X5 Retail Group Q1 2012 Trading Results Conference Call Transcript [1]

Presentation

Operator

Thank you for standing by and welcome to the X5 Q1 2012 trading results conference call. At this time all participants are in a listen-only mode. There will be a presentation followed by a question and answer session, at which time if you would like to ask a question, you will need to press *1 on your telephone keypad. I must advise you the conference is being recorded today, Wednesday 11th April 2012. I would now like to hand the conference over to your main speaker today, Mr Andrei Gusev. Please go ahead sir.

Andrei Gusev – *X5 CEO*

Thank you all for joining the call with X5 to discuss the Q1 trading results. This time around we decided to change the format of our conference call to have an introduction to the results, followed by the questions.

Before I proceed with the specific comments, I would like to refer you to the disclaimer statement in our trading results press release as I and my colleagues during this conference call will be making references to various forward-looking statements and statements that are other than statements of historical facts and therefore I would like to remind that actual results may differ materially from those implied by such forward-looking statements and we undertake no obligation to revise or publicly release the results of any revisions to these forward-looking statements in light of new information. I appreciate everybody's understanding on this matter.

I would like to start the call by reviewing recent developments and the underlying trends and we will be happy then to answer questions. Here with me are Kieran Balfe, Greg and Anastasiya. X5's top-line trends this quarter reflected the 12.6% year-on-year expansion in selling space, which is essentially a focus point on our growth related to this new space added and the performance of the stores, which have been ramping up over the past two years. Obviously the growth was impacted by like-for-like traffic results at our Legacy store. Here I would like to highlight an important fact about X5, that during the last 12 months the skill of the X5 managed stores increased by more than 65% and that is quite a fundamental transformation. What it really

[1] This conference call transcript was prepared by InterCall.

means is that from April 1, the Kopeyka stores that were historically managed by the Kopeyka team were passing to the X5 team and what it means is that X5 was continuing to open many more stores. That, in itself, was a transforming event where subsequently X5 embarked on a transformation, organising itself differently and organising itself (as I spoke last time) around formats that are even more customer-focused and that brought, in itself, the changes in the management team. We are in the process of kind of completing this transformation to handle the speed and the magnitude of that growth that occurred last year and therefore we are seeing quite positive developments that give me confidence that, despite the Q1 results, our strategy is on the right track.

So let me speak about them in more detail. Firstly customer visits, as you may see from our press relief, the traffic was 450 million visits. That's up 7% year-on-year. However, we note that customers are responding very well to our promo and ad campaigns which started very recently. The campaign on discounter has started early April. The campaign on supermarkets started mid-April and therefore we see that, with that activity and where there is other activities that we will put in place, the total traffic increased March-on-March 14%, which is about 40% higher than the format's year-on-year increase in Q1. I will have more to say about what we do in our ad campaigns but I want to say that we are quite excited by the initial reaction to our activities. What I would like to say here is that our average ticket in the format remained stable year-on-year even though we have quite significantly increased our promo and what follows out of that is that our margins are a testament to our ability to effectively manage costs in a situation of difficult sale densities.

Secondly, we are clearly benefiting from the new stores and additional space that we added over the last two years and we see that sales are ramping up in these stores, they mature and their contribution to Q1 sales growth was over 8%. We see that, as we accelerate our growth in Q1, that was probably the lowest growth for us in terms of space added. This would become more of a factor in the Q2, Q3 and Q4 of this year. In addition, I would like to say that, in reference to Kopeyka sales, as you may recall, we were referring to the sales growth of stores that were integrated early in the process. Now we see that Kopeyka overall, including the stores integrated late in the last year, are delivering quite solid growth of 20% as we speak and we see that that particular growth is the one that we see is quite healthy.

Speaking of the rest of the year, we are quite determined to increase the pace of the new store openings and we believe that 2012 was off to quite a great start. Obviously, last year we added during the same quarter 76 new stores. We almost doubled the addition this quarter and it was quite a big extension in terms of selling space. When I would speak about the customer response to the rebranded stores and the services that we have implemented, both in Moscow and the regions, I would like to note here that there is an issue of traffic migration from older to the newer stores and I will speak about it a bit later.

As I mentioned earlier, we are embarking on a new campaign to upgrade the quality of X5 customer relations and advertising programme through TV and print advertising as well as service-focused initiatives in our format. At the Perekrestok chain in the middle of March we have launched a new customer promo. The promo is titled “We love you, we hear you and we care about you” but what is more important is it’s not just a promo but this will allow customers to provide direct feedback in our stores on various issues, ranging from assortment to price to shopping experience and general suggestions for improvement, and there will be dedicated personnel in each store inviting for the feedback. There would be dedicated hours for the store director and we believe that this is a great way to hear from the customers and improve.

In the sub-discounter format, we are proceeding with what we call internally “red button” service and under this programme we instal red buttons at our check-outs that our customers or cashiers can use to signal for additional help or if the line is too long, another person will show up to take care of that customer. We have rolled this out in Q1 in 65% of our stores and we believe that we will be equipping all of the stores with that service by the end of summer. We are airing the new TV commercial board for the supermarkets and for the discounter formats, which are quite connected with the activity we do inside the store and we already received quite a positive response from the customers. Our hypermarket chain is launching a new leaflet with top promotions and we will do this on a weekly basis, much more often that we did before.

You may have tried or saw the new service that we launched on the internet sales offering which we call “E5.ru”. Basically, this is the reincarnation of our previous activities on the internet, however with a different spin whereby the customer can pick up an ordered product at any of our Perekrestok stores in Moscow and the customer can select from 300,000 items (electronics, books, audio, video, household appliances, whatever) and we believe this is a nice extension to our activities and is bringing additional traffic to the supermarkets. Depending on the success of this service, we will roll it out geographically and we will roll this out to the other formats.

Last but not the least important, we are protecting margins and we have been always talking that this is our key priority and I am proud to say that, despite the pressure on the sales densities, we come through a period of such a major change with our margins intact. Basically what we see ... is a lot of positive change going forward that supports our prospects for 2012. We definitely expect better Q-on-Q sales growth as we are opening more stores and as new and rebranded stores ramp up to a more mature sales level. As far as we can see, we are on-track to grow sales 15-20% this year while keeping EBITDA above 7%. That obviously means that our Q2, Q3 and Q4 would show a visible improvement Q-on-Q basis and that is the plan of the management to deliver this. We obviously expect Kopeyka stores to reach a more mature sales level above the 20% observed today and we are targeting 50% upside sales densities by the second half of 2012. So that shows the magnitude at which we expect improvement in performance of Kopeyka stores.

Now let me briefly speak about Q1 trends. Total sales grew 4.4% in ruble terms and that basically consists of 8.3% increase in sales from the new stores on the back of 12.6 year-on-year expansion plan. We had an impact of negative like-for-like of 3.9%. Basically the trends are more or less in line with what we expected during this transition and they reflect several factors. Firstly, the quite high base in Q1 last year which saw the like-for-like performance at discounters and supermarkets at 12% and 19% respectively. We have also under investment in advertising in the previous almost nine months we were silent, which impacted our like-for-like, especially during rebranding where we needed to get the message regarding the reopening of the stores.

Now let's discuss these two factors in a little bit more detail. So basically what has happened in our discounter format, we have expanded quite dramatically, more than 500 new stores, more than 600 Kopeyka stores and these stores were rebranded and consolidated in the areas where the Company was already present. So basically the 65% increase in scale was a transformation for us and what we observed is a redistribution of customers from our older stores to these new stores. Basically we believe that this process is fundamentally over as the customers have selected more convenient shops for them and therefore, going forward, we believe that like-for-like would improve as a result of completion of this customer migration process and as a result of a better base in Q2, Q3 and Q4 and as a result of our sales development activities.

When I look at total traffic, I would like to note that it has increased quite a lot in discounters and we observed two trends: a rather healthy increase in total traffic and a negative increase in like-for-like traffic against a background of the stable average basket. I would like to emphasise that this kind of traffic redistribution is not uncommon during periods of such rapid growth.

Basically, to summarise about discounters, we are quite pleased about improvements in March. We're increasing promotions and advertising. Yes, this takes some time to take effect but we are already quite encouraged how customers are responding to this and basically our focus is on winning customers and growing total sales and like-for-likes.

Speaking of supermarkets, the sales increased by 3% year-on-year in ruble terms. The average ticket was 3.1% higher while the traffic was flat compared to Q1 2011 and, in general, we remain very happy with supermarkets' profitability. However, there are some factors which affected the year-on-year comparison. If you check against the background of Q1 of last year, we implemented an unusually aggressive pricing policy and that helped us to derive a very strong recovery in traffic last year, led by like-for-like sales growth to 19%. However, we see that that particular traffic increase last year came at the cost of the gross margin and therefore our policy in Q1 this year was a bit more balanced. The pricing policy was to support margins and we feel that we have found quite the right balance to optimise the revenues and margins. Basically, what is still being a potential inside the supermarket figures, the few branded Kopeyka stores that are still in the very early stage not yet performing at all at the level of Perekrestok but have full potential, given the location, the quality of real estate, so this masks a somewhat better picture that we expect to envelop over the coming quarters.

Basically, regarding supermarkets, all I can say is that we are very comfortable with our trading position. It's a very powerful format and we believe that none of our competitors have anything close to the value proposition that is being offered by our supermarkets for Russia's middle class and we believe that we are positioned well for growth. When you look at the number of openings in Q1, we added a very modest number of stores (seven) and obviously our strategy is to continue to be the leadership in the areas with the right demographics of our supermarkets.

Now coming to hypermarkets, this is where we see the weakness. Hypermarket sales declined 7% year-on-year in ruble terms. Our like-for-likes decreased by 11% and that was driven by the lower traffic. On the positive side, hypermarkets continue to be solidly profitable with impressive margins. However, we feel that the sales trends are rather weak and that reflects the transition of the format to the assortment changes and to the new pricing strategy. I would like to say here that, with the separation of the supermarket and hypermarket organisation and with the appointment of Jan Fuchs as our new Director of Hypermarkets, our goal is to bring a lot of uniformity to the current sale business model and strategy and pretty much to lay out the groundwork for building sales growth in 2012. We are very much focused on enhancing fresh category offerings, to raise the level of promo campaigns, to increase advertising on a local level and we want to proceed with some decentralisation of decision-making to a store level to give store managers more flexibility. So therefore these kinds of changes obviously take time to bring the right value proposition for the sales customer.

That pretty much brings me back to X5 business transformation. As we have been telling you, the Company has gone through an unparalleled process of change over the last year and we have assembled a new senior management team with Russian and international retail experience. We believe that this is the right team to guide X5 on its next leg of growth and we will be presenting this team in the fall of this year when X5 is going to host its analyst and investor day. Basically, there is much more behind these changes as we now not only move people to the formats but we gave them significant control over decision-making and more independent competition on pricing, assortment, category management and we believe that, with format managers to be better informed regarding the P&L responsibility, we can achieve much more autonomous and independent results. This, coupled with our fundamentally new approach with managing the supply chain in ways that focus more on the customers, I would say these are the two priorities for the year, sales development and supply chain development, and we believe that our investments in technology and logistics will drive the productivity up.

We would be happy to answer any questions you have. Let me remind you that we will be speaking very soon again regarding our 2011 financial results on the conference call on April 19. Now Kieron and myself would be happy to take your questions and discuss the Q1 sales development. Operator, we are ready to start with the Q&A.

Questions and Answers

Operator
Thank you. We will now begin the question and answer session. If you would like to ask a question, please press *1 on your telephone keypad and wait for your name to be announced. If you would like to cancel your request, please press the # key. That's *1 to ask a question. Your first question comes from Maria Kolbina from VTB Capital. Please go ahead.

Maria Kolbina – *VTB Capital*
Good evening. I have two questions. One is the presentation. I didn't see regional like-for-like breakdown performance in your press release, so can you please comment why you stopped publishing this for Moscow, St Petersburg and regions because it seems to be very useful to understand how X5 is doing in different locations or like if you plan to publish it maybe on a semi-annual basis. This is the first question.

Andrei Gusev – *X5 CEO*

Maria, thank you for the question. The decision that we have taken is that the X5 reporting would be more consistent with the reporting of our competitors, Magnit ... and the likes. So therefore we have taken a decision to provide the information we decided to provide but obviously on various meetings and the road shows, we would be happy to provide further colour on our regional performance. I would like to say that, due to limitations in St Petersburg and due to the rather high market share in Moscow and St Petersburg, you can be well-assured that the Company will continue to develop quite aggressively in the regions.

Maria Kolbina – *VTB Capital*

Okay. And with regards to your traffic performance in Moscow, St Petersburg and regions, can you provide more colour which regions were the most struggling in terms of the traffic in Q1 of this year?

Andrei Gusev – *X5 CEO*

I would say that the traffic results that you see for the whole of the Group are rather evenly spread across most of the regions and I would say that it's very difficult to highlight any particular region as a particular winner or loser.

Maria Kolbina – *VTB Capital*

My second question refers to Kopeyka. You mentioned that Kopeyka grew by about 20% in Q1 of this year. Did I understand it correctly in terms of sales?

Andrei Gusev – *X5 CEO*

Yes.

Maria Kolbina – *VTB Capital*

So that means that Kopeyka generates roughly about 80% of Pyaterochka sales, sales per square metre.

Andrei Gusev – *X5 CEO*

Yes, this couldn't be the case that Kopeyka generates 20% of Pyaterochka sales.

Maria Kolbina – *VTB Capital*

No, sorry, 80% of Pyaterochka sales, sales per square metre.

Andrei Gusev – *X5 CEO*

No, Maria. So let me say it once again. It is 20% increase in sales densities of the existing Kopeyka stores versus what they were performing in Q1 last year pre-integration. So it is a total of 20% improvement and currently, if I were to provide some numbers, Kopeyka was performing at RUR 230,000 per square metre before the deal Pyaterochka were performing RUR 400,000 per square metre before the deal. So basically we have still a long way to go towards where we want to be but, given that we have reported earlier and we are observing very healthy performance in the areas where we started integration first, we are quite confident that we will get there and the only reason, we thought that the report we made on a number of regions was good enough in the period when we were doing integration. Now that the integration is over, we are pleased to report the overall increase and this stands at 20% pretty much six months after the full integration is complete across the board.

Maria Kolbina – *VTB Capital*

So it's 20% growth in sales per square metre in Kopeyka in the first quarter?

Andrei Gusev – *X5 CEO*

It's 20% growth in total sales divided over sales contribution, yes, in the previous period, yes.

Maria Kolbina – *VTB Capital*

Okay, thank you.

Operator

Your next question comes from the line of Daniel Wakerly from Morgan Stanley. Please go ahead.

Daniel Wakerly – *Morgan Stanley*

Good evening, Andrei. My two main questions are, firstly, you acknowledged that you had under-invested in marketing I think you said for the last few quarters. Can you sort of talk a bit more about the rationale for that? Was there a desire to focus more on profits or is it the case that the environment has become more competitive and it is with the benefit of hindsight that you realised you have under-invested? My second main question is on – you didn't use the word in the press release but I guess we're talking about cannabilization. When we look at the like-for-like by format, do you have any sense of which format has the biggest cannabilization effect on its like-for-like number?

Andrei Gusev – *X5 CEO*

I have a rather simple answer to your second question and then I'll move to the first question. When you look at the cannabilization overall, this particular effect is almost not existing in our hypermarket format, simply because we have these locations quite widely spread one versus the other. When you look in supermarkets, I would say cannabilization, in fact, in supermarkets is rather small to negligible and immaterial. And when you look at the discounter format, the cannabilization is evident.

Now let me define cannabilization in a very simple way. Basically, when you look over long periods of time in the situations where you double your network in the very same geography, then you can calculate how much traffic has migrated overall and we have been running this kind of analysis against various regions, against various time periods and what we have concluded therefore doubling the size of the trading area, it is typical to observe that the cannabilization would be between 5-7% on a sales density level. Therefore I think this should put to rest any real fears about cannabilization and this pretty much goes back to another example which I would like to highlight here, that the bigger is the market share in a particular region, the more profitable is the performance and I would say in Petersburg performance is the best example to demonstrate this where we have around 25% market share and we have by far the biggest profitability. Obviously, as we were building this market share, we have been experiencing cannabilization but we proceeded without hesitation.

So I would say that yes, cannabilization is at play and it shouldn't be ignored but the effect of it is not as dramatic as one may think. If I were to conclude on this point, we would like to once again highlight that what has happened in X5 in the last 12 months is truly transformational, that the increase of our branded store base, our managed store base by 65% is not something which happens very often. Until April 1 this for Kopeyka stores, Kopeyka value proposition and the customer perceived them respectively. So therefore you can see that over a short period of time the store base increased by 65% and over an 18 month period of time it was almost double and cannabilization, as I defined it earlier, is between 5-7%. I would say it takes some rather modest cost structure adjustment in order to stay profitable in this game to keep the customers and what we observe is that most customers select the most closely located store. So I hope that addresses your question about how we see cannabilization's effect across the three formats.

Now your first question was about advertising and it was about the trends in advertising. I would like to say that last year we were going through this kind of transformation, we were going through Kopeyka integration and we understood that one way or the other we could have spent advertising dollars but it was a conscious decision to spend them later as the Kopeyka integration would be completed and there would be a more synergetic spending of these advertising dollars. That's first.

Secondly, as we were separating formats and as we were changing rather substantially the visual appearance of each format in the customer's eyes, we didn't want to continue with the old images. As you may recall, the old image for Pyaterochka is something very different from what you can observe today and it goes without saying that our new supermarket advertising is something different. So we were driven by a desire to accumulate some money for the new campaigns, which we believe more appropriately reflect the image of each of the formats.

We are quite pleased with the fact that the messages in these particular advertising campaigns are now quite different. I hope customers would no longer confuse what the value proposition of supermarkets is with what the value proposition of discounters is and quite – not quite soon but in the near future we are going to roll out the hypermarket promo campaign and it will be something different from the first two. So it's a mix of everything: protect margins, save some dollars, be prudent, expect a synergy, etcetera.

Daniel Wakerly – *Morgan Stanley*
Okay, thank you very much and just a final follow-up. Could you just clarify your earlier comment about 14%? Was that traffic growth in discounters and supermarkets on a month-on-month basis? Did I hear that correctly?

Andrei Gusev – *X5 CEO*

Yes, that is correct. When you look at our press release, we report for like-for-like numbers in traffic numbers for the quarter total. So what we wanted to highlight by this point is that, if you look at quarterly average, the sales growth was a single digit number but when you go to just March separations, they shoot to 14%, which means that there is quite a rapid acceleration and we expect the continuation of this trend through April, May and June and that, hopefully, addresses some of the concerns which we hear that in Q2 X5 has to deliver around 20% Q-on-Q sales increase. Well, that is yes but we already see the effect of this in the traffic, that the traffic is becoming strongly double digit and therefore numbers like these give us confidence to say that so far, so good and we are on track to proceed with 15-20% sales growth.

Daniel Wakerly – *Morgan Stanley*

Right. Sorry to sound confused but you're saying that's March 2012 versus March 2011 ruble sales growth for discounters and supermarkets, it is 14%. Is that right?

Andrei Gusev – *X5 CEO*

No, I meant that traffic increased in absolute terms for – there are two metrics to start with. One metric is that if you compare March to February, there is a very substantial increase in itself. So that is one metric and another metric I think to which you are referring is that if you compare Q-on-Q, the increase was 7% Q1 2012 to Q1 2011. But when you compare March alone, the increase was 14%, which is substantially higher. So on the basis of these two metrics, you can see two trends. March was very strong versus March last year and March this year was very strong towards February this year. So we are obviously seeing [declaration] without having the full benefit of our new communication platform.

Daniel Wakerly – *Morgan Stanley*

Great, thank you. Thanks for the clarification, thank you.

Operator

Thank you. Your next question comes from Alexey Krivoshapko from Prosperity Capital Management. Please go ahead.

Alexey Krivoshapko – *Prosperity Capital Management*

Andrei, thank you for the call. I see that you are now bringing smaller stores. Every store which opened in Q1 in the discounter format was approximately 250 square metres versus the historical average of around 400. Can you give us some guidance in terms of these stores, and I would imagine some of them are more in the regions, but what is their sales level versus your current existing store format? That is my first question. The second question: can you shed some light on Kopeyka sales standalone in Q1 2012? As you were giving historic numbers, I recall the you have actual figures. So can you just say if you close any Kopeyka in Q1 and what were the actual sales of Kopeyka stores in Q1 2012?

Andrei Gusev – *X5 CEO*

Alexey, thank you for the questions. In fact, nothing substantially has changed in our average size for the stores. I think you are referring to the average per store but I would like to remind that we have developed a new format convenience store which in of itself is rather small. So if you take the new openings in the convenience store format aside and focus just on the soft discounters that we have opened, you would see that over 33,000 square metres added on net basis in discounters over 118 stores delivers you around 300 square metres on average. I don't think we are going into the territory of 250. In fact, we are quite focused on preserving the boundaries of the format and whenever we meet a good opportunity for a convenience store, we would rather open a convenience store, not a discounter.

Alexey Krivoshapko – *Prosperity Capital Management*

So what will be the smallest size you would go for in this case for the discounter?

Andrei Gusev – *X5 CEO*

Well, we do not typically go anything below 280 (280-300). Anything below would be something that we do not normally take.

Alexey Krivoshapko – *Prosperity Capital Management*

I see, thank you.

Andrei Gusev – *X5 CEO*

Alexey, I think your first question was about Kopeyka and your question was, if I remember correctly, how much Kopeyka has delivered in total – right?

Alexey Krivoshapko – *Prosperity Capital Management*

Yes. And did you close any stores in Q1 for Kopeyka?

Andrei Gusev – *X5 CEO*

Did we close any stores in Q1 in Kopeyka? No, that's a simple answer. I would say I think it would be probably the best approximation how much were the sales of Kopeyka by looking at two figures. We kept the average ticket for Kopeyka in Q1 2012 at RUR 260 and we have enjoyed over 66 (if I remember correctly) million customer visits. So if you multiply one by the other, you would roughly get an idea of the sales but this is as much as I can recall.

Alexey Krivoshapko – *Prosperity Capital Management*

Excellent and this 260, I would assume that this is inclusive of the EG.

Andrei Gusev – *X5 CEO*

Well, I think we are including the EG, yes.

Alexey Krivoshapko – *Prosperity Capital Management*

Okay, thanks a lot.

Operator

Thank you. Your next question comes from Brady Martin from Citi Bank Moscow. Please go ahead.

Brady Martin – *Citi Bank*

Good evening. I have a question just about the progression of sales. I appreciate the cover on marked increase in traffic but I wonder if you can give us more colour just on overall sales growth.

How did that progress through the quarter, like January, February, March, just to get more comfort that this 15-20% growth is achievable? And the second question is really about the promotional campaign. What is the duration of this campaign? Is it something that is planned to be sustained throughout the year or is this something that we're all going to see March through June? What is the plan there? Thanks.

Andrei Gusev – *X5 CEO*
Well, if you compare month by month, I would like to say that January this year to January last year there was almost call it new growth. There was some growth but it was very modest while in February there was an acceleration, with even more acceleration in March to March basis. So that gave you an average for the quarter and I hope that gives you a sense that the growth is picking up.

With respect to your second question, are we going to continue with our advertising campaign, well basically we are coming with themes that we believe will stay for a lot in the market and we believe that both campaigns in supers and discounters have a lot of appeal with the customers and there is a rule that you do not come with these themes and go often. So I would say that these kinds of campaigns may stay around a year and then, if they are successful, they might stay for longer.

Brady Martin – *Citi Bank*
Okay, that's clear. If I may, just a follow-up question, really a clarification on your comments on new management. I wonder if you can be more explicit about what you have done in terms of replacing key managers that left, in particular that left over the last six months.

Andrei Gusev – *X5 CEO*
I am sorry, Brady, your question was what we have done to replace the management?

Brady Martin – *Citi Bank*
Yes, have you replaced the management? Who has replaced the managers that left? I mean what is the interim strategy there? Who is running the individual formats now?

Andrei Gusev – *X5 CEO*

Oh, I see. I think your question refers more to the departure of Oleg Vysotsky. Well, what we are happy to say at the moment is that we have two very strong candidates internally, so one Russian individual and one international individual, both already inside. The board is reviewing the shortlist, which includes not only these two internal candidates but includes some external and we are at the very final stages to announce the winner in the market. Being a public company, I hope you can appreciate that we have to convince ourselves firstly that we went through the most exhaustive process in terms of finding the best talent for this extraordinary organisation like Pyaterochka and I can reiterate that the announcement will come very soon. In the interim, we are quite pleased with support we get from Oleg Vysotsky.

Brady Martin – *Citi Bank*

Okay, very good, thank you.

Operator

Thank you. Your next question comes from Patrick Shields from Wood & Co. Please go ahead.

Patrick Shields – *Wood & Co.*

Thank you very much for the opportunity to ask a question. I just wanted to come to your investments in logistics and the supply chain. You highlighted that that was one of your priorities for the current year and it seems that the X5 business has been investing in everything from its DC's, its warehouse management systems and the supply chain, support and technology for some time. I wonder what it is that it is currently misfiring or what is it about your existing set-up that you continue to be dissatisfied with and can you highlight whether this has caused any supply disruptions, any stock outs, any problems with getting assortment on the shelves in the store base that may have contributed to a weak like-for-like?

Andrei Gusev – *X5 CEO*

Okay. What I wanted to say, the most important about the process that we do about reengineering our supply chain before (and I have been telling about this on the phone several times) X5 was in a major way a vendor-driven organisation. We have been selling those kinds of products for which we were able to collect the lucrative financial terms with our vendors and obviously that was one business model. A decision was taken to restructure the Company into a more customer-focused format. By design, it follows that each format would be in the driving seat to define what assortment the customers need and then the purchase organisation would be servicing and implementing those kinds of needs. If I were to put a simple analogy, it is like turning 180 degrees the way the current flows in the electric systems and obviously during this time you may temporarily observe some interruptions but, long term and strategically, we believe that this was the right decision to take at the right time until the organisation was not incomplete and rather flexible to adapt.

Now this kind of change is obviously requesting additional tools that we were lacking and these additional tools, they would be required for us in the coming years to build on. Well, firstly, I am pleased to announce that we will be proceeding with the implementation of the additional software functionality on the back of the SAP. We have been talking about SAP for many times and, as you well know, it gives us basic functionality in HR, finance and retail. Now we are expanding this functionality and have taken a decision to implement one of the best software packages, GD, that will take control over the full replenishment cycle. This will be a project that would expand over the course of the next two years and I expect nothing from it but improvement at every stage of the implementation. These particular implementations include the phased roll-out of functionality and we will be reporting to the market the progress on each of these as we did with the SAP over the previous three years. But I want to highlight that you can instal software like GD only on the back of a very strong backbone like SAP is and it will not be able to operate otherwise. So that's the first kind of tool that we will be using.

Secondly, we will be upgrading in a major way our software at the store level. Basically, we have a program that by the end of this year there will be quite a massive extension either of SAP capability in the store level or of additional software that has been proving itself very well in the discounter format. So that, together with SAP and with GD, would form a full suite required for running a retail supply chain.

Obviously we will be doing things which are more mundane, which you may have already heard or read in the press, that X5 would be taking a decision to rationalise its physical warehouse space. We will be closing some of the warehouses and will be launching building of the new warehouses. One such warehouse was already closed in early Q1 near Moscow. Yes, it caused some temporary disruptions but I wouldn't call them drastic or material. We are in the process of deciding which other warehouses to close. So this would be the program which would be very gradual, will take us a few years to implement, no rush here. Then, with respect to improvement in our transport management, we have a number of initiatives which we would like to implement over the next nine months.

So all in all, if you look at all of this, you will see that our supply chain would be very different, starting with the needs of the customer in mind and we will be having tools that we didn't have before. We believe that will position us strongly with the full suite of automation retail capability.

Patrick Shields – *Wood & Co.*

Thank you for that; just a couple of additional questions. You talked about this before and you made reference to it earlier in your answer to, if you like, the restructuring of your procurement across the Group. Can you characterise for us how far you are in that process of renegotiating with your key suppliers?

Andrei Gusev – *X5 CEO*

Well, I would say this process never ends. It's like change of seasons; it always goes. So I would say that in a year from now, in two years from now, we will be talking that we are negotiating and squeezing additional favourable times. But, being serious, I think what we have done last year and what we have done in Q1 was quite an important job. Almost all of our contracts have been reviewed and I am pleased to say that X5 has almost performed – I am sorry, has performed on all of the commitments that we have inherited from the past and, as such, we are quite flexible right now to change the assortment as we like.

The work is ongoing and what I can say is that there will be quite an inflow of attractively priced products going into the discounter stores, including on the private label level there would be quite a change in our brand portfolio and we see that the rationale is on our non-food offering in the hypermarkets, reducing some of the product groups where we see quite limited commercial potential and expanding those groups where we see the benefits are. So the simplest way is to say it is the process is ongoing. We are pleased with the margins, pleased with the results and we see only improvement ahead of us.

Patrick Shields – *Wood & Co.*

And maybe a final question, back to the investment and whole kind of logistics set-up. There has been commentary in the press talking about some very big numbers that you need still to invest in the whole supply and distribution. Can you make any comments on what you believe you need to spend from here in order to get the supply infrastructure into the kind of state where you believe it will function as efficiently for the Group as you would like it to?

Andrei Gusev – *X5 CEO*

Well, it's interesting that you refer to a particular rather famous article which I read with great interest and I always wonder how journalists can easily manipulate numbers of such a gigantic scale. I think there was a mentioning of more than $3 billion that X5 is going to spend over the next 12 or 24 months. I hope you understand this is quite far from the reality. If we were to be serious about it, firstly I would start from the comments that X5 logistics is functioning rather well. I would say that, if you look at the overall size of our warehouses, you would notice that, in terms of that as a ratio to the total trade area, we feel very comfortable. In fact, I would say that (and I mentioned this briefly before) with about 520,000 square metres of warehouse space on the back of the total 1.7 million of retail space, it is much better than 1:4, slightly worse than 1:3. What that means is that we have enough space to take care of the rest of the gross for the rest of the year, so there is no rush here.

In terms of transport, I think we are quite adequate and, yes, we do not have as much own transport as some of our competitors but we feel that at about the 60% level that we are today, it is providing us enough flexibility together with outsourced transport.

So one way or the other, I think we are not in any rush here on the one hand. On the other hand, we have quite a clear vision of what we want to become and that is a vision which is not a copy/paste of anything that you see in Russia but it is a vision that is typical of the best in class retailer in this country. That is whom we want to become and basically a decision is spending horizon between four to seven years and I would say for the phase 1 of this, we would be investing as a company between RUR 30-40 million over the course of the next three to four years.

Patrick Shields – *Wood & Co.*

Okay, thanks for those answers and just one additional question, if I may. Elsewhere in Russian retail we saw very strong growth margin improvements the second half on the first half, which is clearly benefiting some of your competitors' direct procurement terms. Do you see yourselves as being in a position to grow your gross margin from here, given the changes that you are implementing?

Andrei Gusev – *X5 CEO*

Well, I would say let's wait. In just a few days we will be publishing our results. I think it would be fair to discuss this subject a few days later if you allow us, thank you.

Patrick Shields – *Wood & Co.*

Thanks.

Operator

Thank you. Your next question comes from Boris Vilidnitsky from Putnam Investments. Please go ahead.

Boris Vilidnitsky – *Putnam Investments*

Hi, thank you so much for taking the time to talk us, really helpful. A few questions from my end: first on the pricing side, it seems like pricing was flat throughout the quarter but traffic was negative while some of the other competitors who reported earlier in the week showed slightly better traffic than you guys did and higher pricing in the order of 4% or so. Can you comment on that? And the second question is the traffic increase that you mentioned that you saw in March, was that through pricing and the marketing campaign and, if so, by how much did you decrease prices in March?

Andrei Gusev – *X5 CEO*

Well, I wonder what is the source of information at our competitors' side. I would be very curious to hear how they commented on being able simultaneously to increase price and to increase traffic. But that particular remark aside, what I would like to say is that it is as clear as ever that the Pyaterochka format was very price-competitive. This particularly is very carefully preserved as a fundamental part of the value proposition of the format. Yes, it is typical for the format to be more relaxed in Q4 but, even on that basis, we tried to be more competitive vis-à-vis Dixy, Magnit and the rest. So all I can say is that, according to our price monitoring, we are still fundamentally looking very, very good and I would say that my response to this would be that customers in this country are very price-sensitive and I would imagine that this is no different from any other places and I would say that, with prices being competitive, this is a fundamental driver of the traffic.

Now more specifically you asked how much we decreased or increased prices. I would say this is not so easy to say in the sense that, even though the inflation is very, very low, the inflation is still ongoing and, as you well know, the fundamental future world pricing system that it is basically driven by the market and all I can say is that we remain very competitive versus our competitors across most regions, in most categories and most SKU's. So one way or the other, we see that we remain strong on pricing.

Now how that affects gross margins, I would say that yes, if you look at the EBITDA and the gross margins, some of our competitors reported improvement but fundamentally it's the policy of X5 to reinvest some of the gains we have on the vendors' side into the customers and it is our policy that the EBITDA and the net income line here is founded by the decreases in OpEx, especially on the personal side. So one way or the other, we believe that our Company has been in line with these strategic guidelines both in Q4 and Q1. As I was saying, our margins are healthy and we believe that we are on the right track here.

Boris Vilidnitsky – *Putnam Investments*
I see. Well, just a couple of clarifying questions. So I agree with you that customers are, indeed, very price-sensitive but, well let's take Magnit, for example, they were able to increase prices by almost 5% and only lost about 1% in traffic while you guys kept prices essentially flat and lost 4% in traffic. So I'm just trying to see how these two things add up. You guys indeed gave up let's say 5% of the pricing yet you lost more traffic. It just doesn't seem to add up to me.

Andrei Gusev – *X5 CEO*
Well, I don't know what is the source of these numbers and, to the best of my belief, I have never seen such a fundamental price increase by Magnit unless you are talking about periods which are far distant in time, like one or two years. So I have no comments on what you just asked, sorry.

Boris Vilidnitsky – *Putnam Investments*
Fair enough. As far as the marketing campaign in April, any comments as far as how much you decreased prices by on average?

Andrei Gusev – *X5 CEO*
What do you mean by decreasing prices? Let me go back to the remark that I had. The price positioning of the format is defined not by itself vis-à-vis one month or one week ago but the price positioning of our format is defined vis-à-vis the local competition as being defined by various methods, including price monitoring, etcetera. So we were not taking any conscious decisions in order to kill the prices or to raise the prices. All what we were doing, we were pricing according to our strategy and, yes, mathematically we can calculate what was the outcome of the strategy on a week-on-week basis but, to be honest with you, this is something we do not do internally. We

believe this is – we are not focused on this and I can reiterate our price position was very strong and it continues to be very strong.

Boris Vilidnitsky – *Putnam Investments*

I see. And a last question I guess. There were some rumours a couple of months ago or a month ago about potential Karusel sale. I don't know if you can comment on that.

Andrei Gusev – *X5 CEO*

Well, I have a very simple comment: it is not on sale and will not come on sale.

Boris Vilidnitsky – *Putnam Investments*

Okay, thank you so much. That's all I had, thank you.

Operator

Thank you. Your next question comes from Mikhail Krasmobrov from Troika. Please go ahead.

Mikhail Krasnoperov – *Troika*

Good evening and thanks for the conference call. I have a follow-up question on Kopeyka performance. From what you have told us, I believe that total revenue growth in Kopeyka stores was just 5% year-on-year. So adjusted for difference in selling space, one extra day Q1 this year and stock losses last year, I am guessing that sales density in Kopeyka stores has improved by 6%. So what should I look at to get this 20% improvement in top line generations that you discussed at the call beginning?

Andrei Gusev – *X5 CEO*

Mikhail, when I was using this number, if you may recall, I was using the term "at least". Because I was using them off the top of my head, I may have been mistaken on some of the numbers. So therefore I can reiterate that the growth in Kopeyka period to period as we speak is (I don't know) between 15-20%, around 20% I think. If necessary, we would be happy to provide you with numbers if you just address us.

Mikhail Krasnoperov – *Troika*

Yes, it would be useful and presumably you still stick to your full year revenue guidance of RUR 65 billion for this particular sub-format that you gave us at the end of last year?

Andrei Gusev – *X5 CEO*

Yes, I am not changing our guidance.

Mikhail Krasnoperov – *Troika*

Okay, thank you.

Operator

As a reminder, that is *1 if you would like to ask a question. We have no further questions at this time.

Andrei Gusev – *X5 CEO*

I would like in closing to thank everybody for joining the call and I hope that we have provided information behind our press release that is important to understand the trends in the Company and we would welcome each and every one of you in the call that will happen rather soon upon publication of our annual results. Please stay in touch and thank you very much, once again, for joining us. Bye-bye.

Operator

That does conclude our conference for today. Thank you all for participating. You may now disconnect.