Ladies and gentlemen, thank you for standing by and welcome to the X5 Retail Group Q1 2019 financial results call.

At this time, all participants are in a listen-only mode. There will be a presentation followed by a Q&A session. If you would like to ask a question at that time, please press “*1” on your telephone keypad.

I must advise you that this call is being recorded today, Thursday, 25 April 2019. I would now like to hand the conference over to your first speaker today, Natalia Zagvozdina, Head of Corporate Finance and Investor Relations. Please, go ahead.

Natalia Zagvozdina:

Thank you. Good morning and good afternoon, ladies and gentlemen. On behalf of X5 Retail Group, let me welcome you to our call today dedicated to the release of our Q1 2019 financials. Here with me today are our CFO Svetlana Demyashkevich, as well as our colleagues from the IFRS reporting and IR departments.

We would like to remind you that some of the information announced during this call may contain projections and forward-looking statements regarding future events or the future financial performance of X5. Please refer to page 7 of our press release for a full disclaimer with regards to such statements. We disclosed the press release as well as financial statements this morning via the usual means of communication. They are available on our website in the IR section.

Now, without further delay, let me pass the floor to our CFO Svetlana Demyashkevich. Please.

Svetlana Demyashkevich:

Thank you, Natalia. Good morning and good afternoon, ladies and gentlemen. Thank you for joining us today. Since we held our 2018 year-end financial results conference call just a month ago, I am not going to give a long introduction. What I would like to do is to briefly go through the market environment in Q1, provide an overview of our financials and month-to-date results in April, and then move to the Q&A session.

As you know, from Q1 2019 X5 has started reporting its financial results under two standards: the new IFRS 16 as well as the old IAS 17 standard, which is comparable with the previous year.
I will not go into much detail on IFRS 16 as you can see all the numbers in today’s press release, but we will be happy to answer your questions after the presentation.

To begin with, let me say a few words about the external environment. In Q1 2019, food inflation continued to accelerate and approached 5.8% compared to 3.6% y-o-y in Q4 2018. At the same time, the analyst community expects inflation to start slowing during the next quarter. Growth of food retail trade in real terms in Q1 was 1.4% y-o-y compared with 1.6% in Q4 2018. This trend was expected on the back of increasing inflationary pressure supported by the VAT increase.

Real disposable income showed a decline of 2.3% in Q1 compared with near zero change in 2018. Weak real income performance is a key risk associated with food demand for 2019 as a whole. The macro environment remains challenging, but we see a few positive trends for the food retail sector. Food inflation is picking up, the unemployment rate is resuming its downward trend (it was 4.7% in March), and the consumer confidence index is slightly improving (to -16% from -17% in Q4 2018). The rouble exchange rate appreciated by 6.2% over Q1 and started Q2 on a strong foot, helped by a higher oil price.

Moving on to X5’s financial performance during the quarter, revenue increased by 15.5% y-o-y to RUB 406 bln on the back of positive LFL sales of 5.0% and a 15.1% rise in selling space. X5’s LFL sales growth accelerated q-o-q to 5.0% from 3.7% in the last quarter of 2018 driven primarily by improved traffic. LFL sales growth was positive for all X5 formats. X5’s LFL traffic and basket growth accelerated to 2.7% and 2.2%, respectively.

I would like to stress that LFL traffic in Pyaterochka in Moscow turned positive during Q1 after being negative in 2018. LFL traffic in Pyaterochka in regions other than Moscow also remained positive in Q1 2019, just as it was in 2018.

We attribute positive LFL traffic dynamics to our efforts aimed at improving the quality of products and services in our stores. This work is ongoing, and 2019 will see many more initiatives from our teams across all of X5’s formats in this area.

Looking at margins in Q1, gross profit margin increased by 98 b.p. y-o-y to 24.8%. The increase was driven mainly by successful measures to decrease shrinkage levels, especially in our proximity format, and better efficiency in logistics, while commercial margin remained flat y-o-y due to our balanced approach to promo. In Q1 2019, SG&A expenses (excluding D&A&I&LTI and share-based payments) as a percentage of revenue increased by 18 b.p. y-o-y mainly due to higher staff costs, lease expenses and utilities costs.

Adjusted EBITDA in Q1 increased by 32.6% y-o-y. Our adjusted EBITDA margin increased in line with gross margin by 94 b.p. y-o-y to 7.3%.

In Q1, we continued to accrue LTI expenses covering the old and new LTI programmes. LTI expenses (including social tax) accrued for the old programme totalled RUB 209 mln, while LTI expenses for the probable achievement of the target to maintain revenue leadership from the new LTI programme amounted to RUB 236 mln.
D&A&I costs increased as a percentage of revenue by 23 b.p. vs the same period last year to 3.1%. This was due to a continuously growing share of assets with shorter useful life in PPE.

Net finance costs increased by 2.1% y-o-y to RUB 4.3 bln due to the increased level of gross debt as of the end of Q1 2019 compared to the end of March 2018. The effect from the increased level of gross debt was partially offset by the decreased weighted average effective interest rate on X5’s total debt.

In April, X5 issued RUB 5 bln in rouble-denominated bonds maturing in 3 years with an annual coupon of 8.45%. As a result of our store network expansion, balanced approach to promo, and additional efficiencies achieved on different levels of our operations, in Q1 the Company’s net profit increased by 65.2% y-o-y to RUB 9.3 bln, while the net profit margin increased to 2.3%.

Turning to our balance sheet, at the end of Q1 our net debt to EBITDA ratio was at 1.6x. Going forward, we seek to maintain this ratio below 1.8x while paying dividends in line with our policy.

In Q2 2019, we expect total debt to increase due to the need to raise funds for an upcoming dividend payment planned for early June.

Turning to cash flow, net cash flow generated from operating activities in Q1 was RUB 17.2 bln, up from RUB 13.7 bln a year ago. The change in working capital in Q1 was negative RUB 3.2 bln. This was mainly due to a decrease in accounts payable vs year-end 2018, which was partially compensated by a decline in inventories. The inventories declined from the level of product inventories in the seasonally high last quarter of the year that were sold during Q1 2019.

Net cash used in investing activities, which generally consists of payments for PPE, decreased from RUB 17.4 bln in Q1 compared to RUB 25.7 bln for Q1 2018, mainly due to the slower pace of new openings.

Wrapping up on our Q1 2019 performance, let me say a few words about capex. X5’s total capital expenditure amounted to RUB 12.4 bln compared to RUB 16.4 bln in Q1 2018. Approximately 67% of capex in Q1 went to the expansion of our store base. The remaining capex includes maintenance (around 13%), store refurbishments (around 6%), logistics, IT (around 4%) and other investments.

Now just a few words on our quarter-to-date results. We see good results in April. Total turnover (including VAT) grew by 14.6% y-o-y in 24 days of April. Please note that this year Easter will be on 28 April, while last year it was on 8 April, so pre-Easter sales, which are normally notably higher than on other dates of the month, are not yet reflected in the month-to-date growth that we have given for 24 days. Based on last year’s data, we estimate an additional impact from pre-Easter sales of more than 1% to net retail sales. Before Easter sales, our LFL sales growth in April so far is 4.2%, with traffic being the main driver.

This concludes my brief presentation of the results. Thank you for your attention, and I will be happy to answer your questions.
Operator:

Thank you very much. If you would like to ask a question over the phone today, please press “*1” on your telephone keypad and wait for your name to be announced. You can cancel the request by pressing the “#” key. Once again, “*1” to ask a question over the phone today. The first question we have today comes from the line of Maria Kolbina from VTB. Please, go ahead.

Maria Kolbina:

Good afternoon. Congratulations on strong numbers for Q1, they were ahead of our consensus expectations pretty much on all lines. The question from my side is – you showed quite significant gross margin expansion in Q1, almost 100 b.p., and I think it was the highest gross margin expansion over the last years. Do you think you will be able to maintain the same level of profitability in Q2 and in the quarters to come? Can you provide any estimates on that? My second question is on your shrinkage. I know that you do not openly talk about the level of shrinkage, but do you think you will be able to improve this ratio, the shrinkage expense this year, and what is your estimate on this improvement? If you could comment on that. The third question, can you talk in general about the key market trends that you see for the first four months of this year? Thank you.

Svetlana Demyashkevich:

Thank you for your kind words about our results. We are also quite happy with them, honestly. Talking about gross margin, the main driver for the gross margin expansion, as I was saying before, was the decrease in shrinkage level and logistics. We still have targets for the year to improve this level, and we still see a positive trend. I would expect that this positive factor will still be in place for the next quarters.

At the same time, when we look at the commercial margin, it stays stable. Depending on the seasonality (you can understand the commercial margin trends depending on the quarter looking, for example, at last year’s results), I would say that we will try to keep our promo levels at levels comparable to last year. We would expect that commercial margin will be performing more or less in accordance with the trends we had last year. At the same time, as always, we do always look at the market, and if we need to make investments in pricing, we are ready to do that. We have additional surplus within our gross margin, I would say, based on the fact that shrinkage and logistics are improving ahead of the plan if we look at our budget. I think that answers the question on gross margin trends.

The second question from you was on key market trends. For us, I would say Q1 2019 is of course much easier compared with Q1 2018, because of the higher inflation and also all the changes we are doing in the formats, particularly in Pyaterochka. The main change for us is probably in the trends we see in Moscow: as I said, positive traffic in Moscow is a very good result for us. We do expect that this effect from our operational projects and operational improvements we are doing in the formats will continue to give positive results.
We also see some changes in the behaviour of our clients in Perekrestok that influence its baskets. For example, we see that we have more young clients – the check for them is lower, but the frequency of coming back to the supermarket is higher. We also see a very strong trend for ready-to-eat assortment in all our formats, and we are preparing for that. We launched our kitchen factory, which will be producing around 800 SKUs of ready-to-eat assortment. We also see that this gives an effect of increasing the frequency of clients coming to the store with a lower average check. Overall, we think that the results for Perekrestok are exceptional both in terms of LFL sales and LFL traffic.

As I was commenting in the beginning, we still do not see a lot of positive changes in consumer trends, but, at the same time, we do not see any worsening of the situation. As we are present in mass segments, we think that with improvements in our operations and our offer to customers, we are very well placed to benefit from the situation. That is what we are already seeing in our improving traffic and sales numbers, as well as the sales density.

Maria Kolbina:
Svetlana, thank you very much for the answer. Coming back to gross margin, is it fair to assume that the gross margin level should be closer to 25% in the next quarters based on IAS 17?

Svetlana Demyashkevich:
We are not giving such an exact guidance on gross margin, so I cannot answer that.

Maria Kolbina:
Thank you.

Svetlana Demyashkevich:
Thank you.

Operator:
Thank you very much. Once again, to ask a question over the phone today, please press “*1” on your telephone keypad. You can cancel the request by pressing the “#” key. Once again, “*1” to ask a question over the phone today.

Thank you very much. There are no further questions on the phone at this stage.

Natalia Zagvozdina:
It appears that we have satisfied all the interested parties with our release and the presentation. Thank you very much for your attention. You know where to find us if you have any follow-up questions – the IR will be happy to answer them. Thank you, have a good day.

Operator:
Thank you very much. That does conclude the conference for today. Thank you for participating. You may all disconnect.