X5 Retail Group Q2 2012 Trading Results Conference Call Transcript [1]

13.07.2012

Presentation

Kieran Balfe – *X5 CFO*

Good afternoon everybody. Thank you all for joining our call to discuss the second quarter of the 2012 trading results. Before we begin with the specific conference call details, I would like to refer you to the disclaimer statement in the trading results press release regarding forward-looking statements. During this conference call we may make reference to forward-looking statements by using words such as “plan,” “objectives,” “goals,” “strategies,” and other similar words, which are other than statements of historical fact. Actual results may differ materially from those implied by such forward-looking statements due to known and unknown risks and uncertainties, and reflect our views as of the date of this call. We undertake no obligation to revise or publicly release the results of any revisions to these forward-looking statements in light of new information or future events.

Today, I would like to start the call by providing a brief statement regarding the resignation of Andrei Gusev from the CEO position at X5. Andrei’s resignation was the result of a mutual decision by both himself and the Board of Directors. Ultimately, the Board and Andrei had some differences about how best to execute X5’s strategy going forward and, in light of this, Andrei felt it prudent that he resign so that the team he has assembled could get on with the business of retail without further distraction. It is clear to all that Andrei has done an exceptional job leading the transformation of the Company to a multi-format retailer and assembled an extremely experienced Senior Management Team that is more than capable of running X5’s operations until such time that a new CEO is named. The Company does have a plan in place to provide temporary oversight of X5’s activities through the delegation of a Board Member, Stephan DuCharme, to assume Andrei’s responsibilities. Stephan has extensive experience in Russia and was instrumental in the hiring of most of the current Senior Management Team. He will, of course, have the support of the other members of the Supervisory Board and their retail experience, as well as access to Andrei Gusev himself, who will be available in an advisory capacity.

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

Post the reorganisation of X5, I think X5 is now well positioned to grow fast going forward and so the format ahead is to execute the strategy that has been approved by the Board to deliver the growth that we all know that we are capable of.
I'd now like to turn my attention to the movements in Q2 and the results, and recent developments underlying the trends that we saw during the quarter. Thereafter, I'd be happy to answer any questions that you have either on the results or the resignation of Andrei Gusev.

In terms of the results themselves, we see definite improvements in the second quarter year-on-year, quarter-on-quarter, and month-on-month that should provide positive momentum going into the second half of 2012. We also expect inflation to move higher from its historic lows in the first half of the year. We will remain focused on executing our strategic plans. However, given the absolute growth that we have seen in Q1 and Q2, and the slower than expected start to July, we are guiding for a soft 15% top line growth for the year, which will be dependent on, first of all, an escalator promo activity and communication with the customer in all three formats, higher inflation with tariffs picking up in the second half of the year, increased social spending, and potential impact of a weaker grain harvest; a larger number of stores in the second half of the year, an 18% increase in selling space in 2012 versus 11% in 2011. In the first half of this year we added about 40% more stores versus H1 in 2011. We also see potential upside in the Kopeyka realisation in the second half of 2012. We expect all Kopeyka stores to reach maturity and to approach a 50% total upside on their sales densities vis-à-vis what they were when we acquired Kopeyka. In June 2012 business has already reached on a like-for-like basis about a 30% increase. Assortment improvement and our movement to more customer-oriented products will drive traffic in our stores and, finally, our quality programme, which targets an increase in the quality of our products on the shelves of our stores and a better customer service.

In essence, we believe that the 15% growth is still viable and we reiterate our guidance on the EBITDA margins greater than 7% for the full year and we'll update the market on our expectations during our conference call regarding H1 at the end of August.

Our net sales for Q2 increased by approximately 10% year-on-year, which reflects a 13.4% year-on-year expansion in selling space, and the performance of stores, which have been ramping up over the past two years. More importantly, we'll have seen positive movement in year-on-year top line growth in Q2 2012 compared to Q1 2012, primarily due to increases in traffic at our soft discounter format, as well as the performance of rebranded Kopeyka stores. I will talk more about the monthly trends within the quarter a little bit later in the call.

We are still in the transition process, having transformed the business in 2011 and through Q2 2012, and we're starting to see the benefits of this now, especially in the traffic and like-for-like results in our Pyaterochka and Perekrestok stores.

As stated in previous calls, the transformation of our hypermarkets is a longer-term project, which will extend into 2013, as we make adjustments to the product category, the store size, and layout to achieve the business model we envision. It is important to remember that this format will separate from the supermarket format, only in Q4 of 2011 and although we've made progress in assortment changes, the hypermarket team, along with the commercial department, are continuing to work on a number of operational changes, which we will roll out in the second half of 2012. In general, the results for Q2 and the positive developments we have seen during the quarter gives me confidence that our core strategy is on the right track and in support of this, I would like to highlight a few items.

First of all, one of the most important indicators, which is total customer visits, was up year-on-year by 13.3% in Q2 to 464 million visits. Customers continue to respond well to our promotions and add campaigns, especially at our soft discounter format where traffic increased by approximately 17% year-on-year. We also saw a turnaround in traffic in our supermarkets, which was up by 3.4% year-on-year in the second quarter of 2012, compared to a year-on-year increase in the first quarter of 2012 of only 0.4%. It is important to note that the average ticket at supermarkets increased by about 2.1% year-on-year, whilst soft discounters were basically flat even though we have significantly increased our promo and marketing campaigns. The results in average tickets were also in line with the exceptionally low food inflation in Q2 2012 of between 1.2 and 3.6%.

Secondly, we continue to benefit from new stores and additional selling space added over the last couple of years. Sales are ramping up at these stores, as these stores mature and their contribution to Q2 sales growth was slightly over 11%. This will become more of a factor in Q3 and Q4 of this year, as in H1 2011, that period only accounted for less than 30% of the total space added in the entire 2011. Third, we have continued to increase the pace of organic new store openings in 2012. In H1, we increased new store openings by 38% to 296 new stores, compared to 214 in H1 2011, and in terms of selling space we added, the increase was approximately 90% with 93,000 square metres of new selling space added in H1 2012, compared to only 49,000 square metres in H1 2011.

Lastly, we continue to focus on our strategy to increase new store openings in the regions, other than the central and north west regions. These "other" regions increased our year-on-year sales by approximately 17% in Q2 2012.

Now, let's drill down further into the second quarter trends. Total sales growth of 10% in Rouble terms consists of an increase of 11.1% in sales from new stores, which were impacted by a like-for-like sales decline of approximately 1.1%. We are pleased with the results in like-for-like sales where we have seen improvements in both basket and traffic.

Taking a look at these key drivers in more detail, we'll start with soft discounters where sales were up almost 16% year-on-year in Rouble terms. Discounters' selling space has expanded by about 15% year-on-year on the back of 531 new stores. On a monthly basis, we saw a steady year-on-year increase in Rouble sales during the quarter with April, May, and June sales increasing by 12, 18, and 23% respectively. Total customer traffic increased by about 17% at soft discounters to over 350 million visits. Like-for-like traffic was down negligibly by two-tenth of a percent, while the average basket increased by about 2.3%. As a result, Q2 2012 like-for-like sales at soft discounters increased by 2.1% compared to a decline of 2.3% in Q1 2011. On a monthly basis, like-for-like sales swung from a negative of 3% in April to a positive of 3 and 7% in May and June respectively. The increases were driven primarily by higher baskets, as well as improvements in traffic.

Looking at the results month on month, traffic improved by 6% from -5% in January to 1% in June. The improvements are due to increased promotions and advertising, and this strategy is winning with customers and growing total sales and like-for-likes. We expect this to continue, as we invest to expand selling space, especially in the regions, whilst at the same time maintaining our focus and fine-tuning the Pyaterochka shopping experience.

Supermarket sales increased by over 3% year-on-year in Rouble terms this quarter, primarily due to an increase in traffic as well as on the back of a higher ticket. Year-on-year traffic increased by 3.4% in Q2 2012, compared to a 0.4 decrease in traffic in Q1 2012. On a monthly basis, traffic results year-on-year in April, May, and June went from -3 to 3 and 5% respectively. The average ticket increased over the same period by 2% to 3%. Our supermarkets finished Q2 in positive like-for-like territory, going from -6% and -2% in April and May respectively to 2% in June. This was primarily due to a 7% improvement in like-for-like monthly traffic, while basket growth remains stable at 2% and 3% during the period. We've added four new stores in Q2 and we will continue to expand this format in appropriate areas of Russia.

Hypermarket sales declined 10% year-on-year in Rouble terms, led by a 13% decrease in like-for-likes that was primarily due to lower traffic. We are committed to the turnaround in our hypermarket format and we are testing new store layouts and assortment and marketing mix in Q3, and expect greater progress in this area in the second half of this year. We look forward to providing the investment community with more details on our plans, objectives, and results on our first half of the year financial results, and this conference call will take place in the second half of August.

At this stage, I would be happy to take your questions and discuss the second quarter developments.

Questions and Answers

Patrick Shields – *Wood & Co*
Obvious one first, you said you'd be willing to answer questions on the departure of Andrei Gusev, the CEO. Perhaps you could elaborate on precisely what the differences in execution are that led to his decision?

Kieran Balfe – *X5 CFO*
I think I would say the following that I think when Andrei took over that role, one of the primary objectives he had was to essentially reorganise the Company and empower the formats to run this Company, and I think he did a terrific job in that respect. I think he had a vision for the future and that vision may not have been necessarily shared by the Supervisory Board, and I think the results of that disagreement led to Andrei to tender his resignation and depart. I think everyone recognised he's done a phenomenal job in reorganising the Company, establishing an excellent platform for future growth, and hiring a very professional team that forms the basis or foundation of the platform that we will use to continue to grow the business. I think everybody knows that top line growth is a key focus for us and we all believe that it's possible to grow the top line in the business at continued speed going forward. From that perspective, I think that it was time for Andrei – he felt it was time to step down and we respect that decision.

Patrick Shields – *Wood & Co*

Is the fact that there's been some discussion about the potential for doing M&A, which is obviously an area of his historic expertise, is that one of the points where the visions for how to grow the business departed from that that the Board had?

Kieran Balfe – *X5 CFO*

I don't think it's a specific M&A issue. I mean I think we have all made it clear that we're an organic growth company and most of our growth going forward will come from organic growth, and we would only ever look at M&A as a potential add-on to that organic growth strategy. We made this very clear, I think, over the last several calls and, in fact, during our road show, so I don't think that M&A is a primary spot.

Patrick Shields – *Wood & Co*

Okay, maybe moving away from that – I'm sure other people would want to ask more detailed questions on it – just in terms of...I'm not quite sure what you mean by a soft 15% in terms of the sales guidance, and enumerated a whole long list of kind of contingent factors that needed to come about to make the 15%, if I understood where you were telling us. What for you is going to be the critical issue in terms of whether or not you make 15% or 16% or 17%, or 13 or 12 or 10%, because if we look at the monthly sales trends, which you've given us in the presentation, which I have to say are pretty helpful, it looks to me as if, you know, there is a very strong recovery in sales dynamics, something that the market has been anticipating and something that you've guided for. What makes you cautious at this point in time that that 15% might not be achievable?

Kieran Balfe – *X5 CFO*

Well, I think we've been here before. I seem to remember when we were on the call for the first quarter, we were quite bullish with the performance in March and what have you, and we believed that things would get better going forward. I think part of it is a certain amount of caution on my side that, as I look at the first two weeks of July, all I would say is that I think they're probably a little softer than I would have expected them to be and so it's not a question of the trends all going in one direction. There is quite a stretch for us to make this second half of the year in order for us to make 15%. I mean to do 15% we've basically got to do somewhere around 23/24% growth in the second half of the year versus second half of last year, and I think that's reasonable to say that that's quite a stretch, so I think it's incumbent on me to lay out what the assumptions are and I think I've done that this afternoon to let you get a feel for, you know, where the risks might be, be they in an internal X5 environment, be they more macroeconomic, and we'll comment much more on that when we talk again in August on the P&L update. I think it's important that I lay out both the upsides, which are clearly there, as well as the risks.

Patrick Shields – *Wood & Co*

Okay, I mean perhaps you could then just highlight what for you are the two or three key variables in that long list.

Kieran Balfe – *X5 CFO*

Well, I mean clearly inflation is an issue. You know it's been at a historical low inflation and I never thought I'd see the day when German inflation and Russian inflation would be pretty similar, but we're in those kinds of times, and so inflation will obviously be an issue, and then I think it's the usual execution risk on the rollout of new stores, making sure that the second half of the year builds on the momentum of the first half of the year, where we've increased fairly dramatically our organic openings. I suppose last but not least is the whole promo efforts that we continue to offer the consumer not only an excellent assortment on a day-to-day basis, but also promotions that appeal to the consumers' needs both from a type of product and from a pricing point of view.

Patrick Shields – *Wood & Co*

Does that mean you still that the kind of recovery in the promo activity now is still not fully up to speed or it's not to the point where it's kind of at mission critical status relative to where you've been in the past?

Kieran Balfe – *X5 CFO*

Well, I mean it's an ongoing process. I mean, you know, we've had several promos over the last quarter. I mean we had our promo where we had – it wasn't quite buy one get one free; it was more buy one and get a large discount on the second one, and that worked very well for us. We also had a themed European 2012 Championship promo together with another promo called Catch a Moment. I mean all of these things are ongoing in our business; promo isn't something that kind of starts and stops. It's kind of an ongoing thing with a chain as big as ours and with the various multi-formats that we run, and so from that point of view I think again it's important for me today to point out to you the results that we've had in the last quarter and what's happened in June and all the rest, but it's also important for me to recognise that the second half of the year is quite a steep climb with 24% to do, and you know that there are certain assumptions that we'd have to have go our way, as it were, for us to realise that and I think I've mentioned some of the macroeconomic ones already, and that's just giving you a sense of that.

Victoria Petrova – *Credit Suisse*

Thank you very much. Could you just have one clarification question? Were you talking about 7% EBITDA margin as a guidance right now or not? Also, could you please elaborate a little bit on your sales per square metre in the regions you're expanding in versus Moscow and St Petersburg?

Kieran Balfe – *X5 CFO*

First of all, I can confirm it is 7% EBITDA. This is something we mentioned on our road show and I reaffirm here today that I believe X5 is in a business that has an EBITDA of 7% plus as its target, and I'm reaffirming that today. In terms of our growth in the...

Victoria Petrova – *Credit Suisse*

7 plus.

Kieran Balfe – *X5 CFO*

7 plus, correct. In terms of our growth in the region, I mean it depends on which region you go to, but let me put it to you this way. Essentially the sales density will drop as we move from Moscow and St Pete's into the more rural areas of Russia, but also your SG&A drops dramatically as well, and so although there may be a difference in terms of the sales density, that's compensated by the latter SG&A move and essentially what that means from a point of view of EBITDA is it doesn't mean a great deal, because I think we've seen our competitors deal with that model and deliver 7 to 8% EBITDA on an ongoing basis. We already have over 1,200 stores in the regions and I think we're capable of implementing that model as well, so even though the sales density goes down, the profitability shouldn't be impacted.

Victoria Petrova – *Credit Suisse*

Sure, sure, Kieran, and this is clear. I am a little bit just more concerned about selling space growth versus overall growth, given the regional expansion. Should we...could you give us any numbers just to maybe be able to factor it into our sales growth assumption?

Kieran Balfe – *X5 CFO*

Yes, I mean I guess for the first half of the year it was roughly about a 50/50 split between the "other" regions and what I would call the central and north west region, which was where we originally started the business from. Going into the second half of the year, I would expect that to become, you know, maybe a little bit more towards the regions, a little less towards Moscow and St Pete's, but I don't think it will have a very large dilutive effect on the top line growth.

Victoria Petrova – *Credit Suisse*

Thank you and my very last question, I promise. Kieran, should we assume that you are the person responsible for the strategic outlook of the Company and tactical outlook for the Company before we see the new CEO stepping in, because when you hold your promises, we have...investors have seen you on the road show when you...when all the goals, the outlook, the strategic measures taken, is anything changing here and who is responsible for it to be taken forward? Thank you very much.

Kieran Balfe – *X5 CFO*

Sure. In terms of things changing, the answer is no. I mean the message that we have conveyed on the road show, and you were a part of that road show that we were on, those messages are as valid today as they were when we spoke them, or when we were on the road show, so the strategic, I suppose, message in overall terms has not been changed. In terms of who is responsible, well, I think as we alluded to in our press release, you know, Stephan DuCharme, who is a very seasoned Executive with a long history and track record in this part of the whole, who has worked for people like the EBRD and Salomon Brother etcetera, will take over Andrei's responsibilities on a day-to-day basis, but I think Stephan would be the first to say that this is a team effort and, you know, Stephan's team comprises not only the CFO, but also all the Heads of the formats, the Head of Commercial and Supply Chain, IT, HR etcetera, and we as a team, as an Executive Board, are responsible for the strategic direction of the Company going forward.

Obviously, we are supported greatly by the Supervisory Board, who in their capacity as representing the shareholders, you know, take the role of examining and criticising, and testing the assumptions of the Executive Board, and in that sense they have a very serious to play in the definition of the strategy of the Company going forward. I think that's pretty much how it will until such a time as the new Chief Executive is named.

Maria Berasneva – *Morgan Stanley*

I have a couple of questions. The first one is can you please outline the key changes you're implementing to improve the performance of the hypermarkets? The second question is could you please comment on the performance of your branded Kopeyka stores in terms of the like-for-like and the sales growth for the second quarter?

Kieran Balfe – *X5 CFO*

Okay, well, in terms of hypermarkets I think we're taking a number of measures to raise the sales densities. This would include a series of things like the optimisation of the non-food range by eliminating inefficient SKUs and upgrading the food range with more branded goods in our stores. We also are working hard to improve the fresh offer. We are also decreasing the non-efficient 10,000-square-metre hypers to about 7,000 square metres and we're sub-leasing the remaining 3,000 square metres to sub-tenants. We've also put enhanced control in our service quality, including minimising waiting times at cash registers for customers. We have been very aggressive in our promo catalogue for 2012, and these in general would be the kinds of things that we'd be doing across the spectrum to make sure that our hypermarkets go from strength to strength.

In relation to Kopeyka, I can say that, you know, basically we have like-for-likes of about a 30% increase year-on-year, and I'm seeing some very positive momentum coming through.

Maria Berasneva – *Morgan Stanley*

This is for the whole of the second quarter, 30%?

Kieran Balfe – *X5 CFO*

Correct, but probably more emphasised towards the last month/month and a half of the second quarter I would expect that positive momentum to continue to develop in the second half of this year for us to come closer and closer to the business case, which we outlined for that acquisition when we made it in 2010.

Maria Berasneva – *Morgan Stanley*

Sure and in terms of the sales growth for Kopeyka as a whole, what are you saying?

Kieran Balfe – *X5 CFO*

Well, in essence, you know, I saw I suppose with my latest kind of review that it was doing about 7 billion or thereabouts a month, all stores included, so annualised that's about 84 thereabouts. As long as we can maintain that kind of momentum then I think we'll reach our targets that we had established at the time of the business case.

Maria Berasneva – *Morgan Stanley*

Fantastic and just a quick follow-up question, how far along are you in the process of implementing the changes we've discussed on the hypermarkets?

Kieran Balfe – *X5 CFO*

I think we're reasonably far along. Again, let me point out that just for anyone who didn't see us on the road show, on various different calls, and press releases and what have you, and meetings, the hypermarkets are not a drag on the results; they are a profitable format for us to have. They are not loss making by any measure of being and so I just need to reiterate that although we make quite a song and dance about hypermarkets that's because they compare unfavourably to our other two very strong formats, but it doesn't mean that they're negative in terms of profitability or anything like that.

In terms of the progress we've made, I think it's across three real areas. Look, we're testing the marketing mix, we're testing new assortment, and we're testing new store design. We have a number of tests in place in different parts of Russia. We're monitoring the outcomes of those very rigorously and I would expect us to roll out the findings of that starting in H2 this year and rolling into 2013.

Maria Berasneva – *Morgan Stanley*

So you're saying that starting from the third quarter we should start to see these activities restored to yield some results and we should expect some turnaround?

Kieran Balfe – *X5 CFO*

Well, I would say in H1 2013 with a bigger ramp up in H2 2013, remember these are large stores and it takes time to communicate the message and get the traffic and all the rest to happen, but I think you should certainly see something by the end of H1 in 2013 with much more coming in the second half of 2013.

Svetlana Grizan – *Goldman Sachs*

I have one question. This timeline for the new CEO appointment, do you have any guidance? Is it like one year, half a year, three years? Just I think it's very important for investors. Thank you.

Kieran Balfe – *X5 CFO*

I think the Board are obviously searching for a new Chief Executive as we speak. It's difficult to know what that timeline to be, because we will obviously need to find the right candidate for that position, and that could happen tomorrow morning, it could happen sometime a lot later, so it's difficult to answer that question except to say that all resources are being deployed in that regard.

Kalim Aziz – *Armajaro Asset Management*

Good afternoon, sir; I'm just wanting to understand...get a little bit of a flavour firstly about the announcement that we had heard earlier regarding the requisition in Siberia. I mean where does the Company stand today in respect of that Siberian acquisition? Do we have any more developments or is that put on hold or are we going ahead with it or not?

Kieran Balfe – *X5 CFO*

We're in discussions with that company. Nothing has been put on hold, but that dialogue is continuing. Again, as I had mentioned I think on a previous call, that's an opportunity for us to enter into a new geography essentially for us in Russia, one of the few that still remains new for us, and in that sense would give us a greater geographical footprint. That said, you know, we need to make lots of...we need to consider things, including not only price, but also how we would intend to manage that, given the distance that it is from the rest of Russia, and all of those factors are obviously complex and need to be discussed. At this stage, we have no announcement on the Siberian transaction, except to say that the dialogue is ongoing with a potential seller.

Kalim Aziz – *Armajaro Asset Management*

Okay, that's the first question. The second question I wanted to focus on was in respect of there is CPI or food inflation and there is wage inflation. I mean has X5 salary increases etcetera already reflected in the first half and do we expect to see any wage price inflation in the second half for X5, and how does it compare to your expected food inflation for the second half?

Kieran Balfe – *X5 CFO*

Yes, I mean I think, you know, in essence our policy regarding changes in CPI and the impact that that has on food inflation remains the same, which is that we put through changes in order to protect our profitability and, you know, as I've said on many occasions, as I've travelled, there are two types of inflation in the world; there is good inflation and bad inflation, and good inflation sometimes happen when your food inflation takes off and your price on the shelf increases with that, and the game with bad inflation is when your suppliers start pushing through inflation to you, and out job is to make sure that we can continue to negotiate well with our suppliers and get excellent terms from them, so that we can pass it onto our consumers, so that we can minimise the impact on the consumer that arises from food inflation taking place. We will continue in our major format to be very price-sensitive, to be the price leader, to continue with the virtuous cycle of offering great prices, generating more traffic and through generating more traffic, building our volumes with suppliers, which in turn gives us the opportunity to pass greater benefits to our consumers and so on and so forth. We pass through inflation in a manner which protects our bottom line, but at the same time allows us to grow traffic.

Kalim Aziz – *Armajaro Asset Management*

Okay, in terms of the wage inflation, we still are waiting for that answer. Wages, have you increased the wages for the company's employees already in the first half and there is no more additional wage increase we are looking at in the second half?

Kieran Balfe – *X5 CFO*

I mean in essence the comments I made when we made the Q1 profit and loss release remain intact, which is that we have up until that point put through any wage inflation that exists in X5. We obviously haven't released our profit and loss count for the second quarter. We'll only release that in August and when we do then I will update everybody regarding what has happened in terms of SG&A.

Kalim Aziz – *Armajaro Asset Management*

Okay, last question from my side. I mean from what we hear and understand that the crops for this year globally and especially in Russia doesn't look that good in respect to agricultural commodities, and as such I mean what has been your experience in respect of historically when you had a tighter crop and higher price of inputs with respect to your sales volume, your ability to price...pass through the price increases due to the increase in the cost of soft commodities?

Kieran Balfe – *X5 CFO*

I mean I'd go back to what I said at your first question, which is really to say that, you know, whether it's a poor crop or whether it's something else, which drives inflation, inflationary pressures are something which we, as a retailer, have to pass onto the consumer ultimately, because that's the only way that we can preserve our bottom line. In terms of the timing of that, obviously we will seek to pass it through or to hold back on passing it through as much as we can. We'll obviously try to negotiate as hard as we can with our suppliers to make sure that we're coming through as one of the last two receive those inflationary pressures. Why? Because we're thinking of the consumer and benefiting the consumer, and our job is essentially to keep the prices, especially in our major format, as low as they can be in this marketplace, so as to drive traffic and ultimately have a bright future in the retail sector.

Lucas Albert – *Dow Jones*

Hi, back to the issue of the soft 15% growth that you spoke about, I'm curious how you see this being affected by outside forces such as inflation and particularly rising food prices and how you expect to affect consumer demand in the second half, really both for your company and perhaps more broadly the market in general.

Kieran Balfe – *X5 CFO*

The inflation piece is certainly an important one and I think there are various factors driving inflation, first of all the global macroeconomic situation is probably causing certainly inflationary pressures to come to bear in Russia, and secondly we're obviously coming out of a cycle of elections to typically in Russia and in many other countries the inflationary impact coming through from for example the use of utilities tends to be somewhat distorted during election periods. This is very normal in many countries and I think we saw an element of that in the first half of the year in Russia. I think there is a general expectation that inflation will grow in the second half of the year, partly because of the macroeconomic situation in places like Europe, and also because of the internal issues that Russia has, including the utilities I have just referred to. Obviously for us inflation in that sense is an opportunity to grow the top line, but obviously we need to focus on making sure that we pass through that inflation on a relatively slow basis, if I might put it to that way, i.e., to be the last to pass it through because our real objective here is to not only to drive profits but also to drive traffic, the way you do that is by offering the consumer the best available prices for the quality.

Patrick Shields – *Wood and Co*

Just coming back to this point about inflation and prices – how much would you expect to be able to defray that in the supply chain, in order to maintain margins? You have made the point that you will try and pass them on but it is in your interest also to try and preserve some of that margin while offering your customers the best prices in the market. Particularly since you have started the process of renegotiating your supplier relationships, how do you see that playing out with defraying some of those rising prices in the supply chain?

Kieran Balfe – *X5 CFO*

In essence it is done on a case-by-case basis. What we're talking about here is essentially in an inflationary environment, there is as I said earlier good and bad inflation, and so what we are trying to do at any given time is if there is inflation in the market place and our prices have to rise, we are trying to pass those prices through at the last possible moment so as to look after our consumer in the best possible manner and maintain the lowest prices in the marketplace possible. Clearly we relay that to our suppliers and as the number one and the biggest retailer in the country that has some weight. From that perspective I think it is clear that we have a very professional, commercial team that does our buying and they convey that to our suppliers and we work very hard to convince the suppliers to pass through that inflation to us as late as possible. Why, so that we can generate additional volume on our shelves which benefits not only the consumer but benefits us as retailers and benefits the suppliers. The more enlightened suppliers will understand that and will work hand in hand with us to do that. I think everyone understands how that process works.

Patrick Shields – *Wood and Co*

One of the observable trends in the second half of last year, this is not on a like-for-like basis, this is the aggregate average ticket in supermarkets was rising, that was certainly the case in the fourth quarter. Then in the first quarter of this year that average ticket has fallen back again in the second quarter. There is some seasonality I guess. Could you just explain what that is and what are you seeing in the performance of the supermarkets business? On the previous conference calls you have been talking about repositioning some of the value proposition, I guess there has been some repositioning of pricing, some assortment changes, and although traffic has been in negative territory in terms of revenues, do you believe that you are positioned to be more profitable in that supermarket division.

Kieran Balfe – *X5 CFO*

I think supermarkets has always been a very profitable sector for us and so much so that some of our competitors have made attempts and are making attempts to enter that sector. I think we have conducted a great deal of market research over the last 15 months and I dare say that we understand our consumer even better than we had understood the consumer in the past. In essence it is a broad approach to meeting the consumers need, because at the end of the day that comes down to not only putting the right assortment on the shelves, but making sure that the store layout is correct; that the aisles are wide enough etc. I am happy with the results that we have had from the research that we have done and the plans that we have implemented to drive that business, and I was especially happy with the second quarter, with the results, and like for likes and what have you. I do think that that format will continue to have strong legs going forward, not only in terms of top line growth, but also in terms of profitability and clearly we will remain as the – for the foreseeable future – the number one supermarket chain in the country.

Patrick Shields – *Wood and Co*

Slightly left field – in the presentation that you took around on your road show, you gave in some of the later slides, you gave payback periods across the formats. They surprised me just in terms of the length of payback period, even in owned stores. I just wonder whether there is something specific to how you calculate payback period that means payback period is in some cases up to seven years on a soft discounter store. That seems to me to be a relatively long and inefficient payback period.

Kieran Balfe – *X5 CFO*

You're referring... we took around on the road show earlier this year which is also published on our website. I think it very much depends on where the stores are located and as you rightly say how in fact we open those stores, whether we are using rented locations or whether in fact we buy the store out.

I think the numbers are representative of the payback period and the maturity period that we typically experience. We said in discounters – just to remind the rest of the folks who are on the call today – that the payback period in discounters was somewhere typically around 20-40 months for a leased store and could be up to 70-84 months for owned stores. That doesn't mean that it is always that for owned stores, but remember it costs about $1.4 million to open an owned store typically. I think we gave that number somewhere else in the presentation, and so from that point you can have situations where that takes place. I think again that format of discount stores remains the backbone of what we do in X5, the stores themselves typically mature somewhere between nine months and one year, and obviously there are two retail chains in the country that have a very large proportion of their portfolio in that store which is of course the store that is probably most attune to Russian needs. Even though those paybacks may be high from the perspective of looking at the owned stores, they can go up to 72 months. In terms of us making sound investments and those investments returning greater than our weighted average cost of capital of 12%, I think even with those payback periods we're in very good shape.

Patrick Shields – *Wood and Co*

You would define payback as free cash flow or net present value of free cash flow. What actually do you define as payback?

Kieran Balfe – *X5 CFO*

Well it is essentially how long it takes to recover the investment that you have placed into that store. Typically we do a cash flow on the store, we look at how much we have invested into the store, not only to for example buy the place, but also to renovate the place etc, then we have to calculate the cash flows coming out of that store once it passes through the renovation period and we're comparing one to the other thereafter.

Jamie Vazquez – *Santander*

Thank you. I just wanted to come back to the departure of the CEO and perhaps if you can be more specific on the precise point where there was a disagreement on strategy. Secondly I have a question on like-for-like of the discount format. I was wondering if you can say whether the chain excluding Kopeyka had positive like-for-like in the quarter.

Kieran Balfe – *X5 CFO*

I don't really have much more to say on the departure on Andrei Gusev vis-à-vis what I have already said, so I have nothing further really to say on that.

In terms of the like-for-like for discounters, yes they are positive and we I think talked about the Kopeyka like-for-like growth particularly for the last six weeks of the second quarter being somewhere around 30% like-for-like year-on-year. If you back that out of the calculation you see roughly what the impact that would have had on our ex-Kopeyka growth in discounters which would have been still very healthy even with Kopeyka backed out.

Jamie Vazquez – *Santander*

Finally a question on hypermarkets – how do you think the hypermarket positioning will compare in two years time with what you have now? Should we say that the level of choice will narrow and the level of service will fall and prices will fall and there will be no loyalty scheme? Will be positioned more as a discount hypermarket or am I wrong with that.

Kieran Balfe – *X5 CFO*

I think in essence what we have done in the first half of this year since Jan took over is to test I suppose three separate things. We're testing different assortments, we're testing different marketing mixes, and we're testing different store layouts. Ultimately as we continue to expand further and further into the regions, we have to give the consumer what he or she needs and that has to be aimed at the earnings of each individual in that part of the world and the needs of folks in that part of the world. Essentially there is no magic to this, you do the research, you do the testing, you use what works and you don't use what doesn't work.

I think even visiting out stores now you can see some of the changes in the assortment and the store layouts and what have you, and I think what you will see are those ideas that work very well being rolled out and it will all be very much customer driven.

Tatiana Kormiltseva – *Renaissance Capital*

Thank you for your presentation, I have a couple of questions. First of all I want to get back to CEO departure. Can you please elaborate if you have any information on whether the Board have preferences on Russian or foreign CEO. The second question will be – can you talk a little bit more on the KPI of the new CEO. What will be one of the main KPIs, like the share price growth, the top line growth or the margins, or everything? My next question more about the business – do you feel like the 15% year-on-year growth will be also difficult to achieve because of the cannibalisation and increased competition on the Russian market. If yes – what do you experience more, the cannibalisation from own openings or from the competitors. Thank you.

Kieran Balfe – *X5 CFO*

Thanks for the questions. In terms of the first question – is the Board searching for a Russian candidate or a foreign candidate and does the Board have a preference. I would suspect that the Board will search for the suitable candidate and that suitable candidate can come from any part of the world. I have no further information on it than that. I would assume that the Board will not limit themselves by geographic jurisdictions and that the right candidate will be found for that job, regardless of the nationality of that candidate.

In terms of the important things for a CEO coming into that job – I daresay they remain the same pretty much as they have been for any CEO who has operated in retail, or indeed in Russian retail over the last many years. Top line growth is clearly a key component for all of us; we all focus on it greatly. At the end of the day retail is about sales and so top line growth will remain a key focus for all of us. Clearly growing at any cost will never be the X5 way, profitability and profitable growth will be the way forward, and we have expressed on many occasions that we believe we're in a business where the EBITDA north of 7% is very achievable, for those who are best in class in the retail market in Russia, and we will have to continue to focus on that. I daresay that the new CEO will have that as part of his or her agenda on day one.

In that sense I think nothing really changes. Those remain kind of the key, at least from a profit and loss account, the top line growth but delivering the EBITDA of north of 7% remain in place.

In terms of the increased cannibalisation in competition – I mean in the end of the day, of course there is increased cannibalisation and competition in the market place. The question really is more the degree of that and how severe it is. I think it is fair to say that modern retail is still only 40% of the overall Russian universe. We are about 5.7% of the retail universe in Russia. The law only restricts us when we get to 25% of the food retail universe. Yes there is a certain amount of cannibalisation and yes there is increased competition year on year, but I think it would be fair to say that there are lots of opportunities to continue to grow our network over the year come and show whoever takes over that job will be well focused on capitalising on those opportunities.

Anton Farlenkov – *Goldman Sachs*

Hi Kieran, a couple of question, firstly on Gusev's departure. Does the Board consider internal candidates? Your senior management team has a number of very experienced and outstanding guys from legal; why not appoint someone from existing management who has experience. My second question is – how strategy can change post-Gusev's departure and what do you plan to focus on and can you highlight three key challenges and three key priorities for the business in the medium term.

Kieran Balfe – *X5 CFO*

Again I am not a member of the supervisory Board but I would assume and I will go back to my earlier answer that the Board will review all candidates that would be appropriate to that position, regardless of their location. I would assume that would include internal and external candidates. I think this would be very normal when a Supervisory Board seeks to hire a new Chief Executive. In fact I would almost say it is par for the course.

In terms of the strategy and what have you – there is clearly a number of items that are top of the agenda, one will be our continued growth in our discounter format, not only in terms of the rollout of stores, where we have increased dramatically the organic from about 350 stores in total rollout of stores in 2010, to somewhere north of 800 this year that we expect. The bulk of those obviously being in the discounter format. Clearly the rollout of that format will remain front and centre for us, and under the guidance and the leadership of Frank Mros we look forward to continued expansion there. I think clearly the turnaround in the hypermarkets will remain a key focus for us. It is something although the hypermarkets are profitable, we feel we can do a great deal more with our hypermarkets and I think I have spoken quite a bit today about the steps we're taking to improve things at the hypermarket front.

I suppose in essence taking two steps back from all of that – it will be important to make sure that all of our business units are supported in the appropriate manner, and that we continue to develop our logistics, continue to develop our IT, in order to support this considerable expansion. At the end of the day all of those things have to work very closely together in order to deliver what is finally great assortment at great prices to the consumer. All of those things will continue to remain in focus over the next several years.

Elena Jouronova – *JP Morgan*

Hello, thank you very much for the call Kieran, can you clarify will there be any additional payroll costs or other country benefits associated with Andrei's departure.

Kieran Balfe – *X5 CFO*

I don't have a comment on that at this stage. I think this is something which given the size of the Company and what have you is not likely to have a significant impact on the profit and loss account, and I think I will address that question in more detail when we release our quarter results, the P&L, the second half of August.

Elena Jouronova – *JP Morgan*

I have a few other operational questions. Would you say that overall you are happy with your current promotion activities, or you feel that you actually need to do a bit more of those and maybe start investing in price? The reason I am asking is because based on my calculations, there was not that much of an improvement in traffic if you exclude the impact of Kopeyka on your like-for-like. I am wondering if you plan to do more promotions and most importantly if you plan to invest your margin.

Kieran Balfe – *X5 CFO*

Let me take the second question first because I think this is something which is frequently asked and something we can dispel quite quickly. There is a myth in the world that says that as you increase promotion your margins should contract. I kind of disagree with that a little, because if you're really well organised in doing your promotions then essentially your promotions should pay for themselves. It is in the supplier's interest and in the retailer's interest to make sure the promotions are successful. If there is one thing that X5 does very well it is buying product. From that perspective I would expect that one should not be too worried about the increased promotional level and the impacts on margin. I think if you look at what has happened really to the discounters margin for example over the time that we have been doing promotions, let's take it back to Q1, it really isn't impacted, and that I think is really something which we need to just get our head around.

In terms of what future actions we will take – clearly we have several of these on the go at any given time, and again it is much of what works in promotions becomes a question of trial and error. If the promotion is particularly successful then maybe you repeat it and if it isn't so successful then you do something else. We have had some very successful promotions in the second quarter of this year, across the different formats.

In discounters we had this catcher moment, this twice-weekly kind of promo. We also had this crazy prices promo which gave a discount of the second product that you bought, and in supermarkets we have also increased quite a lot of promotional activities in quarter two. They went up by about 55% in quarter two versus quarter one, and we had this glasses as a gift campaign which basically peaked at the end of Q2 2012. Again all of those we monitor very, very carefully, taking a look at the uplift in sales and what have you, and we use what works and those that don't then we don't repeat it.

I can't see there will be any major change in our approach to promos. They will remain an integral part of our business across the different formats that we have in an effort to try and drive not only traffic but improve the customer experience.

Elena Jouronova – *JP Morgan*

It feels as if in terms of promotion activity, you are quite happy with what X5 is doing, but it is clear I think to everyone that there is still a lot of room to improve footfall. Where are you in this process? What else can be done to do this? Is this really about having, right now as you have like the SAP system in place, supply system in place? Is just about really improving product availability on the shelves, getting the right assortment in place? I am just trying to get a feel of what really should drive this footfall increase, because to me it didn't seem the promotion activities changed the picture a lot. Maybe I am right; maybe I am just too sceptical about that.

Kieran Balfe – *X5 CFO*

It is fine. I think in terms of our traffic growth and what have you and our traffic development, I am quite I suppose pleased with the traffic development. Traffic is not normally something that changes in an instant and one has to fight, not only for every 1% but for every 1/10th of 1%. I think you have mentioned all the key variables that we focus on, you have mentioned assortment and price and you may have mentioned marketing mix and media mix. These are all of the things that go into making up a great promo and I suppose if I look at the team that is executing against that in 2012, I have to say we have a very heady team of people who have great experience, not only in Russia, but also across the globe in executing great promos. We have I would say a broader view of what is possible in Russia, vis-à-vis what we might have had say 12 months ago. I can only think that we will go from strength to strength as we borrow and reuse ideas that have worked in different parts of the globe.

I have mentioned some of the promo campaigns that we used in quarter two, I think some of them were very successful and I would trust that that is just the beginning.

Elena Jouronova – *JP Morgan*

I am very sorry for taking up so much time but three more questions from me. In terms of negotiations with suppliers – when do you enter into your next round of negotiations and who now will be the key decision maker, who will be responsible for the process?

Kieran Balfe – *X5 CFO*

The negotiations are ongoing. You typically have about a maximum one-year time horizon when you are negotiating you're contracts. The person who negotiates that is the Commercial Director for the Company, Paul Martins, and he will continue to lead the team in negotiations. Andrei's departure doesn't in any way impact the negotiation process, and the terms, the timing and all the rest that would be associated with that.

Andrei's departure in fact doesn't impact any of those things in the formats and the day-to-day running of the Company, be it in logistics or in the formats or whatever. The reality is that the big change which Andrei instituted in the Company and did remarkably well was he built a company that was being run on a day-to-day basis, if I might put it that way, by a set of people other than him. these people are heavyweights like Frank Mros, Paul Martins etc who have many, many years of experience in retail, and these are the people who have the responsibility to continue to run our business in that period of time when we're waiting for the appointment of a new CEO.

Not only in terms of commercial, buying and what have you, but in a broader sense I think the Company is well positioned to go through Q3 and Q4 and handle the various different processes that happen in any retailer on a day-to-day basis.

Elena Jouronova – *JP Morgan*

Then comes the question of expansion plans, because that is probably not what you can call day to day; that is a strategy defined by the Board, approved by the Board. I think we know roughly how much stores you want to open this year since this plan was approved but what about next year. I think some time in Q3 the head of the Company should present a plan so that we have an idea of what to expect for 2013 and then besides that do you think there can be some risk to your current year expansion plans because of Andrei's departure or really not.

Kieran Balfe – *X5 CFO*

No I don't think that there is any risk that would be brought about by Andrei's departure to the development plan for this year. Let's face it we're already into quarter three at this point, and the plans for opening stores are – well let's put it this way, if you haven't got pretty much organised at this stage, you're not going to be. You have to sign he agreements well in advance in order to do the renovations on time etc, because all of this stuff takes time. I am well confident that we will complete our expansion plan for this year in the manner and in the way that we had outlined, not only on the road show but I think on previous calls year.

In terms of next year – I would say again what I have said I think in the past which is to say that the organic growth capacity of X5 I think is probably in little doubt at this point. There was a time even as close as something like quarter one last year, where I think we were generally viewed as an M&A outfit with not quite stellar credentials in the organic area. That is when we were opening about 300-350 stores a year. I think last year we increased that to 550, and at the same time we had to integrate over 600 stores from Kopeyka, and this year we have come to the market and said that we feel that we will something around or north of 800 stores. It is very clear that X5 has not only the management bandwidth but the access to capital to be very aggressive in its organic growth, and I would not expect Andrei's departure to in any way diminish that approach to expansion.

Elena Jouronova – *JP Morgan*

Thank you very much and then the final one. I understand that you're still looking at the whole deal but can you share with us who really was or still is the person who is primarily responsible for these discussions. Was it Andrei, was it one of his deputies, just that and that is it from me. Thank you.

Kieran Balfe – *X5 CFO*

Thank you. We have a director of M&A whose name is Anton Mironenkov and he was and is the lead on those discussions with the potential seller. Again Andrei's departure doesn't in any way impact our ability to either go ahead with that deal or to shut it down.

Kalim Aziz – *Armajaro Asset Management*

Sorry to bother you again, I wanted to understand a little bit better about the potential credential that you would be looking for in the new CEO. I guess is this going to be more with a retail hat with respect of how to focus the efforts, increasing footfall and traffic and managing the retail aspect of the business, or are you looking at a person who is more COO person to look after the middle and the back end of the business, or are we looking for somebody from a similar person like Andrei who was a more M&A orientated person.

Kieran Balfe – *X5 CFO*

I don't think I am in a position to comment further on the credentials that the Board of Directors will use to select the new Chief Executive. What I can say is and it is obvious from anybody who has ever reviewed the profiles or met with our Supervisory Board is that we have the strongest and the most balanced Board I have ever met, with very deep retail expertise but also very broad expertise in anything from HR to finance to banking etc. We're talking about a very experienced Supervisory Board and I am very confident that the Board will carry out the search in the normal way and will select the candidate that is right for that position given the fact that the team that is in place right now is already very strong and capable of running the business in a very proficient way.

Tatiana Kormiltseva – *Renaissance Capital*

Thank you, just a follow up question on resignation of Andrei Gusev. Can we clarify is it possible that any restatement of the operating or financial results could follow the resignation of Andrei?

Kieran Balfe – *X5 CFO*

I am sorry I am not sure I understood the question, you mean in terms of guidance.

Tatiana Kormiltseva – *Renaissance Capital*

I mean the historical data that is already available, for the fourth quarter, revenue growth. Can it be followed by any... restatement? Can we expect this?

Kieran Balfe – *X5 CFO*

No you can't expect it. One of the nice things about what I do is that I have access to all the numbers and I can say categorically that I do not expect any restatement of any numbers that have been published in the past.

Tatiana Kormiltseva – *Renaissance Capital*

Thank you, just one last question from me on the EBITDA margin guidance. Like you are saying that any promo will not probably result in margin contraction. Shall we assume that confidence of above 7% EBITDA margin is very well confident like in terms of if any price investments will be strengthened and more promo activities will be implemented in X5?

Kieran Balfe – *X5 CFO*

You can take it as a given that as an executive team when we run this business day to day we take it as a given that on an annual basis we need to be delivering an EBITDA at or above 7%. Obviously there are various ways you can reach that objective. In the end of the day that is the EBITDA target and we have confirmed this I think for the last – certainly since I have been here, and we will continue to do that. I think we have numerous ways to reach that objective and the fact that we have a very strong management team, excellent IT systems that give us full transparency on the business and therefore great cost control and what have you, puts us in a position to be able to make that statement with some surety.

Jamie Coleman – *Tansel*

Kieran could you tell us a little bit about SG&A and the level? It seems to be increasing as time goes by.

Kieran Balfe – *X5 CFO*

Well again today isn't really so much about SG&A because of whatever I was going to say on SG&A for quarter one I have said it, and for quarter two we haven't released our results yet. I can't really comment on it, except to say that in general SG&A is something which we take very seriously, and part of the logic of rolling out SAP and giving ourselves the kind of tools that are necessary to control SG&A, is because we understand that SG&A and the control of it is going to be critical in the years to come. Again I think Russia in terms of modern retail is still relatively underdeveloped, but if you follow the development of retail anywhere in the world, what you will typically see if that the winners in retail are those people who when competition becomes quite tough and that might be many years from now in Russia, the winners are the guys who can watch their gross margins be compressed and at the same time compress their SG&A in order to protect their bottom line. I think we're very clear for the necessity to build that kind of capability in the Company at this stage of our development. I think we have already taken the big steps to do that over the last three years. I think we have an unparalleled ability to be able to see the best practice and spread them across the Company. From that point of view, SG&A remains one of our top priorities going forward.

[No further questions]

Speaker

Everyone, thank you for the call, we are now ending the call, thanks.
