Home Retail Group
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Q2 Trading Statement

Richard Ashton
Finance Director

1. Preamble

Good morning and thank you for joining our call today. I am Richard Ashton, Group Finance Director, and I have with me John Walden, our Group Chief Executive, who will join me in taking your questions in a moment. We are conscious that it is a particularly busy reporting day for you all and that following our call, there are a series of other retailers holding either conference calls or presentations, so we will aim to end our call no later than 8.15 a.m.

To get started, the trading information that we are providing today is for the second quarter of our financial year, covering the months of June, July and August.

2. Argos

I will begin by giving you some detail on each of our businesses, starting with Argos, where like-for-like sales increased by 1.2%, with this being its ninth consecutive quarter of positive like-for-like sales. Growth in the quarter was principally driven by further good sales of electrical products, where we have continued to see growth in TVs, video gaming and white goods, partially offset by a continued market decline in tablet sales.

TV sales were helped by the World Cup, but growth was also driven by a strong performance from sales of large screen units across both branded and own brand ranges.

Very strong growth in video gaming continued to be driven by demand for both the PS4 and Xbox One consoles, which will begin to annualise towards the end of the third quarter.

In tablets, the trend of the first quarter continued with further sales value declines resulting principally from the movement in sales out of higher priced units into lower priced models, while tablet sales volumes overall were broadly flat.

The growth in sales of electrical products was partially offset by declines in furniture, homewares and jewellery.

Internet sales grew in line with total company sales in the quarter and represented 44% of total Argos sales. Within this, we saw further growth in mobile commerce which grew by 36% to represent 22% of total Argos sales, up from 17% for the same period last year.

On gross margin, we are pleased that for the first time in several years we saw an improvement in the gross margin rate of approximately 25bps, with the principal drivers being an improvement of approximately 50bps from a reduced level of promotional sales, together with a number of small positive items that add up to a further approximate 25bps improvement, partially offset by a reduction of approximately 50bps from the mix impact of the growth in sales of margin dilutive electrical products.

Finally at Argos, a net 13 stores were added in the quarter as part of the previously announced format trials. This included nine Argos concessions within Homebase stores, and four small format stores, three of which are in London. This takes the portfolio to a total of 747 stores. In addition, there were a further 11 digital store conversions completed in the quarter, which takes the number of digital concept stores to a total of 19. Including the 13 format trial stores, we are now trading from a total of 32 digital concept stores.

3. Homebase

Turning now to Homebase, like-for-like sales were up 0.1%. This broadly flat like-for-like-sales performance was especially pleasing against an 11% like-for-like growth for the same period last year. There was further growth in sales of big ticket products, which was offset by the expected sales decline in seasonal products following the strong growth in the same period last year. Sales in the remaining product categories were slightly up.

There was a net reduction of six stores in the quarter, resulting in a total of seven store closures in the first half, thereby reducing the portfolio to 316 stores.

Finally on Homebase, the gross margin rate for the period was down approximately 75 bps, with the principal drivers being a reduction of approximately 50 bps from stock clearance activity in respect of the store closures, and a reduction of approximately 25 bps from the mix impact of the growth in sales of margin dilutive big ticket products.

4. Summary

In summary, we have had a good first half. Argos has continued its recent record of positive like-for-like sales and delivered an improved gross margin rate performance for the first time in many years. Homebase has successfully annualised a strong second quarter last year, holding like-for-like sales broadly flat.

At this halfway point of the financial year we expect to deliver full-year Group benchmark profit in line with current market expectations, where the range of forecasts is currently £122 million to £135 million, with a consensus of £131 million. If achieved, this would represent an improvement in earnings year on year of around 15%; however, as always, our full-year outcome will depend upon our performance during the key Argos Christmas trading period. Whilst we are operationally well prepared for this key period, we remain cautiously optimistic about broader economic conditions. Key economic indicators seem to be improving; however, retail spending in general has been inconsistent across both product categories and geographies, suggesting that there is not yet a sustainable, broad-based consumer recovery.

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

Questions and Answers

Warwick Okines, Deutsche Bank

I have three questions about Argos. First, on the gross margin mix effect from the swing to electricals, that 50bps mix effect was a fair bit stronger than in the first quarter; can you say why that is? Was that a wider performance gap between electricals and furniture or was it a shift within either of those broad categories?

Richard Ashton

I do not recollect that it was, Warwick. My recollection of the breakdown we gave on the first quarter was that sales mix had an adverse impact of c.50bps, and that 'other' was a positive impact of c.25bps, resulting in a reported movement in gross margin rate for Argos of down c.25bps.

Warwick Okines

I stand corrected.

Richard Ashton

The impact of sales mix on the gross margin rate is down c.50bps in the second quarter and was down c.50bps in the first quarter of this financial year. In terms of the product category mix, while there has been movement, on balance the growth is still fairly consistent in margin dilutive electrical categories and it is this that is still driving the c.50bps reduction.

Warwick Okines

Thanks. Second, on the promotional activity effect, could you say how much you think that might have depressed your sales by, and perhaps explain how the promotional activity was different year on year?

Richard Ashton

The reduced promotional activity has not really suppressed sales in the current quarter. The reduced promotional activity is about the phasing of the sales and stock levels of seasonal products. We had a very strong start in the first quarter of the current financial year in sales of seasonal products in both businesses. We reported strong seasonal sales in both Argos and

Homebase, which meant the stock sell-through was much faster in the first quarter than we expected, so the dynamic for us for the second quarter was making sure we were maximising margin and not over promoting in some of those seasonal categories, given that our concern was not whether we would clear through the seasonal products, but whether we would have enough stock of seasonal products to get us through the season. The reduced promotions are not therefore a change of trading stance overall.

We also did some different things around catalogue launch, resulting in a small underlying improvement in terms of stock clearance running into the recent catalogue launch, but the main driver to the margin improvement is the timing of sales of seasonal products this year versus last year. Last year, the season came big but it came quite late, which meant we were promoting seasonal products in the second quarter of last year. This year, it was the other way round: the season came fairly early for us in Q1 and seasonal sales eased off year on year in Q2. If you remove seasonal sales performance from both businesses and looked at the run rate of all other product categories in both Argos and Homebase in the second quarter, the run rate is virtually exactly the same in both businesses as it was in the first quarter.

If you recollect, at Q1 we did talk on the analyst call about the pull-forward of the strong seasonal performance and the fact that it was pulling forward sales, potentially, out of Q2, meaning we would have to carefully manage stock. You have to look at the first half of this financial year as a whole to see that season unwind.

Warwick Okines

Finally, the internet percentage has not grown year on year in this quarter again. Do you have any better thoughts as to why store-to-store is as strong a channel as the digital channel?

John Walden, Chief Executive

We do not have a great theory. I suspect that it is down to a couple of things: first, we are starting from a high base for internet sales; and second, we are making changes in digital and in customer experience, but our customers are used to shopping in a certain way. So we have put through a lot of change already, but there is still a lot of change that has not yet landed with customers. Hub & spoke, extended ranges, better home delivery and faster collection are all things that have been in process this year but, frankly, we have not widely communicated these changes to customers to a point where it has given people a chance to understand how they can shop differently with us.

I have to believe, then, that the internet participation number will go up. We expected that by the end of the five year transformation plan, it might start approaching 75%. I still believe that it will go up; I think we have to give ourselves a chance to get the new offers in the market, and give customers a chance to start shopping with us in a different way. I suspect that, given all that is going in to improving digital experiences, we are bound to see participation grow, but it may take a little time.

Anne Critchlow, Société Générale

My question is on the digital concept stores; have you seen any uplift in sales from those now? I think you have 32 in action? Also, do you envisage any changes to capex guidance versus the previous guidance of £300 million for Argos over three years? I then have a second question on furniture; were you surprised to see sales declines when the overall market has been growing? I know that furniture market share is hard to come by, but what do you think of your performance versus competitors?

Richard Ashton

On the digital concept stores, we are in a similar position to the one we reported in Q1. The like-for-like sales performance of the digital concept stores tracked roughly in line with the company average in the second quarter, so there is no particular uplift. Going back to the question that we were just asked about internet sales and to John's response, we have not delivered any substantial localised marketing around those stores. We will soon get to a couple of areas of critical mass, one in London and the other outside of London, where we will start to increase the level of local marketing for those stores in order to make people more aware of the changes that are happening.

We are now trading out of 32 digital stores but we only reached that number in the last couple of weeks of the second quarter. Our efforts have been focussed on starting the second tranche of trials. We talked at the FY14 results presentation about opening a further 25 digital concept stores ready for Argos peak trading in FY15, and that has very much been our focus.

On capex, we are not in a position to give any updated information. In terms of capex for the current year, we raised guidance to £200m from £175m at a Group level for FY15 at the FY14 results presentation, of which Argos would take up around £125 million, up from £100m. Part of that increase was around some of these extra digital concept stores and the format trials, which were not included in the original capital expenditure guidance of £300 million we disclosed when we launched the transformation plan. We will start our budgeting process for next year after Christmas peak trading. At that point, we will have a look at the performance of the digital concept stores and decide what we are going to do around capex. As usual, any further guidance on capex will come with our full-year results, once we have completed that planning cycle.

John Walden

On furniture, we were a little surprised at the rate late in the quarter, with furniture seeming to pick up in the market. We did not necessarily get the participation that we would have expected during those few weeks, and we are not sure exactly why. One of the issues may be that, as you may know, we launched our new ranges in July with the new catalogue. In that catalogue was a lot of new product. It was a soft launch of our new home line called Heart of House. We did not specifically market the Heart of House brand until about two to three weeks ago. Part of what may be happening, then, is that customers are not familiar with this new brand and are not sure what to expect. Since they do not see it in a store to touch it, they need to understand a little more about it. That might be a bit of the challenge, but it has only been a few weeks where we have seen the strength, so, hopefully, we will be able to come back on that and see the kind of participation with the market that we would normally expect.

Geoff Ruddell, Morgan Stanley

Can I just ask the obvious question about recent speculation on Homebase? Are you happy with the current Group structure?

John Walden

There are always changes that we can make, and I am sure we will make some. On the question of Homebase in particular, however, let me broaden it a bit. Back in late April, I mentioned that, jumping into the new Chief Executive job, there were three things that I was prioritising:

(1) the transformation of Argos;

(2) short-term peak and other near-term trading at Homebase; and

(3) like any new chief executive would do, taking a look at the strategy and structure and considering the priorities going forward, which I am continuing to do.

At this point in time, nothing has changed in terms of those priorities.

I would tell you a couple of things that I have found. One, which may not be a surprise to you and may be obvious, is that Homebase is a good business, with growth opportunity. With respect to the specific speculation over the summer, we are certainly aware of it. I can tell you that there has been no decision as to divestiture of Homebase, or any other part of the Group, and there is no sale process going on. Should the Group make a decision to make a material change like that, we would tell the market in due course. At this stage, then, there is nothing new to report. In October, when we report our half-year results, I will certainly provide an update on my views of the review, having been at it for a few months.

Geoff Lowery, Redburn

I have two questions. Can you talk a bit more about your expectations around video games and related categories as we go through Christmas and into next year?

Second, can you update us on your views of the sourcing environment? Particularly thinking of the dollar cost, are you seeing any particular new pressures or, indeed, easing on the other side of that?

John Walden

On VGS, you may recall we are anniversarying launches from last year in the third quarter, so there will be an anniversary challenge for us. We are also anniversarying some really big software releases last year. There are some new ones coming out this year as well. We think that there will be challenges because we will be comparing to some good numbers from last year, but we still think positively about the market and about the share that we have been able to earn, so we still expect to see some growth in that business.

Richard Ashton

With respect to sourcing, we will not be talking today about product pricing in the current catalogue, given its commercially sensitive nature, but we are not seeing any noticeable change in the sourcing environment. From an FX perspective, as you will be aware, we have had a slight headwind in FX in the first half this year. We talked about FX being negative for us in the first quarter. It has got closer to neutral in the second quarter, so, in the margin guidance and the margin walks that we talked through a moment ago, there is not a driver of FX in the second quarter.

We would expect, given the currency hedges in place, to start moving into positive FX for the second half of the year. FX will therefore, on a full-year basis, be close to neutral. Where the real benefit on FX will come – and this was expected to be a much bigger benefit until about a week ago prior to the recent weakness in sterling – will be in the first half of the next financial year. Given the current spot rate, which is now back at around $1.60, we will end up close to a neutral position in the second half of FY16.

Closing Comments

Richard Ashton

That just leaves us to thank you all for participating. You will hear from us next on Wednesday 22 October, when we report our half-year results. Thanks for joining us today.