

Trading Statement Conference Call – 14 March 2007

Operational Review

Richard Ashton
Finance Director

1. Preamble

Good morning and thank you for joining the call to discuss our year-end trading statement. You will have seen that, this morning, we have put out two announcements. The first is the trading statement covering the final eight weeks of the current financial period and, as previously announced, our financial year-end has been changed from 31 March to the end of February.

The second statement is, therefore, the detail regarding the impact of the change of year-end. I expect the focus of this call to be primarily on the trading statement, but we will be available to deal with any more technical questions in respect of the change of year-end later in the day.

2. Overall Performance

In terms of overall performance, as you will have seen from Terry's quote, this short trading period has been ahead of our expectations. After the third quarter, consensus of benchmark profit before tax (PBT) moved up by a little over £10 million to around the top of the range at that time, i.e. to around £360 million for a full financial year.

We now expect to come in a further £10-15 million higher for the 52 week pro forma year to 3 March 2007, driven principally by Argos, with around a £10 million increase; a couple of million increase at Homebase and in interest, driven off the higher cash balance that we have at the end of the year; and a couple of million increase in Central Activity costs.

While we are pleased with this short period and the likely outturn for the year, we remain cautious on the retail environment. You will all appreciate that comparatives for the whole market, but particularly Argos, become much tougher as we start to anniversary the World Cup impacts that fell into our first and second quarters last year, where, on the new restated year-end, we will have reported +6% and +5% like-for-like respectively.

You will also probably have seen market commentary of forecasts of lower household cash flows this calendar year, primarily as the expected eventual feed-through of three interest rate rises kick in. As a retailer, we still face certain inevitable cost pressures that add to what we expect to be a challenging retail environment, although we hope that this rate will ease slightly from the 4% underlying inflation that we have experienced in the current year.

Having said all that, we have talked in the past about all the things we have done to position our business accordingly and we approach the new financial year from a point of operational strength.

3. Trading - Argos

Let me turn to Argos first. In the last eight weeks, we have increased like-for-likes by 3% against a flat comparative last year. The two main drivers of this were the exceptional growth that we have seen in TVs and video game systems. This offset some continued market weakness that we have seen in audio, DVD, VCR and compact digital cameras. Total internet sales grew at 37%, representing around 17% of sales in the period, and Check & Reserve, our online reservation for in-store pickup, continued to grow strongly, by around 50%. Argos Direct grew to represent nearly 24% of total company sales.

In terms of the gross margin, this was slightly ahead, at around 50 basis points versus the comparable period. The drivers are the ongoing supply chain initiatives and better stock management through peak, which has resulted in improved stock clearance post-peak. These two benefits offset the margin dilution we see from the strong growth in TVs and video game systems.

New stores contributed 5.5% in the year, and we expect to open around 30 stores in the financial year 2007/08. We expect this to add a similar contribution to sales growth of around 4%, which is similar to the fourth quarter rate. This will be a little lower than the rate we have seen this year, because the impact of the Index acquisition stores fully drops out, and, of course, the larger sales base against which we measure ourselves.

4. Trading - Homebase

Turning to Homebase, let me explain a little more about the shape of this short period. This eight-week period represents a little over 10% of the full-year sales for Homebase, and so is the lowest volume trading period of the year. With regard to comparatives, the 9.9% like-for-like you see us reporting today is against a comparative of being down 9% in the fourth quarter last year.

On a two-year basis, therefore, we are broadly flat on a like-for-like basis. Just to remind you, in the third quarter of financial year 2005/06, we were increasingly promotional, which had the effect of pulling forward sales from the fourth quarter last year into the third quarter, hence the very weak comparatives that I just mentioned of -9% in the fourth quarter last year.

We have seen strong gross margin in the quarter from Homebase, as it continues to benefit from supply chain initiatives, as well as improved stock management disciplines and clearance of stock post-Christmas, in readiness for the peak trading period of spring.

With regard to new Homebase stores, we would also point out that we intend to open around 15 new stores in financial year 2007/08, but we expect the contribution from these new stores to be significantly lower than the 3.6% we have seen this year, which is really down to a phasing issue of the timing of new stores opened this year versus new stores opened next year in our store pipeline, together with the size of those stores that we intend to open.

5. Year-End Cash Position

With respect to our year-end cash position, we expect to report a modest net cash position at our new balance sheet date of 3 March 2007. While this compares to market expectations of a net debt position of around £100 million based on our 31 March year-end, there are three broad explanations of what has driven that improved cash position of around £150 million versus the guidance we have previously given.

The first one is the two profit upgrades that we have had in the year so far: the third-quarter profit upgrade and today's profit upgrade will drive around £25-30 million of extra profit in the business since we initially gave debt guidance at the half-year.

We have delayed one piece of capital infrastructure, which is our fourth home delivery two-man warehouse. We now think we will be able to manage through peak 2007 without that warehouse, given some of the changes we have made internally to the distribution within the business, which means that we will look to build that warehouse next year, so we are delaying around £25 million of capex into next year for that piece of land. In terms of guidance, the capex for 2007/08, we had previously guided at £225 million, which will now increase to around £250 million.

That gives you about £50 million of the improved cash position, but by far the biggest driver is the timing impact of the change of year-end. Not including March in our year-end cash flows has a significant improvement in the year-end position on a cash flow basis. The March 2006 and 2005 cash flows typically averaged around £100 million net outflow, principally driven by the quarterly rent bill that we pay in March. Those three things are the three drivers of the year-end cash position.

6. Change of Year-End

Finally, just a word on change of year-end, you will see in the summary table that, for the first half of this year just finished, the benchmark PBT is reduced by £5.4 million from what you saw at the interims, to reflect the move in the period covered. Similarly, you will also see that the pro forma benchmark PBT figure for financial year 2005/06 is now £337 million, which is the comparative number against which we are talking about when we give guidance, where we said we would be approaching £375 million of benchmark PBT.

As mentioned, all the detail regarding the preparation of these pro formas is in the separate announcement, so we invite you to take your time to read these and come back to us with any questions at a later point. With that, let me hand over to the operator to take questions on the trading statement.

Questions and Answers

Eithne O'Leary, Oriel Securities

Could you run us through what you think was behind the pickup in big ticket demand at Homebase over the last few months?

Richard Ashton

We have not really seen a pickup in demand for big ticket. What we are saying is that, coming off where we were last year, we saw very weak growth in the big ticket areas in the fourth quarter last year.

If we go back and remind ourselves of what happened in the third quarter of the previous year, it was a very promotional period in the marketplace. We, as well as some of our competitors, such as B&Q and MFI, were being aggressive on the promotions, which had the impact of dragging forward big ticket sales in particular into the third quarter. That meant that, when we reported our fourth quarter last year, we reported -9% like-for-like in Homebase.

Today, we are reporting +10% like-for-like for the fourth quarter, which means that, on a two-year like-for-like basis, we are just slightly ahead, so there is no real change to the underlying growth rate of big ticket; it is just the impact of what happened around the third and fourth quarters last year in what was a very competitive environment.

Eithne O'Leary

Has it has stabilised overall?

Richard Ashton

Yes, it has.

Richard Ratner, Seymour Pierce

What were kitchen sales like at Homebase?

Richard Ashton

The three big growth areas that we have had over the fourth quarter were kitchens, bathrooms and furniture, where we have seen double-digit growth.

Richard Ratner

Moving to furniture, apart from people disappearing from the industry, do you think that you benefited from Harveys' very weak performance?

Richard Ashton

It is very hard to say. We have seen relatively strong growth in that particular area, given the rollout of the offering that we have had within the Homebase business, both on the mezzanines and off the catalogue. To attribute it to the weaker performance of a competitor is hard to say, really.

Robert Miller, Redburn Partners

I have a question on mix. At the time of the demerger, you gave some broad details on the Argos mix. You said electricals in the year to March 2006 was 45% of the mix. What has been the movement in that for the period you are now reporting on?

Richard Ashton

It has not really changed very much. Within that category, there are many different sub-categories that are growing in very different areas. Within that area, we are seeing exceptionally strong growth in TVs and video game systems, but weaker growth in things like audio, DVD and VCR. In terms of a total, it has not really moved that much.

Robert Miller

In fact, therefore, the total influence of electricals on the gross margin mix is not significant.

Richard Ashton

It is significant from the point of view that the areas that are growing strongest within the electricals sub-category are our weakest margins. Sales participation is not changing that much. Within that level of sales, however, we are growing stronger in our weaker margin categories. TVs and video games are at the bottom end of that margin range. We are seeing margin dilution from these categories throughout the year, but also in the fourth quarter.

Robert Miller

Can you quantify it?

Richard Ashton

I am not going to quantify it specifically, but I can give you broad guidance. We are seeing a 50-basis point margin increase in the fourth quarter for Argos. We are seeing margin dilution off TVs and video game systems and we are seeing some ongoing benefits from supply chain gains, but more importantly, the bigger benefit to the fourth quarter margin, which is the +50 basis points, is the strong operational control of the business we had over peak which we referred to in Q3, which means we have exited peak trading in Argos in a relatively clean stock position. Markdown and clearance of stock to get ready for the new catalogue launch in January has been quite a bit lower than we did this time last year, which offset the dilution impact that we have seen from video games and TVs.

Robert Miller

I have not had time to read the other statement this morning. Is the £375 million on the February year-end?

Richard Ashton

It is. On the face of the trading statement, we give the high-level pro forma results, in which you can see benchmark PBT, on the second page, of £337.1 million. That is the comparable measure for the 52 weeks to 4 March 2006, against which we will say the £375 million is the 52 weeks to the end of February 2007.

Robert Miller

What was the comparable number for the March year-end for the £337 million? Is it the £319 million?

Stuart Ford, Head of Investor Relations, Home Retail Group

There is no comparable figure. We have only re-stated financial year 2005/06; we have not re-stated financial year 2004/05 as well.

Robert Miller

What number are you comparing the £337 million February 2006 number with for March 2006?

Stuart Ford

We are not, because there was no pro forma benchmark PBT number already in the market by the way that we drew up the prospectus. It is the first time that you are seeing that £337.1 million, because we have gone through the exercise of pro forming net interest income, for example, based on the debt allocation that we received on a pro forma basis at demerger.

Robert Miller

Is that detailed in the announcement?

Stuart Ford

It is, yes.

Jamie Isenwater, Deutsche Bank

Could you give us the average net debt for the year just ended with the new pro forma for the year-end?

Richard Ashton

The cash flows are quite variable, so to give you an example of the extreme ranges, if we get to an end-of-December number, where we have traded through peak, our net cash position could be in the region of £200-300 million, because we are paying the supply base post-peak in January and February. There are other times in the year when it will be down as low as £100-200 million of net debt. In terms of the average, theoretically, off the pro forma numbers we have given today, you can just reverse into it off an interest rate, which gives you the average number for the year.

Jamie Isenwater

What average interest rate should we work from?

Richard Ashton

5.5% would be a fair assumption to use.

Weeyang Yeo, Goldman Sachs

In your first-half results, you were quite negative on the UK DIY outlook, talking about the third year of negative like-for-like decline. Do you still maintain this view, especially after the strong performance from Homebase that we have seen recently?

Richard Ashton

We do. When Terry made that comment, we were saying that it would be very difficult to call a turn in the DIY market until we had traded a peak period in the DIY market. We have not yet done that. We knew that in the third quarter we would reverse off the promotions and that our like-for-like would be quite weak as a result of that, and it was, and we knew that in the fourth quarter the pull forward of sales from the fourth quarter to the third quarter last year would not repeat, so we expected to see a strong headline like-for-like in the fourth quarter, but it would be coming off a very weak comparative.

For the fourth quarter last year in Homebase, it was -9% like-for-like. If you look at the two-year basis of like-for-like growth to try to neutralise out the promotions, we are still negative on a like-for-like basis in the second half, on a two-year basis. Our view still stays as it was: we are coming into peak trading, we have Easter and spring, and we are going to do around 30% of our volume in Homebase in the first quarter. At the first quarter trading statement, we will have a much better view if, off the back of that peak trading period, we are seeing some improvement in the market.

Andrew Hughes, UBS

First, on Homebase gross margin, I know that there are lots of big swing factors there, but could you talk about your relative pricing against your peers, and whether that has changed at all?

Second, on supply chain, I know that there is a steady list of reasons why your costs of goods sold tend to go down. Is there any step change, though, in terms of what you have been doing with regard to supply chain?

Richard Ashton

In terms of the relative pricing position, there is no real change. The margin gain that we are seeing in the fourth quarter is not about us putting prices up, so that relative position has not really changed.

In terms of the supply chain benefits that we have been getting, we have been talking about a run rate on supply chain benefits of in the region of 100-150 basis points for the year to date, which has been underlying and running throughout each quarter of the year and is still there in the fourth quarter. We would look to continue to drive some of those benefits going forward. Whether it is still at that level of 100-150, or whether it falls a little, as we become more mature in those initiatives, is hard to say, but there has been no real step change.

Where the big benefit has come in the fourth quarter and why we are at 500 basis points is just the stock management position that we took over Christmas. We exited from our stock position on Christmas decorations, lighting and trees etc in a much cleaner position than we did last year or historically, which has meant that, in getting ready for peak trading, which is starting now, we have to run a number of clearance sales.

Since we have had less stock to clear out, the margin dilution of markdown has been much less in the fourth quarter than it was this time last year. That, compounded by the fact that it is only an eight-week period in which we do only a little over £200 million of sales, means that you get this big headline basis point movement. In absolute pound terms, however, it is a few million pounds of gross margin benefit on a £200 million sale basis that drives that basis point improvement.

Andrew Hughes

Going back to that relative pricing survey, when you do that survey, do you say to yourself that half of Homebase's range is not comparable with other retailers, either because it is a completely different product or an own-brand product?

Richard Ashton

It is not done at a company level, but at a category level. There are some areas where we have to be much closer on our pricing with competitors than others. There are some areas where we understand that there is a differential. We are also factoring in the fact that we have a series of 10% events that are well-known and understood and that we have a Spend & Save offer where customers can get significant discounts. We have to include all of that when we do those kinds of comparisons.

Bruce Hubbard, Citigroup

What was the debtor book at year-end?

Richard Ashton

It is going to be around £35 million higher than it was at the last year-end.

Bruce Hubbard

Could you give us some sense of how the Financial Services (FS) profits have gone year-on-year?

Richard Ashton

FS profits, year-on-year, are going to be broadly flat. As we said at the half-year, we have the reduction in letter fees coming through. While we have an underlying growth in the operating profit from the FS business, that has been offset by the reduced letter fee, which, as we said, was going to cost us in the region of £4 million in the second half of the year. Without that year-on-year, we are going to be broadly flat on FS profits.

Bruce Hubbard

You have done spectacularly better than what syndicate analysts expected in terms of cash flow at demerger, even allowing for the changes in timing. Are you not, arguably, quite significantly undergeared?

Richard Ashton

I would not say that. Not allowing for the timing, we have done spectacularly better. If you strip out the underlying timing of March, the March impact of that cash flow is around a £100 million outflow. If we are saying, at the moment, that we expect to be around £50 million of net cash, reversing out the impact of not having the March makes us £50 million of net debt, which is not that different from where people were at demerger, saying that we would be around £100-150 million of net debt.

Bruce Hubbard

My understanding from some of the institutions is that some of the syndicate research was north of £100 million debt for March 2007, so I think you have made considerable progress. Presumably, you would hope that your cash flow would continue, so are you not significantly undergeared now?

Richard Ashton

You are right. The £100 million is off a March year-end, so we are going to be +£50 million. If you take out the March year-end, we are at £50 million of net debt. We have driven about £25 million of better profits and have deferred £25 million of capex on our new fourth Argos Direct warehouse into next year. There are only three drivers. The underlying cash flow is about £25 million better than we previously guided to – I accept that.

Bruce Hubbard

I was actually making a point relative to demerger rather than to interims, but it does not matter – it was a philosophical point on leverage.

Richard Ashton

In terms of leverage, we do not really see any great change at the moment. What we talked about at the interims is that, on a capitalised lease basis, our adjusted net debt/EBITDA ratio was about 3.2 at that time, which put us right in the middle of UK-listed plc metrics. The current position, as we work it out, gives us an adjusted net debt/EBITDA ratio of about 3.1, so it has hardly changed, because the capitalised lease base goes up quite significantly too.

At the time of demerger, we had an annual rent bill of about £285 million; we now have one of £315 million. That is an increase of around £30 million on capitalised leases that gets multiplied by eight and adds a quarter of a billion to the adjusted net debt. That is always going to be the case on that adjusted net debt/EBITDA ratio, so we have to grow profits to maintain that ratio even at the current level. Nothing has changed that much for us on that balance sheet view of the world.

John Baillie, SG Securities

On the run rate at Homebase in terms of sales, was it very different coming out of February against the 10% like-for-like over the whole period?

Richard Ashton

January was partly in our third quarter trading statement. It is slightly complicated, because our January trading statement runs to 6 January, which is done deliberately to pick up the Boxing Day and New Year sales. Allowing for the fact that all that was in the third quarter, we have not seen a significant change in the run rate for the three weeks of January that we have in the fourth quarter and the rest of February. The market has picked up a little in January, but we have not seen a big change in the run rate between January and February.

John Baillie

In terms of the gross margin, and just to help my French colleagues, what does 'strongly' mean?

Richard Ashton

We are now disclosing it on a current-year basis on the final page of the re-statement. In the fourth quarter, for Argos, it means that it is up 50 basis points; for Homebase, it is up 500 basis points. Those drivers are principally the supply chain gains that we mentioned earlier, but more importantly the improved stock position that we came out of the peak in both businesses and the reduced clearance. That has an artificially higher impact on the basis point increase, given that we are recording it against just an eight-week sales number.

John Baillie

How much of that 500 then rolls over into the first quarter of next year?

Richard Ashton

The underlying buying benefit rolls forward. We have been running with buying gains of around 100 basis points throughout the year. We would hope to continue to grow those kinds of buying gains. The rest of it in the fourth quarter is the one-off clearance that we had to put through in January and February to clear the stores ready for peak trading, which has already started. It is already done and finished and has no roll forward into the current year.

Robert Miller

What is the run rate of the sales of the approximately 30 old Index stores?

Richard Ashton

At the time when we bought them, their annual run rate was £75 million. With an Argos model and the Argos catalogue in those stores, they are running at a little over £100 million a year on an annual run rate basis. Going forward, within the underlying portfolio, at the time we bought those stores, we also knew that one of the reasons why we were buying them was because we were coming to end of lease life in a town on an existing Argos store.

When we talk about 30 Argos openings this year, the net number is 25, because there are five store closures. A couple are Index stores that have just run to end of lease life, and the others are where we have closed the Argos store in a town where we have bought an Index store, because the Index store is better positioned for us.

Robert Miller

I am not sure what the new Argos profit number is for last year. It seems that quite a lot of your profit increase in 2006-07 could have come from the Index space.

Richard Ashton

No, not at all. While we have done £100 million of sales, an element of that is that we traded them in peak last year. They were already in our peak trading for last year so, on an annualised basis, the big space impact came into last year's number.

Steve Davies, Numis

There is a reference to strong garden sales at Homebase during this period. Have you seen any pull forward of some of those sales, given the mild start to the spring? Could some of that flip backwards in the first quarter of the new year?

Richard Ashton

It is a very good point. We have seen it stronger. That reference is deliberate and you are absolutely right: it is driven off what is probably a milder start to the spring than we had this time last year. It is hard to say whether some of it is pull forward. It really depends a little on what happens with weather ongoing. Sometimes, when you have a bad spring and you lose it, it never comes back. Hopefully, if we have a good spring, it is not a pull forward, but it is hard to say.

Conclusion

Richard Ashton

Thank you very much for your time today. We look forward to speaking with you at our preliminary announcement on 2 May.