**Morrisons' analyst meeting transcript**
**10 September 2009**

**Speaker key**

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| IG | Ian Gibson |
| RP | Richard Pennycook |
| MB | Marc Bolland |
| BH | Bruce Hubbard |
| CH | Chris Hogbin |
| MT | Matt Truman |
| TG | Tom Gadsby |
| AK | Andrew Kasoulis |
| CB | Clive Black |
| MD | Mike Dennis |
| GL | Greg Lawless |
| JK | John Kershaw |
| JA | James Anstead |

IG My name's Ian Gibson. Besides me, the names and faces you know well, which are Richard Pennycook and Marc Boland. We're pleased that this morning we're announcing another good set of results as you've seen, with our like for likes, excluding fuel, up 7.8%, with underlying profit up 22% and we're very pleased to announce an interim dividend that's up 35% to 1.08 pence. We'll follow the usual format. Richard will start off with the financials, Marc will then give you a business update on this first half, so that will be followed by a general Q&A for you, and we'll kick off with Richard. Thank you.

RP Thanks Ian. Morning ladies and gentlemen. We're pleased to be reporting another set of good interim results this morning with a profit momentum somewhat stronger than we'd anticipated at the start of the year. We continue to make good progress towards our goal of being the food specialist for everyone and in delivering the remaining elements of the optimisation plan. Our journey from national to nationwide is well underway and Marc will update you on all these initiatives later. The financial results are a direct reflection of our success in achieving these plans. If we turn to the financial summary, this is one of those occasions where the statutory accounts don't show a clear picture of business performance. On the face of it, we're reporting sales growth below previous levels, but pre tax profits way ahead of expectations, and this has been caused by two factors. At the turnover line, the effect of much reduced year on year pump prices in the forecourts, leading to lower cash sales on fuel, and at the profits line, a large exceptional item. I'll give you more details on each of these items in a moment. Our net debt at the half was £885 million, rising as anticipated due to the Co-op and Somerfield acquisition and the development of our new RDC at Sittingbourne. At this level, interest cover was a healthy 18 times and gearing was 19%. In 2007, we outlined an enhanced and progressive dividend policy which would bring our cover into line with the average for the European sector by the end of this year, and I'm pleased therefore to confirm that in line with this policy, and reflecting the excellent progress that we've been making, we're increasing our interim payout by 35% to 1.08 pence and would expect a similar level of growth for the full year.

Moving on to some of the detail. This chart shows the sales breakdown in our normal format, and tells a relatively straightforward story these days. £75 million of sales from new stores was a step up on the previous run rate and it will grow further in the second half as the converted Somerfield stores come on stream. £432 million of like for like store sales, equating to 7.8% growth, completed the second full year of growth achieved through the re-launch of the Morrisons brand. As anticipated, our fuel sales were down overall, with the reduction in average unleaded pump prices year on year from

110 pence to 95 pence, so about 10%, a welcome relief to our customers. We continued to grow volume, with total litreage up 3%, reflecting the strength of our value proposition on fuel. Last year we introduced the measure of underlying earnings, in order to eliminate one off items, the oddities of pensions accounting and to smooth out fluctuations in the tax rate, and this chart lays out the calculation for the half year. It's no surprise that property gains were very small. A large pensions credit reflects the impact previously announced of a range of measures designed to put our defined benefit pension schemes on a sound footing, with highly prudent actuarial assumptions and reduced future liabilities. You will recall that we previously injected £200 million in cash into the schemes in order to strengthen their funding position. The credit shown here of £91 million represents the effect of moving from a final salary to a career average method of future benefit accrual. It's pleasing to note that we report a small pension surplus as part of today's results, despite the state of the markets. There's further detail at the back of your pack, where you will see that our actuarial assumptions remain very prudent. Finally, there's a technical adjustment as usual for IAS 19, for the anticipated returns on pension scheme assets, and this time that was a £4 million charge. So adjusting for these non trading items, underlying profits growth was 22%, compared to the headlines sales increase of 5%.

The next chart highlights the operating leverage performance. On the face of it, our operating profit margin has grown by 80 basis points half on half. That's from 4.3% to 5.1% and I'll explain the component parts of that in a moment. You'll note that our other income was up nicely, reflecting the fact that our third party rents are holding up extremely well through the recession. Our administrative expenses were up by just under 10% year on year, contained well below the underlying level of growth in the business. So just unfixing those basis points of margin improvement, I estimate that 40 basis points, so approximately half, was simply the mathematical effect of seeing pump prices come back down from last year's highs. As you know, fuel sales carry a very low margin, so fuel is a smaller part of the overall mix. This has the effect of making our margins richer. A further improvement effect came from the year on year reduction in energy prices throughout the business and I estimate this was worth a further ten basis points of margin improvement. There's a negative effect coming from one off costs associated with the Co-op and Somerfield acquisition, which incurred £21 million in the half, so that's a 30 basis point impact on the operating margin. So netting out 40 basis points of fuel windfall, 10 basis points of energy gain and the 30 basis point hit from store acquisitions, overall we achieve 60 basis points of margin improvement from delivering optimisation plan targets and in driving operational leverage as a result of our sales growth. We're very pleased with the resilience of this performance, and as you know, it led us to upgrade our profit expectations for the year a few weeks ago.

Turning now to cash flow. The half saw another period of strong operational cash generation, with cash from operations up to £533 million. As anticipated, capital expenditure was well up year on year at £572 million, reflecting the activity being undertaken in relation to phase two of the optimisation plan and the acquisition of the Co-op and Somerfield stores. I'll give you more detail on those in a moment, but here let me just update our full year guidance of capex, which was originally £1.1 billion. We're seeing build costs on stores come down due to capacity in the building trade, and the same for work associated with the optimisation plan. Accordingly, we now expect capex for the year to be no higher than one billion, whilst our depreciation charge for the year will be unchanged from previous guidance at £310 million. As a result of this and the increased profit guidance we gave in our trading update in July, we're revising our year end net debt guidance down by £100 million to one billion.

When we last spoke to you, we had announced our acquisition of stores from the Co-op, but we were unable to provide you with much detail. At that early stage, the precise locations were subject to confidentiality because of the staff affected, and also they were subject to OFT approval. We're now in a position to update you clearly on the deal. Marc will discuss the programme of conversion to Morrisons and how they're trading, but this slide just clarifies some of the other numbers for you.

During this calendar year, we will open 34 stores from the deal, with a total capital cost, including acquisition, of £320 million, and for this we will operate 480,000 square feet of trading space. We were aware, when bidding for the package of stores, that there were four stores that may not fit our operating model, so those are currently non-trading. This was fully factored into the business case. If we do choose to keep them, that will be upside for us. We've been able to open the stores well ahead of time, due mainly to the very swift response of the OFT to the clearance process, for which we are very grateful. The words OFT and grateful don't come into the same sentence very often, so I'll just labour that point for a moment, but as a result of that, turnover from those stores will be about £225 million this year and that's well ahead of our initial estimates, when we thought it would take longer to get those stores open. So the combination of accelerated year one sales and tight control of start up costs means that non-trading costs this year will be about £10 million lower than our original estimate of £40 million, so looking at 30 million now. Out of that £30 million, £21 million has been incurred in the first half. That's included in operating profit.

I think it's worthwhile at this point just to give you a perspective on industry growth and our own like for like performance. With lower commodity prices now coming through and the stabilisation of Sterling, we're likely to see a reduction in food price inflation and therefore lower nominal growth rates across the industry. In addition, we're conscious of the long period of strong like for like performance we've enjoyed over the last two years. I think the combination of these factors will lead to a natural reduction in comparative growth rates, and this has been well flagged. However, we maintain our objective of growing ahead of the market each year, and while top line performance for us remains a focus, at the same time we will not lose sight of the importance of margin progression and the continued generation of profitable growth. So to sum up, this has been a really positive first half performance, and I'm now going to hand you over to Marc, who can update you on the operational performance. Marc.

MB Good morning ladies and gentlemen. As Richard said, it's a good set of results. The strength of the performance has resulted from a wide range of actions taken in the business. Now, let me first start taking you through the sales performance. We saw a sales like for like growth of 7.8% excluding VAT in the first half, which is on top of the 7.7% we saw as growth in the last year first half. Our customer growth has been a strong sales driver again, but if you look at the bottom of the slide, you can also see that basket size and sales densities have improved. For the two years we have now had growth on growth, and therefore the second half, as Richard already said, we will face stronger comparables, and the explanation that we see that the overall industry growth will slow on the back of lower inflation. However, as previously indicated, we do expect our sales to grow ahead of the market on an annual basis. We are focused on delivering continued operating margin improvement as well as top line performance. So let me put it in other words. We're delivering profitable growth. Now, where does the growth come from? You've seen this chart before, but we have attracted over one million new customers on a weekly basis for the last two years, and Morrisons brand continues to be embraced in all regions of the UK, and therefore we're making a good step forward in our journey from national to nationwide. Market Street continues to attract new, younger and more affluent customers. Now, you've seen this chart now for about, I think, four times, at least being improving, so let me take you a bit more in depth why people are coming to Morrisons and share some market research with you.

Oliver Wyman is a leading strategy consulting firm which has commissioned an extensive three year, UK wide survey of retailing. It started in 2006 and the survey provides detailed insights on consumer and customer perceptions about retailers, and if you look at the left hand side, you see the most important drivers of that consumer satisfaction, which are staff and store impression, which is choice, which is product quality and which is value. The survey also provides other insights, but we want to focus now on the four most important areas. Here you can see the Morrisons performance against the major competitors in 2006. The black vertical line represents the average score of the big three, the yellow line represents Morrisons, and as you can see, Morrisons was weaker in 2006 on staff and store environment, on choice and particularly very strongly behind in product quality. In fact, we were only ahead on value and this does not come as a surprise to you. When I shared with you in 2006 the first research I did, actually I told you that Morrisons was probably seen a little bit as a discounter, so this is confirming actually what we shared together in 2006. Now the 2009 survey shows a significant improvement of what is being indicated by the red line being Morrisons. We can still see the relative position of the market, which sits on the black line, and the red line, you can see that choice through range development has largely improved. We talk really about range development that we did over the last two years, and I shared with you how many new things we have already brought in. Pleasingly, we have retained our value perception whilst significantly improving on quality, because if you look at the quality dimension, that's not a small step. If you see product quality moving up where the yellow point was to the red point there, that consumers talk about us in that way, that quality of products, individual product has improved. That's a strong indicator. But what it also shows is that value is nearly the same, and as I shared in earlier research with you, normally when you see these kinds of researches, a value indicator will drop down dramatically if you improve your quality. Since we have had a very consistent story to customers, talking about value and talking about fresh food, these two things are really played back by customers. Now, Oliver Wyman has conducted the same research in the US and in a couple of countries in Europe, in Germany, in France, so over the three years, they've got quite a few results in, and they've shared with us that our survey results are one of the most dramatic ones they have seen actually over retail in the research that they have done, so this is really a very big step change.

Now, the result of this progress has of course come from a number of elements from the optimisation plan, so let me move to the optimisation plan update. First in store. The first half of the year now, we've again stepped up in product development. We have now formed a high level product development team that we have acquired throughout the country, taking out the specialist that we needed on fresh food and other products, and we have again launched 1,600 new products. You'll see by Christmas, by the way, a few things you really want buy, because we might be leading market quality at Morrisons pricing again. Our stores have been further segmented, a new management system has been rolled out and completed in the first half of the year, and self scan checkouts have now been installed in 160 stores and we are on track to complete 270 stores by the end of the year. Now I'll move to distribution. We've been discussing it a few times with you, but we've now opened the RDC at Sittingbourne in August, and it's a 900,000 square foot immense building. I've been there myself when it was just opened in August and it was immense. You see a picture there that could not represent really its true proportions. It was opened three months early because it was important to meet the volumes from the Co-op Somerfield, so we managed not only to open it in time, we managed to open it three months early to meet already these volumes. In 2010, we will save 22 million kilometres on the back of the complete remanagement of our distribution system through the opening of this one in Sittingbourne, so that's a benefit for next year. It is built to our own specifications, because we shared with you that we bought the freehold in advance, and therefore now have finished it to our own specifications, so it can take more volume than we expected, and therefore as a result the south west RDC of Bridgewater, as we have at the moment in our planning, has been re-phased until 2011/2012, because we are not having immediate requirements for that capacity now, so we have re-phased it a little.

So let me go to another longer term project. Further progress has been made on IT systems. New payroll systems have been rolled out and after piloting it in last quarter last year, over 80,000 of our colleagues are at the moment paid through the new systems. The first stage of new financial and distribution systems was completed in the first half of the year, and the roll out of a new EPOS system will start in the second half of the year. And as you all know, this is a longer term project that will take us into 2011. CSR. We told you last time on the fact that the CSR carbon footprint etc had improved very, very strongly and was actually already finished ahead of time, but let me take you now through the three programmes that focused on the first half of the year. We wrote Let's Grow two, to remind you that it's a programme that we shared with you last time. That's about an initiative where we encouraged children to grow fruit and veg at their schools, so it's cooperation with schools in the country that was highly successful last year. We launched it again this year actually last Monday, and you'll see it on television starting this week. 8,500 schools have already pre-inscribed into the programme, so they've pre-registered already 8,500 schools, before we even put it on television, so we expect again a huge, huge cooperation with schools to educate children, which brings ourselves also into perspective, wanting to reach out to more affluent, younger customers. It fits and ties in well with our position. We also launched the leading farming research programme in Scotland to support UK farming, in cooperation with the Scottish Agricultural College. At the same time, we started our fresh food academy last year which, for this year, will train 500 apprentices of butchers, bakers and fishmongers to be fully certified by colleges. So we are the ones that, at the moment, have the largest programme in the country running to get these kind of skill sets better developed.

Now let's turn to space. 22 stores were opened in the first half of the year, including one replacement and 19 former Co-op Somerfield stores. We expect to open around 23 stores in the second half of the year, including one replacement and 15 former Co-op Somerfield stores. This puts our new opening programme well beyond the original one million square foot target by January 2010. And let me come back slightly for a moment to strategy that we shared with you six months ago. We shared clearly with you that Morrisons has three areas of opportunity. One is the new customers, second is new locations and third is smaller stores. 40% of the UK households have not yet experienced a refreshed Morrisons. We told you that 8.4 million households doesn't live within a 15 minutes drive time. We told you that now we are able to operate, and that's what I'm going to share with you now on the Co-op Somerfield stores, a range of stores between ten and 40,000 square foot, and our focus is to move from national to nationwide. Now then, six months ago, we started talking about the Co-op Somerfield stores. 19 stores were opened in the first half of the year and 33 stores were opened ahead of schedule by 1st September. These stores have allowed us to reach to many new customers, particularly in the south, circa 1.2 million customers as new households have now access to these stores. The converted stores can be found edge of town and in town locations, and it's important to emphasis, as I said last time, that these are not convenience shops but they provide convenience shopping. Now let me explain it to you by a [video] clip, because you might not have been in these stores, but we like to give you some insights what a store, a converted store, from Somerfield to us, already open, looks like.

MB So you might have thought what kind of store is this? They might have found a maximum store for this one, to shoot all these pictures. That might have been the 19,500 square foot store, the one that really shows the best performance. This is a 13,500 square foot store you just saw, at Tildsley in Lancashire. As you have seen, customers are enjoying a real Market Street experience in a store of 13,500 square foot. Now, when we saw each other two and a half years ago, you were challenging me and saying can you make Market Street alive in a 20,000 square foot store or a 25, because how would it fit? We've incorporated a baker, a butcher and fishmonger in stores as small as 10,000 square feet, which is unique in the country, which therefore redefines that we can really stretch our performance. Ranges are tailored to the needs of the local catchment area and there's a higher fresh fruit participation in these stores than any of our competitors. I'll give you an example there. If you take the Morrisons 12,000 square feet store in Lowth, Lincolnshire, it has more fresh fruit in store, prepared products, than one of our competitor stores with a 60,000 square foot store in Bradford, and we just did a numerical count, one by one, line by line. So that's encouraging, it's early days, but let me look at some initial findings on the performance.

Early signs we have seen, because we opened them, remind yourselves, the last one just before 1st September, but in the first few weeks we have already seen a 50% sales uplift on pre-acquisition performance. You would normally expect premium pricing in these stores of this size. The prices are on average 15% lower than customers previously experienced in these stores. I'm particularly pleased that the basket size data indicates that a full shop is done rather than mostly a top up shop. However, you can see they're used for both, that's why I called it convenience shopping. If you want to go out, you can go out in let's say two minutes, through a self scan check out and do a really convenient shop, but the shops are built for a total shop, for total shop. So on the smaller stores, if you look at the sales densities, they're higher than our estate average. Now again, early signs, I'm not the one that's going to sell you a story because it has just opened, but the early signs are positive. Smaller stores are becoming part of our strategy to move from national to nationwide, but for choice, as I shared last time with you, if you go around the country and we see a plot of land, we will always build the biggest store available, up to 40,000 square foot, 35 to 40.

Now let me summarise the first half. We have seen for the first half a strong like for like sales and underlying profit growth. We have seen a healthy cash flow and a strong balance sheet. We have seen 2010 initiatives being on track. We have won for the second year running unprecedentedly the UK retailer of the year, very good for our staff, very motivational, they're really proud. The former Co-op Somerfield stores were converted ahead of time and show very good early signs. So the second half of the year, it will be a competitive year but our performance to date, the successful implementation of the optimisation plan and our continuing customer gains confidence that we will deliver our profit expectations for the year. Thank you.

IG Now let us go to Q&A, and if I may ask you, since we are live on the wires, to state please your name and company. Whom can I give the floor for the first one? I have to look at the mikes and so bear with me. I know noticed that you were the first.

BH Good morning. It's Bruce Hubbard from Odey Asset Management. I know you don't give too much detail on inflation. Can you give me some idea of your best guess of by how much industry inflation will ease in the second half of your year versus that in the first half?

RP Yes. I think to the extent that we comment on inflation, it's been in the context of the TNS numbers that I think most of us look at, and we would see that the movement that TNS are picking up as being directionally right, so we think that that would indicate inflation by the year end to be if not out of the system then pretty well down into low single digits.

BH Any risk of deflation?

RP I think in a sense that's just maths, isn't it? What the customer is seeing, as they've been seeing for a while is quite big fluctuations in individual items in their basket. The good news is those fluctuations are moving now the right way, so on individual, everyday items, they're seeing quite big reductions. Potatoes, onions, pears, grapes, these are all down 15% plus year on year, so customers who are shopping around to manage their own inflation, as TNS describe it, I think are beginning to see the opportunities to buy things that were much more expensive a year ago.

IG Thank you, Bruce.

CH Thank you. Chris Hogbin from Bernstein. I have two questions, if I can. On inflation, as inflation moderates in the second half and presumably into next year, in relative terms do you think Morrisons are better positioned than your peers, sorry, competitors, to deal with that? So what drives you into being in a better position or worse position as inflation comes down? Secondly on strategy, the optimisation plan is almost done, it's been very successful, it's really helped the business, so strategically, are you going through a process of answering the question of what happens next, because national to nationwide sounds as it's keep up the good work and add some space. Is that your strategy forever and ever or is there actually a strategy formation process? And if so, when do you expect to share that with us?

MB Let me take the strategy and maybe you want to expand on the inflation point.

IG Okay. Let's just deal with the inflation first then, to follow on from the previous answer. I think we talked before in a relatively minor way that because of our vertical integration with manufacturing, when commodity prices are on the rise, we will see that a little bit earlier than competitors who will be pushing back against third parties for those sorts of products. So when commodity prices are coming the other way, at the margin we will see a little bit of a competitive gain in that particular area of product. I guess also we would see that because we've continued to support brands and our very important branded promotional programme, as inflation comes out of the system, the quid pro quo will be obviously more attractive pricing on those branded products. We've not been leading the charge on pushing into our own label in the way that some of our competitors did. So I don't think there's a big differential advantage to us in inflation coming down but there are one or two minor advantages.

MB Let me pick up the point on strategy. As we've been saying, national to nationwide is not just a sentence. There are two things to it. One, there's no other retailer that has the opportunity that we have to reach out to 40% of people that have not been in the stores and don't know Morrisons. All other big retailers are known to the complete population of the UK and we still find people all over the UK, but particularly in the south, who simply don't know us, so there's a huge consumer opportunity there. At the same time, there is the opportunity in terms of space because we are seeing councils being very much embracive to our products, where we now see in the Co-op Somerfields and the change in stores, they are really, really positive about us, so we see space as a second opportunity. But let me re-phrase as well that if we look at three years ago, we were looking at Morrisons being very good at 35,000 square foot. That's where we were when we started with the optimisation plan. Today we're talking about 10,000 square foot. That was an area actually where Morrisons retailers stayed away from. It's a difficult area to manage, it's a difficult area to make money in and it's a difficult area to put extra services in. We do absolutely not what the market is doing. We're not following the market to say, and that will be a question coming up, is the next step to go into convenience? That's not the next step. The next step is to make these stores work very hard, because the beauty is that they work on one format and therefore also one cost system with our distribution system in the back of that. However, it is probably to be able to do what you've seen on the small video, to do a full baker, butcher, fishmonger on 10,000 square foot is for a customer the biggest innovation they have seen in retail after convenience stores have been started, because now they can do a full shop, with full fresh offer, on a very small footprint. So when you're asking strategy forward, we always have to look for the single biggest opportunity which is close to you, and that's what we're doing. So yes, are we building on our strength? Absolutely. That's what we should do, because we are vertically integrated, we're strong and fresh, we have to make that work harder, even in all of our stores, and we can take some of the learnings of the smaller stores that we've now opened, in terms of Co-op Somerfield, and even translate that to some of the stores we have of the ex-Safeway. So there is a continuous improvement direction which looks very positive. Come to the front. Matt.

MT Thanks. It's Matt Truman from Nomura. Three, if I can. Seen a step up in promotions from your peers, Sainsbury, and peer promotions, Tesco with the Clubcard launch. How do you combat particularly the Clubcard and have you seen any early impact? Out of interest, the four stores that don't fit the characteristics you want, what actually are the characteristics of these stores and why don't they fit? I'd be quite interested to hear. And lastly, just what sort of magnitude do you expect from IT savings that you outlined in the presentations.

MB I'll take the last two. Yeah, we have seen a step up, as you say. If you look at TNS, we see a step up. What we are seeing at the same time is that we have followed a very clear strategy to not again follow the crowd. We have our own promotional strategy which has to do with not only getting the volume of promotions up, but sharpening up promotions and looking very much at what consumers want. The healthy thing about our growth is if you look one page next in the TNS analysis, that the growth that we have, so particularly where does the growth come from, the Morrison growth comes predominantly from background sales and not from promotions, whereas the market is for 80% promotions. So I think we would like to continue that with you and with our investors, because that is the most healthy growth you can have, is to get growth from partly promotions but then background sales. Now why is that background sales with us? It's because the effect of people through the door, shopping at Market Street, new customers not knowing our stores well enough and find out after a couple of months all the great things that they can find at Market Streets and in your products, these are the things that are not always on promotion but sold at a fair value, a good price.

IG Matt, in terms of the Co-op four stores I'd said that we'd identified when we had the bid for the whole package that these things didn't fit. I think one of the great strengths in terms of our delivery at the moment is that we have an operating platform which works for the whole of our estate, and has an example in the supply chain. That means big wagons with pallets as opposed to small wagons with trolleys or dollies. So some of the stores don't have a loading dock, you can't get a big wagon into them. It's those sorts of practical considerations. We would need to break our operating model to make those stores work and we're keen not to do that. In terms of IT, you'll remember in the optimisation plan which concludes in January that we said the IT was investment rather than benefit, so there's no real benefit built in over that period. As Marc mentioned, the programme runs all the way through 2011 and component parts of it will start to deliver benefit. We'll articulate that when we come to it, but in terms of the remainder of the plan through to January 2010, there's nothing more to come.

MB Thanks very much.

TG Tom Gadsby from SocGen. Are you expecting a consumer recovery in the second half and into next year? Are you planning accordingly and, for example, ramping up your premium ranges? Or are you still a bit more cautious than that?

MB As I've said before you, we can live in both worlds. If I would have had the free choice two years ago whether Morrisons would grow fast in a recessionary or non recessionary period, I actually don't mind. Why? Because actually we can play very strong on value, like I once said, twisting very quickly, and I think we've done that very quickly. Our value range was redesigned before anyone else and we also tailored our Market Street to a lot more value products. We can also, through product development, as I have said, we act very quickly, and we have already done so by these lines in developing a lot of high quality products for a very sharp price. So in case we would see in the second half or after signs of upturn, we immediately react, and we have already reacted to a few now. Giving you an example, we see for instance, and I said this morning on the wires, our cake shop is up more than 10%, but largely more than 10%, which is not very normal in these days when everybody's talking about problem of obesity, by the government, and at the same time tightening their belts, but cake shops are up more than 10%. Therefore, we are product developing now for Christmas very strongly, so you'll find fresh from the cake shops lots of products that really is first class. Now, we are therefore, like we have done with the market going down somewhat and pre-empting it, yes, we have already product development plans now for Market Street, but if we see uptakes in certain departments, we will very, very quickly react. What we have done, for instance, now, to give you there also a little bit we haven't discussed, we've turned on our oven fresh very strongly in the last year, and oven fresh is again such a big department, we service hot chickens. We are by far a market leader in hot chickens in the market now. We have more than 30%. We have more than 10%

more than the number two biggest retailer in the country in the sales of hot chickens, and why is that? Because we simply saw that people these days probably want a quick answer for a good price. So we have reacted with Market Street very much to the sentiment of what is needed in the market. We can do so again, because nobody has a cake shop in this whole market. Nobody runs a fresh cream cake shop. We do, so we can react now towards Christmas, but if we see a further upturn, we can turn that now very quickly. We have hired such a very good quality team now to do product development that the quality will be highest level, the pricing is, as I told you about our fishmonger, fishmonger, best in the country, I dare to say that, pricing 30% less than the highest. Same thing for the cake shop. Andrew.

AC Andrew Kasoulis from Credit Suisse. Can you help us a bit on cash flow? Even if you increase the dividend a little bit above the current policy, even if you spend a bit more on capex and new space than we're all predicting, on my numbers anyway you've still got debt going down, you've got gearing going to virtually zero within a few years. So can you give us a little bit more of your broader view on cash flow, on distribution policy, because simply spending a bit more or paying a bit more dividend I'm not sure answers the question.

RP Thanks, Andrew. If you'll forgive me, I'll duck that until the prelims. We've got a very clear balance sheet strategy, as you know, which includes the dividend policy. We said in the context of Co-op Somerfield, Sittingbourne RDC, we've been delighted to be able to actually invest more than we thought we were going to be able to, and so for this period that's been the right thing to do. That has meant that the debt is rising a bit and will rise a bit through to the year end, but I think further out, we would talk about that at finals rather than interims.

AC Just quickly, can you tell us what you're going to do with the south west depot? Whether that's going to be a freehold purchase? Are there any other big ones, abattoirs, I'm guessing pack houses, that you haven't told us about yet?

MB The depot is going to be a freehold one.

RP Yes. The only two big infrastructure things remaining that were in the optimisation plan were the south west RDC, which was always going to be freehold and the remainder of the systems programme.

IG Round to the other side. Clive.

CB Clive Black from Shore Capital. A few questions if I may? Firstly, in terms of cash flow, drawing on Andrew's question, you had more or less flat operating cash flow in the first half. Should we have expected a better working capital performance, given the very strong sales? And could you guide us, A, to where you see the full year being there and, B, maybe explain why we are where we are at the half year? Secondly, just in terms of an earlier question on your opening programme. Your capitalised interest looks very low, or is very low. Can you give us a reasonably concrete indication as to the actual number of superstores you would expect to be working on in the next 12 to 24 months, i.e., 25,000 square foot superstores? And lastly, in terms of the trading outlook. We all expect inflation to go down, it is going down, but at the same time, this time last year, most people didn't think the sun was going to shine the next day, so should you not expect quite a lot of potential trading up in the fourth quarter of this year?

RP If I can take the first point on cash, Clive. In terms of the cash generation in the first half, we thought that was about where we expected it to be. In terms of working capital, through to the year end, we will see that we've got a new RDC being stocked up, so we don't see big gains from working capital this year. And in terms of capitalisation of interest, it is very low and we've capitalised pay marginal funding costs, which at the moment is a very low funding cost and obviously that's the most prudent way to do it.

CB Should we have expected more negative working capital given your sales growth?

IG As I say, we're comfortable with where it is. I think I've talked previously that one of the things that we've been able to do in a relatively small way is swap some trading terms around and get some margin improvement as a result of that. It's not been big but as you can imagine, our credit situation has been a lot easier than certain suppliers to us and we've been able to use our balance sheet strength to get better trading terms.

MB And on the last point, on Christmas, Clive, I think what we'll see is yes, inflation will tail off throughout the second half of the year, but as Richard said, it will be different for different lines and I expect that people around Christmas will certainly see certain lines to be, even as we were mentioning, inflationary, but other lines will still have some inflation in them and therefore we will see the basket for Christmas being, as we said, sort of at a lower level but we expect still Christmas to be for people here a treat because we saw that last year as well. Never forget the consumer sentiment last year was strongly negative but still Christmas was a period where grocery trade did pretty well.

CB Smaller stores to be redeveloped, the number of superstores you have actually put a digger in and start digging in the next 24 months, could you tell us that please?

MB Well, we will come back for more detail on rebalance and on the other programmes back in March, Clive, because then we'll give a complete update where we are with the optimisation plan. Thank you. Coming back here. Mike first please.

MD Mike Dennis from MF Global. Two questions. One, could you actually put a figure on your Market Street growth rate? You said double digit. And corresponding with that, what has been the impact on shrink. I'm sure it's a big improvement, so within the gross margin, and is that going to travel into the second half? You said you're coming up against some tough comps. And the other thing is could you give us directionally how far you can go with manufacturing vertical integration as a percentage of your cogs, in terms of is this a big opportunity for Morrisons? How far can you go?

MB Three things. First, Market Street. We have given you the already hard indication, as we said, it is more than double digits, so we're not sharing a complete detailed number there. Also, for competitive information, because people are looking now very clearly at our Market Street being such a point of difference. Yes, it's been more than double digit. Shrinkage, however, and that's another very strong point of Morrisons, I can still confirm however that shrinkage is under control. The one thing that we are really good at is the operational side of things, so we keep our shrinkage under control whilst growing the fresh food participation, so that we'll be industry leading. Our waste and mark downage levels are industry leading, we're industry leading and still are, even on all the product development we've done, all the ranges we've brought in and all the work we have done on the new product development in the first half year. The manufacturing side is a clear point of difference. We have at the moment completed what we needed in terms of our sole supply for things like meat, and I think that you always want to work towards your capacity, so getting things right and me being an ex-manufacturer is very aware, Ian being a strong background in manufacturing is very aware, that we want to combine the optimisation of our facilities and planning ahead for the future. We are not looking for all kinds of, let's say, things that are offline, so are we going to build a chocolate factory tomorrow? We are not, but are we going to be very much keen on looking how to further our facilities that we have? Yes we are and we are at the moment, as we have constantly done, improving our facilities. So we have our own bakeries as know, we've got a total abattoir, three really high level abattoirs, two of them opened recently and one opened in Spalding, which gives us the benefit, not only in terms of having it ourselves, in terms of Market Street, but really it's a customer benefit of having it fresher. I explained it from the first day. It is between six and 24 hours earlier in store and fresher in store than anyone else, and that benefit we want to keep. We're only going to do it for the benefits, what we can really translate into customer benefits. We're not going to do it to just make the business bigger on the manufacturing side as such.

IG First, Greg.

GL It's Greg from Collins Stewart. Can you talk a bit about the space rebalance programme? How much of the portfolio has been touched? And you haven't mentioned non food today, can we just have a bit of an update on your plans there?

MB Yes. The rebalance and the non food direction elements I'd like to pick up on, because this is only an interim, part of the pre-launch that will give you an overall picture on the 2010 programme, and we will certainly come back to these two points. So since we now want to focus ourselves on all the information we can give you on the Co-op Somerfield stores, it's interlinked with that, we'll come back to these two other points in March. Sorry about that. James. John coming up.

JK John Kershaw, Bank of America, Merrill Lynch. A very quick one. First of all, on the Co-op, it looks a very impressive sales uplift and sales density. Just to clarify the header. Can you perhaps comment on profit density? Clearly they will have a higher shrink, higher fresh penetration, but better profit density. Can you give us a comment versus the core chain? Secondly, I suppose the market has grown unusually fast in the recession because of the inflation. In the second half, just directionally, do you think we'll still have a recession like environment for the industry, so it goes sub 3% below its medium term growth rate? And finally, given I'm not logistics expert, can you tell me what 22 million kilometres saving means as a proportion of your drive time or drive distance?

MB Yeah, the Co-op, I think we gave already quite a clear guidance there, that the Co-op sales densities as we see them now, but let's not start labouring numbers too much on things we have just opened, 1st September the last one, that's why I cautioned it already twice. But we have shared with you 50% higher sales optic, very convincing, and a 15% lower price levels, very strong, and a better range in stores. And yes, they have higher sales densities than the average already now, so it has not matured yet, higher sales densities than the average of the estate. I'm not going to go in much more detail now, but that we see that these stores will even operate better towards a mature stage, absolutely. So I have to keep it there. When we look at the recessionary part, I'd like you to take the recessionary part and the 22 million kilometres please.

RP Just one thing on the profit density, John. We have no expectations for profit numbers out of these stores year one, so I think we've said that before. These things take a little while to get themselves up and running. 22 million kilometres, working assumption about 90p a mile, so in new money we can work out what that would be.

IG A mile. A mile in this one so actually it's quite a round number if you square it back to miles.

JK Just on the actual industry growth with low inflation, just a comment on that, and just one follow up on, no more details on the Co-op but it sounds like you're in a position of sufficient comfort that you're in roll out mode beyond the Co-op, you're actively seeking sites for that smaller format. You've got enough evidence that you're very comfortable.

MB Let me first comment on that last point, because let's not labour as well that second half of the year, I think we've had now three or four different angles, the inflation angle, the growth angle and we came very clearly back to you with our view on that one. I think on the Co-op Somerfield, yes, it gives us already the first confidence that if tomorrow we see a store that we either can buy or a small plot of land in a council where we can put down 10,000 or 11,000 square feet, so would we put it down? Yes, the confidence is there. What has also gave us confidence that we can therefore translate some of that knowledge back to our further estate, yes, for the coming years, we can translate it also back to some of the Safeway stores, ex-Safeway stores that we have. So I think there is directionally already the confidence that we have, seeing the first results in the Co-op Somerfields. Last question please, if there's any. No. Yeah.

JA James Anstead, Barclays Capital. Just two quick questions please. Firstly, on the other operating income. Although it was a small number, I imagine it's fairly high profit margins and that's jumped quite dramatically year on year. Is that a sustainable source of growth? And then secondly, on the Oliver Wyman survey. Obviously, you're doing very well now on these four key categories you're focusing on, but if you go beyond those top four, would you identify two or three more where you would say you're still behind the other top three or where you see there's enormous growth potential, improvement potential?

MB Let me first take the one. No, we have not seen indicators that we have sat on, no, we have not seen indicators where we have not improved on, otherwise Wyman wouldn't have confirmed that the whole set of results of have been so impressive and so dramatic. What we only take from it is nothing but learning to improve. So this is not that we are there. We know that retail is something that you have to reinvent yourselves every year to a certain extent, because what we now see, that people are so much focused on the day to day, I am very confident and that's what we see in our journey, is when we started our journey with our food specialist for everyone, we have now given it more legs to walk every time as a programme, and it's not a programme, it's a nationwide strategy. And therefore, if you look at these indicators from Oliver Wyman survey, we look very carefully at the things even we improve on, how we can sustain them. So when we now say yes, we're known for fresh, that's why we started a farmers' programme, that's why we started the food academy, that's why we started some of these initiatives Let's Grow. Even though we will be see as fresher, if you take one of these examples on quality, freshness is seen as a Morrisons attribute that scores higher than any other retailer. Are we then saying nice? We're going to sit down and say yes, we're fresh, let's work on the other six. We will work at every individual one, but the one thing we want to retain and that is the Morrison product to take out from now, because we haven't seen the end of the tightening belt exercise, is value. Morrisons is a brand that really stands for strong value for customers, and that will continue.

IG James, just to finish on the other income question, I don't think there's much more to go there. We had a number of quite big schemes open over the last three years, Speke in Liverpool is an example. We're pleased with the way in which that space has been rented out and there's not much more of that to come.

MB Thank you very much for your time, thank you very much for your Q&A, and hope to see you soon.