Chairman's statement

Overview

This statement covers trading for the 25 weeks to 23 July 2006 and is presented in accordance with International Financial Reporting Standards.

In March, having completed the process of converting Safeway stores to Morrisons, and divesting substantially all of those stores that would not fit the Morrisons trading model, we set out our plan for the next phase of our development, which we call the Optimisation Plan. Progress towards our optimisation targets has been pleasing in the first half, giving us confidence that they will be achieved ahead of our original timetable.

The period saw little change in the size and shape of the stores estate, with a further 6 ex-Safeway stores divested or closed and one new store opened in Leyland, to leave the Group with 373 trading stores at the half year. We expect to open 3 new build stores in the second half, at Swadlincote, Cardiff and Crowborough, and we announced in July that we are selling a further 6 small stores to Waitrose along with one of the ex-Safeway distribution depots, at Aylesford, that was closed earlier this year.

Turnover for the 25 weeks was £5.85bn, in line with the prior period. Given that 66 stores were sold in the intervening period this was a satisfactory performance. Strong growth was achieved in the stores converted from Safeway, whilst the original Morrisons stores, which started the period recording negative like for like sales, had, as anticipated, moved into positive territory by the end of the period. Fuel sales were very strong, and the fact that like for like volumes grew by 4.5% underscores Morrisons value credentials in this prolonged period of high fuel prices. Overall, like for like sales increased by 6.6% including fuel, and 4.6% excluding fuel, during a period which saw generally good growth across the sector.

Profit before tax was £134.2m, compared with a loss in the prior period of £82.1m. Operating profit was £163.8m compared with £50.7m before exceptional costs in the prior period, reflecting progress in delivering the Optimisation Plan. There were no exceptional costs this time, compared with £118.8m in the prior period when the Group was in the midst of the stores conversion process.

Cash flow was strong, with £418.8m generated from operations compared with £326.6m in the prior period, which was impacted by exceptional costs. This led to a substantial reduction in net debt, to £881m compared with £1.1bn a year previously and £1.6bn two years ago. Despite the reduction in debt, net financing costs were up slightly at £29.6m due to lower interest capitalised and the effect of marking-to-market certain interest rate swaps that do not qualify for hedging treatment.

Capital expenditure was significantly down after the intense activity of the previous two years, with investment in the period of £115.3m and an expectation that capital expenditure will approximately match depreciation this year.

With the Group returning to profitability, the Board is pleased to confirm its intention to pay an interim dividend of 0.625 pence per share, the same level as last year. This will be paid on 13 November 2006 to shareholders on the register on 13 October 2006.

Optimisation Plan progress

The last annual report set out the Board's plans for the next phase of development, having completed the task of converting and integrating the Safeway estate. It confirmed that this next "optimisation" phase would continue for three years, but that we were confident of delivering good improvements in like for like sales and profitability in 2006/07. At this interim stage of the year, it is pleasing to see the improvements coming through solidly and sustainably.

The objectives behind the plan are simple – to apply the Morrisons philosophy, which worked so well over many years, to the new, bigger business and adapt it where appropriate, to reflect things that have changed. Underpinning our actions is a vision once again to be the Best Grocer in Town, and progress is being made on all fronts. For the first time in two years, colleagues in the business have been able to concentrate, exclusively, on the day job, and this is bearing fruit. The quality of the existing team is amply demonstrated by the speedy way in which challenges have been addressed. Further improvements in standards are showing daily, in range selection, merchandising and supplier relationships.

The lifeblood of the business is, of course, sales – our ability to encourage more customers into our stores, and to buy more. In core Morrisons stores, we need to rebuild sales lost in the previous two years through cannibalisation, the distractions of the conversion programme and competitor openings. In the converted stores, we need to attract customers who are new to Morrisons. Good progress is being made in both areas. Customer numbers were up, on a like for like basis, by 5.3% overall and a particularly strong performance was seen in the converted stores as new customers tried us and liked what they found.

With our store management teams able to focus, once again, on the basic disciplines of shopkeeping, we have been able to ensure that customer service is delivered well whilst also improving our efficiency. Our objective of saving 6m labour hours this year, without detriment to service or the need for any programme of redundancy, is well on course for achievement, with attendant savings of £50m. Our operational focus has also resulted in improvements in wastage levels, contributing to our three year gross margin uplift target of 0.9%, the majority of which we now expect to deliver this year.

A strong contribution to this target has been through improved buying terms delivered by our trading team. They, too, are now able to concentrate fully on their normal tasks of product innovation and delivering the unique combination of everyday low prices and a comprehensive programme of promotions that have made us consistently first for value. Our suppliers are now seeing growth again with Morrisons, and they have responded in supportive fashion.

Our abattoirs, fruit and vegetable pack-houses and meat and cheese processing facility were all operating at capacity in the period, to serve the new bigger business. This high level of operating efficiency has further helped the margin performance in the period.

Our distribution network has coped well after the inevitable disruption associated with three large depot closures early in the year. Stores have received good service, despite the fact that our distribution infrastructure is still not optimally structured to serve our needs in the South. We are pleased to have proved that we can maintain our industry leading levels of in-store availability, albeit the cost of achieving this is currently too high. We are on track to deliver the £30m of distribution cost savings previously announced, this year, and some further rationalisation of the network is currently the subject of consultation with colleagues.

As previously announced, we opened our new head office in Bradford in April, and the relocation of 1,400 colleagues was achieved with minimal disruption. The elimination of duplicate facilities will save £30m in the current year, a previously announced target, but as important is the improvement in efficiency and morale being seen from having the vast majority of our central colleagues in one location for the first time since the Safeway acquisition.

We are, naturally, cooperating fully with the inquiry into grocery retailing being undertaken by the Competition Commission, which we believe is exploring the correct issues. We have responded to their detailed and extensive requests for information, and have endeavoured to provide this in a timely and cost effective way through our in-house team.

The Optimisation Plan is still in its early stages, but the Board is encouraged by progress to date and delighted that the efforts of colleagues throughout the business are bearing fruit, both for customers and our shareholders. Morale is good, and we thank all our colleagues for their dedication and professionalism. We are delighted, on their behalf, to have been recognised as best for service by both The Grocer and Checkout magazine in their annual awards

Board

Marc Bolland joined us as Chief Executive on 1 September, replacing Bob Stott who retires on 30 September. He has made an enthusiastic and energetic start, seeking to understand the heartbeat of the business and getting well acquainted with colleagues in all areas. In addition to taking over Bob’s operational responsibilities Marc chairs the Executive Board, has responsibility for Group strategy and will be a member of the Nominations Committee.

During the first half of the year we confirmed Paul Manduca as our Senior Independent Director. Paul is leading the process of selecting and appointing a new Deputy Chairman, in succession to David Jones, who retired on 30 June. Executive search firm Egon Zehnder has been engaged to assist with this. We are also seeking an additional independent non executive Director with recent and relevant financial experience to support the workings of the Audit Committee.

Trading update and outlook

In the 8 weeks since 23 July 2006 the Group has continued to see good trading momentum, with like for like sales up 6.5% including fuel and 5.9% excluding fuel. Converted store sales growth remains strong, despite 176 of the total 226 converted stores now being in their second full year post conversion and therefore having annualised the initial conversion uplifts.

The Group's sales levels are slightly stronger than we had anticipated at the time of preparing the Optimisation Plan, and give us confidence for the second half despite an expectation of a tougher trading environment.

At this early stage in our optimisation programme, we are encouraged by the progress being made. We are very clear that there remains much to do in order to establish the levels of profitability expected by our shareholders, and in that regard will lay out our plans for the next phase of profit recovery when we present our full year results in March 2007.

21 September 2006