End of Year Trading Statement Conference Call – 13 March 2008

Operational Review

Richard Ashton
Finance Director

1. Preamble

Good morning everyone and thank you for joining our call today. I am Richard Ashton, the Finance Director of Home Retail Group and I am joined by Terry Duddy, our Chief Executive who will help take questions in a moment. The trading statement that we have released today covers the final eight weeks of our financial year ended 1 March 2008 and, therefore, comprises the January and February eight-week trading period.

2. Highlights

Let me briefly talk you through some of the highlights before we go into Q&A. With regard to the Group's profit performance, as you will have seen from the opening quote to our statement, the results for the period are such that we expect a second consecutive year of double-digit earnings growth, which is in line with market forecasts. Those forecasts are for consensus benchmark profit before tax (PBT) of £429 million, which will be 14% growth on last year's £377 million. This is on top of 12% benchmark PBT growth in the previous financial year.

Looking ahead, we are reiterating our caution on the weakening consumer outlook. We have already seen the slowdown evidenced at Homebase over the last few quarters, but we expect both businesses to have limited like-for-like sales growth opportunities in the new financial year. Following our January trading statement, market forecasts for the financial year to February 2009 already reflect the likely negative like-for-like position at both Argos and Homebase. Consensus currently stands at benchmark PBT of £393 million, although with a wide range, as we would expect at this very early stage in the new financial year.

What we are saying today is not meant to be interpreted as a more cautious view than that which we have previously provided and, as such, we do not really expect changes to forecasts in either the year just ended or the one just begun.

3. Argos

Four factors have contributed to Argos achieving record profit growth this year: positive like-for-like growth, the ongoing new store opening programme, the gross margin improvement, and excellent cost productivity. In the final eight weeks of the year, there was a contribution to sales growth from new space of 3.5%, with the chain reaching 707 stores. Our plans are to continue opening about 30 stores a year, which will add around 3-4% to sales.

The like-for-like performance for the quarter was a positive 1.9%. The clear driver was, once again, the video gaming category. There were two other key drivers, however: first, a strong January sale period and second, the earlier timing of Mother's Day, which boosted sales at the end of this short period, rather than in Q1, as it was last year. Excluding these two factors, the like-for-like for the period was broadly flat.

There was also a natural offset in the gross margin percentage, which reduced by 50 basis points, attributable to an adverse product mix impact, given that we saw faster growth in low-margin categories – e.g. video game systems – as well as from the strength of the January sale activity. We have pointed out that ongoing sourcing gains and foreign exchange (FX) benefits continued but, given our 4% average price decline on reincluded lines in the catalogue, these are being passed on to the Argos customer. The Internet was, once again, our fastest-growing channel, up by over a third in total. Online Check & Reserve for immediate store collection increased by 69%.

4. Homebase

Net new space growth was 4.6% for the quarter, with about 3% from our normal store opening programme and the balance from the 12 Focus stores we have already relaunched. We will continue to open about 10 new stores next year, adding about 3% to sales. In addition, the Focus stores should add a further 5-6% to sales in the new financial year. The like-for-like sales performance in the quarter was a decline of 5.3%. As with the previous period, most product categories continued to see a difficult trading environment. An exception to this continued to be strong growth in kitchens, where we continued to see benefits from our ranges, the mezzanine floor presentations, and the increased availability of our installation service, which was in over 280 stores by the end of the year.

The gross margin percentage increased by 150 basis points versus the same period last year, as we continued to achieve supply chain gains as well as FX benefits.

5. Conclusion

Let me summarise by repeating that we expect to be reporting benchmark PBT growth for the year just ended of over £50 million, which is in line with current market forecasts and would be an increase of approximately 14%. While we face the obvious challenges of the consumer environment into the new financial year, we will keep building on our significant operational strengths across the Group.

Questions and Answers

John Guy, MF Global

Is there any impact of the extra day in trading in February with regard to the like-for-like number?

Could you flesh out the gross margin gains reinvested into price? What was the split between sourcing for both Argos and Homebase?

With regard to the Focus acquisition openings, are you still on track to open the net 22 stores? Has there been any progress? Are you going to have to dispose of any stores that may be too close to existing Homebase stores?

Richard Ashton

We are reporting on a 52-week calendar year; therefore, the impact of a leap year is irrelevant. It just changes the date at which we stop the year end. This quarter is an eight-week period compared to a similar eight-week period last year, so while 29 February is in it, it makes no difference to the number of days that we report. There is, therefore, no impact on our financial statements from the leap year.

In terms of the gross margin impacts, we are still continuing to see the supply chain gains through both businesses. We normally try to give clearer guidance on the breakdown of the gross margin split, but it is quite hard to do this quarter and, to some extent, not that relevant, given that it is only eight weeks long and is a low-volume period.

In Argos, the FX and buying gains have gone into the 4% price reduction that we have seen and netted off in the P&L. The reasons why we are negative are the stronger January sale period and the adverse mix impact of the low-margin video game systems, which had been the strong growing category for us in the quarter.

In Homebase, we are continuing to see buying gains of about 100 basis points per quarter. We have been seeing that all year and expect that to continue going forward. We still have some FX gains coming through the P&L that have helped contribute to the 150 basis points that we have seen in Homebase.

In terms of the Focus stores, we talked about a net 22 of which 12 have opened and are trading at this point in time. As you rightly point out, we are under a review with the Office of Fair Trading (OFT). That review has been ongoing since within two or three days of us announcing the transaction and was fully expected. We had an OFT review when we did the Index transaction and we fully expected to have one with this transaction. We are cooperating with them fully and sharing all the information that they are requesting from us.

In terms of what the outcome will be, it is completely in their hands to form their view as to what, if any, is the impact at a national and local level. What we have done in our store opening programme is to have formed our own view of the low-risk versus high-risk stores and are opening them on a low-risk basis first so if there are any challenges, they will be with stores that we have not opened or invested any money in.

Paul Smiddy, HSBC

What are the total budgeted revamp costs for the 22 stores?

Richard Ashton

The total capital expenditure for the 22 stores was £30 million. In terms of how we incur it, it is now likely to be about £20 million in the year just ended and about £10 million in the year to February 2009.

Paul Smiddy

What is your total projected return on investment (ROI) on the project?

Richard Ashton

We look at investments that generate a post-tax return in excess of our hurdle rate, which is in the low teens. This investment, in terms of viability, therefore, is set above that level.

Paul Smiddy

Has there been any change in your presumption that you will achieve that result?

Richard Ashton

No, there has not. The viability that we did was based on a difficult trading environment that we flagged in Q3, so we factored that in to the valuation that we did for the business at that point in time.

Paul Smiddy

Are you seeing any pressure on input margins as a result of not being able to pass through inflation on input costs as quickly as you might want to?

Richard Ashton

There is ongoing pressure on raw material cost inflation, which has been building over the last 12 months or so. We have a number of initiatives in the business: we can look at alternative sources or countries of supply, and we still have the ability to offset that inflation by pushing more and more of our product down that route. While there is inflation in those overseas markets, it is still significantly cheaper than buying in the domestic market for the right product, where it is cost-effective to do so. That enables us to offset increases in some areas with ongoing reductions from putting more product overseas.

David Jeary, Investec

To what extent is the growth in kitchens in Homebase the result of fitting? I assume you add the fitting turnover onto kitchens. What is the underlying product sales growth trend within that number?

Richard Ashton

Most of it is product; very little is the benefit of fitting because we include the cost of fitting in it, so we make very little profit on it. The bigger benefit that we are seeing is the ability to sell the kitchens with an installation attached. It is also resulting in a level of trade-up on the average transaction values, where customers are willing to spend more on a kitchen with Homebase, where they know that they can have it fully installed.

David Jeary

Do you have any market data that says what the overall kitchen market is? You are obviously taking market share, but what do you think the overall market is doing?

Richard Ashton

I do not know. We would expect to be taking market share. A number of other retailers have talked about having a flattish like-for-like on kitchens to slightly improved, but I think that our performance is one that says that we must be taking share in kitchens.

Matthew McEachran, Kaupthing

Could you give us some flavour for volume growth if there is some trading-up taking place in terms of the number of kitchens?

Richard Ashton

We are seeing double-digit growth here, most of which is coming out of either a higher number of kitchens or a trade-up. The second half is a little stronger than the first half, which comes from the point on installations. The installation service has been ramping up through the course of the year, moving from a small trial last year into a scenario where it is available in 280 of our 330 stores. We are not far off a national roll-out at the moment.

Matthew McEachran

What kind of penetration is the installation service achieving in the kitchens zone?

Richard Ashton

I could not tell you exactly what the penetration level is. It is driving a faster growth rate in the second half than the first half.

Matthew McEachran

That is clearly a very good performance and well done on that, but it puts the spotlight somewhat on non-kitchen performance. Are you not seeing any knock-on benefit from that business in terms of peripheral or complementary areas?

Richard Ashton

I would not say anything of note. We are getting a varying range, but most of the categories are generally finding trading quite difficult. One of the areas at the better end is cookshop, which you could probably link to kitchens. If people buy a kitchen, they may buy some implements that go with it.

Assad Malic, Credit Suisse

You mentioned that video gaming was a strong driver of growth. Has there been any material difference in hardware sales versus software sales post-January? Could also give us a sense of how material video gaming is in the sales mix?

Richard Ashton

We operate mainly in the hardware market. We do sell some software, but it is not the predominance of our sales. When we talk about video gaming systems performing well, it is mainly hardware-driven. It has remained quite robust through the first and second halves.

Assad Malic

How material are they in terms of the overall sales mix?

Richard Ashton

In terms of the mix, participation of company average is in the low single digits. It is not that significant in terms of the mix, but it is in terms of the growth rate, because it is running at very strong double digits.

Assad Malic

How has average selling price growth in flat-panel TVs fared over the past few quarters?

Richard Ashton

There is no significant change. We have seen a slowdown in the growth rate of sales of flat-panel TVs. Going back to FY06, we were talking about a more than doubling in the volumes that we sold. In the first half of the year, that was running at very strong double digits, but not at the doubling level, and that slowed in the second half of the year. We still have growth in the flat-panel TV arena, but the second half is running at just about double-digit growth.

Assad Malic

Is your average selling price down year-on-year?

Terry Duddy, Chief Executive, Home Retail Group

Yes, it is going to be down. It is not that much different from the last quarter, when we talked about it. We have just gone through the January sales, so you are now seeing the new generation of ranges coming in. There is not much to report, other than it has declined by about 30% year on year and remains about flat quarter on quarter.

Simon Irwin, JP Morgan

Are you seeing any changes in trend in terms of bad debts on the store cards?

Second, what are you seeing in the jewellery and furniture categories?

Finally, I am interested in the outlook for store disposals? Can you get rid of stores that you want to get rid of, or are these generally stores coming off lease?

Richard Ashton

We are seeing very little change in terms of bad debts. The comments that we made at Q3 still stand. We made some changes to the scorecard cut-offs in August 2006, which was around the time when we were doing the demerger and flagging our cautious view, so we pre-empted that quite well. What that has meant is that our levels of delinquency are very marginally down on last year, which has meant a very marginal improvement in our bad debt costs. The real point is that no increase at all has come through in the delinquency or bad debt costs side.

We flagged jewellery in Q3 as being slightly down, particularly because it is a big-volume period for us. Q4 is a relatively low-volume period for us, but it has performed very well. This strong growth in jewellery in Q4 is attributable to the non-anniversarying of Mother's Day. It is hard to say what the underlying trends are in jewellery because we have Mother's Day in Q4 this year, but it was in Q1 last year, and jewellery is a key gifting category for Mother's Day. We talked in today's statement about the two points of like-for-like growth in Argos, of which about one point is driven by the non-anniversarying of Mother’s Day and one point by the January sales. That gives you a feel for the strong growth that we are seeing there.

There is no real change in furniture. It has been running at about flat to slightly down for most of the year. In Q4, it has run at a similar level, so there is no real change. To your point of whether big ticket is getting worse, we have seen no significant acceleration in that reduction in the year just ended.

In terms of the property disposals, we are doing whatever we can. We made a number of closures in the year just gone, which we are mentioning in terms of the net store numbers in Argos and Homebase. They are hard to get out of. If you have a loss-making store on a retail park that is not particularly well-positioned, they can be quite challenging to get out of, but we are working hard with our landlords. We tend to trade off by going to new sites and, at the same time as taking a package of new stores, trying to wrap up an exit of an underperforming store, which we have done on about five stores within the Group this year, particularly in Homebase.

Simon Irwin

Are you happy to pay to exit some of these stores?

Richard Ashton

We paid on one of them, we came out neutral on another, and we made small gains on two, which we mentioned in the first half, when we said that we had made some property gains on exiting stores, which were offset by the one-off costs of our new warehouse. That was all disclosed in our first half.

Simon Irwin

I assume the £20 million refit costs will not be in your benchmark PBT.

Richard Ashton

The refit costs of £20 million and £30 million are capex, so clearly would not be. The one-off costs of integrating, which were about £15 million, will not be in benchmark PBT. They will be in exceptionals and will be split between about £10 million in the current year and £5 million next year. At the acquisition, we talked about £30 million capex and £15 million one-off costs. About two thirds of each is in this year and one third next year.

Andrew Hughes, UBS

At the last call, when the topic of B&Q warehouse refits came up, you said that there was no noticeable impact either because the number was small or there was so many other things going on. Is that still the case in terms of potential impact?

Terry Duddy

Yes, this is pretty much the case. If anything, we have seen less than 1% so far. It was a tiny impact in some areas on an overall basis. We have gone from a pinprick to something a little bit more than that.

Andrew Hughes

Given the store overlap, would you not be seeing a double-digit impact on the stores that do overlap?

Terry Duddy

No.

Andrew Hughes

Is that not how it would net down to 1% across the Homebase estate?

Terry Duddy

It would, but it is not as high as double-digit.

Andrew Hughes

In terms of your share buyback comments, you were hunkering down somewhat pre and post-Christmas. Are your comments about no share buybacks in any way share price dependent?

Richard Ashton

We have not made any comments yet, have we? Are you asking us for one?

Andrew Hughes

Last time, you were looking at buybacks before Christmas and then they went off the agenda.

Richard Ashton

You are right. We said that we would be monitoring how we traded over the peak period. We have traded relatively resiliently. We have come out with quite good profit growth. All that has happened is that we are moving the bar. The bar has now moved onto a consensus view for trading next year that says that profits will fall. Given a tough trading environment, a reduction in profits consensus level next year, and difficult liquidity markets, we do not think that this is necessarily the right time to look at a formal change to our capital structure. We are always monitoring it and will close the year with a relatively strong cash position, although not as strong as it was at the first half, because clearly we have used some of that cash to fund the Focus acquisition and the capex related to that, but we will still end up in a relatively strong cash position.

In terms of the adjusted net debt EBITDA ratio, which is how the banks and rating agencies look at us when they consider the capacity that the Group has to take on more debt, that still puts us right in the middle of a typical UK retail plc metric, at about three times.

Peter Brockwell, ING

I have a couple of questions on Argos.

Following your comment on bad debt, could you update us on the most recent trends in interest-free credit penetration, particularly for bigger-ticket products?

Second, looking at FY08/09, if we are looking at a negative like-for-like for Argos, what is the potential for further cost savings? What flexibility might you have particularly with regard to staff costs?

Richard Ashton

We do very little interest-free credit – it is almost insignificant. The vast majority of our promotional product is on 'buy now, pay later', which we offer on a suite of three, six, nine and twelve months. Most of our volume goes through on three and six months. Our volumes going through there are very similar to the levels that we saw last year. Of the sales volume going through the loan book, about 75% is promotional credit and 25% is revolving, which is very similar to last year's level. That results in our loan book being very similarly split, about 50/50 revolving and promotional.

The credit penetration is a little ahead of last year, but not by much. We have found that the level of applications coming through the business is very consistent with that seen in previous years. The difference is that the quality is not as good, so the level clearing our scorecard cut-off hurdle is not as much. The higher levels that we set in August 2006 mean that, while applications are running at a similar level, new accounts are running slightly down, but those accounts that we have are spending a little more, and penetration is broadly flat or very slightly ahead.

In terms of cost control, we will do everything that we can around cost productivity. We had a good year on cost productivity two years ago and an exceptionally good year this year. However, it becomes increasingly difficult to anniversary [sic] cost savings and reductions. There is nothing particular that we would do around changes to store structures or management, because we made some two years ago, so it would be difficult to go back and do them again. However, we can do things like monitor staffing hours, where we have some flexibility. We take on a high level of temporary staff – about 20,000 – over peak to handle volumes. There is flexibility in that area: if we think the volumes are not coming through, we do not take as many temporary staff. There is therefore, the ability in Argos in particular to flex some of the variable costs. It is much harder to do that in Homebase because it works off a different model.

Peter Brockwell

Over the Christmas period, what percentage of the total would temporary staff costs be?

Richard Ashton

We do not give out those numbers in terms of ratios of the costs base. We bring in 20,000 temporary people, so there is quite an element of cost there and some flexibility around it.

Fraser Ramzan, Lehman Brothers

Where else do you think you could make savings in the event of lower volumes? Where else are costs flexible? I guess that you have been working on the model quite a bit over the last few years.

Richard Ashton

It is hard to say at this stage, depending on the variability in our volumes. We recently announced the closure of one of our six regional distribution centres (RDCs) for Argos stores. We ran six RDCs that serviced 700 stores. Castleford, our oldest RDC, served our lowest number of stores. We took the view that, next year we can take that store workload, spread it over the remaining five RDCs, and close that RDC. The benefits of that closure will start to help us in the second half of the year. There are things like that that we can do, but they are step changes.

We are also changing our view of opening a fourth home delivery two-man warehouse, which we planned to start building this year. These warehouses tend to be big pieces of infrastructure, at about 750,000 sq ft, and take about 12-18 months to get up and running. We had a view that we would have spent the money on that this year and next, so that it was ready for peak 2009. We are now deferring that by at least one year and potentially two, given our view of more pessimistic volumes, particularly on some of the two-man home delivery products like furniture, where we think that we will be able to manage with our existing infrastructure and just sweat it harder. It is not just about managing the cost base, but about looking at the infrastructure, working out how to manage it more efficiently and ensuring that we are not bringing on capacity that is not needed.

Fraser Ramzan

In terms of volumes, what was the average selling price at Argos in the quarter just gone? I think it was up over Q3.

Richard Ashton

It was not a significant change – it is in the region of a 50-pence increase.

Tony Shiret, Credit Suisse

Could you clarify some of the comments you made on flat-panel TVs earlier on? In terms of the second half, you said that you have seen slowing volume growth and that it was just about double digits. You then talked about average selling prices being down about 30%. Is that a correct interpretation? Are we talking about value down 20%?

Richard Ashton

The volume has gone from triple digits in 2006-2007 to very high double digits in the first half of the year and to low double digits in the second half. That is sales pounds, not units.

Tony Shiret

You had a positive 10% in the second half then.

Terry Duddy

Yes. Price deflation was more around 20%.

Tony Shiret

In the first half, when you talk about strong double digits, you said not quite two times, so are we talking about 70-80% value increases in the first half? I want to see what the magnitude of the change in value sales has been.

Richard Ashton

The numbers that I quoted are pounds of sales.

Tony Shiret

What do you mean then by strong double-digit in the first half?

Richard Ashton

It is at the upper end of 50-90%.

Tony Shiret

90% down to 10% then.

Richard Ashton

10% would not be strong; I am saying 50% plus, but less than 100% - that would be triple-digit.

Tony Shiret

The first half then, was somewhere around 90% in value.

Terry Duddy

That is a good guess – keep going.

Tony Shiret

The second half was just about double-digit, which would seem to imply about 10%. Is that fair?

Terry Duddy

Correct.

Tony Shiret

So 90% to 10% - is that right?

Richard Ashton

We are not going to go into it exactly.

Tony Shiret

It is however, a fairly substantial drop in value.

Richard Ashton

Correct.

Tony Shiret

Is the current run-rate still double-digit?

Richard Ashton

At the back end of the quarter, it is still double-digit, but it is has been slowing, as we said.

Tony Shiret

Is there any more promotional activity in the TV market?

Terry Duddy

There is not much more. It is always hard to tell through a January sale because people are getting out of their underlying stock and you are not really clear on what they are doing in terms of ongoing stock. I would not say there is any more. Coming back to the overall point, if you go back to the first quarter which we anniversaried off the World Cup, the sales rates are unbelievable, astonishing really. Even now, at the level at which flat-panel TVs are running, we would want greater growth, but double-digit growth on flat-panel TVs at the moment is very nice to have. If anything, I am a little encouraged by it. We knew it was going to slow down, it took a long time to do so, and it still has some growth in it.

Tony Shiret

Moderately encouraged, then.

Terry Duddy

I am. I am less than double-digit encouraged!

Closing Remarks

Thank you for your time today. We look forward to speaking with you again when we release our year end results on 30 April.