

X5 Retail Group Q3 2013 Financial Results Conference Call Transcript*

**14 November 2013
Moscow, Russian Federation**

Presentation

Operator

Ladies and gentlemen, thank you for standing by and welcome to the X5 Q3 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, at which time if you wish to ask a question, you will need to press *1 on your telephone. I must advise you that the conference is being recorded today, Thursday 14th November 2013. I would now like to hand the conference over to your first speaker today, Mr Gregory Madick. Please go ahead.

Gregory Madick

Hello 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 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 at 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.

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

Sergey Piven

Thank you, Greg. Thank you all for joining us to discuss X5's Q3 2013 financial results.

To begin the call, I would like to comment on the Company's Q3 revenue, which was already discussed at our Capital Markets Day a month ago, so I will be brief.

Our total net retail sales in rouble terms increased by 6.6% YoY, primarily driven by selling space expansion, price inflation and the positive performance of stores over the past two years.

* This conference call transcript was prepared by InterCall.

Looking at the individual format's results, we see that net rouble retail sales at the Pyaterochka format increased by 7.2% YoY, which comprised a 9.8% increase in net sales from new stores, driven by 16.9% increase in net selling space, which was partially offset by 2.6% decline in sales from like-for-like stores.

In terms of the increase in selling space, "Other" regions grew by 28.8% YoY at 30 September 2013, contributing 10.1% to the format's total increase in net selling space, while the Central region increased selling space by 10.9% YoY and accounted for 5.2% of the format's total increase.

Looking at the top-line growth, net sales from "Other" regions increased by 20.1% and contributed 5.0% to the total YoY increase while sales in the Central region increased by 6.0% and contributed 3.2% to the total YoY increase.

The increase in net sales from these regions was offset by 4% decline in sales from the North-West region which negatively impacted the total Q3 YoY increase by 0.9%.

The format's negative 2.6% like-for-like performance was mainly driven by older stores in the North-West and Central regions, which reported negative like-for-like sales results of 7.6% and 1.3% respectively and, to a lesser extent, by a 0.8% decline in like-for-like results in "Other" regions.

Perekrestok recorded a 2% YoY increase in rouble net retail sales, which comprised a 4.8% increase in net sales from new stores, driven by a 5.9% increase in net selling space, which was partially offset by 2.8% decline in like-for-like sales.

In the Central region net selling space increased by 7.5% YoY, which contributed 4.1% to the total increase while the North-West and "Other" regions added approximately 8.9% and 2.5% respectively and contributed around 1% and 0.9% of the total YoY increase in Q3 2013.

In terms of net retail sales, Perekrestok in the Central and North-West regions increased sales by 3.1% and 6.2% and accounted for 2.1% and 0.6% of the total YoY net sales increase respectively, while the "Other" regions net sales decreased by approximately 3.4%, which impacted total YoY net sales by negative 0.7%.

The negative 2.8% like-for-like performance was mainly due to decreases in traffic in the Central, North-West and "Other" regions, driven by operational issues related to increased competition, lack of investment in marketing activities and operational issues related to assortment, service and availability.

Karusel's net sales in rouble terms increased by 5.6% YoY, primarily due to positive like-for-like results of 4.1%.

The increase in like-for-like results was mainly driven by improvements in Central and "Other" regions which demonstrated like-for-like sales of 5.9% and 5.2% respectively.

The improvement in Karusel's 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 fruit and vegetables, as well as improved service. These improvements have been supported by improvements in store routines and effective marketing campaigns that are returning customers to the stores.

Before we move on to margins, I would like to say a couple of words about October results, which demonstrated significant improvement over September, with positive like-for-like, which continued into November.

Moving away from sales, I would like to turn the discussion to our Q3 2013 margins.

We ended the quarter with a gross margin of 25.1%, a 225 basis points improvement over the gross margin in Q3 2012 of 22.8%.

The main reason for the increase was the improvement in our commercial terms with suppliers, which resulted in a significant decrease in cost inflation YoY while food inflation over the same period was slightly higher. While we continue to work on improving our terms with suppliers, we will seek to balance this through increased investments in price and other measures to bring customer traffic. This will impact gross margins starting in Q4 2013, which will partially offset the more favourable sales mix and operating leverage characteristic of Q4.

We have continued our focus on cost control of controllable SG&A expenses but we did see an increase in both controllable and non-controllable expense categories as a percentage of total net sales, resulting in an increase of 22 basis points to 21.5% in Q3 2013 compared to 21.3% in Q3 2012.

The controllable and largest component of SG&A expenses was staff costs, which increased by 31 basis points YoY as a percentage of net sales to 8.3%. The main driver for the increase was bonus accruals that were offset by a decrease in the admin portion of salaries and wages due to a decrease in administrative personnel.

Staff costs have remained relatively stable as a percentage of net sales, primarily due to our ability to control these costs through employee efficiency initiatives, optimisation as well as balancing the use of out-staffing for non-core stores and DC functions and during peak periods.

We do expect to see some pressure on this component of SG&A starting in Q4 as we plan to increase investments in employees to drive sales.

Our largest non-controllable expense in Q3 2013 was lease expense, which increased YoY by 63 basis points as a percentage of net sales of 23.4% in rouble terms. As a percentage of net sales, the decrease in sales densities accounted for approximately 26 basis points while the increase in average lease rates and proportion of leased to own stores contributed 37 basis points. The increase in absolute terms was

due to an 11.1% increase in average lease rates at stores older than one year while new stores lease expense contributed 12.3% to the total increase.

Our D&A costs were lower as a percentage of net sales by 65 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.

The remaining SG&A expenses were, by and large, in line with the 2012 period. However, I would like to add that we do expect some increase in marketing and advertising expense in Q4 to support our efforts to increase traffic.

As a result of the factors discussed above, we reported an EBITDA margin of 7.4% in Q3 2013 compared to 6.1% in Q3 2012. We still maintain our guidance for an EBITDA margin of 7.0% plus, despite the strong Q3 and the fact that Q4 is historically a strong quarter for EBITDA margin expansion, due to our plans to focus on top-line growth.

Turning to X5's finance costs, YoY our net financing costs increased by approximately 6.1% in rouble terms. The increase was due a 20 basis points increase in our borrowing rates, which averaged 8.7% in 9M 2013, which was offset by a decrease in our total debt in rouble terms.

At the end of Q3 2013, our net debt to EBITDA ratio improved to 3.1 times as compared to 3.15 times at 31 December 2012 and 3.4 times at 30 September 2012. We are still well within our covenant limit of net debt to EBITDA of 4 times.

Moving to taxes, our effective tax rate for 9M 2013 was 24.0% compared to 25.3% in the corresponding period of 2012 and in both periods was above the statutory rate of 20.0%, primarily due to the non-deductibility of certain items. The decrease in the effective tax rate YoY is in line with the rate reported in Q1 and 6M 2013 and reflects the sustainability of the Company's ongoing tax planning initiatives.

As a result of the above, our net income margin for Q3 2013 was 1.9% compared to 0.3% in the corresponding period of 2012.

In 9M 2013 we saw significant improvement in net cash generated from operating activities, which increased by 48.0% YoY, due primarily to strong cash flow generation related to operating activities plus 66%, supported by lower taxes and interest payments +24.0%, which were offset by changes in the working capital -42.0%.

Our Q3 2013 net cash generated from operating activities decreased YoY to US\$104 million compared to US\$131 million in Q3 2012, primarily due to changes in working capital.

The main change to working capital in Q3 was in trade accounts payable, which was directly affected by the high inventory balance at the beginning of the period and the ongoing inventory drawdown during Q3 2013. This negatively impacted our trade accounts payable through reduced purchases during the period. We have also improved the processing of invoices, which decreased payment delays due to mistakes in documentation and invoice delivery times as part of our efforts to be a better partner to our supplier and improve the working relationship.

In terms of capital investments, our cash flow used in investing activities decreased in Q3 2013 to US\$159 million from US\$195 million, which reflects the slower pace in selling space expansion as well as a decrease in spending on logistics and special projects.

Our accrued capex in the first 9M 2013 amounted to approximately US\$420 million, of which 66.0% was focused on selling space expansion, 24.0% on store refurbishment and the remaining 10.0% was made up of expenditures on IT, special projects and logistics, compared to 62.0%, 14.0% and 15.0% respectively in 2012.

We maintain our 2013 target for selling space expansion of 11.0% but expect capex to come in around RUR 25 billion.

As we stated at the Capital Markets Day, we launched the refurbishment programme for Pyaterochka on 1 October and plan to refurbish 130 Pyaterochkas by year-end. As of 12 November, we have refurbished 72 stores: 29 in the north-west region, 30 in the Urals and 30 in the Central region.

The cost has been closer to the high side of the average range provided at the Capital Markets Day of US\$360,000 due to the fact that we are starting with the oldest stores with the most obsolete equipment and requiring the most work. The stores refurbished as part of the pilot programme continue to show improvements.

I would like to update you on some of the other initiatives which we spoke about during the last call and investor day.

We have almost completed the roll-out of our SAP ERP auto-ordering system for the Pyaterochka retail chain. Currently, all dry food, groceries and drinks from our DCs are covered by the system and we will include these categories for direct supplies by the end of this year.

We will complete the implementation of fresh category auto-ordering, excluding fruit and vegetables, by the end of Q1 2014. Currently orders for fruit and vegetables will be done at the store level.

Also by the end of November, the top 100 selling SKUs in all categories except fruit and vegetables will be managed by SAP replenishment.

We have also continued the roll-out process for JDA demand and fulfilment and have completed 90.0% of the dry food at our distribution centres and all dry categories will be completed by the end of the year.

We have pushed back the completion for fresh categories to January 2014 instead of year-end 2013 due to modifications we made during the pilot programme and non-food is still on track to be completed by H1 2014. We still plan to roll out the system in Perekrestok and Karusel stores in Q2 2014 and complete the process by Q4 2014 for the same categories.

Regarding the separation strategy for DCs, we are on track to finalise the strategy by the end of November and begin executing the new plan in January 2014 after the end of the high season.

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

Questions and Answers

Operator

Thank you. As a reminder, if you would like to ask a question, please press *1 on your telephone and wait for your name to be announced. If you wish to cancel your request, please press the # key. Your first question comes from David Ferguson. Please ask your question.

David Ferguson – Renaissance Capital

Good afternoon everyone. You talked about giving up some of the gross margin or investing in prices in Q4 of this year. Can you give some colour on the extent to which you think you can get further purchasing gains into next year and the likelihood of you having to reinvest those gains back into pricing? That's the first question.

Then, secondly, can you give a little bit more detail on the improvements in October and November? Is it just relative to September or relative to Q3 and what's driving that improvement? Thank you.

Sergey Piven

I will try to answer first the second question. It is relative to both. It is better than in September and it is better than in Q3.

About the first question, as you know, as we mentioned that during our investor day, sales is among the top priorities for our Company for the next foreseeable future. So we do have a plan of beefing them up and that includes managing promo, managing the right price strategy, investing in our communications and investing in our people as well as investing in solving the operations issues and logistics. So all of that or

most of these elements will have effect on the margin through the cost side or on the gross margin side and we will see these effects in Q4.

Operator

Your next question comes from Patrick Shields. Please ask your question.

Patrick Shields – Wood & Co.

Thanks. Just maybe I will start with a question just to continue on the gross margin. I am not sure if I really understood the answer. There are a whole set of initiatives that may sound like they are going to dampen margins in Q4 relative to where they are in Q3. What is the outlook? What can we expect in terms of the gross margin going forward for next year?

Sergey Piven

For Q4 and for the full year 2013 we maintain the previously communicated guidance of 7% plus EBITDA and for 2014 we will come back to you early next year with the guidance.

Patrick Shields – Wood & Co.

Okay but, in terms of the gross margin, is the Q3 level in your opinion a sustainable level?

Sergey Piven

I can just say that for this year it will be 7 plus and for the next year...

Patrick Shields – Wood & Co.

No, I am not talking about the EBITDA margin. I am talking about the gross margin.

Sergey Piven

You are asking not about the EBITDA; you are asking about the gross margin, right?

Patrick Shields – Wood & Co.

Yes.

Sergey Piven

Okay. As you know, we do not give guidance on gross margin looking forward but you can imagine that the plan, which involves promo and pricing, might affect the gross margin of course. On the other hand, we know that Q4 traditionally has better mix. People buy more confectionery, which have a high margin. So on the balance, I think we will still have to invest in our customers.

Patrick Shields – Wood & Co.

But looking at Q3, given the fact that we saw a big growth margin increase but concomitant with a collapse in traffic, what we shouldn't interpret the Q3 performance is you stopping investing in prices to try and boost profitability relative to traffic. Your objective is to continue to invest in prices to support traffic.

Sergey Piven

You are correct but I would draw attention not just to the prices side of the equation. I would like to stress that we have a plan which involves more than pricing and, in fact, pricing is the maybe more stable element of all that. I have always said that I am against playing with prices too much, up or down, but it does involve also the promo management. We are running much more aggressive promos right now, we are communicating them much better and much more aggressively and that can be seen around Moscow, St Petersburg and other Russian cities. It also involves a plan of operational improvements, it involves the plan for reconstructions and it involves the plan for personnel. So it's all part of – it is not single actions; it is all part of I think consistent planning which has been done and is being done as we speak.

Patrick Shields – Wood & Co.

Okay, good. You have got a \$9.3 billion balance sheet but only a cash balance of \$100 million or a bit over \$100 million at the end of Q3. How do you see your cash position evolving? It looks like, relative to what you told us at the investor day when I think your guidance to capex was 30 billion (somehow I seem to remember that from the presentation) – you are now saying 25 billion for the year. So that is going to save you \$100-and-odd million but when do you believe that the Group can sustainably generate some free cash flow?

Sergey Piven

It is difficult for me to say when, especially because we didn't even comment yet on the next year performance plans but we did improve our – if you look at 9M of this year, we did come closer to becoming free cash positive but we are still, of course, far away from that but we are moving I think in the right direction.

Patrick Shields – Wood & Co.

In the past you have talked about generating cash out of the working capital cycle. That doesn't seem to be happening yet. Are you still confident that you have the levers to improve your working capital management?

Sergey Piven

In fact, we are improving the tools for managing our working capital and you can see that on the receivables side. Paradoxically, part of what you can see on the payables side is also the result of these efforts because we are just, apart from the effect on the payables which our drawdown on inventory produced, this is also at least half of the day or maybe even closer to the full day is really better processing of invoices and avoiding the backlogs which we sometimes used to have in the past, both on receivables side and on payables side. Just payable amount is, of course, higher but in percentage terms we improved our receivables much higher than payables. So we do make an effort of managing the working capital in terms of operations.

If we think about strategic decisions which each company makes in finding the balance between the payment terms and payment delays and margin with its suppliers, then I think we are probably on the more aggressive side compared to some of our large competitors, which some of them have even positive cash side cost with plus three days. We have still minus 15/16 days and this balance can come in – you can draw a line in different places of this balance and each company chooses their own. I think our balance is where we are right now. Probably we will bring one or two days back in payables once we renegotiate with suppliers but, as I said, I don't think that on payable terms we will see a lot of improvements in the future but we do, of course, work a lot on the inventory side and there I would be watching the operations very closely that we deliver some inventory next year and we make it more efficient.

Operator

Thank you. Your next question comes from Maria Kolbina. Please ask your question.

Maria Kolbina – VTB Capital

Good afternoon. I have two questions. The first one is on like-for-likes of the refurbished stores. I remember that you had mentioned during the analyst day that you see double digit like-for-like improvements in refurbished stores. So is it like the target level of like-for-like that you plan to achieve or you are already seeing double digit like-for-like improvements? Maybe you can provide more besides indication to the level of like-for-likes that you are seeing for the refurbished stores. So that is the first question.

The second question is on gross margin in Q3 once again. So it has improved by around 140 bps QoQ so can you provide a breakdown of how much is coming from better purchasing terms and how much is

coming from increased pricing and can you also remind us has there been any change in the purchasing and negotiation terms with your suppliers? Are you collecting bonuses on a quarterly basis? Are you collecting them on a monthly basis or at the end of the year? If I am not mistaken, you had some changes in this respect as you have been merging two formats in terms of the purchasing, so these comments would be very much appreciated. Thank you.

Sergey Piven

Okay, I will try to answer them one by one. First of all, I think the question was on gross margin of Q3, to what extent it comes from better purchasing terms and to what extent it comes from higher pricing. Now we did price in line with the food inflation. We do track this metric. So I did not see in our pricing something which is far above the normal inflation cycle in this country for food. I can't say that we increased prices in Q3 frankly speaking. What did happen were two things basically. One is we, indeed, received better conditions from our suppliers, resulting from the negotiation campaign which we held before and also some efforts which were done specifically in Q3 because our purchasing teams continue to work and they do have negotiations throughout the year as well as at the end of the year in the annual campaign. So what happened was also one of these actions which our commercial guys did, which was more commercially effective promo (we put it this way), so they managed to receive more discounts from our suppliers for the promo, which helped a lot our margins.

In hindsight, we see that we probably need to invest more in our customers in terms of also product, so that resulted in slight changes to our product lines and – can you hear me? I am sorry, there is some noise. But coming back to promo, you probably and some other customers also noticed our more aggressive promo campaign in Q4. So on the balance, that is what I can say about the Q3 margin and the reason why it is higher than probably some of you expected.

Now the other part of the question was about how we collect the bonuses from suppliers. Technically speaking, we did change the planning cycle rather than collection cycle this year versus last year. Last year it was more focused on the end of the quarter and the months between the quarter-ends were given less attention. Traditionally it was like that in X5 and this year we have quite a good control system which allows us to plan and track the collection of bonuses each month but I don't think it has improved the collection of cash per se. It has more improved the planning and the closing of the months versus closing of the quarters this way.

Did I answer all your questions or were there any others?

Maria Kolbina – VTB Capital

Thank you – the first question for like-for-like of refurbished stores. So you have mentioned double digit like-for-like improvements. So can you elaborate is it like the target levels that you plan to achieve or you

are already seeing some double digit like-for-like improvements? Can you comment on that because there was quite a weak definition as to this double digit like-for-like?

Sergey Piven

When I was speaking about reconstructions, refurbishments, I was speaking about Pyaterochka and, in terms of Pyaterochka, I do not remember mentioning any actual like-for-likes of double digits but I do remember Olga during the investor day mentioning as a target level double digit like-for-likes for the refurbished stores. She, of course, meant the annualised data when the store actually becomes mature after reopening. Currently we can't say that we have a consistent picture of double digit like-for-like growth on the stores, which we refurbished simply because some of them came out of refurbishment last week, some of them came the week before last, some of them spent a month or so. This is too short a period to judge and compare to the targets which we set to ourselves, including the targets which were announced during the investor day.

Maria Kolbina – VTB Capital

And when can we expect to get this information, like early next year or like H1, Q1?

Sergey Piven

I hope very much that you will see it in our total like-for-like results for the next year.

Maria Kolbina – VTB Capital

Thank you.

Operator

Thank you. Your next question comes from Maria Berasneva. Please go ahead.

Maria Berasneva – Morgan Stanley

Thank you for taking the questions. I just would like once again to clarify on the working capital side. So should we assume there will be an improvement in the working capital going forward, starting from Q4?

Sergey Piven

Working capital consists of several elements. I commented quite extensively on what we do on accounts receivable and accounts payable and what's left is inventories. Inventories we will, of course, try to

improve by the year-end but what needs to be remembered is that during the high season the focus is, of course, much more on sales and preventing the out of stocks rather than maintaining the inventory level. So what I can just repeat is that our main focus in Q4 is sales and smooth operations.

Maria Berasneva – *Morgan Stanley*

Okay, thank you. In terms of the payback period for the new capex on convenience stores, what is the target there?

Sergey Piven

I don't think we ever disclose this information.

Maria Berasneva – *Morgan Stanley*

Okay, thank you. In terms of when we think about capex for the next year, I know you haven't given margin guidance but, in terms of the levels, are you expecting to see similar spend in 2014 as we did in 2013 or maybe you can give us some colour on the split between growth and refurbishment and maintenance capex?

Sergey Piven

Look, we will give you the more detailed update early next year when we come up with our annual guidance. You can expect, of course, that the capex spend will be higher than this year simply because we announced the refurbishment programme which we didn't have fully this year. I can't give you any more detail at this point in time.

Maria Berasneva – *Morgan Stanley*

Okay but basically you will try and keep the gross capex and then slap the refurbishments capex on top of it – is that roughly the idea?

Sergey Piven

Yes. We are not going to stop or at least we do not have any plans now to stop growing.

Maria Berasneva – *Morgan Stanley*

Okay and maybe one last question, if I may. On the like-for-likes front, so you are seeing improvement in October and November. Maybe you could just highlight once again what is driving this improvement in

your opinion and also do you expect like-for-likes to return to the positive territory next year for the Group and for the convenience format or discount format in particular?

Sergey Piven

If you allow me, I would reserve the answer for the second part of the question till we come up with our plans for next year. Answering the first part of the question about what is driving the improvements in like-for-likes, I just can repeat what I said. It is the realisation of the plan, which involves promo, pricing, communication and personnel.

Maria Berasneva – Morgan Stanley

Okay but the like-for-likes for October and November, are they in the positive territory yet or close to being positive?

Sergey Piven

That is correct. The October like-for-likes are on the positive territory. November, we need to finish November to basically comment on it.

Maria Berasneva – Morgan Stanley

Okay. On the positive territory, that's across the Group or discounted formats as well?

Sergey Piven

It's across the Group.

Maria Berasneva – Morgan Stanley

Okay, thank you.

Operator

Your next question comes from Alexey Krivoshapko. Please go ahead.

Alexey Krivoshapko – Prosperity Capital

Hello. I'm really sorry for getting back to this but can you please remind us how often does it go when you see some campaigns for suppliers last for the next year? I am still trying to understand better this

increased gross margin in Q3. What percentage of suppliers you covered in Q3 and isn't it so that there are more to do in Q4? I was thinking that the campaign lasts for more than a quarter.

Sergey Piven

The major campaign is annual and what you saw in Q3 are the results of this campaign, not the campaign per se.

Alexey Krivoshapko – Prosperity Capital

Okay. Another question: what was the [unclear] on a like-for-like basis for 9M if you have this information and what are your expectations for the next year?

Sergey Piven

I am sorry, I didn't catch the question fully. You were speaking about inflation?

Alexey Krivoshapko – Prosperity Capital

The question was what was your understanding of like-for-like inflation and wages for X5 as a Group for 9 months, by how much the wages have increased in 9 months in rouble terms?

Sergey Piven

I can't give you the precise answer right now. Simply I don't have this figure to hand but if we may come back to you with that?

Alexey Krivoshapko – Prosperity Capital

Okay, thank you.

Operator

Your next question comes from Andrei Nikitin. Please go ahead.

Andrey Nikitin – Alfa Bank

Thanks, my questions have been answered.

Operator

Thank you. Your next question comes from Natasha Zagvozdina. Please go ahead.

Natasha Zagvozdina – Verno Capital

Thank you very much. Actually, I would be also be interested and I will appreciate it if you could send that information regarding the like-for-like inflation in 9M of this year because in the analysis of operating costs, personnel costs went up by a surprisingly low number or maybe now you can provide some explanation to the fact that there was very minor growth in personnel costs. That was the first question.

My second question will be if you could confirm that you are on track of refurbishing 130 discounters planned for refurbishment in Q4 and if these refurbishments as well as 1100 discounters for 2014 will be excluded from the like-for-like calculations because I remember something about that was discussed at the Capital Markets Day and I was left with the impression that you will keep the stores in the like-for-like pool for like-for-like calculations. Thank you.

Sergey Piven

We are on track to refurbish 130 stores this year. About the technique for like-for-like collation, this store are excluded from like-for-like calculations for the period it is closed. So it is included once it is back open.

Natasha Zagvozdina – Verno Capital

And could you tell us on the 130 stores, what was the average amount of days during which they were closed?

Sergey Piven

To the best of my memory right now, it was 12 days, which is higher than average which we expect for the reason which I mentioned during my speech, because we first decided to take the stores which are the most difficult stores, which require the most work.

Natasha Zagvozdina – Verno Capital

I understand. And the question about the personnel expense increase, which to me looks quite low?

Sergey Piven

As I said, we plan to invest in personnel in Q4 to help drive sales and also we do expect some changes in policies. Well, we do see some changes in the Government policies about the out-staffing personnel,

basically the people from other countries, so this might have an effect next year on costs but it is too early to judge right now how this situation will develop.

Natasha Zagvozdina – Verno Capital

Thank you for the outlook but, if we speak about the 9M, you increased selling space about 10%, your personnel costs only went up by a little bit more than 5%. Could you explain why or how you have managed to keep personnel costs in this kind of almost no inflation or no growth territory?

Sergey Piven

What I can draw attention to today is to the bonus accrual, which was higher last year than this year. So you can count that into the positive effect of this year's costs, which you don't see, of course, separately in our accounts.

Natasha Zagvozdina – Verno Capital

But it will be a part of the full year accounts, right? Will we be able to see that part of the personnel costs?

Sergey Piven

I didn't get fully the last question.

Natasha Zagvozdina – Verno Capital

If we adjust the bonus accruals, what was the like-for-like or give us the total personnel cost growth on a YoY basis, if there were no bonus accruals in either 9M 2012 or 9M2013?

Sergey Piven

If we can get back to you on that because this I think is the same question as Alexey asked on the wage inflation.

Natasha Zagvozdina – Verno Capital

Yes, thank you.

Operator

Your next question comes from Anna Kochkina. Please ask your question.

Anna Kochkina – BCS

Good afternoon. I wanted to get back to questions about the gross profit margin. Specifically, I would like to know if you expect any further improvements. Maybe you have short term or long term targets for this particular item.

Sergey Piven

We do have targets for improving the supplier terms and conditions which they give us but we do not have right now the plans to ever grow the gross margin. I think specifically for Q4 we will do our best to invest in the customer.

Anna Kochkina – BCS

But I am speaking more long term. Do you expect to see further improvements in gross margin next year, maybe in the next few years?

Sergey Piven

It depends on the competitive situation, which does not become any simpler so we will have to wait and see but we do intend to keep our price level competitive.

Operator

Your next question comes from Patrick Shields. Please ask your question.

Patrick Shields – Wood & Co.

To come back to the gross margin, could you kindly give us a little bit of colour? Now that you have separated the procurement between the formats, between the banners, are you achieving – I mean the gross margin you achieved was distributed across the formats or is it mostly coming from Pyaterochka? Where has the commercial effort been strongest to rethink or to improve the gross margin position?

Sergey Piven

We do not see significant changes in gross margin between formats due to splitting of the commercial function. That is number one. Number two is we do see the commercial function in its split mode functioning well but I think it is too early the results in numbers yet. They need to finish with the annual negotiation campaign so that we can see how much they bring.

Patrick Shields – Wood & Co.

You spent a bit of time on your presentation, commenting on the SAP ERP implementation and the JDA replenishment and implementation, obviously two very important projects. What are the principal operating efficiencies that you will derive from these? Could you elaborate a little bit more and how do you expect that to be visible? It's improved shrinkage, it's improved inventory – what are the operational benefits that we are likely to be able to see?

Sergey Piven

Availability, which means few out of stocks; smoother ordering, which will have positive effects I think on our service level and logistics; more efficient stock management; potentially some personnel cost changes because the system will replace certain employees who may do some tasks manually. Indirect effects will be that we will be able to put store directors in Pyaterochka into the trading area from the back offices, which I think improves the operational control of the store and the customer interaction.

Operator

Your next question comes from Yulia Gerasimova. Please ask your question.

Yulia Gerasimova – Goldman Sachs

Good afternoon – three questions please. The first one on the assortment for the promo actions that you are doing, so how exactly do you [unclear] the products in which you want to have the promo campaigns? Is it driven by the kind of suppliers who are offering the largest discounts to you or you [only implementing] your category management initiatives that you mentioned on the Capital Markets Day? That's the first question.

Sergey Piven

The main purpose of promo is, of course, to drive sales. So our category management guys do take into account – the most important factor which they take into account is, of course, the sales potential of this or that item. Also the structure of the promo consists of various kinds of items and some of them are considered and are the traffic builders, so there is more attention to sales potential and traffic generation. Some others are more viewed as commercial items which bring not only the sales and they do not only give our customers better price but they can also bring sometimes better margin. I must say that our promo is not driven by suppliers. It is driven by us according to our promo plan and according to our sales targets.

Yulia Gerasimova – Goldman Sachs

Okay, thank you very much. My second question relates to the refurbishment programme at supermarkets. Could you please comment because you have mentioned pretty much these numbers on the discounters side – could you comment on the supermarkets? How many stores were refurbished in 2013 and just once again reiterate whether you are committed to refurbish I think it was 10% of the supermarket base in the next year which you mentioned on the analyst day?

Sergey Piven

By now we have 21 supermarkets refurbished during this year.

Yulia Gerasimova – Goldman Sachs

Is it all or are you planning to refurbish more by the year-end or you will stick with this 21 for this year?

Sergey Piven

There will be some more refurbished and I can comment how many probably during our next call, how many we finished during this year, but we plan to reopen them all before the beginning of December. We do not plan to have any refurbishments during the high season.

Yulia Gerasimova – Goldman Sachs

Okay and the next year is 10% of the total base, right?

Sergey Piven

I think this is on the high side, frankly speaking, just from the impression but, more precisely, we will tell you probably the beginning of next year when our budgets and plans are finalised.

Yulia Gerasimova – Goldman Sachs

Okay, understood. I think the last question on the supermarkets – what percentage in your opinion of all your supermarkets basically requires full refurbishment? So this 10% that you are going for is maximum 10% you are going to do next year. Will it cover all that you need to refurbish in full or like there's much more to come in '15 and '16?

Sergey Piven

Well, I joked once that in the long run we're all dead, so in the long run every store has to be refurbished but the cycle is different depending on the format. So no, I don't think that all our stores need immediate refurbishment. We will go according to our plan. I think it is pretty good – the results of this year or the number of stores refurbished this year is a pretty good reflection of our plans for refurbishing the stores.

Yulia Gerasimova – Goldman Sachs

Thank you very much, that's all from me.

Operator

Your next question comes from Natasha Zagvozdina. Please ask your question.

Natasha Zagvozdina – Verno Capital

I apologise if I missed it in the first part of the call – does your trading in October and first half of November confirms your outlook for 9-10% retail sales growth that you gave us for Q4 of this year?

Sergey Piven

I don't remember the outlook for Q4 which I gave, frankly speaking. I am not sure but the outlook for 2013 is in line with 2012. So if it implies there's growth, then we maintain this growth.

Natasha Zagvozdina – Verno Capital

It's on one of your slides, 9-10% retail sales growth target for Q4 of this year. I was just wondering...

Sergey Piven

It's mathematics.

Operator

Your next question comes from Artur Galimov. Please go ahead.

Artur Galimov – Sberbank

Good evening. I just have a brief follow-up question on working capital movements in your cash flow statement. So basically those were mostly affected by the low payables, which you mentioned practically is

at \$180 million. So apart from those factors which you outlined earlier, which are high stock in the middle of the year, more efficient invoice processing and lower purchases, to what extent can one argue that part of gross margin gains you showed in Q3 were driven in a sense by some upfront payments to your suppliers to get those better commercial terms?

Sergey Piven

I would say to none extent...

Artur Galimov – Sberbank

Okay right, so those are some of the reasons which you mentioned previously. I also have another question on like-for-like, which you said was in positive territory in October. If you look at the breakdown of ticket and traffic, do you see that this improvement is coming from less negative traffic performance or faster growth or probably both?

Sergey Piven

I am sorry, I maybe missed it but you wanted to comment on Q3 like-for-like results, right?

Artur Galimov – Sberbank

No, about October like-for-like performance and you said this is in positive territory in October and probably in November as well.

Sergey Piven

The most improvement comes from traffic.

Artur Galimov – Sberbank

Okay, right. And also speaking on these promos you are planning for Q4 and probably those promos are underway already, you said that there was amongst it driven by your commercial teams. So considering ongoing improvements of purchasing terms with your suppliers, did I understand correctly that, on balance, you would expect more or less flat QoQ gross margin in Q4?

Sergey Piven

Did I understand correctly that the question was about what will be the level of gross margin in Q4?

Artur Galimov – Sberbank

Well yes, the impact of those aggressive promos you are planning for this quarter also, given that probably you will continue to improve purchasing terms. So what will be the net impact on gross margin this quarter?

Sergey Piven

Well, I do think that the promo will have the effect on the gross margin but that's about what I can say right now. We do invest in traffic and in our customers and again you concentrate on promo and you concentrate on pricing but I want to draw your attention that it is part of the plan and the plan involves more than that. So that is why maybe even it is better and I am more comfortable commenting on the EBITDA for the year, which will be 7 plus, rather than commenting on separate parts of the plan. The plan does not exist without any of its parts, so it is not just the promo and it is not just the pricing and it is not just the advertising. It is together and together they will have the effect.

Artur Galimov – Sberbank

Okay, right, thank you for that.

Operator

Thank you. We have no further questions at this time. Please continue.

Gregory Madick

Well, thank you all for joining us on the call and we look forward to continuing our dialogue with you next year. Thank you.
