X5 Retail Group Q4 & FY 2012 Financial Results Conference Call Transcript [1]

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Presentation

Operator

Ladies and gentlemen, thank you for standing by and welcome to the X5 full year 2012 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 would like to advise you all that this call is being recorded today, on Tuesday, 12th March 2013, and I would now like to hand the conference over to your speaker today, Mr Gregory Madick. Please go ahead, sir.

Gregory Madick, X5 Executive IR Director

Thank you all for joining the call to discuss our Full Year 2012 Financial Results. Before we begin our presentation, I would like to refer you to the disclaimer statement in the financial results press release regarding forward-looking statements. During this conference call we may make reference to forward-looking statements by using words such as “plans,” “objectives,” “goals,” “strategies,” and other similar words, which are other than statements of historical facts. Actual results may differ materially from those implied by such forward-looking statements due to known and unknown risks and uncertainties, and reflect our views as of the date of this call. We undertake no obligation to revise or publicly release the results and any revisions to these forward-looking statements in light of new information or future events.

I will now turn the call over to Stephan DuCharme, the CEO of X5 Retail Group.

Stephan DuCharme, X5 CEO nominee

Thanks Greg and thank you all for joining us to discuss X5’s 2012 Financial Results. We will also provide some details on where we are in the Company’s ongoing transformation and what we are focusing on in 2013. First, I would like to update you on the personnel changes and how the Management Team is developing. I am pleased with how the team is working together both at

[1] This conference call transcript was prepared by InterCall.

the Executive Board level and also within the respective divisions and the results that are coming from this collaboration. Aside from addressing the operational issues that the Company is facing, we are working to develop and establish a Group wide corporate culture based on common goals and personal accountability. This is something that had not received enough attention during the rapid growth and assimilation that was the result of our past M&A activities.

Regarding the operational issues, we will discuss some individual initiatives that we are rolling out a bit later in the call to give you more detail on how we are addressing these issues. Regarding the soft discounter format, the active search for a General Director is ongoing and this clearly represents one of my top priorities. In the meantime, the three Operational Directors continue to manage the day-to-day operations at the format under the supervision of myself, the CFO, and the Director of Strategy.

In terms of where we are in the transformation process, I will confirm what I have said in earlier calls regarding the estimation for the time required to complete this process. My expectation and the expectation of the board is that we will have completed the stabilisation of our operations by the end of this year, including like for like sales growth, expansion, and margin.

Now, let's turn to last year's financial results. I would like to begin by saying that 2012 was a challenging year and we're clearly not satisfied with the results. We struggled with operational issues for most of the year and we experienced significant change at the Senior Management level. In Rouble terms, our net retail sales increased by 8.3% year-on-year, primarily due to the results of new stores opened over the last two years. During the year we continued to struggle with like-for-like results at each of our formats. By the end of the year we did see positive trends at both our hypermarkets and supermarkets with the latter posting a 2.5% increase in like-for-like sales in Q4. However, during this time we have also seen deteriorating results from our soft discounters.

Net sales from new store openings increased by 9.7% while our like-for-like sales decreased by 1.4% resulting in n 8.3% increase in net retail sales. The decrease in like-for-like sales was due to a 3.1% decrease in traffic and a modest 1.7% increase in basket. In spite of these operational challenges, we did manage to open a record number of new stores. During the year, X5 increased its store footprint by 800 new stores to more than 3,800 stores or approximately 2 million square metres of selling space. We also maintained good cost discipline in 2012, delivering a gross margin of 23.6% and keeping SG&A expenses at a percentage of net sales excluding the impairment of asset effects at 20.5%, which was in line with 2011. As a result, we maintained an EBITDA margin higher than 7%, as per our guidance with the full year EBITDA results coming in at 7.1%.

In 2013 we plan to focus on a number of initiatives to improve our top line results and margins. Many of these proposals will entail a back to basics approach to retail operations and will reflect the fact that we have to some degree taken our eye off the core retail operations during the M&A based growth over the past years. As we have said during previous calls and meetings with investors, our rapid increase in scale and the subsequent reorganisation of the Company presented many distractions for management and resulted in a decline in operational efficiencies and the value propositions of our stores. For much of this time, the symptoms of this lack of focus were masked by double-digit inflation and relatively low levels of competition in our core markets. Clearly this has changed and so must we, so what are we doing to turn the situation around?

We have introduced a number of new initiatives in 2013 and we will continue with those that were launched in 2012 to target inefficiencies in our current operations. The focus of many of our initiatives is to improve how we conduct our operations on a day-to-day level and involves the establishment of better and more consistent business practices throughout the organisation. There is clearly no quick fix. At the same time, the task is clearly achievable. Given the size of our store network, especially at the Soft Discounter format, the improvements will not be measured in months or maybe even a quarter or even quarters. However, we expect that by the end of this year we will have established the levels of efficiency required to support the growth both the Board and shareholders expect. We are focused on supporting long-term sustainable growth.

As discussed in our Q4 and full year trading update conference call, we said that we would be providing more details on the initiatives we are implementing, focus mainly on our top line results and to address the operational issues we are facing. With this, I would like to hand over to Sergey Piven, CFO of X5 Retail Group.

Sergey Piven, X5 CFO nominee

Thank you Stephan. As we have stated in past calls, one issue that has negatively impacted our results is availability. This has been a problem at all of the formats, but is more pronounced at the soft discounters due to the format's relative scale and geographical distribution. The issue's origins reside most at the logistics and store levels, and the initiatives that we are implementing will encompass IT solutions, improvements in operational processes and systems, as well as employee competency and motivation. Currently our logistics operations are not as good as they should be and after changing the leadership at this division last August we have carried out an in-depth assessment of the division's operations. As a result, we have made personnel changes in the DC Director and Transportation Director levels, and are also working with third party logistics operators in an effort to determine the optimum balance for managing our logistics operations.

We are also in the process of improving deliveries to stores optimising scheduling. These changes will be supported through improvements in the motivation system for drivers and/or pickers.

In terms of the effectiveness of IT in our logistics operations, we have successfully rolled out voice-speaking technology last year and are satisfied with the results. We have also implemented palette way in technology at the tailgate of the receives, which is also working effectively and in 2013 we plan to roll out software to optimise route planning to improve delivery efficiencies. At the same time, we are also improving how we analyse the service level for the individual formats that will increase the transparency of the metrics calculation and provide a valuable tool and opportunity for vector analysis.

The store availability has been negatively impacted by store personnel not following prescribed systems and procedures when ordering products. To resolve this we are improving the training as well as simplifying procedures and dumbing down systems to eliminate user errors. These measures have been initiated and will help improve the situation until such time as we complete the rollout of JDA and SAPRP auto ordering, which are both ongoing and should be completed in 2014. We will continue with the initiative launched last year at the Soft Discounter format where we are focusing on maintaining 100% availability of the format's 500 best selling SKUs. We have also raised the issue of assortment in the past and this is something that we have made some progress on during 2012 and which we are reinforcing in 2013. Beginning in 2012, our assortment was driven by the format heads. We are now in the last stage of extensive category reviews where we are working to standardise the assortment and optimise the individual formats' active metrics, but equally for the Soft Discounter format, the review of the entire food assortment and the adjustments that go along with this will result in a more appropriate assortment structure and positioning of the format. Going forward this will be an ongoing process and will help us better manage our product range both in terms of shelf space in the stores and supply chain operations.

Another area of the assortment that we are targeting is fruit and veg. This is one of the main traffic generators for food retailers and we have increased our focus on this category and we already see some progress in the category versus 2012. We are doing a number of things to improve the quality of our fresh offering, which includes better store and supply chain procedures and increasing direct imports. Currently, we are applying stricter requirements for suppliers regarding quality and better in-store monitoring to ensure that products on the shop floor are fresh. There have also been changes to the assortment layout where we have expanded the footprint of fruit and veg, and this category has been moved nearer to the store entrance at Pyaterochka. We plan to improve our own production facilities for our prepared foods category. This will increase the range and quality of prepared foods in our supermarkets and hypermarkets.

Regarding our non-food category, which applies mainly to hypermarkets and supermarkets, we have increased both the quality and quantity we offered you in part to the initiation of direct imports. This has allowed us to expand the product range and better meet our customers' needs. We are continuing to refine this category and expect improvements in 2013, especially in the hypermarket format. Working hand in hand with assortment we are also reviewing our pricing policies across the formats to ensure that we have the right prices given the formats' value proposition and assortment. We have also initiated measures to improve our ability to react quickly to changes resulting from monitoring results of the competition's prices and to ensure that the formats' categories are priced competitively across the full range of products.

We have talked in the past about the need for investment in store refurbishment to improve the shopping experience for the customer. We plan to increase investments and refurbishments, and cosmetic improvements at all of our formats in 2013 and, where possible, full store refurbishments will be done through partial closure of the store in order to minimise the impact on sales. We will also consider increases in refrigeration units in the trade area of soft discounters and increasing the size of the trade area by removing refrigeration rooms from storage areas.

Another change of soft discounters is the launch of hot bread corners at select stores where we have installed ovens to prepare fresh bakery items and the reaction so far from customers has been very positive. We have also stepped up our focus on store cleanliness and ensuring that proper lighting is in place and sufficient baskets and carts are available to customers. This is a good opportunity to talk a little bit about what we are doing to improve customer service and the shopping experience at our stores. We are increasing the number of cashiers available to reduce lines especially during peak periods. We have made the phone numbers for Store Directors and Regional Supervisors available at the cashier stands and we have hot lines available in the stores that go directly to the Supervisors. We have also introduced mystery shoppers who are volunteers that visit our stores and provide feedback on the experience to our managers. Finally, we are considering a new loyalty programme for our hypermarket customers.

A large portion of the initiatives that I have detailed above are dependent on the performance of our employees in the stores. As such, we have and will continue to spend a significant amount of time on improving how our people execute their day-to-day responsibilities. We're making improvements in store procedures and routines, including initiatives to improve and simplify standard procedures, as well as to optimise and standardise routines. This will be supported by changes and improvements in training, documentation, motivation, and accountability of store employees. There will be rewards for improvements in areas like sales shrinkage, execution of store procedures and customer service and penalties for not meeting these standards. We are also looking to decrease the share of outsourced employees in our stores where practical. Some of the initiatives that will help us accomplish this are the promotion of cross-function employee job descriptions, as well as the improved motivation practices we are introducing to retain and develop our employees. This is an important step as we try and develop a corporate culture and identity that promotes teamwork and accountability, as well as a sense of pride in the work we do.

In closing the discussion on the top line, I would like to add that we will support these initiatives through a robust campaign of advertising and promo. In 2013 we plan to increase the effectiveness of these programmes to ensure that our store promotion activities are timely and scheduled appropriately. We have strengthened the marketing departments of the formats and expect a more coherent and targeted plan for these activities in 2013. It is important to remember that these activities are designed to generate excitement in the stores and attract customers. Their effectiveness on building and retaining traffic is predicated on the fact that the stores' everyday offer is commensurate with the customers' expectations.

Moving away from sales, I would like to turn the discussion to 2012 margins. We finished the year in line with our stated guidance of gross margin between 23 and 24%, and EBITDA margin north of 7%. Our gross margin in 2012 amounted to 23.6% while EBITDA margin was 7.1%, which represented a 20 basis points decline compared to 2011 respectively.

On the one hand this is quite an achievement given how we struggled in the top line and the record organic expansion we realised in 2012. Based on the current round of supplier negotiations and increase in direct imports, there is scope for improvement in our commercial conditions. We also expect improvements in supply chain management as better processes and motivations should result in better management in this area. We expect to reinvest at least a portion of these gains into improving our relationship with the customer. We also plan to continue to focus on cost control at the SG&A level. It is important to note that our SG&A expenses faced outward pressure in 2012, as it became clear that the top line was not growing as expected and we continued to expand our store base. As a percentage of total revenues, SG&A, excluding the impairments of assets effect was in line with 2011 at 20.5%. The largest component of SG&A is staff costs, which as a percentage of net sales decreased 16 basis points year-on-year in 2012 to 8.2 due to the reclassification of security and maintenance staff expense from staff costs to other store costs, and the reduction in bonus accruals and the social tax rate. This was offset by an increase in employee salary and wages on the back of new store additions and a decrease in income recognised on our LTA programmes.

We have continued to optimise our personnel costs at the end of 2012 and this should continue to enable us to maintain strict control over staff costs in 2013. Other expenses as part of total SG&A expenses were significantly lower in 2012 compared to 2011 due to a decrease in our bad debt provision in 2012. This was primarily due to a comprehensive review of our H receivables and improvement in collectability within the framework of the Company's accounting policies. We also released historical tax and legal provisions, which naturally expired at the end of 2012. We maintained 2012 utilities cost in line with 2011 despite the increase in the store base and tariffs. This is the result of our ongoing efforts to increase store efficiency by installing meters for water and electricity consumption to help control these costs. We will continue to focus on efficiency improvements to support EBITDA margins. This includes introducing new processes and technologies to improve energy consumption, inventory management, in-store and warehouse productivity, transportation of wheat management and other areas to offset the rise in labour, energy, and real estate costs in Russia.

I would like to comment briefly on the non-cash impairment of assets charge that we recorded in quarter four 2012. The majority of the impairment was focused on property, plant, and equipment, and related mostly to our hypermarket format. This impairment was based on the review of the hypermarkets' historical results and the subsequent adjustment to the format's business model. This in no way changes our approach, neither to our multi-format strategy nor to our plans for developing the hypermarket format. The other large impairment was to intangible assets, specifically the Kopeyka brand. We recorded this asset when we acquired Kopeyka at the end of 2010 and had not made a decision on the rebranding to Pyaterochka. Since the stores have all been rebranded, it was time to reflect this change in the gearing value of our assets.

Turning to X5 financial position. We saw a significant increase year-on-year in our net financing costs of approximately 10% in 2012, because of the conversion of our USB denominated debt into Rouble by year-end 2011 and the generally higher rates on Rouble denominated debt. We also saw an approximately 12% increase in our total borrowings at the end of 2012, as well as increase in borrowing rates during the year. However, we ended 2012 with a net debt to EBITA ratio of 3.15 times compared to 3.13 times at year-end 2011, while our interest coverage ratio remained healthy at 3.29 times. Excluding the effect of the impairments in 2012, we went from a net loss of $127 million to an adjusted net profit $250 million or 1.6% of net sales compared to net profit margin in 2011 of 2%. The 40-basis-point difference is primarily due to a 20-basis-point decline in EBITDA margin due to a lower gross margin and a 20-basis-point increase in our net interest expense.

Our 2012 net cash from operating activities decreased year-on-year by approximately 34%, primarily due to a decrease in changes and working capital and higher interest expense in 2012 compared to 2011. Our working capital benefited from our improved terms with suppliers and increase in trade payables; however, as we built up inventories ahead of the peak hold this season and were not able to convert them to sales, we ended the year with a significant increase in inventories. This resulted in a decrease in the working capital contribution to cash from operating activities. As a result, in 2012 we increased our borrowings to support our capital expenditure programme and fund working capital shortfalls. I would say that our team did a good job in managing capital expenditures in 2012. Our Capex of RUR 28 billion was well below our approximately RUR 45 billion plan for 2012 and we still managed to add the number of stores which we guided. The decrease was primarily due to the optimisation of the regional plan, which primarily included cuts to new store openings as well as lower construction in expansion costs due to careful management of our store load. Our Capex in 2012 was primarily focused on organic expansion as we opened a record 800 new stores and expanded our retail footprint by approximately 242,000 square metres.

Before we take questions, I would ask Stephan to share a few words on our strategic roadmap.

Stephan DuCharme, X5 CEO nominee

Thank you Sergey. I believe we are making good progress in addressing the challenges that the Company faces and there is significant scope for improvement to deliver on X5's potential. The changes we are making will enable us to re-establish the necessary return to the type of growth that will support our longer-term strategy for sustainable profitable growth and value creation. There are several yardsticks that you should keep in mind of measuring our success.

First, successful formats; our goal is to be the shopping destination of choice for customers in each of our formats. We are improving how we go about the daily business of retail in our formats with a focus on assortments, price, service, availability, and accountability to drive like-for-like growth and organic expansion. In 2013, we intend to accomplish the turnaround in our operations. At the same time, we must recognise that 2013 will be a year of continuing change and adaptation. All of these factors come together to underpin our sales growth outlook and we, as a Management Team, would not be satisfied with any sales growth below 11%.

Second, intelligent allocation of capital: the Company has established a 2013 Capex plan of up to RUR 30 billion and we are targeting an 11% net increase in retail selling space for the year. Much of the growth in selling space will focus on scaling up in Russian regions outside of central Moscow and northwest St Petersburg regions to build our regional market positions. As we build out our store base and market share in each region, we can drive major economies of scale. There are many regions where X5 has only a handful of stores and the operating leverage from running common logistics, local sourcing, and spreading fixed overheads over a larger base is still largely untapped.

In terms of formats, we expect increased openings in discounters and supermarkets quite substantially, but we'll add fewer hypermarkets, while we fine-tune the business model for this format over the next six months. In addition, X5 will increase investment and maintenance and remodelling of older stores to bring them up to the standard of our new store models. We will increase investments in X5's logistics network to handle the planned growth and total sales volumes, and increase productivity. In addition, IT spending will also increase as we roll out new software systems to interface with SAP such as our JDA supply chain management and SAP ERP auto-ordering systems.

Third, we will grow margins and increase shareholder returns. We see significant opportunities for delivering value for shareholders by continuing to increase efficiency to protect profit margins. In 2013 we believe X5 can operate with improved gross margin levels and sustain an EBITDA margin of 7%. In addition, we are placing increased emphasis on improving that income and maintaining a return on equity.

Sergey and I will now be happy to take your questions.

Questions and Answers

Ivan Kushch, VTB Capital

I have several questions. First is, as far as I remember you guided earlier for Capex for 2012 of RUR 40 billion or above, but in fact it was some 40% below that number, however, the revenues were indeed quite impressive, so the question is, why did you spend less than planned which it has remained under invested versus your initial plan? And my second question would be, could you please give some colour how your like-for-like sales, in particular traffic, is basically all in January and February 2013, so what are the recent trends in like-for-like sales? Thank you very much.

Sergey Piven, X5 CFO nominee

First of all, on the Capex 2012, as I mentioned before, part of this Capex result is due to optimisation of the Capex, part of it the shift from the construction and own stores into the [leased] stores openings. In fact, we have now higher share of leased stores than in 2011. Then we…the rest of it is probably that we realised that we were more aggressive in our Capex planning than in fact the reality demanded from us, so we just did not invest into the programmes where we did not see the sense of doing it, so that I think covers most of the answer for your question.

As for like-for-like in 2013, we published on our website in the presentation of trading results for January and February. We can see that in January our total Group showed 0.2 negative like-for-like with discounters being positive and with supermarkets and hypermarkets being negative. In February the situation for the Company is about the same; it's 0.1 negative, almost a breakeven like-for-like with soft discounters lagging behind with 1.2 negative, with all other formats including supermarkets, hypermarkets, and convenience stores being in positive like-for-likes.

Ivan Kushch, VTB Capital

Thank you very much. That's it for my side, thank you.

Andrey Nikitin, Alfa Bank

Thanks for the long awaited Conference Call. A few questions on Capex. If I look at your total Capex number for last year, it stands at $902 million, while as per your cash flow statement, it's $796 million. Could you please advise where we should look for the difference?

Sergey Piven, X5 CFO nominee

It's accrual versus cash basis.

Andrey Nikitin, Alfa Bank

Okay. Do you mind telling us out of the 65% last year's Capex spent on new store openings how much was spent on the discount format specifically?

Sergey Piven, X5 CFO nominee

I'm sorry; we do not provide that level of detail.

Andrey Nikitin, Alfa Bank

Alright, and as of last year, which percentage of your warehouse base was leased versus owned?

Sergey Piven, X5 CFO nominee

We have to get back to you on this a bit later. We will answer it later, okay. We need to check.

Andrey Nikitin, Alfa Bank

Alright, and again, for last year, what was the share of the fresh foods in your assortment?

Sergey Piven, X5 CFO nominee

What kind of fresh do you mean? Is it total fresh or fruit and veg or what kind of…?

Andrey Nikitin, Alfa Bank

Total fresh.

Sergey Piven, X5 CFO nominee

Just one second. Okay, our…if we break down our product range, as we do in the annual report, you can see that our dairy products, eggs and oils 15.5%, then they are fresh. Fresh and processed meat 10.8%, fruit and veg 9.3, fish and frozen foods 6.5, so that's what you would classify as fresh as far as I understand.

Andrey Nikitin, Alfa Bank

Alright. Any chance at all to have a bit more break down for the 2013 Capex of RUR 30 billion?

Sergey Piven, X5 CFO nominee

We intend to spend a high percentage of our Capex for store refurbishment that in 2012, approximately 26%. As for the rest, as before, we plan to spend the majority of our Capex on opening new stores.

Andrey Nikitin, Alfa Bank

Do you envisage your operating cash flows as sufficient to cover those Capex needs or do you think you may need additional financing?

Sergey Piven, X5 CFO nominee

We will cover most of our investment from our operating cash flow, but we may need to draw additional financing. I think we are standing good on our covenants and we are standing good on our credit plans, so we have access to this financing.

Andrey Nikitin, Alfa Bank

Do you think that an overall rice issue recapitalization could be a possible solution?

Sergey Piven, X5 CFO nominee

We do not have these plans at the moment.

Andrey Nikitin, Alfa Bank

Alright, that's all for me, thanks.

Victoria Petrova, Credit Suisse

Thank you very much for disclosure. First of all you're talking about refurbishment and this year a large, quite a large portion of Capex will be attributed to the refurbishment. How can we quantify it? Should we assume it would increase traffic? Should we assume it would put you in somewhat new competitive position? Because of already, in the case of X5 faced a lot of issues with integration Capex, which were also attributed to ultimate increase in sales, and we have not in really observed it last year, [due we're on the fritz] and when do you expect them, basically us to see them, the impact of your refurbishment investment? Should it be the second half of the year or maybe next year, how do you look at it internally?

Sergey Piven, X5 CFO nominee

Okay, first of all, I would split the integration Capex from refurbishment, because these are two different issues and we do not plan to have any integration Capex this year, because we have nothing to integrate.

On the store refurbishment, of course when we invest we expect some return and in terms of our priorities of our refurbishment, Capex investment, we will invest first of all into the stores and equipment where they can bring additional sales, so I mentioned already that we planned to expand the cold equipment, the refrigerators in the stores, so we expect that this will show in sales very soon after we do that. On more general refurbishment, we expect that this is just keeping up to the standards, so to our customer expectations, so this is a long-term investment. We would be very pleased if it reflected in traffic immediately, but we know from our experience that it takes some time and also this is something which you simply cannot avoid if you want to run a successful retail chain. You have to invest in your facilities.

Victoria Petrova, Credit Suisse

Thank you very much. Secondly, thank you very much for your disclosure on what issues would be addressed such as availability, etcetera, but I'm a little bit concerned about the previous team has already told us that IT integration is over, that promo campaigns has been an issue and the topic for X5 for a long time, logistics issues have been being addressed for awhile now, so what is different now? Because we're already sold that all of these problems have been addressed and now it seems that it's not the case. Could you just elaborate on that?

Sergey Piven, X5 CFO nominee

There are two things there. One I think it's a big ship, so it doesn't turn very fast and the second was probably we have to admit that we could have been more effective in implementing these measures and this I think is reflected in personnel changes, which we've had.

Victoria Petrova, Credit Suisse

What will be an indication that these initiatives you are implementing are successful? Because now we don't have confidence. We don't know when we should start believing that it's actually taking place.

Sergey Piven, X5 CFO nominee

One part of the job for myself as the CFO is to keep track of the metrics, how these changes and these initiatives are working, so that is for sure on the top of my plate right now. As for you we can just promise to you that we will keep you updated. We plan already the investor day for the end of May where we can share already some first results of our initiatives, which ones are successful and which ones are less successful. We will just remain open.

Victoria Petrova, Credit Suisse

Thank you very much, and my very last question, when I look at January and February's results, they show quite different dynamics between the months. We see quite strong soft discounter net retail sales growth in January, and then in February we see that hypermarkets show negative dynamics as well. During your previous conference call you were talking about already happening turnaround and positive dynamics in supermarkets and hypermarkets, and lagging soft discounters. Could you comment on that in the view of January and February results?

Sergey Piven, X5 CFO nominee

I think in January we had some supply chain issues, mostly in supermarkets and hypermarkets, in the beginning of January, especially in fresh and fruit and veg, so I think that is part of the way it is reflected in the results. Generally, yes, in supermarkets we see the positive trend since the second half of last year and we are quite pleased with their performance. We hope that this month will be rather an exception for them than a rule.

Stephan DuCharme, X5 CEO nominee

If I could just add to that. I think one of the things we would ask you and other investors to take into account is the fact that certain trends will be visible more quickly, in others there will be up and down as we go through the year. We look at things not just on a monthly basis but on a daily basis, and there are different dynamics day to day in each of the formats. We think the ship is pointed in the right direction. March is looking good, I can say that, but there will be different dynamics. Going back to your previous question, what are we looking for primarily is for some of these changes to come through at the like-for-like and sales growth level but on a sustainable basis.

Elena Jouronova, JP Morgan

Hello, good evening, thank you very much for doing this call and for such a detailed disclosure of like-for-like by month and by format. If we can just continue looking at these numbers. I have noticed that ticket growth, like-for-like ticket growth slowed in February compared to January, whereas we know that food inflation in general in Russia was more or less the same in January and February. Can you please explain what happened there? Have you become a bit more promotional? Are these price investments, or this is something you're seeing across the industry right now, because I believe that was also a trend for some of your competitors. That would be my first question. Thank you.

Sergey Piven, X5 CFO nominee

Can I clarify that, so you are talking about the difference between 1.2% basket in January and 0.6% basket in February? Am I correct?

Basket is affected by seasonality more than it is affected by general inflation. If you just remember the schedule of holidays etc, so I would expect the differences, first of all. Secondly, because this is year-over-year, 1.2 and 0.6 are not significant, I think not significant inferences and you see that also the mix is different. The composition of this 1.2 and 0.6 is different. We have soft discounters contributing 2.7% in basket in January and then 0.4 in February, and vice versa, hypermarkets were negative, highly negative in January 6.7, and they were much less so in February. I think these fluctuations happen on a seasonal level and they are less related to food inflation in Russia, than they are related to specific seasonality and operation situation in the stores.

Elena Jouronova, JP Morgan

There have not been any additional price investments in your discounters in particular where like-for-like basket growth moderated from 2.8% to 0.4%, there has been nothing special there, is that right?

Sergey Piven, X5 CFO nominee

Nothing that was reflected in this basket now.

Elena Jouronova, JP Morgan

That is clear, thank you. then if I may take a step back and discuss a bit the targets that were mentioned for 2013, I think that the market will likely look at it as guidance when we talk about 11% revenue growth and flat EBITDA margin, but can you please explain to us how we should treat these numbers. Is it more like the targets that were laid out before the management team by the board of directors that these are your goals you are willing to achieve for 2013, or this is really the numbers that are realistic considering all the things that you want to do. Just help us understand a bit what is behind these numbers and what is your level of confidence here. This is just really the target that we should treat as guidance or this is what was set out as a target by the board in front of X5s management.

Stephan DuCharme, X5 CEO nominee

I will take that one. Just to reiterate one more time that this is a significant year of transition. We all feel we know what needs to be done in terms of the overall direction. As Sergey said we have launched a lot of initiatives at various levels within the Company. There is clearly some uncertainty as to when these various initiatives come though at the different levels, to give you a specific example, we're, as you know we have made adjustments to the assortment at the discounters. How quickly that comes through one never knows. Sometimes there is even an initial negative effect because of the change in the assortment. We are, as a management team, presenting our view on 2013, we are faced with the fact that there is still a lot of uncertainty. One of the options before us had been not to provide any guidance whatsoever. We decided as a management team to come out and say this is what we think we could do anything below this we would not be satisfied with as a management team. This is not something that is being imposed on us by the board. Whether you want to call this guidance is up to you to decide yourself, and at the end of the day I think our approach as a management team is we would prefer to under promise and then over deliver, but no one knows at this point.

Elena Jouronova, JP Morgan

Thank you that is very clear. Then a few more questions, in terms of maintaining flat operating margins, I am trying to grasp how realistic this can be and I think there is upside to your gross margin, but then I am trying to think about your operating costs this year and it looks like you're going to be investing more in personnel, hiring new cashiers and spending and focusing more on training personnel, that means higher SG&A costs, then you continue to focus on leasing stores because you like to rollout stores at an even faster pace and this means that your rents should go up as well. In this environment how do you expect to sustain SG&A to sales where it is unless you have any new provision releases or these sorts of items which we can't really forecast, like the other operating expenses which dropped 80 bips in 2012? From the other expenses line, the cash expenses line, like personnel and trends, how can you expect to have a flat EBITDA margin with these items going up, or am I wrong in thinking that they should go up at all this year.

Stephan DuCharme, X5 CEO nominee

We do think this margin remaining flat is realistic; to take your specific example of investing or training store personnel, on the one hand yes that may entail additional costs. On the other hand there is significant room for improvement in terms of efficiency of operations. Within stores for example we have always had a very large number of classifications of employees. We have had individuals doing just one type of job as opposed to let's say three jobs. Simple restructuring of business processes within stores allows for much better efficiencies, part-time working hours etc, so there are both positive and negative elements to what you have just described, and I think the overall effect would be that we come out flat.

I don't know whether Sergey wants to add anything to that.

Sergey Piven, X5 CFO nominee

I would view what we said as investment in efficiency of the store. It has quick pay off frankly speaking, so I agree with Stephan. We have a lot of room for improving efficiency and we have detailed programme show to do it.

Elena Jouronova, JP Morgan

That is clear, and then two more questions from me, in terms of your store openings, expansion, you said you would like to target mostly regions, and expand outside your core geographies, central and North West. Can you give us an idea of what percentage of selling space do you target outside Moscow and St Petersburg, the big cities in particular?

Sergey Piven, X5 CFO nominee

We generally do not provide this level of detail, but you know that we have regulatory constraints in St Petersburg to expand our store base, so you can figure out how many stores we can open there. In Moscow yes the opportunities, the city is densely populated with the stores already, the competition is quite high, so yes our focus is on regions, but I am afraid we cannot provide you with a more detailed guidance on this split.

Elena Jouronova, JP Morgan

But regions, more like North West region and central region or outside the two cities and surrounding regions. You have the 25% market share in St Petersburg but not in the entire North West and I am sure your presence is quite large in the North West, so you would be targeting regions outside North West and Central, going more into the South, the Euro, or you're going to be focusing on expanding presence in these areas where you are already quite well presented?

Sergey Piven, X5 CFO nominee

For sure North West is part of our expansion and scope, so yes we are going to expand in North West outside of the areas where we cannot for regulatory reasons, but also other regions of Russia.

Elena Jouronova, JP Morgan

Then the final question about the refurbishment programme, can you give us some details on how many stores you want to refurbish this year. Is this your entire store base of discounters or not, then we can probably calculate the spending per store ourselves. What negative impact do you think this will have on your revenue this year, because you said you may want to close the stores for some time, for how long? Any details like that would be much appreciated, so that we can model it somehow.

Sergey Piven, X5 CFO nominee

What I can say is that the Capex for refurbishment of these stores is included into our Capex estimate, and the closure of the stores are included in our 11% growth projection which Stephan just committed us to. Giving more detail on that, I don't think we can give you more detail on this investment.

Elena Jouronova, JP Morgan

Even the number of stores or percentage of stores?

Stephan DuCharme, X5 CEO nominee

The answer is as many as possible, as quickly as possible, but also as intelligently as possible. I think by the time we get to the analyst day we will have a bit of a track record there. We are almost wanting to do this on a store-by-store basis to make the right decision in order to achieve the right return, so we have certain plans, but at this point we would prefer not to provide any breakdown.

Alexey Krivoshapko, Prosperity Capital Management

Hello, I have got a few clarification questions and one kind of forward looking if you may say so. You said that your old stores was lower at the end of 2012, can you give us an idea what percentage of space did you have in ownership at the end of 2012.

Sergey Piven, X5 CFO nominee

Leased versus owned stores? It is 54.4% as of end of 2012, leased space versus owned, compared to 53.3% the year before.

Alexey Krivoshapko, Prosperity Capital Management

54.4 leased at the end of the year. Is it selling space, no warehouses here?

Sergey Piven, X5 CFO nominee

Yes.

Alexey Krivoshapko, Prosperity Capital Management

Previously you have been giving numbers for Kopeyka, we understand that it is now all Pyaterochka, but still can you give us an idea how much Kopeyka generated in total revenue in 2012.

Sergey Piven, X5 CFO nominee

I am afraid we can't give you that level of detail.

Alexey Krivoshapko, Prosperity Capital Management

Hopefully at some point of time you would be able to disclose this given the fact that X5 paid considerable amount of money for the business and the management promised a number of synergies, fast track integration and what have you, and we don't even know... two years after it was closed. Hopefully at some point in time you will be able to disclose the information.

Sergey Piven, X5 CFO nominee

The integration is completed, all stores are rebranded, so they are operated and managed as part of Pyaterochka format.

Alexey Krivoshapko, Prosperity Capital Management

I understand, but we still need to understand how good was the deal. I hope that in some point in time you would be able to reveal this to us.

Sergey Piven, X5 CFO nominee

I can't promise you that.

Alexey Krivoshapko, Prosperity Capital Management

I guess we will just address it separately. One final clarification thing, can you tell us how much you spent on acquisition of real estate. You say here in your Capex breakdown that this was the expansion Capex, but that I understand included both store maintenance and acquisition of property. Can you tell us like roughly how much did you spend on buying real estate last year.

Sergey Piven, X5 CFO nominee

We will come back at the end of the call to that, okay, Alexey.

Alexey Krivoshapko – *Prosperity Capital Management*

Final question, what tax rate do you need for next year given the deferred tax you have got at the end of Q4 2012?

Sergey Piven, X5 CFO nominee

Can't answer that question.

Victoria Petrova, Credit Suisse

Hello, I have one follow up question. You were talking about your 2013 expansion target of 11%. Do you have some sort of longer-term number of stores in mind which would help us in our modelling process? Do you target a certain number of stores in each format by let's say 2017 or 2016?

Stephan DuCharme, X5 CEO nominee

We are not prepared today to present a midterm expansion strategy. At some future point we might be able to talk about this. We will expand, again very similar to the comment I made on the stores, we will expand as quickly, as intelligently, taking into account the constraints we have.

Irana Miklazcic, Threadneedle

Hello, thank you so much for the call, just a very quick two questions, first on working capital. You had some deterioration in working capital position during the year; do you think that this would reverse in 2013? This is the first one and I will ask the second one later.

Sergey Piven, X5 CFO nominee

On working capital, we do not see so much deterioration as we don't see a positive addition from working capital changes into the cash flow which we observed in 2011, and we do not have them in 2012. I don't see the deterioration on working capital.

Irana Miklazcic, Threadneedle

I suppose what I am referring to that you didn't have similar positive swing as you did in 2011. Do you think that in 2013 we would sort of go back to the position where you were back in 2011?

Sergey Piven, X5 CFO nominee

What I can say is for sure working capital is a matter of focus for us here and we have some initiatives to improve receivables and inventory, but whether we will be able to go back to the previous levels remains to be seen.

Irana Miklazcic, Threadneedle

The second question just on the overall balance sheet structure, do you think that in the current balance sheet structure, meaning that an equity position on the balance sheet you have enough scope in the vast operation to essentially turn it around or your debt level is a constraint?

Sergey Piven, X5 CFO nominee

No I think we are good with debt level, we are good with covenants, and we intend to go forward with the current structure.

Vitaliy Baikin, Gazprombank

One question from me, could you please repeat how much do you expect to spend on capital expenditure in 2013, and if possible could you please break down this amount, Capex for IT, warehouses, etc.

Sergey Piven, X5 CFO nominee

It is 30 billion Roubles but we don't break it down.

Yulia Gerasimova, Goldman Sachs

Good afternoon, I have two questions please. The first one is a like-for-like, if you can share with us what is your internal target or internal expectations from the like-for-like for the full year. Can we hope that we will end up with a positive like-for-like seeing in your trends in January and February which is [unclear] or it is likely to stay in negative territory? Why I am asking this because your expectations on the sales growth that you mentioned, 11% basically , for me this seems like actually a negative like-for-like given that last year your net selling space increased by 14%. This is my first question.

Sergey Piven, X5 CFO nominee

Let me try to answer that, first of all as you see and as we have seen the situation with like for likes is a difficult one. We see the increased level of competition in our strongholds, we see also competition growing in Russian regions, everybody grows, new stores open, so it is a tougher environment to do business than it was several years ago. However we of course target positive like-for-like for all formats for 2013, so that is the minimum which is acceptable to us.

As for your calculation of negative and positive like-for-like derived from the space we open, you have to take into account that we open new space mostly in Russian regions where the sale densities are lower than in our strongholds, so that necessarily doesn't mean that they will bring lower like-for-like, or that we project negative like-for-like for this year.

Yulia Gerasimova, Goldman Sachs

Understood, thank you very much, I think my next question would be, you mentioned that the refurbishment process is ongoing, basically on a store-by-store basis. If you could tell us maybe just approximately what percentage basically of your store base by format already went through the refurbishment and how much is left basically. It will be good to understand it.

Sergey Piven, X5 CFO nominee

What I can say is that it is not all the stores for sure, because it is impossible, but I can't give more detail. I think Stephan already answered why.

Maria Berasneva, Morgan Stanley

Good afternoon, I have two clarification questions. I just wanted to clarify where you talked about potential changes in pricing, where do you think you need to change pricing and why, and the second question if you could please clarify with the inventory that was involved in clean up at the distribution centres, that impacted gross margin. What inventory was involved in that?

Sergey Piven, X5 CFO nominee

As per the first part of your question which we are just having a small internal conversation about this. As far as pricing is concerned, we will continue with the pricing policy which is in line with the value proposition of the format. Basically that means that Pyaterochka will continue with relatively low price strategy. Perekrestok will focus more on assortment and service and hypermarkets will partially realign their prices to be more competitive and to improve their sales densities. That is what we can say about our pricing strategy so far.

If you could remind me the second part of the question please.

Maria Berasneva, Morgan Stanley

The second part of the question was relating to the inventory clean out at the distribution centres that impacts the gross margin, so the clarification I was asking was what inventory was involved in the clean out, if you could give us a bit more detail.

Sergey Piven, X5 CFO nominee

It is mostly the obsolete stock from non-food. Then it is the stock out of metrics where as you know we are moving with the assortment review quite heavily, so I think those are the two basic categories.

Maria Berasneva, Morgan Stanley

On food from the hypermarkets presumably, the changes in assortment there?

Sergey Piven, X5 CFO nominee

Yes.

Vitaliy Baikin, Gazprombank

Could you please share your thoughts on how your gross margin will be evolving in 2013, so you did not expect any impact from the inventory clean up, but do you expect some margin build up from supplier terms and part of that to be invested back into prices. What are your basic ideas as of now?

Sergey Piven, X5 CFO nominee

I am afraid we cannot give you the exact forecast of our gross margin, but what I can say is that we in fact expect some improvement in commercial conditions from our suppliers based on the results of our campaign in the end of 2012, and also which continues also in the beginning of 2013. However we have to remember that the competitive situation remains tough, so at least part of that we may need to reinvest into the customer. That is what I can say, we plan to remain competitive on price, and we plan to work with our suppliers on improving the commercial conditions.

Vitaliy Baikin, Gazprombank

Do you expect that inventory clean up may affect your gross margin this year?

Sergey Piven, X5 CFO nominee

We think that this year it will affect us much less than last year.

Vitaliy Baikin, Gazprombank

Thank you and one clarification question on Capex. Do I understand it correctly that 26% of the intended Capex for this year will be directed at refurbishments?

Sergey Piven, X5 CFO nominee

That is our estimate.

Vitaliy Baikin, Gazprombank

How much do you think might be spent on a per store basis, for example on refurbishment of one discounter store. What investment do you expect on a per store basis?

Sergey Piven, X5 CFO nominee

The answer even if we gave it would be a bit misleading, because our different stores require different level of investment and refurbishment, somewhere It is enough to put the chiller, somewhere it is enough to put the refrigerator and in some stores you need to refurbish them completely. It differs from store to store and at this point we are not ready to share our complete store refurbishment programme with you, I am sorry.

Vitaliy Baikin, Gazprombank

How many stores are in this programme, let's put it this way.

Sergey Piven, X5 CFO nominee

We will provide you some more detail on this programme at the investor day but at this point that is all I can say.

Maria Berasneva, Morgan Stanley

Hello once again, I am sorry if I missed this but I just want to clarify whether the disruptions at the distribution centres that per your press release impacted like-for-like traffic at discounters in the fourth quarter of 2012, were they fourth quarter specific or do you envisage those issues to continue into 2013.

Sergey Piven, X5 CFO nominee

They are quarter specific; they are related to high season in the fourth quarter. One thing, second to the situation with our operations last year, so we do not expect that they will repeat.

Maria Berasneva, Morgan Stanley

I am sorry, by high season you mean overcapacity?

Sergey Piven, X5 CFO nominee

In December usually your logistics turnover increases dramatically because the stores in November and December they need to stock up for the high season, which is pre-Christmas, pre-new year sales, December is usually by far the largest month, the best month in terms of sales, so all this puts additional strain on logistics in every company and if you apply that to our already stretched logistics operations, that resulted in some sort of disruptions from time to time with deliveries scheduled, which we fought as they appeared basically, but for sure we do not plan for this situation to repeat this year.

Maria Berasneva, Morgan Stanley

Just to clarify, when we talk about stretched operations, we're talking about ongoing changes in the systems and optimisations you implemented that impacts logistics centres and the communication between logistic centres and the stores correct.

Sergey Piven, X5 CFO nominee

Not really, we talk about the volume and the capacity of DCs and transport. We were operating very close to our capacity limits before the New Year in 2012.

Maria Berasneva, Morgan Stanley

You are going to put more capacity in 2013; therefore we are not going to encounter that anymore?

Sergey Piven, X5 CFO nominee

Yes.

Darya Babashkina, Alfa Bank

Hello, I have a short question regarding the effective tax rate. If I am not mistake, a year ago it was mentioned that effective tax rate may stay in the range between 25-26%, and this year you managed to improve it by approximately 1 percentage point. Do you think the improvement is sustainable and can you give colour on the sustainability of the rate? Thank you.

Sergey Piven, X5 CFO nominee

I can confirm that last year we showed this result, but we can't talk in detail about that for the future. We do not give projections on that.

[No further questions]

Gregory Madick, X5 Executive IR Director

Thank you very much for joining us on the call. As Stephan and Sergey had intimated we will be holding the strategy day, analyst day on 27th May, so please mark that in your calendars and we will provide you updates and invitations closer to the date. That concludes the call. Thank you very much.