, as our confidence and understanding is based on the achievements from 150 invested stores over several years.

## **Financial Review**

**Richard Ashton**  
**Finance Director**

### **1. Basis of Preparation**

Today I would like to take you through the maiden half-year results of Home Retail Group. I would like to point out that the numbers are quite complicated as a result of the demerger. The financial results for the first half are for Home Retail Group as a wholly owned subsidiary of GUS, and hence the capital structure under which we operated for the whole of the half will be very different going forward, as it changed position on the date of demerger, 10 October 2006.

We are maintaining the GUS measure of benchmark profit before tax, but we are making one change to that definition: we will be excluding the net financing benefit we get on the pension scheme assets. Because of the capital structure I have talked about and the fact that we are in a very different position in the first half compared to the second half, we have done a pro forma calculation of benchmark PBT, which

we think will be more useful this time next year when comparing the first half performance.

Finally, we will be changing the year-end of the group from 31 March to the end of February because we are currently operating non-coterminous year-ends within the group – Homebase has historically always been at the end of February; Argos and the rest of the group have been at 31 March – and given the fact that the rest of GUS was 31 March, it was never an option to move the trading divisions of the businesses while we were part of GUS, but it is now an option to which we need to move going forward.

## **2. Pro Forma Benchmark Results**

Group revenue was up 8% following the strong growth we saw in Argos, offset by a slightly lower performance in Homebase, where sales were up only 1%. Gross profit, which includes distribution costs, was at 34.4%, up 20 basis points. The two things driving that were the weaker performance in Argos, offset by very strong gross margin performance in Homebase. Distribution cost of sales were approximately held flat in the half.

Benchmark operating profit was up 2%. The pro forma net interest income at £5.7 million reflects the underlying third-party debt we would have paid as if we had started our year with the £200 million net debt position that we were artificially inserted with at demerger. That gives us a charge for the year of around £3 million, against which we recharge £8 million into the Financial Services business as their cost of sales, which gives us a credit of £6 million. That results in a pro forma benchmark PBT of £113 million. There is not a measure against which you can compare that to for the prior year, given the artificial nature of that calculation, but it will be useful for you this time next year when we come to compare the actual benchmark operating profit under the new capital structure. The remaining charge of £35.7 million is the extra interest charge we took on the GUS capital structure, which was eliminated on 10 October. It really has no meaning for us going forward.

## **3. Benchmark Operating Profit**

In terms of focusing on the underlying profits of the business, benchmark operating profit is a fair and useful measure of how the businesses have performed in the first half. We had a strong performance in Argos at 22% up, although Homebase was down just over £10 million at 22%. Financial Services were up by approximately £0.5 million. In Central Activities, there is an allocation of roughly £7.5 million from GUS of their share of central costs into Home Retail Group for both the first half of last year and the first half of this year. On top of that, we have reallocated some central-related costs that Argos incurred previously, which gives you the £9.8 million and £10.4 million. Both of those are relatively artificial numbers for the first half this year, given that they are allocations from GUS. The guidance we have given for central costs on a full-year basis for Home Retail Group as a standalone company is £20-25 million, including the £5 million reallocation, which still remains a good estimate for the year.

## **4. Trading Performance**

### **Argos**

Sales performance in Argos was strong, but given some of the product areas where we grew, margin was down year on year. Benchmark operating profit grew 22%, but that is artificially inflated by the fact that at this time last year we took the one-off charges for the Index acquisition and the £4 million charge for the

restructuring of the Argos management structure in store. Reversing that out to give you an underlying picture, the benchmark operating profit grows by 3%. That sales growth, offset by the margin, is then a function of the cost inflation of 4% we have seen. We are seeing cost inflation levels above 4% on things like rent, rates, utilities, the national minimum wage impact on the staff costs, particularly in store, offset by a number of cost-saving initiatives we have had in the business in the first half. We have seen a 7% growth on volume against the 11.5% sales growth that we saw in the first half.

### **Homebase**

Sales were up 1.4%, and gross margins were ahead given the reduction in the promotional stance we took. Benchmark operating profit was down 22% given the underlying cost inflation at 4% we are seeing in the Homebase business and the 4% volume growth on the space that we put down in the first half of the year.

### **Financial Services**

We are now breaking out the Financial Services portfolio into store card receivables and personal loans receivables. We also have a number of other small loan books that are in collection and run off that are not really relevant going forward. We are also disclosing the provisions and the provision percentage that we hold against that book.

The growth that we are now seeing in the store card portfolio, where store card receivables were up by £16 million in the first half, was offset by the continued planned runoff in the personal loans portfolio, which was down around £17 million in the first half. In the second half, we would expect the personal loan portfolio runoff to slow. As you get to a lower level the collection rate on that book slows down, but post the half year we move into the faster growing period for the store card portfolio, which is obviously supporting the retail sales through Christmas. We would expect that to move from a broadly neutral cash flow position in the first half to an outflow in the region of around £25 million in the second half of the year.

We have seen a small increase in the provision percentage at 11.6% from last year's 9.8% and the year-end at 10.9%. In line with industry standards, when we track consumer portfolio delinquency levels as tracked by the Finance and Leasing Association, we are roughly in line with the trends that market is seeing and driven by the increase in individual voluntary arrangements that the market is seeing at the moment. The other factor that is blending up that percentage cover is also the fact that as you run off the personal loans book, you are collecting the better quality customers. They are the ones who pay off first and are obviously a very low level of reserves, and you end up with a rump of book at the end of the runoff that will carry a significantly high level of provisions, which tends to blend your average percentage on your loan book up.

Store credit card sales in the business of £235 million represent an increase of 21% on the prior half. More interesting to note within there is that we offer two credit facilities in our store card: a revolving facility and a suite of promotional credit facilities. Within those credit sales of £235 million, £170 million is on promotional credit, so over 70% of the volume that is now going through our Financial Services book is promotional credit and facilitating big ticket purchases within the retail businesses. That just goes to the point about how important this Financial Services operation is for us and why it gives us such a competitive advantage. Given that, we do not really see a significant change to the profit levels of Financial Services going forward. If we become more efficient in that business, we will factor that into a better priced product for the retail businesses and reflect the improved profits in the

retail businesses by a lower credit charge rather than in the Financial Services business on a standalone basis.

## **5. Other Income Statement Items**

The financing impact on retirement benefit balances of £6.6 million credit versus the £1 million is the change that we have made to the definition of benchmark PBT from the measure that GUS used. The reason it is up year-on-year is because we put a £100 million one-off contribution into the pension scheme at 31 March 2006 to clear that deficit off and move us into a small surplus. That has an impact on a higher return because the assets have increased. We did not think it was appropriate to record that increase under the underlying benchmark PBT. We have moved it below there and will hold it there going forward. The other thing to note is the exceptional items of £16.4 million and the pro forma benchmark PBT tax rate for the year of 32.5%.

## **6. Exceptional Items**

Upon demerger we had a one-off exceptional cost of £15 million, which is principally driven by compensation to be paid to staff for the loss of their tax-efficient share savings schemes – their save-as-you-earn scheme – and their stock options, where approved stock options that would have been tax exempt become taxable given the early vesting on them. We will be compensating staff for that cost, together with the professional fees associated with the demerger that Home Retail Group incurred and the banking fees related to putting the new £700 million facility in place post demerger. Our estimate for the full-year cost on those remains at £15 million, which is what we had previously guided, and the £9 million is the first-half charge; we expect to take approximately £6 million in the second half. That will be the end of that demerger exceptional in that area.

In addition, there is a waiver on a loan from Experian for £7.3 million. From a cash perspective, it is not relevant; there is no cash from this particular entry, and there will be an equal and opposite entry in the Experian results of \$13 million. It is all factored into the demerger and was part of how we allocated the £200 million net debt; it can be ignored going forward. In the second half and going forward, the maximum for the incentive scheme costs still remains at £45 million, which is a range of costs around the 30,000 employees who have now become shareholders through the gift of shares we have given them and a number of reinvestment schemes for the senior 100 managers in the business. There are secondary tests against those which relate to total shareholder return, benchmarked against a basket of our competitors, and a measure of return on invested capital. The maximum cost of £45 million will be spread equally over three years. In the second half of this year, we will take roughly a £7 million charge; there will be a £15 million charge next year, a £15 million charge the following year, and a £7 million charge at the maximum level. Obviously, those performance criteria are relatively tough and it is unlikely we will get to a maximum of £45 million, but we will not know that until the back end.

## **7. Dividend Policy**

We had established a policy that dividend cover would be at least twice covered by basic benchmark earnings per share going forward. We are starting with a view that we will pay approximately one-third of the anticipated full-year dividend at the half-year, which results in a 4p dividend at the interim, which will be payable on 24 January. For the full year, it will be based on the 11 months' results given the change in year-end, and we will be paying it on the higher level of basic pro forma benchmark EPS. The dividend will then reflect a go-forward rate as opposed to

paying it on the benchmark EPS which actually reflects the cash flows of the business, and so we are paying it on a slightly higher level of operating profit.

## **8. Pro Forma Balance Sheets**

The balance sheets are pro formas because the capital structure for GUS has moved significantly from the year-end through to the demerger. Although we were very close to being demerged at 30 September, we were not fully demerged, and there are still some small intergroup balances that existed in the balance sheet. There are really no significant movements on the prior year, other than in working capital.

## **9. Cash Generated from Operations**

EBITDA at £184 million was up 6%, driven more by the ongoing investment programme we have had in the business and a higher add-back of depreciation and amortisation. With working capital at £207 million and other operational cash flows of £1 million, total cash generated from operations was £392 million. Other operational cash flows in fiscal year 2006 at £89 million was the abnormal level we had because had put an extra £100 million contribution into the pension scheme. That is not something we would intend to do in the current year.

## **10. Movements in Working Capital**

### **Stock Movements**

It is a rather difficult time to cut a balance sheet, particularly from a working capital basis, because we come from a year-end position where we have peak trading in Homebase, where its balance sheet and stock levels run down up to 30 September. However, at 30 September we are just about to enter peak trading for the Argos business, so its stock levels have built up during the half year. The stock movement you see there of an outflow of £50 million is really driven by an inflow of around £40 million on the Homebase stock level from its peak trading level that it held at 31 March. There is an outflow of £90 million in Argos, where it is building stock for peak trading, which commenced very shortly after this half-year date of 30 September.

### **Creditors and Accruals**

In terms of creditors and accruals, we have seen a strong performance in the working capital management on that side. Some of that we will expect to unwind; seasonally, the business would naturally have a more positive working capital position at this point of the year, partly because going into the second half the loan book with the runoff of personal loans is flat in the first half, but is likely to move into an outflow as we tend to get strong growth in the store card portfolio in the second half of the year. More importantly, in setting the forecasting and buying programme for the business, we were working off a market view of a flat to 1% or so like-for-like view in the Argos business. Given the very strong sales that we had in the first quarter, where like-for-like was around 7%, that meant to avoid a reduction in availability in the second quarter, we had to move a lot of our buying into more of the domestic arena as opposed to the DI arena.

Obviously, there is a much better working capital benefit from domestic sourcing; we tend to operate that off of a range of 45-60 day creditors, so we are sitting on the position at the half year where we have a higher level of domestic buying than we would have had at the year-end. That has resulted in a stronger creditor performance, the majority of which will unwind in the second half of the year. Having said that, we have made good progress in our trade creditor management,

and an element of the £236 million is an ongoing and permanent improvement in the working capital position of the business in the first half.

## **11. Movements in Net Debt**

### **Capital Expenditure**

Capital expenditure was £90 million in the first half, which is quite a reduction on the £144 million that we saw last year. At a Homebase level, capex is roughly flat half on half, but if you cast your mind back to this time last year, there were a number of abnormalities in the first-half capex. We had acquired and fitted-out ready for peak the 33 Index stores that we bought in the first half of the year. We had put in place investment in a number of Argos stores to further roll out the Argos Extra stocked-in offering, which involved a significant amount of mezzanines in the stock rooms within the Argos business. In August 2005, we also opened a new 750,000 square foot warehouse for Argos Direct's two-man home delivery in the North East, which was done on a freehold basis, so there was an element of the fit out and build of that facility in the first half of last year.

We have looked at the full-year capex number last year of £255 million and I think we have previously guided to a year number of around £225 million. We would still view that to be a good number on a full-year basis, but it will of course reduce slightly due to the fact that we are bringing the year-end forward from March into February.

### **Other Cash Flows**

Other investing activities last year included the Index acquisition of £45 million. Again, there is no real movement in that this year in the first half. Taxation is a fair reflection of our cash flows on a historic and on a go-forward basis. The interest is reflecting the charges under the GUS capital structure, which is not relevant going forward. The invested capital line is the movements in the inter-company debts that we have seen in the first half, which also is not relevant going forward. The dividend of £62 million is our contribution from a cash flow perspective to GUS' final dividend that they paid in the first half of the year. We will pay our own dividends, so there will be a dividend in the first half of next year, but it will be based on the guidance I have given you. The dividend that we have proposed today would amount to a £35 million outflow in the second half.

## **12. Change of Year-end**

We currently operate non-coterminous year-ends within the group, with Argos on a March year-end and Homebase on a February year-end, which is to clear it away from the distortions you get from the Easter trading period. If you ran to a 31 March year-end in Homebase, there would be certain years where we trade with two Easters and certain years with no Easters. That would severely distort the financial performance of the business, which we think is very difficult for people to understand. In the decision to change year-end, it was clear that we have to move the Argos business to February. We were not able to do that under GUS as much as we would have liked to because despite many conversations with David Tyler, he was not keen to move the rest of the group to February just to fit in with our reporting.

This means that we will report the financial performance for the business up to 3 March 2007, an 11-month period, for the group, but it will still include the 12 months' trading for Homebase. When we come onto the impact of benchmark operating profit, the guidance we are giving you here is based on actual trading. Dividing the Argos number for the year by 12 to come up with nearly £25 million is not how that number is calculated. It is calculated day by day; we know the sales

and the gross margin of the business day by day, and it is done on an actual basis. Central Activities is, of course, an estimate, and we have guided you to £20 to 25 million for the year; we do not have a prior number against which we can compare it to, but roughly one-twelfth of the cost base running at £25 million per year will give you £2 million. The Homebase impact will not be material because it is already on that year-end, nor will Financial Services, given that it is making around £5 million or so per year, and so an 11-month year will make an immaterial impact to the number. In terms of pro forma information, we will at our second-half trading update provide pro forma information that will restate the prior year to the new accounting date, and with our announcement at the year-end we will give a pro forma number for 52 weeks to 3 March 2007.

## **Closing Comments**

**Terry Duddy**  
**Chief Executive Officer**

We are pleased with the progress that we have made in the first half, particularly with the approach that we have taken in following the strategy which we set out so clearly at the time of the demerger. We have followed each of those components and we are growing our business and investing for the longer term.

## **Questions and Answers**

**Richard Ratner, Seymour Pierce**

Are there any property profits in these figures? What were the comparative property numbers, if there were any? That includes any premium on the surrender of a lease or part of a lease.

**Richard Ashton**

There are no property profits in the numbers on a disposal basis. We actually only have around five freeholds in the Homebase business, and the Argos portfolio is 100% leased. We still hold three pieces of freehold infrastructure, as well. There is a couple of million of premiums in the Homebase business on a leased basis, which is consistent with the prior year. You will always get the odd £1-2 million of premiums as we move the leases, so year on year they are consistent.

**Richard Ratner**

Are you saying that there was actually £2 million in property profits last year on that basis and £2 million this year?

**Richard Ashton**

Yes.

**Rod Whitehead, Deutsche Bank**

If the new refurbishment of Homebase works, how quickly would you seek to roll that out from next year? You mentioned that furniture and kitchens has been the strongest category. Has it been positive on a like-for-like basis, or is that just the

space growth from the additional mezzanines? If your intention is to continue to be less promotional in Homebase, will that apply to kitchens and furniture over the New Year period?

### **Terry Duddy**

Assuming we are successful in the trials that we have, we will roll out 30-40 per annum. We intend to do 100 in a three-year period from the time we start to roll out. Furniture and kitchens are positive on a like-for-like basis in that sense; it is hard to take out space there as you roll out mezzanines and look at the specific stores, but they are the drivers of the uplift we see in those individual stores. If you look at the business on an overall basis, they are positive.

In terms of being less promotional, last year we ran seven days of 10-15% off, which is why we decided to tactically change our trading stance. That was our lowest like-for-like performance during that month, and one of our lowest profit months. However, we gained a lot of market share the previous year. This year, we pulled off the promotional stance and held our market share. As we move into the next quarter, it is going to be a difficult year-on-year comparison because we intend at this point, depending on how the market goes, to be less promotional, so we are likely to lose on a like-for-like basis in comparison to last year. We have to think about where market share will end up, which we will not know for another month and a half. However, if we manage to somehow hold our market share during that period, which would be very tough, I would say we have a reasonable stance. This is not going to be our ongoing stance in terms of promotions; as the market starts to return, we will chase some business because we think we will get the returns, but we will play that as we go.

### **Brad Crombie, Merrill Lynch**

Can you tell us what the gross margin improvement in Homebase was year on year? Can you break down the difference between pricing effects and supply chain effects on the gross margin? You have commented on the quarterly impact on gross margins in the first quarter rather than the second quarter. Could you comment on the breakdown between those two quarters? Secondly, is the outlook for trading at Homebase post September the same as it has been? Can we take your comments to be the same, or is there something that might have changed over the last eight weeks?

### **Richard Ashton**

In terms of gross margin at Homebase and how we performed in the first half of the year, gross margins were up around 150 basis points. That is a level of disclosure we have not previously given, and so I am not going to break it down into the drivers of that. In terms of the quarterly impact, we saw a stronger impact in the first quarter firstly because the first quarter is four months, and so our first half in Homebase runs for seven months. That first quarter is the peak trading period of spring, Easter and bank holidays, so it had a much bigger impact. That was the area where we do most of our promotions; our two biggest promotional periods are that and the Christmas/January sales. You can factor into that a stronger gross margin improvement from reversing off promotions in the first quarter than we did in the second quarter, and the 150 basis points is the average for the half.

There is no comment to the other part of your question.

### **David Jeary, Credit Suisse**

Given your balance sheet, which is still relatively ungeared, what are your future plans? I was thinking in particular of a couple of years ago when you were talking quite positively about a possible third leg to add to Argos and Homebase, which seems to have gone quiet. Secondly, will you have a chance to carry the strategy out?

### **Terry Duddy**

We are pursuing this strategy because it is the right strategy; we think that is what shareholders would support us in doing, and that is what we will continue to do. The strategy is working for us, but we have not excluded the idea of ever having a third leg; we would not do that. However, I have said that we had two years during the time of the strategic review to take a good look at what potential acquisitions there could be, and during that period we never found anything that was financially or strategically sensible. We do not expect that to suddenly change. If something does appear and we think it is the right thing to do for the reasons we have talked about, we would go straight to the shareholders to ask them to back us. That does not mean that we would exclude reviewing any kind of organic growth that we might want to look at, but our focus is on the organic growth of both Argos and Homebase, as we said at the time of the demerger.

### **Richard Ashton**

In terms of the balance sheet, we are a predominately leasehold portfolio business. We have 1,000 stores; of those, we have five freeholds and the rest are leasehold. That means that we are in a position of having annual leasehold commitments now running at slightly in excess of £300 million. When you do that on an adjusted net debt basis and capitalise the leases, as the rating agencies do, at a factor of eight, it gives you adjusted net debt of £2.4 billion of those leases. If you do an adjusted net debt/EBITDA ratio and compare it to the retail sector average, we are in the middle of the pack; we are neither over- nor under-leveraged. It does not mean that we will stay there forever; we are always open-minded as to what we may do, but two or three weeks post demerger is not the time to be reviewing and changing the capital structure of the business we spent two years working to ensure we had it right for the demerger. However, at the right time in the future we would happily consider that if we think it is right to make a change.

### **Andy Hughes, UBS**

Given the 4% underlying figure after savings, how significant were the cost savings? What might the underlying cost growth be for both businesses next year? Secondly, do you think there will be a tail of Homebase stores that you will not bother refitting, and therefore might we expect some closures in due course?

### **Richard Ashton**

If you look at some of the things that are running abnormally high on the 4%, if we are looking at rent within the business, the Argos store portfolio splits into two different types. We have a high street portfolio, which are secondary and tertiary sites, with rental growth running at around 5%. On the out-of-town retail parks, our prime sites carrying open-A1 planning, we are still running at around 7-8% annual inflation, and it is very competitive to get those sites. That blends into a significantly higher level of cost inflation than 4%, and given that we have just talked about our annual lease commitments being around £300 million, you get a feel for what that

would do on the weight of the cost base. The Homebase sites tend to be in the middle of those two. While they are out-of-town retail parks, they tend to be bulky goods, and the pricing pressure on those rents is not quite as high. Again, they are running at around 5-6%.

In terms of rates, we are seeing the two-year transitional positions, so we saw a low-double-digit increase last year, which we are seeing again this year. The national minimum wage went up in October by 5.9%, and on top of that we are seeing the significantly higher double-digit increases on anything to do with oil prices, including our gas, electricity and fuel costs for distribution to stores and our home delivery network. That gives you an idea of why it would be higher.

The balance that gets you back to the 4% is all of the things that are coming down or going up by less than that. We are still continually attacking the discretionary spend base in the business. We restructured the Argos store management in the first half of last year, and obviously we saw some benefits on a run-rate basis in the first half of this year from that. Pay levels at a non-union level within the business were running at around 2%, which helps blend it down, as well. So there are a number of factors which offset and will give you a bit of clarity at how you end up with 4%.

Going forward, you can see some of the key drivers. One of them is the rates view. We are in our second year of that transitional increase, which should begin to drop out. That will help us a bit going forward. The rents will stay pretty much where they are; we have not really seen that much softening in the sites that we are looking at for rent review. Obviously, we would hope that anything to do with oil prices would not necessarily ease, but we would at least hope to not see the double-digit increases that we have seen this year off the back of where the oil price is now.

### **Terry Duddy**

There is a tail of stores in Homebase; there was a tail when we bought the business and we knew there were a number of stores that were not contributing. During the first couple of years, we managed to improve the performance of those stores. We have looked at them, as we always do, and make our decisions on them, and we do not think that closure is the right thing to do. We always look for relocation. Trading the stores often makes more economic sense for us. We did a couple of relocations this half and we are likely to do another couple next half, so we will continue to look at relocations. There will be a number of stores that we will not refurbish because we will not get the returns from them.

### **Richard Ashton**

In view of the complexity around IFRS and impairment, we took a big charge on impairment last year due to the trading performance of the stores on the implementation of IFRS. When you invest in an underperforming store which is actually at a negative net cash flow, you end up in a bizarre situation where you can put investment into that store and it can generate a very healthy return, but it will instantly become impaired on the accounting standard. It is a non-cash entry; in my view it is a little obscure that that has happened. It means that we are in a bizarre situation where depending on the success of the trials and the speed of the rollout of the trials, we will be in a position where ongoing we will take non-cash impairment charges on some stores that are underperforming, even though their performance improves significantly following the investment. It is not something I think is necessarily right, but it is the way it works.

### **Andy Hughes**

You have a trial in East Anglia with the Post Office for free pickup. How is that going? If it does work, is there any other national body you could link up with to increase the number of pick-up points further?

### **Terry Duddy**

It is a tiny trial, and I have not really looked at how it is going because it is at such an early stage. I think the likelihood of it turning into something big is highly unlikely, but we are positive. We want to try a number of things, and that is one of the things we will try.

### **Simon Irwin, JP Morgan**

You gave us a number for the price cuts that you have made since you launched the Argos catalogue. Can you reference that year-on-year in terms of whether that is higher or lower and give us some idea of overall inflationary or deflationary pressure? Two years ago you warned there was significant deflationary pressure in electricals running into Christmas. What are you seeing this year?

### **Terry Duddy**

We often talk about two things with respect to price cuts. One is reincluded prices and the amount we bring those prices down on a year-on-year basis. The other is that during the life of the catalogue, we go on cutting prices. In that sense, 2,600 would be about right. We actually say on a non-stop price drop we claim that we tend to do at least 500 per month, which would be a run rate for it.

The issue on reincluded prices is slightly different. We have not referenced it in the announcement, but we have traditionally been at about 3-4% reduction on reincluded prices. This year, we did say that we had some raw material price increases, specifically on gold. During the current catalogue, we increased the prices of our jewellery based on gold price increases. That would be exactly the right thing to do because if we do not do that, then people in Birmingham buy the gold, boil it down and sell it. We have to have those gold prices at the right price. We have increased our prices in gold, which has changed our reincluded prices number. If we include it, it would be about -1%; if you exclude gold, it would be around -2%. You called it price deflation, but it is an estimate of our reincluded price reduction. I would expect that to be around the same level of 3-4% going forward.

### **Simon Irwin**

Do you have a comment on how you are seeing pricing going into Christmas in terms of competitor activity?

### **Terry Duddy**

It is as competitive as always. The killing fields are in LCD plasma TVs.

### **Tony Shiret, Credit Suisse**

You have talked about inflation. In Argos, you said that your sales were up 11.5% and your volumes were up 7%. I presume your average transaction value (ATV) was up somewhere in between those. What was your ATV? Isolating out the LCD effect, what will that be going forward? Secondly, you implied that the Financial Services business was being run on a flat margin basis and you were effectively using it as an enabling method to drive promotional sales within Argos. I assume that on this

credit you do make some money in providing it. Is there any net margin effect within the Argos EBIT margin movement? Can you give us your planning assumption for the DIY market in 2007?

### **Terry Duddy**

We finished the half with the market for DIY at -4%, so that is where we are tracking it for the half. The difference in what is going to happen between Christmas and January is not going to make a big difference to the market up until March, so I think we will be in the situation of -4% coming in towards the end of our financial year – February/March – and after that, the big call will be what happens post Easter. I cannot actually give you a view of what that market will be like. We will be planning on it continuing to be negative, so it will be a slight reduction. I will have a much better idea after Easter.

### **Richard Ashton**

ATVs have gone up in Argos. They are not fully the driver on the difference on the cost base growth and the sales growth. We are in a scenario where we got higher than expected like-for-like, and you would hope to always get leverage of your cost base off that higher than expected like-for-like, so there are two real drivers there: lower through-put of units because of higher transaction value, and more efficiency on the like-for-like element that you would expect on that particular area. I cannot isolate out the LCD factor for you in ATV.

On the Financial Services business, there are two things here. On the promotional credit offers, where a credit offer is revolving credit, we are making the money from the customer in those areas. We charge 25.9% APR on our revolving credit store card, and the retail business gets a commission from the Financial Services business of 50 basis points. Where the promotional credit is interest-free credit or 'buy now, pay later' and does not flip into revolving credit, there is no customer income stream on that offer. So, what you are really doing is looking at the cost of operating that, the cost of opening that card, and collecting out on the debt and the financing charge of that, and you are neutralising that cost and passing it back to the retailer on a zero-margin basis. The difference here is that if you were getting it from say GE Capital, you would be paying them a margin for a similar thing, and we are effectively charging it through a cost. Yes, the gross margins on the retail businesses are benefiting from what it would be if they were getting it from a third party, but their gross margins are taking a hit for it because it is still a charge. The cost of credit is a charge within the gross margin line. It is just that that charge would be a lot higher if we were not running it in house and charging it across at zero cost from our Financial Services business.

### **Tony Shiret**

I've lost the will to live!

### **Richard Ashton**

I've achieved my objective!

### **Bruce Hubbard, Citigroup**

The wider industry has shown low single digit EBIT growth for the last four years, and you have shown results similar to that. The industry has had negligible increases in its invested capital, but your invested capital has more than doubled. Could you talk us through your thoughts on scale of investment and the returns you think you got, and the shape of your capital structure going forward?

### **Richard Ashton**

I understand what you were doing around the underlying, but the factor it misses is that the management team in the business has been very focused on the returns on capital in this business over the last four or five years. Its key focus of attention on some of those areas has actually been on divesting some of the low-performing assets. While you talk about the capital employed of Home Retail Group on a pro forma basis going up significantly, on a real basis, you could argue that it has fallen significantly. We sold out of the home shopping business, which had over £800 million of capital employed in it, and it was making around £20 million of operating profit in the year we sold it. We also sold out of the remaining European home shopping operations that had significant capital employed in them. In the last three or four years, we have actually divested over £1 billion of capital employed that was making around £50 million of operating profit, which pre-tax is a 5% return. It is not that we are not focused on return on capital; we think we have done a pretty good job of getting out of some of our low performing assets over the last three or four years and actually getting very good prices for them. We would want to get that into the equation. I understand the analysis you are doing, but I do not think it tells the full story about what management has been doing around managing the capital of the business.

### **Bruce Hubbard**

Are you saying that the return on capital of your business has gone up on the basis of the businesses you have at the moment?

### **Richard Ashton**

No, I am not saying that. I am saying that based upon the businesses we started with and where we are now, it would have done. When you take the underlying, I agree with what you are saying, but we are looking at our investment decisions and the returns that we are making and looking at getting that return over a period of time. You cannot put a new store down in a new town that costs £2 million to capex it and hit your hurdle rate in the first year. We are working on a maturity profile of those stores, so a Homebase store and an Argos store typically will generate around 80% of sales maturity in the year that you put that store down. At that level, you are not going to get a return on that capital in the first year because the maturity profile builds and the returns start to come. Do the same analysis in three or four years and see where the maturity profile has worked out. We are getting the returns on that. It is also worth noting in terms of incentivisation schemes that return on invested capital is one of the key incentivisation metrics that this management team has because we understand that historically we have put in a significant amount of investment into this business and we need to get a return on it, which we understand.

### **Fraser Ramzan, Lehman Brothers**

You mentioned that you are planning to expand your internet capacity. Could you expand on that?

### **Terry Duddy**

It is actually just the ability for the number of disks that we have which runs the whole system. What happened last year and over time as you start to grow and the amount of hits that we get increases, the system starts to creak, so this year we increased the actual capacity for the e-commerce system to be able to take the number of enquiries that it receives.

### **Fraser Ramzan**

You mentioned that you have a phone-forward service from your delivery driver. One of your competitors appears to have gone to a two-hour delivery slot. Did you consider that as an option for home delivery?

### **Terry Duddy**

We did, but we put it aside on the basis that it was not economically possible if you want to make money, or not lose too much money, doing that. You need to be careful in terms of the comparison you are making for that. Tesco Direct does that on the basis of taking two to three days for being able to order that product and for it to be delivered in store and to be delivered on one of the grocery runs it is on in its 15 stores. What I talked about was next-day delivery and specified-day delivery, which is also the basic offer they have; their basic offer on one-man delivery is pretty much the same as ours. We now include next-day delivery in our specified-day delivery, and I think there is little comparison. The two-man delivery service that I talked about, which is the three-slots, phone-ahead service, is unmatched in the UK.

### **Rod Whitehead, Deutsche Bank**

What is the outlook for the jewellery market? Was weak jewellery a factor behind the negative mix effect in the first half, or was it purely just TVs? Where does your figure of -4% for the DIY market in the last six months come from, and why are your expectations so negative? It has never had two negative years, but you are now saying it is going to have three negative years. What is your thinking behind suggesting that this year is going to be lower than last year, which according to Kingfisher was down 3.7%?

### **Terry Duddy**

Jewellery did not have a big effect in the first half, and jewellery has not performed as well, which had been the case previously. It is down to how it will perform, but as I said earlier, we put the prices up to relate to the increase in gold prices. It is hard to show where the demand will be. However, we have managed the business as best as we can for the margin we will get.

I do not think I provided any prediction on DIY. What I said was that -4% in that half is based on our GFK figure. We have had two interest rate rises – one in June and one in November – which have previously had some impact in this marketplace, particularly the DIY market. Why would I not remain cautious? I do not know what the effects of those will be. Even before the November interest rate rise, I asked what we thought it would be. People were asking me to make a call on a turn, but,

actually, it has turned. It was -6% last year and it is -4% this year, but I do not know when it is going to go positive. What will I plan for next year? In planning for next year, I think it makes sense to plan for slightly negative. If the market is better than that, great, but it makes sense for us to plan on that basis and stay a bit cautious. I do not know what the impact of those two interest rate rises will be.

**Robert Miller, Redburn**

What are you spending on the Homebase trials? What are your hurdle rates on invested capital? What was the differential performance in the gross margin of the first half versus the second half of last year at Homebase?

**Terry Duddy**

Spending on the trials is not relevant. We are trying to find out what the right spend needs to be. What we have in these circumstances is stores that are not able to take a mezzanine, and what we now have to do is reconfigure those stores. We will take out lower-performing product groups such as some core DIY and put in furniture, kitchens and bathrooms and try to do that with the best reconfiguration of the space and the best use of capital. We know what the products are and we know what the products will sell at. Now we have to ask what is the best spend we can get away with. That is what we are trialling.

**Richard Ashton**

In terms of hurdle rates, we work off a factor that builds off of the GUS post-tax cost of capital of around 7%, which is what they disclosed in the annual report, our weighted average cost of capital, given that we do not have the same debt/equity mix, is likely to be a little higher than that. We build in a factor for the fact that some of our capital expenditure programme is on maintenance, and so we put another point on for that, and then we factor in a one-third increase for headroom and delivery of value. That gets you to a number that we are working of a minimum hurdle rate of about 12% post tax. That does not mean that someone walks in with a capital expenditure programme of 12.1% and it gets signed off. That is just the point at which it says 'Don't bother knocking on my door'.

In terms of the margin guidance, we said last year that margin in Homebase was actually in line for the year. That was a slightly stronger performance in the first half year-on-year, with a weaker performance in the second half. That weaker performance in the second half on a percentage basis was really driven off the promotional activity that we matched with some of our competitors, particularly around Christmas and January. That is one of the reasons why reversing off that level in the third quarter this year will mean that our top-line sales on a like-for-like basis will look less attractive, but the payback will be in the margin improvement and the cash generation from the business.

**Robert Miller**

I do not think we were told what the move was from the first half to the second half, but I think it was flat in the first half last year. You took all of the pain in the second half. What was the order of magnitude?

**Richard Ashton**

I am not going to go any further into last year's numbers under GUS than has already been given. We have given you more guidance in the first half of this year

and we have given you an estimate of what the year-on-year is, but I will not go back and restate guidance that GUS has previously given.

**Terry Duddy**

The Q&A has gone on longer than even I expected, so unless there is anything vital that anybody needs to know we will call it a close if that's ok. Thank you.