# Interim Results 6 September 2012/13

## Slide 2 - Sir Ian Gibson

Good morning everyone and welcome to our interim results announcement for the six months ended 29 July 2012.

Looking back on my notes of the interim results meeting a year ago, I notice that I said then that the first half of the year had been yet another difficult period for the UK economy and for the consumer. Disappointingly I have to report that there has been little respite in this last half year and that, if anything, life has been slightly tougher.

I'm therefore pleased to be able to report that against this backdrop we've made steady progress in delivering balanced growth, with turnover increasing by 2.3%, underlying EPS up by 10% and with our interim dividend growing by 10% too.

And as well as delivering our day to day business, we've also been pressing ahead with our strategic initiatives, laying the foundation stones for the successful future of our business. Dalton will be talking about those in more detail later.

I'll now hand over to Richard who will take you through the results in more detail.

## Slide 3 – Richard Pennycook

Thanks Ian and good morning everyone. Let me take you through the numbers.

## Slide 4 – Financial summary

You are familiar now with the pattern of our performance, in this low growth environment. We set up the business in 2010 to deal with reducing consumer disposable incomes, ensuring that we could drive profit performance through our self help measures and earnings performance through improved balance sheet efficiency. Once again, in this period, we have delivered operating profits and earnings growth ahead of topline growth.

Our statutory profit before tax is down marginally, due mainly to the higher financing costs associated with the equity retirement and also to start up costs for new channels, which I will come onto later.

Our dividend growth of 10% is in line with our underlying earnings growth, and consistent with our guarantee to shareholders of a minimum double digit return for this year and next.

## Slide 5 – Turnover bridge

I always show you a sales breakdown in this format, and this time there is a somewhat different shape to previous periods. New store contribution was 2.2%, similar to past periods, but like-for-like sales were negative, and in the round the total store sales growth of 1.3% resulted in a loss of market share in the half year. There were both structural and trading reasons for that. Dalton will talk you through the trading environment, and our planned response, and I will touch on the effect of new space in a moment.

Looking at the fuel performance, it is pleasing to see that once again we grew volumes, reflecting our reputation for having the best value petrol in town. You will recall that in our budget submission to the Chancellor, we urged him to consider deferring the planned 3p per litre fuel duty increase, and we were pleased that he did so. Fuel prices were still a headwind for consumers, albeit at a lower rate than previously, and it is of concern to us that the oil price has once again been climbing in recent weeks.

You will note on the chart that we have shown convenience sales separately. Whilst they were insignificant, given that we only have trial stores currently, we feel it is important to show the performance of our new channels.

## Slide 6 – Space growth imbalance – short term headwind

I have talked before about an imbalance in the industry, between the rate of market growth and the amount of new space being built or recycled. This chart updates something I showed a year ago, and gives a sense of that imbalance. You will note on the chart that in 2011 and 2012 we are seeing space growth outstripping market growth – a position which will improve as industry space growth rates subside and stronger market growth accompanies economic recovery. It has been vital, since 2010, to have self-help measures in place to offset the headwind of low sales growth, and that will continue for some time to come.

## Slide 7 – Changing competitive environment

This chart illustrates one of the changes that took place in the period, at individual store level. It shows our heartland – indeed at the top of the picture is Hilmore House, our head office. Our Thornbury store, in the centre of the picture, is a big, well performing Morrisons. During the period, its sales have been impacted by the conversion of an old Netto store to Asda – literally a stone's throw away. While the Asda is little more than a small supermarket, it inevitably takes some trade – and there are around 100 of those that have opened close to a Morrisons in the past year. This helps to explain our like-for-like headwind. We start to annualise those effects in the second half.

## Slide 8 – Underlying earnings

As usual this chart shows the breakout of our underlying earnings calculation.

We've shown the initial costs of getting multi-channel and convenience under way, and these investments will become bigger in the future. We want to be very transparent on how these investments are performing, and hence we have split out the initial costs this time. Overall we expect c£15m of these costs in the full year.

Underlying earnings per share were up 10%, ahead of profits, helped by both the gradual reduction in headline corporation tax rates and the early effects of the equity retirement programme.

## Slide 9 – Operating profit

Our operating profit performance was pleasing, and consistent with the guidance we have previously given. Our tight cost control can be seen in the administrative expenses line, up 2%, and our overall operating margin increased by 10 basis points.

## Slide 10 – Cash flow

Turning to our cash performance, we delivered a 23% improvement in operating cash flows, up to £833m in the period. I would caution that the working capital benefits were seasonal and will largely reverse at the year end.

In combination, our investments in capex and acquisitions of £414m were modestly ahead of prior year, whilst our equity retirement programme continued at the rate necessary to meet our target of £1bn by March 2013. It appears from the cash flow as though dividends were down year on year. To remind you, last year we re-balanced the dividend between interim and final. That helps explain the apparent reduction this time, when in fact dividends are up 10%. And of course we are seeing the impact of the buyback in this line.

Our continuing investments and increased shareholder returns resulted in net debt rising to £1.7bn – to leave gearing at 32%, still comfortably the lowest level in the sector. We anticipate net debt of around £2.1bn at the year end, as we draw towards the conclusion of the equity retirement programme.

## Slide 11 – Debt maturity profile

This chart shows the maturity profile of our funding, and we took the opportunity to improve it further in the period with the raising of £400m of 14 year debt repayable 2026, as well as a £150m top up on our revolving credit facilities that are due to be refinanced in 2016.

## Slide 12 – Impact of equity retirement on reported EPS

As you know, we are very focused on shareholder returns and on capital discipline, and I will talk about each briefly in the next couple of charts. First, this chart shows the early effect of the equity retirement as it starts to enhance returns. In the past 12 months, the primary drivers of earnings enhancement have been underlying profit growth and improvements in our tax position, but the equity retirement was also positive to the tune of 4%. Over the full year we anticipate about 5% EPS growth from this source.

## Slide 13 – Return on capital employed (ROCE)

In March, at our prelims, we published ROCE for the first time. I said then that our future investment programme would result in a flat profile of returns going forward, albeit our working capital gains in H1 resulted in a small rise this time.

As Dalton will tell you, we are beginning to crystallise our plans for Fresh Formats, multi-channel and convenience development, and these activities will require capital. In order to balance our returns, we are amending the timing of our new space programme to accommodate this. Originally, we planned to open 2.5m square feet of space over the three years to January 2014. We have now reshaped that programme to run over 3.5 years to July 2014. As a result, our new space guidance for this year and next has changed, as shown on the chart, to 500,000 square feet this year and 900,000 next year. Equally, our capex for each year will reduce by £100m with guidance for this year now down to £1.1bn.

Now let me hand you over to Dalton.

## Slide 14 – Dalton Philips

Thank you Richard. Good morning everyone.

First, let me start with some context covering the trading environment, how that's impacted the consumer and how we've responded.

Secondly, I'll give an update on the progress we're making towards our vision of being "Different and Better than Ever".

## Slide 15 – Market backdrop

The UK grocery market remains uncertain and challenging.

Globally, commodity prices continue on their long-term upward trend leading to high input costs across a whole range of food products.  And the UK has its own challenges.

Uncertainty about the Euro zone is acting as a drag on growth, economic output has been falling, and despite private sector job creation, the overall unemployment figure remains stubbornly high.

This is compounded by constrained credit, and high, although decreasing, inflation, which continues to sap consumers' spending power.

## Slide 16 – Consumer behaviour

As a result, consumers feel they've less money in their pockets and consumer confidence remains low.

With consumers either choosing not to, or unable to spend, behaviours are changing.

They're still spending to a budget but, for some, that budget is even tighter.

They're checking the price of every item, switching to Own Brand, trading down within Own Brand tiers and buying only what's needed.

At home, they're applying that strategic thinking to what they eat.  Filling up at breakfast, preparing a lunchbox and eating together in the evening.  They're cooking quicker and cheaper traditional meals, like Spaghetti Bolognese.

## Slide 17 – Sales performance

The pressure on consumers has been reflected in our first half sales performance where, as Richard mentioned earlier, our total sales growth, excluding fuel, has slowed to 1.3%.

Sales in our like-for-like stores are down by 0.9% and whilst basket spend was slightly up versus last year, customer numbers were down 1.8% as they shopped less frequently and put fewer items in the basket.

## Slide 18 – Responding to customers

Looking ahead we're finding innovative ways to add real value to our customers.

Just this week we launched our new Fuel Saver scheme which helps customers get discounts off fuel at our forecourts and at the checkout, we've recently introduced customer specific money-off vouchers.

In the aisles our new POS communicates the great value we're offering at £1 and 50p price points, complemented by industry leading deals on fresh fruit and vegetables, and an increased choice of meat and fish in our 3 for £10 offer.

For customers trading into Own Brand, our M savers range has products in every category, and we're broadening our range of pack sizes across fresh food, to help customers buy only what they need.

For mealtimes we're focusing our offers on the core essentials like baked beans and tinned tomatoes. We've recipe card suggestions in-store for those eating on a tight budget and our meal deals, like our Champion Breakfast for under £5, feature all the key ingredients.

## Slide 19 – Our convictions

Before I talk about the progress we've made with our strategic initiatives, I want to remind you of the six convictions that underpin them.

These are our firm beliefs about how we see the market developing, what our customers will expect and how we can make the most of our unique capabilities.

- we'll be a food focused retailer, not a generalist.
- we believe food shopping should be experiential, not purely functional.
- and that even when the economy does improve, consumers mindsets will have shifted with value always at the core.
- we believe that outstanding customer service is delivered by nurturing skills in our colleague base,
- not just drills.
- and when we sell general merchandise, it will bought through clicks not bricks.
- finally, customers increasingly want multi-format, multi-channel retailing.

By tailoring our offer to different customers' needs we can serve more customers,
more of the time.

## Slide 20 – Three areas of focus

These convictions shape the areas on which we're focusing our business;

- driving the topline,
- increasing efficiency,
- and capturing new sources of growth.

## Slide 21 – Driving topline

Our focus on driving the topline centres on four initiatives, strengthening our Own Brand, Fresh Formats, enhancing our Service Culture, and completing National to Nationwide.

Today I'll update you on the progress we've made throughout H1 with our Own Brand development and Fresh Formats concept.

## Slide 22 – Strengthening our own brand – new ranges launched and performing well

Given Own Brand accounts for approximately half our store sales we can truly differentiate ourselves by offering the price, quality and range our customers want.

By capitalising on our strengths in vertical integration we're creating a fantastic, relevant, own brand that customers really believe is 'worth switching supermarkets for'.

What could be more relevant when customers are feeling the squeeze, than our M savers range? With more than two-thirds of our range under £1, we're really dialling up the value and taking the fight to the discounters.

We've increased the range by almost 30% so far, with even more products to come in H2, and since launch we've increased our value tier market share by 270bps.

We've also made significant improvements to our core Morrisons products. The everyday family favourites that customers know and love. We've improved packaging, introduced new lines and reformulated recipes.

Since the beginning of the year over 2500 products have been re-launched from deli meats to spreads and sandwich fillers and to help customers manage their budget, we're putting the price on our packaging demonstrating our commitment to value for money, and providing reassurance that prices won't change the next time they shop.

## Slide 23 – Strengthening our own brand – additional launches to bolster our brand

We're on track to have 5,000 Own Brand products re-launched by the end of this year. By January 2014 we'll have launched around 10,000 products - that's around a third of our range.

We'll complement our food offer with our new Morrisons children's clothing range - Nutmeg. We're creating a fresh, no-nonsense, fashionable range that's simple to buy in a category that customers want in their local supermarket. We're busy preparing the range, building the team and readying our new distribution centre for launch next year.

## Slide 24 – Fresh formats – making good progress

At Morrisons, we're passionate about what makes us different. Our craft skills, vertical integration, and the quality and range of fresh food on Market Street.

With Fresh Formats, we've taken those strengths and reinforced them making "Different and Better than Ever" a reality for our customers.

Last year we trialled our new concept in 12 stores, and during H1, we transformed a further 33 taking our total to 45 stores right across the country.

We've liberated over 100k sq ft of space to-date to accommodate our extended fresh food range and give space to the categories that customers want. This isn't a one-size-fits-all concept, so we've tailored our offer across different demographics, locations and store sizes to include the elements that appeal most to customers at a local level.

Across every store, we've continued to highlight our fantastic value greeting shoppers with industry leading fruit and veg deals and fresh offers right across Market Street.

Our customers say they love the spacious and bright feeling in our stores, the wider range of fresh products at unbeatable prices and the extra choice on our counters.

This translates into a sales uplift within our expected range of 4-6% versus control, in line with our ROCE criteria. A really encouraging result given the tough market.

## Slide 25 – Fresh formats – pushing ahead with roll out

We're taking a measured approach to introducing Fresh Formats to our estate. This isn't about refreshing with a lick of paint. These stores are complex to run. Across our stores, we've real butchers, bakers, greengrocers, fishmongers, florists and cheesemongers with unique, fresh expertise. From filleting fish, deboning beef, making handmade sausages, creating bouquets, baking from scratch and the list goes on and on highlighting to our customers how, and why we're so different.

During H2 we'll continue to transform stores with this concept. We'll take it into smaller stores and urban areas, tailoring and testing, as we've done before, to inform further rollouts.

By the end of January we'll have over 100 Fresh Format stores, including some 20 new builds representing around 30% of our sales. In the year we'll incur total costs of £20m in implementing these stores, as well as capex which will average £1.7m per conversion, in line with previous guidance
and included in the £1.1bn overall guidance that Richard mentioned.

And we remain on track to deliver our 750k sq ft target of liberated space.

## Slide 26 – Increasing efficiency

Our second focus is on driving efficiency making the savings that we can invest into better service and value. We've increased efficiency with three initiatives:

- productivity within our stores;
- our IT systems;
- and indirect procurement.

## Slide 27 – Driving store productivity

Across our stores, we've continued to drive productivity, both in the back office and on the shop floor. We've successfully rolled out a range of new initiatives in H1 including the electronic receipt system for news and magazines that I mentioned at the Prelims.

We've maintained our high in-store standards throughout as recognised by The Grocer Awards we received in June for our service and availability. In the coming months we'll rollout even more initiatives including more self service checkouts in high usage stores, and improving our existing checkouts. We'll trial new initiatives of all shapes and sizes.

For example;
by adding 8 extra buttons, representing some of our most popular products, to our checkout screen we'll stop 500m excess button presses and save up to £2m.

We're also changing our till system to print during, rather than after the transaction, saving up to £3m and reducing the time our customers spend at the checkout.

With these initiatives landing in-store, we're on track to deliver £40m savings this year.

## Slide 28 – Tackling indirect procurement

We're pressing on with our strong momentum on indirect procurement implementing over 100 great cost saving ideas, many of which have been suggested by colleagues around the business.

We've focused on the big such as retrofitting energy-efficient LED lighting on the shop floor and also the small, such as switching our bin bags which saved us over £300k. In some cases, even very small changes have saved money such as moving from 6 types of napkin to only 2.

We'll continue to establish a clear and robust centralised procurement system across the business and we'll deliver our 3 year commitment of £100m savings by the end of 2013.

## Slide 29 – Revamping our systems

We're making great progress upgrading our systems through our Evolve programme.

Last month, we concluded the roll-out of our EPOS till system, which is now in all our petrol stations, as well as our stores. This is a single system that replaces 5 legacy systems.

In the coming month, we have major releases both in the supply chain and in our manufacturing business. When fully rolled out, the new Supply Chain Management system will allow us to track stock at every stage throughout the supply chain improving traceability and visibility.

The manufacturing release will see Oracle installed in our meat businesses, following its successful roll-out to the Produce business last year. We're on track to deliver £100m savings by Jan 2014.

## Slide 30 – Capturing growth

Alongside driving sales and increasing efficiency, we've many opportunities to capture growth through expanding our vertical integration capability or extending into new channels and formats. Be that with Kiddicare, Morrisons online or our M local Convenience format.

## Slide 31 – Vertical integration

From field to fork, our vertical integration gives us great flexibility, in the quantity and quality of what we make and how we make it.

In 2010 we outlined a £200m investment to enhance our manufacturing capability. Over the last two years, we've boosted our fresh credentials with investments in Simply Fresh, Farmers Boy, and Flower World and since March, we've been busy integrating the meat processing plant we purchased in Winsford. We now process 48 products at the site, increasing to 60 by the end of September, including our new M savers range.

In July we started expanding our Colne meat manufacturing site, enabling us to process 450 extra tonnes of pork per week and just this week we opened our Grimsby International Seafood plant starting with salmon and white fish, with a plan to introduce prawns later this year.

We can now buy and process seafood direct from the quayside reducing the time from 'catch to kitchen'. Take a key item like fresh salmon. We've cut the middleman and today offer the freshest salmon in the UK.

By the end of H1 next year we'll have completed the expansion of Colne, we'll have fully integrated our Winsford site and be expanding our operation at Grimsby.

We're on track to deliver our £50m EBITDA growth target and we'll continue to review future investment opportunities as they arise.

## Slide 32 – Moving to multi-channel

We've a clear conviction that consumers will increasingly want to shop using different formats and channels especially when it comes to purchasing general merchandise. Our Kiddicare acquisition marked our first step towards becoming a multichannel retailer.

The business is performing really well with online orders up 20% and sales in-store up 18% and we're ready to expand our Kiddicare estate into the ten Best Buy stores we acquired earlier this year.

We've also been using Kiddicare's industry-leading platform to ready ourselves for our first category launch online. Away from non-food, we've an exceptional opportunity to capture growth in online grocery with the market expected to double in value over the next five years.

Last year we took a stake in a world class online grocery business, Fresh Direct. Our team have brought back rich learnings from New York and they're currently developing a proposition. I'm feeling really positive about how it's lookin and I'll update you at our year end presentation.

At the end of September, we'll open our first new Kiddicare store in Nottingham followed by two more in Birmingham and Thurrock by the year end with the remaining 7 stores next year.

We're showcasing over 3,000 products, with an expanded range in healthcare, food, and books supplied by our new distribution centre in Daventry. We're also on track to launch our first Morrisons category online this Autumn.

With Morrisons Cellar we're building on our depth of expertise in wine; a category that complements our fresh-focused offer. Morrisons Cellar will offer a wide range at exceptional value for money helping our customers to explore and buy fantastically priced wine with confidence.

## Slide 33 – Advancing convenience

As a sector that continues to grow significantly faster than the UK grocery market, convenience is another opportunity to capture growth.

A year ago we translated our fresh and affordable offer into a convenience format with significantly more store space dedicated to fresh foods than our competitors and our market street products such as meat and fruit & veg at the same price as our main estate.

To develop a flexible proposition, we've trialled M local over the last year in a range of locations.  We started with two residential stores in Ilkley and Wilmslow, and a suburban store near Manchester University followed by a petrol station store in Doncaster.

In May we opened our first city-centre store, in Birmingham with an extended food-to-go range to cater for the lunchtime crowd.  Looking forward, we're expanding our M local network into London, an area where we've a significant opportunity given our current market share.

This will be supported by our new 100,000 sq ft multi-temperature distribution centre, in Feltham, West London.

By the end of this year, we plan to have up to twenty M local stores.  We're on track to deliver the infrastructure and logistics we need as we start to expand into the London area opening our new distribution centre early next year.

And throughout the rest of the country, we'll continue to use our successful hub-and-spoke supply system where appropriate.

## Slide 34 – In summary

In summary,  we've made steady progress in what was a very challenging half for our customers.  Overall sales were up, as were underlying earnings, dividend and our EPS.  We've got a lot done but, and there's always a but, there is lots of exciting work still to be done.

We continue to offer great quality products at amazing value to our customers.

We enter H2 in a strong position, progressing well on our strategic initiatives such as Fresh Formats, Own Brand and Productivity Improvements and with our growth agenda in manufacturing, on-line, and convenience, we're positioning ourselves well for the future.

With a business like this you've got to trade it for today whilst building it for tomorrow.

We expect the challenging economic environment and consumer pressures to continue through the second half of this year and into 2013 and we have developed our financial and operational plans accordingly.

Notwithstanding these conditions, the Board believes the Group will meet its expectations for the year.