



X5 Retail Group Q2 2013 Financial Results Conference Call Transcript^{*}

**15 August 2013
Moscow, Russian Federation**

Presentation

Operator

Thank you for standing by and welcome to the X5 Q2 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, Thursday 15th August 2013. I would now like to hand the conference over to your first speaker for today, Gregory Madick, over to you sir.

Gregory Madick

Thank you, and thank you for joining the call. Before we begin I would like to refer you to the disclaimer statement in the Financial Results press release regarding forward looking statements.

During this conference we may make reference to forward looking statement 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 publically release the results of any revisions to these forward looking statements in light of new information or future events.

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

Sergey Piven

Thanks Greg and thank you all for joining us to discuss X5's Q2 2013 financial results.

To begin the call I would like to briefly comment on the company's recent press release.

On Monday we announced that Janusz Lella will be replacing Valeriy Tarakanov as General Director of the supermarket format effective 1st September 2013.

When Valeriy was appointed general director in August 2012 we had agreed initially to run the supermarket format until the end of 2013 at which time we would evaluate our options regarding the position.

* This conference call transcript was prepared by InterCall.



The decision to make a change now was a mutual one between all parties and was accelerated in order to allow Janusz to participate fully in the budgeting and strategy development processes.

Valeriy's entrepreneurial approach to retail has been instrumental in developing and updating the supermarket format's value proposition to focus on fresh, service and store-in-store concepts. This has resulted in better product quality as well as more visually appealing stores and concepts like the "New Ocean" in-store fish market. Valeriy will continue to lead the Convenience store format and advise on strategic projects for all formats.

We expect a clean hand over of responsibilities in September as Janusz has been working with X5 as an advisor and consultant for the past two months. During this time he has been working closely with Valeriy and the supermarket team to identify operational inefficiencies and other areas for improvement. This working knowledge of the operations and people should help mitigate any potential issues associated with the leadership transition and allow Janusz to hit the ground running.

We are excited to have Janusz join the management team as he brings many years of retail experience as well as a successful track record of restructuring operations to improve efficiencies, sales and profitability. This will undoubtedly complement the work Valeriy has done to refine the format's value proposition and provide a source of retail best practice and solutions that will benefit the other formats as well.

We look forward to introducing Janusz and the rest of the format directors at our upcoming Analyst and Investor Day on 11 October in Moscow.

I would now like to move on to our Q2 2013 financial results.

As announced earlier our total net retail sales in Rouble terms increased 7.9% year-on-year primarily driven by selling space expansion, price inflation and the positive performance of stores added over the past two years.

Drilling down to the individual formats' results we see that net Rouble retail sales at our soft discounter format increased by 7.7% year-on-year, mainly due to a 17.2% increase in net selling space that was offset by a 1.7% decline in sales from like-for-like stores.

In terms of the increase in selling space, "Other" regions grew by 32% year-on-year at 30 June 2013 contributing 10.8% to the format's total increase in net selling space while soft discounters in the central region increased selling space by 10% year-on-year and accounted for 4.8% of the format's total increase.

Looking at top line growth, net sales from "Other" regions increased by 24.9% and contributed 6.0% to the total year-on-year increase while sales in the Central region increased by 5.1% and contributed 2.7% to the total year-on-year increase.

The increase in net sales from these regions was offset by a 4.3% decline in sales from the North-West region, which negatively impacted the total year-on-year increase by 1.0%.

The format's negative 1.7% like-for-like performance was mainly driven by older stores in the North-West and Central regions which reported negative LFL sales results of 1.7% and 0.5% respectively while "Other" regions reported positive 0.6% LFL results.



The decrease in soft discounter's LFL results was primarily driven by a 5.0% decline in traffic; of which the North-West region contributed approximately 2.2% and the Central region 1.9%, and reflects the on-going operational issues the format faces as well as the aging store base and increased competition in these core regions.

Supermarkets recorded a 5.6% y-o-y increase in Rouble net retail sales, which was primarily driven by a 9.3% increase in net selling space.

In the Central region net selling space increased by 11.0% year-on-year which contributed 6.0% to the total increase while the North-West and "Other" regions added approximately 7.0% each and contributed around 1% and 2.5% respectively to the total year-on-year increase in Q2 2013.

In terms of net sales, supermarkets in the Central region increased sales by 6.0% and accounted for 4.2% of the total year-on-year net sales increase while supermarkets in the North-West and "Other" regions increased net sales by approximately 5% each and accounted for half a percent and 1%, respectively, to the format's total net sales increase.

Hypermarkets net sales in Rouble terms increased by 5.4% year-on-year primarily due to positive like-for-like results of 4.3%.

The increase in like-for-like results was driven by hypermarkets in "Other" regions which contributed 2.8% to the total increase while stores in the Central and North-West regions contributed approximately 0.8% percent each.

The improvement in hypermarkets like for like sales is due to the improvements in the format's value proposition to customers which has been driven by improvements in product quality, especially fruits and vegetables, as well as improved service. These improvements have been supported by effective marketing campaigns that are returning customers to the stores.

In terms of trading update for July and August we are not seeing any material improvements to the June run rate.

You may have noticed that we did not provide a July sales update in the presentation. We have made a decision to only provide quarterly trading updates and will no longer be issuing interim monthly results.

Given where we are in the turnaround process and the potential short-term volatility in results due to the introduction of new initiatives, any analysis or conclusions based on these results would be a distraction to management and the market.

That being said we maintain our guidance of 11% top line growth for 2013.

Moving away from sales I would like to turn the discussion to our Q2 2013 margins.

We ended the quarter with gross margin of 23.6%, an 82 basis point improvement over the gross margin in Q2 2012 of 22.8%.

The main reason for the increase was the improvement in our commercial terms; however we did record an increase in shrinkage primarily related to the expansion of our fruits and vegetable category and the abnormally hot weather in May and June.



We have continued our focus on cost control at the SG&A level but we did see a slight increase in these expenses as a percentage of total net sales primarily due to an increase in lease and other expenses.

As a percentage of total revenues, SG&A expenses increased in Q2 2013 to 20.3% compared to 19.7% in Q2 2012.

The largest component of SG&A expenses in Q2 2013 was staff costs, which decreased by 9 basis points year-on-year as a percentage of net sales to 8.0%. The main driver for the decrease was a reduction in bonuses, which was offset by an increase in base salaries.

The increase in base salaries is due to an increase in employees related to the 733 new stores added year-on-year where sales continue to ramp up as the stores mature as well as an increase in bonuses paid to store employees.

Our lease expense, in Q2 2013, increased year-on-year by 54 basis points as a percentage of net sales primarily due to an increase in net selling space and to a lesser extent and increase in our average lease rates. In absolute terms lease expense increased by 21.5% year-on-year, of which 61% was due to the addition of new stores while 39% was due to rate increases at older stores.

Other store costs as a percentage of net sales were higher year-on-year in Q2 2013 by 14 basis points primarily due to an increase in maintenance and repairs at our stores, which mainly consisted of simple repairs to equipment and store appearance.

Our D&A costs were lower as a percentage of net sales by 20 basis points despite additional capex for new stores primarily due to the impairment we recorded in Q4 2012 on PP&E, prepaid leases and intangible assets.

We maintained our Q2 2013 utilities costs 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 on-going efforts to promote efficient consumption of electricity, water and other utilities.

Other costs were higher by 48 basis points as a percentage of sales primarily due to an increase in agency fees paid to reverse franchisees on higher revenue and a gain recorded from the disposal of fixed assets in Q2 2012.

As a result of the factors discussed above we reported an EBITDA margin of 6.9% in Q2 2013 compared to 7.0% in Q2 2012. We still maintain our guidance for EBITDA margin of greater than 7% and see plenty of opportunities for greater efficiency in our operations.

Turning to X5' finance costs, year-on-year our net financing costs increased by approximately 17.6% in Rouble terms. The increase was due to an increase in our total Rouble borrowings at the end of Q2 2013 as well as a 30 basis point increase in borrowing rates which averaged 8.8% in the first half of 2013.

At the end of Q2 2013 our net debt to EBITDA ratio deteriorated compared to year-end 2012 to 3.23 times compared to 3.15 times at 31 December 2012 but was still well below Q2 2012 which was 3.40 times and we are still well within our covenant limit of net debt to EBITDA of 4.0 times.

In August we signed a new Rouble 15 billion club facility that will refinance the 12.4 billion Rouble outstanding balance on the previous facility as well as other short-term obligations. We are very pleased



with the terms of the new club loan which for the 3-year 9.7 billion Rouble tranche is the same as the previous loan – or MosPrime plus 2.5% – the new loan also includes a 5-year tranche for 5.3 billion Roubles with a rate of MosPrime plus 2.75%.

Moving on to taxes, our effective tax rate for Q2 2013 was 23.9% compared to 25.5% in the corresponding period of 2012 and in both periods was above the statutory rate of 20% primarily due to the non-deductibility of certain items. The decrease in the effective tax rate year-on-year is in line with the rate we reported in Q1 2013 and reflects the sustainability of the Company's on-going tax planning initiatives.

As a result of the above our net income margin for Q2 2013 was 1.7% and in line with the corresponding period of 2012.

Our Q2 2013 net cash generated from operating activities decreased year-on-year to \$49.3 million compared to \$68.8 million in Q2 2012 primarily due to changes in working capital.

Our working capital benefited from a lower inventory balance at the end of the period due to the inventory draw down during Q2 2013, which also negatively impacted our trade payables by reducing purchases during the quarter.

We also saw an increase in our trade accounts receivable due to technical reasons associated with the collection process that resulted in a delay in June collections.

Other accounts payable were lower due to more efficient processing of reclaimable VAT paid to suppliers which is offset against VAT due on sales.

Turning to capital investments, our cash flows used in investing activities decreased in Q2 2013 to USD 152 million from USD 195 million primarily due to a decrease in spending on IT, logistics and special projects.

Our accrued CapEx in the first six months of 2013 amounted to USD 229 million compared to USD 390 million in the corresponding period of 2012. 70% of the H1 2013 CapEx was focused on selling space expansion, compared to 54% in the 2012 period, while store refurbishment accounted for approximately 20% compared to 13% in H1 2012. The remaining was made up of expenditures on IT, special projects and logistics and represented approximately 10% of 2013 capex or 33% of capex in 2012.

We maintain our 2013 targets for CapEx – or approximately 30 billion Russian roubles – and new selling space expansion of 11%.

On our previous call we mentioned our pilot program for light and full refurbishments of soft discounter stores that was launched during Q2. The pilot programs have been completed and I would like to give you an update on where we stand.

There were 17 light remodels, 10 in St. Petersburg and 7 in Moscow, as well as 6 full refurbishments, 3 in Moscow and 3 in the city of Perm in the Ural's region, that were part of the pilot project where we tested different approaches to store renovation.

We have taken the best ideas and practices from this process to optimize the reconstruction process and now we are preparing to roll this out on a wider scale beginning at the end of this month and focusing on stores in the Central and North-West regions.



Initial feedback from customers is encouraging and we expect that this will help create a more positive store image, attract new customer groups to the stores and improve like-for-like traffic and turnover.

We have made solid progress on our roll out of SAP ERP auto-ordering system for the soft discounters.

Currently the system has been rolled out in 5 out of 8 regions for dry food groceries and drinks, the remaining 3 regions – North-West, Urals and Privolshkiy – will be completed by the end of October. We are also in the process of evaluating the results of a pilot program for Fresh categories – excluding Ultra Fresh - in the Central region and expect to roll this out to all regions by the end of the year.

As we mentioned earlier the auto ordering system will provide numerous benefits, including decreasing inventories, potentially by up to 3 days, improving availability, by between 8% to 10%.

We have also continued the roll-out process for JDA demand and fulfilment at our distribution centers, hypermarkets and supermarkets. We plan to have this completed for dry food at our distribution centers by the end of October; for fresh categories, except fruit & vegetables, by the end of the year and non-food in the first half of 2014.

The roll out in the supermarkets and hypermarkets will begin in Q2 2014 and be completed by Q4 2014 for the same categories.

In parallel with the rollout of these systems we have also been making progress on other initiatives to improve our logistics operations. We have launched a Distribution Centre that will be dedicated to supplying fruits and vegetables to the soft discounters in the Central region and expect to have completed the transfer of deliveries from this DC by the end of September. This will improve the quality of fruits and vegetables, decrease shrinkage and reduce seasonal supply risk.

We continue to work on measures to optimise logistics costs and improve service levels and are focusing on route optimisation, improving stores' receiving areas and delivery schedules to remote regions.

I would like to add a few comments on the progress of the decentralization of logistics and category management functions to the soft discounter format.

The format has taken over control of five distribution centers, not including the new distribution center focused on fruits and vegetables, in the Central region and is currently working on optimizing delivery routes and schedules.

We have also established the category management function within the soft discounter format and the new team is in place. As you may recall we created the category management function to replace the activities of X5's centralized commercial department for the soft discounter. The new function is organized around six departments, Drinks, Fresh, Grocery, Private Label, Marketing & Support and Regional Products which is comprised of the 8 geographic regions where we operate.

We look forward to updating you on these and other initiatives at our analyst and investor day on 11 October when we will also be reporting our Q3 trading numbers.



That concludes our discussion of the results. Operator, we are ready to begin the questions and answer portion of the call.

Questions and Answers

Nick Ashworth – Morgan Stanley

Hi. Good afternoon everyone. Just a couple of questions from me, if I may. Firstly, on finance costs. You say the cost of funding has gone up a little bit, I think it was 30 basis points, the first half of this year on the first half of last year. Where do you see financing costs going for the full year? And then secondly, just going back to the bit on logistics you talked about at the end, I think you said you already have five distribution centres now dedicated to Soft Discounters in the Central region. Do you have an idea of how many distribution centres across the organization will be split out for Soft Discounters in the longer term and what sort of time frame are you thinking for that? Thank you.

Sergey Piven

In terms of the rate I don't think we expect any change. In terms of logistics the company is now working on formulating the strategy plan for the three years which includes logistic and supply chain as part of it, so we will be ready to provide you comments on that and the outlook I think on the analyst day.

Maria Kolbina - VTB Capital

Yes, good afternoon. I have basically one question. It's with regards to the trends that you see in July and August. How does it look versus the second quarter of the year? In June you showed some deceleration in top line growth and overall you grew by 7%, so how does July and August look like? Is it more skewed to like 7% or it's slightly higher, and is there a potential risk for the top line being slightly lower than 11%? Thank you.

Sergey Piven

We do not see any major improvements in July or in August until this date, so the second half of the year is going to be challenging but we think we will do it, we still have some opportunities.



Maria Kolbina - VTB Capital

Sergey, and when you say you don't see any improvements, any improvements versus June or versus second quarter? Can you specify which month you're referring to because June saw the lowest growth in the second quarter?

Sergey Piven

Versus June we see slight modest improvement.

Patrick Shields – Wood and Co

Yes, thanks very much for the questions. Firstly, I missed some of your opening comments so this may have already been covered. Have you said anything about guidance for the full year and can you, in terms of your previous guidance whether that is being maintained for the full year, both in terms of revenue space and profitability? My second question is you talked a little bit about or you mentioned the rollout of both the SAP system and the JDA system. Now, your comment seems to suggest that this is basically being applied to the Hypermarket and Supermarket divisions but Pyaterochka seems to be left out of that. Am I misunderstanding the rollout of those IT tools and does this mean that you're going to have to invest in a separate standalone infrastructure for Pyaterochka or is Pyaterochka coming at a later date?

Sergey Piven

You didn't miss much because we didn't change any outlook at this call. On your second question about SPA and JDA SAP has an auto replenishment module built in which is suitable for us but it is not sophisticated enough to suit all the needs of supermarkets and hypermarkets which have much richer assortment and much more complicated assortment that is why we are implementing JDA in supermarkets and hypermarkets and in discounters we are implementing auto replenishment with SAP tools. Does this answer your question?

Patrick Shields – Wood and Co

It does indeed. Maybe if I could follow-up just on working capital. In, I believe, that the first half we saw a reasonably significant drawdown of cash or a realization of cash from the drawdown of inventories which relates to high inventory levels that you took in to the end of last year. That was matched to a degree by the fact that payables came down as well. For the balance of the year do you expect to be able to generate cash out of working capital management? And if so, do you have a feeling for whether it's going to be in line with last year's second half or better than?

Sergey Piven

Last year there was a modest increase in cash in the second half. I can't give you any exact guidance but please be assured that we are going to work very closely on our working capital and this is one of our priorities and of course one of the priorities of myself and finance team who will be coordinating this work.

Patrick Shields – Wood and Co

Okay. Then, while I'm on the line maybe about the gross margin. Obviously, some seasonal evolution between the first and second quarter in terms of the increase in shrinkage overall, but if we're looking at the gross margin for the full-year do you expect to be closer to 24%, over 24%. Do you have a feeling for where the gross margin is going to go?

Sergey Piven

On that I can't give you any guidance, I am sorry.

Victoria Petrova – Credit Suisse

Thank you very much for presentation. My first question is on personnel changes. Could you please let us know if there were any changes in Logistics department? Is Mr. Sotnikov still running it? And my second question is when I look at your slide number two, if I'm not mistaken, when you talk about growth in the second quarter, actually -- about net sales breakdown, actually Supermarkets are showing quite an impressive result. For example, the highest growth in North West region and at the same time you are changing management there. Could you please comment on that because as far as I remember Mr. Tarakanov has not been running Supermarket format even for 12 months? This is my first question.

Sergey Piven

The comment on logistics, Mr. Sotnikov is still with the company he is appointed to run special projects. As we mentioned before the logistics, soft discounters now has their own logistics in the Central region with five DCs, we appointed a person to head this part of our operation and the rest of logistics operations are run by Mr Shulga who is an operating director. At the same time as I mentioned the company is working on the logistics and supply chain strategy for the next three years as part of strategic plan and I think a lot will depend on which way the company takes in developing its logistics so we will keep you updated if there any personnel changes.



On the appointment of Mr Janusz Lella, what I want to say is of course that appointment or leaving the position is not a reward or is not a punishment it is a matter of mutual understanding and what the company sees best, whom the company sees best to lead a big operation which is supermarkets, and what we think is that Valeriy's input and entrepreneurial approach as I mentioned in my speech has been very, very good in setting the strategic framework and direction for supermarkets that it should focus on servicing the customers and offering the best fresh categories among all the competition. Janusz is a guy who has 27 years of operational experience in retail with some of the best companies on the market and I think his skills will be essential in executing and fulfilling the plans which the company has and which board of directors has for us. I think that explains pretty much this appointment and one last comment is that again as I said in my speech the change was planned anyway in early 2013 and so this is also as always in life a matter of a good candidate appearing on the horizon and at this level you sometimes have to adapt the timing of the decision to fit best the company and the candidates. I think that this is the best solution for Valeriy, for Janusz for the company and from my point of view of course it is very important that the new format leader will be participating and leading the strategic plan development and also the budget development for the best year so he will be able to take full responsibility for executing this plan.

Victoria Petrova – Credit Suisse

Sergey, thank you very much. I have one clarification question, just in general. Apart from Logistics where I understand you're still working on the strategy, should we consider management team and by that I mean, of course, your four CO divisional heads and format heads as a complete team? And secondly, you have talked a lot about different initiatives, for example, logistics improvement, format improvement. Can you quantify any of your targets in basis points if you can? And that's it from me, thank you.

Sergey Piven

Answering the last question is easy; I would not do it today. The first one is also easy I think the team is complete, we are working, we start to work as a team, we welcome Janusz as our new team member. I have known him for a couple of months he has been around, he has been helping Valeriy to sharpen the plans and the strategy and I think his contribution has been very positive, we have Olga now as a full member of a team who has been with us for a couple of months already and we established a very good relationship with her. The rest of the team has been there for several months and I think we can speak about ourselves that we are a team who is in the same boat.

Patrick Shields – Wood and Co

Yes, me again. Just, obviously you said that the process of developing the three-year logistic strategy, but you've also highlighted the fact that the process of separation for the logistics, the standalone logistics



infrastructure for Pyaterochka is underway, certainly in Central region. And you've talked about the fact that you've commissioned a DC specifically for fresh categories. Can you just give a feel for what the centralization rate is for Pyaterochka now and what you hope to get out of -- what you hope to achieve in terms of covering the assortment needs of the store network?

Sergey Piven

The overall centralisation right now is at the level above 70%, with Soft Discounters being higher than that and the big formats being to the lower end of this. About logistics first of all and this is a follow up from the previous call we allocated under the management the DCs which were already servicing exclusively soft discounters, so there is no basically major restructuring or anything it is just the management reallocation of responsibilities. The one off changes in logistics or routes or supply chain. The ultra-fresh fruits and vegetables DC which I mentioned is excluded from that move because it is new we just launched it, it is run by our partner, and the decision to reallocate it is part of the strategy which we are developing.

Patrick Shields – Wood and Co

Okay. Understood. Do you -- can you comment on something that you started last year was to increase direct imports? Do you have a -- can you elaborate on where you are in terms of -- in terms of the penetration of direct imports in the overall assortment?

Sergey Piven

We have two major focuses of direct import, one is fruits and vegetables and the other is non-food. As far as penetration is concerned I don't think we need to comment on that but we have seen significant progress since last year in both these directions which brings us confidence that we need to continue with this programme. We will be happy to comment more on that on our analyst day.

Patrick Shields – Wood and Co

Okay, and maybe one thing that has proven pretty important in contributing to your margins has been the fact that you've been able - as a percentage of sales, been able to keep the labour costs low relative to your peers and it would seem on a year on year basis. What's contributing to that?

**Sergey Piven**

We started from zero last year, we made significant progress in two categories but let's look at the numbers. Even if you have significant share of that as direct import it still has marginal effect on gross margin. All in all we are happy with the progress but this is not a turnaround move which will save us or break us, this is a good practice which we need to continue and develop that is it.

Kalim Aziz

Yes, thank you very much for the call. It was useful. I just wanted to get some perception of how, in this long process of restructuring, reorganizing and putting the business back on track relative to some of your competitors, how do you feel now? Where do you feel you are? What is your sense of the task that lies ahead of you? And how confident do you feel that you can see clearly where you want to go and your chances of achieving, reaching the goal?

Sergey Piven

The task is huge as I said, but we are quite confident, we have strong people, as I think and we will do our best and we will achieve the results. In more detail I will be able to share I think at the analyst day.

Ullah Adamson - T Rowe Price

Hi. Thank you. Just a follow-up question regarding the gross margin expansion in the second quarter. Would you say that any of the expansion came at the expense of working capital deterioration? It seems that historically you maybe pay your suppliers a bit faster? And maybe you can comment a bit more on the overall operating cash flow deterioration year on year in the second quarter? Thank you.

Sergey Piven

The margin didn't come from trading and working capital for margin; there were no special actions on that and no actions in that direction as far as I am aware. The margin came from better commercial terms.

Gregory Madick

Thank you very much for joining us on the call and we look forward to speaking with you again at the analyst and investor day on 11th October.
