

**X5 Retail Group N.V.
Q2 and H1 2018 financial results
Conference call held on 14 August 2018
Edited transcript**

Speakers:

- Andrey Vasin, Head of Investor Relations
- Igor Shekhterman, CEO
- Svetlana Demyashkevich, CFO

Participants asking questions:

- Brady Martin, Citi
- Natasha Zagvozdina, Verno Capital
- Maryia Berasneva, Morgan Stanley
- Marat Ibragimov, BCS
- Yulia Gerasimova, Goldman Sachs
- Victoria Petrova, Credit Suisse

Operator:

Ladies and gentlemen, thank you for standing by, and welcome to X5 Q2 and H1 2018 financial results.

At this time all participant lines are in a listen-only mode. There will be a presentation followed by a question-and-answer session. At which time if you would like to ask a question you will need to press star one on your telephone keypad and wait for your line to be opened.

I must advise you that the conference is being recorded today, Tuesday, the 14th of August 2018.

And I'd now like to hand the conference over to your first speaker today, Head of Investor Relations, Andrey Vasin. Please go ahead, sir.

Andrey Vasin:

Good morning, and good afternoon, ladies and gentlemen, and thank you for joining this call where we will discuss X5 financial results for the second quarter and first half of 2018.

Speaking on the call today are Igor Shekhterman, X5 CEO; Svetlana Demyashkevich, our CFO; and myself, Andrey Vasin, the company's Head of Investor Relations and Macro Analysis.

I'd like to remind you that we disclosed the press release this morning via our website, the RNS, and our own e-mail distribution list. Both the release and the presentation for this call are currently available on our website in Investor Relations section.

Before we start, I would like to draw your attention to the fact 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 the beginning of the presentation for a full disclaimer with regards to such statements.

I will now pass the floor to Igor, who will take you through company's key results and achievements.

Igor Shekhterman:

Good morning. Thanks, Andrey. Good morning, and good afternoon, ladies and gentlemen, and thank you for joining our call today. So the key topics I would like to cover today are highlights of the company's key achievements in the first half of this year, the key initiatives we are focusing on at the moment and also say a few words about our future plans.

After that, I will pass the floor to our CFO, Svetlana Demyashkevich, who will discuss the external environment and provide more detail about our financial results. After that, we will be ready to answer your questions.

So let's start with the key achievements. X5 continued to grow revenue at a strong pace of 19.6% year-on-year in the first half of this year. We achieved this despite food inflation deceleration to record low level. We also remained the fastest-growing public food retailer in Russia for the third year in a row.

Like-for-like sales and traffic in the first half of this year reached 0.8% and 0.1%, respectively. I would also like to point out that both indicators grew in the second quarter after a decline in the beginning of the year. We made significant efforts during the second quarter to achieve positive like-for-like performance. The adjusted EBITDA margin in the first half of this year was 7.0%. There was a strong recovery in profitability in the second quarter after an expected decline at the beginning of the year.

We continue to prepare the company for the future in terms of innovation, big data and omnichannel sales. We have already identified the key areas for our development strategy. Now we are working on detailed road map for the development and implementation of projects in these areas.

The company continues to develop its loyalty card programmes. In total X5's three retail formats had around 30 million active loyalty card user at the end of June. Penetration in traffic in June reached 41% at Pyaterochka, 44% at Perekrestok and 74% at Karusel.

We are working actively to develop the commercial function, including the development of direct imports strategic partnerships with suppliers and private label. We continue to develop our online business through Perekrestok Online where the number of orders in the first half of this year reached 116,000.

Now I would like to talk about a few key areas where our business is developing. First, I would like to give you an overview of the changes in our management team.

As you know, the first half of this year saw some important changes in the company's management team with the appointment of new General Director for the Pyaterochka and Perekrestok retail chains.

X5 has always been known for having a strong succession pool. As we stated before, our goal is to promote candidates from our internal pool to key vacant positions while also continuing to attract high quality professionals from the market.

In June, Sergei Goncharov was appointed as the General Director of Pyaterochka while Vladislav Kurbatov was promoted to General Director of Perekrestok. Sergei has excellent track record in strategy, brand management, operational management and retail business development.

He has significant experience in building client-oriented businesses with a focus on efficiency, which he demonstrated in his previous position, where he was responsible for the drogerie format as well as the development and launch of a new concept for the pharmacy format.

I'm confident that with his strong professional skills and high personal motivation, Sergei will introduce new approaches to strike the right balance between Pyaterochka's growth and a focus on efficiency, quality and returns.

Vladislav joined Perekrestok as Operational Director in 2015 at the very beginning of the supermarket format transformation. He has already made a huge contribution to Perekrestok's successful expansion and, in particular, to developing the current customer value proposition, making in-store processes more efficient and strengthening the format's focus on customers. He also played important role in the launch of our regional supermarket model and increasing sales densities in Moscow.

Vladislav's 12 years of successful operational management experience at Perekrestok and other food retailers, combined with his excellent understanding of our customer, helped the Perekrestok team to complete the transformation of the business successfully.

Johannes Tholey, the new Commercial Director at X5, is another valuable addition to our team. He also has more than 30 years of experience in retail, having worked for major international companies, including as CEO of Globus in Russia. Johannes will be responsible for developing the company's commercial operations and foreign trade and improving the quality of the product mix across the chains.

Now I would like to touch some of the key achievements across X5 formats.

Pyaterochka continues to record revenue growth rate of above 20%, which is ahead of its peers. In the second quarter, like-for-like sales and traffic returned to positive territory, thanks to more favorable weather condition and management initiatives. I would like to comment on the latter in more detail.

While for 2 months I was acting as the General Director for Pyaterochka, I found a number of issues that Sergei Goncharov and his team will need to address. We will focus on operational excellence, including reducing shrinkage, redesigning in-store business processes and decreasing staff turnover rates, adapting the product offering and promos to the local needs of customer and

ensuring the healthy and balanced growth of the chain with a focus on up-to-date CVP and, of course, on our customer.

We started doing a lot to decrease shrinkage. The Moscow macro region recently saw the launch of our shrinkage committee. We plan to roll out this initiative to other macro regions. Key efforts to reduce shrinkage included adjusting the offering to suit the store format, cutting inventory, effective promo planning and control, identifying temperature issues during storage of transportation of goods.

Also, we will improve logistics business processes, including the system for remote quality control of fruit and vegetables. These initiatives are expected to generate a positive effect next year, but we also expect to see certain improvement by the end of the current year.

We have begun transforming the format's management model to make it more sustainable. The number of executives reporting directly to the Pyaterochka General Director has been reduced from 21 to 15.

Pyaterochka's rapid growth required the creation of another macro region level, which will take on the full scope of operational management, letting the headquarters to focus on strategic priorities, setting goals and monitoring progress.

As part of the transformation, 6 macro regions have been established and headed by directors reporting to Pyaterochka's CEO who are all internal candidates with excellent track record. This will also accelerate decision making and streamline local promotions and assortment management to better adapt stores to regional markets, especially in the fresh and fruit and vegetables categories.

Low engagement and loyalty among store personnel results in higher turnover rates, which also negatively affects shrinkage and store operations. We have developed a plan to streamline the management and recruitment and also introduce a new incentive system.

The healthy food trend is gaining traction in Moscow and St. Petersburg with more and more customers attracted by the unique product offering. In review of this, specialty stores are becoming increasingly popular. In Moscow, a pilot project was launched to adjust the product range, reflecting the clustering of stores based on their location, consumer behavior and income.

This year, in partnership with Dunnhumby, X5 completed a project where customer missions and customers were segmented. This and next year, we plan to adopt our CVP for the group of stores identified with Dunnhumby, which will allow us to make the CVP more relevant for our customers.

We are making considerable efforts to develop a regional Pyaterochka model focusing on low turnover stores, including adjusting the product mix to customer needs in the regions and improving business processes. We are going to cut capital expenditure on opening regional stores.

We will also review our private label management principles, including product quality, especially of core label Krasnaya Tsena in Pyaterochka. We have introduced new products in line with the local needs of customers and revised the pricing strategy.

Perekrestok continues to perform at an outstanding level ahead not only of its direct peers but also of X5's other formats. In the first half of this year, net retail sales grew by 22.8% year-on-year, the highest among X5's formats. Like-for-like traffic also showed the strongest growth at 4.9% year-on-year.

We continue to refurbish our supermarkets. The first half of this year saw the completion of the refurbishment at 13 Perekrestok stores. As of the end of June, over 77% of Perekrestoks operated under the new concept.

To address our customers' needs, the format has a special focus on the fresh category. Perekrestok shows the highest NPS in fresh meat, fruit and vegetables and also ranks high in dairy products.

Following the development of specialty stores in Moscow, Perekrestok launched its own brand of product with the ultra-short shelf life called Green Line. In Moscow, we run the project jointly with suppliers of VkusVill, while in St. Petersburg, Perekrestok uses in-house capabilities. Some of our Moscow supermarkets already feature special zones with these products. We plan to expand the Green Line series to 200 product items going forward.

We recently rebranded Karusel grocery chain, including an update of the logo and brand concept. Changing the logo and brand concept of Karusel is a continuation of the work on updating the format's positioning.

Following the pilot store in St. Petersburg, this April we opened the second Karusel hypermarket under the new concept in Moscow region, town of Sergiev Posad. The pilot store concept was improved including an enhanced store layout, more convenient equipment and navigation as well as a new visual and corporate style.

We have started actively refurbishing the hypermarkets in accordance with the new concept. One Karusel hypermarket was opened following refurbishment in the first half of this year, and 6 further stores were closed for refurbishment and will reopen in the third or fourth quarter of the current year.

I would also like to share our brand for increasing the quality of our products. In line with the latest market trends, the quality and variety of fruit and vegetables mix is now taking center stage. We must bring the best products from this category to our consumers at an optimal price.

We started actively developing direct import, which will improve our procurement terms, raise the quality of our format offering and mitigate the risk of supplier shortage. Currently, direct import accounts for roughly 3% of all supplies, and our target for the next 3 years is to reach 10%.

Next, I would like to comment on IT, innovations and big data.

We continue to improve our IT infrastructure in line with 2020 road map approved in the summer of last year. We focus primarily on improving the stability of our IT infrastructure to support strong organic growth and making our IT processes more efficient.

In June, we started the pilot run of Pyaterochka-based lab store with the goal of fast-tracking implementation of new technologies across X5 stores. The first working groups responsible for specific focus areas have already been launched.

The development of our IT system goes hand in hand with innovation as we see the underlying innovative technologies as the main driver behind the company's future success. As Russia's #1 food retailer, we aim to lead the ongoing transformation of the industry by using big data and developing automation, omnichannel technologies and other new ideas, which will enable us to better meet customer needs and grow our business. In terms of our omnichannel goals, we continue to actively develop online sales of the Perekrestok web store. This segment is growing strongly with the number of purchases from both existing and new customers continuing to increase. The number of orders per day reached 850 in July, increasing from 700 in the second quarter of this year. This year, we expanded our footprint beyond Moscow to cover some parts of the Moscow region. The second dark store in Moscow is set to open in the near future, while the Saint Petersburg debut is scheduled for the end of this year.

Since the launch of the online platform, the average net retail revenue both online and offline customer in Moscow has increased by 1.7x, while the average NPS in the second quarter of this year reached 82%, significantly above our full year target of 73%.

As you may know, a special big data department have been established at our company. With the big data strategy drafted and several pilot projects launched, we are now working to build the right management team, and we already have the infrastructure we need to launch projects.

To conclude, I would like to highlight our priorities and forecasts for the second half of this year. These are:

- Continuing to execute on our business plan focused on optimizing operating cost on the back of continued consumer rationality and intensifying competition;
- Adapting the assortment and service at shops in accordance with market trends and consumer needs, especially in Moscow. Improving the quality of the fresh category, especially fruits and vegetables, and adding new position in the product range;
- Increasing NPS level across all formats;
- Developing supporting infrastructure to support rapid growth of the businesses, including future development of logistics and IT;
- Developing detailed road maps for innovation products across X5 retail group and expanding the big data division to further improve the efficiency of the business in all areas;

- Continued implementation of the format goals:
 - Pyaterochka – focus on improving the operational efficiency of the business, including by reducing shrinkage, improving the quality of business processes and level of services; reducing staff turnover; and enhancing supply in the category of fresh and fruit and vegetables.
 - Perekrestok – developing the regional model and online business and adding unique assortment.
 - Karusel – rolling out the refurbishment program across the whole chain and increasing sales density.
- As for our forecast, we can confirm the openings guidance for this year announced earlier this year and continue to expect around 2,500 gross openings across all formats.

Now I would like to pass the floor to our CFO, Svetlana Demyashkevich, who will comment in more detail on the company's financial results for the second quarter of this year. Thank you for your attention.

Svetlana Demyashkevich:

Thank you, Igor, good morning, good afternoon, Ladies and Gentlemen, thank you for joining the call. Let me start with the external environment. Then I will give an overview of some of the key trends in our financials and also provide you with some insights on our quarter-to-date results.

So to begin with, I will say a few words about the external environment.

Food inflation continued to decelerate to new low in the second quarter of 2018. From 1% in the first quarter, it dropped to 0.4% in the second quarter of this year. The growth rate of food products turnover accelerated towards the end of the second quarter of 2018, but it's too early to speak of a trend towards accelerating demand growth.

The rate of growth in demand for food products still looks weak relative to higher wage growth rates. A stable recovery in demand is limited by unstable real disposable income dynamics.

After a short period of growth in February through April, in June the growth rate slowed to 0.2% year-on-year. Consumer behavior during the period remained rational and sensitive to promo. The consumer confidence index remains negative at the same level as in the first quarter of 2018, around minus 8%.

We realize that we're operating in a highly competitive market with several strong players in every segment. Major retailers continue to add space, increasing competition. In addition, we are seeing growing pressure from specialists in Moscow. In this regard, we must continue to focus on operational efficiency and cost control. This remains our key priority for 2018.

Moving on to X5 financial performance. During the quarter, our revenue increased by 19.3% year-on-year to RUB 383 billion in the second quarter of 2018 despite decelerating inflation.

Looking at margins, in the second quarter, the gross profit margin increased by 11 basis points to 24% of revenue in the second quarter of 2018 due to stable share of promo and positive impact on the commercial margin from proportionally more sales coming from Perekrestok, the share of which reached 14.5% of net retail sales in second quarter of 2018.

The negative effect from SG&A year-on-year was due to increased staff costs, lease expenses and utilities costs. All the factors affecting the SG&A expenses are described in our today's press release, so I would prefer not to go into details right now.

The adjusted EBITDA margin totaled 7.7% in the second quarter of 2018, and we are in line with our business plan for the first half of the year. In second quarter of 2018, we continued to accrue LTI expenses covering the previous and new LTI programs. The LTI expenses accrued for previous program totaled RUB 450 million, and for the new program, RUB 148 million.

Depreciation and impairment costs increased as a percentage of revenue by 25 basis points to 3.3% versus 3.1% for the same period last year. This was due to continued growth in the share of assets with shorter useful life, driven by growing share of leased space in X5's total real estate portfolio.

In the second quarter of 2018, net finance costs increased by 8.2% year-on-year. The effect from increased level of gross debt was partially offset by the decreased weighted average effective interest rate on X5's total debt as a result of declining interest rates in Russian capital markets and actions undertaken by X5 to minimize interest expenses.

X5's effective tax rate for the quarter totaled 25.1%, driven by the deferred tax on investments accrual in the second quarter of 2018 associated with potential dividend payments for 2018.

The company's net profits in the reporting period totaled RUB 8.7 billion, which represents 2.3% of revenue.

Turning to our balance sheet, at the end of second quarter, our net debt-to-EBITDA ratio increased to 2.18x but, according with the company's business plan, should gradually decrease during the second half of 2018.

Turning to the cash flow, the change in working capital in the second quarter of 2018 was negative RUB 8,126 million compared to minus RUB 11,873 mln reported in the second quarter of 2017. This was due to seasonal decrease in accounts payable and the reduction in accounts receivable due to VAT deductions driven by transition to more effective interaction with counterparties. However, larger increase in inventories in the second quarter of 2018 compared to the second quarter of 2017 was driven by growing share of regional stores with lower turnover.

Net cash used in investment activities, which generally consist of payments for property, plant and equipment, increased to RUB 23.8 billion in the second quarter of 2018 compared to RUB 19.1 billion for the second quarter last year. This change was primarily related to acquisitions as

we completed partial payment for O'KEY's supermarket business and the acquisition of Polushka stores in Bashkortostan.

I would like to say a few words about capex. X5's total capital expenditure amounted to RUB 20.4 billion compared to RUB 19.9 billion in the second quarter of 2017. Approximately 60% of capex in the second quarter of 2018 went to expansion of our store base, around 9% to refurbishments, the rest to logistics, IT and other.

Finally, I will give a short update on the quarter-to-date results before we go to a Q&A session. X5's net retail sales quarter-to-date increased by around 18.7% while like-for-like sales rose by 1.1%.

With that, I would like to conclude the discussion of our results. Thank you for attention, and we're ready to take your questions.

Andrey Vasin:

Ladies and gentlemen, this concludes our presentation. We are now ready to take your questions. This session will last approximately 30 minutes, and we would kindly ask that all participants limit themselves with 2 questions each.

Operator, can we have the first question, please?

Operator:

Thank you. Participants, as a reminder, if you do wish to ask a question please press star and one on your telephone keypad. That's star and one to ask a question. And if you wish to cancel that request, please press the hash key.

And your first question is from Brady Martin from Citibank.

Brady Martin:

I just have a question on the tax rate. So the tax rate ticked up again in Q2, about 25% now. I understand that was due to some kind of provisions for dividend payment or something. Just wondering, if you envision paying dividends on an annual basis, should we expect a sustainable tax rate at this level of 25%? Or is there something that you can do to bring it down closer to the statutory rate of 20%?

Svetlana Demyashkevich:

Thank you for your questions. Actually, yes, it's a structural change. You know that this year, for the first time, we paid dividend. And that's IFRS, we need to accrue deferred tax on this payment of dividend and future payments of dividends because we do expect that we will continue to pay dividends as we now have the dividend policy.

So so if you look at the effective tax rate without this impact of deferred tax accrual, then the rate is at the level of our normalized effective tax rate. So no major changes within our operational business and operational management of tax, but just structural change related to

dividends. Yes, I would expect that the level of effective tax rate in future when we will continue to pay dividends will remain at pretty much the same level.

Brady Martin:

So, you think the sustainable level for the company on an annual basis is something like 25%? I think before you were paying dividends, the outlook was something like 22%. Do I understand that correctly? Now we should be expecting something like 25%?

Svetlana Demyashkevich:

As you know, we do not give guidance in terms of our profit numbers including effective tax rate. I think I explained the structural change. And of course, we are managing our tax and doing our best to decrease our effective tax rate. But at the same time, we're a big company, of course, and we do pay tax as normal practice.

Brady Martin:

OK, maybe I can rephrase the question. I know you don't want to give guidance, but the statutory rate in Russia for your company is 20%. The first 2 quarters, you're recognizing 25%. So is this a more reasonable expectation in the medium term for you to pay? Or is there something you can do to reduce it closer to the statutory rate? Do you have any kind of tax optimization strategies to reduce the tax rate? I think many investors would be disappointed to get a 2% or 3% dividend and suddenly realize that your effective tax rate has gone up 300-500 basis points, which seems kind of counterproductive. That's my question. I don't need you to give me the exact rate. Is there something you could do to reduce that?

Svetlana Demyashkevich:

So continuing to answer the question on tax rate. Our more or less stable level of effective tax rate is around 22-23%, and the rest is coming from the newly accrued deferred tax on dividend. So this difference will remain.

Of course, we're using all our possibilities to decrease the tax rate. But of course, we're not using any tax optimization schemes because we don't think it's appropriate. So yes, we would expect that structurally, if we plan to pay dividends, we'll need to pay this additional tax.

Operator:

And your next question is from Natasha Zagvozdina.

Natasha Zagvozdina:

I'd like to hear the clarification on the store openings. Did Igor say 2,500 new stores across all formats?

Igor Shekhterman:

Yes, you're absolutely right. It's 2,500 across all our formats. Thank you for the question.

Natasha Zagvozdina:

And that is net of closings or it is gross openings?

Svetlana Demyashkevich:

Gross.

Igor Shekhterman:

It's gross openings, 2,500.

Natasha Zagvozdina:

I'm not sure that I got it right before then. Did we at some point have 2,700 stores as your openings target?

Svetlana Demyashkevich:

No.

Igor Shekhterman:

No.

Svetlana Demyashkevich:

The guidance from the very beginning from our call in March was 2,500. So we're not changing it.

Igor Shekhterman:

Yes, it was the same number we indicated in our previous calls.

Natasha Zagvozdina:

And then your capex guidance of RUB 80 billion to RUB 85 billion plus, and on top of that also the M&A also remains unchanged?

Svetlana Demyashkevich:

Actually, our guidance regarding capex was almost the same level we had in 2017 also depending on M&A activities, which brings us closer to RUB 90 billion. So also, we're not changing the guidance. So nothing really changed in that respect.

Natasha Zagvozdina:

So RUB 90 billion would be inclusive of the M&A that you partially accounted for in the first half?

Svetlana Demyashkevich:

Well, again, depending on M&A activities, it's plus/minus RUB 5 billion, I would say.

Operator:

Your next question is from the Maryia Berasneva from Morgan Stanley.

Maryia Berasneva:

My first question is with regard to the EBITDA margin. Previously you said that you target 7%-or-higher EBITDA margin for the full year. Do you feel comfortable with that target? And do you see any structural reasons for the margin to be substantially different in the second half to what we have seen in the second quarter?

Svetlana Demyashkevich:

Thank you for your question. And actually, you might remember that during the previous calls we had in the first half of the year, we indicated that we do expect in different scenarios, even with different levels of inflations, EBITDA margin coming to the level of the 7%-plus. And now we see the results of the first half. We are in line with our budget, in line with the plan. And we do expect that the second half will be also in line with our plan. We'll see how the competition and inflation evolves, but we're still quite comfortable on achieving those targets for this year.

Maryia Berasneva:

OK. And my second question was on Pyaterochka store openings. Firstly, I see that you have closed 212 Pyaterochkas in the first half. If my calculations are right, it equates to around 16% of the gross openings.

Should we expect this rate of closures to continue in the second half? And what is driving the higher rate of closures so far this year? And in that context, when we look through 2019, do you have any thoughts on what number of stores would you like to add next year?

Igor Shekhterman:

With that, let me start and Svetlana will proceed. So we don't have any guidance at the moment regarding the openings for the next year. I think we will have it at the end of the current year. Regarding the goal in the number of stores, there were not very effective openings in the last years, and it's the reason why we closed the stores to the number you indicated.

Svetlana Demyashkevich:

Actually, in the beginning of the year, understanding tougher external environment, macro environment and competition, we took several steps to increase our efficiency. And within that, we also analyzed all store openings of last year and made the decision of more impressive closings of nonperforming stores. So that resulted in higher rate of closings in the first and second quarters. But of course, it is positive for our results in the second half of the year. We do not expect such high rates of closings in the second half of the year because we did this exercise mostly in the first half.

Operator:

And your next question is from Marat Ibragimov from BCS.

Marat Ibragimov:

My first question on traffic turnaround in Pyaterochka stores. In the first quarter, it was deeply negative – minus 2.2%. In second quarter, it was plus 1.3%. What drove that traffic turnaround? Can you please explain?

Svetlana Demyashkevich:

I would say it was a mixture of external and internal factors. When we are talking about external factors, the trends of temperature regimes in the second quarter – comparing to the second quarter of 2017 and first quarter – comparing to first quarter of 2017, the trends were very different.

So if we are talking about the first quarter, it was abnormally cold. So that affected traffic negatively. At the same time, the average check was higher compared to 2017. And then the situation changed in the second quarter of the year, where the temperature was generally higher, and that drove higher traffic in the stores but less average check, so there were more small purchases.

Secondly, and we're constantly doing that, but there was a special exercise also in the beginning of this year to start adjustment of assortment in Pyaterochka, providing more appropriate assortment for the local needs of the local customers, including Moscow. A lot of attention now is paid to Moscow as one of our core regions – probably the core region and the more revenue-bringing region.

We did see negative trends in the fourth quarter and first quarter of the year in Moscow, so we are trying to reverse them and a lot of work was done in the second quarter to do that. So we do already start to see some results.

And also, as you heard, Igor was talking about the processes we're doing now and the efforts which are taken by Perekrestok's management and Pyaterochka's team also to improve situation with business processes, attract more customers in the store, adjust assortment to local needs, etc.

Igor Shekhterman:

And also, I would like to add that the launch of our macro region model gives us more opportunity to adopt the local assortment.

Marat Ibragimov:

Do you think – maybe it will make a lot of sense for you to do – expand the exercise on Karusel stores because Karusel's traffic drastically continues to be negative. Maybe it could help others to deliver the similar turnaround?

Igor Shekhterman:

I think one of the reasons of negative traffic of Karusel is general situation with hypers. And the second, we – as I mentioned in my speech, we closed 6 hypers at the moment for their

reconstruction. It is one of the reasons of negative traffic for Karusel. And it's also our main target in the Karusel to improve or increase the average basket.

Marat Ibragimov:

OK. And my last question on LTI. Of course, it dropped quite significantly in second quarter year-on-year. Can you please give some guidance on a full year figure? I understand this cost now includes only LTI under second phase, but I would expect that either in the third or in the fourth quarter of this year, you'll start to include costs under the third phase of LTI.

Svetlana Demyashkevich:

Well, actually, this present accrual includes accruals on old LTI program and new LTI program. The biggest accrual is still on old LTI program. But still, it's decreasing in accordance with the schedule we were also talking about during our previous call.

At the same time, it is very beginning of the new LTI program as the probability of us achieving all the goals is still quite low. That's why the amount accrued for the new LTI program is not that high.

Marat Ibragimov:

You have not elaborated on the LTI program yet, am I right?

Svetlana Demyashkevich:

We started to accrue the new LTI program partially depending on the probability of achieving the targets in 2020.

Marat Ibragimov:

And can you please remind us or tell us what are the KPIs for LTI 3?

Svetlana Demyashkevich:

This new program includes 2 major KPIs, leadership in revenue among Russian public food retailers, it's the first KPI, the same we have for the old program. And the second KPI is leadership in EBITDA multiple, also leadership among the Russian public food retailers.

Operator:

And your next question is from Yulia Gerasimova, Goldman Sachs.

Yulia Gerasimova:

First question for me will be about the Magnit refurbished format. I'm sure you were aware that the company has launched the new concept of the refurbishments. And though there's little number of stores have been opened, I was wondering whether some of these stores have been opened next to your existing X5 stores. Have you seen this new format? And what was the impact on the stores? That's the first question.

Svetlana Demyashkevich:

We know that this pilot was just launched, and we heard some comments from Magnit's management. But it's too early to see any effect or inputs. We'll, of course, pay attention, and we'll measure the effects of their stores on our stores and I think it will be more appropriate to comment on that after probably the second half of the year. So far, it just started to open. It's just too early to judge.

Yulia Gerasimova:

OK. And then my second question will be on this LTI program, which we commented previously. I mean, we all just heard about this multiple leadership that is embedded as a target for your LTI, but there are a lot of factors which are actually affecting the multiples. Why didn't Supervisory Board simply just focus on the total shareholder return or that kind of metric? Because ultimately, I think if the returns are improving, that's probably will actually drive your market capitalization up as well, while multiple could be a function of different factors, including what's happening today, for example, with the macro, geopolitics and sanctions and so forth. So why did you choose this particular factor to target?

Igor Shekhterman:

Let me start and Svetlana will proceed to answer from there. First of all our goal is to be leader in revenue and multiple, we need to be #1 Russian public company. In these circumstances all of our competitors are in the same situation regardless of macroeconomics.

Svetlana Demyashkevich:

Yes, it's important to remember that both measures are comparative measures. So we need to best among our competitors. And that's quite fair, I would say, from the Supervisory Board to expect from management.

Igor Shekhterman:

And also we have a proportion of 50/50 for the more balanced growth.

Yulia Gerasimova:

OK. And what if this multiple leadership will be achieved not because of your improvement but because your competitors will simply have a multiple derating like we are seeing with Lenta, for example recently? So would be still then management eligible for the payment?

Svetlana Demyashkevich:

Well, that's life, and it's not maybe perfect. Yes, if we'll win, we'll win. We still get a payment.

Andrey Vasin:

I just want to add that actually, there are 2 more triggers in this LTI program. With regards to EBITDA margin, we should not sacrifice. And net debt-to-EBITDA, we should be below 2x, which

is in line with our dividend policy. So yes, you should consider it combined with 2 main targets of the program.

Igor Shekhterman:

Yes, two targets and two triggers that make our LTI program quite balanced.

Yulia Gerasimova:

OK. And I apologize for the small follow-up on Maria Berasneva's question about the store openings. I realize that it's too early to provide 2019 guidance, but just from your comments, Igor, you are saying that you are targeting a more balanced approach to the openings. Should we read that as going forward, we would probably see not higher openings or even less number of openings in absolute terms going forward given that you're targeting more balanced approach? Should we read it like that?

Igor Shekhterman:

I think we will give more guidance during our Capital Markets Day that we invited all of you. It will be in the end of October, and we will be ready to give guidance for the next year. At the moment, we are not ready to give guidance regarding the openings.

Operator:

There being no further questions at this time, speaker, please continue.

And we've had another couple of question come through. And your next question is from Victoria Petrova from Credit Suisse.

Victoria Petrova:

May I ask one follow-up question regarding potential benefits from your operating targets related, obviously, to operating costs and shrinkage, etc.? How many basis points can you still extract from operating efficiency project theoretically maybe short term within 12 months and longer term?

And my second question is related to competitive environment. You obviously were very vocal about specialist competition pressure, especially in Moscow. You're obviously addressing that. You mentioned how. Do you think that given that your key competitor is only launching their potential refurbishment program, that second quarter was probably the most relaxed one for you in terms of competitive environment and it will only get worse through the year? Or you're not seeing anything happening in the third quarter so far?

Svetlana Demyashkevich:

So yes, you're right. And Igor was talking about the initiatives we are doing in all our formats. And we do expect, I would say, the biggest input on our financial results in Pyaterochka. It's hard to say at what period of time. We do expect some of the quick wins already in 2018. But of course, biggest effects will come in 2019 and further. I think that the biggest impact will be in

decreasing shrinkage and also through improving business processes, working with personnel, increasing the involvement and decreasing turnover of personnel. So increasing the quality and NPS and impression of the customers in our stores.

So that's probably answering the first question. For the second one, well, as you know, when we started the refurbishment program back in 2016, and since then, we are competing and reacting to their refurbishment program. I wouldn't say that the second quarter of this year was relaxed.

Actually, if you look at the comparatives with our competitors, the benchmarks, you will see that you cannot call our results relaxed. They look quite impressive, I would say. So we're not relaxing. We're trying to be very fast and to develop and trying to be as efficient as we can and as fast as we can.

So of course, we understand that there will be more competitive pressure coming to us, but it's not news. We live in such an environment for many years, so just continuing to work. That's normal.

Victoria Petrova:

And if I may, just the very last follow-up question. Do you think that your customer demand has bottomed in the second quarter or can it get any worse on your estimates, which are obviously much more precise than ours given that you see your data from the stores every day?

Svetlana Demyashkevich:

Well, if you look at the traffic numbers and NPS numbers, I would say that we see positive dynamic in terms of customer demand in the second quarter, and we hope to continue to see this. We also do expect a high season in the fourth quarter as usual. So it's hard to say. Why do you think the demand bottomed?

Victoria Petrova:

I just hope that there is no room for further deflation acceleration, but I might be wrong.

Svetlana Demyashkevich:

Well, actually, the prognosis of our internal macroeconomists say that we should expect some acceleration of inflation in the second half of the year. We do already see some acceleration in July. Because in July, it was 0.5%-plus, where in June, it was minus 0.2%.

And also, we see some positive shock on inflation starting from end of July. Plus there are some of the factors related to the dynamics of harvest comparing this year and last year. So yes, I think we would expect that demand and inflation might accelerate, but we're being quite conservative about this in our prognosis.

Andrey Vasin:



Ladies and gentlemen, this concludes our conference call today. Thank you very much for joining us on the call, and we look forward to speaking with you again at our Capital Markets Day on October 25, which this year will be in London.

We will circulate the invitations in the near future. Please do not hesitate to contact us if you require any further information. We appreciate your interest in our company, and we look forward to continuing dialogue.

Operator:

Thank you. That does conclude the conference for today. Thank you for participating, and you may now disconnect.