J Sainsbury plc
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Interim Results Transcript

David Tyler
Chairman
Good morning everybody, good morning, welcome to this Presentation on Sainsbury's Interim Results for the 28 weeks to the 22nd September. Now everybody knows that we are operating in an intensely competitive environment in retail. And this fact has been underlined this year by the unceasing flow that we have had of retail insolvencies and CVAs. Indeed hardly a week seems to go by without another one emerging.

At Sainsbury's we've recognised for some years that there is an urgency to make fundamental changes to our business to get out ahead of the expected competitive challenges, above all those from the discount sector and from the digital environment.

As a result, you will see further progress in our announcement today in a number of important areas where we have made significant moves. You will see progress delivered by Argos which we acquired as you know in 2016. You will see progress at Nectar which we acquired in 2017. And of course, right now we are progressing our planned merger with Asda and we are in close contact at present with the CMA as part of its investigation.

All of these initiatives and many others will underpin our ability to improve service and value for our service for our consumers in the years ahead and will therefore allow us to earn decent and good returns for our shareholders. I believe that the first half of this financial year indeed is indicative of that. You will see that underlying profit and underlying earnings are up and that our balance sheet has been further strengthened.

And so I would just like to record my thanks and that of the Board, to Mike and our very committed and capable Management Team. In a really challenging market they are successfully delivering an unprecedented amount of change in our business and I believe they have positioned Sainsbury's today very well strategically and that they, the Management Team, have the clear capability to execute our ambitions and our plans highly effectively.

So that is enough from me. Before we turn to Mike, Kevin is going to take us through the financials. Kevin.

Kevin O'Byrne
Chief Financial Officer
Thank you, David. Welcome everyone. In the period, the 28 weeks to 22nd September we delivered underlying profits of £302 million up £51 million year-on-year. The profit growth was predominantly driven by synergies with a solid food performance and reduced interest costs. General merchandise margins were down largely reflecting a change in our mix and our cost saving plans are well on track.

Bank profits were down in line with the guidance we have given for the full year and we generated good underlying free cash flow although this benefited from some phasing that will unwind in the second half. We incurred one off costs of £170 million in the period. Key items included costs to restructure our store teams, new bank systems and the Asda transaction. While the market backdrop is tough for food, general merchandise and clothing

and the key trading periods are still ahead of us. We are on track to deliver current market consensus.

Sales in the half were up 3.5 per cent or 1.2 per cent excluding the impact of fuel sales. Retail operating profit was up £63 million or 23 per cent, this included £58 million EBIT of synergies. Interest costs were down £9 million year-on-year reflecting the redemption of the Eddystone secured financing issued in 2006. You will recall that we repaid £568 million in April 2018. And underlying profit before tax was up 20 per cent while profit after tax was down 13 per cent with the impact of the one off items of £170 million offset by a tax credit in the period.

Like-for-like sales grew 0.6 per cent in total, ex-fuel sales grew 1.2 per cent. We had a modest pickup in the contribution from new space with reduced new space contribution from the grocery business, more than offset by a net increase in the number of Argos stores in store and the annualisation of the majority of Argos and Homebase closures. Grocery sales grew 1.2 per cent with a stronger performance in the second quarter when sales grew by 2 per cent.

General merchandise sales grew 1.5 per cent driven particularly by the growth in the electricals category and sales in clothing declined 1 per cent impacted by a change in timing of promotions in the Half.

Convenience and online grocery channels continue to grow strongly up over 4 per cent and almost 7 per cent respectively with weaker underlying sales from our supermarkets in part reflecting the repurposing of space to Argos stores and concessions and the resulting reduction in general merchandise sales.

In the Half, we delivered £58 million of EBIT synergies, this equates to £63 million of EBITDA synergies to take the cumulative total to £150 million. And since the end of the Half, we have now achieved the targeted £160 million of EBITDA synergies about nine months ahead of the original schedule that we shared with you. Key drivers have been the faster rollout of Argos stores in stores in Sainsbury's and very good progress and goods not for resale savings.

We continue to see some upside in synergies as we benefit from the joint commercial model in particular. But as we have previously said, we don't plan to make any further separate disclosures of these as any ongoing savings will be treated as business as usual. And as time passes it will become difficult to distinguish between synergies and other savings.

We achieved an important milestone with the Bank in the first half, successfully completing the transfer of 1.1 million credit card customers to our new platform. In the half, Bank income was broadly flat year-on-year and total profits down around 50 per cent in line with the guidance we gave in May. Higher interest income from mortgage and credit card balances was offset by higher costs driven by depreciation on the new bank platforms being brought into use. Higher bad debt charge predominantly driven by the first-time impact of IFRS 9 and higher interest costs mostly due to the costs of Tier II capital issued in November 2017. We saw good growth in customer numbers for both the bank and Argos financial services and our NIM reduced to 4 per cent impacted by the growth of the lower interest secure mortgage book and continued market pressure on unsecured lending margins.

The underlying bad debt as a per cent of lending was flat but the year-on-year increase largely as a result of implementing IFRS 9 the arrears performance in the book is stable. IFRS 9 as we have previously discussed is the new accounting standard which changes how the industry accounts for potential bad debt impairments and there is further detail on page 47 of the accounts.

As I said, we incurred material one-off costs in this period. £65 million related to bank transition and Argos integration both were part of previously announced programmes. £14 million related to losses on disposal of property assets. Restructuring costs are additional costs relating to the previously announced material changes to our store colleague structures and Mike will talk more about this in a few minutes. And finally we incurred £17 million of costs relating to the Asda transaction.

We guided in May to operating cost inflation of around 3 per cent this year with colleague wage increases being the main driver of this. Against this pressure we continue to make very good progress with our cost saving targets. The biggest driver in the first half has been changes to our store operating costs. We continue to drive a lot of efficiency savings through technology investments. Examples include significant improvements in online picking productivity, more efficient voice picking in depots and the use of new technology to reduce instore refrigeration costs.

We continue to be disciplined in how we allocate and invest our capital and we are seeing our returns improve. We look at our capital in three key categories. Maintenance capital, capital we spend on repairing and upgrading our existing stores and IT systems. Growth capital, capital we spend on new growth initiatives and efficiency capital, capital we spend to deliver our cost saving programmes. The latter two categories as you would expect, have higher paybacks. In our Half, our retail capex was down around 10 per cent year-on-year.

As you know, free cash flow is a key measure for Group Management. As usual we have a favourable working capital position in the first half which is due to the timing of supplier payment runs. We delivered strong free cash flow during the period although this was flattered by some phasing such as the timing of the Bank capital injections of £110 million which will be made in the second half.

Net debt has improved by £530 million from the year end to £834 million. The reduction was principally due to the strong free cash flow of £619 million as well as favourable £107 million movement on the fair value of foreign exchange hedging, a £250 million swing year-on-year. For the full year we continue to expect net debt before any benefit of these fair value movements to reduce by around £100 million versus March 2018 as the improvement in the first half partially unwinds due to the normal seasonality associated with supplier payment runs and the phasing of the Bank capital injections.

Our key leverage metric is lease adjusted net debt to underlying EBITDAR and our medium term target is three times. For this we include hybrid securities which total around £495 million. In the period this metric reduced to 3.2 times as noted this is flattered by some phasing. The IAS 19 Pension Scheme calculation has moved into surplus at the end of the half, reflecting the impact of higher corporate bond yields on the discount rate.

Overall the Group delivered a good performance in a challenging market. A solid performance in food impact and impact from general merchandise margin mix and a material contribution from additional synergies delivered well ahead of schedule. Underlying free cash flow generation remains strong.

In terms of outlook, though the market backdrop is tough in food, general merchandise and clothing and the key trading periods are still ahead of us, we are on track to deliver the current market consensus.

I would now like to hand you over to Mike.

Mike Coupe
Group Chief Executive
Thank you, Kevin. So just to pick up, I'm sure front and centre of part of your questions today will be the CMA process. This lays out the timetable which the CMA themselves have published on their website. But it is also important just at this point to perhaps reiterate the underlying case that we are putting to the CMA.

The first point to make and it is self-evidently the case, our market is changing and changing very rapidly. And the competitive forces aren't abating, and they are driven by a couple of things. Firstly, the rise of discounters and secondly the change in shopping habits driven by online and digital. So as a customer you have more choice than you have ever had.

If you think about what the CMA are there to do, they are there to protect customers and in the end their test is whether or not there is any harm done to customers. And we are making a very strong case as to why we believe that not only will no harm be done, we will actually improve prices and our overall proposition for our customers through the generation of significant synergies that can only be delivered by bringing the two organisations together.

We are now engaged in that process with the CMA. As you imagine that involves a lot of detailed discussions, a lot of evidence, and a lot of data and of course the CMA are an evidence-based organisation and a world-renowned evidence-based organisation. So they will look at the facts and produce the preliminary findings towards the back end of January in line with the timetable that is outlined here today. I won't be able to go much further than that despite whatever questions you ask me during the course of today. I am sure you will ask a lot, but that hopefully gives you a flavour for where we are and indeed the direction of travel as we look forward and indeed the basis on which we are making the case.

And of course, it is against that backdrop that we talk strategically about our plans now, four years ago and those market dynamics haven't changed and if anything the changes in the market are accelerating and not decelerating and you can see that writ large in some of the competitive dynamics in the market more widely which David has already referred to. We laid out our strategy four years ago, we are getting on and executing that and there are four main headlines. The first is to make sure we are differentiating our food offer and I will talk about that in some detail, grow our general merchandise and clothing business. We still believe there are significant market opportunities in a relatively unconsolidated market and adapt our business to our changing customer habits. To grow our Bank, and again we will talk about that as we go through this Presentation. But also to make sure that we deliver cost savings that enable us to invest in our underlying customer proposition and maintain and improve the strength of our balance sheet which again hopefully during the course of today you will see we have managed to achieve.

Front and centre of the changes in our business in the last period of time as been the change to our management structures. This has been probably one of the single biggest people changes this organisation has ever made in its history. We have been through a consultation process with 136,000 colleagues both management and retail colleagues and we have simplified our structure. So the overall points of principle around making our business simpler to operate, streamlining our management structure, but also reinvesting labour hours into the front line colleagues and to be able to pay our colleagues better and introducing a headline rate of pay of £9.20 an hour, whilst also simplifying our colleague contracts.

So not an insignificant undertaking. We will be the first to recognise that that has an impact on our business and perhaps the biggest impact happened during the sunniest part of the summer and then inevitably that would have had a consequence in terms of our online operations. But we are in good shape now. The changes took place finally on 23rd

September so our colleagues will have enjoyed their pay cheque at the new improved rate of pay, an average increase of 9 per cent, over 30 per cent over 4 years, on September 23rd and we are getting on and running our business in the run up to Christmas. And you can see that in the metrics, so despite some of the commentary you may have seen, actually in the first half, in the 28 weeks that we are reporting, we actually won The Grocer Magazine Service Award 12 times out of those 28 weeks. So still the best in the industry. And our in-store availability as measured by The Grocer Magazine is materially ahead of our next best competitor, some 2 per cent ahead of our next best competitor. So despite all the challenges and changes in our organisation, we continue to maintain store standards which are ahead of the industry. And of course now that we are through those changes we have introduced new service standards in our organisation. We have a programme called 'WOW' service which is front and centre of our colleagues' minds as we go into the run up to Christmas. And we have also introduced an app which allows our customers to feedback in real time through what is known as 'Lettuce Know'. And so literally every store on a day to day, week to week basis understands their performance metrics in terms of their customer service and can act on that literally on as I say on a week to week and day to day basis. So a big step up in our performance there.

In terms of the product changes, again we recognise the need to both be more competitive but also to seek to ways to differentiate our product proposition. And we have talked previously about our product quality framework which allows us to put products in different parts of the spectrum it's basically is a grid which looks at functional performance and emotional attachment to certain products. And at the bottom left hand corner, commodities, things like toilet rolls at the top right-hand corner added value speciality products and things like Freefrom products. And clearly on that spectrum we have the need to make sure that we satisfy our customer's right across that spectrum. We use that as the framework for how we think about products but it is also a changing framework. The nature of our market is very dynamic. It wasn't that long ago that fillet steak was probably in the quality option box. Actually as we look at our competitive set, if we look at what the discounters are doing, a lot of the products that might have been considered as quality or speciality are actually moving into mainstream, everyday items. And as I say fillet steak would be an example of that. So we have to constantly review our business and look at our ranges in that context and that changing and dynamic marketplace.

But as an example of how we use the PQF, we have used the cheese category. First of all we have seen a significant reduction in our cost of goods by looking at our value chains. That has resulted in us being able to lower our prices and therefore seen a consequential volume growth. We have looked at the range hierarchy. One of the successes of this Quarter is the growth of Taste the Difference, we have seen the sales grow by 3 per cent, volumes up 4 per cent. We know if we give our customers the right value options they will tend to trade up. But equally we need to get the rest of the hierarchy right. We have rationalised the ranges so reduction in the SKU count to make it simpler for customers to shop, improved layouts. And we have introduced new products, new concepts, new designs to make sure that customers can see where there are trade-up options and where we can add value, add range and add choice, genuine choice for our customers.

Again we are looking to differentiate our product ranges through what we call distinctive products, some of which are own brands, some of which are owned brands and some of which are working with other branded third parties to introduce new and unique products. So an example of that, big trend in the UK is towards flexitarian eating, I am sure there are plenty of flexitarians in this room. Eating more vegetables, less meat and looking at how we can combine those products together has helped us introduce a range called Love Meat and Veg and there are some examples of the products there.

Again vegetarianism is rising in the UK. Products you see on that side is a Shroomdog, a mushroom based hotdog and again a big trend and opportunity for us to differentiate relative to our competition. And then Naturli which again is a vegan based spread, plant-based burger patty which again adds differentiation and difference in our ranges.

Another example, Little Ones. Again we tended or we do tend to under trade in our baby product, our baby category. We have introduced a new range of Little Ones products which now accounts for 26 per cent of the categories volume. So again a great introduction and again a driving differentiation and difference. Something that you can't buy in our competitors.

Hyde & Wilde is an example of an Owned Brand, a product that we brought to the market in the craft beer sector. Again that is a growing part of the market and now it is our second fastest selling craft beer brand. So again an example of where we bring in differentiation to our offer.

Quinoa, we are partnering with the only Quinoa farmer in the UK. Again a unique opportunity, something around the peripheral of our overall offer, but nevertheless something that makes a difference in terms of offering differentiation and choice.

And the last example is actually a brand we brought to the market with Ribena, the manufacturer, which again is an exclusive brand to Sainsbury's in the spirit mixer category. So again working with suppliers across the spectrum, not just own label, own brand, but also looking at how we can get exclusive brands into our business.

It was not that long ago this industry used to or you used to obsess about trading intensity, it has kind of dropped off the agenda. But one of the things that we would like to highlight is how we are repurposing our space and making our space productivity higher. And that is perhaps one of the untold stories in our overall strategy. So we talked four years ago about the need to repurpose about 1.5 million square feet of our space and we have repurposed around 700,000 square feet of that space. And typically that means putting new offers in like so Sushi Gourmet as an example. Or perhaps more significantly transferring Argos stores into Sainsbury's stores. And as a result of that, of you take a typical store, maybe 5,000 square feet of space goes to Argos, a slight reduction in food space and then a re-balancing of space between our clothing and general merchandise where we tend to put more clothing in which is more profitable and take out the obvious big ticket items like electrical which are better served by the Argos business model.

But if you look at net across our business, it actually means on a like-for-like basis, we have improved our sales density by 2 per cent across the entire business. If you look more specifically at the stores where we have done that. So if you take Argos as an example, we have put roughly 250 Argos stores in Sainsbury's stores, the increase in sales intensity has actually gone up even further. And indeed if you look at the overall metrics, very significant increases in the sales intensity of general merchandise for obvious reasons, but also an increase in the sales intensity of food. And that is missing another part of the equation which is as a consequence of moving Argos stores into Sainsbury's stores, we have also reduced significantly the amount of square footage in Argos. So again that has an improvement or has an overall consequential impact in the trading intensity in our business. And one of the reasons why the headline synergy number is being delivered is because of that trading intensity effect where we are taking costs out of part of our business, investing in our core real estate, improving our sales intensity in our core real estate and that is a formula we can continue to drive as we look forward as shopping habits change and as there is a significant move towards online.

And that is another reason why we are looking at other opportunities. Beauty would be an example of that. So we have a trial now in seven stores of looking at Beauty as a category and whether or not we can do a bigger and better job of serving customer missions. It is a growing category, it is a profitable category and it is also a category where we think there is a competitive opportunity for us as we look forward. And again it is an example, if we can get it right, of where we can use our space differently to accommodate the changing nature of the way that people are shopping.

If we look at our channels, we continue to drive sales in the channel part of our business so starting with our convenience business. We think we run the best convenience stores in the market. We would say that wouldn't we? But that is evidenced by the fact we have the highest sales densities in the industry. That business has grown by 25 per cent over the last three years, again reflecting changing shopping habits, but also reflecting the fact that we continue to invest selectively in quality real estate in that market. The underlying like-for-likes have also moved forward. As I said already, we have market leading sales densities, but we are also all the time looking at how we refine our ranges within those stores and the chart on the right is demonstrating how we are moving away from having the same range everywhere which is basically the grey bar to having more difference between the stores and therefore more range differences and much more local ranging on a site by site basis. So you can see how much that has changed over the last couple of years as we get better and better at fine tuning the ranges on a local basis on a store by store basis. So to illustrate it. If you take the store just across the way from here, the range would be markedly different to say a store on a housing estate in Hull, and that wouldn't necessarily have been the case a few years ago.

We also maintain a strong position, price position in our Convenience business particularly relatively to the two mainstream competitors, Tesco and the Co-op.

I want to talk about Digital more widely, although we have had a very successful period in our groceries online business, growth of 7 per cent, we have appointed Clodagh Moriarty to the Board to bring together all of our digital properties as we think increasingly as our digital offer as a channel in and of itself. And as we look forward we are starting to bring together our digital properties to show up in my words, in our digital real estate to our customers on a common platform. That is challenging across an organisation like ours we have lots of legacy systems, but nevertheless we are making strong investments in this area both in terms of the underlying operation of our business. So we have seen an improvement in pick rates as a result of our online picking systems. We have introduced same day deliveries now across almost 60 per cent of the UK. But also using SmartShop as an example in our stores and being able to join that together with our grocery online business so that customers only have to sign on once wherever they are in the Sainsbury's real estate, not just in Sainsbury's but also within the Bank and also ultimately within the Argos business as well. So it is a very important part of our programme as we look forward to adapt to the changing market and think more holistically about how we bring our digital properties together and how we show up to our customers in that world in a single minded way a more joined up way.

We also acquired Nectar, I think, in February of this year, not February of last year, it feels like a long time ago, but it was only about 6-7 months ago. It is the UK's largest loyalty scheme. It is based on affiliate members as well. We have been in a privileged position where we have signed up, we have resigned four of our major partners. We have signed up three new partners and as we look forward we want to broaden the coalition to mean that customers can both earn and burn their Nectar points across a wider range of product areas and categories.

And we have already 1.2 million users of the Nectar app and again we are undertaking a significant trial looking at how we digitise the Nectar proposition as we look forward. And so

trials have been taking place on the Isle of Wight and in South Wales and again we are pleased with the results of that. And as we look forward we think there is a significant opportunity to join together the Nectar proposition as part of our overall digital real estate.

And of course Argos is a central part of us as well. And again we have invested a lot in improving the Argos shopping journey, making sure it is easier to checkout. Introducing things like Virtual Reality. So you can see how the television might look in your living room. And we are starting to trial things like voice ordering through Google Assistant. So again looking at how we can adapt technology, but also joint together our digital real estate as we look forward.

Talking specifically about the non-food categories. So starting with General Merchandise. A pretty good performance against a very challenging market backdrop. So we saw sales grow by 1.5 per cent, ahead of the market. Again looking at how customers are changing their shopping habits, the Argos proposition is unique in its ability to deliver products to customers quickly. And we are seeing that in the growth of fast track delivery and fast track click and collect sales up 18 and 21 per cent.

We have seen a strong performance in Argos driven by electricals not least in part because of the timing of the World Cup this year and that has had an effect on the margin mix which we believe will carry through into the second half. And of course the summer weather has a benefit in the sense you sell a lot of fans and barbecues, but then you don't sell many lawn mowers so there is a trade off in one way or another in terms of the mix effect as a result of sunny weather.

What is pleasing is if you look at the Argos stores in stores, the stores of which there are ten that have been open for more than three years have actually grown about 45 per cent, or have grown by 45 per cent over the three year period they have been opened. Stores that have been opened for more than two years by 35 per cent and stores that have been opened for more than a year by 10 per cent. And Argos stores in stores in Sainsbury's stores account for roughly 15 per cent of our overall turnover in Argos. And so you can see that over time that will have a compounding effect because the main bulk of the conversion programme was in the last year or so. So it gives us some comfort that we should see some future growth out of the Argos proposition as we look forward.

Again this chart illustrates the changing shape of the retail real estate as a result of the acquisition of Argos and putting stores in stores. So we actually now operate 122 less stores and if you, let's say roughly 12,000 square foot of store, that means there is roughly a million and a half square feet of real estate that has come out of the market as a result of moving those stores into existing Sainsbury's stores. We have opened now 200 or at the end of the half at least, 251 Argos stores in Sainsbury's, roughly half as a result of relocations, roughly half in spaces where Argos already didn't exist.

We talked before about the fact we have gone through a significant closure period within the Homebase business so around 85 less Argos's in Homebase which means although we have more stores there has been quite a significant shift over the last couple of years in the shape of the real estate since our acquisition.

So we have a total presence including click and collect points now of 1,100 points of presence. So as well as stores in stores and having physical real estate, we are also rolling out collection points within the remaining parts of the Sainsbury's real estate. Against the objective of being there for our customers whenever and wherever they want and we believe that is a very powerful proposition as we look forward.

We haven't mentioned Habitat much but again there has been a lot of reshaping of the Habitat business, again closures in the Homebase real estate and we have opened a number of new stores, some in Sainsbury's stores, but actually also in the last period of time a couple of standalone stores one of which is in the Westfield Centre in Shepherds Bush and one of which is in the centre of Brighton. So we just putting our toe in the water as to how we might develop that business into the future.

On the right-hand side of the chart it is self-evidently the case that customers are becoming more digitally savvy, they increasingly use their mobile phones to order products from us. It is little short of remarkable that you can sit in this room, download the Argos app and order something and have it delivered within 4 hours to a convenient location for you. Whether that is a store, your office or indeed you're home or indeed somewhere else. And you can see that in the shape of our business. With now 60 per cent of our transactions enabled through some form of digital interaction with our business.

Not only are we improving the way we show up to our customers in our stores, the way that we interact digitally, we are also seeing improvements in our net promoter scores as a result of a lot of operational changes within the Argos business. So our online availability, our availability is up 5 per cent year on year. We have reduced our out of stocks by 2 per cent. We have more digital stores so we are changing the shape of the existing real estate as well. And we have also introduced pay @ browse so you no longer in many stores have to go to a check out to pay you can actually do that as you are buying your item in real time.

Clothing has been a bit more challenging. It is fair to say over the summer I think that is broadly reflected in the market more holistically. There aren't many clothing retailers at the moment punching the air. But it is also as a result of us changing the phasing of some of our promotions. But nevertheless we have seen growth in menswear and we continue to have a lot of faith in our clothing business. It has been a big growth engine for us in the past and we consider that to be the case in the future. And not least because we are now offering clothing online within Argos as well as within Tu online. And again that business is growing like topsy, albeit from a relatively low base. And we are introducing a new petite range coming to our stores in the second half for those of you who may or may not be interested in that. I think that is for ladies in particular rather than men, but anyway.

And last but by no means least, the Bank. We have seen a growth in Argos Financial Services, a growth in penetration with now the Bank use or the Argos Financial Services, a product used now in 19 per cent of transactions and that is to say a 10 per cent growth year on year. The Argos card app, mobile app, is now being used by a million customers and 60 per cent of users have switched to paperless statements so again making that business more efficient. And again showing the changing nature of the way that our customers shop with us. 40 per cent of all payments are now made via the app, again a reflection of that changing customer behaviour.

We are pleased with the mortgage business. Now our balance sheet is over a billion pounds of mortgages. We have seen growth in travel money, again a business where we have got relatively low but nevertheless increasing market share and we have doubled the sales of car and home insurance. And again there is a strong link between the bank and the Nectar scheme. And again as we look forward our challenge is to make it more and more joined up across our digital real estate.

So in summary, we think we have had a solid first half. We continue to look to differentiate our grocery business whilst making sure that we remain competitive and therefore reducing our costs is an imperative part of our programme as well. We have outperformed in general merchandise from a market growth point of view albeit that is partly driven by tech growth and therefore has had an effect on the margin mix. The challenge with promotional phasing

within clothing, we believe it is a strong business with plenty of growth opportunities in future and we have grown the Bank in terms of customer numbers and the profit for the Bank is in line with guidance.

So thank you very much and now we will open up to questions.

Question and Answer Session

General chat before session

I think you were first so, very eager.

I seem to be the only person who put my hand up but I'm sure that's not the case.

If it is anything like the press call where we only had about three questions so if we could stick with one it would be fine

It's not about Brexit so we

Question 1

Andrew Gwynne, Exane
It's Andrew Gwynne from Exane. A couple of questions. So the first is just on the market conditions at the moment. You will see hinted in the outlook statement, and David covered it a little bit in his introduction, but just elaborate a little bit on what you are seeing in the grocery segment and also the general merchandise segment?

And the second one is an optimistic question. But how confident are you that you will get the yes from the CMA given what you have got to so far?

Answer: Mike Coupe
Shall I answer the first one, sorry the second one first and say I have said all I am going to say on the CMA which is what I said upfront. I mean I don't think there is anything. Just to give you a bit of colour, there is nothing that has happened that would be a surprise. They will do a wide-ranging investigation that is what you would expect them to do. They will look at it in a detailed way. In the end they are an evidence-based organisation and we have provided them with lots and lots of evidence and we would stick with the central thesis of the case which is by bringing the organisations together we can uniquely deliver synergies which will be passed back to customers in the form of lower prices. And if their test which it is, do no harm, as far as customers are concerned we think there is a compelling case for why not only would we do no harm, we'll actually benefit customers with lower prices, better service and better range, better quality. So on that part, I think we have made the case, but we can go no further than that. We are in the detailed part of the investigations and we will have to see what happens in January when they produce the preliminary findings.

As far as the market is concerned, I think we have to be sensible in terms of just recognising the fact we are almost in unprecedented times. Consumer backdrop, political uncertainty etc. So whilst we have confidence in, our, the choices we are making, in our business we have to colour that with the background of just really moving into our busiest trading period in a period of unprecedented uncertainty. And inevitably if there is uncertainty that has the potential to knock onto the way that customers are thinking and feeling. Not necessarily evidenced at the moment but as we run into Christmas and get nearer to the end of March, who knows what may happen and I think we just have to counsel caution at this point which is why we are comfortable with consensus but we certainly would not go any further than that at this stage.

Andrew Gwynne
Okay, that's clear thanks.

<u>Question 2</u>

Rob Joyce, Goldman Sachs
Thanks, Rob Joyce from Goldman Sachs. Three from me. First one I guess just to slightly elaborate on your answer there Mike. Is there anything specific in the second half that means given the strong results in the first half, given the additional benefits to come from Argos that you didn't want to push the guidance up versus consensus?

Second one, just I wonder if you could comment on, I think M&S noted yesterday a bit of a change in shopping behaviour. They said they were seeing a move away from that frequent little and often kind of shopping. Not sure if that is something you are seeing in your business?

And thirdly, a couple of specific ones. Just in terms of the Asda exceptionals you pulled out there in the first half. Can you say what Asda costs are embedded in the underlying number from last year as I think you had to absorb them last year?

And then secondly just on that, another one, anything you can say on the EBIT benefit from fully consolidating Nectar in the half? Thanks very much.

Mike Coupe
Okay, Kevin can take the last two.

Answer: Kevin O'Byrne
Just on Nectar, there is some benefit from Nectar but clearly the strategic rationale for buying Nectar was to get the database that Mike talked about to operate Nectar right across all our brands, the Bank, Argos and Sainsbury's and create a sort of unique currency for customers of Sainsbury's. The way we are running Nectar is very different to the way Aimia ran Nectar and you will probably understand the key assumption in any contribution from Nectar is the assumption of how many points customers actually use or don't use. We have taken a more prudent view on the points assumption than Aimia would have taken and hence the confusion isn't as much as you might think, but there has been some contribution as you can imagine from Nectar in the numbers we are not breaking it out.

On the Asda cost. There was Asda costs last year, they weren't material because as you can imagine they are backend loaded and the heavy lifting that you are seeing now, there is a lot of lawyers, work accountancy, getting ready for prospectus, there is economists etc. So there is a lot of heavy lifting going on now. So there were some costs last year again we haven't broken them out, but not as material as you are seeing in the first half of this year.

Further answer: Mike Coupe
And I am not sure I can give a lot more colour than I have already given. We are about to enter our 8 busiest trading weeks of the year so to call anything this early in the year is always dangerous. We always have this conversation at this time of year. You just don't know what you don't know. But I think we are in potentially unique times, so I think we have to counsel caution just in looking at the outlook in the balance of the financial year remembering our financial year ends in the early part of March. So we will have to see how that plays out over time. But given we have got our busiest trading period, given we have got a backdrop of uncertainty, that would always colour our thinking in terms of the way that we are looking forward.

Further question
And anything on that shopping behaviours changing?

Further answer: Mike Coupe
Sorry, on shopping bit. No I certainly all evidence we would have and believe me we have got evidence coming out of our ears for obvious reasons would overwhelmingly demonstrate that customers are shopping more frequently, they have more choice and they exercise that choice. So I don't have any basis on which I could make that judgement other than I would be able to demonstrate beyond reasonable doubt that customers are shopping around more than ever and when they shop around they tend to buy less. I don't know if there is something unique to the M&S business that would buck that trend. But whatever data you look at would overwhelmingly support that sort of not just choice but exercising of that choice.

Rob Joyce
Thank you.

<u>Question 3</u>

Greg Lawless, Shore Capital
Hi Greg from Shore Capital. Can you just talk a bit about deflation and inflation? M&S yesterday were talking about deflation in their business. I am just trying to understand underlying volumes given your negative like-for-like in your supermarket estate.

Mike Coupe
I'll let Kevin answer that.

Answer: Kevin O'Byrne
We don't publish a number. We have inflated less than most of our competitors in the half and we have seen one of the most encouraging volume performances that we have for a number of years. Volumes are down slightly but material improvement year on year.

Further question
Down slightly 1 per cent or?

Answer: Kevin O'Byrne
We don't disclose a number, but when I say slightly it would be certainly less than 1 per cent.

Greg
Thanks.

<u>Question 4</u>

Vincent Lee, Bernstein
Hi, it's Vincent Lee from Bernstein here. Two questions from me please. So back in Q1 you said that you made £150 million of price investments. Are you seeing any volume traction in Q2 as a result of those investments?

And on the same points, how much did you invest in prices in Q2? Did you feel the need to invest to compete against Tesco's new ranges?

My second question is, going into Q3 and Christmas trading can you talk maybe a little bit about your expectations for clothing and GM? You touched a bit on it earlier, but maybe you could give a little bit more colour on the kind of margin pressure you are expecting?

Answer: Mike Coupe
Yeah well I think we have probably had a go at answering the first part of the question. It is always difficult to relate exactly which bit drives what, but you would have to make some kind of assumption that the changes we made in our proposition have had a material impact in improving our volumes. We have already talked about the fact that the volume trend has got better albeit is still slightly negative. Again Kevin has talked about price position. If you try and unwrap it we are effectively inflating our business less fast than the market and our competitors. Now you can draw your own conclusions from that but we don't talk specifically about price investment in this statement, but we would always seek to keep ourselves competitive on GM and clothing.

Further answer: Kevin O'Byrne
I think Mike said it already in the outlook. We are cautious in the outlook. If you think of the GM market in particular it looks like it can be very competitive, there are lots of people under pressure there. Our experience in the first half was we outperformed the market. We delivered stronger sales. Our margin pressure largely came from mix, very largely came from mixes. We mixed more into electricals, but we would be, our working assumption would be it is going to be reasonably competitive and there could be some margin pressure going into the second half.

On clothing, probably one point worth making. We talked about the phasing of clothing promotions in the first half were not actually, we were sort of removing some promotions as well so that is not going to go into the second half. So I would not expect any upside in the second half from moving a promotion into the second half. We sort of taken a promotion out of the programme. So underlying, we would see a sort of continued position in the clothing market and I suspect weather will have quite a lot to do with what the actual number turns out to be.

Further answer: Mike Coupe
Maybe just put a little bit of colour on it. Again if you look at the market dynamics David referred to it up front. We are in a period of quite significant restructuring in the retail industry generally and particularly in the clothing and general merchandise industry. And it is inevitable when you have retailers in some form of distress and almost every retailer that we look at and gets reported has some challenge that people will promote in order to drive sales and to sell the stock that they have got. So again one of the reasons why we would counsel a little bit of caution as we run up to Christmas is just the sheer backdrop of what is going on in the sector. You have to say that one way or another that would potentially have an impact on the way that people choose to trade the Christmas trading period. The more desperate you are, the more you tend to mark down and promote businesses in order to sell stock.

Vincent Lee
Thank you.

<u>Question 5</u>

Kiranjot Grewal, Bank of America Merrill Lynch
I have got two questions. Firstly where do you see your price gap versus the discounters at the moment?

And the second one. Could you give us a bit of colour on maybe customer capture and/or range performance in the context of your higher end competitors struggling. Are you seeing any movement from say the M&S's and the Waitrose's down to yourselves? Thank you.

Answer: Mike Coupe
Yeah. I mean again it is sometimes difficult to disaggregate, but assuming we have done a good job of selling Taste the Difference which is probably some read through in terms of our performance relative to our mainstream competitors and it has probably had an impact or has had an impact on our Convenience Business where again by refining ranges, by being more specific in the way we target ranges and that would not in the least be as a result of things like Taste the Difference. You know we are being more competitive not just on price but also on range. But to actually try and unpick it in the overall scheme of running a business like this is always going to be challenging. We don't specifically refer to a price gap versus the discounters other than acknowledging that there is one. And also acknowledging that one of the ways of closing down that price gap and a unique way of closing that price gap is by the Asda potential merger going through where it would create a one-off or rather significant cost benefit, not least in the cost of goods which would be passed back to the customers in the form of lower prices. And that has a huge benefit to customers.

Further question:
I suppose if you don't give the gap, can you tell us the direction of it? Has it shrunk?

Further answer: Mike Coupe
It has definitely come down for sure. And again there is always. It is not just around individual product pricing, it is also about looking at range hierarchies and how we use range hierarchies different and we have introduced some new products, opening price point products which again in and of themselves are more competitive relative to the discounters, not dissimilar to what a number of our competitors have been doing as well. So the absolute pricing gap has come down over the last 3-4 years but also the range structures and hierarchies are leading to lower price points in our organisation.

<u>Question 6</u>

Dusan Milosavljevic, Berenberg
Three questions from me. The first one. Can you provide some statistics to show that the growth that you are generating in your banking business is coming through the mortgages and insurance and the new aspects of your business as opposed to the Argos business and unsecured financing because there has been some concern about that from investors in respect to the current environment in the UK?

And second one is you mentioned in the release that the labour changes you made have impacted your performance over the summer so if you could maybe elaborate on that?

And the third question is just in terms of the commentary you have made on Argos where store in-store is now 15 per cent of Argos total performance. How is the phasing of that grown, you know a lot of them came within the last year?

Answer: Mike Coupe
Well I will ask Kevin to respond on the Bank, maybe if I could take the other two points. On the phasing to be quite honest I would have to break out the exact profile of the store in-store investment. But it is fair to say that in the twelve months from last November to now would be the time we had made the most store in-store investments. So we could probably, I don't think it would be a problem to break out the exact profile of the stores and broadly speaking the number of stores would be a proxy for the level of penetration over that time, it wouldn't be far out.

We have been through a huge amount of people change in the organisation. It is inevitable if you are consulting with 136,000 people and you are doing that three times over a relatively short period of time. You introduce a level of uncertainty for those colleagues. And we would

recognise that and no matter how well you manage that people, generally speaking, don't like change, don't like uncertainty and we respected that and have done our best to make sure we have managed our colleagues through that period of change. It happened. Normally you choose to do these things at quieter times of the year and generally speaking the summer holidays are the quieter times of our year. It happened to coincide with six weeks of the best weather that the UK has seen for a decade and so we saw a very significant uplift in demand, not least in some particular fresh food categories and that undoubtedly at the time we were at sort of peak change, had an impact on our operational performance which I think has been reflected by some people in this room, and certainly reflected in my inbox. And if you take a proxy for our service delivery, the number of emails I get about it, then we are basically back to where we would have been sort of April, May time of this calendar year. So we are confident we have got things back under control. We have reinvested hours back into our front-line colleagues, changed our management structures and that is bedding down. And indeed as I have said already, we also introduced the new colleague rates of pay from September, so getting a 9 per cent pay rise for a lot of our colleagues would be relatively speaking, quite motivational. So all of that is now gone through our business.

Answer: Kevin O'Byrne
On the Bank, we have taken actions that you would expect in the current climate. If you look at the period we are talking about, we reduced our unsecured lending in that period. We actually increased our Argos Financial Services lending because that is actually, it is a very high margin lending as you can imagine when you look at the rates and under a stress test, that is actually a good place and of course it supports our customers to buy products in the business and we have increased in the Bank the majority, all the increases in the mortgage book, net increase. And that is obviously secured lending, 56 per cent loan to value, it is a very good loan book.

<u>Question 7</u>

Nick Coulter, Citi
Thanks, it is Nick Coulter from Citi. Firstly, just to follow up on the Bank. When do you expect to get a return on the capital injection of 110 which I think is going in in the second half? And where do you see the ROCI, or whichever return measure you use on the Bank? Then I have got two more. Thank you.

Answer: Kevin O'Byrne
Well at the moment the return on equity in the Bank is below, you know you can work out yourself. We have put about £750 million of capital into the bank and we are clearly, the maths, you can see we are not getting a return on it. We are very clear on the steps we are taking to get a return. We are focusing on secured lending to remove some volatility and that will help returns. We are focused on Argos Financial Services which is a high returning business. We are focused on our commission business and you have seen some very good growth in travel money in our insurance business and we are being more cautious on our unsecured lending. We clearly have a very high-quality book as evidenced by some of the things we have said before. But we are even being more cautious in the current climate. And we are nailing down costs as we try and scale up. The issue now we have to grow the Bank because we have made a big investment into the infrastructure. Now is not the time to stop that investment, now is the time to invest carefully and all of the capital we are talking about allocating to the Bank to support that growth.

Further question
I guess that Asda will help as well if that comes through. But just in terms of time frame, how long do you think it takes then to cross your whack because it has probably moved to a different direction of what was initially intended…?

Answer: Kevin O'Byrne
We clearly have internal targeting and projections on that, but we are not willing to share them at the moment. And I think some of it will do with the environment will drive some of the timing on that. If we could predict that more carefully. But as you say I think we are making all the right moves right now, we are being very disciplined with our capital as a management team across the business. We are very aware that we need to and want to get a return from the Bank. And I think as we combine our assets with Nectar, with Argos etc, we have all the tools to do that. There are a few years of probably heavy lifting and then Asda will help as well.

Further question
But as you say, £750 million to date, hundreds more to go in and an EBIT that is projected to be £30 million. You can see why?

Answer: Kevin O'Byrne
We are not sitting here satisfied with the Bank right now either in the Bank or in Sainsbury's. So we are all very aware that we need to get a return and we are very pleased with some of the investments and the assets we have, but it is you know we have said I think a number of times, it cost more than we expected and it took longer. Although I would point to the fact that we put 1.1 million customers onto our platform on the credit cards this year. We've had a successful new loan book transfer etc. And you know we have seen, if you look across the market, some of these things. You know if they fail they are even more expensive. We haven't failed. We have got the platform.

Further question
Thank you. Then on the Argos synergies, you have been clear you expect more. Should we think of those are part of the ongoing £500 million pot or are they in addition to that £500 million?

Answer: Kevin O'Byrne
What we have always said publicly is we have committed to the £160 million. We are delighted we achieved well ahead of plan. And we would stop measuring them. There is a very practical thing that having a couple of people spending all their time working out what is a synergy? What is a cost saving? You know we had to do that as part of the transaction. It has to be audited. That is not a very good use of time. Secondly we did say that beyond the £160 million we reserved the right, we would probably invest in the underlying offer. And you can see some real progress in the business, in the Argos business where we have talked about some of the margin pressure etc. So investing in new ranges etc would probably make sense from a shareholder and clearly from a customer point of view.

Answer: Mike Coupe
It is a wonderful business because you tend to think of things in compartments we're managing in the round. You know sometimes you win over here and lose over there and vice versa and all the time you are looking at those trade-offs you are making on a week to week, day to day basis. And it is undoubtedly the case that they are more upsides within Argos, but equally we are in a competitive market where we will need to make other investment choices as we look forward and that is right across the business.

Further question
Absolutely, I am just trying to understand if it is part of the £500 million or in addition to the £500 million for you to then have a choice as to what you do?

Answer: Kevin O'Byrne

The £500 million is a separate tranche of work, we have got very clear programmes on our cost transformation and we continue to work hard at that.

Further question
And lastly just on clothing. Are you moving to a more full price model and away from heavy discounts? And if so what did you see happen to cash gross profit in the Quarter?

Answer: Mike Coupe
We wouldn't break out the cash gross profit separately, but as a direction of travel for our business, not least from a customer point of view we would always look towards a business that has more stable, more consistent pricing and wasn't disingenuous in the way it represents itself to its customers. That is a direction of travel for the business and clearly as part of that we would be looking at how we would adapt our clothing business to that kind of strategy.

Further question
But your cash gross profit was better than your like-for-like or your growth in that category?

Answer: Mike Coupe
Won't comment on cash gross profit.

Nick Coulter
Thank you.

<u>Question 8</u>

Dan Ekstein, UBS
Thank you. Dan Ekstein from UBS. I have got a question on the digital slide and the digital strategy more broadly. You talked about a groceries online strategy and an Argos digital strategy. At the moment they are two quite separate components. Does it always need to be that way? You have got 250 Argos's in Sainsbury's at the moment, mostly your online grocery is picked from store. It is clearly not as easy as it might be on paper, but you know the Holy Grail in terms of unit economics is putting general merchandise onto an online grocery truck. And it feels like if anyone is in a position to do it, it could be you guys. I mean how far are we from seeing that or is it something you don't think is going to be possible?

Answer: Mike Coupe
I think the way you have framed the question, a number of years away from that kind of approach, simply because of the economics. Broadly speaking there is a cut-off point where the economics of the Argos business model work, you know a price point in effect. And below that the groceries online type model works. So there is always that trade-off to be made. But the idea of full scale integration is many, many years away. The way I would think about it is how we start by integrating the front-end piece. So things like single sign-on, making sure that you only have to enter your credit card details, your name and address once across the entire ecosystem. In the summer for the first time if you searched for a fan on groceries online and it wasn't available within the grocery business we took you to the Argos website where you could buy a fan and then brought you back to the Sainsbury's grocery online offer. That kind of search mechanism is again the kind of thing you can see happening relatively quickly because it is largely technology based, not logistically based. So these are the kind of things we are working on and increasingly in the mobile and digital space. And again Nectar points across all of our real estate wherever you are both in terms of earning and burning, that again will come through the business in the next six months or so. So it is a step by step journey, but probably the last thing on that journey would be to think about how you integrate the deliveries from stores to customers, although there are things that we are doing in terms of delivering to stores using our grocery network for Argos

products as an example. So again that is a benefit that sits behind the scenes in the way that we are running the business differently.

Closing Remarks

Mike Coupe
Are we done? Well thank you very much and I will see you all again sometime in May. Thank you.

End