X5 Retail Group N.V.
Q1 2020 financial results
Conference call held on 24 April 2020
Edited transcript

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

Participants asking questions:
- Nikolay Kovalev, VTB Capital
- Kirill Panarin, Renaissance Capital
- Elena Jouronova, J.P. Morgan
- Maxim Nekrasov, Goldman Sachs
- Marat Ibragimov, Gazprombank
- Alexey Krivoshapko, Prosperity Capital

Natalia Zagvozdina:

Good morning and good afternoon, ladies and gentlemen. Welcome to X5 Retail Group conference call dedicated to our first quarter 2020 financial results released this morning.

As we proceed with reporting on the two standards, you'll find IFRS 16 as well as IAS 17 numbers in our release. I'd like to remind you that some of the information announced during this call may contain projections and forward-looking statements regarding future events or future financial performance of X5, so please refer to page 8 of our results release for a full formal disclaimer with regards to such statements. We disclosed the press release as well as financial statements this morning. You can find them now on our website in the Investor Relations section. Without any further delay, let me pass the floor to X5's CEO, Igor Shekhterman.

Igor Shekhterman:

Thank you, Natalia. Good morning and good afternoon, ladies and gentlemen. Thank you for joining us today for our call today. I hope that you, your family and friends are safe and sound.

I would like to begin with an update on X5’s operations during the last few months and how we are responding to the COVID-19 situation. After that, our CFO, Svetlana Demyashkevich, will provide more details about our results and give some color on year-to-date trading and changes in our investment program. Following our presentations, we will be happy to take your questions.

Let me start with a brief overview of new regulatory requirements and our key areas of focus during the COVID-19 situation. At X5, we are working hard to ensure that our business continues to successfully fulfil its critical role for society while also protecting our employees and customers, especially those who are potentially more vulnerable to the effects of this virus. Number of new COVID cases in Russia continues to increase and official estimates suggest that it may peak in late April or early May.

A nationwide self-isolation requirement was introduced in Russia on March 28 and it will last until April 30, though this is widely expected to be extended. Moscow was placed under full lockdown on April 13th. On the back of these events, we had to deal with stock-up buying by our customers in the last two weeks of March. After the initial stock-up period, we began to see less frequent customer visits to stores, but a much larger basket. This was the result of consumers' response as the self-isolation regime progressed in April. We also see that our proximity stores are demonstrating higher LFL revenue in April, benefitting from their convenient locations. Our express delivery and online operations are seeing the record-high demand. I will talk about this in more detail later.

The current restrictions on people's mobility aim to prevent the spread of the virus. At the same time, grocery stores and pharmacies across the country remain open, along with health care institutions and a few other government sectors.

On April 15th, Moscow and a number of other regions introduced a digital pass system for residents and private cars. However, visiting a local grocery store or pharmacy by foot does not require a pass. The new system requires companies, including X5, to issue special passes for the lockdown period for store personnel, drivers, as well as key office workers. We have had no problems getting the required passes for our employees as we were prepared in advance.

Given the recent developments and new regulations, we have established working groups, assessed key operating risks areas and developed emergency plans for our operations to provide sustainable service to our customers.

We are in a constant and constructive dialogue with the authorities. Thanks to the active participation of the Ministry of Industry and Trade of Russia, as well as the Moscow Department of Trade, we have been able to develop a measures designed to help retailers adapt to the challenges. We have jointly set up a system of emergency think-tanks with state bodies at the federal and regional levels. This has enabled us to quickly address emerging problems and find solutions.

Today, the key priority for X5 is to provide a safe environment for our customers and employees, expand our digital solutions and maintain the efficient operations of our supply chain. These three elements will ensure that our customers have access to fresh food and essentials. Our operational personnel are on the front line for delivering an regular supply of food to more than 70 million people in Russia. I would like to take this opportunity to once again publicly thank our store and logistics workers, who have kept up their hard work and dedication during the lockdown period.

Now I would like to say a few words about the changes in customer behaviour that we have seen since the start of the coronavirus outbreak. Since March, we have seen an increase in demand, with sales peaking on March 15-17. Sales of high-demand products such as buckwheat, cereals and canned meat over the course of that week exceeded normal levels by dozens of times, but later normalized.

In the end of March, we noticed decreasing traffic both in Moscow and in the regions across all formats. As customers started to prioritize safety, their trips to stores became less frequent, but value of their baskets increased well above the traffic decline. We believe this is because food retailers currently cover additional demand previously satisfied by the HoReCa sector. This would also explain why our customers are now buying a wider range of SKUs.

I want to provide some additional color on the structure of demand. To date, we have seen no decline in the share of fresh products, fruit and vegetable in our sales. Consumers continue to buy these products from us and we are happy to supply them with fresh and healthy products. We have also seen no trading down by our customers as yet.

After the introduction of self-isolation restrictions in Moscow from March 28, and a full lockdown from April 13, we saw a deeper decline in customer traffic in our supermarkets and hypermarkets located in shopping centers. At the same time, LFL performance at our Pyaterochka proximity format is positive.

Now I will say a few words about the results of our digital and online services. Today everything related to digital transformation is becoming even more relevant. Thanks to the digital transformation projects that X5 implemented last year, 97% of our office personnel are already working remotely. As customers look for more digital solutions during the pandemic, X5 is able to support them with delivery services. We see significant opportunities for the growth of our online supermarket Perekrestok.ru and express delivery from Pyaterochka and Perekrestok stores, which have seen significant growth in the last two months. We plan to develop these services more aggressively and we are considering reallocation of investments from store openings and renovations to growing our digital business in 2020.

I want to remind you that X5 has two different delivery propositions for our customers – express and stock-up. Perekrestok.ru aims to fulfil the stock up mission. During normal times we delivered orders in one or two days, but this is currently at 4-5 days due to the increase in demand. Our existing infrastructure was overloaded tenfold increase in demand. Each of the online orders placed in March-April is 1.3 times bigger compared with the normal basket in terms of the number of SKUs, which means more time is required to assemble each order and more space is needed in the delivery truck. Given these changed parameters, the number of online supermarket orders fulfilled daily has declined, but turnover of our Perekrestok.ru operations nevertheless increased by nearly 2.5 times year-on-year in recent weeks. The average check has also risen to around 4,500 rubles in the first three weeks of April compared to 3,800 rubles in February.

To meet the strong demand for large food product deliveries, we launched a new dark store in Moscow on April 10, almost 2 months ahead of schedule. Currently it is ramping up and delivers around 1,000 orders per day. Once it reaches full capacity, it will increase number of orders we can fulfil in Moscow by 40% to more than 10 thousand orders per day in the current situation with increased average basket. In times of normalized demand, our combined online supermarket infrastructure in Moscow and St. Petersburg will be able to fulfil over 16 thousand orders per day.

In June, we will start Perekrestok.ru online sales in Nizhny Novgorod, where we will be using former Karusel hypermarket as a dark store.

To support growing demand, we have increased the number of pickers and couriers, as well as our own transport fleet by 20%, and also partnered with five transportation companies. Accelerated training has been launched for all new employees, as the effectiveness of a dark store depends on how efficiently the order pickers work. The online supermarket team now continues to work primarily on expanding capacity.

As of the end of March 2020 we saw unit economics improving at Perekrestok.ru, and we have stopped all digital marketing as it currently has no impact given current capacity limitations. We now expect the online supermarket's financial performance to be better than budgeted for 2020, and we have full confidence that the business will be profitable after three years of operations.

Another increasingly popular service is express delivery from stores. Today, the service is available from 131 Pyaterochka stores in Moscow and Moscow region, covering 100% of the city area inside the Moscow Ring Road. Currently, the number of orders is almost 12,000 per day, compared to 600 orders in February, the average check is around RUB 2,000. The service is also available in Kazan from 9 stores. We plan to enter St. Petersburg in May. The current demand for this service is exceeding our initial forecasts. If we see this demand as sustainable after lockdown is lifted, the number of stores with an express delivery option may be increased to 500 locations in up to ten cities by the end of 2020, compared with our original plan of 200 stores in six cities.

We also piloted a dark store model based on Pyaterochka stores in Moscow for our express delivery operations. We are very pleased with the results. Today five dark stores operate in Moscow. The first one we opened is now delivering up to 400 orders per day. By the end of May, we plan to add five more dark stores. The sales from these dark stores are several times higher compared to the sales previously generated by offline stores that were located in the premises. Capex to open a new dark store for express delivery compared with a regular store is several times lower, which presents an interesting opportunity from the capital allocation perspective.

In addition to the development of express delivery based on Pyaterochka, we are currently piloting the same service for Perekrestok supermarkets at an accelerated pace, which is called Perekrestok.Bystro. A pilot was launched last week in 9 stores in Moscow. By the end of May, the service will cover the entire Moscow city area and will expand to other cities by the end of 2020.

At present, our digital businesses Perekrestok.ru and Pyaterochka express delivery are handling a combined more than 20,000 orders per day in Moscow.

To conclude, I will say a few words about our initiatives in the social area. Supporting local communities in which we operate has always been a key part of our sustainable development strategy. Our Smart Kitchen is donating 500 ready meals every day to doctors and medical staff in four Moscow hospitals. We also donated 3,500 food sets for doctors of the Research Institute of Emergency Medicine and their families through the Basket of Kindness project. Every week we deliver food sets to the doctors and medical staff of 9 Moscow laboratories that conduct research on coronavirus infection. We also offer ambulance crew members free snack kits on the daily basis at our Karusel hypermarkets.

We also continue food donations to elderly people and those in need through our Basket of Kindness program. Since March we have already provided 7,900 food sets to people in need in Tula, Moscow, Moscow region and St. Petersburg. We provide additional discounts to volunteers who help the most vulnerable citizens in the current situation.

The first hours of trading at our stores have been prioritized for the use of elderly people who are potentially most vulnerable to the virus. We also offer free delivery service for pensioners in Moscow via our Pyaterochka express delivery. The format has launched a hotline for pensioners, where they can leave a request for a set of products, which is processed by the volunteers. Perekrestok also launched a special hotline for pensioners in Moscow and St. Petersburg. Our initiatives also include trading with a zero retail mark-up for a number of socially important goods, which was necessary to support low-income groups of customers. This is our joint initiative with Magnit which was later on supported by other key players. In this situation, we decided to do this together, recognizing our responsibility as the sector leaders.

To conclude, I would like to say that I am proud of our staff who are on the front lines serving our customers when they need us most, and whose efforts are truly heroic.

Now I would like to hand over to X5's Chief Financial Officer Svetlana Demyashkevich. Thank you for your attention.

Svetlana Demyashkevich:

Thank you, Igor. Good morning and good afternoon ladies and gentlemen, thank you for joining our call today.

Since Igor gave a detailed update on the current situation, I am not going to give a long introduction. What I would like to do is to briefly go through the market environment, changes in our expectations for 2020 due to coronavirus situation and market changes, provide an overview of our financials, month-to-date results in April and then move on to the Q&A session.

To begin with, let me remind you that X5 is reporting results with year-on-year comparisons against a very solid first quarter of 2019, when food inflation was on the rise, our proximity operations started to see the results of their shrinkage reduction efforts, our supermarket operations were in high demand and performing very strongly on the back of their attractive CVP and when Karusel hypermarkets were not yet undergoing a transformation.

During 2019, as you remember, we continued to invest in prices to sustain positive price perception among our loyal and our new customers, which helped us to continue to generate positive LFL traffic in Q1 2020.

However, the effects of operational changes at the Pyaterochka level that made shrinkage reduction possible during 2019 have now stabilised and this factor did enhance our margins in Q1 2020. Furthermore, food inflation for the entire retail industry in Q1 2020, before the impact of COVID-19 and FX factors in March, continued on a downward trend. This has made year-on-year comparisons tougher for the entire sector.

Having said that, I want to highlight that X5 delivered very good growth and solid profitability in the quarter, benefitting from good LFL customer inflows to our proximity stores and supermarkets, thanks to improvements in labour productivity on the back of various measures to better incentivise and engage our operational personnel, reflecting our focus on product assortment and quality of goods we offer to our customers. We are also satisfied with how the company is performing operationally and financially amid the COVID-19 situation. I will elaborate on this later.

I will now say a few words about the external environment in Q1. In Q1 2020, food inflation decelerated further to 2.0% from 3.5% in Q4 2019 y-o-y. However, it started to increase in March and reached 2.2% y-o-y after hitting a low of 1.8% y-o-y in February. Key factors driving the acceleration were seasonal dynamics and rouble depreciation on the back of lower oil prices.

Growth in consumer demand accelerated to 3.5% y-o-y in January-February 2020, from 1.6% in Q4 2019. The main factors behind the acceleration were a declining trend in food inflation and an increase in wages as well as the calendar effect in February due Russia having to two more days off than in 2019. Demand in March was abnormal starting from middle of March, driven first by the expectations of and later by the introduction of lockdowns. Demand remained high in April, with a clear trend towards less frequent store visits but a larger basket.

Consumer sentiment was improving in Q1 2020 from -13% in Q4 2019 to -11%. We think this indicator probably does not reflect the change in sentiment in the second half of March related to the COVID-19 situation.

Moving on to changes in our expectations for 2020. Internally, we have developed two main scenarios regarding inflation, nominal disposable income growth, oil price and the rouble exchange rate in order to assess the potential impact on our operations and our financial results forecast in 2020.

We are currently going with the base-case scenario, which I will discuss in some detail. Under this scenario food inflation is 3-4% for 2020, taking into account changes in the oil price and rouble exchange rate.

Under our base-case scenario, we are not expecting significant changes in revenue growth for the full year compared with our original budget. But after a strong start of the year we do not rule out a slight deceleration in the revenue growth rate in Q2, cycling off customers' stockpiling in previous weeks and reflecting a recovery of HoReCa volumes, which currently food retailers address, together with food delivery services.

A general macro slowdown in Russia after the COVID lockdown may result in lower purchasing power of the population, which may impact overall demand for food as well as lead to trading down by consumers. So far, we have not seen these trends. If indeed, consumers' income will suffer, our Pyaterochka format will be better positioned compared with supermarkets due to price advantages to consumers.

You have seen in our operating results that the COVID-19 situation boosted demand and our sales in March. But we also had to take measures to ensure the safety of customers and our personnel, which requires additional expenses on disinfection and logistics. In line with other federal retailers, from mid-March we introduced temporary employee bonuses in stores and in supply chain, which will be paid during the coronavirus lockdown, which is currently due to end of April.

At the same time, we see positive operating leverage effect, which helps to offset higher operating costs. We have started negotiations to receive better terms with landlords, especially for stores with significantly decreased traffic, for example in shopping centres and our formats and business units are fully focused on minimising operational expenses wherever it is possible without sacrificing the safety and quality of our operations.

As you can imagine, 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. However, our internal targets for EBITDA profitability for the year are at this time unchanged. I will comment on our investment programme for the year a bit later in my speech.

Turning to X5's financial performance during the quarter. Revenue increased by 15.6% on the back of positive like-for-like sales of 5.7% and a 11.0% rise in selling space. Our store openings as well as refurbishments were implemented in line with our original plans in Q1.

X5's like-for-like sales growth accelerated quarter-on-quarter to 5.7% in Q1 2020. LFL traffic and basket growth accelerated in Q1 2020 to 3.7% and 1.9% y-o-y, respectively. In January-February, LFL traffic was the main driver of LFL sales growth, while in March LFL basket became the main driver due to stocking up by consumers amid the COVID-19 situation.

Looking at margins in the first quarter. Gross profit margin decreased by 43 basis points to 24.3% in Q1. The margin decrease was mainly driven by the difference in food inflation levels in Q1 2020 and Q1 2019, continued targeted price investments in January and February, as well as higher logistics costs due to measures taken to ensure uninterrupted supply chain operations while protecting employees' health as the impact of the coronavirus pandemic caused significant spikes in demand. Our share of promo remained at around 35%, as planned, and was unaffected by the COVID-19 situation. Shrinkage as a percentage of revenue was stable compared with Q1 2019.

In Q1 2020, our cash operating expenses decreased by 27 basis points year-on-year as a percentage of revenue. Our staff costs stabilised as a percentage of revenue, even including additional operating personnel motivation in the second part of March, because during 2018 and 2019 we managed to bring average wages for in-store personnel in line with market average benchmarks and the company is now enjoying fairly low personnel turnover and also higher labour productivity.

The share of lease expenses and utilities costs in revenue decreased, reflecting positive operating leverage effect and the positive weather factor compared with Q1 2019. Our negotiations with landlords had not yet impacted our rental rates in March. We expect to see these results starting from April.

Adjusted EBITDA in Q1 2020 increased by 11.9% year-on-year. Our adjusted EBITDA margin decreased by 23 basis points to a very healthy, I would say, 7.0%, reflecting gross margin performance and helped by the positive operating leverage effect.

In Q1, we continued to accrue LTI expenses covering the new LTI programme. LTI and share-based payments expenses totalled RUB 495 mln. Let me remind you that the LTI targets are (1) maintaining market leadership by revenue and (2) achieving leadership in terms of EV/EBITDA multiple relative to peers. Accruals will continue in approximately same quarterly amounts during 2020 if both targets are achieved.

Depreciation, amortisation and impairment costs increased as a percentage of revenue by 32 basis points versus the same period last year to 3.4%. This was mainly due to revenue growth outpacing the growth of gross book value of assets as well as impairment and accelerated depreciation of non-current assets as we continued to transfer Karusel stores to Perekrestok, in line with the transformation plan.

Net finance costs decreased by 6.1% year-on-year as our weighted average effective interest rate decreased on the back of the key policy rate dynamics in Russia, as well as actions taken by X5 to minimise interest expenses through debt portfolio maturity and a combination of bank debt and bond issuances.

We currently see no issues with accessing rouble liquidity either from banks or on the domestic bond market. Today the regulator reduced the key rate by 50 b.p. to 5.5%.

In Q1, the company’s net profit adjusted for the effect of the Karusel transformation totalled 8.6 billion roubles, which represents a 1.8% net profit margin. The small y-o-y decline in adjusted net profit, apart from gross margin effect, is mostly related to the 1 billion rouble FX revaluation impact due to the significant FX weakness and volatility in March.

Turning to our balance sheet, our better working capital and operating cash flow generation enabled us to reduce our short-term debt and to reduce net debt/EBITDA to 1.5x. Going forward, we will aim to maintain this ratio below 1.8x.

I want to just say a few more word on cash flow. Net cash flow generated from operating activities in Q1 was 40.0 billion roubles, which is 22.8 billion roubles higher than a year ago.

Growth of the business, healthy profitability levels and better working capital were the main contributing factors.

The change in working capital in Q1 2020 was positive 15.1 billion roubles. This was mainly driven by the smaller decrease in accounts payable and inventories due to higher inventory turnover in March.

The changes in our Q1 2020 inventories reflect our ongoing efforts to improve inventory turnover across all formats as well as higher demand and faster product turnover in March 2020 due to the COVID-19 situation.

The changes in accounts payable reflect several factors. One factor is the growing share of fresh in our assortment, which implies faster payment terms as stipulated by the Retail Law. This trend is structural and very gradual. Another factor is a COVID-19 related increase in our buying activity in February and March in order to ensure sufficient stocks of high-demand goods had a positive effect on our payables in Q1 2020.

Let me say a few words about capex. X5's total capital expenditure in Q1 2020 amounted to 17.5 billion roubles. Approximately 44% of the quarterly capex went to expansion of our store base. We opened almost similar number of stores vs Q1 2019. The remaining capex included refurbishments for 261 stores (34% of capex), logistics (1%), IT (2%), maintenance (8%), and other investments (approx. 11%).

Let me update you on our capex programme for 2020. Initially, we planned to open around 2,000 gross proximity stores and supermarkets in 2020. In addition, we planned to refurbish around 1,300 Pyaterochka stores and about 30 Perekrestok supermarkets. Looking at the coronavirus situation, its effects and broad consequences for the economy and consumer demand, we now plan open 20-25% less stores than originally planned. We have also suspended store refurbishments to new concepts outside of Moscow and St Petersburg. The number of refurbishments will decrease by around 40 from what was initially planned. At the same time, we will continue investments into digital transformation and the development of digital services, which is particularly relevant to date. Igor spoke about this earlier. As a result, we expect a reduction in capex from the originally planned amount. Capex in 2020 should not exceed capex in 2019.

Finally, a few words on our month-to-date results. Demand in April remains elevated with a trend towards less frequent store visits but a larger shopping basket:

- Net retail sales (excluding VAT) grew by 17.5% year-on-year in the first 23 days of April.
- LFL sales growth was at 8.1%.

This concludes my brief presentation of the results, thank you for your attention and I will be happy to answer your questions.

Natalia Zagvozdina:

Thank you very much, Svetlana. And operator, we could start the Q&A. But could I please ask the participants to limit themselves to two questions.

Operator:

Thank you. Ladies and gentlemen we will now begin the question-and-answer session. As a reminder, if you wish to ask a question please press star one on your telephone and wait for your name to be announced. Please standby while we compile the Q&A queue. This will only take a few moments. If you wish to cancel your request, please press the hash key. Once again please press star one if you wish to ask a question. And the first question comes from the line of Nikolay Kovalev.

Nikolay Kovalev:

I have 2 questions. First, the presentation was quite detailed. The first one is on the refurbishment program. So we already saw quite a significant amount of capital expenditures in the first quarter, almost RUB 6 billion. So I was wondering, can you help us understand to what level you lowered the average capex for the new concept? And can you share with us what are the like-for-like results of the refurbished stores? So results versus capex would be quite helpful for us to understand.

And my second question is on the different provisions that we saw in the last couple of quarters. It looks like the first quarter of 2020 is less impacted by the result, but can you also help us to understand if you anticipate any further provisions for part of sale or taxes in the upcoming quarters?

Svetlana Demyashkevich:

Thank you for your questions. I will start with our new concept development. We're actually quite happy with the development and with the performance of the stores in the new concept. And of course, it's harder to judge by March and April, where we have elevated demand in all our stores. But I think that statistics were quite representative in January and February, where we already saw around 10% additional like-for-like sales as a result of this new concept refurbishment in the existing stores. So actually it is in line with our expectations, in line with our budgets. And that's why before the development of the COVID-19 situation, we were planning to proceed with our refurbishment program and opening new stores in the new concept. But as I commented, understanding that recent situation will probably affect the income of the population and overall demand. And in our stores, we think that we should be more careful with the refurbishments. And first of all, we want to focus only on Moscow and St. Petersburg and to decrease the number of refurbishments in other regions of Russia.

In terms of capex per store for this new concept, actually, our aim is to keep capex per store at the level very close level to the capex we had previously for our stores, maybe just slightly higher, around 5 percent. So we do not expect significant impact on our capex numbers in that respect.

And another question you had on provisions for Karusel and for tax. So regarding Karusel, actually, it will depend on the pace of transfers of Karusel stores into supermarket format, also on the pace of closings of the stores and on individual decisions and negotiations we can have with the landlords. And also, it will depend on the pace of reduction of personnel in these liquidated stores. So yes, we do expect that we will see some results further in next quarters of 2020 and 2021. We do not expect them to be higher than what you saw after the initial effect of the transformation last year, but it's hard to exactly estimate them. As I said, we have a lot of individual factors affecting each particular accrual at each particular quarter. So in terms of tax, tax provision for 2019 for both tax restructuring and tax resulting from the transformation of Karusel was around RUB 5 billion. Yes, it's a material amount. But at the same time, it's not, of course, critical for our P&L.

And as for Karusel, as I commented, I wouldn't expect significant numbers in the future in terms of tax. But as I said, we will accrue probably some of the provisions related to just operational transfers, additional impairment of the stores, et cetera.

Operator:

Next question comes from the line of Kirill Panarin.

Kirill Panarin:

I've got 2, please. So first, on your gross margin. I wonder to what extent was it helped by changes in sales mix towards dry foods in Q1? So what are the trends in the first quarter gross margin if you adjust it for one-offs, such as different sales mix or higher logistics costs? And what are your thoughts on the outlook? That's the first question.

Svetlana Demyashkevich:

Well, as I said during the call, the biggest impact on gross margin was on changing cost of logistics due to higher demand and more pressure on our supply chain in March. And we already see that we have less pressure now in April, where the demand normalized. So as I said, for 2020, we do not expect any adverse changes from our initial budgets, both in terms of total EBITDA margin or gross margin. So overall, we see that this negative effect on EBITDA margin resulted from higher logistics costs, from additional personnel costs like bonuses to employees who work under this pressure of coronavirus situation and also some additional expenses that we are making to ensure the safety of our employees and our customers. All these costs are, at the moment, balanced by positive operational leverage and higher revenue that we are receiving. And we do have, I would say, the same expectations for the year going forward.

Kirill Panarin:

OK. Great. And secondly, it would be great to hear your thoughts on competitive dynamics. Do you see smaller players also benefiting now from higher demand? Or do you see them struggling for whatever reasons? And do you think that market exits might accelerate over the next 6 to 12 months?

Svetlana Demyashkevich:

We do see, of course, that the proximity format is benefiting the most among all segments. And of course, supermarkets and hypermarkets situated in shopping malls are suffering less traffic. And we even had to close several of our supermarkets located in shopping centers.

In terms of traditional retail, usually, during the crisis, and we saw it in 2014, 2015 and before that, in 2008. Of course, crisis is the time for consolidation of the market. And large players and leaders of the market benefit in this situation due to high efficiency, higher purchasing power, high levels of digitalization, et cetera, et cetera.

Operator:

Next question comes from the line of Elena Jouronova.

Elena Jouronova:

I have a few questions as well. So I wonder, firstly, what is the latest thinking in the company about a more substantial change of strategy in your capital allocation from the retail stores to dark stores, i.e., spending less capex on off-line and more on online? And this question is not just about 2020 but more conceptually about how the company is currently thinking about the future.

Igor Shekhterman:

Thank you for the question. I think the current situation definitely moves us to reconsider our strategy because we are absolutely sure that it will change the consumer behavior. And now we are in the process of developing of our strategy and changing our plans for the next 2, 3 years. And we will discuss our new strategy with the Board in the beginning of July, and I'm sure we will present our new strategy on Investor Day in October.

But definitely, regarding the changing behavior there will be the new way of online delivery. And so we see that now practically most of the competitors who have online delivery are growing quite quickly. And we understand that it will be not just for this time, that people will like these services, and we are sure that the change in customer behavior will also change the demand for this services for the longer time, and it will change the economics. Even now we see that unit economics is changing positively for us, and we see a big potential demand for these services.

Buying food through remote channels is becoming the mainstream. It's absolutely understandable for us, and we have accelerated the development of our express delivery infrastructure. If the increased demand for the service exceeds our current expectation, we could increase the number of stores with express delivery service to 500 in 10 Russian regions. And thanks to our infrastructure development last year, now we have very good infrastructure, IT model, and we can quickly roll out. For instance, in March, we added 10 new stores to online delivery per week. Now we can include even more stores every week.

Elena Jouronova:

And if I may ask a follow up. I actually have no doubt about very strong competitive advantages that X5 has in terms of online. But there is one element which currently, in my opinion, you lack, and that's the last mile. And that's capacity – that of courier that will allow you to achieve much faster click-to-consume or click-to-eat time, whatever is the right way to call it. So how are you doing the last mile currently? Who is your logistics partner? And most importantly, what kind of investment do you think you need in order to match what the services like LavkaLavka and Samokat are able to offer?

Svetlana Demyashkevich:

Well, first of all, we have 2 models, which are quite different in terms of their logistics. For Perekrestok.ru, our online supermarket, we have dark stores and our own delivery with our own couriers and trucks. And actually, yes, we do invest more this year. And we'll rechannel some of the capex that we planned in terms of faster openings of off-line stores. Part of this capex will be rechanneled to faster opening of new dark stores for Perekrestok Online and to buying more trucks to ensure that we're able to meet this elevated demand from our customers.

In terms of express delivery, which we have for Pyaterochka and Perekrestok, so far we outsource to several companies that provide couriers. And the picking is done by employees of Pyaterochka or Perekrestok, depending on the format. So it's a hybrid model at the moment. It doesn't need any additional capex, as you can see. On the opex, it depends on a unit economy. And what we see already is that, of course, with high demand and higher density and higher share, the unit economy improves both for express delivery and for Perekrestok.ru.

Igor Shekhterman:

And it's also one of the important expenses in online delivery is digital marketing. Particularly now, we excluded it from our P&L because now we do it without any digital marketing.

Svetlana Demyashkevich:

Yes, of course. At the moment, we are able to attract new customers without any additional marketing spend. And it will allow us, I think, even after the end of lockdown, to keep this new inflow of customers who've already tried us and will be happy with our service.

Igor Shekhterman:

And regarding capex, X5's dark store we transformed from a former Pyaterochka, we do it practically without any capex. We just took a Pyaterochka stores that were not performing so well and transformed them to dark stores.

Svetlana Demyashkevich:

That's the third, I would say, format that also we are exploring. It's in the pilot mode for now. We just took several Pyaterochkas, which were underperforming and transformed them into dark stores. We'll see what model of express delivery ensures higher-return investments and higher speed of growth. And probably, we'll proceed with some combination of these models and our strategy going forward.

Igor Shekhterman:

And I think one of our benefits compared digital competitors like Samokat and LavkaLavka is that we have 2x higher average ticket here because we have a higher number of SKUs.

Svetlana Demyashkevich:

Yes. Not mentioning the purchasing power, of course, for all our food categories, which is a huge benefit.

Igor Shekhterman:

And 30 percent of our customers in express delivery are new customers.

Operator:

There are no more questions at this time. Please continue. Oh, we've got another one, if that's OK.

Igor Shekhterman:

Yes. Sure.

Operator:

Sorry. It came from the line of Nikolay Kovalev.

Nikolay Kovalev:

I have a quick clarification question. I just like to estimate, 20 percent cut in store openings and 40 percent cut in refurbishment program. Is it fair to assume that capex might go down by around RUB 15 billion this year versus the target we discussed during the late strategy day? Or it will be somehow offsetting digital transformation?

Svetlana Demyashkevich:

It's hard to comment because I don't know your target. But yes, if we're talking about our budgeted numbers, the promos, the forecast we have internally is lower than the budgeted number for capex. Surely, it will decrease mostly as a result of decreasing number of store openings and a decreasing number of refurbishments. We do rechannel, as we commented earlier, some of this capex into new online models. But the numbers, of course, are not that material compared to off-line stores. So overall, as I said, we do expect that capex should be not more than the level of last year's capex.

Operator:

Next question from the line of Maxim Nekrasov.

Maxim Nekrasov:

My first question is a bit of like clarification regarding your 2020 budget. So Svetlana mentioned that basically your sales growth expectations and margins have not changed much versus previous scenarios. And does it mean that you expect basically the similar growth as before but with 20 percent lower openings and 40 percent lower refurbishment this year?

Svetlana Demyashkevich:

Well, as we see, we have higher growth in the first quarter than we planned. And actually, the result of April in terms of revenue growth and even like-for-like performance is also higher than we budgeted initially. We do expect that probably it will be compensated by slower growth in the end of second quarter and going to the third quarter because probably the income of population will be pressured.

At the same time, of course, there will be some positive factors also like rechanneling some of the demand from HoReCa and also a decrease, of course, in tourism and all people staying in Russia probably for the summer. It will also have some positive effect on the demand. It's hard now to estimate overall effect but weighting negative and positive factors that we already know, we see that with high probability we can leave at least our budgeted revenue numbers at the same level.

Maxim Nekrasov:

OK. My second question is regarding the promo activity. So in the press release, you mentioned that some of the gross margin decline was related to higher-priced investments made in January and February. So if you could disclose what – like how much higher the share of promo was in January-February year-on-year? And how much higher it was in the first quarter? And whether you think it is fair to assume it should be lower on a year-on-year basis in the second quarter and potentially the second half of this year, considering the high base in terms of promo activity last year?

Svetlana Demyashkevich:

Well, first, let me remind you that we made some price investments in the second half of 2019. And you also might remember that we had higher levels of promo activities in the fourth quarter of 2019 following overall trends in the market.

So actually, after the fourth quarter in January and February, the level of promo stabilized and remained at around 35%, actually decreased from around 40% in the fourth quarter of 2019. But when you're comparing the result of first quarter this year and results of the first quarter last year, of course, you will see the discount in terms of gross margin. Probably the same difference will be for the second quarter of the year, just because of the price investments we did in the second half of 2019 into overall levels of commercial margin.

At the same time, of course, we are looking at changes in the mix, but also in increasing average share. And as I commented, we have very positive trend in April. We do see that the basket is increasing. And we also think that some part of this increase is due to an inflow of customers from HoReCa to food retail. It also increased the numbers of – number of new assortments in the basket.

Also, a factor that affects gross margin is the level of inflation. And in January and February, the level of inflation in 2020 was lower than we had in 2019. The difference was quite significant. If the difference in inflation in the second quarter and going forward will be less, then also the gross margins will be less affected.

And again, we do have less pressure on logistics at the moment, which also is positive news. And of course, we constantly continue to work on our shrinkage levels. And we do expect that some further improvements that we will see during the year in that respect.

Operator:

Next question comes from the line of Marat Ibragimov.

Marat Ibragimov:

In the third quarter, you booked slightly more than RUB 1 billion in FX loss. This relates to accounts payable on import contract. Do you think it would make sense to hedge this FX risk, your FX exposure to FX future or options going forward? So it's too costly, and it is not a good way for you to hedge this risk.

Svetlana Demyashkevich:

We actually address this question on our hedging policy each year when we consider and adjust our finance policy in the end of each year in December, discussed with the Audit Committee and our Supervisory Board. And each year before making this decision, we do a backtesting on what would be the overall results in case we hedge our exposure. And every time, actually, the results of backtesting are negative. So that's why actually we do not use hedging options.

At the same time as you see, our exposure to FX is not that significant for the company. And in every case where we do have this exposure, we usually have the ability to negotiate. For example, we still have a couple of rent contracts in dollars. And as soon as we have the devaluation, we started to negotiate to renegotiate the terms of this contracts.

We also usually are able to spot this devaluation through the prices through the shelf inflation, and that was actually the case in '14 and '15, where even with high devaluation that we face at the moment, we're able to keep our EBITDA margin quite stable.

Marat Ibragimov:

OK. And my next question about FX – sorry, price inflation from your suppliers, what you see, how – and generally policy when you see that some supplier wants to raise its seller price due to some reason, for example, due to rouble devaluation. You are trying to postpone this as much as possible. You don't accept this request? What's your policy? And how much of this inflation you pass on to customers?

Igor Shekhterman:

On currency, I don't see visible growth in producer prices.

Marat Ibragimov:

OK. But in case of import – not import, but from wholesalers which import their stuff from abroad, apparently, they're facing higher costs due to rouble devaluation. Don't they apply to you to raise prices?

Svetlana Demyashkevich:

Now overall, the share of imported goods or goods, which are linked to fixed drivers in their cost is actually not that significant. For example, the share of direct imports in our revenue is only around 4%. And mostly, we are talking about fresh products, fruits and vegetables.

And I would say, in all core categories and in all categories, which are essential during the time we are now. Actually, we have internal supply. We have local suppliers predominantly working in roubles. So I would say that we are quite hedged in this respect, and we don't see this as a major structural issue for us.

Operator:

It comes from the line Alexey Krivoshapko.

Alexey Krivoshapko:

Actually I have 2 forward accounting questions. Second, can you shed some light in the quarter inside your depreciation charge, which went up quite a lot versus Q4? How much was this impairment of something which was related to the Karusel in absolute numbers?

Svetlana Demyashkevich:

Overall impact of impairment of Karusel transformation was around RUB 470 million.

Alexey Krivoshapko:

OK. And I guess the second question is like, if you were to borrow today kind of given where rates are, what would be your current of cost of debt?

Svetlana Demyashkevich:

The last actual placement, the bond issue that we did just recently was last week. Actually, we received money just this week was at the rate of 6.9%. So I think that it's quite a good rate for us, even below our expectation, I would say.

Natalia Zagvozdina:

With that, we'll conclude today's call. Thank you very much for participating. If you have any follow-ups, you can address them to IRO@x5.ru mailbox, and we'll be happy to get back to you. Have a good day. Thank you. Bye.

Operator:

That does conclude the conference for today.