Full-Year Results – 30 April 2008

Terry Duddy
Chief Executive

1. Preamble

Thank you for coming today to the presentation of our full year results. As usual we have a fairly full agenda. Following this introduction I will give you some highlights and a review of the Argos and Homebase operating performance. Richard Ashton will then run through the Group financials. I am pleased to say today we have Maria Thompson, the Group Commercial Director, with us. She will be presenting later. Amongst a number of key accountabilities, Maria is responsible for all the programmes of combined purchasing between Argos and Homebase. The Far East buying offices also report to Maria. Additionally we have been asked to provide further insight into our import buying, and the issues retailers will be dealing with in the short-term. Although not presenting, Sara Weller, Paul Loft, and our Chairman, Oliver Stocken, are also here today. We will leave plenty of time at the end of our presentation to answer any questions that you may have.

2. Financial highlights

This last year has been a terrific performance, the 15% growth in profit before tax is built on 12% growth achieved in the previous year. A combination of gross margin improvement and robust cost management in both businesses has compensated for a challenging sales environment to produce this healthy growth. Specifically, there have been record profits in the Argos business.

3. Argos – financial performance

Although we achieved some like-for-like growth overall, it was challenging and helped by better than expected performance in the first half. Again, the growth came from new products, such as video gaming and flat-panel TVs. We have gained share in consumer electronics – or brown goods as they used to be termed. Market research studies show that we have grown to number two in that market.

Older technology – audio, DVD, and landline phones continued to show ongoing market-driven weaknesses. Even though furniture and homeware were more difficult markets towards the end of the year, our performance appears to be well ahead of many of the specialists in this area. On gross margin, the gain was achieved in the first half from foreign exchange benefits. Our trading strategy was right for the second half as we invested in price as the market began to get tougher over the peak trading season.

We also saw an adverse product mix on margin. Sales were driven by video games and other consumer electronics. These are lower margin categories, and that trend will continue to put pressure on gross margin. Overall for the year the margin gain helped a lot. The profit performance was also enhanced by exceptional cost productivity. Let me illustrate some of the factors that helped with this cost

performance.

4. Argos – cost productivity

We have a continuing programme of operational measures to improve overall cost productivity that has come to fruition over time. This year has seen a number of these improvements that while providing long term benefits are one-off step changes that will not be repeated to the same degree as experienced in the year just completed. Examples of this productivity improvement are; we have reworked the store stockroom to accommodate more products for immediate collection. We have been carrying an increased amount of technology lines, such as LCD TVs, and have moved other fast-selling lines from home delivery to store collection. There have also been operational improvements in home delivery. We have moved to booking more customer delivery slots at the point of ordering, rather than as telephone follow-ups. We have also implemented new processes to manage multiple product deliveries such as collating small items to reduce delivery costs. We have reduced costs for flyer publications, improved transport to stores and distribution centres, together with a raft of other areas of improvement throughout the year. This is an ongoing process to manage down costs, but it is unlikely for the forthcoming year that we can achieve the same step change.

5. Argos - value

The final point on Argos is to update you on our process for ensuring that we are price competitive. This follows on from an update from Sara last year. Value is stated as the key reason to shop at Argos. Along with other customer ratings of our brand, our ratings on value have continued to improve over the last year. Our pricing plan is to deliver competitive everyday prices on products that a lot of our customers want to buy. The market is dynamic with prices constantly changing. We have always monitored our competitors closely. In addition to our regular monthly store checks of 15-20 competitors, we now scrape prices from the internet sites of our major peers on a weekly or biweekly basis – checking over 3,000 identical and comparable products.

As well as tracking by specific competitor we also track products by category. We know it is relatively easy for onlookers to make a simple price comparison – typically on a small number of identical electronic products. However, as a business we have to match how our customers shop by mapping all comparable products in a real time fashion that also takes promotional pricing into account. There is a continuous process to identify outliers, and the actions taken in response are formally reviewed by the Argos board each month. In all categories and across the board Argos is more competitive on value with more products at lower prices than its major peers.

6. Homebase – financial performance

Whilst March and April were very strong months, the first half was impacted by the adverse weather from May through to August. In the second half the market was more difficult, and began to show the effects of the consumer downturn. We have managed the business to maximise gross margin, and have not chased low profit market share. The margin gains have come from continued Group-wide supply chain benefits. The impact of negative like-for-like sales led to reduced profits despite being partially offset by gross margin gains and good cost management.

While margin management has been the focus of the trading strategy we have also continued to improve the customer offer on which Paul Loft provided a full update last October. The roll out of installation services has clearly supported the strong kitchen performance. We completed further range reviews and implemented multi-channel initiatives. Ongoing operational programmes have improved customer experience, employee engagement, and on-shelf availability measures even further. The purchase of the Focus stores has strengthened the position of Homebase as the number two brand, and provided additional leverage, further buying, and supply chain opportunities for us to pursue over the coming year.

7. Outlook

Against the backdrop of weakening consumer conditions we have been clear in our view that we expect negative like-for-like sales at both businesses in the new financial year. We also know that many people are concerned about the current uncertain times, and this is why we have chosen to provide some background to the current trading. Overall Argos is trading in line with our expectations, not withstanding the continued adverse product mix, as the strongest areas of sales growth are still driven by lower margin consumer electronic categories. Trading at Homebase however, has started the year weaker than expected. You have received a prudent view of the first quarter that took into account a weakening consumer outlook, the impact of an early Easter, and the glorious weather last year. The poor weather this March and April compares to these great conditions last year. As you know Homebase has a high proportion of its sales that are seasonal and outdoor related. However, it is important to remember that the weather comparables could get easier from this point forward. At this early stage, while we still have the peak month of May and the summer ahead of us, it is far too early to make any call on the full financial year. The next trading update for the full quarter will be announced on 12 June 2008.

8. Strength and growth

We have had a good operating and financial performance over the last year. The fundamentals of the Group are extremely sound. We have both the confidence and the ability to continue to invest in the business for the long-term. We are pleased that we are making progress in each of the elements of our growth strategy. In her presentation Maria will cover our expertise in leveraging the combined purchasing scale of Argos and Homebase. She will outline the significant headwinds related to cost price inflation that will be impacting the whole market. However, our combination of scale, infrastructure, and in-house expertise means that we retain real competitive advantage over other retailers to deal with these conditions. We will continue to exploit further sourcing and supply chain opportunities. We will not allow these market issues to weaken our position for competitive value in the Argos business. Although we do believe it will lead to a reduction in price deflation over the coming year.

9. Increase share in large product markets

We continue to make progress and gain share in the big ticket categories of consumer electronics, white goods, sports and leisure, and kitchens. Whilst also maintaining our share in furniture. These product markets provide opportunity for incremental growth, however it is worth remembering that the major driver in both Argos and

Homebase are small ticket sales. These products provide footfall frequency. The average basket value in both businesses is £20-£30. At Argos we sell over 180 million items a year. Around 80% of those are below £30. It is also worth remembering the breadth of the product offer in both businesses and the Group as a whole. While we are market leader with a 10% share of a £60 billion market, we are diversified across all home and general merchandise categories.

10. New space

We have thoroughly reviewed our new store viability process and the pipeline for potential new stores. We see multiple years of further portfolio growth for both Argos and Homebase. We are confident that we can continue to open around 30 stores per annum for Argos. The expanded product range, our success in both the high street and out of town locations, and the development of Check & Reserve supports our view.

Following the acquisition of Focus stores we are confident in a continued pipeline for Homebase of around 10 stores per annum. Our new Homebase stores are typically in the successful smaller format, going into catchments where our broader home enhancement offer is particularly attractive.

11. Multi-channel leader

Argos' fully integrated multi-channel convenience continues to build. Internet orders now represent 21% of all sales, or £900 million. There are over 40,000 reservations being collected each day through this market-leading service. More customers are finding that the combination of Check & Reserve and Quick Pay kiosks are providing real convenience benefits. We have kiosks in every store, and 1,800 in total across the portfolio. We are continuing to translate some of these opportunities into Homebase. The Homebase website re-launched last month, with many of its products now fully transactional. We will have further multi-channel developments over the new financial year for both businesses.

Richard Ashton
Finance Director

1. Introduction

The financial results being reported today are the actuals for the 52-week period ending 1 March 2008, and the prior year comparatives are the pro forma results for the 52-week period ended 3 March 2007. The basis of preparation of the pro forma results is unchanged from that previously provided, and the details of the calculation and preparation are repeated in the appendices for convenience.

2. Income statement

Group sales increased by 2% in the year. Terry has talked about the drivers of that in Argos and Homebase. Gross profit increased by 5%, or 110 basis points to 35.2%. Key drivers to this were the Argos gross margin increase of 50 basis points, and the Homebase gross margin increase of 250 basis points. Within cost of sales, distribution costs remained constant at 5.5% of sales. That is despite the increasing

level of overseas sourcing volumes, and the cost of relocating and dual-running the Homebase warehouse that we reported in the first half of the year. Operating expenses increased by 4%, of which 3% was underlying inflation. The remaining level of costs grew 1%, which is a level of cost productivity at the Group level of one point, but a significantly stronger level of cost productivity at Argos. Benchmark operating profit increased by 11% to £398 million. There was a near doubling in the interest income to £33 million. This was driven by the higher level of average cash during the year, and also by favourable interest rates – where we were experiencing 90-day term deposit rates on LIBOR in excess of six percentage points – given the credit turmoil seen during the year. Benchmark PBT increased by 15% to £433 million.

3. Benchmark operating profit

Terry has covered the performance of Argos and Homebase. The highlights of the other two segments are; financial services operating profit increased by 10% to £5.5 million. This is consistent with the stated return objective we previously supplied and is also in the appendix. It is important to note in financial services that both the level of delinquency and bad debt costs in the year are slightly down on FY07.

Central activities increased by £5 million to £29 million. The sole driver of that was the investment made in business development opportunities in India and HomeStore&More. All the central head office costs have been held flat with inflation offset. Group operating margin increased by 60 basis points to 6.7%.

4. Income statement

There are items that are clearly non-comparable, such as the interest costs on the first line attributable to the GUS capital structure. There is a more detailed breakdown of exceptional items provided in the appendix slides. I want to draw your attention to the impairment charges of £10 million we are taking against the Homebase portfolio. That predominantly relates to the uninvested store portfolio that we have in Homebase, and the doubling of the demerger incentive costs, driven by the fact that those costs are costs incurred from the point of demerger that happened halfway through FY07. This year there is the full annualisation of those costs. We still expect that three year cost to max out at £40 million.

The effective tax rate on benchmark PBT has fallen slightly to 32.1%. That is driven by a relatively flat level of tax disallowables and the increasing profits we have made during the year.

5. Dividend policy

The Group's policy remains to target dividend cover over the medium-term of around two times, based on basic benchmark EPS. With an approximate one third/two thirds split between interim and final dividend payments. The final dividend we are proposing of 10.0p provides a full year dividend of 14.7p. The EPS of 33.9p would leave cover at 2.31 times. This is a slight increase from last year's cover of 2.25 times. We think this is an appropriate position given the current outlook for the following year.

6. Balance sheet

The Group has a relatively simple balance sheet, without any complicated financial structures. I will now run down some of the key drivers of the variances we have seen.

The increase in goodwill is driven by the Focus stores acquisition. The property, plant, equipment and other intangibles reflects the £200 million of capital expenditure we have spent in the year – offset by the £150 million of depreciation. Inventory growth of £98 million is driven by the ongoing growth of the overseas sourcing volumes. The increase in the store portfolio, we have opened 48 stores in the year. The earlier timing of Easter means that we had to accelerate some stock buying at the February year-end in readiness. The funding of stock has been covered by an increase in trade and other payables, leaving invested capital up 4% on the year. The 11% growth in operating profit means that there has been an increase in the return on invested capital of 70 basis points, to 12.7%.

We have also seen an increase in the retirement benefit asset of £74 million. That is wholly driven by an increase in the discount rate that we have to apply at the end of the year. It is up 120 basis points, and has reduced the liabilities on a discounted basis. There is no real change to the level of assets within the pension scheme. We have made no additional cash contributions into the pension scheme on a one off basis other than the normal P&L changes.

The Group's capital structure is constantly monitored. The board is of the view that given that the outlook for consumer spending looks weak it would like to maintain flexibility through a prudent balance sheet approach. However, the Board will continue to review the capital structure to ensure that it remains appropriate going forward.

7. Financial Services - receivables

Gross store card receivables grew £34 million to £482 million. Store card penetration increased marginally to 8.5%, from last year's level of 8.0%. The increase in credit sales was attributable to an increase in the promotional credit offers. The mix of promotional to revolving credit is now 75:25. Last year it was 72:28. Therefore, three quarters of our volume on credits sales is now on promotional products. These are predominantly the three, six, nine and twelve month 'buy now pay later' products we offer. The personal loans portfolio continues to runoff, with a further £15 million collected in the year, and the provision percentage has increased slightly to 12%. This is mainly due to the mix impact of the more heavily provided personal loans portfolio, which is in the final stages of runoff. As already mentioned, the delinquency and bad debt costs are slightly reduced versus the level we saw last year.

8. Cash flow statement

On the change of year end it was not possible to recreate the opening balance sheet as at 5 March 2006. Therefore the prior year comparative is a short period of 11 months, meaning it is harder to carry out comparisons on the cash flow statement. Statutory EBITDAR was up £87 million to £539 million. This was driven by three factors, the increase in operating profit of £39 million, the short period FY07 was only

11 months, and a lower level of exceptionals this year – there were a number of demerger exceptionals last year totalling £23 million, this year that level was broadly nil.

The cash generated from operations fell £57 million to £564 million. This was due to the working capital outflow. With regards to the change of year end, FY07 included a £100 million runoff benefit in working capital for the change of year end. There was also a step change improvement in supplier terms that benefited the trade payables line. The FY08 level of working capital of £48 million – comprising £15 million of loan book and about £35 million of trade working capital – is a more normalised level going forward.

The second half of the cash flow statement becomes less comparable year on year because it takes some of the impacts of the previous capital structure as discussed in last years full year announcement. Cash tax of £95 million is slightly down on the short period. This is a little odd given that the prior year is the short period and profits have grown this year. This is because we have agreed settlement with HMRC on a number of outstanding tax items. We had inherited these on demerger; some had dated back to 1999. We had made cash payments on account for tax on those, and we managed to claim some back this year, this means the cash tax is slightly below the level you would expect given the profits we have earned in the year.

Capex of £208 million is slightly below the level we guided to. Previously we have talked about a level of guidance of £225 million of ongoing and £30 million for the Focus acquisition. The Focus acquisition Capex will be split over two years. We have taken £19 million this year, and there will be approximately another £10 million to come next year. As referred to at our Q4 trading statement we have delayed the opening of our fourth 2-man delivery warehouse. It would have been a self-built freehold venture at a cost of around £50 million. That has been delayed by a year to two years, and a view will be taken when we start building that over the next year or so. This means a saving on capital expenditure. The dividend paid is as we have already disclosed today.

Acquisitions and disposals is predominantly the acquisition of the Focus stores. The repayment of borrowings of £225 million was the repayment on schedule of the financing facility inherited from GUS at the point of demerger.

We have ended the year in a strong financial position. Net cash has increased by £114 million to £174 million. There is a reconciliation in the appendices slides explaining how to reconcile the decrease in cash and cash equivalents through to the end of year cash balance.

9. FY09 modelling assumptions

The number of new stores will be around 30 in Argos, and 10 in Homebase. That would lead to space growth of around 3-4% in both businesses. In addition, in the Homebase business we expect 5% of space growth from the Focus acquired stores. Given the comments we have made around the slightly adverse product mix, we think the gross margin will be slightly down for FY09. That is consistent with our long-term ambition to hold margin flat at Argos. We were flat two years ago, flat last year, and up slightly up this year. Over a three-year trend we are on track to hold gross margin. Homebase gross margin will be up approximately 100 basis points.

For the first time underlying cost inflation is slightly different in the two businesses. Last year they were both 3%, and the year before 4%. The key driver to the difference is the level of rental inflation we are seeing in the businesses. The rent bill is relatively significant at £350 million across the Group - £200 million in Homebase, £150 million in Argos. We are seeing an easing in the level of rent inflation in the Homebase business, but mixing up to higher levels in the Argos business as a higher proportion of our rent reviews are in the out of town retail parks where we are seeing mid to high single digit rental increases.

Central Activities will continue to incur around £5 million of costs on the development opportunities in India and HomeStore&More. While interest will benefit from higher cash balances, it is also likely to suffer from a lower effective interest rate on the cash deposits. Our current view is that interest income will therefore be approximately flat in FY09 on the current year level. JV and associates will revert to a small loss, given that this year's number is aided by the near £3 million gain on the sale of our share in AAGUS.

There are two impacts. Firstly, corporate reduction from 30% to 28% will benefit us by two points. There is potential for that effective rate to then marginally increase if profits fall given there is a relatively fixed level of disallowables within the business. Secondly, capex of around £200 million, and a working capital outflow similar to FY08, with growth in the Financial Services loan book of around £10–£20 million.

10. FY09 modelling assumptions - Focus

Given the changes to the phasing of the Focus store opening programme, the net number of stores at year end was 12. We are now of the view that there is one undertaking we have to provide to the regulatory authorities and that there will be 21 stores rather than 22. Sales growth of around £75 million is not the full year sales number as some of the stores are still in the process of opening. We are currently trading out of 19 stores with 2 more still to be opened. The annualised run rate on sales of those stores on a full year basis would be around £80 million. The purchase price remains at £40 million. The capital expenditure previously announced of around £30 million will be slightly less as we will now not be opening one store. We are still comfortable with the exceptional revenue costs of £15 million, subject to the point that we have one store on which we have given an undertaking that we need to exit. We are not yet clear what the terms and conditions of the exit will be. We are still comfortable with the operating profit number of those stores for FY09 of around £10 million.

Maria Thompson
Group Commercial Director

1. Introduction

Good morning. I will be covering four areas this morning. The first two relate to the issues facing the general merchandise manufacturing base and specifically the areas from which products are sourced and the macro economic factors affecting that manufacturing base. I will then cover what this means for Home Retail Group in terms of further opportunities and our approach to global sourcing. Finally, I will explain why Home Retail Group is better placed to address these challenges than the rest of the

market.

2. General merchandise manufacturing base

Some 60% of all the products sold in Argos and Homebase are manufactured in the low-cost geographic regions of China, South East Asia and the Indian sub-continent. The greatest proportion comes from China. We believe the Home Retail Group profile is typical of the general merchandise market. Regardless of how goods are sourced, their manufacturing base is already overseas for the most part.

3. Cost drivers

The most significant drivers of cost prices have been under considerable inflationary pressure over the past year. The market has seen raw material increases, export subsidy withdrawal in China, increased freight costs, local labour and other internal cost pressures – across China and South East Asia in particular. Looking to the future, exchange rates and strengthening local currencies have the potential to increase cost pressures further.

4. Pressure from raw materials

Raw material prices have risen in the key categories of plastic, steel, chipboard, and cotton. These are the key components in a wide range of general merchandise.

5. Other cost pressures

Additionally, on July 1 2007 the Chinese government cut export subsidies across virtually all general merchandise product categories, resulting in manufacturers incurring an average 7% cost increase overnight. It remains possible that the Chinese government could still make further changes dependent on international and global macro economic pressures, or internal and local market conditions – including inflation, labour availability, and manufacturing stability.

Freight costs are another factor impacting on goods manufactured overseas. Freight costs have risen steeply over the past year, and we believe they are 30% up year on year. Demand continues to exceed supply, but again this could change in light of a slowing US economy. The overall freight rates have also been impacted by the new costs of fuel surcharges and port congestion charges.

Labour costs are rising in China in particular, with regulation around minimum wages and overtime, and reinforcement of employee contracts. Annual labour inflation in China is running at 10-20 %. These could all lead to further cost increases over time.

6. How have these pressures translated into our costs of sourcing?

Home Retail Group have not been immune to cost increases. Looking at a sample of 1,500 directly sourced re-included lines for the current Spring/Summer Argos catalogue we have seen an average net cost price rise of 3% on an FOB basis year on year. We have been able to manage cost increases as a result of combining our Argos and Homebase volumes. Our customers have benefited from selling price deflation over the same period. The five main reasons are that firstly we have significant general merchandise buying scale as we have moved more products to import –

specifically directly to the manufacturer thus cutting out the margin that either domestic suppliers or import agents earn. We continue to build supply chain efficiencies through the sourcing, supply chain, and stock management areas. There has been and will continue to be natural price deflation in certain product categories through technological innovation and global market demands. Lastly we have benefited from a favourable US dollar to sterling exchange rate, enabling us to use those benefits to drive better margins plus fund selling price reductions.

Looking forward, maintaining the historic levels of price reinvestment is under pressure. This is due to a continuation of the cost inflation that has already been referred to, and secondly because of the likely unfavourable currency environment such as the Chinese Yuan which has strengthened versus the US dollar by 7% over the last few months. The same applies to the Thai Baht and the Vietnamese Dong. These pressures affect the worldwide retail market and are not Home Retail Group specific.

7. Current position on direct sourcing

Our approach to sourcing is multi-faceted and is done at an individual item level. It is iterative, and not necessarily sequential. We can do any of these things at any time in a product's life cycle. The important concepts to focus on are that the supply chain stock and Forex risks are exactly the same whether the line is imported via an import agent, or directly sourced. Direct sourcing takes out the current margins earned by import agents. Our in house tools around e-procurement, encompassing auctions and tenders, continues to be widely used and deliver incremental benefit.

We continue to successfully move more products to import, and increase the participation of products and sales directly sourced from the manufacturer. 31% of total sales in FY08 were from import products. 58% of those imports were directly from the manufacturer, with the opportunity to grow imports further. There still remains the opportunity to move more products bought in domestically or by import agents to direct sourcing.

8. Current position on direct sourcing

The 7,500 SKUs we have directly sourced across Argos and Homebase over the past year reflects all the major categories. Over 95% of what we directly source comes from China and South East Asia. This reflects the strength of the Asia manufacturing base.

9. Further sourcing opportunities for the Group

We still see considerable sourcing opportunities for Home Retail Group through four major areas: Increasing our levels of import versus domestic supply, and particularly the levels of direct sourcing from the manufacturer; there is the opportunity to expand our overseas sourcing locations; we continue to focus on improving our supply chain; and we are embracing other cost reduction activities.

Let me spend a few moments talking about each of these in turn.

10. Further to go on importing

As shown earlier we continue to increase the level of imports and more specifically those sourced directly from the manufacturer. There are no preset targets for our growth in imports or directly sourced lines, as we can exploit opportunities across unbranded, exclusive and own brand products.

There are some natural limitations in product categories such as horticulture or where supply chain realities make imports less attractive, specifically low volume, high cube and volatile-demand products or where the import agent or domestic supplier holds the product licence. These aside, there is still considerable opportunity to move more goods to import, which affords us greater visibility of cost and control of the supply chain and the manufacturer.

11. Other sourcing locations

Historically Asia has been the most cost advantaged sourcing location and we believe this remains the case because of its breadth of manufacturing base, scale and expertise. For Home Retail Group however, there remains the opportunity to expand alternative locations such as Eastern Europe. This is attractive despite the strengthening of the Euro as it offers some cost advantage in certain product categories, but also supply chain benefits in terms of transit times, the ability to carry lower stock in the UK and faster reaction to customer demand. South America, South East Asia and the Indian subcontinent offer further opportunities to broaden our direct sourcing as manufacturing in these regions gains scale and expertise. We already have a programme of activity under way in Eastern Europe, South America and the Indian subcontinent.

It is worth remembering that there is little or no opportunity to significantly increase the proportion of domestic manufactured goods. The UK does not have the manufacturing base for most of the products and the global and raw material pressures apply equally to the UK.

12. Supply chain initiatives

Sourcing location is just one element of driving down cost. Another is enhancing and managing our supply chain capabilities. To this end there are many initiatives already under way. Increasing our offshore operations, such as pick and pack enables us to enjoy the benefits of direct sourcing without incurring UK costs for consolidation and prepacking. An example of pick and pack would be nails. We buy the nails in bulk and have them delivered to an offshore location where they can be packed into many configurations, thus enabling us to breakdown one product, a nail, into many skus. We also do this on many other products.

Much work is under way to drive transportation efficiencies, not least the improved selection and use of ports for both shipment and receipt of goods to reduce overland transportation. There is further opportunity to drive benefits through our supplier base, whether domestic or import, through more joint sourcing and supplier consolidation.

Another area of focus is packaging. Reduction in packaging affords many benefits, not least reduced cost of product, but also greater space efficiency in container utilisation on pallets in our distribution centres and stores. Importantly it helps us reduce the amount of waste we and our customers generate.

13. Cost reduction processes

In addition to supply chain initiatives we continue to use our in-house, supply chain tools, which are rigorously applied at individual item level. We use cost modelling across all import and comparable domestic products. We monitor and quantify the potential impact of raw material and currency fluctuation. We continue our full value chain category analysis to identify the impact of volume growth, brand premium and other factors across our supply base. We continue to apply our e-auction and tender process across merchandised products and more recently corporate procurement. An example of our approach is shipping, where we tendered each individual route in our import supply chain, enabling us to compare and contrast quotes and then use these quotes to leverage the service providers and negotiate what we believe to be an advantageous shipping cost versus the market.

14. Summary

The cost and currency pressures will be felt across all retailers, regardless of their sourcing, routes and methods. Home Retail Group will continue to be better placed than most, given our scale in general merchandise buying. We have established strong relationships with key manufacturers of scale and we continue to build on our existing track record of successful sourcing, using our in-house expertise and infrastructure. There remains further opportunity to exploit overseas sourcing by migrating more products to direct sourcing from the manufacture and import per se and by expanding our global sourcing regions. We also continue to pursue all supply chain and other cost reduction activities. The important point here is that scale alone does not drive optimal benefit; scale must be supported by both expertise in the supply chain and the necessary, sophisticated tools to understand costs.

Terry Duddy
Chief Executive

1. Summary

For a second year we have achieved double-digit earnings growth. This is an excellent performance, but understandably the focus is on the weakening consumer outlook and we have been clear we expect that to result in negative like-for-like sales performance in both businesses in the short term. We believe, however, we are operationally and financially well positioned to manage that challenging and changing environment. We are clear in both confidence and capability to continue our strategy to deliver long-term growth.

Maria has set out our competitive strength in sourcing, scale, expertise and infrastructure. There is significant opportunity to continue to leverage the combined

purchasing power of the Group to protect our competitive position and support gross margin. We will continue to target increasing share in big-ticket product markets, but this will build on a strength and potential resilience of the broad product offer and low-ticket baskets that provide frequency of footfall in both businesses.

Both Argos and Homebase have strong store pipelines that provide new store opportunities with good returns and multiple years of growth. You will all hopefully appreciate that the leadership we have in multi-channel convenience for the customer, specifically in the Argos business, continues to grow. Thank you, our presentation is complete, so Rich will now join me with Maria to take your questions.

Questions and Answers

Robert Miller, Redburn Partners

Can I ask about the supply chain? When you talk about, for example, 100 basis points of margin at Homebase both this year and next year, what are your core assumptions about currency and retail price?

Richard Ashton

Given that we forward buy currency and it varies over a six-month and 12-month period, the first half of last year was forward bought at about $1.90; the second half of last year was forward bought at around $2.00. For the first half of the current year we are seeing that the forward buying achieved about $2.00, so we are still seeing a foreign exchange (FX) gain benefit in the first half of this year. That is one of the key drivers to the ongoing reduction in prices in re-included lines being seen in Argos. Given that we were at $2.00 for the second half of last year, in the second half this year I think we are going to start seeing a headwind coming from FX. At best it will be flat and more realistically it might be slightly down, but not that significantly. We have already started to forward buy that now and we are in the high 1.9s on that level.

One of the issues that we are also having on FX is that the differential between spot and forward is getting bigger as the interest rate differential between the UK and the US is getting bigger. Six to 12 months ago the differential between spot and forward was about 1 to 1.5 cents; it is now running at around 5 cents. When you start looking at the screens and ask why we cannot buy in at $2.00 because it is tracking around there, it is because when you forward buy on six to nine months you are getting a reduction of around five cents in what you are buying, so a $2.00 spot is actually about a $1.95 forward buy.

Terry Duddy

On the first part of your question, on a competitive basis, there is an assumption that we hold our competitive position and that is something on which we have focussed on in the Homebase business. It is feasible, but if the market goes back to where it was in 2005, that would put pressure on that margin for us to be able to maintain that. When we talked about achieving these types of gross margin increases, it was based

on some form of status quo as far as competitive positioning was concerned.

Robert Miller

The implication surely is that prices will have to rise to achieve that sort of gross margin gain?

Terry Duddy

I do not think that is a direct implication, but I do understand that you could get to a point where the pressure on cost prices would lead to prices generally in the market rising, but that is going to be dependent on what the market does. We do not have a plan to put up our prices; we have a plan to remain competitive in the market.

Robert Miller

In the current year therefore, you think you can achieve 100 basis points of margin increase on flat prices, year on year.

Terry Duddy

I think Richard's guidance slide was extremely clear on aiming for around 100 basis points of growth in the Homebase business.

Robert Miller

Is that the achieved margin or the bought in margin?

Terry Duddy

That is the achieved margin.

Robert Miller

Can I also ask on the subject of Homebase, to what extent these days are margins based on volume rebates? How prevalent is that relative to say, a few years ago, given the change in the mix of your business?

Terry Duddy

There has been no significant change in volume rebates.

Richard Ashton

The only change is where you are moving from UK domestic to DI/DS. The domestic market is not changing very much. What is happening is that you are ending up with a lower base cost but you have to factor in that loss of volume rebate when you move

from a domestic to DI/DS, so that all becomes part of what we are talking about, all part of the financial equation, along with other factors such as transportation, breakage levels and shipping costs. One of the other things you have to factor in is the level of volume rebates you think you will get versus the cost price in the UK. You do not get the same level of volume rebates when you are doing DI/DS.

Maria Thompson

I think volume rebates and other terms have improved as a result of us bringing the two companies together and leveraging the scale across the entire supply base.

Robert Miller

In 2005 when the market was very weak, there was a chase to try and hit volume rebate levels towards the end of the year, which produced a highly promotional market. I am talking about the DIY market in general.

Terry Duddy

I do not think that was the case in our circumstance.

Jon Guinness, Fidelity International

What would the bar chart on page eight [of the presentation slides] look like if you weighted each product by sales?

Terry Duddy

Sara did this last year and that in itself is not a volume-related chart, but if we were to relate it to volume as we showed last year in the presentation Argos would be even more competitive. What we have shown you there is a straight price comparison. Volume related, relative to the products of which we sell the most, we would be even more competitive.

Jon Guinness

What would it be like over time, say the last six months and next six months?

Terry Duddy

We are steadily holding our position. We have got better at this, as we are trying to show in the way we set out this story for you. We have been monitoring what promotional efforts do and what the promotional affects will be and tracked that over time, so the simple answer is we will always aim to be at least that competitive. Our plan is to remain that competitive and it is something we look at in detail. I constantly see a comparison of five electrical products in a report that gets repeated six months later. We are really on top of this detail; we look at it every week; we review it as a board every week. We deal with any outliers. We do not react to people who promote price and products where they do not have stock. We are very sensible in what we are doing and we are very sensible in getting value to our

customers, which is our prime objective.

Assad Malic, Credit Suisse

Can you quantify the change in the mix of consumer electronics as a percentage of sales year on year? Secondly, in terms of your assumption about gross margin in Argos being slightly down, what does that assume in terms of the level of price reinvestment going forward on the re-included lines?

Terry Duddy

Consumer electronics have grown, but off the top of my head I cannot tell you what that would be. I specifically spoke on the issue of where we would be in terms of market share. In terms of consumer electronics that would be £1.4 to £1.5 billion of sales and that has been a slightly growing number.

On your other point about re-investment, we are not at that stage yet for the next catalogue and we look at that on a line-by-line basis. I specifically mentioned what is happening in terms of raw materials, because I wanted to relate that to what is happening in gold prices as we have seen other competitors having to put gold prices up. We will have to do that, so that will have an impact on our re-included line price deflation, but there will be some impact as well from other cost price rises, but I would estimate that price deflation will fall, but I do not know what that number is right now.

Assad Malic

Does the current guidance assume a continuation of the adverse mix?

Terry Duddy

They are two completely different things.

Richard Ashton

We are doing our best to give you our view that says that there are some strong categories at the moment. Consumer electronics is going strong, within that VGS is doing as well as things like sat nav. They are margin dilutive. The query you have to play with is the balance of what we might do around price reduction in the new catalogue, but that is not happening for a while yet and we could not give guidance on what that percentage is, but the two are intrinsically linked.

Assad Malic

A last question, can you break out the year-end stock position between Homebase and Argos?

Richard Ashton

It is not really a meaningful number to give you, because we are doing joint buying

now and hence we have some joint products and I could not do it because a huge chunk of it is owned at the centre, in two-man home delivery warehouses that are Group facilities with Group stock.

Simon Irwin, JP Morgan

Three questions, first, in terms of your purchasing in China, in which currencies are you making purchases? Is it US dollars, is it renminbi or are you doing some in sterling? What is the effective exchange rate rather than the US dollar forward?

Richard Ashton

We are buying solely in US dollars, so that is the exposure that we are dealing with and the rates I gave you before are the effective rates that we are factoring in going forward. Within some of that we talked about there being a head wind on FX, this includes the strengthening of the renminbi versus the US dollar. That is one of the head winds we are facing going forward.

Simon Irwin

Are manufacturers largely swallowing that at the moment?

Richard Ashton

It is an ongoing negotiation there with a whole batch of things. They are taking some and we are absorbing some. What we have had so far is a strengthening of renminbi but the US dollar to sterling has been going the other way so it has been off-setting each other. As you move to a more neutral dollar to sterling going forward in the first half of this year or a potential weakening, that will only compound some of the head winds we are facing for FX.

Simon Irwin

You talked about a multiple-year programme of opening 30 Argos stores a year. Are you effectively telling us that the 800 store portfolio is going to be extended at some stage?

Terry Duddy

I have said that consistently for a while. We have always said that there would be in excess of 800 stores and I am taking that 800 out of consideration, because, I gut fed back that the maximum would always be 800, but the slide says somewhere in excess, so on a rolling basis we will be looking at our store portfolio. If we look at the next three years plus we will be opening 30 stores a year. Next year I will update that and we will take a look at where we are in terms of viability and the pipeline. Right now it is 30 stores a year for the foreseeable future.

Simon Irwin

Last year there was a certain amount of confusion between various players in the DIY

market as to whether seasonal was higher or lower gross margin and whether a poor season was good or bad for gross margin versus interior. Can you tell us your thoughts on this year?

Richard Ashton

We can only comment on the impact of seasonals on our business and our gross margin. Given the gross margin guidance we gave you at the demerger that said the Homebase gross margin is around 50% and since then we have had a year where we were up 300 basis points and another up 250 basis points, we are now trading at around 55% of gross margin. Within that seasonals for us are dilutive, so a poor seasonal performance at the moment is actually helping the margin percent, not the margin cash, but like you I hear similar things from other retailers, but I cannot comment on them because I do not know the details of their seasonals and margins.

In Argos it goes the other way round. Its margin at demerger was slightly in excess of 30 points and since then has been roughly flat, seasonals are slightly accretive and hence we talked about the adverse margin mix we are seeing, which is a lower level of accretive seasonals and a higher level of dilutive consumer electricals – VGS, sat nav and things like that.

Chris Walker, Lehman Brothers

Could you give us some colour around the product categories in Homebase, particularly the core categories and whether you are seeing any weakness there or whether it is just seasonal? Secondly, how are the Focus stores trading? Are they meeting your expectations?

Terry Duddy

The category explanation given was only for the last financial year and has been pretty well covered, which is that kitchens performed well throughout the year; there were seasonal effects in the first half and some weakening in the second half in some big ticket items. We have not provided a category explanation for the current update. It is too early to tell with the Focus stores.

Richard Ashton

We have had some of them open for a couple of months and some for a couple of weeks. We were trading out of 12 at the end of the year and 19 currently, with two more to go. They will open in the next four or five weeks. These are sites where stores were closed for a while then we had to refit and re-open them. Therefore you have to drive the traffic and the footfall back into them. We are seeing significant uplifts in stores that we have opened compared to what they were trading at before, but it is not a statistical sample on which you could determine whether they are good or bad numbers at such an early stage in the cycle. We would have to trade them for a lot longer to see where we are going. Not surprisingly there are variances. Some are trading significantly ahead of where we had modelled them and some are below. There are reasons why both are doing that and we need to get into that a bit more over time as we open the rest and see how they perform.

Terry Duddy

Operationally it has gone really well. We have had some delays related to regulatory issues, but we have opened these stores really quickly and all the ones that I have seen are absolutely excellent.

Peter Brockwell, ING

In terms of the Homebase asset impairment charge, can you give us a few further details, especially in relation to the number of stores and is this charge linked to any incremental like-for-like sales deterioration? On Focus you are talking about a year one revenue contribution of £80 million. From memory I think you were previously talking about £90 million. Even adjusting for the one store that has been sold it looks to be a major difference. Are there any store location issues?

Richard Ashton

I had expected someone to pick up on that. On Focus stores the answer is quite simple – it is in rounding. The model for 22 stores was £87 million of modelled sales. We said circa £90 million when we rounded it up. The one store we are losing, which is Woking was modelled at £5.5 million of sales. We have taken that store out and we now get to £81.5 million of sales and that rounds to circa £80 million. That is the difference. It looks like £10 million, but it is not. There are no changes to the numbers that underlie the assumptions that we made when we acquired the stores and they have not traded long enough for us to have any different view to the one that we had when we did the original viability study. It is simply one number rounded up and another rounded down and the store that has come out was a pretty big store with a high level of sales at £5.5million.

In terms of impairment, this is quite a volatile non-cash item, so the £10 million we are taking this year is actually an increase in charges on certain stores for £15 million and the release of certain stores for £5 million. This impairment will swing both ways. It predominantly relates to the uninvested store portfolio. Paul talked at the last presentation about there being 100 stores in the portfolio in which we have not invested. They are underperforming the core portfolio and there are around 70 of them that we think we have the opportunity to invest in and improve. The impairment charges are almost all, but not fully related to those uninvested stores. As their performance changes and you go in and improve some of those, and we have done that with one or two of the midi trials so far, as they improve some of the impairment charge has to be subsequently released back and that is what has happened this year. Additionally, other stores in which we have not invested are underperforming even more and you end up taking a slightly higher charge. It is a very volatile number. As we said it is non cash and that is why we exclude it from our benchmark measure.

Peter Brockwell

How many Homebase stores would be losing money pre central overhead?

Richard Ashton

It is not that many, because an impairment store base is on a fully-loaded overhead basis, so an impairment store is actually at an operating profit level, so when you are allocating all your fixed costs to a store then there are a number of stores that lead you into the impairment. There are still some at a contribution level that are not making a contribution. I will not go into the detail, but it is nowhere near being significant on the operating profit basis, which is what leads to the impairment calculation.

Peter Brockwell

Can you give me a rough number? Is it double-digits?

Richard Ashton

Yes it is double-digits, a low double-digit number on a store contribution basis.

Terry Duddy

We have known about some of those stores since the time we bought the business and we have slowly been moving out of them over time at the rate of a few a year. We will continue to work on that.

Rod Whitehead, Deutsche Bank

When you talk about 55% gross margin at Homebase, is that pre distribution cost and shrinkage?

Richard Ashton

It is only pre distribution. As I said today distribution is only 5.5% of sales, so pre distribution is around 55% and post distribution it is going to be around 50%. Everything else is in there – shrinkage, losses, stock provisions and breakages.

Rod Whitehead

Terry, could you talk about how you see the outlook for consumer electronics over the year ahead? I am thinking about categories such as TV, sat nav and video games. Christmas is a way away, but it is always very important and given that you have had strong performance in a couple of those categories do you think it will continue and what could drive consumer electronics as you go through the year?

Terry Duddy

The growth in LCD TV has slowed, but it is still growing. The growth in video game systems, sat nav and mobiles is still buoyant. I am not going into current trading, but

we have seen some of those trends towards the end of last year. Some of those areas such as LCD TV are not as high growth as they were before, so we see a circumstance where they are a buoyant and an important category for us. That is why we made the remark relative to the margin. We do see them as being adverse to our product margin overall. At this stage we talk about the resilience of particular areas, because those people who want to buy a Wii are still doing it. We sell out our supply every week. There is a regular incoming supply and a sell through. We will see even more demand for the Wii Fit. Customers are choosing where they would like to spend money and they are quite happy to spend money on desirable, hot technology products.

Andy Hughes, UBS

Firstly, where are you on internet only lines for Argos and for Homebase in due course? Secondly, on Homebase, is there any rule of thumb about if you lose sales at the start of the season, do you get them all back or do you mentally right off the bit that will not return? Finally, on currency is there a Euro issue? What percentage do you actually acquire in Euros?

Terry Duddy

Online only is interesting. We have a number of products in Argos, which are online only. We are growing that. It has been an area of interest for a while, but it is not substantial at this stage, but we continue to look at it and work on it. There are more online only products available in Homebase. They are often Argos-sourced products. We actually started the Homebase website with more Argos products than Homebase products. We have now increased the number of Homebase products on the website and we are changing the mix of Homebase products away from online only to online and store.

Andy Hughes

Do you see a time at Argos when online only is a material chunk of sales?

Terry Duddy

It is feasible and we think it is important to work towards doing that. We have to take it week by week; there is no rule of thumb. On seasonality, at this point we are not panicking and I hope nobody else is. You do get those sales back. Some you lose such as horticulture, but we hope that we are going to get enough good weather to sell a lot of our garden furniture.

Richard Ashton

There is no really significant exposure to the Euro. The difference on the dollar is purely because we are buying stock. On the Euro we are also trading in Ireland, so we are selling product and generating a pool of Euros. The profitability of the business is more of an issue. That is your exposure, because you are buying and selling things in Euros, you are paying bills and staff in Euros, so it is trading issue as opposed to the dollar, which you need to buy in order to buy products and that is why

you have to manage the exposure. It is less of an issue for us at the moment.

Tony Shiret, Credit Suisse

I am struggling a little bit to get this cost inflation figure. I know that the purpose of the presentation is to achieve that end and I wondered if you could, without going through the FX analysis and the other stuff, give us a bit more of a guide for the change in the rate of cost inflation and cost of product?

Richard Ashton

I am not sure what else to say. We have talked about the issue around the head winds; we have not priced the catalogue for the rest of the year and we are seeing an adverse margin mix coming through, which is giving some pressure. We have to manage that dichotomy between the cost pressure on product versus how much we think we can feed through into price or a reduced level of deflation. We will do that when we get to the point in the year when we do the final pricing for the catalogue, but I cannot give you much else right now.

Tony Shiret

You obviously have some idea about the increase in the cost of the product on a sterling basis, excluding mix and volume. You clearly have some idea of that. Is it going to be 5% more expensive than last year on a sterling basis?

Terry Duddy

We do not at this stage, but we will have shortly. The pricing of the next catalogue will take place over the next three or four weeks. I sit with Sara and others and go through that in detail. It is bottom up on a line-by-line basis. We have talked to you about the trends there and what we can do about them. We will see what each individual buyer and category has managed to do in negotiations over time. When we get there we will be able to be more explicit than we have been so far. It is not a case of avoiding the question. When we have it we will be happy to share it with everyone else.

Tony Shiret

Are you going to commit to give us that information with the Q1 trading update?

Terry Duddy

We have not given it before in terms of what the overall price inflation will be. You will not get the re-included line price deflation for Q1 trading. You will get information on prices in the week before the catalogue launch.

Caroline Gulliver, Execution Ltd

Can I go back to the Argos value chart on page eight? I know you said that you monitor it weekly and you are very on top of your pricing, but I was interested in the

27% of products, where competitors are more than 2% cheaper than you. I wondered if there are any trends within that Group either by category or competitor, whether it is specialists, online retailers, supermarkets or other general merchandise players that are consistently cheaper.

Terry Duddy

The majority of that 2% usually relates to a 2% or 3% difference.

Robert Miller, Redburn

You have slightly danced around the subject of whether you should be buying back shares or not by talking about being flexible with your balance sheet approach. I would have thought that if you think the share price significantly undervalues your business and it is a great value-creating opportunity, you should be stepping in and buying a load of shares. Can you be more specific about what metrics you use to decide what your balance sheet optimality is and why you are not buying back shares?

Richard Ashton

I am not sure I agree with the point that we dance around it in the statement. I thought we were relatively clear. If the world changes going forward, then we will look at it as appropriate. The metric we use is the one we have always talked about. We are a business that has net cash but has substantial leased portfolio debt on an adjusted net debt basis in excess of £3 billion. Those slides are in the appendices, so you can see how we calculate them. Depending on whether you are looking at the eight times multiplier or the NPV, which most of the rating agencies tend to use, ours is slightly above or below three times adjusted net debt EBITDAR. As we have said before, you can calculate the retail sector on a weighted average basis and that puts us bang in the middle of that sector. There is some flexibility around our balance sheet, but given our view of the outlook at the moment, we do not think this is the time where we should move from an average to a more aggressive sector position.

Terry Duddy

If there are no further questions, we really appreciate your time and thank you very much for coming today.