Presentation

Operator
Thank you for standing by and welcome to the X5 Q1 2013 Financial Results conference call. At this time all participants are in a listen-only mode. There will be a presentation followed by a question and answer session (operator instructions). I must advise you that today's conference is being recorded today, Tuesday 21st May 2013. I would now like to hand the conference over to your first speaker today, Mr Gregory Madick. Please go ahead, sir.

Gregory Madick
Hello, thank you all for joining the call to discuss our first quarter 2013 financial results. Before we begin our presentation, I would like to refer you to the disclaimer statement in the financial results press release regarding forward-looking statements. During this conference call we may make reference to forward-looking statements by using words such as “plans,” “objectives,” “goals,” “strategies,” and other similar words, which are other than statements of historical facts. Actual results may differ materially from those implied by such forward-looking statements due to known and unknown risks and uncertainties, and reflect our views as of the date of this call. We undertake no obligation to revise or publicly release the results of any revisions to these forward-looking statements in light of new information or future events.

We had planned for Stephan DuCharme, X5’s CEO, to participate in the call today, but due to obligations arising from the X5 Supervisory Board Meeting this week, he will not be able to attend.

I will now turn the call over to Sergey Piven, CFO of X5 Retail Group.

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1 This conference call transcript was prepared by InterCall.
Sergey Piven

Thanks Greg and thank you all for joining us to discuss X5’s first quarter 2013 financial results. To begin the call, I would like to comment on the Company’s recent announced appointment of Olga Naumova as the General Director of Pyaterochka, our Soft Discounter format, and provide an update on the Company’s transformation.

As most of you are aware, on 16th May we announced that Olga Naumova has joined X5 as General Director of Pyaterochka and a member of the X5 Executive Board. This appointment completes the Executive Team of X5. The search to fill this important position was not simple. However, based on our past experience, we have a better understanding of the key qualities required in a candidate in order to be a successful leader of the Soft Discounter and execute against the format’s strategy. During the interview process we had several candidates who made the short list, including some with a retail background. In the end it was Olga’s managerial experience, strategic vision, and systematic approach to change that proved to be the deciding factor. One of the key qualities required for the position is a strong Russian background and Russian market experience at the General Director level. Olga has over 20 years of experience in the Russian market, primarily at the General Director level and as Commercial and Marketing Director in leading Russian metallurgy and IT companies. During this time she has demonstrated her ability to successfully lead change management and restructuring projects within large and complex organisational structures. Olga has a very broad and strategic view on business development and a proven track record of managing a large team in Russian and international environments. This experience will be critical, as Olga steps in to lead the evolution of the Soft Discounter format into a truly modern retail operation. There is no shortage of Russian and international retail expertise at X5’s Executive Board level and within the Soft Discounter format at various management levels. Olga will be collaborating with and leading these teams to drive the changes necessary to elevate Pyaterochka to the next level. Olga has met and participated in management workshops with the Company’s Senior Executive Team over the last month and there is a clear alignment in terms of what she and the teams see as the key business values for the Company and what needs to be done to achieve them. This is an important factor, because it provides a solid basis for an effective onboarding for Olga and indicates a good fit with the team, another important consideration in filling this role. The challenges we face in turning around the Soft Discounter’s operations will require a strong pair of experienced hands that can effectively lead the format’s team through the changes required to deliver against our strategy. Olga is this person.
This brings me to the ongoing business transformation and recent changes we have made to the Company’s organisational structure. These changes will focus primarily on the Soft Discounter, but will also allow us to strengthen the operation across all formats.

In 2011, we began the process of decentralisation and the transfer of many functions to the format level in order to move closer to the customer. As part of this process and the continued development of a more customer-centric format business model, we have decided to create dedicated supply chain and category management functions for the Soft Discounter format, while the bigger supermarket and hypermarket formats these functions will remain [there]. This change will recognise the distinct operating model of the Soft Discounter, including but not limited to a small assortment and volumes as well as high centralisation compared to the larger formats. It also provides each of the formats with a more focused service and a better set of tools to deliver value to their customers. These changes will be rolled out step by step starting with a supply chain in Moscow and Moscow region, where we will dedicate five distribution centres and transportation resources to the Soft Discounter format as of June 1st. From this date we will also begin the process of creating a dedicated category management function at Pyaterochka. As regards both of these two division heads, both of whom will report to Olga Naumova, we have already selected the internal candidates to be appointed and their teams are being informed. Because we are implementing the changes within the Company in a transparent and open way, the reaction from our employees has been positive and we will continue to move forward in this way. As we are rolling out the changes in stages, this will provide us with an opportunity to test assumptions and minimise business disruptions and risks. As a result of these changes, we decided to move our analyst day to 11th July in order to give the team a chance to establish themselves in their new roles and to provide a more detailed presentation of the changes we feel are necessary to complete the transition.

We look forward to providing you with future updates on the progress and results of these changes.

I would now like to move onto our quarter one 2013 financial results. As we announced earlier, our total net sales in Rouble terms increased 8.1% year-on-year primarily driven by selling space expansion, price inflation and the positive performance of stores added over the past two years. Net Rouble retail sales at our Soft Discounter format increased by 9.1% year-on-year, which was primarily driven by a 27% year-over-year increase in sales from other regions and 6% year-over-year increase in sales from the central region. These increases were offset by a 2% decline in the sales from the North West region. The increases were mainly driven by a 17% increase in net selling space at the Soft Discounter, of which approximately 11% came from expansion in
other regions. Also, average ticket grew year-on-year by just over 1%. Supermarkets recorded a 6.2 year-over-year increase in Rouble net retail sales, which was primarily driven by a 6.5% year-over-year increase in sales from the central region. Sales from supermarkets in other regions increased by 6.8 year-over-year, while the North West region grew by less than half a percent. The growth in net retail sales was mainly driven by selling space expansion of 9%, of which the central and other regions accounted for approximately 5% and 4% respectively. Supermarkets also benefited from approximately 2% year-on-year increase in the average ticket. Hypermarket sales in Rouble terms remained relatively flat year-on-year and were mainly impacted by store closures and downsizing in other regions. Net retail sales in Rouble terms increased by just over 4% and 1% in the central and north west regions respectively, which were offset by a 4% decline in sales from other regions due to a 3.5% decline in that region’s net selling space.

Moving away from sales I would like to turn the discussion to our quarter one margins. We ended the quarter with a gross margin of 24.4% in line with the gross margin in quarter one 2012 of 24.5%. Our commercial terms have improved year-on-year, but were offset due to a combination of investment and price and promotions, as well as an increase in losses during the 2013 period. The losses were primarily related to expanded layout for fruit and veg, as well as [unclear] seasonal growth and alcohol, the latter due to changes in Government regulations. We have continued our focus on cost control at the SG&A level. However, we did see a slight increase in these expenses as a percentage of total net sales, primarily due to an increase in lease expense. As a percentage of total revenues, SG&A expenses increased in quarter one 2013 to 21.4% compared to 21.2% in quarter one 2012. Staff costs represents the largest component of SG&A expenses and in quarter one 2013 our total staff costs decreased by 32 basis points year-on-year as a percentage of net sales to 8.5%. The main driver for the decrease was a reduction in [unclear] which were offset by an increase in bestsellers. The increase in bestsellers is due to an increase in employees related to the 729 new stores added year-on-year where sales continued to ramp up as these stores mature.

Our lease expense in quarter one 2013 increased year-on-year by 30 basis points primarily due to an increase in net selling space and to a less extent increase in our average lease rates. Other store costs were higher year-on-year in quarter one 2013 by 11 basis points, primarily due to an increase in maintenance and repairs at our stores. We maintained our quarter one 2013 utilities cost as a percentage of net sales in line with costs in the 2012 period despite the increase in the store base and tariffs. This is the result of our ongoing efforts to promote efficient consumption of electricity, water, and other utilities. As a result of the factors discussed above, we reported an EBITDA margin of 6.8% in quarter one 2013 compared to 7.1% in quarter one
2012. We still maintain our guidance for an EBITDA margin of greater than 7% and see plenty of opportunities for greater efficiency in our operations.

Turning to X5’s finance costs, we saw a significant increase year-on-year in our net financing costs of approximately 12% in quarter one 2013 in Rouble terms or by approximately 8 basis points as a percentage of sales. The increase was due to an approximately 2% increase in our total borrowings in Rouble terms at the end of quarter one 2013 as well as a 30 basis points increase in borrowing rates, which averaged 8.8% in the 2013 period. However, as of the end of quarter one 2013, our net debt to EBITDA ratio deteriorated slightly compared to year-end 2013 to 3.18 times compared to 3.15 times at 31st December 2012, but improved significantly from the end of quarter one 2012, which was 3.36 times. We are still well within our covenant limit of net debt to EBITDA of four times. Our interest coverage ratio remained healthy at 3.22 times compared to our covenant limit of 2.75 times. Our effective tax rate for the first three months of 2013 was 24.9% compared to 26.6% in the corresponding period of 2012. The decrease in our effective tax rate was due to the elimination of certain historical tax provisions as well as the Company’s ongoing tax initiatives. As a result of the above, our net income margin for Q1 2013 was 1.6% compared to 1.7% in the corresponding period of 2012.

Our quarter one 2013 net cash generated from operating activities increased year-on-year to $28.4 million from net cash used in operating activities of $77.1 million in quarter one 2012, primarily due to changes in working capital and decrease in the income taxes paid in 2013 compared to 2012. Our working capital benefited from the high inventory base at 31st December 2012 and the subsequent inventory drawdown during quarter one 2013. This also negatively impacted our trade payables due to a decrease in purchases during the quarter. We did see significant improvement in our trade account receivables where the combination of approved collection procedures and a focus on front margin resulted in a reduction of $87 million during the quarter. Our cash flows used in investing activities decreased in quarter one 2013 to $105 million from $180 million primarily due to a decrease in the number of new stores opening in quarter one 2013. Our Capex in 2013 was primarily focused on organic expansion, as we opened 66 stores during the period. We are also in the process of rolling out a light and heavy store refurbishment pilot programme for our Soft Discounters and in quarter one we launched light refurbishments at 10 stores in the North West region and seven in the central. This would be completed by 24th May and, based on the results, we will target more stores in these and other regions. The light refurbishments require only short store closures and are mainly focused on lighting, refrigeration equipment, navigation, air conditioning, improving off shelving, and other fixes. We’re also doing five full refurbishments as part of the pilot programme, two in the central region, starting in May,
and three in other regions starting in June and July, and expect the stores to be closed for up to 20 days.

Regarding hypermarkets and supermarkets we are moving forward with select refurbishments, some of which will require stock closures, while the work is carried out. We also opened three supermarkets with a new expanded fish section. First results in sales have been very positive and so we plan to roll out this programme for another 10-12 stores before the end of this year. I would like to update you now on some of the initiatives which we mentioned during the previous conference call that we are currently working on.

Regarding [availability of] the changes in the organisational structure mentioned earlier will result in improvements in the logistics service level for both the Soft Discounters and the larger formats, which should in turn improve availability in all formats. Also, the team has all the tools and it’s fully focused on tracking top selling items’ availability in everyday regime. The active rollout of the auto replenishment system is underway at the Soft Discounter format and we plan to have this completed for stores in the central region by the end of June and for all regions by the end of the year. We have started with dry food and drink categories and we will add more categories as we become comfortable with the initial results of the rollout. We already see a positive impact in terms of the time Store Directors spent on the daily order process. We also expect positive impact on stocks and availability of goods as a result of rolling out this programme. We have also improved the analytical tools we use to measure our results; among others, by introducing a new service level reporting system that provides more accurate data on deliveries, including timing of deliveries, and comparative information on direct deliveries from suppliers to the stores. We have initiated a new system to track the availability of the top selling SKUs that provide data on the availability of these items at our Soft Discounter, supermarkets and hypermarkets, which the team is using now.

In terms of assortment, we expect positive results from the creation of the category management division at the Soft Discounter format, which will provide dedicated Category Managers for drinks, fresh grocery and on food categories, and will build on the decisions made about the assortment in the first quarter. We have also taken steps to address pricing in some regions and at different formats to ensure we are in line with competition and the value proposition of our stores, and have seen positive results from these actions. Finally, we have strengthened the management of Soft Discounters by reducing the store to supervisor ratio from approximately 21 in 2012 to 8 currently. This would provide additional support for Store Directors and ensure that store policies and routines are being followed. To further support this, we have rewritten the instructions for
store employees and Store Directors to provide more concise and understandable directions to accomplish their daily tasks.

To summarise, we continue our back to basics work.

That concludes our discussion on the results and initiatives. Operator, we are beginning to start the question and answer portion of the call.

Questions and Answers

Patrick Shields – Wood & Co
First question really, I just want to understand some of the dynamics that happened through the first quarter, and it certainly looks as if your growth margin execution was pretty strong in the first quarter. I think that's better than most people expected and I just wonder whether there has been any sort of change in philosophy, because it looks like...you know, if we look at the like-for-like performance through the quarter, traffic deteriorated towards the end of the quarter, and I'm talking about Pyaterochka now, and did so again in April, judging by the handouts that you've given us today. We know that you have to deal with an unseasonal inventory build at the end of last year, so I think most people in the market expected heavy discounting through the quarter to impact growth margins and potentially operating margins more than it appears to have done. Has there been some kind of change in terms of a greater focus on preserving margins, a greater focus on preserving cash flow; obviously the cash flow performance in the first quarter was pretty strong. I just wonder whether there is any relation between the strength and the margin, and if you like the deterioration in traffic like-for-like through the quarter, as we decided to trade off margin for traffic, as it were.

Sergey Piven
Let me try to answer several parts of your question. First of all, as I mentioned in the previous call and I mentioned today, we continue our focus on operation, which includes the focus on sales margins and stocks, which I think we are going to see the results of that in the nearest future. Second, in terms of our cash flow, as I mentioned we benefited from the selloff of the stock which we made for the high season in the end of December, and that had positive impact on our cash flow. In terms of like-for-like sales, we have to remember the current [unclear] of the [unclear] the Russian Federation this year versus the previous year. We have a rare combination of Easter and May holidays happening at the same the time. Last year, Easter was much earlier, so pre-Easter and Easter buying happened actually in April, while this year it's been delayed to May, so
that reflects I think a lot in our like-for-like and the decline in like-for-like which you happened to notice on April is directly related to the calendar of this holiday.

**Patrick Shields – Wood & Co**

But I think what's also noticeable is that in both March and April your basket like-for-likes seems to be much closer to inflation than has been in the previous few months, which one interpretation of that is potentially not as much investing in prices.

**Sergey Piven**

What we've seen, for example, in one of our formats in hypermarkets is that when you invest in price, first you see the negative effect on the basket, but the basket actually grows along with the traffic or even maybe sometimes faster simply because people realise that they can basically buy more with you, because your share of wallet of the customer increases, because you provide a better deal for the customers, so I think I see no contradiction of our pricing initiatives; careful, but quite active approach to promo and the growth of the basket.

**Patrick Shields – Wood & Co**

The conclusion is you're not deemphasising promo. Promo is still a full part of your commercial approach to your value proposition and you continue to hope that that is going to be visible in a turnaround in traffic, part of which is attributable to the seasonal oddities, if you like.

**Sergey Piven**

Promo has always been part of our tools to sell the products. It will continue to be part of our tools. There may be some modifications because we try to improve from quarter to quarter; again, I refer you back to our back to basics retail theme, we try to watch very careful the results of the promo and we will adjust accordingly. If we see positive or negative customer reaction to any specific items or any specific approaches in promo, but yes indeed we will continue strong communication of any promo actions which we might have, so this remains part of our strategy.

**Patrick Shields – Wood & Co**

Just on Capex, are you willing to give us any guidance for Capex again for the full year? I mean it's certainly one of the reasons why you're...I mean there was a limited amount of cash drawn in
the fourth quarter, I mean obviously working capital management was very good, but you only spend $100 million on Capex, which is a relatively low number and I just wonder whether we’re seeing again, you know, the focus on operations rather than the focus on expansion being visible in moderating Capex, certainly in the short-term.

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**Sergey Piven**

Low number of Capex spend in the first quarter relates to mainly two things. First we opened fewer stores than last year. We only opened 66 stores this year, so this is reflected in Capex. The other thing is I mentioned about our pilot programme of light and heavy refurbishment, which is now in the final stages of testing, and we will invest much more aggressively in the refurbishment of the stores in the remaining parts of the year versus the first quarter.

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**Patrick Shields – Wood & Co**

I understand that you spent less because you opened fewer stores, but the question is whether that's a deliberate policy to rein back on store openings while you're addressing some of these other issues, or is this just a phasing effect and you'll return to a more significant number of store openings through the balance of the year?

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**Sergey Piven**

We do not change our forecast to the top line. We do not change our forecast of the Capex, so of course we expect more store openings in the remaining part of the year. We already have seen some increase in store openings and in lease contracts signed in April. We just expect to ramp up the growth.

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**Maria Berasneva – Morgan Stanley**

My first question would be a clarification, so if we look at the like-for-like traffic at discounters, we see that it has deteriorated in March and then we saw no recovery in April, so how do you expect this to evolve for the rest of the year, if you have any expectations? The second question, I understand that you're effectively separating logistics for discounters, logistics and procurement for discounters, from supermarkets and hypermarkets, and how will it take to improvement the changes to logistics for discounters in your opinion?
Sergey Piven
The first part of the question about Soft Discounters like-for-like, you mentioned that we've had, as far as I've understood, weaker March and then recovery in April.

Maria Berasneva – Morgan Stanley
We saw no recovery in traffic in April.

Sergey Piven
No recovery.

Maria Berasneva – Morgan Stanley
Yes, on the like-for-like basis in this country.

Sergey Piven
Yes. Yes, it's all there in the numbers. We already mentioned or I already mentioned that the calendarisation of holidays this year does not help or did not help April sales, but we expect slightly better results in the second quarter due to both a combination of our initiatives more certainty with the Management Team and also calendarisation which didn't help April, actually helped a little bit in May.

Maria Berasneva – Morgan Stanley
Okay, so maybe let me put the question differently. Do you expect the traffic for discounters to come back to the positive territory this year or at least be flat year-over-year?

Sergey Piven
This is indeed minimum which we will accept from discounters. We do not plan for them negative like-for-like in total. Then in terms of splitting it between traffic and basket, I can't give you the more precise forecasts right now. Let's wait until the team formalise their strategy, which the first versions we will be happy to share with you at the investor day on 11th July. Could you please repeat the second question you've had?
Maria Berasneva – Morgan Stanley

Absolutely, so with regards to the changes that you are implementing within discounters, you're effectively separating logistics and procurement for discounters from supermarkets and hypermarkets, and how long will it take to implement the changes to logistics for discounters in your opinion?

Sergey Piven

First of all, Maria thanks for asking that, I would like to clarify that we are creating the full category management function in discounters, which is different from procurement function, and that is exactly where we expect to see the improvements and creation of more customer-centric approach. Category management will include not only procurement, but also management of the assortment, management of pricing and promo, as well as the marketing actions together in the holistic approach to the marketing equation and value proposition of the format. In terms of creation of this function, we expected to have the base of the team transferred by 1st July and we expected to finish the creation of category management in the form which works I think by end of August. Of course, this is something which will then be fine-tuned and perfected, you know, continuously, but we expect the new team fully up and running for the next negotiation campaign which will start in autumn. As for logistics, I mentioned that on the central region we move very fast, because our split of this year’s [share] allows a smooth transition. They actually already have dedicated this [unclear], which serviced Pyaterochka. In other regions, there will be no rush on that. The team will be preparing the plans, which again I think we will be happy to share on the investor’s day, on 11th July. My estimate is that we will have it in a well-controlled and step-by-step process, which will take of course beyond 2013.

Brady Martin – Citi Bank

I have two questions really. One is just hopefully a clarification on exactly what happened in April. The second question is just about the tax rate, so if we look at the growth for April, you had a slowdown it looks like in every format; I mean you've mentioned a couple of times that it was due to the Easter holidays, but if were also look at your competitors, Magnit, Dixi that have also reported April numbers, we didn't see a similar slowdown to that level, and particular if you look a look at Pyaterochka, your growth is down 8.7% from 11% in March; through March, basis upon 17%, food inflation is about 8%. I'm just having a hard time understanding why growth in that format is so weak. Are there some other reasons other than holiday development and maybe you
can give us some colour on what's happening in the first few weeks of May, and are these numbers a lot better that the market will be more excited about it. That's the first question for tax.

Sergey Piven
Okay, I will try to answer this question. Why we're having maybe lower results than our competitive. Of course, since the last call, we have not been able to solve all of our issues. That's why regretfully I think it could be expected that our results are worse than Magnit for the first quarter and were for April, but we did not have any April specific issues in our organisation or in our supply chain, so that's what I can answer for this question. Regarding the second part on the tax rate, I already mentioned that our low tax rate is due to some reduction in the previous year’s reserves and that's as much as I think we can comment on the tax rate.

Brady Martin – Citi Bank
If I may just follow up, can you give us some idea on the first part on growth, what did the numbers look like in the first couple of weeks of may, which you should already have, and then on tax rates, do you have some target for the year, some kind of effective tax rate for the year? Is this lower tax rate and provision, is this something that we're just seeing in Q1 or is this something you think you will see for the full year?

Sergey Piven
I think the tax rate which we reported is sustainable, but I'm afraid this is as much as I can disclose.

Brady Martin – Citi Bank
It's about May numbers or are these significantly better than April?

Sergey Piven
Where we see the good improvement is mostly in the hypermarkets, which are now firmly I think in the positive territory. About the rest of the formats, I would not be in a position to comment on any definite trends right now; Soft Discounters, of course, we expect much more improvements in the remaining part of the year especially due to two facts; first that some of our actions have lead
time and secondly is that the new Management Team will take more active measures on improving the performance.

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**Tatyana Bobrovskaya – Metropol**

Hello, my first question is related to your refurbishment programme. On the last call you've told us that you plan to spend about 26% of the total Capex, which is about RUR 7.8 billion. This seems a pretty large amount and according to our estimates it should be about 500-700 store refurbishments; if we are right, it is a quite large amount and do you expect in pressure on margins due to the closings of these stores and can you give us an approximate guidance of the stores refurbishments this year?

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**Sergey Piven**

We confirm this 26% number, but we never disclosed and we cannot disclose right now the number of the stores which will be part of the programme. As for the closure of the stores, one of the peculiarities of this programme is that we tried to minimise the number of days the store is closed. This is in fact one of the key parameters how we will assess this programme of being successful or not. This puts a lot of pressure of course on our organisation and the product team, which does now the pilot, but so far we have been quite happy with the results they achieved. It’s literally just a couple of days which the store is closed, so I do not expect…I expect in fact the benefits of the slight remodelling to be higher than the loss of couple of days of sales for each store to be closed.

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**Tatyana Bobrovskaya – Metropol**

Yes, but it was very few refurbishments since the beginning of the year and what about when it’s going to be a large number of stores?

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**Sergey Piven**

The programme is designed in such a way that we…as I said, that the number of days the store is closed is one of the key requirements of the programme, so if we are not sure that we can fulfil this requirement, this story is not closed and the team has a task to figure out how to achieve this target.
Tatyana Bobrovskaya – Metropol
Okay and my second question is related to the lease expenses. We see that one of the reasons you named is the increase of the leased selling space, but actually the gross in the leased expenses seemed higher than the growth in the leased selling space, so I would like to ask you about [unclear] to bring more colour on the rest cost dynamic this year and what do you expect in this area this year?

Sergey Piven
Here, we have probably a combination of factors. Number one is we opened…organically we opened the record number of stores last year, which are ramping up, and most of these stores will list or at least the proportion of leased versus own stores is moving toward the leased stores, so this has an effect. The other effect is of course if you look at our sales growth, you will see that a major part of our sales growth comes from other regions, which is not Moscow and not St Petersburg where the sales densities are lower, which also has some effect on the lease costs as a percentage of our revenue. I think these two factors explain most of this number.

Tatyana Bobrovskaya – Metropol
Okay and my last question, if I may, is related to the very small number of openings in the first quarter and in April as well, so you're saying the selling space has increased by only 1.5% while you confirmed the guidance of 11% selling space increase this year, so when should we expect the acceleration of expansion – in the second half of the year or already in the second quarter?

Sergey Piven
We are seeing the acceleration already now, but traditionally X5 opened more stores in the last quarter than in other quarters, so that's the tendency which continues this year.

Jamie Coleman – Tamsel
Are you still doing the analyst day this Sunday and Monday or is that being postponed?

Sergey Piven
That has been scheduled for 11th July to allow our new Pyaterochka team to present to you their views and to ensure the ownership of Pyaterochka’s strategy by this team.
[No further questions]

Gregory Madick
Well, that concludes the Q1 2013 financial results conference call. I'd like to thank you for joining us today and we look forward to providing updates on future calls and investor day. Thank you.