Second Quarter Trading Statement Conference Call – 11 September 2008

Operational Review

Richard Ashton
Finance Director

Preamble

Good morning and thank you for joining our call today. I am joined by Terry Duddy, our Chief Executive, who will help take questions in a moment. The statement that we have issued this morning is for our second quarter, which covers the months of June, July and August, and which also includes the performance for the first half in total.

Argos

Turning first to Argos, as anticipated its like-for-like sales performance turned negative after the somewhat surprising resilience of the first quarter. You will be aware that the overall retail market has been more challenging over the last three months, driven by the pressures on household cash flows and reduced consumer confidence, as well as some volatile weather patterns. Excluding food, the non-food market has clearly been even more negative.

Within its categories, Argos still achieved positive growth in consumer electronics. The rate of growth was however, lower than the previous quarter, and this was one of the key drivers of the like-for-like sales between the first and second quarters. Video gaming continued to be the strongest area, with TVs and Sat Nav still providing positive growth for Argos in the quarter. The most challenging areas were the furniture and homewares markets, which continue to be impacted by both the weaker housing market and the more discretionary nature of spend.

The Argos gross margin movement reflected the change in product mix, as we had set out to be the likelihood for the full year. It was though a smaller decline than the first quarter, attributable to a lower growth rate in the margin-dilutive consumer electronics categories.

Our Check & Reserve service continues to demonstrate the truly multi-channel convenience of the model. It grew by over 40%, as 30,000 customers a day made immediate collection of goods that they had reserved on Argos.co.uk. The internet channel in total represented 22% of all of Argos' sales.

Homebase

Turning to Homebase, like-for-like sales, while better than the first quarter, still reflected the generally difficult trading environment in the majority of its categories. Seasonally-related areas were broadly in line with the company average. Despite a poor second quarter last year in this area, the weather overall was not really any more helpful for us this year. There was a good June, a mediocre July and a poor August. The more discretionary areas, such as garden furniture, performed the worst due to the weather, while garden maintenance and horticulture did relatively well. Kitchens continued to perform well, driven by the previous rollout of the installation service that we are now anniversarying.

Homebase net new space was 8.0%, being the combination of the contribution from the net 21 acquired Focus stores, which have all now reopened, with the balance being from the normal store opening programme.

The gross margin at Homebase was up 125 basis points, driven predominantly by the continued sourcing and supply chain progress.

Since the year end, the deterioration in market conditions, as already reflected in recently reduced analyst consensus forecasts for future years, has caused us to review the Homebase carrying values. As a result of this review, we expect to incur substantial write-downs in our half-year results. The write-downs will be recorded as exceptional items and, for the avoidance of doubt will be non-cash in nature.

Finally, on profits, we should report benchmark profit for the half year in line with our expectations. While there is a wide range of full year analysts' forecasts, the consensus is £362m, or a £71m decline on last year. Pro-rating that decline, given a normal phasing of profits, the reduction in the first half would be approximately £25m against last year's first half profits of £150m. There is also the reference in today's statement that cash generation in the first half has been good.

Questions and Answers

Ben Spruntulis, Citigroup

First, could you remind us of your hedging arrangements and how these impact the bought-in margin over the next few years?

Second, could you give us an update on the input cost pressure that you are seeing and degree to which you think sourcing gains could offset this cost inflation this year and next?

Richard Ashton, Finance Director

We are predominantly buying in US dollars. We are forward-buying on about a six-month lead time. Our policy is to have 90% of the currency bought in advance of the catalogue hitting the streets, so that we know where we are when we come to price that catalogue, and we have not changed that policy. We talked about the first half this year having a foreign exchange (FX) benefit and at the last conference call, about the second half this year moving to FX neutrality, and both of those have been the case.

We talked about the first half next year moving into a position of a headwind on FX. As we start to hedge that position out now, as we will in the second half of the year, clearly the strengthening of the dollar will mean that that FX weakness will be slightly higher for us now than we thought that it would be at the start of the year. You need to bear in mind that each cent of change costs us £4m-£5m at the buying margin level.

We have seen cost price inflation on products. The catalogue that went out in July has moved to a reincluded line position of almost neutrality, which is where we guided it to be, from a track record where we have been running more like at an average of 3% price reductions. That number has varied from anything between minus one to minus six at the extreme, so there have been different levels.

The two key drivers behind it are clearly the cost of goods sold (COGS) inflation across a range of products, and also the significant increase in the price of gold meaning that the biggest price increases have come in our jewellery mix. Within that range of product categories, there is a significant number where we are seeing price deflation, so there is a big range. While we are broadly flat, there is a mix of products where we are still seeing cost and retail price deflation and there is a range of products where we are seeing COGS and retail price inflation.

Ben Spruntulis

Are you getting a sense of how you think that will evolve over the next year or so in terms of talking to your supply base?

Terry Duddy, Chief Executive

We still expect the cost price inflation to continue. In the current catalogue we are seeing cost price inflation at the direct sourcing factory level slightly higher than it is at the domestic level, but this will eventually flow through onto the domestic suppliers. You are going to see it for at least the next catalogue, but the key point is that we are continuing with our direct sourcing (DS) programme. We will not be able to offset all of the COGS rises in those circumstances, but there is a lot that we can do.

Ben Spruntulis

Finally, can you quantify the FX benefit in your first half numbers approximately across the Group?

Richard Ashton

We talked before about buying the first half this year at about $2 and we bought the first half last year at about $1.90. Those numbers, which we quoted at the last conference call, still remain good. Each cent, as we have just said, is worth £4m-£5m, but they are not necessarily benefits in the P&L because the FX is going to offset the COGS inflation. While we are seeing COGS and shipping cost inflation, the FX has been helping us to offset them. In terms of what has gone through the gross margin line, it is virtually nothing.

Robert Miller, Redburn Partners

Can you tell us how much more you have had to do on costs in both Argos and Homebase in order to hit a first half profit in line with expectations?

Richard Ashton

It is an ongoing programme. We have had cost reduction programmes for several years now. We have a good track record, particularly in Argos, on cost productivity. We delivered expectations last year off the back of a good cost number. In the first half, we have done another job on costs, as we have to. We talked about closing one of the six regional distribution centres (RDCs) in Argos in the first half of the year and are about to do that in the next few weeks. It has been a challenge for us. We have run the business over the last three or four years from six RDCs, so reducing that number to five while still growing the store base is an operational stretch, but it is something that we needed to do to move to the next stage of cost efficiencies.

You will probably also have seen press coverage of headcount redundancy programmes in the Homebase business, particularly at the store level, which again we have had to do to reflect the like-for-like sales environment that we are trading in. They are some of the bigger examples; underneath those, there is a whole raft of ongoing good housekeeping exercises.

Robert Miller

Looking forward, you did incredibly well on costs in the Christmas season in Argos last year and I think that you have said in the past that it is going to be tougher given what you did to deliver cost improvements in the second half. What do you think you can deliver now in terms of second half like-for-like cost performance in Argos?

Richard Ashton

It is difficult to say at this stage because as you know we bring in about 20,000 temporary staff into the business over peak. The level at which we bring them in will depend upon how we trade from now through September, October and November. If trading remains difficult we have the ability not to take on some of those contractors. To talk about what our level of like-for-like costs will be is a function of where the like-for-like sales will be, and the answer is that we will have to deal with it day by day and week by week. I could not give you a good guide at the moment for what that would be.

Terry Duddy

In theory we will have some more flexibility because we bring on a lot of people. One of the things in the Argos business is a circumstance where we have very few full-time employees in stores. We have people on shortened and contracted hours, which is how we have been able to flex it. However when the sales are at the minimum, we need minimum staffing.

As we move into a circumstance in the next quarter where sales are higher, we can probably allocate our staff better, which is exactly what we are trying to do in Homebase in terms of changing the mix of employees. We have talked about a realignment programme of people in stores, which is about getting people away from full-time contracts and working in the middle of the week, into part-time contracts at the weekend. It is just an ongoing aspect of trying to flex, where we can, our labour and other costs against the sales rates.

Robert Miller

I think that you set a two year target for Homebase gross margin expansion of 100 basis points per annum. Are you sticking to that?

Richard Ashton

We are at the moment. The benefits that we are getting this year are coming purely from the improved buying arrangements and bringing more and more of the Homebase volumes onto the Group supply arrangements. We know that there is a lot of that still to be done hence we still feel comfortable about getting it at the bought-in level. The consumer and competitive environments will dictate somewhat whether we can let that drop through to the gross margin line, but at the moment we are confident of getting it into the business. For the current year we are comfortable about reporting it through the gross margin.

Robert Miller

Presumably however, given what has happened to the currency, it implies that you will be passing on more inflation next year than you are this year in order to achieve that target.

Terry Duddy

When we did the forecasts, we said that it depended on where FX would be. At that time we did not say, regardless of where FX went, we would always deliver it. We were very specific about that.

Richard Ashton

The assumption was however, clearly an FX-neutral position.

Robert Miller

With regard to the Spring/Summer 2009 catalogue comment that you made, just to be clear, you have not as yet hedged any of the currency.

Richard Ashton

For January?

Robert Miller

Yes.

Richard Ashton

We have, because we have to be 90% bought by the time it hits the street and we are buying six months in advance.

Robert Miller

What have you done so far for the Spring/Summer 2009 catalogue?

Richard Ashton

At this stage, we are roughly halfway through that buying programme.

Simon Irwin, JP Morgan

In terms of Argos, where you put prices up and where have prices come down – and I take what you say about the overall mix being flat – are you seeing any overall change in behaviour – i.e. are consumers responding to those higher prices in terms of holding back?

Second, the like-for-like sales for Homebase seem to be tracking below most other players in the market. Do you have any thoughts as to why that is? Is it price or mix for example?

Third, what was your stock at Homebase like at the end of the period and what are your feelings in terms of the DIY promotional market, which appears to have accelerated a bit more during July/August?

Terry Duddy

In terms of Argos prices, it is hard to tell, as you would expect. We are only a couple of months in so far. It is also not helped by the fact that where prices have come down is in technology, because that has been a natural deflation and that is what has been growing that anyway, and where we have tended to hold prices more is in the furniture and homewares category, where we did not think that there was the demand and that was already difficult.

It is then, really difficult to tell whether or not those prices that have gone up or down have actually had a real impact on the performance of the businesses, because they happen naturally to fall in the markets that were already technology up and furniture and homewares down. What is probably interesting within all of that, though, is that jewellery has performed better than we have seen for a while, with prices in that category definitely going up.

Simon Irwin

Was that volume or value, or both?

Terry Duddy

Both. Out of all of that then, if you have followed everything that I have said – and I have given it a broad brush – I think that the final answer is 'not sure', so it is difficult to tell.

As far as the like-for-like sales comparison with other people in the marketplace is concerned, we are not embarrassed by any like-for-like sales that we have seen in the marketplace. Are you talking particularly about DIY?

Simon Irwin

Yes.

Terry Duddy

Let me make my point about consumer electronics anyway. You have seen Currys sales at negative 7% like-for-like and Comet sales at negative 9%-10% like-for-like. We have said that our consumer electronics are in positive growth, which is a comparably very good performance.

In terms of DIY, if we had reported for exactly the same period that B&Q reported, which was a very good May and a very good June, we would have performed equally well, in fact I could probably say slightly better. For what has been reported so far then, I have seen nothing that we would find embarrassing, but I do not know how B&Q have traded during this quarter that we have reported on, which included a very difficult August.

Richard Ashton

Stock across the Group at the half year is going to be similar to the level that we had at the full year. In terms of this time last year, off the back of the poorer weather in July, we overwintered a range of stock across the Group, worth £30m-£35m. We will be overwintering a similar level this year to that of last year. It makes commercial sense for us to do it. It makes no sense to try to mark it down heavily at this stage, given that things like garden furniture are just not going to sell irrespective of what you do to them.

We know from past experience that we can reflect that carried over stock in a lower level of buying next year and get it out at the beginning of the season at relatively full price. Our level of overwintering is going to be very consistent with what we had last year. That partly reflects the poorer weather that we saw at the back end of the quarter.

Simon Irwin

Going back to Terry's comment on like-for-like sales, does that imply that the bulk of the damage to Homebase's like-for-like sales was done in August?

Terry Duddy

Yes, or towards the end of the quarter.

Simon Irwin

What about the promotional climate?

Terry Duddy

Our promotional climate is the same year-on-year. In terms of what we have seen in the marketplace, when B&Q announced their results – which looked very good – the following weekend they went to 15% off everything over £50, which is the first time I have seen that promotion since January 2006, but they have not repeated that since.

Simon Irwin

Did that put pressure on the rest of you to respond or have you just let them do what they want?

Terry Duddy

We did not respond. With our promotional plan being the same year-on-year, that is no response. I cannot explain why they wanted to run that promotion.

Simon Irwin

We will find out next week.

Paul Smiddy, HSBC

In terms of Homebase stock levels, did all of the overwintered stock come out of the DC, go into stores and go back again, or is it fresh product that has gone back for this winter?

Richard Ashton

It is virtually all fresh product, with one exception – air-conditioning – whereby the level that we had overwintered last year we did not even sell this year given the lack of requirement for air-conditioning. We bought no air-conditioning this year on a stock-buy basis, so we did not add anything to it, but we did not sell out, which means that we have a few million pounds of stock that will be overwintered for a second year.

Terry Duddy

We have not cut their prices either because it is not worth it. We need a few hot weekends, weekend on weekend. A couple of million pounds is not much to sell.

Paul Smiddy

Are there no write-downs behind that stock value of £30m-£35m? Is that the original bought-in cost?

Richard Ashton

Correct.

Paul Smiddy

What is the aftermath of the DC workers' strike at Argos in terms of wage settlements or any other ramifications?

Terry Duddy

We settled at 4.1%, which was within an already uncomfortable range but not substantially more than our original offer which was clearly below their cost of living, as they saw it and as was reported. The impact is that we have made a lot of preparations to prevent the impact on stores, although we were never quite sure what it might be. I would say that we probably saw an impact on our serviceability but I could not put a number on it.

What was the second part of your question?

Paul Smiddy

That was it – I just wondered whether there were any long-term effects from it or any short-term costs.

Terry Duddy

There will have been a short-term impact on sales but I would not point to that as being something that I could identify within this negative like-for-like sales performance.

John Stevenson, Shore Capital

In terms of currency, what was the rate for the Spring/Summer 2008 catalogue and what it is likely to be, given that you have already bought 50% of currently? Following on from that, are you minded to push all the currency movements through into pricing as we move into next year and into autumn/winter, and how do you think the Argos customer would react to that?

Richard Ashton

We quoted the numbers earlier but we bought the first and second halves this year at about $2. Last year, the first half was about $1.90 and the second half was about $2. That is what we meant by a backwind in the first half and neutrality in the second half, given that it is relatively flat. I will not go into detail on what we are buying at currently, but that rate is becoming significantly lower, given the current level of the markets.

While we buy forward, we did accelerate it a little about two or three months ago. When we quoted earlier on the call that we were about 50% bought, that would be a higher level of buy than we would normally have at this stage of our buying cycle, partly based on an instinct that said, at $2 plus, it seemed sensible that we should be fulfilling our requirements a little earlier given the likely downwards forecasts that we had seen in the marketplace.

It still means that we are heading to a position where we will be significantly less than $2 for the first half next year. What that will be I cannot quantify at the moment – it depends on where we go over the next three or four months – but it will almost certainly be less than $2 by a significant number of cents.

John Stevenson

Are you minded that that is going to be pushed through into pricing? Do you think that your consumer would take that just as straight inflation?

Richard Ashton

It is again, too early to say. It is something that you have to take in the round when you come to do the pricing of the catalogue. As we all say, it is a combination of what the COGS inflation or deflation is and what is happening with shipping costs, with FX and with the competitive environment.

Terry Duddy

The key point is that this is going to happen to everyone who is buying on that basis, so what does it do to competitive pricing? We will see where others go who maybe have to price a little earlier against that decline in the dollar than we have to.

John Stevenson

In terms of cost control and holding the first half expectations on that basis, do you think that there is sufficient scope to widen the initiatives that you have coming into the second half to protect the bottom line further given where we are in terms of the exit rate and the like-for-like sales performance?

Richard Ashton

We have done another robust job in the first half. You have to remember that we talked about five points of cost productivity in Argos in the second half and we earlier talked about the efficiencies that already came to us as opposed to efficiencies that we achieved over the Christmas trading peak, which we said, with hindsight, were not ideal cost savings given what happened to the customer experience. It will be quite difficult in the second half to reach another robust level similar to that that we saw in the first half, but we always say that and we always do our best to try to get there.

Terry Duddy

In terms of the run-rate coming out, as we go into this next quarter, we may see a difficult September-November, but historically we have not seen December being that negative over a four-to-five year period – by negative, I mean minus 1% - minus 2%. It all depends on December, not on Christmas. Traditionally, what has happened – and we hope that it happens again – is that people come out and shop during December. If it is the case that December is double in one month what the other months are, it is hard to see a similar run-rate continuing.

Peter Brockwell, ING

In terms of the Homebase like-for-like sales numbers in the second quarter, you are saying that, on comparable trading weeks, you matched or even beat B&Q.

Terry Duddy

It is very slight but enough for me to feel better.

Peter Brockwell

Arithmetically, assuming that B&Q achieved flat like-for-like sales for the six weeks to mid July, are you really saying that August like-for-like sales were down by around 15%?

Terry Duddy

They reported on May, June and half of July.

Peter Brockwell

That was plus 0.2%.

Richard Ashton

The second half of July and August were the weaker six weeks, so our quarter is split into two distinct periods. The number that you quote, without getting into exact numbers, is not far away from where it is. We are not getting into the weather impact in the statement, but again it is driven by the weather scenario. Last year the weather was poor in the first half of the quarter, so we have done well against it this year. This year it was very poor in the second half of the quarter, so the seasonals start to underperform in the second half of the quarter etc.

Peter Brockwell

However if you look at first quarter going into second quarter, first quarter your seasonal merchandise sales were down 20% like-for-like. Are you saying there was no bounce-back in seasonal quarter one into quarter two, bearing in mind you had a minus 8.0% like-for-like soft comparison for quarter two year-on-year?

Richard Ashton

We said that the seasonals in this quarter performed roughly in line with the company average. They performed better than the company average in the first half of the quarter and worse than it in the second half of the quarter, versus minus 20% in Q1. There was a quiet bounce-back in seasonals but they are still negative.

David Jeary, Investec

In terms of Argos' gross margin, given what you did in the second quarter versus the first quarter, is there any change to broader market expectations of about a 50 basis points decline over the year?

Second, on TV pricing, given the advertising contretemps between you and a certain other retailer, what impact might that have had on sales and gross margin?

Finally, could you comment on whether there have been any changes in run-rates on debt and repayments within Financial Services?

Richard Ashton

There is no real change in the gross margin guidance. Clearly, in the first quarter we were down more than we expected. The trade-off was the like-for-like sales and the lower margin consumer electronics growth that we saw. In the second quarter, gross margin has come back to a level closer to where we thought it would be off a lower level of consumer electronics. At this stage, there is no change to that guidance, but clearly Christmas is still to come and all the comments that we have made about the competitive environment stand good.

Terry Duddy

On the TV issue, there was hardly any gross margin impact. Clearly, branded TVs, where the action has been taking place, is not as big as it is for us as it is for that large market competitor. Therefore, a rebasing of prices, which has tended to happen, has not hit us as hard. All I can do is go back to the performance on consumer electronics that I mentioned earlier, where we achieved positive growth.

Richard Ashton

In terms of Financial Services, at the year-end we said that both delinquency and bad debt costs were very slightly down on the run-rates of the prior year. Where we are now, six months later, we have seen a marginal increase in delinquency and bad debt. We are now very slightly above where we were about a year ago. To put that into context, what I mean by the bad debt cost being slightly up equates to about £1m ahead in the first half, which is not very much but it is a slight increase over where we were before.

Rod Whitehead, Deutsche Bank

On Homebase, given the write-down and the poor performance of the business, what are your thoughts on the opening programme for the next couple of years? Equally, for Argos, given the continuing growth of the internet, are you are going to be trimming back your store openings?

Second, if like-for-like sales stay at these depressed levels, are there implications for year-end volume rebates at either Homebase or Argos?

Terry Duddy

What we said is that we would open up to 10 new Homebase stores, but only if we had good viabilities and if they get over our internal hurdle rate. Given our outlook, the number of stores that we will open will come down. There are some in the pipeline that we are committed to but overall, we will not be anywhere near the 10 number that we have been talking about. That is a natural depletion as we look at stores that have good viability.

It does not mean that we will not look at opening new stores, because we do not want to miss great opportunities, which still exist. There will be a natural rundown in the potential opening of good stores. Even though a lot of good bulky space is becoming available in the marketplace, for obvious reasons, that will take place and the pipeline will start to reduce.

Rod Whitehead

Is that a net number for 2009-10?

Terry Duddy

I do not know what the number will be, but it will not be 10.

Richard Ashton

It applies to 2008-09 too. Terry's point stands equally well for this year and next year.

Terry Duddy

The internet issue changes nothing for Argos. When we open new Argos stores our internet and home delivery participation grows. Our opening programme in Argos will be the same, but it has the same caveat, with a requirement to see good viabilities. To date we have always seen those in Argos. We have seen a circumstance where they are providing very good returns, well above our hurdle rate. The chances are that the number that we are looking at will remain 30, but the same issues stand. If we think that the stores are not viable, we will not be opening them, which has always been the case, but it is not related to internet participation.

Richard Ashton

Over time, rebates are becoming less material for the Group because, as we said six months ago, as we move to Direct Import/Direct Sourcing (DI/DS), we do that on a non-volume rebate basis. Volume rebates are then, more from the domestic suppliers than the import suppliers. On the import basis, it is clearly all in a one-off price, so they are becoming less material for us. In terms of where we are during the first half, the rebate level is relatively flat versus where it was this time last year, so we are not seeing much change on the rebates.

Terry Duddy

Suppliers also have to be realistic. I am not saying that they will change this year but they will need to think about what the rebate levels ought to be for next year versus the volumes that are going to be in the marketplace. They normally reward you for a higher level of sales, but those levels of sales are going to have to come down.

John Baillie, SG Securities

On cash generation, are we expecting the capex figure to be lower than earlier indications?

Richard Ashton

Following on from what Terry just said, we could expect it to be slightly down versus where we previously thought it would be. It is difficult to be specific at this stage for the current year but I do not see it being ahead of where we had guided to, rather, I see it being slightly down. It is not a material reduction, but slightly down from where we have been in the last few years.

John Baillie

In terms of working capital, apart from the rollover of the Homebase furniture, should we expect a favourable move in working capital this year, given the slowdown in the business?

Richard Ashton

It is more things like barbecues, air-conditioning rather than furniture. There is some outdoor garden furniture in the overwintering stock. In terms of working capital, I expect outflows to continue. We have had outflows over the last year on working capital and from memory they have been in the region of £50m and we spoke about that being a similar level as a normalised run-rate going forward.

Given the push that we are making into DI/DS, that is a working capital-intensive exercise. We hold the stock for longer and we have to pay it slightly differently. Sometimes it is cash on factory gates, so you do not achieve the working capital terms that you would normally achieve with domestic. It is one of the costs of DI/DS that is traded off against the improved margin.

Andrew Hughes, UBS

On the Homebase goodwill write-down which you are saying is going to be several hundred million pounds, is that both a reduction in the expected cash flows and a change in the discount rate, or is it just more the cash flow outlook?

Richard Ashton

It is a bit of everything. It has to be based on your current view of assumptions, and your view of your cost of capital at the moment has probably gone up somewhat. The risk premium on equities, the beta factor in retailers and the cost of debt are all slightly higher, which have an impact. In terms of where the majority of the issue comes from, it comes from our view of the medium-term profitability of the business changing going forward. That is the bigger element of it.

Andrew Hughes

Is there anything stage left which might see an impact from having lower shareholders funds as a result of this? Obviously, you have no debt.

Richard Ashton

We have no debt or balance sheet covenants at the moment. We have a pricing metric at the moment whereby, if we were to ever draw down on our unused banking facility of £700m, it would be priced at an EBITDA/fixed charge cover ratio. It will have no impact on us at all and given that it is a non-cash item, it has no impact on the cash balances either.

Andrew Hughes

Finally, in terms of John Lewis moving to free delivery on their e-commerce orders, has there been any impact from that?

Terry Duddy

We have seen no impact from it so far. I have to say that the idea of free delivery, given the rising costs of fuel, was not something that I had high on my list of promotional activity. We normally do something nearer Christmas in terms of free delivery on internet orders, so we will go back and have another look.

Closing Remarks

Richard Ashton

Thank you all for participating and we look forward to speaking to you at the half-year results on 22 October.