Preliminary Results & Strategic Business Review 2006/07

Introduction – Sir Ken Morrison

Slide 1

Good morning ladies and gentleman, and welcome to our preliminary results announcement for 2006/07 and the presentation of our strategic business review.

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This is our agenda for this morning.

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This year has seen a good demonstration of the sound progress we have made in getting back to our former operating standards. The absorption of the Safeway business is at last behind us and we saw solid growth in sales, profit and cash generation.

I was delighted in September to welcome Marc Bolland to the company as Chief Executive Officer and I have worked closely with him since in helping him to learn about our unique culture. He will be talking to you later about his proposals for the future.

The Board is recommending a final dividend of 3.375p per share, to bring the total for the year up to 4.0p – an increase of 8.1%. The dividend is covered 2.3 times by earnings and we are pleased to be growing the dividend once again.

The search for a new Deputy Chairman, which we announced in the interims, continues, and good progress is being made.

The Competition Commission enquiry into the Grocery Industry continues and our latest information suggests the outcome is likely to be towards the end of the year. We have co-operated fully with all the requests for information. We believe that the final outcome should favour us as we are the smallest of the big companies and, as local competition would appear to be the main criterion, we believe we should see opportunities in important locations where we are not currently represented.

Key Features 2006/7 – Marc Bolland

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Ladies and Gentlemen

Good morning – it's good to see so many of you here today.

In this first part I am going to focus briefly on some of the key features of the past year.

Later I shall be discussing the outcome of my Review and our future plans.

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2006/7 was an unusual year for UK grocery retailers.

It began with price deflation, characterised by price cuts on key basket items such as milk, bananas and bacon.

Later unusually, we started to see some price increases through the effect of higher energy and commodity prices.

But there was also an increasing focus by consumers, the media and the industry on health, quality, freshness and provenance of food.

This was a shift away from merely focusing on price, the main area of attention in recent years.

Let's have a look at the results for 06/07.

As Ken said we have had a good year. The turnover has gone up by 3%. Our profit growth has been encouraging, with PBET of £331m.

Importantly, our cash generation has been strong with net debt falling from £1.15 billion to £0.8 billion.

This reflects exceptionally low investments but also more firm control of capex and working capital through the year.

Let's have a look at underlying growth factors.

Like for like sales of 5.2%, excluding fuel, were strong, and primarily reflected the continuing good progress of the Safeway converted stores.

Morrisons stores, which were showing like for like sales declines last year, had turned marginally positive by the year end, but were still growing behind the market

We also saw a growing number of customers visiting our stores and increasing customer spend.

Our smaller stores, those of less than 25,000 square feet of selling area, have performed particularly well.

Now to the optimisation plan.

At our interim results last September we updated you on our optimisation plan.

Since then we have made good progress in delivering our Gross margin, Store Labour cost, Distribution cost and Central cost goals. Richard will update you in more detail.

To summarise: the Company did well in 2006/7 on the road to recovery. There is more work to be done!

And now I'll hand over to Richard who will take you through the financials and key operating metrics in more detail.

<u>Financial & Operational Review – Richard Pennycook</u>

<u>Slide 6</u>

Good morning ladies and gentlemen. Ken and Marc have both referred to a satisfactory first year of profit recovery for the business, and I am going to fill in the details for you. First, a technical point. This was a 53 week period for us, and all the numbers here are on that basis. At the back of your packs we've included a ready reckoner to help you take out the effects of the extra week where required.

Slide 7

In summary, 2006/7 was a good year for us – we hit or exceeded our optimisation plan targets and saw good momentum in the business. As we've said before, we think 2006 was an unusually benign year for the sector, with good overall growth and less intense price investment than in earlier years. We are grateful for having had a tailwind last year, but we have no illusions about the environment getting tougher again going forward.

I will talk about turnover and operating profit in more detail later, but on this slide I would like to highlight three things:

- Firstly the property profits of £38.5m. The largest item here was the disposal of 6 stores and a depot to Waitrose, and in addition we divested another 8 stores as the final elements of the Safeway portfolio were cleaned up. Most of these stores were leaseholds.

- Secondly, as we flagged at the half year, we were able to avoid exceptional items this year, after the large costs of the previous two years. This is good discipline and we intend to take any costs associated with Marc's future plans as normal items in the income statement.

- Finally, on this slide, we are very pleased with the net debt number at year end of £772m. It was important, in 2006, to tighten things up, with a brake on capital expenditure and good control of working capital.

Slide 8 – operating profit

Turning now to operating profit, this chart is in our new income statement reporting format and shows a gross profit improvement year on year of 240 basis points. Most of our optimisation plan targets are incorporated here, and I will show them in more detail in a moment.

Administration costs were £272m in the year, and increased slightly year on year. The costs we show here are primarily head office and above the line marketing, but also costs we choose to take centrally rather than charging to the business, such as IT costs. The increases in the year were related to greater marketing activity and pensions funding.

Slide 9- Turnover bridge

Understanding the dynamics of the business has become much easier in the past year, but there are still some residual effects from the Safeway integration and conversion period. This slide breaks out the various turnover related effects year on year. Moving left to right, disposals continued to have an effect on the business, being £700m in the year, and this obviously has had a drag effect on our market share performances through the year. This will be much reduced in the new year, with disposal effects counting for less than £75m.

Like for like sales growth delivered an additional £483m of store sales in the year, and I will talk about this further in a moment. Fuel was a helpful contributor to our increased turnover both in terms of increased average prices and volume, reflecting the fact that fuel is a good traffic driver for Morrisons, and we are very competitive.

Finally, on this chart, we've shown the 53rd week effect of £231m.

Slide 10 – Sales performance

A brief look at sales in more detail. The ex-fuel like for like of 5.2% was a shade better than we had anticipated at the beginning of the year, and we were pleased that this was achieved by growing both customer numbers and basket size. A highlight in the year was the success of smaller stores, which received a lot of attention, and grew sales per square foot by 12%. We've said previously that making the smaller stores work for us is vital, and the response last year has given us real confidence. This has three benefits:

1. It makes the smaller stores themselves viable, and they account for 30% of our store sales

2. It opens up future opportunities for new stores in towns where, previously, a 40,000 square foot superstore would not have worked

3. We are learning things in the smaller stores, about space utilization and back office efficiency that we can apply throughout the business.

We continue to be dissatisfied with the performance of core Morrisons stores. Whilst they turned positive in the second half, the trend has not been emphatic and their sales densities remain well below their past best. When Marc talks, later, about his plans for the business, he will be acknowledging the need for change not just to deal with the converted stores but across the board.

There has been much debate about the effect of inflation in the year, and I want to be clear on the situation for Morrisons. We measure inflation based on the average shopping basket bought by our customers, and include the benefit to them of promotional activity. Across the whole of 2006, this shopping basket cost slightly less than it would have done in 2005. So price investment was less dramatic than in earlier periods, but overall our customers were continuing to pay less for their weekly shop.

Slide 11 – profit bridge 1

This profit breakdown is in a format you've seen before and this first chart picks up business as usual. On the next I will show the improvement effects coming from the optimisation plan. This chart highlights, very clearly, that business as usual will not deliver the profit improvement required to recover the business. The profit contribution from like for like sales growth was very valuable, at £50m, but this was swallowed up by pay inflation and energy costs. Manufacturing was a valuable profit contributor, as we increased volumes substantially to serve the new, bigger, business. Hence the profit base pre optimisation initiatives was only £76m.

Slide 12 – profit bridge 2

We began the year by laying out clear targets on gross margins and costs. The margin target was 90 basis points over three years, and the cost targets were £110m in-year. To remind you, we gave the gross margin target at a time when there was intense price activity in the market on staple items such as milk and bacon. Had that continued and deepened, the three year target would have been suitably challenging. However, there was an outbreak of rationality in the market early in the year, and that allowed us to make more rapid progress towards our goal. Overall, in the year, we delivered the full 90 basis point target.

Following the closure of three depots at the start of the year, we made great strides in bringing our distribution costs down despite the high cost of fuel. The £45m savings achieved were £15m better than target, reflecting great credit on our supply chain colleagues. Marc will talk about the further work we have to do in this area.

Our central costs also came down slightly ahead of target, as we consolidated in our new head office and switched off surplus mainframe capacity

We saved 11m hours in store which enabled us to achieve our optimisation plan target of 6m hours saved and to absorb the impact of wage inflation in the year. We will continue to make significant improvements in this area, and again Marc will outline our initiatives to deliver further benefits.

Finally we invested in increased marketing activity and the profit increase triggered vesting of a 2004 share incentive scheme.

<u>Slide 13 – cash flow</u>

Cash generation was stronger than profit generation in the year, a rare event in grocery retailing. Cash from operations obviously benefited from the profit growth, and the proceeds from the remaining property disposals of £158m also helped. A major contributor was tight control of capex, with total investment of £257m, after spend of £1.1bn in the previous two years. This was a necessary part of bringing the business back under control, and also a reflection of only opening 4 new stores, but is not a sustainable level of ongoing investment. Marc will outline our future capital requirements in his section.

Overall, the cash generation in the year of £403m leaves us well placed to fund the next phase of the optimization plan and to look at balance sheet efficiency in the future.

<u>Slide 14 – balance sheet</u>

Freehold ownership gives us a very strong balance sheet. Our property is valued on balance sheet at £6.2bn, but this includes the original Morrisons stores at depreciated historic cost rather than current values. It is therefore a prudent number.

On pensions, you will see that the deficit fell by half in the year, to below £200m. This was due to improved market conditions and to the accelerated funding that we have been putting in. We will be discussing with our trustees further steps to reduce the deficit, but at these levels we are comfortable that our pensions exposures are very manageable.

Our gearing of 20%, interest cover strengthening to 7.8 times in the year and our dividend cover rising to 2.3 times all point to emerging balance sheet capacity. We are conscious of this, but in the next period can also see requirements to fund a stepped up investment programme, bond amortization and further pensions deficit reduction. We will look at balance sheet efficiency hand in hand with funding these requirements, and Marc will address this further in his review.

<u>Slide 15 – performance update</u>

Before handing over to Marc, I want to just touch on most recent trading, which saw a slow start to year. The five week picture shows like for like ex fuel of 3.4%, well below the run rate of 2006. In the past two weeks performance has inevitably been hit by the problems experienced with petrol supply, but the soft non fuel trend has been with us since Christmas. This underlines the importance to us of actioning the results of Marc's review.

<u>Strategic Business Review – Marc Bolland</u>

Slide 16

- Share with you the results of the and plans going forward
- Way conducted review
- No big consultants – own organisation
- All aspects of business
- Departmental heads helped us get the answers
- Customers suppliers, stores, colleagues, shareholders competition analysis
  Research 3,000 customers and 8,500 colleagues

Slide 17

- From stakeholders remarks and research - some clear perceptions
- Supermarkets cut costs
  Health – 80% people trying to eat more healthily
- Quality – 72% of shoppers worry more than use to about quality of food

Slide 18

- When I look at Morrisons specifically taking all stakeholders input into accounts
- Unique experience
- More promotions (Mercer)
- Industry leading availability
- Industry leading service grocer award 2 years running
- platform for segmentation and communication
- Flexibility - property extensions etc
  42 in planning 117,000 sq ft
- Execution

Slide 19

- I have found some clear areas
- Customers that know us like us, non customers perceive us as downmarket
- Organics and healthy food/non food
- Store difficult to navigate
- Come back
- Come back
- Outstanding committed people - competency gaps

Slide 20

- On the basis of customer perception we reviewed positioning
- Tesco omnipresent
- Asda non-food – George

- Sainsburys food perceived higher price
- Waitrose food specialist, high price and exclusive
- Morrisons focused on food, great value
- People that know us understand other don't - we need to sharpen and communicate our position

Slide 21

- Sharpening up and communicating better
- 100% of British meat from farm assured sources next month
- Buy all own livestock
- 80% of our produce from own supply chain
- 1700 products
- Qualified
  1500 butchers
  800+ fishmongers
  2000 bakers
- Great food great value
- Link to revitalising the brand

Slide 22

- To communicate our positioning better – brand and store development
- Own territory
- Not today, April roll-out
- Advertising campaign – website – local communities

Slide 23

- What will our customers see and experience
- Evolution
  Open up counters to make bakers visible
  Sandwich example
  1,700 lines just made for you
- Updating
  remove unnecessary packages
  Environmentally friendly

Slide 24

- Customer experience was one size fits all
- More chilled and convenience Double The Best, Organic and Eat Smart
- Look at total non food range
  Focus on Health and Beauty - Home and Leisure.
  No electricals or clothing

- Tailoring range by store type
  20 stores clusters.
  Your Camden store will be approx. 20% different range to Dumfries
- Already have savings in optimisation plan. Future cost improvements in store on top of that

<u>Slide 25</u>

- Higher rate than recent years
- 8 stores 2006/07
- Planning 42 extensions
  117,000 sq ft

<u>Slide 26</u>

- Reviewed the business thoroughly and benchmarked externally
- Profitable - covers cost of capital
- Up to 24 hours better
- Safeway southern volumes - further growth
- Some gaps in chill chain

<u>Slide 27</u>

- Like manufacturing – distribution important business block
- 6-12 hours lead time in 103 stores
- Distribution infrastructure cannot meet future growth not geographically optimal

<u>Slide 28</u>

- Present situation
  Stem mileage study
- Plan to reduce stem mileage by 40%
  Less cost
  Environmental impact
  Planning efficiency
  Facility in south –not full RDC can't say much– first step.
- We are looking for sites
- Closed two sites in South – site constraints

<u>Slide 29</u>

- Investment & savings

Slide 30

- Important subject - we have not always presented ourselves as being pro-active – we are now catching up
- Introduced compostable packaging for organic fresh range
- Targets Morrisons style realistic – focused on 2010
- Working with the carbon trust
- First time CSR report
- This is not to be modern, I see this as a licence to operate

Slide 31

- Other building blocks
- We have outstanding people, however searching for new leadership in these areas
- Review every 12 months
- 600 colleagues including store general managers
- Staff discount new to company
- Systems developed many years ago
- Important for future development
- New MIS Director

Slide 32

- Average capex including new space around £400m
- Table summarises investments referred to earlier
- Additional £450m over 3 years

Slide 33

Slide 34

- Average capex including new space around £400m
- Table summarises investments referred to earlier
- Additional £450m over 3 years

Slide 35

- Next 18-24 months building blocks in place
- We are ready for next steps