X5 RETAIL GROUP

X5 Retail Group N.V.
Q4 and FY 2019 financial results
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Edited transcript

Speakers:
- Igor Shekhterman, CEO
- Svetlana Demyashkevich, CFO
- Natalia Zagvozdina, Head of Corporate Finance and IR

Participants asking questions:
- Elena Jouronova, J.P. Morgan
- Nikolay Kovalev, VTB Capital
- Sharat Dua, Fiera Capital
- Egor Makeev, Raiffeisen Bank
- Alexey Krivoshapko, Prosperity Capital
- Victor Dima, ATON
- Kirill Panarin, Renaissance Capital
- Artur Galimov, Sova Capital

Natalia Zagvozdina:

Thank you. Good morning and good afternoon, ladies and gentlemen. We apologise for the technical difficulties and long waiting time for everyone trying to connect to this call. On behalf of X5, let me welcome you to the call dedicated to our Q4 and FY 2019 financial results. We would like to remind you that some of the information announced during this call may contain projections and forward-looking statements regarding future events or the future financial performance of X5. You may find our formal disclosure in the press release.

Our financial statements, annual report and updated investor presentation were made public this morning through all the usual means of communication and are also available now on our website. Without further delay, let me pass the floor to X5 CEO Igor Shekhterman.

Igor Shekhterman:

Thank you, Natalia. Good morning and good afternoon, ladies and gentlemen. Thank you for joining our call today. Before we start talking about business matters, I would like to wish you all, your loved ones, your friends and family to stay in good health and keep the good spirits in these turbulent times!

I will begin our call today by concentrating on how we are responding to the current situation with the coronavirus and the global market backdrop that has developed due to low oil prices. I will then highlight very briefly some of X5's main achievements in 2019. After that, our CFO Svetlana Demyashkevich will provide more details about our financials, give some colour on YTD trading and our guidance for the year. Following our presentation, we will take your questions.

Let me start with our observations regarding the last few weeks, and how consumption patterns in Russia have been affected by coronavirus. As of yesterday, Russia officially had over 100 cases of coronavirus. At this time, the authorities have imposed certain international travel restrictions, schools will be closed starting next week, precautionary measures are being taken at clinics, mass public gatherings have been cancelled, and travellers arriving from various destinations have been advised to observe a 14-day self-quarantine. A number of companies, including us, have provided employees with the necessary technical means to work remotely and are encouraging or requiring the staff to do so. Thanks to our earlier focus on digital transformation, we have already managed to shift 70% of all office employees to operate remotely, and we will bring this number to 95% over the next week.

Our business processes are running as normal, although we see some additional pressure on our logistics at the moment. At this time, all of our stores continue to operate their usual hours. However, from the second week of March, we have started to see an increase in stock-up buying by our customers, especially in Moscow. Between 1 March and 18 March, our sales growth significantly accelerated to over 17%. We observe a more aggressive buying of general merchandise and food products in our stores, especially items with long shelf life such as canned meat, vegetables, pasta, and cereals. This trend is even more pronounced in our online operations and is also more visible in Moscow compared to other cities and regions of operation. Our commercial department has built up an extra supply of general merchandise and dry groceries at our 42 warehouses, and right now it is more about the efficiency of our logistics and more frequent stock-ups for stores than about actual availability of the goods, which is not an issue.

We also receive full support from the Federal and Moscow governments, and their assurance that all necessary assistance, including financial, will be provided to food retailers, if any difficulties in ensuring the uninterrupted supply of products to our stores appear in the future.

When a public health issue like the coronavirus arises, online and express delivery channels are in high demand, and X5 is a retailer that offers both. Today, we see a unique opportunity to acquire new customers in our online supermarket and express delivery, and serve the community better. We can also redirect our investments into express delivery and add stores that offer this service at a faster pace. Thanks to our significant investment in our online platform and delivery infrastructure last year, we are now able to handle the increase in demand for these services.

The average number of Perekrestok.ru orders placed per day on the weekend of 14–15 March, jumped more than 90% compared to the previous week and exceeded 13,000. Delivery time therefore increased from same or next-day delivery to delivery in four to five days, as we are operating at full capacity and delivering over 8,000 orders per day. Over the last weekend, the average check in online increased significantly, to nearly RUB 6,000 for newly placed orders, which is 50% above the average check we had in December. We also see an increase in the number of SKUs per order by 1.3 items to 55 items, which is clearly related to a stock-up caused by growing coronavirus concerns. On the weekend of 14–15 March, we have also seen a 2.5 times revenue increase at Perekrestok.ru for placed orders, compared with the two previous weekends.

Our express delivery service is currently available from 50 Pyaterochka stores in Moscow, which cover 40% of households in a 2.5 km radius. Next week, we will be launching this service in Kazan. Our average check for express delivery was around RUB 1,500 in February and jumped to nearly RUB 2,000 over the last few days. By the end of this year, this service should be available from more than 200 stores, fully covering Moscow and six additional cities. If the negative coronavirus situation develops in Russia, we may increase the number of stores with an express delivery option to nearly 300 locations.

We remind you that Russia has 100% self-sufficiency in domestically produced grain, sugar, various cereals, poultry, pork, dairy products, eggs, fresh vegetables from greenhouses, sunflower and other vegetable oils. In this respect, the country will benefit from the import substitution trend of the past decade. As Russia's largest food retailer with our own direct import operations, X5 should be able to secure alternative supplies at the best prices in the market given the scale of our operations to provide our customer with affordably priced products.

Let me summarise this part of my speech by providing the list of measures we are undertaking at X5 to better deal with the coronavirus situation:

- X5 has created a working group responsible for coordinating all business activities until the situation is fully back to normal
- We have increased delivery volume by 2–4 times for high demand categories from our DCs to our stores in order to meet the increased demand
- I already said that we currently have no shortage of high demand goods, and we aim to increase our DC level inventories for the period of high demand
- We have reallocated some of our truck fleet from the regions to Moscow, including the drivers, to satisfy the need to replenish stores more frequently with increasing volume of goods as well as to provide our online operations with additional delivery capacities
- In stores, we have changed the display for high demand categories, making them more readily accessible right from the pallets
- We have increased the number of people working in stores, changed their schedules, including cancelling all vacations for retail operations personnel
- All cashier desks in our stores operate at all times to minimise customer waiting time
- Our store workers are provided with disposable gloves and disinfectants. We expect to supply all of our store personnel with disposable masks later this week
- Every three hours, we disinfect high frequency items such as door handles, trolley handles in all of our stores
- We feel well prepared to support our customers and ensure the availability of goods in our stores stays at normal level at all times.

Before I move on to X5's 2019 results, I want to briefly touch on the main market trends we saw last year.

- We continued to see a negative impact on sale densities across the market from the fast rollout of stores by the main players. Last year, Russia's top seven retailers expanded their combined selling space by 10% in Moscow and the Moscow Region, and by 15% in other regions.
- Specialist retailers continue to grow at rates above the market average.
- Promo activity remained elevated, which limited private label growth across the market.
- The average check declined by 1.2% last year across modern food retail chains, impacted by stagnating per capita income and by shifting consumption patterns towards day-to-day fresh purchases.
- The ready-to-eat segment, although still small, was growing 5 times faster than the offline food retail segment.
- The online food retail segment increased by 70% in 2019 to RUB 45 bn, compared with a 7% growth in the offline food retail segment. Last year, we saw the entrance of such players as Yandex and Sberbank into this market, with offers of new digital distribution models. We expect that between now and 2023, the Russian online food market will expand by 10 times.

Now I want to summarise our key achievements of the last year.

- We maintained leadership in revenue and LFL growth compared to our main peers. As a result, our food retail market share grew to 11.5% from 10.7% a year ago.
- The number of active members of our loyalty cards programmes increased by 8% to 40 mln. We currently generate more than 7 mln data points on a daily basis from our loyalty programmes.
- We started to focus more on customer feedback as a tool to define our assortment, especially for new private label products that we introduce. We already collect several million customer ratings on a monthly basis. By the end of this year, we should be receiving up to 10 mln customer ratings on a daily basis.
- We have succeeded in making X5 a more attractive employer, which is a key strategic advantage for a retailer. Personnel turnover decreased by 20 pp over the year to below 50% and we saw label productivity increase by 6.9% y-o-y.
- We decided to transform the X5 hypermarket format. This will enable us to focus on those segments of the food retail market where we see the most potential. It put some short-term pressure on our financial results, but we are confident that it is the right decision for our long-term strategic goals.

- We are successfully developing new businesses.
    - Last year, Perekrestok.ru became the #2 player in e-grocery. This was achieved in less than two years, and our online revenue increased 3.3 times in 2019. We aim to make this business EBITDA-positive in 2021.
    - Our parcel delivery business 5Post was established as a separate business unit. 5Post leverages X5's existing logistics and store infrastructure. 5Post and parcel lockers operated by our partners are currently delivering around 1 mln parcels per month for pickup in X5 stores, which is helping to bring additional traffic to our stores. Just like our Perekrestok.ru business, we aim for 5Post to have positive EBITDA in 2021.
    - We also launched express delivery from our network of proximity stores in Moscow, and next week we will be launching it in Kazan. In addition to the short-term factors driving demand right now, we see growing demand for this service from our customers as they adapt to new technologies and competitive offers from technology players like Yandex and Samokat.
- In December 2019, our first sustainability strategy for 2020–2022 was approved. This strategy establishes measurable sustainability targets, which will be integrated in our overall business strategy.

To conclude, let me highlight our priorities.

- In 2020, we will be working on maintaining our market leadership while keeping the margins at a healthy level.
- Given the recent developments related to the coronavirus, we have established working groups, assessed key operating risk areas, and developed emergency plans for our operations to provide a sustainable service to our customers.
- In parallel, we will continue rapid expansion of our online and express delivery services. At Perekrestok.ru, we see not only a more than 2 times business growth in 2020 but also a higher share of new clients, which is currently rapidly growing due to the coronavirus situation. In June, we will be starting Perekrestok.ru online sales in Nizhny Novgorod, where we will be using a former Karusel hypermarket as a dark store. In Moscow, we will have four dark stores for Perekrestok.ru by the end of the current year. We apply strict return and cash generation requirements for new businesses, and the management has a ROI targets to ensure a balance between investments and returns.
- A key area of improvement of our existing business in the coming years will be the rollout of the new Pyaterochka and Perekrestok concepts, including additional refurbishments. Given the recent adverse movement in the rouble exchange rate and possible delays with supplies of equipment or input parts from China and other destinations, we will be looking

to renegotiate FX-linked capex contracts or will consider postponing such investments if necessary.

Now I would like to hand over to X5 CFO Svetlana Demyashkevich. Thank you for your attention.

Svetlana Demyashkevich:

Thank you, Igor. Good morning and good afternoon, ladies and gentlemen. Let me start by adding some colour to Igor's recap of the current environment. I will start by saying that internally our processes and our finance function are well prepared to face potential challenges that the current situation related to the coronavirus may cause. In addition, we have been offered full government support, as Russian authorities want to ensure that food supply is uninterrupted across the retail industry and X5 as the sector leader is considered a strategically important company during this period. Currently, all of our operations are running normally, except that we are witnessing increased pressure on our logistics and store replenishment operations due to increased demand for certain goods. Igor has already discussed additional measures being taken regarding high demand categories.

Talking about the macro environment, lower oil prices caused adverse exchange rate fluctuations and a higher cost of funding. However, X5 is well-placed to withstand the macro headwinds, as we have a natural hedge against the weak domestic currency via high food inflation and also because 100% of our borrowings are rouble-denominated. Less than 2% of operating costs and less than 20% of capex are FX-linked. Budgeted FX capex is mostly for new stores and DC equipment, electronic price tags, some spare parts for our transport and IT infrastructure, as well as software. We make 4.3% of our food purchases via direct imports, while the largest purchasing volumes for most food products are from domestic suppliers, and we should be able to get the best terms in a volatile market. Secondly, I would like to point out that we are also well-placed financially in the current situation as in anticipation of the potential negative macro changes we managed to secure sizable amounts of new long-term funding at a very attractive rate just before the oil price situation developed.

It is currently difficult to estimate the potential impact of the coronavirus and macro situation on our absolute annual EBITDA, as the situation is changing very rapidly. Internally, we have looked at several main scenarios regarding the oil price, rouble exchange rate, and inflation in order to assess the potential impact on our operations and our future financial results. Our initial budget for 2020 had the oil price of USD 50 per barrel and 65 RUB/USD exchange rate, headline CPI of 3%, food inflation of 2.8%, and nominal food retail trade growth of 5.5%. In our negative macro scenario, the oil price is USD 30 per barrel (annual average), the RUB/USD exchange rate is 75, headline inflation is 4.4%, and food inflation is 5.3%. In this scenario, X5 remains profitable and continues expanding and investing, although the pace of investment may be reconsidered and float. We will be looking to prioritise capex projects. We will concentrate even more on efficiency of our operations in order to provide our customers with uninterrupted food supplies. At the time, retailers as well as domestic food producers will likely receive government support during the whole period.

On the macro topic, let me remind you that in 2014 and 2015, when Russia went through a period of a significant increase in key rates and extreme rouble exchange rate volatility, large retailers with significant operating efficiencies were able to maintain better performance through such periods compared to their smaller peers.

Now I would like to highlight the main market trends observed in Q4 2019. Food inflation for this period continued to slow and averaged around 3.5% y-o-y. The key factor driving this slowdown was the early and plentiful harvest of 2019 on the back of warm weather conditions. Demand for food products continued on the positive trend and reached +1.6% in real terms in Q4 2019. Real disposable income also continued to grow at 1.1%, and consumer confidence over Q4 2019 improved. Against this improving macro background, the food retail industry continued to consolidate, and the share of the top 5 retailers was 26% at the end of 2019.

Now a few words about X5's financial performance in Q4 and FY 2019. Trading was not easy over the last quarter as competition and hypermarkets increased promo activity. We did the same and were successful in not only keeping positive LFL traffic in our stores, but delivering the highest LFL growth rate among our largest competitors.

The gross profit margin in Q4 2019 declined slightly, driven by commercial margin as a result of targeted price investments. This was partially offset by successful measures to decrease shrinkage. Our efforts to further reduce shrinkage will continue, but the impact on our gross margin will not be as visible as in 2019. This is primarily because the CVP update for our core formats will increase the share of the fresh category, which has the highest shrinkage level among all categories. We will aim to mitigate the structural change with higher efficiency in our assortment planning, product quality tracking, marketing and logistics.

SG&A expenses were well under control in the last quarter. Our adjusted EBITDA margin for Q4 2019 was in line with our expectations, at 6.7%. For the full year, our adjusted EBITDA margin grew in line with our internal target, by 11 bps y-o-y to 7.3%. This improvement was achieved due to our operational improvements, including measures that brought shrinkage down by 49 bps and despite pricing pressure in the market. In Q4 2019, we achieved a sustainable gap in EV/EBITDA leadership over other listed peers and started to prepare for the second part of our LTI.

Depreciation, amortisation and impairment costs increased as a percentage of revenue, mainly due to impairment of non-current assets related to the Karusel transformation. Net profit in 2019 under IAS 17 was impacted by a combination of one-off items – one related to the Karusel transformation and the other related to tax accruals for previous periods, including reorganisation of certain X5 legal entities. The impact on our net profit from these two items was almost equal for Q4 2019, while for the full year about 75% of the impact was due to Karusel transformation and 25% was due to taxes and X5 reorganisation. Our financial leverage remained healthy, at 1.7x under IAS 17, and we want to maintain this ratio below 1.8x.

Net cash flow generated in Q4 2019 from operating activities was lower than a year ago mainly due to a smaller increase in accounts payable, due to the calendarisation effect and also a larger change in inventories as a result of low base effect due to stock optimisation last year.

Approximately 49% of the quarterly capex went to expansion of our store base. The remaining capex included refurbishments (9%), logistics (7%), IT (8%), maintenance (14%), and other investments (ca. 13%). Total capex in 2019 decreased by 3% y-o-y to RUB 81 bn.

Based on our solid financial results for the year, the Supervisory Board recommended a dividend of RUB 30 bn for 2019. This is 20% higher than in 2018 in rouble terms and represents an 82% payout ratio based on the adjusted net profit for the year.

Finally, I will give you a short update of the YTD results before we go to the Q&A session. Our net retail sales growth YTD (excluding VAT) is 14.6%. LFL sales rose by 4%, driven predominantly by traffic. Turnover in Perekrestok.ru is up 2.3 times y-o-y. As Igor said, in the first 18 days of March, net retail sales growth accelerated to 17.2%, from 13.3% in the first two months of the year. This may accelerate further given the trading trends of the last several days. Originally, we planned to open up to 2,000 new stores in proximity and supermarkets this year, before closings. In addition, we planned to refurbish 1,300 Pyaterochka stores and 30 Perekrestok supermarkets to update them to the new concept. However, the situation has changed due to increased uncertainty regarding overall consumption in this turbulent year. Moreover, our stores are currently seeing an increased inflow of customers and closing them for renovation would not be timely. In addition to that, part of capex is FX-linked. Therefore, we may have to slow down the pace of openings, and especially renovations, until the demand in our stores normalises and we find ways to either renegotiate with suppliers or find alternative solutions in order to preserve healthy investment returns.

Our EBITDA margin performance in 2020 will reflect food inflation trends, which are difficult to predict at the moment. We will continue to benefit from our market leading positions, our purchasing power, and of course from our leadership in infrastructure. Our constant focus on efficiency of operations and the use of new digital solutions should provide support to our margins, while the recent increase in the inflow of customers to our stores, as well as to online and express delivery operations are also supportive for the short-term margins outlook.

We guided you at the Investor Day that 2020 capex may grow in line with the pace of our revenue growth. However, subject to changes in the environment, we will be carefully considering and prioritising every investment project in order to preserve the required returns.

I will conclude by saying that our constant focus on the efficiency of our operations and capital allocation discipline should support our annual dividend payments, which we expect to grow steadily. With that, I conclude the discussion of our results, thank you for your attention and we welcome your questions.

Operator:

Ladies and gentlemen, we will now begin our Q&A session. As a reminder, if you wish to ask a question, please press "*1" and wait for your name to be announced. If you wish to cancel the request, please press "#".Once again, it is "*1" if you have questions. We have a question coming from the line of Elena Jouronova, please ask your question.

Elena Jouronova:

Hi, ladies and gentlemen, I have a few questions. The first one is regarding your different economic scenarios for this year. I appreciate that it is tough to tell right now, but still – have you analysed, under the base case scenario, how could your dividend payment change? What would be the worst case for this year?

Svetlana Demyashkevich:

As I said, the dividend for 2019 in the amount of RUB 30 bn is proposed already and subject to approval by the General Meeting of Shareholders. Of course it is hard to say anything about the dividend payment for 2020, as you understand perfectly. We do have several scenarios internally, but honestly, they are changing every day, so we are in a very agile mode. I think we will be ready to discuss potential dividend payments closer to our Capital Markets Day in October, and we will give you some guidance. At the same time, our intentions still stay to keep our debt/EBITDA ratio at around 1.8x and keep growing dividend payments steadily.

Elena Jouronova:

OK, thank you. Another question I had was regarding the refurbishments of Pyaterochka stores. Can you share with us please the latest data on what kind of average uplift in sales you are seeing after the refurbishment, and how many stores you have refurbished?

Svetlana Demyashkevich:

At the moment, we are quite happy with the results of our refurbished stores, and we do have pilots going on already both in Moscow and in the regions. The average uplift in traffic is around 10%, and we still continue to look at the situation depending on the region and we are also quite happy that the NPS is increasing together with refurbishments, and we can clearly see this difference.

Elena Jouronova:

And how many stores were refurbished altogether?

Svetlana Demyashkevich:

More than 420 stores, and we continue to add them every day.

Igor Shekhterman:

Not refurbished, but openings plus refurbishments. Around 400 stores are opened or refurbished in new concept, and we did it in practically all regions of Russia, in big and small cities, and we have four different concepts that we adapt to the big cities or small towns. Again, we are quite happy with the result.

Elena Jouronova:

And are you happy with EBITDA that you are seeing in the stores? Because on the one hand we see higher NPS and higher revenue, but on the other hand there is an increase in the fresh category and shrinkage. Overall, are these refurbishments proving to be EBITDA-accretive?

Igor Shekhterman:

I can give you the following comments. As you understand, the main driver of EBITDA is also the sales density, and it is very high. Speaking of stores opening in the new concept in Moscow, I can tell you that their EBITDA is higher than in stores we have in the old concept.

Elena Jouronova:

OK, that is good to know. Now I would like to ask a few technical questions to Svetlana. A lot of impairment is coming from Karusel, and frankly some of them missed my forecast. Can you help us better forecast 2020? What sort of impairment should we assume in opex, like part of depreciation? And how much in income tax? Can you guide us – how should we think about impairment for 2020?

Svetlana Demyashkevich:

Let me start with tax. Overall, one of the tax effects that we see in 2019 is around RUB 5.5 bn, split in two halves: the effect of the Karusel transformation and tax effects of previous periods related to the reorganisation of our legal structure. In terms of Karusel, I do not think that we expect a further significant tax effect. In terms of impairment, it will depend also on the pace of transfers of stores and closures of stores within the transformation. There will be some additional impairment during 2020, and it will also depend on this pace. At the moment, we see very positive results of transformation of old Karusel stores into Perekrestoks, and that of course increases our profitability. A lot of effect caused by liquidations of non-performing stores is already included and accrued in 2019. I think we will disclose these effects transparently in each quarter, but there will be some effect in 2020 from this transformation, as we guided in September and October last year when we talked about the transformation.

Elena Jouronova:

OK, thank you. The final technical question from me is on working capital. I have read and heard from you right now the explanation why you had working capital outflow in general for 2019. But again, that was quite surprising. I want to make sure that going forward you still expect to have broadly the same working capital turnover and no more cash outflows from working capital overall this year. There is nothing going on in terms of paying faster to suppliers or offering better discounts, nothing like that, right? It was purely the calendarisation effect that impacted your payments, is that correct?

Svetlana Demyashkevich:

Yes, you are right that the biggest impact was from calendarisation, and we will not see that effect in 2020. Another effect, which is much smaller, but we will probably see it going further, is our more efficient way of paying to suppliers, which also improves our payment discipline and actually has a positive effect on our supplier relationships and our overall terms with suppliers. I view it as a positive factor. Other than that, we do not expect any significant adverse movements during this year.

Natalia Zagvozdina:

Dear colleagues on this call, could we please ask you to limit yourselves to two questions in each go, so that others can ask questions as well. Thank you.

Operator: Our next question comes from Sharat Dua, Fiera Capital, please ask your question.

Sharat Dua:

Good afternoon, everyone. Thank you very much for the explanation at the beginning of the call about some of the issues related to the virus. I just wanted to make sure I have fully understood a couple of those. You are saying that your stores are operating as normal, but there are some shortages and it is an issue for the DCs and logistics to sort out. If you could just help me understand, what that actually means and how soon you expect to get back to normal stock levels in the stores. What do you need to do to achieve that? Further to that, you have mentioned potentially getting some funding from the federal government. What might that be used for? What sort of conditions will be for such funding? And in relation to the stock that you keep, you mentioned that Russia is self-sufficient in a number of core food items, but you also do import certain products. Can you give us a breakdown of what you source locally versus import? And what are your prospects of maintaining the imports, given that this is a global issue? Thank you.

Svetlana Demyashkevich:

Thank you for your question. Our stores keep operating under their regular hours and logistic operations also continue as normal. We do feel some pressure in terms of replenishment, logistics and traffic in our stores because of the increased demand, which is natural as people prepare for a potential quarantine. At the same time, we are quite confident in our supply as we had started to prepare for this situation several weeks before it evolved, looking at how things develop in Europe. We are quite confident that we will be able to ensure uninterrupted supply of products to our stores and that the stores will be operating as normal.

In terms of imports and local supply...

Igor Shekhterman:

...we have already mentioned that most of the products are available in Russia. In terms of vegetables, we have a solid supply from Russian greenhouses. We have import components in the fruit and vegetable categories, but at the moment we do not see any problems here and our direct imports are made in line with the plan.

Regarding your question about the support from the federal government, we are still at the negotiation stage and discussing potential options.

Svetlana Demyashkevich:

I would just like to add that in 2014–2015, we saw the government support agricultural producers, which actually boosted substitution of local products. We can potentially expect similar support to be extended to strategically important retailers, but it is too early to say anything about it, because we have just started these discussions this week.

Natalia Zagvozdina:

The largest part of all direct import comes from Ecuador (about 30%) and it is bananas. Then follows Turkey with 16%, and Serbia with 9%. The items that we procure from them, apart from bananas, are garlic, ginger, bell peppers, broccoli, and greens – the list is as usual. Among imported items are also, quite naturally, olive oil, wine, certain exotic fruit, and salmon. In the protein category, salmon is the only large imported item for the market overall. We will re-arrange the import of this item or replace it with similar products for the period of supply pressure.

Sharat Dua:

What about branded products from international brands?

Natalia Zagvozdina:

International brands are sourced domestically. Henkel, Coca Cola, Pepsi, Danone, Unilever – all these companies have production sites in Russia, and all their products come from local factories, not from overseas.

Sharat Dua:

OK. Sorry, I did not get the second answer. Ecuador is No. 1 in bananas, which other countries did you mention?

Natalia Zagvozdina:

Turkey – 16%, Serbia – 9%, Belarus – 8%, Israel – 5%, China – 5%, and other countries with smaller shares in the direct import. The overall share of our own direct import is 4.3%, so it is not that significant in terms of influence on our operations or our FX exposure.

Sharat Dua:

4.3% of total sales?

Natalia Zagvozdina:

Yes.

Sharat Dua:

OK, thank you.

Operator:

Thank you for your questions. Our next question comes from the line of Nikolay Kovalev, VTB Capital, please go ahead.

Nikolay Kovalev:

Hello, I have two questions – one on tax accruals and the second one on capex. So half of RUB 5.5 bn has already been booked. Can you tell us a bit more for which year it has been accounted for and shall we anticipate more accruals in the future? And if so, how much? And on capex, I have a follow-up question. If you go for up to 2,000 openings and 1,300 refurbishments, what will your capex be in the base case, and what level per store do you budget for your convenience and supermarket refurbishments? Thanks.

Svetlana Demyashkevich:

Regarding tax accruals, the recent accrual that you see in the financials represents the calculation of probabilities of potential tax charges for several years when we had these transactions in our structure, before the final reorganisation of the legal entities. Whether we will see further accruals or not will depend on the tax authorities' view on these transactions and the outcome of the ongoing legal cases. At the moment, all the probabilities are accounted for and accrued in our financials, which are also confirmed by the external auditor. I think we are trying to be very conservative in that respect.

The other question was about capex. As I have said, in our initial budget – with new store openings, refurbishments of both Pyaterochka and Perekrestok stores in line with the new concepts, and our investments in new technology, new businesses, like Perekrestok.ru, 5Post delivery, etc. – we expected that our capex would grow. At the same time, given the changing environment, we will be considering all lines of capex very carefully and reprioritising all projects. Of course, the main focus of this reprioritisation will be on new openings – we will see how demand evolves – and refurbishments, because it will not be sensible now, amid high demand, to close stores for refurbishment. Probably, we will postpone these activities at least in the cities where we see the situation develop. At the same time, we believe that we still need to invest in technology to be prepared for further challenges. We see that the economy is evolving and changing. For example, thanks to our developments in recent years we are now in a position to have 95% of office employees work from home starting next week. This is not the case for most Russian companies, and we are quite ahead of the game in that respect.

Igor Shekhterman:

I am sure that the current situation will drive the next wave of changes in customer behaviour and we are happy that we invested heavily in digital transformation last year, which enables us to build an IT platform and a strong base. Today, we can roll out our express delivery and online operations very quickly. We are now reconsidering our priorities and will invest enough to proceed with our digital transformation this year.

Svetlana Demyashkevich:

Regarding your question about the new concept and capex for refurbished Pyaterochka stores – on average, we see capex around 15% higher than in the old stores. At the same time, in terms of ROI, we do expect that returns will not be decreasing, as we see much higher sales density and traffic in the stores. Weighing up all factors together, we think that we have very successful results from the piloting of our new concept.

Igor Shekhterman:

And something we have already mentioned, regarding express delivery. Next week we are launching it in a new region, Kazan, on the basis of a dark store. If it goes successfully, we will roll it out across other Russian cities. We also plan to start the rollout of express delivery in St Petersburg before mid-May.

Svetlana Demyashkevich:

I think it is very important to understand our new model of express delivery. At the moment, it is available from Pyaterochka, and we will start express delivery from Perekrestok in the coming months. It is a highly scalable model because it does not require any additional capex. We just have a platform which is potentially scalable across all our 16,000 stores. At the same time, we only need 130 stores to cover Moscow, and we will have this number of stores open for express delivery by the end of May. The project roll-out might even be accelerated given the ongoing situation. We are happy that we started piloting this model last year, and we think that it will help us better serve our fellow citizens in the current environment.

Operator:

Thank you. The next question comes from the line of Egor Makeev, Raiffeisen Bank.

Egor Makeev:

Good afternoon. I have a couple of questions. My first question is, what impact on your margins and particularly gross margin do you anticipate from the current surge in sales?

Svetlana Demyashkevich:

Of course, the current situation has a positive impact on gross margin as it increases our LFL sales and sales densities quite significantly, but it is very early to project how the demand will evolve in the upcoming months. We are trying to be quite conservative with such projections and are certainly committed to transparent communication with you on these matters in the next quarters.

Egor Makeev:

OK, thank you. Just to clarify. The sales mix right now is far from normal, I suppose. So the gross margin on this sales mix is either in line with or better than the usual one. Is that correct?

Svetlana Demyashkevich:

We have not seen any adverse impact on the gross margin so far, but the situation is changing every day and we are monitoring it closely. I think food retailers and X5 as the leader in the food retail industry and its mass segment are well positioned as compared to most players and industries in Russia.

Egor Makeev:

OK, thank you. My second question is, do you consider entering new formats, for instance, hard discounters? Or is it off the table at the moment?

Igor Shekhterman:

We are always considering new opportunities and interesting business options. In the recent years, we have looked to see if the market is ready and prepared for hard discounters. There are two main components of a hard discounter – high quality and a high share of private labels, so it should be a very efficient model. We are currently piloting a hard discounter and in December will make a decision on potential opening of a hard discounter stores next year.

Egor Makeev:

OK, that is clear, thank you.

Operator:

Thank you. The next question comes from the line of Alexey Krivoshapko, Prosperity, please ask your question.

Alexey Krivoshapko:

Good afternoon, thank you very much for the call, explanations and a very detailed annual report. I have just one question. Can you help us better understand the evolution of your gross margin last year? We understand that losses were gradually declining. At the same time, the gross margin after these losses, has been slipping down from higher (maybe not so high) levels of Q2 2019 towards the year end. And this also happened despite the fact that you have a smaller share of hypermarkets in the business. What was your commercial policy? Why did you do these price investments? Who were you targeting and how do you measure the results?

Svetlana Demyashkevich:

It is quite a complex question. I will start with how gross margin was evolving in 2019. As you remember, there were higher expectations in 1H 2019, so having the annual budget and annual management of our overall result and being happy with overall EBITDA margin above 7%, as we usually communicate, we were able to invest in prices and respond to the competition evolving in the market in Q3–Q4 2019. Overall, we are quite happy with the performance of our gross margin, including commercial margin and very positive shrinkage-related impact last year.

With regard to this year, again, we should comment separately on the normal environment that we budgeted for at the end of last year. In that respect, I would say that we do not expect significant changes in our gross margin. Overall, our budgeted EBITDA margin was only affected by one-off effects of the Karusel transformation.

At the same time, what affected overall results in our budget for 2020 was the expectation of lower inflation in 2020 compared to 2019. Now it is very hard to project what food and overall inflation will be in 2020. I think we will need to build our scenarios and get a better understanding of our expectations closer to the end of April. In the meantime, we will monitor the situation as it unfolds.

In respect of shrinkages, I think we went down from the levels above the market, which we faced at the end of 2017 and 2018, to the quite improved levels we see in Pyaterochka and Perekrestok now. So, we do not expect further any significant decrease, but of course we will be working on improving them further as we have set quite ambitious targets for our formats.

Operator:

Thank you for your question. The next question comes from the line of Victor Dima. Please ask your question.

Victor Dima:

Hello. Thank you very much for taking your time to answer questions. Maybe I have missed it, but given the high demand that you are seeing in March and going into the Q2 2020, do you expect a much more depressed level of LFL growth as the situation calms down? If so, what would be the normalised level? That is my first question. And the second one, I assume that I understand it correctly that the online format can break even in 2021. What would be the key drivers for that in terms of unit economics? Could you give us two or three of them? Thank you.

Igor Shekhterman:

I can start with the second question. We already have positive unit economics for some DCs and dark stores that serve Perekrestok.ru.

Svetlana Demyashkevich:

I think we have communicated from the very beginning that we expect all our new businesses, including express delivery, online operations, and 5Post (our logistics operator), to achieve positive profitability in the medium term. As a company, we are not ready to keep investing over endless periods. At the same time, we are quite happy with the pace of their growth. For example, Perekrestok.ru grew by 3.3x during 2019 operating in the normal course of business. So, yes, we do expect that our online format will turn profitable in 2021, and the drivers for that will be positive unit economics of dark stores coupled with increasing density of deliveries and an increasing average check. We do see both trends as expected, and we are quite happy with the dynamics seen both in 2019 and in the beginning of 2020. Perekrestok.ru demonstrated strong results even before the coronavirus outbreak: in January and February, average check and the number of orders were steadily growing in line with the budget targets.

As for your first question, I think that as a food retailer operating mostly proximity stores, we will still see continued demand. Even after people make supplies in the current turbulent situation, they will still continue to eat. So, I do not expect that our operations will see a massive impact. Of course, it is hard to say, as it is not a usual situation for us. We will see how the situation evolves and will keep you updated. In April, we will have a results call for Q1 2020. By that time, I think we will have a better understanding of the trends and the situation, and, of course, we will be ready to share that.

Victor Dima:

Thank you.

Operator:

Thank you for your question. The next question comes from the line of Kirill Panarin, Renaissance Capital. Please ask your question.

Kirill Panarin:

Hi everyone. Thank you for taking my questions, I have two of them. First, you have talked about direct imports. Could you also tell us about the imported products that you get from distributors? What is the share in sales for those? And the second question is about the different scenarios you have talked about. Can you elaborate on your margin expectations in the bear case scenario? Would it still be maintaining margin levels at roughly about 7%? And what would be the drivers vs the base case, if you think they be different in the bear case scenario? Thank you.

Svetlana Demyashkevich:

The share of our direct imports is 4.3%. It is hard for us to estimate the share that is coming through distributors, as we usually buy from the internal market and mostly in roubles. I think it is around 15%. We still do not think that it will have a massive impact on our supplies. Of course, this share significantly decreased after the situation we had in 2014 and 2015. Now, we are quite confident in terms of supply. I can assure you that all major socially important SKUs are produced locally. We are sure that we will have enough of these supplies.

The second question was about how the EBITDA margin will evolve. As I have said, in the normal course of business scenario assumed in our budget as at the end of 2019, we did not expect massive adverse impacts on our EBITDA margin apart from some one-off effect of the Karusel transformation. As discussed back in September and October, the decision to transform our hypermarket format is strategically important for us, and we believe that in the long run, it will enable us to increase our margins structurally. We already see that our Karusel stores transformed to the Perekrestok format are doing better in terms of ROI and the EBITDA margin.

Kirill Panarin:

Just to clarify, apart from Karusel, if we talk about adjusted EBITDA margins, there should not be a material change in your profitability profile due to the weaker rouble, lower oil price, and potentially higher food inflation this year. Is that correct?

Svetlana Demyashkevich:

I was talking about the normal course of business, which was budgeted for and expected by us at the end of last year and the beginning of this year. As I have said earlier it is very hard to forecast how the current changes in the macro environment and consumption will influence the margins going forward. The first priority for us would be to ensure uninterrupted product supply to the population and to secure our position as a food provider for people. I hope that it will not significantly influence our margins. So far, we have even seen some positive impact.

Kirill Panarin:

OK, that is great. Thank you for your comments.

Operator:

Thank you. Our next question comes from the line of Artur Galimov, Sova Capital. Please ask your question.

Artur Galimov:

Good afternoon. Thank you for the call. Just a small follow-up question on the chain expansion and capex this year. Svetlana, you have given us two clear scenarios for the macro situation development in terms of exchange rates and oil prices. So, assuming that things will remain as they currently are, with RUB 80 per dollar and oil prices around USD 25, what would roughly be the decrease of your capex in store openings? You have not specified the exact number, but maybe you could give us an idea of the scale of the reduction in store openings that you would go for under this scenario this year?

Svetlana Demyashkevich:

This is a very good question. We are thinking about it internally and it is just too early to say now. I suppose we will have more understanding and decisions made internally by the end of April when we have our call for Q1 2020. So far, the expectations are that the pace of renovations will probably slow down and the first reason for that is that we do not want to close the stores amid higher demand seen at the moment. Other than that, we will monitor the situation. On the positive side, we will probably have more opportunities in terms of rental options. On top of that, as the market leader with the highest efficiency levels, infrastructure and financial resources, we will also have more opportunities for consolidation. At the same time, there are some negative factors related to some FX-linked capex for equipment. For us it is also a question of assessing demand and household income levels in the medium and long term this year. We will work on that and as soon as we have the answer, we will share it with you.

Artur Galimov:

To make it clear, your decision will largely depend on the estimated impact of current developments on your ROI from new openings, right? If ROI can be lower, some downgrade decisions could be made despite your previous comments that EBITDA margin should not be largely affected by external factors other than the Karusel transformation.

Svetlana Demyashkevich:

There are a lot of variables in the equation now. However, we still have our internal requirements in place for investments and IRR levels when we make our investment decisions. You are completely right that we will not make any unreasonable investment decisions. All our internal requirements still apply. If we do not see an opportunity for securing acceptable returns on these new stores, we will decrease our appetite.

Artur Galimov:

OK. Thank you very much and good luck this year.

Svetlana Demyashkevich:

Thank you.

Operator:

There are no more questions on the line. Please continue.

Natalia Zagvozdina:

Ladies and gentlemen, thank you for your interest in our company and your participation in the call today. Please stay well. We wish you luck and all the best. Thank you. Goodbye.