X5 Retail Group N.V.

Q2 and 1H 2014 financial results

Conference call held on 14 August 2014

Edited transcript

Speakers:

- Gregory Madick, Investor Relations Director
- Stephan DuCharme, CEO
- Sergey Piven, CFO

Participants asking questions:

- Maryia Berasneva, Morgan Stanley
- David Ferguson, Renaissance
- Maria Kolbina, VTB
- Alexey Krivoshapko, Prosperity Capital Management
- Natasha Zagvozdina, Verno Capital
- Marat Ibragimov, BCS Capital Group
- Svetlana Sukhanova, UBS
- Nikolay Kovalev, VTB Capital

Operator: Thank you for standing by, and welcome to the X5 Q2 and 1H 2014 financial results conference call. At this time, all participants are in the listen-only mode. There will be a presentation today followed by a Q&A session. At that time, if you would like to ask a question, please, press "*1" on your telephone. I must advise you that this conference is being recorded today, Thursday, 14 August 2014. I would now like to hand the conference over to your first speaker, Mr Gregory Madick. Please go ahead, sir.

Gregory Madick: Hello. Thank you for joining today's call. Before we begin, I would like to refer you to the disclaimer statement in the financial results presentation regarding forward-looking statements. During this call, we may make reference to forward-looking statements by using words such as "plans", "objectives", "goals", "strategies", and other similar words which are other than statements of historical facts. Actual results may differ materially from those implied by such forward-looking statements due to known and unknown risks and uncertainties and reflect our views as of the date of this call. We undertake no obligation to revise or publicly release the results of any revisions to these forward-looking statements and might have new information of future events. I will now turn the call over to Stephan DuCharme, CEO of X5 Retail Group. Stephan?

Stephan DuCharme: Thanks, Greg, and thank you all for joining us to discuss X5's Q2 and 1H 2014 results. Before updating you on what has been happening at X5 I would like to address what is probably on most people's mind at the moment – the Russian government's recent ban on certain food products from Europe, the USA, Canada and Australia. Our concern is first and foremost for the Russian consumer, and ensuring that we maintain the levels of product availability that we have recently achieved and that any gaps in our assortment are filled with appropriate substitutes. Based on our initial analysis, we are comfortable we can do this. In terms of revenue, the banned products represent about 8% of our assortment and, as it would be expected, due to the size difference in assortments and positioning of the formats this is slightly higher for Perekrestok and Karusel, approximately 9%, and lower for Pyaterochka, approximately 7%. We are already working on securing new sources for products affected by the ban. Manufacturers, suppliers and traders, both within Russia and across a range of third-party countries, have indicated that they have the ability and capacity to meet the increase in demand for products in these categories. Much, of course, depends on the specific category. And as we all know, the categories most affected are fish, fruit and vegetables, and cheese. In other categories, such as chicken, meat, milk, and to a lesser extent, dairy products, there should be no impact on the width of assortment available to our customers. In terms of prices, we expect that food inflation will remain relatively stable at current levels through the end of the year. However, with the ban in place there is a possibility that we could see a slight increase this year. We will work with our suppliers to minimise any potential impact on prices going forward. Our commercial teams are in touch with suppliers on a daily basis to ensure we adapt immediately to new developments. We are cooperating with the Russian government regarding the concern that no predatory pricing activities take place that would negatively impact the consumer and their access to products. We do not expect the current list of socially important food products subject to government price regulations to increase. I would like to reiterate that our first concern is for the 5.6 million daily customers across our formats and we will continue to make the necessary adjustments to our assortments to ensure that our customers have the products they want and need at a fair price.

Turning now to our ongoing transformation, I would like to stress that we will continue to execute on our change initiatives irrespective of the new macroeconomic and political environment that we now face. It is important to remember that such challenges always give rise to opportunities for those who seek the silver lining in the cloud and take advantage of the opportunity. Our transformation and our performance, they are in our own hands. In terms of where we are in this process, it is clear from the results that individual formats are in different stages, so I think it is appropriate to provide an update of our progress on an individual format basis.

Pyaterochka is furthest along, and I am very pleased with the results year to date, including their strong sales growth in July. Olga and her team continued to improve execution of retail basics across the entire of Pyaterochka system. The cluster based operating model that the format has adopted is fully up and running, providing the necessary control and transparency to manage the scale of the business and to allow for further significant development. It also represents an important tool to manage, compare and develop the 66 cluster directors. When we introduced category management principles at Pyaterochka last year, we started with a quick and dirty review of the assortment, first in the Central and North-West Regions in June, followed by the remaining regions in September. We conducted a more thorough review of the format's 51 categories starting at the end of the year, focusing first on big categories as a percentage of sales and starting in the Moscow and Central Regions. We have already implemented this in the Central and North-West Regions, and we plan to have this completed in all regions by November of this year. We are also working on other assortment enhancements in cooperation with suppliers. They include ready-to-shelf packaging, package size optimisation and private label products. This not only improves the on-shelf appearance of products, but also allows us to optimise shelf space and increase the effectiveness of store operations. It is important to remember that category management is an ongoing process that never stops and is driven by the market, changes in customer preferences, new product offers and, as we have now seen, sanctions.

In terms of logistics at Pyaterochka, we are on schedule with the separation along the format lines. At Pyaterochka this will include the addition of 8 new DCs over the next 12–14 months, with the first to open later this month in Rostov. During this period we will also be adding DCs in Moscow, Saint Petersburg, the Urals and Central Russia, Kazan and Voronezh. Another important driver of change and future growth is Pyaterochka refurbishment programme. As we stated in the Q1 financial results conference call, we have reduced the planned number of store refurbishments from 1,000 to not more than 500 in order to focus more on quality rather than quantity. Currently we have refurbished 162 Pyaterochkas and rebranded 9 stores, rebranding being a late form of refurbishment costing approximately RUB 9 mln for rebranded stores. Currently our plans call for 350–400 refurbished stores and approximately 100 rebranded stores this year. All of the above has been accompanied by improved communication and a revival of the Pyaterochka fighting spirit that was missing from this format in previous years. All of these initiatives are coming together to drive the strong results for Pyaterochka in Q2 and in July, where total sales growth y-o-y was 32.7%, including LFL sales growth of 18%, including a 6% Traffic and a 12% Basket.

Moving on to Perekrestok, Janusz and his team have finalised and started implementing the strategic concept for the new Perekrestok value proposition and store concept. At the heart of the new concept is the role of category management, including the update of the assortments. We have already completed the first phase of the update, which represents 15% of the assortment in terms of revenue and is already on store shelves. By the end of this year we will have reviewed over 80% of the new assortment in terms of revenue or approximately 110 subcategories which will also be available on store shelves by that time. The remaining assortment will be rolled out to store shelves by the end of Q1 2015. We can already see improvements in July sales results from the categories that we reviewed in the first phase, including beer and sausage products which are up by about 20% and 13% respectively, and ice-cream which is up by 33%. This gives us confidence that we are on the right track with these changes and the consumer is starting to react.

Another important aspect of the ongoing changes is the physical look and feel of the new Perekrestok store. We plan to open our flagship store under the new concept in Moscow in October. The new store will feature the full assortment, including our plans for a new Perekrestok private label as well as the look and feel of the new value proposition. This will be an important message not only to our customers, but also to our landlords and future real estate partners to whom Janusz and I have already presented the new concept. We are also actively refurbishing older stores, and have completed 19 stores to date this year, which include some elements of the new concept. In total, we plan to complete up to 29 reconstructions this year, with remaining ten incorporating more of the new concept attributes. Going forward we will be refurbishing stores in line with the new concept brand book, and stores that have been recently refurbished will be updated to reflect Perekrestok's new colours and logos. Over the next 12 months we will also be adding new logistics capacity for our big formats by opening new DCs in Saint Petersburg, Yekaterinburg and Nizhny Novgorod. This will help alleviate bottlenecks, improve service level and support a more aggressive expansion plan for our larger formats. In terms of expansion, we feel that Perekrestok has the potential to lever more square metres of selling space than it had in the past. The team is already planning on ramping this up next year, and we feel that we should be opening not less than 50 new stores per annum over the next few years. We are hopeful that these changes will drive traffic, basket, as well as sales densities, going forward as the Perekrestok supermarket takes back its rightful position in Russian retail.

At Karusel, Vardan has been in place for a month now, and we are pleased with his onboarding supported by all members of the X5 Executive Board. Also I am very encouraged by the way the Karusel team has taken to him. In terms of the business, we are currently evaluating the results of the three pilot stores, which include two regional stores that entered the pilot programme after various updates to assortment, including on production and store layout in Q4 2013, as well as our flagship hypermarket store in Moscow that was launched in August 2013. This assessment will guide us as we finalise our revised Karusel value proposition and model that will in turn enable us to increase expansion and improve sales densities in line with what we have seen at Pyaterochka and expect to see at Perekrestok. Vardan will be focused on guiding the team to finalise the appropriate niche for Karusel in terms of store size and layout, assortment and value proposition.

In other areas of the business, as I have already touched on, in terms of the logistics separation, we are on schedule with the programme and we expect to complete it before the start of the high season in 2015. By the beginning of the current high season we will have 9 Pyaterochka mono-format DCs, 7 Perekrestok/Karusel mono-format DCs and 14 multi-format DCs, as well as 2 DCs for Express stores in Moscow. We have already started our planning for the high season particularly taking into account our increased volumes, and our DC development programme will support us in this. Based on discussions with the format heads and heads of transport, we are confident that we can repeat the good performance of the 2013 high season in terms of product availability to stores. For your information, we have also introduced a separate transport division that acts as a service provider to the formats and reports directly to me. With our increased X5 focus on external and internal benchmarking we expect the transport team to deliver service to the formats comparable to market competitors and at a market cost. We cover 50% of our transport needs internally and will maintain an appropriate balance of internal and external transport as we move forward. Last but definitely not least, as you can see from the 1H results, we have not seen any deterioration in our gross margin as the result of the logistics work streamline, and going forward we do not expect any negative impact on costs or capex.

From my very first call with investors, I have always made it a point to speak about the X5 management team, about stabilising it, developing it and allowing it to evolve over time, as we handled both the transformation and turnaround at X5, while moving on the strategic growth opportunity in Russian retail. On a personal note, I am very proud of what the X5 management team has achieved over the last year, particularly during 1H 2014. We have continued to improve operations and the timely delivery of the turnaround through better execution, communication and team work. This is the result of not only improved operational and financial results, but also a sense of corporate identity both at X5 and the format levels. Equally important, we are identifying further opportunities as value propositions and organisational structures become ingrained not only at the format levels, but also at the corporate Group level as the central office focuses increasingly on adding value to the business in a post-transformation X5.

In Q2, we did announce two changes to the Executive Board of X5. These changes have and will be carried out in a planned and orderly fashion and reflect the need for various skillsets at different stages of the turnaround process. These changes will not negatively impact the turnaround schedule or our results. As I already mentioned, on 21 July, Vardan Dashtoyan assumed the General Director role at Karusel. Svetlana Volikova did an excellent job over two years in stabilising the operations at Karusel and improving the format's financial and operating results. However, we are now moving into the next phase of X5 hypermarket evolution and I feel that Vardan's customer focus background as well as a combination of managerial and entrepreneurial experience will provide the necessary catalyst to jump start Karusel's growth and expansion. Sveta will remain with X5 as head of Internal Audit and Control for the Group where her experience as financial controller and former director will strengthen the effectiveness of this activity. In terms of the CFO transition, we are in the active phase of the search process and the finalisation of our shortlist. We do not plan to discuss or speculate on potential candidates and we will provide updates and announcements to the market regarding this process when appropriate. Meanwhile, Sergey Piven continues to fully execute the duties and responsibilities of CFO. As I said earlier, our transitions reflect the different stages of the turnaround process. When Sergey agreed to take on the CFO role, the scope of his activities included much more strategic and operational responsibilities. As we were moving into a more traditional CFO role, Sergey has decided to pursue opportunities outside of X5. I would like to thank him again for stepping up in January last year to take on this role, which we always understood would be reevaluated as we completed the turnaround. It is important to note that we have strong financial teams in the Group and format divisions at X5, including IFRS reporting, treasury, budget and planning. This and the orderly transfer of responsibilities will enable a "business as usual" environment during the changeover. The fact that we inform the market sooner rather than later, when we have identified the candidate, reflects the level of stability we have achieved within the organisation, and as part of the Company's broader transition out of the turnaround phase.

Finally, before I turn the call over to Sergey, I would like to make a brief comment on July's results. As you can infer from my earlier comments on Pyaterochka, we have rebounded nicely from the one-off holiday and weather impact on June's traffic with total revenue increasing by 23% and LFL up by 14%, including a 5% traffic and a 9% basket. Olga, Janusz and Vardan will provide a more detailed update of their formats' progress and potential at our Capital Markets Day on 29 October and we will also provide our view on revenue and selling space growth for the year at this time. I will now hand the call over to Sergey Piven, X5 CFO, to comment on the key drivers of our Q2 and 1H results. Sergey?

Sergey Piven: Thank you, Stephan. Before we discuss the results I would like to make some brief comments on the changing macro environment in addition to Stephan's earlier comments. Looking ahead we do see potential inflationary risk impact on prices in 2015. First, there is a recent Cabinet decision to introduce a sales tax of up to 3% which might cause a one-off spike in price growth. There is also a possibility of higher taxes on refineries leading to an increase in gasoline prices and the resumption of tariff increases for natural monopolies in 2015. Another factor is exchange rates: the recent weakness in the rouble may also contribute to higher inflation due to the pass-through effect this has on prices. It is unclear how and when exactly these factors will impact the consumer and consumption. However, as we have stated previously, we still see growth in food retail sales supported by increases in real wages and consistently low levels of unemployment. We also feel that modern retailers like X5 will offer consumers better quality products, prices and convenience, which will enable us to continue gaining market share at the expense of traditional and regional retailers. In terms of X5 results, we have not seen any material impact from the changing macro environment on our Q2 or current trading results and July numbers support this emphatically. We will continue to monitor the macro environment and will adjust our strategy accordingly.

Moving on to revenues, I will talk briefly about the drivers behind the improvements in both our topline and LFL sales in Q2. These are primarily the same as the previous two quarters which we explained in detail in prior conference calls and press releases. Basically they are a continuation of the positive trend that began in Q4 2013 and was largely related to our focus on back to basics retail initiatives, including improvements to availability, assortment and promotions. The impact of these initiatives has been most visible and significant at Pyaterochka mainly because, as Stephan commented earlier, this format has made the most progress in terms of its transformation and we are already seeing the results of the turnaround initiatives hitting both the top and bottom lines. This format is also the largest contributor to total revenues accounting for approximately 70% of X5 total revenues in Q2 2014, and 15% out of the 16.6% increase in the Company's total Q2 revenues y-o-y was due to Pyaterochka. Pyaterochka's 23% y-o-y growth in Q2 was split evenly between improvements in LFL sales, mainly improvements in basket, and sales from new stores that were driven equally by average ticket and number of customers. Geographically the improvements in Pyaterochka sales are primarily coming from the Central Region which accounts for over 50% of the format's sales and grew by 25% y-o-y in Q2. Our assortment changes, category management principles and separation of logistics were rolled out first in the Central Region, which explains the trend in improvements. We are in the process of expanding these to the rest of Pyaterochka's regions this year and expect to see improvements there as well. Pyaterochka stores in other regions, which are all regions except the Central and North-West ones, also performed well in Q2 growing sales y-o-y by 28% mainly due to addition of new selling space. The moderate growth in Q2 from Perekrestok and Karusel is mainly a reflection of where they are in the turnaround process. We expect to see improvements in the results of both of these formats as they move further along in their respective transformations. Finally, "Other income" decreased as a percentage of sales by around 6 bps or by approximately 50% in absolute terms y-o-y in Q2 2014 primarily due to a decrease in franchise royalties and advertising income. Moving on to margins, the improvement in our gross margin in Q2 2014 was primarily impacted by a decrease in logistics expenses and better commercial margin and shrinkage.

The improvement in our gross margin in Q2 2014 was primarily impacted by a decrease in the logistics expenses and a better commercial margin and shrinkage. The improvement to the commercial margin is primarily related to better managing promos in Pyaterochka and to a lesser degree in Perekrestok. This is directly related to the improvements we have made in our relationships with suppliers. As you may remember, this is part of the company-wide initiative that was launched last year with our inaugural suppliers conference. This has also been supported by the category management principles which are in practice at Pyaterochka now and which are in the process of being rolled out at Perekrestok and Karusel. The overall shrinkage of logistics expenses was due to operational improvements as we become more efficient in managing these activities. However, it is important to remember that our formats are at different stages of the turnaround process and we may still experience some volatility to this item going forward. In terms of EBITDA, we finished the quarter within the EBITDA margin of 7.3%, which was 43 bps higher than last year, primarily due to the improvements in the gross margin and operating leverage, which was offset by a 40 bps increase in the SG&A expenses as a percentage of sales. The two main components of our SG&A expenses are staff costs and lease expenses. As a percentage of sales, we were able to decrease staff costs by 34 bps in Q2 2014, primarily due to increased employee productivity and a decrease in our staffing expenses and administrative payroll. We have continued to improve employee productivity allowing us to decrease the number of employees per store including our staffing y-o-y at all of our formats, which in turn has enabled us to raise salaries and benefits for regular retail employees. In terms of lease expenses, we did see an increase and we should expect to continue to see inflation in these expenses in future periods, based on changes in market conditions, competition and general inflation. However, as we are improving our sales densities and operating leverage as a percentage of sales, this expense was only up by 16 bps in Q2.

In terms of the breakdown, Pyaterochka counted for approximately 70% of the y-o-y increase, while Perekrestok and Karusel accounted for around 17% and 6% respectively, and Express the remainder. The main driver for the increase in the lease expenses was related to new stores added in 2013, primarily at Pyaterochka. We also saw an increase in these rates at older stores due to indexation and currency-related terms. The only other notable change in the SG&A expenses was to other expenses, which increased as a percentage of sales by 53 bps, primarily due to an increase in provisions for VAT. As we have stated in the past, the accrual and release of provisions as part of managing and recognising potential risks will fluctuate from quarter to quarter.

Our net profit was up y-o-y by 72%, which was primarily due to the reduction of our effective tax rate through the creation of a consolidated group of taxpayers, which is made up of various X5 subsidiaries and allows us to net the current tax losses of these subsidiaries against the taxable profits of others. In general, we think that this will allow us to achieve an NTR of approximately 21–23%. That profit also benefitted from a one-off refund related to overpayment of taxes in previous periods.

Turning to our balance sheet, at the end of the quarter our Net Debt / EBITDA ratio improved 2.5x compared to 2.68x at 31 December 2013 and 3.23x at 30 June 2013. We carried a total debt of RUB 110 bn, which is effectively lower by RUB 12 bn than a year ago. Also we improved the term structure of our debt by reducing the proportion of short-term debt from 45% of the total debt portfolio a year ago to just 18.8% as of today.

This helps our financial position in the environment of rising interest rates and uncertainty at the financial markets. Our operating cash flow increased by more than RUB 11 bn this quarter compared to Q2 2013 due to higher sales and margins as well as positive changes in the working capital and lower income taxes paid in Q2 2014. With cash-based capex this quarter more or less in line with the last year's, together with our strong operating cash flow, we were able to deliver a free cash flow of almost RUB 8 bn in Q2 2014, which made it possible to improve our debt position as mentioned earlier.

Our focus on sales and availability resulted in a slight increase in inventories, and in terms of receivables the increase was primarily due to a reduction in the netting of financial assets and liabilities, which we explained in the Q1 Call and disclosed in our 2013 Annual Report. This will continue to impact receivables until next year. We also had an increase in supplier bonuses receivables related to the increase in purchasing activities.

Working capital remains one of our key sources of financing, and we will continue to focus on improving our inventory and receivables management in future periods. In terms of capital investments, in Q2 approximately 60% of those went to expansion of our store base, where we added around 72,000 sq m gross. The next largest category was store refurbishments, which accounted for approximately 38% of the capex spent during the period. In Q2 2014, we completed the refurbishment of 87 Pyaterochka stores, up from 28 in Q1, and at the end of the period additional 21 were still being refurbished. At Perekrestok we refurbished 9 stores, and 5 were still in progress. The remaining capex was made up of IT, logistics and other investments. We will look forward to providing a more detailed update on our plans and expectations for this year and future periods at our Capital Markets Day in October. That concludes our discussion of the results. Operator, we are ready to begin the Q&A portion of the call.

Operator: Thank you, sir. As a reminder, if you wish to ask a question, please press "*1" on your telephone and wait for your name to be announced. If you wish to cancel your request, please press the "#" key. The first question comes from the line of Maryia Berasneva from Morgan Stanley. Your line is now open.

Maryia Berasneva: Good afternoon. Thank you for taking the questions. Congratulations with the results. My first question is with regards to the gross and operating margins, which have increased in Q2. The release mentioned the improvement in the logistics expenses and commercial margin. I am just trying to understand why this is not being passed on to the customer to drive traffic rather than improving margin, because I understand that was something you were looking to do this year.

Sergey Piven: Thanks for the question. We have always been talking about making rational investments into the customer. In the current situation, where Pyaterochka is working at the best of their capacity to put the goods to the customer through our supply chain and experiencing and achieving growth rates close to record, we felt that there was no need to undercut the market in terms of prices or excessively aggressive promos in Pyaterochka. On the other hand, our other formats, as we mentioned during our speech, are in the process of fixing the category management and assortment.

In this case we are also very careful about overinvesting into the price not to ruin the value propositions of the format, while they are actively improving other aspects of customer value propositions. I think we should focus on those and invest in line with our strategy. All that does not mean that we abandon or that we are not going to invest in the customer, but that just supports our previous claims that we will do this rationally and in line with what market allows or forces us to do. We are in a competitive situation here more and more, and that affects all our actions, of course.

Maryia Berasneva: Thank you very much. One more question from me, if I may. Are you still expecting to spend near RUB 40 bn in your capex this year? Given your… or reducing your spend or your refurbishment programme for Pyaterochka stores, I wonder if there is a potential for the capex to be lower for the full year, if not, where will this dedicated capex go to?

Sergey Piven: RUB 40 bn is, of course, the maximum capex number. We are not going to spend over that amount. Whether there is a potential for savings, we will update you at the Investor Day in October because as you might have already understood from our numbers, there is a major portion of investment which is still ahead. We are ramping up our refurbishment programme, and you saw that we refurbished more stores in Q2 than in Q1, and this trend continues in Q3. We are opening new DCs, which is also a major target for our investment. All that, probably, asks us to wait until October to come with a more precise guidance, and I think it will be together with our expectations on sales and profits for this year. All these items come together.

Maryia Berasneva: A potential for savings but you are not revising the numbers for now. Any other changes to the guidance that you would like to air on this call?

Sergey Piven: No, we think it is premature based on a) the external environment, which is rapidly changing, and b) on [the fact] that we have started the year from the very low base, especially Pyaterochka. You should remember that in Q4 2013 we had already the higher base and we are also working very hard on expanding our logistics capacity. All that, I think, calls to wait until October to be more certain about what rates exactly we are going to reach, I mean growth and profits alike.

Maryia Berasneva: Thank you very much. And let my colleagues ask the questions.

Operator: As a reminder, if you would like to ask a question, please press "*1" on your telephone. Our next question comes from the line of David Ferguson from Renaissance. The line is now open.

David Ferguson: Hi, good afternoon everyone. Two questions, please. The first on sanctions. If you talk to new suppliers, how do you think the commercial terms that you agree will compare with the terms that are already in place with existing suppliers and do you see any sort of gross margin impact? That would be the first question. The second question: you talked about the improvements in LFL traffic in July. Is there anything specific behind that that you would identify and how would you think about the sustainability of that over the entire Q3? That's it, please.

Stephan DuCharme: David, it is Stephan. I will take the question on the sanctions, and then Sergey will jump in. You will appreciate the situation is very fluid at the moment. We are handling it day to day, and it is premature to make any kind of predictions in terms of the impact of the sanctions, either on sales or on margin. What I can say, is that our commercial team is in place. Everyone is back from holidays. We are talking to suppliers across the categories, we are talking to traders. We are looking at alternative markets. The picture is a mix. There is, of course, a fear, and our primary concern is our customers. There is always a concern that substitute products might be more expensive. We don't think that is going to be a general statement, a general result across the board, but it is, you know, really, too early to say, at this point it very much depends on the specific product; it depends on the category. In terms of fruit and vegetables, it depends on the seasons; it is going to depend on the weather as we move into fall in the Northern Hemisphere and into spring in the Southern Hemisphere. There are a lot of factors we can't predict, and it is very a question of handling this day to day.

Sergey Piven: I will try to answer the second question, about the LFL results in July. I think there are three things which we need to look at. One, and that's the obvious one, is what we mentioned at the call, is that we have been working on various improvements versus the customer, which gradually we think start to work, of course. We see these July results at least partially, as a continuation of seeing the results of our work. But there are two other factors which we need to take into account. First of all, if you look at the last year, July, August, generally Q3 of the last year were not the best months in terms of LFLs, I think that was pretty much the bottom of our performance in terms of LFLs in 2013. The base is lower in July than it was in Q2, slightly lower. The second thing for the improvement was, of course, the weather conditions in June, which were very detrimental to our drinks and refreshment business, which improved significantly in July, with the Central Region of Russia being hit with the warm weather. And as you know most of our operations are concentrated exactly in those regions, Central and North-West. I will put these three reasons as the main drivers for improvements in LFLs for July.

David Ferguson: That's great. Thank you very much.

Operator: Our next question comes from the line of Maria Kolbina from VTB. The line is now open.

Maria Kolbina: Good afternoon. I have a few questions. The first one is on sustainability of your staff costs optimisation and particularly about the decrease in outstaffing expenses down 24 bps. Can you share some thoughts on that? Have you suffered from any decrease in your productivity or store ambience, or quality inside the stores if you have cut down the number of employees? Any thoughts on that? And the second question is on the refurbished stores programme: can you give some numbers on the LFL performance of the stores. At least, if you can't provide exact numbers, maybe some indications for Pyaterochka and for Perekrestok? I think that would be very useful. Thank you very much.

Sergey Piven: On the sustainability of our staff costs. We are actually big fans of own personnel, I can reveal the secret to you. We think that one well-trained person who has been employed with our company for a long time, is well-motivated and has a lot of experience is worth a number of untrained, unskilled and not motivated outstaffed employees. That's why our push to gradually replace our staffing with our own employees and simultaneously our push on motivating, training and retaining these employees in the stores will continue. We think it can only do better for our profits. And what is more important, it will do better for our customers. And you can be sure that we will not stop that, we will have the outstaffing levels at the levels which are minimum, required to provide security for our operations and appropriate human reserves for our operations for unpredictable conditions, etc. But the focus will be our own staff. I think that is sustainable. In terms of the cost effect, of course, we are helped with a good LFL growth, and there is a portion of operating leverage also in the staff costs. Our people are more productive because we sell more per employee, and because we sell more also per sq m. That is a direct relationship. As long as we continue our good trends, of course, we can promise that this metric will also show good progress.

Maria Kolbina: Sergey, I have one question. How big is outstaffing personnel as a percent of the total in Q2?

Sergey Piven: Just a second, let me have a look. It is about 23% as of the end of Q2. That is across the system. And the highest percentage has been in Karusel because there is a lot of support staff there, which is not customer facing, but rather handling the receiving and logistics operations in the store and movement of goods in the in-store warehouse, a small warehouse, or backrooms. The lowest number was in Perekrestok, and also the biggest progress was made in Perekrestok in terms of this personnel. We think longer-term it's the right strategy for Perekrestok, which was traditionally focused on service, and we think this is the right focus, and the service can be provided only by well-trained employees, our own employees. That is the picture.

Maria Kolbina: Can you share your thoughts on the way you see the level of outstaffing employees in a short-term perspective?

Sergey Piven: I think it will be reduced.

Maria Kolbina: OK. And do you think you will be able to keep wage expense at the level that you showed in Q2? Or do you think it will be going down? Because I understand you will be cutting down outstaffing personnel, but you will have an increase in wage, in salary growth at the same time.

Sergey Piven: In salaries, yes, we do pay more, higher salaries to our own employees than to the outstaffed, but we also expect the efficiency improvements from those employees. What you can be assured of is that we will continue to monitor very closely our expenses, and as part of it, the staff expenses, which is the major part of our costs. We hope to perform in those.

Maria Kolbina: OK. That is clear. Thank you.

Stephan DuCharme: Maria, if I could add to that, it's Stephan. Results from an important element, which is flexible scheduling in the stores. Even as we move from outstaffing to our own employees, I think, as we get better at flexible scheduling in the stores, moving to part-time positions, to positions that cover more than one task, we can improve the efficiency depending on the store, on the type of format, so there is a little bit of a reserve there, which we should cover any increases that might occur.

Maria Kolbina: Thank you. And my second question is on performance of refurbished and rebranded stores.

Sergey Piven: What we can say today is that our refurbished stores continue to outperform the stores which have not been refurbished. Their performance is in line with our plans, which we commented at the last call also. We are quite happy with the programme and what you can see probably is that the number of stores which we are refurbishing per quarter is increasing. That means that we are moving along the learning curve of how to perform the refurbishments, and so far we are quite happy with the performance of the stores.

Maria Kolbina: Thank you.

Operator: Our next question comes from the line of Alexey Krivoshapko from Prosperity Capital. Your line is now open.

Alexey Krivoshapko:[…] I actually have two questions. Stephan, can you repeat, please, what was the sales growth in July? Did I get it right, 32% or was it just for one format?

Stephan DuCharme: It is for Pyaterochka .

Alexey Krivoshapko: For Pyaterochka.

Stephan DuCharme: Yes.

Alexey Krivoshapko: And I also have a question to [you] then in this case – what was the total sales growth for the Company in July, if you can say that?

Stephan DuCharme: 23%.

Alexey Krivoshapko: Sorry, can you clarify, please? In Q2 you got a significant increase in other expenses which y-o-y went up from RUB 1.5 bn to RUB 2.6 bn. Can you explain, please, why it happened and what is inside these increased expenses?

Stephan DuCharme: These are tax reserves on taxes which are not related to profit, other than profit tax.

Alexey Krivoshapko: And why is it not in the cash flow?

Stephan DuCharme: And they change from quarter to quarter depending on the assessment and in line with the IFRS rules.

Alexey Krivoshapko: And what is the rational for those provisions? What [was…]

Stephan DuCharme: You know, Alexey, sometimes I asked myself the same question, what is the rational of this or that IFRS rule. But regardless of the answer, I give to myself, I have to follow them. That is what we are doing.

Alexey Krivoshapko: But why in this case it is not in the cash flow statement shown with the figure but a different sign? Or is it somewhere in the working capital?

Stephan DuCharme: Because it is provisions, and not cash items.

Alexey Krivoshapko: But then you should adjust for them on the cash flow statement with a different sign. No?

Stephan DuCharme: It is other non-cash expense, other non-cash items. If you have a look at the number of 520 [m] in our six months report, page number four.

Alexey Krivoshapko: And what was the amount which was accrued in Q2, if you have this? Or shall we say it is just this RUB 520 m which was mainly in Q2?

Stephan DuCharme: Look, if we have this 53 bpsrecalculated, You know, I do not have a calculator by hand right now and I do not remember the number, but if you just recalculate it based on the revenue, that would be, most of it would be these reserves. Most of it.

Alexey Krivoshapko: I see.

Stephan DuCharme: But if you need, you know, a detailed calculation to the ruble, we can send it to you separately after the call. I will just ask our guys to prepare the number.

Alexey Krivoshapko: That will be handy. Thank you so much.

Operator: Our next question comes from the line of Natasha Zagvozdina from Verno. Your line is now open.

Natasha Zagvozdina: Thank you very much for hosting the call and congratulations on good numbers! I have a question for Stephan or Sergey, if you would like. You have a choice – you are either using the cash flow in Q2 paying down debt or you [as dividends to shareholders. Going into next year,*(interrupted)*

Sergey Piven: Natasha! Natasha!

Natasha Zagvozdina: Yeah?

Sergey Piven: Natasha, I am sorry, there is something with the sound and connection because we cannot hear you very well.

Natasha Zagvozdina: Oh, I am sorry.

Sergey Piven: There is some echo over there. If you could speak maybe further from the speakerphone.

Natasha Zagvozdina: Is it better if I speak this way? Is it better now?

Sergey Piven: Not particularly. Sorry.

Natasha Zagvozdina: OK. Let me email you my question.

Sergey Piven: OK. Thank you. I am very sorry for that, but really we could not hear you.

Operator: Next question comes from the line of Marat Ibragimov from BCS. Your line is now open.

Marat Ibragimov: Thank you for the opportunity. I would like to ask a question regarding the banned products. You said that they account for about 8% of the assortment. What is the share of these products in total sales and probably in profits? Can you say that?

Answer: That is the percentage of sales we were giving.

Marat Ibragimov: So these are sales. Another question is regarding the implication, the price increase from the domestic suppliers who supply the same assortment as the banned products. They were reporting in the media that they are planning to increase their prices. Can you say, how much they increased the prices, the first reaction, and also how you plan to deal with this because there is a concern that the government may tighten pressure on you in order to limit the price growth.

Sergey Piven: I know how much some of them would want to increase prices – that is high through the roof. And that is not because of sanctions. That is f normal behavior of any commercial person. But we always, always stand and watch the interests of our customers. In the end, there is a negotiation of what the supplier wants, regardless of the situation (whether it is because of sanctions, or because of the commodity price increase, or whatever) and what we think our customer can afford. With the same profit margins in retail business as we have, we cannot allow suppliers just raising their prices every time they feel they are entitled to. So in terms of sanctions and the way it usually works, with sanctions it works the same way. We try to create a competitive market and a competitive situation between the suppliers and we assess carefully and permanently the value-to-quality ratio which is suitable for our customers. And then if we can find an alternative supplier, and with the current supplier we cannot agree on the appropriate price structure, we change the supplier. This is approximately the way we are handling the situation with the banned products, although because of the legislation it might be more difficult for certain categories, and fish is the bright example, but even with fish I do not think it will be very easy for our suppliers to just bluntly raise prices, because we, as one of the leaders of Russian retail, will take any measures including negotiations but also any measures which are necessary up to the legal measures to prevent predatory pricing. We just think our customer cannot afford to pay every time what the supplier wants. That is it. We will watch their interests.

Marat Ibragimov: As far as I understand, your strategy *(interrupted)*

Stephan DuCharme: Let me just add to that. It is Stephan. You have to appreciate it, it is not one decision across the board. This is a multitude, dozens, hundreds of decisions that are being taken now every day. With respect to every product we need to look, if there is a substitute product, if the substitute is a perfect substitute. If it is a perfect substitute in all other things being [considered], there should not be a price increase. If there is a price increase, that is being proposed, why it is being proposed, whether we understand what is being proposed. If it is not a perfect substitute, whether there is a justification for a price increase. Maybe, it is a different product of a different quality. This is something that is in the hands of our two commercial teams. They are having those discussions daily, they are pushing back, as you can appreciate and as Sergey has just said. So it really depends at the end of the day, it also depends on whether we want this product in our stores or not and what the full look-and-feel of the assortment in those categories, so we will really handle it grandly on a very commercial day-to-day basis in the interests of our customers.

Marat Ibragimov: Thank you. As far as I understand, your strategy to deal with that in order to avoid the government pressure which is unnecessary for you is to make this type of cases as public so that everybody understands what the reason for the price increase is. Do I understand it right?

Stephan DuCharme: I did not quite understand the question but we are under no pressure by anyone at this point. We are looking at each category. With respect to each category we will make commercial decisions in the interests of our customers. We are obviously cooperating with the government as it asks us for information. We will pass on what is asked of us, but we are under no pressure by the government in any way.

Marat Ibragimov: I just recalled the situation at the end of 2010 when there was a big increase in grain prices which affected the food price inflation, etc. There was a lot of speculation in the media and the government that retailers should reduce their mark-ups or limit their mark-ups. I am afraid, in this case we can also see such negative developments that you will be forced to reduce, to limit your mark-up for these categories. This is my concern.

Sergey Piven: So far we only see two kinds of pressure. One is from our consumers who want the best for the affordable price, and the other is from the competition who want to get our consumers by offering them the best at the affordable price. And this is the thing we are working with. In terms of the government, we are working within the frames of current legislation and if the legislation bans imports of certain products, then we are in line working, you know, within this framework. But today there is no pressure to fix the prices or anything from the government. Believe me, there is much more pressure from competition on us than from the government, that is for s--ure.

Marat Ibragimov: OK, thank you very much. This is exactly what I wanted to hear. Thank you.

Operator: Our next question comes from the line of Svetlana Sukhanova from UBS. Your line is now open.

Svetlana Sukhanova: Good afternoon, everyone. I have a number of questions. My first question would be about your cost of debt. In 1H of this year the cost of debt is already up 50 bps. By how much do you expect the cost of debt to increase for the whole year and what kind of percentage of your debt is linked to the floating rate?

Sergey Piven: Our current cost of debt is approximately 9% but that of course reflects the debt we took before the rise of interest rates. The current rates are anything between 10 and 11+%. How they will move in the remainder of the year, I do not to forecast and I cannot, because the situation changes so quickly, that it would be for me just wrong to assume anything. We have, I think, a good long-term structure of the debt which is, as I mentioned 80% of debt is long-term, so we do not experience shortage of financing and are not going to experience the shortage of financing also because we have committed lines from our major creditors for the amounts which are enough to finance our operations in the next year or two for sure. And the prices of these lines are market prices so they are comparable to 10–11%. Now in terms of the relationship between floating and fixed, it is changing as we take new debt but it is approximately in line with 30% of the debt as floating and 70% as approximately fixed.

Svetlana Sukhanova: That is clear, thank you very much. My next question, if I may, would be around X5. I think about a couple of months ago it was an article in RBC Daily or somewhere, that you are going to scale down E5. Sorry, not X5, but E5. When I look at E5 results, they are very unstable – one month is up, another is down. Can you kindly, please, elaborate on your strategy regarding E5 and on your plans?

Stephan DuCharme: We are currently valuating a number of different options in relation to E5. The reason that the results are up and down is also often a reflection of the marketing spend for the specific month. We are currently looking at different options regarding this model. I am currently not in a position to say anything else but we will come back to you on that when there is anything to report.

Svetlana Sukhanova: OK. Fair enough. And my next question would be I understand that this price monitoring, which is being done by the government, is happening region by region. Can you elaborate on what percentage of your Pyaterochka points of presence is included in that price monitoring?

Sergey Piven: I think it works this way. Maybe in no more than we do, but the government sends us the request for information which we duly answer. And this happens from time to time in all regions, so what I want to say, there are no particular regions where we feel more pressure from the government than in others. It is just a request of information.

Svetlana Sukhanova: But Sergey, is not it daily? I was reading this Ministry of Trade Decree or whatever it is called. It is said this reporting should be done on a daily basis and in selected regions. And I also *(interrupted)*

Sergey Piven: It is impossible to do it on a daily basis. They will drown under the pile of information which we can provide them with.

Svetlana Sukhanova: No, no, I agree with you. That is why I am asking.

Sergey Piven: And there are no even technical means to do it. And it is not done on a daily basis today. But again… I know everybody is very excited about all this sanctions thing, ban and whatever, but this whole thing happened a week ago, right? It is evolving as we speak and I do not think even in the highest levels of the country it is clear, you know, exactly when and what and how. The whole government structure is working now on setting up the mechanism of how to work with this. So let us wait until they set it up, let us not run before them. We, as a big company, are always working within the framework of legislation. But if this framework has not been finalised, then we are waiting and sometimes helping to finalise it. But that is up to the government.

Svetlana Sukhanova: Sure. Let us wait. My next question then would be about your traffic in April and May. All of a sudden, in April and May we noticed that your traffic was in the negative territory, primarily across all major formats. June, we understand, was [a weather one-off], if we can call it so. So can you elaborate on what happened in April and May with traffic? I understand the promo level was quite high during those months. I am looking at like-for-like traffic, for sure.

Sergey Piven: When you asked to explain what happened with traffic, could you please specify a little bit what (interrupted)

Svetlana Sukhanova: Of course. Apologies.

Sergey Piven (continued): What is the point of interest of what happened?

Svetlana Sukhanova: Apologies for not being clear here. My point is April and May last year were still low base of April and May 2013. So this year April and May got a low base of last year. And the traffic, like-for-like traffic, gets to the negative territory despite the heavy promo activity, at least in Moscow region where I live. So the reason for my question is I am trying to understand what kind of triggers were there for that negative traffic despite low base and high promo activity, and I am asking that because I am concerned, what kind of trends we might see starting from October and November when base will already be much higher?

Sergey Piven: OK. Again not to measure the average temperature in the hospital. Let us look at traffic numbers maybe format by format in April and May, right? If we take April, we see Pyaterochka as neutral in terms of traffic, Karusel as positive and Perekrestok being, let us put it this way, the negative leader for traffic with minus 2.2%. All that adds up to minus 0.2%, which is, frankly speaking, a number within the rounding error. Of course, there is a clear issue in Perekrestok. In May 2014, we see Pyaterochka is slightly negative (0.6%), but again nothing dramatic, especially given the overall performance. We see Karusel again positive with 1.2% and Perekrestok which is showing minus 3.6% in traffic. And I think we have been open about Perekrestok. We have been telling during the last call and we have been telling during this call that this format is in its transition state. They are finding the new model, they have prepared the new concept which is communicated and they started to implement it. They have been in the process exactly at that time in April and May. They have been in the process of building up the category management. And the last point, which I want to make, is they did not open a lot of new stores. With the aging store base, as we all know, it is more difficult to make more traffic. So I would narrow down the issue of traffic to Perekrestok, frankly speaking, in April and May. And I think that we could expect much better numbers of Perekrestok once this transformation is finished. And as an example we can take Pyaterochka. Look what happened there, once the work has been completed.

Svetlana Sukhanova: Sergey, all is fair. Thank you.

Operator: Our next question comes from the line of Nikolay Kovalev from VTB Capital. Your line is now open.

Nikolay Kovalev: Hello to everybody, I have two questions. The fist one: I want to clarify how significant your outstanding income tax provisions are and how likely those could be eliminated in the next several quarters to decrease the effective tax rate. What is the outlook, in general? The second question is on the latest shareholder structure. In the press-release dedicated to the unhappened Tamerlan acquisition, you disclose the share of Pyaterochka founding shareholders around by 2% lower. I was thinking that you might have the latest register and can share with us who was the actual selling shareholder of 2%? Thanks.

Sergey Piven: OK, first on the last question. I do not think we can comment on the absence of Pyaterochka founding shareholders. I think you could probably call them and ask them about their plans and exactly what they did. And the first question on tax provisions. I also think that we cannot today forecast the tax provisions because they are made in line with the IFRS rules reflecting the tax risks that appear within our view. That said, we probably cannot answer your question right now. I think we should look at the actuals in terms of taxes and in terms of tax provisions. You know, broadly, our programme,— we have created the consolidated group of taxpayers and we are working along those lines trying to make our taxes as effective as possible, but staying within the framework of legislation. That is most of what I can say. We will be managing them very carefully, but we are not going to give out any projections on that.

Nikolay Kovalev: OK, thank you.

Operator: As a final reminder, if you have any further questions, please press “*”and “1” on your telephone. We have another question from the line of Maryia Berasneva from Morgan Stanley. Your line is now open.

Maryia Berasneva: Thank you for taking the question. One more clarification on debt from me. I would like to understand how much of the debt you are still looking to refinance this year.

Sergey Piven: The exact number does not come to mind immediately. If you give us a little bit of time, we are ready to take other questions in the meantime. And I will come back to you, Maria, as soon as we get this number.

Maryia Berasneva: Sure, and may be just one more thing from me. If we disregard the committed lines of credit, if you were to go to the market today, do you see there is a vast availability of financing, in general, for the corporates, or do you think it has not largely changed, so far?

Sergey Piven: I think the availability for refinancing has not changed a lot, but the price has changed. We can speak for ourselves of course, it is better that we speak for ourselves. We have financing available. We also secured this financing in these times through the credit lines. We just approved another RUB 20 bn committed credit line, to be on the safe side, as prudent people. But what we hear from the market is that financing for other companies is also available. But the price, of course, follows the Central Bank rate and the perceived market conditions, so yes, it is more expensive now to finance than last year, but I do not think there is a credit crunch in the country.

Maryia Berasneva: Surely. Thank you.

Operator: If you have any further questions, please press “*” and “1” on your telephone. There are no further questions at the moment. I now hand back to our presenters.

Gregory Madick: Well, thank you. That concludes the call for today. Maria, we will get back to you offline on the amount of debt that we plan to refinance by the end of the year. And I would like to remind everybody that on the 29th of October we will be hosting our Capital Markets Day here in Moscow with a field trip, optional field trip, the next day to our new distribution centre in Rostov. Thanks again. And we look forward to talk to you in October. Bye.

Transcribed by IB Translations
www.ib-translations.ru | +7 495 984 3510 | info@ib-translations.ru