X5 Retail Group N.V.
Q2 and H1 2021 financial results
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Edited transcript

Speakers:
- Natalia Zagvozdina, Head of Corporate Finance and IR
- Igor Shekhterman, CEO
- Vsevolod Starukhin, CFO
- Sergei Goncharov, General Director of Pyaterochka

Participants asking questions:
- Kirill Panarin, Renaissance Capital
- Elena Jouronova, JP Morgan
- Henrik Herbst, Morgan Stanley
- Nikolay Kovalev, VTB Capital
- Maria Lukina, BCS
- Marat Ibragimov, Gazprombank
- Maxim Nekrasov, Goldman Sachs

Operator:

Good day and thank you for standing by. Welcome to the X5 Q2 and H1 2021 financial results conference call. At this time, all participants are in listen-only mode. After the speakers' presentations, there will be a Q&A session. To ask a question during the session, you will need to press "*1" on your telephone. If you require any further assistance, please press "*0". Please be advised that this conference is being recorded. I would now like to hand the conference over to our first speaker today, Natalia Zagvozdina, Head of Corporate Finance and IR. Thank you, please go ahead.

Natalia Zagvozdina:

Thank you. Good morning and good afternoon, ladies and gentlemen. On behalf of X5, let me welcome you to our call today, which is dedicated to our Q2 and H1 2021 financial results presented in accordance with IFRS 16, as well as pre-IFRS 16, accounting standards. Please note that management will be discussing the results on today's call on a pre-IFRS 16 basis. We would like to remind you that some of the information announced during this call may contain projections and forward-looking statements regarding X5's future financial performance or events. Please refer to page 13 of our press release for a full formal disclaimer. The press release and financial statements were published this morning and are available on our website in the Investor Relations section.

Today we have three speakers on the call: the CEO of X5 Group, Igor Shekhterman; Vsevolod Starukhin, our CFO; and Sergei Goncharov, General Director of Pyaterochka. Unfortunately, Igor will need to leave after his presentation, so Vsevolod and Sergei will be taking your questions in the second part of this call.

Without further delay, let me pass the floor to X5 Group's CEO, Mr Shekhterman. Igor, please.

Igor Shekhterman:

Natalia, thank you. Good morning and good afternoon, ladies and gentlemen. Thank you for joining our call today. I will start with an update on X5's operations and key achievements over the last few months. I am delighted to welcome on the call Vsevolod Starukhin, who joined us as CFO in May – he will provide more details on our results and give an overview of YTD trading. After that, the General Director of Pyaterochka, Sergei Goncharov, will give an update on our core format's performance and key initiatives at Pyaterochka.

Let me start with our results. Revenue increased by 10.7% y-o-y: 9.6 p.p. of this growth was contributed by offline sales and 1.1 p.p. by our digital businesses. Despite last year's high base, when we were dealing with panic buying and lockdown effects, X5 delivered double-digit growth for the quarter. We can confirm with confidence our previously announced guidance of a revenue growth above 10% in 2021. We continue to gain market share. In absolute terms, we are adding more incremental sales than any other retailer in Russia. Our gains in market share are a reflection of the work we have done to improve all aspects of our customer offer and of the high standard of customer service we are delivering both in-store and online.

In H1 2021, our express delivery services and Vprok online hypermarket fulfilled over 10 mln orders and 77,000 orders on peak days, which allowed us to sustain market leadership in e-grocery by total GMV for both Q2 and H1. Our GMV in Q2 reached RUB 11.9 bln, and in H1 it totalled RUB 23.6 bln – a 2.8x increase on last year's base. For FY 2021, we expect GMV from our online sales to be in the range of RUB 50 bln. In Q2, total monthly active users (MAU) of X5 digital services increased by 82% y-o-y to 13.7 mln. Our recently launched food.ru media platform should help us to further increase our online audience.

Our gross margin remained flat y-o-y in Q2 2021, which we consider a solid result given the competitive pressure from both offline and online players. Despite rising operating costs, for which there were some one-off and some structural reasons, we were able to deliver an EBITDA margin of 8.3% for Q2 and 7.7% for H1 before LTI.

While the pandemic is not over, we aim to be flexible and to provide customer-oriented service. We have been able to retain a strong level of consumer demand by continuing to adapt to changes in consumer behaviour. These behaviours include remote work, higher online demand and a preference for healthy and fresh products. We continue to improve our core business, while developing our digital businesses and online capabilities.

Now I would like to say a few words about the operating environment for X5 in Q2 and at the beginning of Q3. Since April, we have been seeing a gradual normalisation in the frequency of in-store transactions and in basket size, which is something we expect to continue. We see increasing consolidation trends in the Russian market, and generally positive ones. The share of the top five players in Russia is just 32%, while in other European markets it exceeds 60%–70%. Recent acquisitions in large cities indicate that competition will be accelerating there, but returns on such investments remain to be seen. Market consolidation is generally positive for the consumer and the economy and could also result in higher predictability in terms of promo activity in the market.

The recent deals have not had an immediate impact on X5, as the acquired players had always been our competitors. Moreover, consolidation is not the only factor affecting the sector: new disruption is coming now from digital players providing grocery and food delivery.

The external environment in the e-grocery segment continues to be very competitive, with many technology players promoting their services with significant marketing budgets. This has contributed to a structural shift towards fast delivery services for consumers, not only in the capitals but in the regions as well.

In H1 2021, the e-grocery market continued to deliver strong growth, increasing in value by 2.5x y-o-y. The GMV of X5's online sales has increased by 2.8x this year, which is quicker than the market and has therefore helped to improve our market share in e-grocery. While growth in the online grocery segment in Q2 slowed to 88% from 324% in Q1, this was only due to the high-base effect of the COVID lockdown. INFOline forecasts that the e-grocery market will increase in size by 2.6x in the current year, and we agree with this projection. In our view, due to COVID, consumers have become used to buying groceries online and having them delivered faster than before, and this habit is only being supported by the marketing efforts of the new players. This is, of course, positive for market development. One structural shift that we are now observing in the e-grocery segment is the growing popularity of deliveries within one hour, which we are responding to by expanding our express delivery capabilities.

One side effect of such growth in the online offering is the temporary shortage in the logistics workforce in some markets, especially in Moscow and the Moscow region. This situation has been further affected by the migrant labour deficit in the country due to COVID restrictions. In July, X5 experienced delivery shortages in its Moscow Pyaterochka operations, which led to stock shortages, especially in the fresh categories, fruit and vegetables. We responded to this situation by indexing the wages of our drivers who supply stores out of our DCs as well as the wages of our DC staff. We aim to be slightly above the Moscow regional market for this type of workforce and to make sure that the July situation does not repeat itself. Despite the stock shortages in some categories, July retail sales growth remained above 10%. Competition for logistics and store workers is currently a challenge across the entire market. Our company is working towards better personnel retention, which may require some additional investments.

COVID vaccination rates and COVID-related restrictions differ across Russian regions. We are taking steps to promote vaccination in order to protect the health of our employees and ensure uninterrupted operations. At X5, around 130,000 employees have received either one or two doses of a vaccine. We estimate that, in 2021, the total cost related to vaccinations will amount to RUB 350 mln, most of which will arise in the second half of the year.

Now let me give you a brief overview of strategic initiatives and new businesses in Q2.

We continued our programme to refurbish Pyaterochka and Perekrestok stores. The new-concept stores continue to demonstrate significantly higher LFL sales growth and NPS levels than the old concept. By the end of June, they represented 21% of all Pyaterochka and 17% of all Perekrestok stores. LFL sales in our refurbished stores increased by 5 p.p. for Pyaterochka and by 12 p.p. for Perekrestok. The Pyaterochka team has already reduced its refurbishment capex to the level of RUB 18 mln and is aiming to bring this down by a further 10% next year. Sergei Goncharov will elaborate on this subject later on.

Digital business net sales as a share of X5's consolidated net sales saw the fastest growth in Moscow and the Moscow region, where the share of digital sales for Q2 2021 reached 3.6%, compared with an average 2% contribution to total sales for X5 Group.

Vprok continued to expand based on its existing infrastructure of four dark stores. The total number of orders increased by 13% y-o-y and exceeded 1 million in Q2 2021, delivering growth despite the high base in Q2 2020. The average Vprok basket in Q2 2021 increased by 6.3% y-o-y, reflecting further expansion in the assortment to 69,000 SKUs. This also reflected a more normalised basket compared with Q2 2020, when a full lockdown was in place for the most of the quarter. In Q2 2021, Vprok expanded its regional delivery network to 42 regions by using the existing 5Post infrastructure.

We are in a good position to continue capitalising on higher online demand with fast delivery. We are continuing the rapid expansion of express delivery services from Pyaterochka proximity stores and Perekrestok supermarkets. This service fulfilled on average 46.6 thousand orders per day in Q2. It is now available from 1,450 stores in 36 regions, compared with 439 stores and only 6 regions a year ago. In addition, ready-to-eat food delivery was available from over 200 restaurants via the Okolo aggregator app. Okolo has expanded to major Russian cities: it is now available in St Petersburg, Voronezh, Nizhny Novgorod, Kazan, Krasnodar and Rostov-on-Don.

Through our loyalty programme, we see that around 25% of express delivery customers are new for us, and the average monthly spending of an omnichannel customer is 37% higher compared to our loyal, but purely offline, customers.

The 5Post e-commerce delivery service fulfilled 4.7 million orders in Q2 2021 from 19 thousand pickup points and is about to become firmly EBITDA-positive this year.

In June, we announced the restructuring of our digital businesses – the Vprok online supermarket, express e-grocery services and Okolo aggregator platform – into a separate business unit within X5. Developing digital businesses is one of our priorities under our 2021–2023 strategy. To achieve this, we intend to crystallise the value of our digital efforts and make them transparent to our customers and partners. We will communicate more details about the timeline and the steps we will take to develop the new business in due course.

We continue piloting our Chizhik hard discounter format. Customers have responded positively to the first stores we opened in Moscow and the Moscow region. According to surveys, the main advantages of our Chizhik stores are their low price, the ability to make quick purchases, our friendly staff and the pleasant atmosphere in stores.

Russian customers remain price-sensitive and take a very rational approach to purchases.

We currently have 20 Chizhik stores, but plan to increase this number to 50–70 stores by the end of the year and open several hundred stores in 2022. We consider hard discounters to be an attractive segment of the Russian food retail market. The hard discounter format accounts for less than 3% of the Russian market compared to 20%–40% in mature European markets. Using our existing logistics infrastructure and purchasing power, we see an opportunity to provide an attractive customer offering. By the end of this year, private label goods will account for 40% of Chizhik sales, up from the current 10%. Without disclosing any precise figures, we expect that the sales density and labour productivity of our hard discounter format will be at least 50% higher than those of other leading Russian retailers. Our pilot has fully confirmed this assumption, and in 2022 we will open several hundred Chizhik stores.

To be present at all stages of the customer journey, which starts long before the customer enters one of our stores and stretches into the online environment, we launched our own food.ru media platform. Consumer preferences are increasingly shaped by the media, particularly social networks, food-related sites, blogs and podcasts. Food.ru is an important communication channel that connects X5 with our customers at the purchase planning stage. In July, the platform's MAU already totalled over 3 million in addition to over 6 million subscribers through social networks and messengers. The amount of content we have created exclusively in-house for this platform exceeds 10,000 units.

We expect the launch of food.ru to improve the user experience and satisfaction of our customers. This will be achieved by enriching the Company's user data in order to improve the quality of personalised offers. Also, the use of a media platform will create a seamless user experience. In the future, for example, you will be able to go from a recipe you like on food.ru to an online supermarket or an express delivery service and see a basket already put together on the basis of the recipe. In addition, tips from food.ru will be integrated with the shelves in offline stores. For example, users will be able to scan QR codes in stores to get recipes that can be prepared using the products on a particular shelf. In addition, integration into retail chains will make it possible to provide customers with ideas on what can be cooked using the products currently on promo.

The Mnogo Lososya ready-to-eat online service, which became part of X5 Group in late March 2021, expanded to St Petersburg. It was operating 30 dark kitchens as of the end of June, and it delivered over 2.4 thousand daily orders in June with an average ticket of RUB 1,500. Currently, 24 sushi points operate in

Perekrestok stores, and in August we are piloting delivery from Pyaterochka dark stores. Next year, Mnogo Lososya will enter six new cities: Nizhny Novgorod, Kazan, Ekaterinburg, Novosibirsk, Rostov and Krasnodar.

We continue testing a subscription service that will offer customers the opportunity to receive special discounts at X5 and its partners' stores. We are also working on the development of fintech services together with Alfa Bank. Together with Alfa Bank, we will begin to provide financial services to the Company's customers. We plan to launch the MVP for a payment service in Q4. In particular, the payment system will be integrated into the mobile applications of all X5 businesses. At the beginning of next year, we plan to launch full-scale banking services featuring a bank card and unique offers for X5 customers.

Our management is currently updating our three-year plan for 2022–2024, which will be presented to you at our Capital Markets Day. It is scheduled for 27 October. We will focus on the pathway to supporting double-digit growth and further increases in efficiency to support profitability.

Finally, I am proud of our ongoing effort to drive sustainability in the business, including ESG disclosure. In May, we published our first sustainable development report under GRI standards, which captures our progress to date against the medium- and long-term goals set out in our sustainability strategy. I am confident that we will meet our targets for 2023 and 2030 and be a leading contributor to sustainable development and achieving the United Nations Sustainable Development Goals. Our progress to date has already been noticed at the international level. For example, MSCI ESG Research upgraded X5 Group's sustainability rating from BB to BBB, and X5 was ranked first among retail companies for its performance in sustainable development by the rating agency RAEX Europe.

Now, I would like to pass the floor to our CFO, Vsevolod Starukhin. Thank you for your attention.

Vsevolod Starukhin:

Thank you, Igor. Good morning and good afternoon, ladies and gentlemen. Thank you all for joining our call today. Let me start with the macro environment, after which I will give an overview of our financials under pre-IFRS 16 and provide you with some insights on key quarter-to-date results.

Food inflation in Q2 remained high at 7.3% y-o-y, peaking at 7.9% in June. The key drivers persist: inflation of fruit and vegetables at 8%, sugar at 42%, eggs at 41% and vegetable oil at 26% compared with the previous year. This was influenced by the acceleration in global soft commodities price inflation and poor harvests. The exchange rate remained rather stable and did not add much to food inflation during the quarter.

Growth in nominal wages accelerated to around 10% in Q2 vs 2020, compared to 6.9% in Q1 2021, which supported domestic consumption.

Unemployment in Q2 decreased to 4.9%, compared to 5.6% in Q1 2021.

The migrant labour supply started to slowly recover: the number of labour permits issued in June declined by 13% y-o-y compared to the 42% y-o-y decline in March, but the shortage of entry-level labour in the market is still noticeable, especially in the retail industry, which Igor has already mentioned.

Let us look at the margins in Q2. As Igor has already spoken about our revenue growth drivers, I will not repeat what he said. Pyaterochka, Perekrestok and our digital businesses were the main contributors; the contribution to our revenue growth from selling space expansion and LFL was comparable for the quarter.

We managed to keep our gross profit margin flat y-o-y at 25.3% in Q2. Two items put pressure on our gross margin in Q2. First, we experienced higher logistics costs owing to the rising market competition for logistics personnel from online players, which was further impacted by higher COVID cases and the low supply of migrant labour. Second, we had slightly higher shrinkages in fresh categories in Q2 due to the abnormally hot weather in our operations' core regions. In H1 2021, however, our shrinkage level was down 10 b.p. y-o-y. These negative effects were fully mitigated by better commercial terms, a favourable product mix that reflected the abnormally hot weather in the central part of Russia and stable promo levels y-o-y.

In Q2 2021, SG&A expenses, excluding depreciation, amortisation, impairment, LTI and share-based payments, as well as the impact of the Karusel transformation as a percentage of revenue, increased by 39 b.p. y-o-y mainly due to growth in courier costs in our fast-expanding express delivery service, followed by higher staff costs and marketing expenses. Courier costs increased in line with the physical expansion of our express delivery service to new regions, while we continue working on per order courier cost reduction by improving couriers' utilisation rate. Higher staff costs were driven by the hiring of additional personnel at Pyaterochka to continue the format's digital transformation. In Q2, we also executed our planned salary indexation for in-store personnel across our regions. The level of salary indexation was slightly above the CPI level for the period. Beyond the reporting period, in July, we started increasing wages for our logistics personnel, according to our annual schedule, and also responding to the more challenging situation with labour in Moscow and the Moscow region. Finally, the level of marketing expenses in Q2 normalised against revenue, as they were lower last year on the back of elevated revenue during COVID.

As a result of a stable gross margin and minor pressure from operating costs, our adjusted EBITDA margin totalled 8.3% in Q2 2021 and 7.7% in H1 2021, which we consider a solid profitability result given the ongoing investments in our new businesses.

In H1 2021, the total negative impact on EBITDA margin from our digital sales, which include Vprok.ru Perekrestok, express delivery from Pyaterochka and Perekrestok stores, the Okolo aggregator and 5Post, is estimated at 38 b.p., up from 16 b.p. in H1 2020. Our core offline business, represented by Pyaterochka and Perekrestok, excluding their express delivery sales, demonstrated a solid 8.2% margin in H1, flat y-o-y.

LTI and share-based payment expenses amounted to RUB 1.2 bln in Q2, which was higher than in previous quarters due to structural changes. In Q2, we continued to accrue a liability for the deferred conditional payout related to the previous LTI programme for 2018–2020, and started accruals for the new LTI programme for 2021–2023 alongside the new LTI programme for our new businesses – 5Post, Chizhik and Okolo – including the previous periods. Going forward, the accruals will be lower compared to Q2 2021, at around RUB 800–900 mln per quarter.

D&A and impairment costs increased as a percentage of revenue by 30 b.p. to 3.4%. This was mainly due to the increase in the gross book value of assets, which outpaced revenue growth, and the accelerated depreciation rate, which was driven by the increased number of refurbishments at Pyaterochka and Perekrestok: we did 805 store refurbishments in H1 2021, more than twice as many as in H1 2020.

In Q2 2021, net finance costs declined by 6.2% y-o-y driven by a fall in the weighted average effective interest rate on X5's total debt from 7.3% for H1 2020 to 6.1% for H1 2021 as a result of lower interest rates in Russian capital markets, as well as actions taken by X5 to minimise interest expenses.

X5's effective tax rate for Q2 totalled 25.2%, including the accrual of deferred tax associated with potential dividend payments.

In the reporting period, the Company's net profit margin, in line with EBITDA margin trends, decreased by 35 b.p. y-o-y to 3.0%.

Let us turn to our financial leverage. At the end of Q2, our net debt/EBITDA ratio was 1.68x. Going forward, we aim to maintain this ratio at a comfortable level below 1.8x while continuing to pay dividends.

Turning to cash flow. In Q2, the net cash flow from operating activities was RUB 36.7 bln. In H1 2021, our operations generated RUB 61.1 bln in operating cash flow, which is up 7% y-o-y and reflects both the growth of our business and the solid profitability of our operations.

The positive change in working capital of RUB 932 mln in Q2 2021, compared to the negative change of RUB 15 bln in Q2 2020, reflects the normalised seasonality of working capital trends. The abnormal negative change in working capital that occurred in Q2 2020 was due to inventory turnover and changes in accounts payable owing to the fact that consumers were stocking up in March 2020 ahead of tough COVID restrictions.

Now, a few words about capex. X5's total capital expenditure amounted to RUB 23 bln in Q2 2021 compared to RUB 21.6 bln in Q2 2020. The growth of 6.5% was primarily driven by the front-loaded number of refurbishments in our proximity format: 368 Pyaterochka stores were refurbished according to the new concept in Q2 2021, which is 3.6x more than a year ago.

In H2 2021, we plan to refurbish about 200 Pyaterochka and 25 Perekrestok stores, so we can say that only 20% of refurbishments are left to be done in H2. Thirty-six per cent of capex in Q2 went to the expansion of our store base, 27% to refurbishments, and another 14% to regular maintenance, altogether amounting to 77% of our total capex for the quarter. Logistics capex was 2% of the total, IT represents 6%, with other investments accounting for 15%, which is RUB 3.5 bln on a quarterly basis and consists of capex on digital businesses, efficiency projects for the retail chains, the Corporate Centre and the business support function. In H1, our capex totalled RUB 43.6 bln, which was slightly below our budget for the respective period, mostly due to the changes in the implementation of various IT and efficiency projects.

Finally, I will give an update on the QTD results, as well as our annual guidance. Net retail sales in Q3 have so far grown by 10.5% y-o-y, and LFL sales have risen by 3.6%. Both LFL traffic and average ticket have been positive since July. Some 1,500 new store openings are confirmed across all formats, including pilot Chizhik stores. Refurbishments will take place at around 1,100–1,200 stores, slightly lower than the 1,300 mentioned in our original guidance. Our current expectation is that capex for 2021 should not increase ahead of our revenue growth. And, finally, our year-end EBITDA margin guidance has been upgraded to at least 7.3 p.p. from about 7 p.p. before given the strong margin we achieved in Q2. With that, I would like to conclude the discussion on our results and hand over to Sergei Goncharov for an update on Pyaterochka's performance, our main growth and profitability driver.

Sergei Goncharov:

Yes, thank you, Vsevolod. Good morning and good afternoon, ladies and gentlemen. I will start with an update on Pyaterochka's operations and key achievements over the last quarter. After that, our team will be happy to take your questions. Let me start with our results. Pyaterochka's net retail sales increased by 10.3% y-o-y in Q2 2021; 9.9% of that growth was contributed by offline sales and 43 b.p. by express delivery. Our stores are getting stronger, and our e-commerce capabilities are expanding as we continue to grow. Pyaterochka generates more than 80% of X5 Group's consolidated sales and 90% of EBITDA profitability. Pyaterochka's EBITDA in H1 2021 reached a margin of 8.4% after LTI. The impact of express delivery on EBITDA in H1 2021 totalled 13 b.p., which we consider quite manageable. The main margin support came at the growth margin level, where a solid commercial margin and a stable share of promo were the main positive drivers. I would also like to reiterate our continued focus on the efficiency of our operations, including our focus on lowering shrinkages. Just to inform you, our shrinkages level reached 2.9% in H1 2021 and 2.8% in June as a percentage of net sales. As a reminder, it is 1.3 p.p. below the figure of about three years ago. We will continue our work in this respect, as we believe that this is one of our key profitability levers. Pyaterochka's revenue growth was supported by a 7.8% y-o-y increase in selling space and LFL performance.

Our network expansion this year is currently slightly ahead of our initial plan of 1,400 stores on a growth basis, and today I estimate that our format will grow by 1,400 stores this year before any store closures. We already have 3,560 new-concept stores, of which 1,405 are stores that have been refurbished since 2019. Refurbishment contributed positively to our 3.7% LFL sales growth, as new-concept stores have LFL that is 5 p.p. higher than that of old-concept stores. Our positive LFL reflects a record-high NPS level of 10 p.p. as of June 2021, which will provide long-term structural support to Pyaterochka's LFL sales. In addition, I would like to point out that net sales grew by 10% in H1, and EBITDA increased by 15%, which signifies 50% higher growth in profitability vs sales.

Starting in April, we have seen a reversal in some trends we witnessed last year. Customers are now making visits to stores more frequently, with a smaller basket size compared to 2020. LFL traffic increased by 13 p.p. y-o-y, while the LFL basket decreased by 8.3% in Q2. This is mostly due to the smaller number of items customers are buying. The average check at Pyaterochka has normalised at RUB 400 in Q2 2021.

Given the strong positive customer response to our new-concept stores, we frontloaded our refurbishments in H1 2021, and in Q2 we refurbished 368 Pyaterochka stores, bringing the number of refurbishments in H1 to 793 stores. In H2 2021, we plan to refurbish around 200 Pyaterochkas so that the annual total number reaches 1,000. We opened 659 new-concept stores in H1, and the total number of stores operating under the new concept reached 21% of the Pyaterochka store base as of 30 June 2021.

As you know, the equipment and construction costs per store depend on a number of factors, including the region and needs of local customers. We are constantly making changes to adjust capex by using simpler but more durable materials and equipment while improving the customer experience through a better assortment and convenience. The new Pyaterochka store – its new concept – is continuously evolving and improving. The number of closures remained at a low level of 46 stores during the quarter, which reflects the increased quality of new openings in recent years.

In H1 2021, the food retail industry faced a number of challenges. High food inflation makes it difficult to shift price increases entirely onto the shelf, but we were able to balance out the negative impact of rapidly rising food inflation and prices, and maintain customer loyalty thanks to the efficiency of our business processes, including our big data–powered assortment, planning and pricing, as well as automation of various operational processes. At the same time, we maintained our promo level at around 35% of revenue, which was stable y-o-y and allowed for solid margin performance in the quarter, as I indicated earlier.

Among other challenges, we are experiencing a temporary shortage in our logistics workforce in some regions, driven by the deficit in migrant labour in the country due to COVID restrictions, which led to temporary shortages in our stores. This was most notable in the Moscow region. We responded to this situation with a number of initiatives, including transporting deliveries to neighbouring DCs with enough capacity, indexing the wages of drivers and DC personnel based on HR monitoring data, and introducing extra seasonal payments. Other measures included strengthening our recruitment function as well as increasing our outstaffing capacity.

In H1 2021, we first experienced an abnormally cold and snowy winter followed by an abnormally hot summer, especially in the central part of Russia and in Moscow. This led to an increase in utility costs due to high electricity consumption and snow removal services in January–March. In Q2, the hot weather positively impacted our sales mix in high-margin categories but also led to some growth in shrinkages in fresh categories; however, we dealt with that very well, as I mentioned earlier. Overall, in H1 2021, our chain delivered an 11 b.p. decline in shrinkages, and we see further scope to reduce this, as I also noted. The number of active Pyaterochka loyalty card users increased by 8.4% y-o-y to 46 mln. In June, loyalty card penetration in our sales reached 80%, while penetration in traffic was about 65%. The average ticket of a customer with a loyalty card was more than twice the average ticket of a customer without one in Q2 2021.

Pyaterochka is better positioned today to connect with our customers online than before the pandemic. In June, the total MAU of the Pyaterochka mobile application was 7.6 mln, an increase of 55% y-o-y. Pyaterochka's data capabilities contribute to a more personalised customer experience. We are scaling our CVM system, increasing the share of personal promo and reducing the share of mass promotions. The CVM product already has positive EBITDA, with personal communications reaching 23 mln customers. Further to our personalised offers, our online customer feedback programme already has 140 mln ratings from 4.5 mln loyal customers. Customers can now decide how and when they want to shop, and they will find us ready when they want to shop at a store or have their order delivered. We continue to develop our express delivery service. As of June, the service was available in 864 stores, and the number of delivered orders reached 2.4 mln during Q2. Just to remind you, we started the service in February 2020 with just 300 orders per day, and now we deliver about 30,000 orders per day. Unlike its tech competitors, however, Pyaterochka already has a well-developed infrastructure of retail stores across Russia. Given our leadership position in the Russian food retail market, we can offer the best prices, and our stores can reach 50% of the Russian population within 30 minutes. In addition – due to high brand recognition – customers trust the quality and prices of our products and believe that we provide the same level of service in express delivery as we do at our physical stores. Brand Finance rated the Pyaterochka brand as number six in Russia, ahead of such consumer brands as MTS, Yandex and Magnit. This news came out just a couple of weeks ago.

We are working to increase the efficiency of our express delivery service. In Q2, we reduced the delivery time and the cost of assembling orders to 47 minutes and RUB 141 per order, respectively. In June, the service reached a positive EBITDA in Moscow on a cash basis before marketing costs and HQ allocation costs. We are piloting dark stores to provide express delivery, having added five new dark stores this year. This brings the total number to 13, all of which are located in Moscow. Many of you may think that Pyaterochka is at its maximum capacity in Moscow. However, this is not the case. We continue organic development in Moscow and aim not to overpay for acquisitions, engaging in organic development in a highly profitable and well-known market for us. We have also revised our approach to refurbishments. We are improving stores where the environment requires it. In the regions where we are limited by the market share threshold, we are relocating our stores to more attractive locations and developing franchising operations. We plan to triple the number of franchisee stores by the end of 2022. The mechanics are already well developed. We give our partners an operating model and carry out high-quality control of compliance with all requirements and all operations that require the high-quality customer service to which our guests have become accustomed.

We are changing our approach to private label development at Pyaterochka by recognising and prioritising quality. We are actively developing the private label category, with the current share of sales at slightly above 20% in H1 2021. The average quality rating by customers is 4.7 points out of five for this category. Sales of private label products increased by 32% in H1 compared to the 10% growth of our format overall. Out of Pyaterochka's top 100 products based on customer ratings, 20% are private label. In H1 2021, we held over 1,000 tastings in order to further improve the quality of our private label goods. The share of our ready-to-eat assortment reached almost 1% in H1 2021 – an increase of 0.4 p.p. y-o-y – and sales of this assortment increased by almost 100% y-o-y.

The focus of Pyaterochka's management remains on maintaining the strength of our customer relationships through loyalty, value and convenience. We are maintaining our commitment to making it more attractive to shop at Pyaterochka. Our success is evaluated internally based on Pyaterochka's NPS and LFL. Pyaterochka's management has set ROIC as one of the core KPIs for the chain. Hence, our growth is measured against the efficiency of our investments. With that, I would like to conclude the discussion of our results, thank you for your attention and open the floor to your questions. Thank you.

Operator:

As a reminder, to ask a question you will need to press "*1" on your telephone, and to withdraw your question, please press the "#" key. Once again, if you wish to ask a question, please press "*1". Our first question comes from the line of Kirill Panarin from Renaissance Capital. Your line is open. Please ask your question.

Kirill Panarin:

Hello everyone. Thank you for the call. Two questions from me. First, I would like to get a bit more colour on the issue of the lack of logistics employees… What was the impact on the Q2 margin? How material was the increase in salaries that you mentioned, and what pressure on the margin do you expect from this in H2? Finally, could you confirm that there is currently no impact on operations, availability, etc.? That is the first question. My second question is on Pyaterochka. Can you update us on the profitability level in the new-concept stores, and whether we can expect the growing share of the new concept to drive the upside or downside vis-à-vis the Group's margin? That's it. Thank you.

Natalia Zagvozdina:

Thank you, Kirill. Sergei, could you start on the logistics? I just have to note that we do not disclose the exact profitability level of the new concept, but it does not deviate that much from the profitability you see for the format overall. It has higher sales density but a similar EBITDA margin. Sergei, please.

Sergei Goncharov:

Yes. What Natalia just said is exactly right regarding the profitability of the new-concept stores. As for the situation with logistics, indeed, starting in July we have been experiencing a temporary shortage in our logistics workforce in some markets. It was particularly noticeable in Moscow and the Moscow region. This situation was mostly caused by the increased demand for logistics personnel; the demand for personnel came from both traditional retail players and e-commerce players. This was an industry phenomenon in July. As for the impact on our sales, it was approximately RUB 2 bln. We do not see any significant or material impact on either our sales level or profitability level.

In terms of our actions, I want to highlight that in July we had a planned indexation for our supply chain personnel, and this is within our projected figures. We aim to be slightly higher in Moscow and regional markets for this type of workforce to make sure that the July situation does not repeat itself. This is a strategic priority for us and, as I have said, despite shortages in some categories, July retail sales growth remained double-digit for Pyaterochka and X5 overall. As a matter of fact, we saw acceleration of our sales growth in July compared to H1 2021.

Kirill Panarin:

Okay, that's great. Thank you.

Operator:

The next question comes from the line of Elena Jouronova from JP Morgan Moscow. Your line is open, please ask your question.

Elena Jouronova:

Good evening, ladies and gentlemen. I have a few questions. First and foremost, please do not take this as a criticism, but I think we did find that LFL sales growth in Q2 was a bit low. Maybe I am wrong, but could you please explain to us if that is really in line with your plans and targets? Maybe you could do something to accelerate LFL sales growth? That is the first question.

Sergei Goncharov:

I will take that one. The thing is that, yes, our LFL sales growth in Pyaterochka was 3.7%, but it is important to look at the composition of that number. Our traffic increased by 13 p.p., while the average basket decreased by 8.3 p.p. on an LFL basis. We do not look at the LFL sales number in a particular period as an isolated number – we look at it as a trend. And what we see is a really positive trend, a real increase (we think in real terms when it comes to traffic as opposed to nominal terms). The basket can be improved by a number of actions, such as increasing promo, which will increase the basket size, or dropping the prices on certain key value indicator products like chicken or bananas. However, we stay away from such tactics and measures, because we want high-quality growth of our sales, and we are very encouraged by the 13% traffic increase without our resorting to such methods.

Elena Jouronova:

Okay. That is understood. You mentioned higher margins and profitability growth, so that means perhaps you did not invest too much in promo in Q2, and gross margins stayed stable and strong. Does that mean the competition is benign and you are not really under pressure to make more investments in price in H2 2021?

Sergei Goncharov:

First, I will explain about H1 and then about H2. Of course, the competition is there. It did not disappear. What we see though, and what you see in terms of our profitability and gross margin, is that we are now able to translate our initiatives and investments in our digital products and initiatives that we started about 2–2.5 years ago. As you remember, we explained some time ago our new approach to price formation and how we are still able to keep the image of Pyaterochka as a low-price store, which is confirmed by increased LFL traffic, and yet maintain reasonable marginality in terms of the basket. This sort of approach would have been impossible without the big data–backed instruments that we developed in our pricing model.

Talking about the expectations for H2, we do not have such plans at the moment. However, the situation may change in the future. We are committed to delivering high service quality to our customers while still being one of the most attractive players in the market from the pricing point of view.

Elena Jouronova:

Thank you, Sergei. Can you please say what the LFL values are roughly in Moscow and the Moscow region? You probably cannot disclose the number, but maybe just the direction vs the average LFL you reported for the format.

Natalia Zagvozdina:

Lena, we cannot disclose it, sorry.

Sergei Goncharov:

But I can comment on the dynamic: we are quite pleased with what we have done in Moscow.

Elena Jouronova:

So, you have positive LFL in Moscow, correct?

Sergei Goncharov:

Yes, our dynamic is positive. However, we do not disclose the exact numbers.

Elena Jouronova:

Understood. If I may, I will continue because this is a very important topic. Sergei, you mentioned that you are monitoring traffic, and that is an important metric. So, we are tracking the number of customers at Pyaterochka on a quarterly basis, estimating traffic per store, and we actually see that the traffic per store in Q2 2021 was 7% below vs 2019. We think that 2020 is not a relevant comparison, so we are comparing to 2019. And to me this looks like a pretty significant traffic migration, either because you are facing more cannibalisation, competition or migration to online. How should we think about this dynamic?

Sergei Goncharov:

You are talking about Pyaterochka as a retail chain operating all over Russia, correct?

Elena Jouronova:

Yes. I am taking the number of customers, I think 1.3 billion customers in Q2, dividing that by the average number of stores you had in Q2, and comparing that to what was there two years ago.

Sergei Goncharov:

A very good and incisive question. The answer is that we are expanding quite rapidly, as you know. Since 2019, we have opened around 3,000 new stores, and those stores were opened in the areas where we have lower traffic compared to Moscow and St Petersburg. We are expanding eastward, into areas where traffic is naturally lower. However, what is important is that the traffic generated by our new stores is good enough to achieve our financial targets. And the answer to that is yes, a resounding yes. We are extremely satisfied with the ROI of the new stores. Moreover, the stores which we are opening in those areas, going eastward and southward… away from areas like St Petersburg, where we basically cannot open new stores due to restrictions. So, when we go there, the capex for those stores is lower, and the return is very handsome. I hope that answers your question.

Natalia Zagvozdina:

Thank you, Sergei. Lena, I would also encourage you to look at the number of loyal customers, which for Pyaterochka increased by more than 8% y-o-y, and the fact that loyal customers spend twice as much as passers-by. If you do not mind, we would like to give the floor to other analysts and investors to ask their questions. Thank you.

Operator:

The next question comes from the line of Henrik Herbst from Morgan Stanley. Your line is open, please ask your question.

Henrik Herbst:

Thank you. I have a couple of questions. Firstly, I think you said, if I heard it correctly, that you plan to open hundreds of stores in 2022. I was wondering if you could talk a little bit more about that. Are they going to be new stores or Pyaterochka stores that are transformed into Chizhik? How should we think about that in relation to the rollout of additional Pyaterochka stores? Is this sort of coming on top, or are you shifting spend and focus a little bit?

Secondly, I wanted to see if you could give us a little bit of an update. I know you have kindly given us some information on EBITDA margins from your digital businesses in the quarter. I think you were saying – previously, at least – that you expected Vprok to be EBITDA-breakeven this year. Given that you now put your digital businesses in a separate unit, we do not really know what will happen with that. Does it make sense to make the businesses EBITDA-breakeven already, or has that changed? Has your thinking around investment in those businesses changed in terms of being EBITDA-breakeven? Thank you.

Vsevolod Starukhin:

Okay. Thank you for your questions. The first question was regarding our plans to roll out Chizhik hard discounters. Just to remind you, our target is to finish the year having opened roughly 50–70 stores, which is the pilot phase, where we are fine-tuning the operational model and building up the private label SKUs, which should represent one of the key drivers of efficiency and customer attraction. We will be ready to roll out this model next year and onwards, opening hundreds of Chizhiks. I cannot disclose the exact number at the moment. This is coming on top of the organic expansion plans for Pyaterochka and Perekrestok.

There is no cannibalisation in terms of this expansion; nor will Chizhik be using Pyaterochka stores. In the vast majority of cases, it will be new places. Just to remind you, the target floor space for Chizhik is around 250 sq m. We also have some Pyaterochkas operating in this footprint, but in general this is not a standard sort of a footprint for Pyaterochka; it usually operates in a bigger footprint.

Now, your second question on Vprok. That is true, actually. Like for all our key projects, we have a target for breakeven of about three years, to generate a positive EBITDA in the fourth year onwards. Vprok started very well last year and has continued good growth this year. However, we have faced what Igor mentioned and what you know very well: we have highly intensified competition in the market from fintech players, which sometime last year started investing heavily in food retail, basically making it part of their businesses, and that has significantly increased the competition, the cost of customer acquisition and marketing expenses. This is moving the breakeven point for Vprok a little bit to the right. However, we are still targeting to break even despite this more competitive environment. Thank you.

Henrik Herbst:

Thank you so much. Can you just very quickly clarify on Chizhik. Did I hear correctly that you said the sales density is higher, but your profitability is the same? Is that profitability in absolute terms or in margin terms versus your existing formats? If your sales densities are higher, but your margins are the same, the EBITDA per square metre or whatever should presumably be much higher. Presumably, the investment in opening a Chizhik store should be lower than for Pyaterochka. Is that math right?

Vsevolod Starukhin:

That is a good question. We are still at the stage where we have opened just 20 Chizhiks. I think just yesterday the 20th one was opened. So, we are still testing the business model and have just around a third of private labels operating in these Chizhiks. Thus, at the moment we still have to rely on our business targets and estimates of the profitability of Chizhik. There are some signs that it actually may be better, but let us be cautious. So, the answer is the following: in our original business model, Chizhik was looking to operate as a store with a much higher sales density, much higher label productivity than any other standard offline retailer in Russia. In terms of margin profitability, however, it will be operating, according to our model, at slightly lower margins versus our existing retail chains. However, it will require significantly lower capex to open a store. As such, it will generate a better ROI per store opening compared to Pyaterochka or Perekrestok.

Henrik Herbst:

Thank you very much and sorry for asking so many questions. Thanks.

Vsevolod Starukhin:

Thank you.

Operator:

Thank you. Your next question comes from the line of Nikolay Kovalev, VTB Capital. Your line is open, please ask your question.

Nikolay Kovalev:

Hello. I have two remaining questions, and both of them are more of a strategic nature. The first one is on your online e-grocery business. We saw an update today from a marketing agency, and you kept the No. 1 spot. Congratulations. It looks like this is the prime issue for the investment case at the moment. My question is, correct me if I am wrong, but, from the recent top management comments, it looks like the Company is cautious about gathering a very aggressive pace of investment, marketing and business promotion. This is a bit different from your key competition in the market, which is rather aggressive. Can you comment on the extent to which X5 would like to shield its market-leading position in online food sales?

Maybe you could also update us on the development of a potential JV, which you have anticipated on a rather short-term horizon.

The second question is on the fintech business. Maybe you could speak more about what kind of products you would like to offer, how they can cover your existing business and, potentially, how significant fintech can be in your profits in the future. Thanks.

Vsevolod Starukhin:

Thank you for your questions. Let me start with e-grocery development. I would like to remind you that our target in terms of market share in e-grocery that we have set for ourselves and shared with you last year is to gain a 20% market share in 2023, if I am not mistaken. We are well positioned to deliver on this target in general. However, what we have seen is a sort of fragmentation of online delivery services that is taking place today. Vprok is an online hypermarket primarily covering the food range. However, it has been building up its non-food range as well, with the number of SKUs close to 60,000 and continuing to grow.

The second segment is express delivery from stores, i.e. from the platforms of our Pyaterochka and Perekrestok stores that offer delivery within one hour. Hypermarkets actually have a longer delivery time – a few hours or next-day delivery. Finally, there is so-called express delivery with a very small range. We are not present in this segment, like Yandex.Lavka and other players with deliveries within 15 minutes. All these three segments cover different customer needs and have different dynamics. But we have to say that they are still establishing themselves. All the players are losing money quite heavily and spending a lot of funds, raised either via an IPO or in some other way. They are investing the equivalent of hundreds of millions of dollars in marketing, infrastructure, etc. We believe that we hold the strongest position in express delivery, already operating a platform of 18,000 stores in the country, and this number is growing year by year at a rate of at least 1,500 stores. We have best-in-market commercial power, logistics infrastructure to deliver products from DCs to our stores efficiently, and it is quite easy for us to scale this up. Our competitors, on the other hand, have to invest in overall capability and specific infrastructure to deliver and manage food products, and to try to match our prices while having significantly less commercial power.

All in all, we are just carefully delivering on our strategy. We are not in the game to throw around a heavy marketing budget just to compete with them in so-called quick delivery, the 15-minute segment or hypermarket delivery. We would rather focus on how we can utilise our strengths, including structural ones, and look for potential partners – if they can add and be complementary to our platforms. This is primarily related to the Vprok hypermarket. So far, it is still a work in progress, I would say, and we will continue to develop this format. Again, we are not in the game to buy market share and throw around one rouble of investment or one rouble of GMV like some other players seem to be doing.

Now the second question regarding the fintech business, which we are calling X5 Bank at the moment. We are combining our forces together with Alfa Bank to remain in the last stage of the customer journey, either online or offline, at the payment stage. We plan to launch the MVP of X5 Bank, the first payment product, by the end of the year. Again, it is difficult to give you a precise estimate of the impact of this fintech platform. However, I can pinpoint the directions where we believe it will contribute to the existing X5 business. To start with, we believe it will help us to potentially join our loyalty programmes with either virtual or physical payment cards provided by X5 Bank and to result in a smoother integration in terms of collecting loyalty bonuses, so-called scores, using X5 Bank and thus to increase the share in the customer's wallet. We remember that the average customer has six to seven shops in their portfolio to cover their needs. We do believe that our various instruments, such as express delivery and X5 Bank, will increase our share in the customer's wallet, replacing competitors with a presence at all stages of the journey.

Next, apart from payment services, we will be looking at offering more classical banking products to customers. These could be deposits, consumption credits, which may also be attractive enough, generating bonuses and being competitively priced versus market products. The third element that we are exploring is trying to build into X5 Bank a direct debit function, which should be successful in converting our large number of customers to X5 Bank as a payment instrument, helping us to address the issue of growing acquiring costs that all retailers are experiencing. Just to remind you, the estimated acquiring costs that we are going to pay this year will be over RUB 10 bln. If we are able to reduce this somehow, it will have a significant direct impact on the profitability as well. These are the few areas we will be looking at to explore and unlock their potential as part of this X5 Bank development over the coming couple of years.

Nikolay Kovalev:

Okay, got it, thank you very much.

Vsevolod Starukhin:

Thank you.

Operator:

Thank you. Your next question comes from the line of Maria Lukina, BCS. Your line is open, please ask your question.

Maria Lukina:

Hi, thank you. I have two questions. My first question is if you can tell us about the changes in customer behaviour that you saw in Q2. The second one is if you can share with us the dynamics or trends that you noticed in July and August in terms of the levels of promo and sales. Thank you.

Natalia Zagvozdina:

Maria, thank you. I suggest that Sergei take the questions. Thank you.

Sergei Goncharov:

Thank you for your questions. I will start with the first one. Currently, we are not seeing any trading down yet, but it is possible given the persistently high food inflation. We aim to maintain adequate and attractive prices, because we believe that that remains the most attractive thing for our customers. In terms of trends, we also do not see much deviation from what we have expected and what we have seen over the past few months. The basket size, of course, decreased due to obvious reasons, as I said before. We are very encouraged by the fact that we are seeing an LFL increase in the footfall in our stores. In terms of projections for the rest of the year, I believe that pricing will continue to be a very important factor for customer behaviour. The good thing is that we are very much aware of that. We are preparing for that through a number of factors. One is investing in and strengthening our pricing model. The second one is focusing on our private label programme. The third one is focusing on our first entry price point in the market. Thank you.

Operator:

Your next question comes from the line of Marat Ibragimov, Gazprombank. Your line is open, please ask your question.

Marat Ibragimov:

Thank you very much. My question is about how you dealt with incoming-food inflation. Did you persuade your suppliers to smooth out these increases as much as possible or did you pass this inflation on to customers? The y-o-y performance of the gross margin figure makes it look like you did not suffer much from the food inflation and you did not invest in prices to keep customers in your stores. Thank you very much.

Sergei Goncharov:

I was told by Natalia to take this one as well. Yes, a good question. There is a combination. We did pass on a part of this inflation, of course. The second one is we have negotiated and are negotiating with our suppliers the issue of trying to control prices as much as possible. Now, the issue of being able to manage the gross margin. As I said, gross margin is a combination of many, many factors, such as basket size and composition, what products we are putting on promo, what products we are not putting on promo, or which products we target with our pricing model. On average, a consumer remembers the prices for about 20 SKUs. Beyond that, the customer does not remember prices. Of course, there are a number of customers, and if we add things up, those 20 SKUs will become something like 300 SKUs. These are what we call key value indicative (KVI) products. We approach and factor our models in such a way that those items are priced at the most attractive level, and then we get back to the basket. That model works for us very well and allows us to achieve two things. One is Pyaterochka, or us in general, being perceived as a reasonable, low-priced player, while still maintaining profitability on the gross margin level.

Natalia Zagvozdina:

Thank you, Sergei. Marat, thank you. Sorry, we are running out of time. I am asking the operator to give the floor for one more question please, and after that we will finish. Thank you.

Operator:

The next question comes from the line of Maxim Nekrasov, Goldman Sachs. Your line is open, please ask your question.

Maxim Nekrasov:

Thanks a lot for the opportunity to ask a question. The question is on margin. Do I understand correctly and did I hear it correctly that now your target for EBITDA margin is 7.3% for this year, which is in line with last year's? Does this mean that, despite a higher share of and growing pressure from the online segment, you still expect at least the same margin? I mean that, excluding online, your offline operations have been improving in terms of profitability. What are the drivers of those improvements?

Vsevolod Starukhin:

Thank you for your question. Yes, your understanding is correct. We are targeting in nominal terms the same margin as last year. However, it includes much heavier investments in the new businesses, which we have not performed before. Our objective is to continue to grow and generate efficiencies from our existing businesses, such as Pyaterochka and Perekrestok. They enjoyed quite significant investments in the past and have a lot of efficiency projects in the pipeline. They are also demonstrating the results of these projects – digital projects, internal digital projects. This helps us sustain this good performance and allows us to generate the funds to invest in the new businesses, which is increasing the Company's future footprint. The answer is yes, we want to balance it.

Maxim Nekrasov:

Okay, thanks a lot. Understood. That was probably the last question from me.

Natalia Zagvozdina:

Thank you, Maxim. Thank you, all the participants. We would also like to thank all our speakers today – Sergei, Igor and Vsevolod. Thank you and have a good day.

Operator:

This concludes today's conference. Thank you for participating. You may now disconnect.