



O'KEY Group

Q3 & 9M 2018 operating results
conference call edited transcript

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O'KEY Group speakers

Armin Burger, CEO

Konstantin Arabidis, CFO

Anton Farlenkov, Head of Corporate Development

Veronika Kryachko, Head of Investor Relations

Participants asking questions

Yulia Gerasimova – Goldman Sachs

Alexey Krivoshapko – Prosperity Capital Management

Presentation

Veronika Kryachko

Good day, ladies and gentlemen, my name is Veronika Kryachko, Head of Investor Relations at the O-Key Group. I am going to conduct today the conference call on third quarter and nine months of 2018 operation results. Our call will start with updates on the Group's operating performance and key developments provided by our CEO, Armin Burger, followed by Q&A session. The senior management team, Konstantin Arabidis, CFO and Anton Farlenkov, Head of Corporate Development are joining us today and will be happy to answer your questions. That's all on my side and I hand over the call to Armin Burger.

Armin Burger

Thank you, Veronika. Good evening ladies and gentlemen. I'm happy to welcome you to our conference call tonight. As all of you may be aware, we recently reorganised our top management team to materialise more synergies for the Group from our two-format business model.

As a result of the changes, the Board of Directors announced me as new CEO of the O'Key Group. I've been with the Group for five years as CEO of our discount format and I also was actively involved in the development of the Group's strategy. For both formats, we see strong synergy potential between influence positively the Group's future growth. But now, ladies and gentlemen, back to the developments in the third quarter.

The sentiment in the food retail market up-to-date was very mixed as macroeconomic instability and intensifying competition continued to put pressure on the sector's performance. The performance of O'Key in the third quarter was also heavily influenced by these parameters, the macroeconomic headwinds, intensifying competition and also some of the changes we made internally in our key business areas like service level, assortment mix and freshers, gave us some headwind as well.

On top of this, we also saw the weakening consumer purchasing power putting negative pressure on our hypermarket business. Like-for-like basket growth in the first quarter was slightly negative, as the decline in items per basket wasn't fully offset by the increase in shelf inflation. For example, the inflationary growth of poultry and sugar in O'Key hypermarkets led to decline in respective categories sales in the third quarter. Striving to improve our customer value proposition in the third quarter, we focused our efforts on strengthening key business areas such as service level, the assortment mix and quality of the fruit and vegetables. This is also one of our main focus in the next coming months to get stronger in these areas and refocus the business.

To tailor our service level to the needs of modern customers, we initiated in the first quarter a roll-out of self-scanning technology in St Petersburg and Moscow hyper-markets and started the integration of a new

supply chain management system, Oracle RPS, into the business processes. The new system will help the company to significantly increase the efficiency and accuracy of a vast number of business processes connected to ordering and logistics operations.

To strengthen our position in the assortment mix and further improve the quality of fruit and vegetables, we aim to put more emphasis on own import development and realisation of synergies from the joint work with Da! discounter business in respect of purchasing terms, improvement and the quality of the private labels. The developments on this front are expected to support the gross margin growth going forward in both businesses.

As for the developments on the marketing front, at the end of the third quarter we started a publication of weekly, fresh category leaflet to strengthen our image. When we strived to make our promo campaigns more vocal, we keep our promo share at the stable level and have no intention in the future to increase them.

Constantly searching for additional growth areas, we are carefully studying diverse business opportunities which can help to leverage our strength. Here we see the wholesale business as one of the most promising areas to be developed further. As the business opportunity is still being analysed, we will be able to provide more colour on it at the beginning of the next year.

Let me also mention our discount to business, Da!. On a discounted front, the growing popularity of the unique value proposition continued to yield solid, like-for-like traffic growth of 10.3% year-on-year in the third quarter. The slowdown in discount for like-for-like average ticket growth in the first quarter was largely a result of two factors. Firstly, gradual changing consumption structure with a shift towards higher margin, private labels led to an average like-for-like price per item decline by 1.8% year on year. Secondly, the change in the customer's consumption behaviour on the back of unusually warm weather which prevailed during the third quarter led to an increase in the frequency of visits to convenience stores and the higher demand for traditional summer items such as ice cream and other topics, resulting in a moderate like-for-like item per client growth and only 0.5% year-on-year.

In the third quarter, we continued to enhance our assortment matrix by introducing 50 new private label SKUs. As of the end of the last quarter, the share of private label in the total SKUs stood around 42-43%. We opened two additional stores in the third quarter, ending the quarter with 72 stores. For the rest of the year, we will open another ten stores to finish the year with 90 stores opening. I initially promised you 25 stores; these stores will come in February already, we just had to delay them slightly due to contractual reasons.

This concludes my update, ladies and gentlemen, and now we are ready to take your questions. Thank you very much.

Questions and Answers

1. Yulia Gerasimova – Goldman Sachs

Yes, good afternoon, Yulia Gerasimova from Goldman Sachs. I have three questions, please. The first one on the recent management changes. Armin, you mentioned that that was done to kind of extract some synergies between the two businesses. However, correct me if I'm wrong, but hypermarkets and Da! format operating some completely different assortment metrics, different logistics, supply chain, different customer value propositions. What kind of synergies actually do you expect to have from the combining these two businesses under one management, because I'm actually struggling to understand the rationale for that management change. That's the first question.

Armin Burger

Yes, that's very easy, thank you for your question. If you think about the buying side in a private label area, we have a lot of synergies if we add the two quantities together. Da! is very large in numbers in SKU quantities already and O'Key can profit from this one. We, in Da!, obviously, can, on the other hand profit a lot from the purchasing power of O'Key on the branded side. Overall, as a business, we both, if you add it up, we'll have a better margin situation and much better cooperation with our suppliers. Internally, we also can obviously align certain business functions in certain departments where we can have positive effects as well.

Yulia Gerasimova

For example? Can you be a little bit more specific on exactly what areas? I got the supplier side though actually under the one O'Key group I think you already have that supplier bargaining power, let's put it this way. But what, exactly, else?

Armin Burger

Firstly, regarding our business functions, I don't want to comment here, you might understand. We moved the head office of O'Key towards the south where the Da! head office is, in a different building but we still move it. Therefore, if you are closer to each other, you can talk better to each other and you find a lot of ways of creating synergies on all different channels. But I don't want to be more clear here. I can tell you that people in the business know it.

Regarding the buying side, here, in theory we have the purchasing power already but to be closer, to have probably negotiations together with the Da! team makes for both bigger quantities and much closer ties in the business. Therefore, it is easier if it's run by one company, by one guy, because from a logical point of view, I can push here a little bit more towards synergy creation.

Yulia Gerasimova

Okay, thank you very much. My second question was on openings from the Da! format. As you just mentioned, you know, we expect 25 openings but it's rather going to be something like 19. So, what's the key obstacle in getting more aggressive in terms of opening. As I understand, the scale is really what you need to improve the profitability in that business.

Armin Burger

I explained you in the last conference call we had that we decided very late to restart the opening schedule for Da! after we had the supermarket sale and we had to focus first on that one. Now we have some very late contracts, we couldn't conclude them together – normally we would like to open beef and alcohol licence, we couldn't conclude on this space and I didn't want to open in the middle of December without alcohol licence, and therefore I moved it now to February. We will have these five, six additional openings in February. The opening schedule next year will not be affected by it; we'll still have 25-30 stores as it is in our business plan for next year as well.

Yulia Gerasimova

Okay. That's clear and my last question was about what is the profitability in the Da! business. I think when you had the first half 2018 conference call, we noticed that there is some expending loss in that business. You just told us there is some improvement in the category mix, there is more shift to the higher margin private label products. So, has this positively affected the marginal side of the business and do you see it improving on your losses in that part of the business?

Armin Burger

Yes, we saw a big improvement; we're very happy with the development and as I said, the synergies should help us further. We're fully within our budgeted targets and there is no negative aspect I could comment on.

Yulia Gerasimova

So, basically, I think you mentioned on the first half conference call you still target to break even next year, so that's still intact?

Armin Burger

For definite, even more so.

Yulia Gerasimova

Okay, thank you. That's all from me.

2. Alexey Krivoshapko – Prosperity Capital Management

Yes, Armin, everybody, hello, this is Aleksey from Prosperity. I would like to ask your view about the hypermarket business. We see basically for quite some time now a significant deterioration, in fact, in hypermarkets which is now running around minus 6% in the quarter, more or less, which definitely is some sort of reflection of not attractive enough stores versus the competition.

What is your opinion about – can this be changed? If so, what should be done to do it? Maybe on the category side, maybe on the CAPEX side, and do you still hold by the previous statements which you gave at the capital markets day I guess, but in May, in Moscow, you highlighted that you're looking to potentially increase the sales densities of hypermarkets into your objective and if so, what steps are you willing to take to get there?

Armin Burger

Yes, my opinion about the hypermarket business, you know our key focus was always to aim for the middle-income customer, for the family customer. This is what we still want to do, this is still where we want to focus. We concentrated, in my opinion, a bit too much on cost-cutting, on cost-saving which is important, and I'm from the discount business and you probably might understand that it is one of the highest priorities we have.

On the other side, a customer that comes to O'Key wants service, wants a friendly cashier, doesn't want to queue at the meat counter, wants fresh qualities and wants an appropriate assortment mix which includes the items you can't buy in discount and you can't buy in supermarkets.

Here, we have to find the right balance between being cost conscious on the one side, not losing the focus there on the other side. And I had a big discussion today with my directors who run the regions. Really, we have to focus on freshness, we have to focus on the assortment mix, on convenience and on the service level up to the degree we had it. If you get all these parameters right, you have a good future even in a very competitive market.

Regarding the sales densities, sales densities obviously, there are two parameters; there's square meters which we use and the way we thought to reduce some of the square metres of the really big stores, I fully approve what my predecessor Miodrag said here; we want a good-sized city hypermarket with a high sales density and therefore better cost structures, clearly. On the other hand, also the sales density has a lot to do also with increasing sales and stopping the stagnation we have and this is the next big target we have. That means altogether we lead to a positive trend again in the hypermarket business and I'm confident that we will achieve that.

Alexey Krivoshapko

Okay, may I ask you, in terms of this positive trend which you mentioned just now, what is the amount of money which is allowed in terms of investments in Q4? You can make them look more attractive in order to get there, or is it just simple operational work on a day-to-day basis which needs to be properly done, basically improve performance? And do you have timing in mind in terms of when should we see this moment?

Armin Burger

Most of the stuff I mentioned to you doesn't cost any money. Smiling cashier is a management issue and not a money issue. A little remerchandising and mini-remerchandising is not a topic of high expenditures either. The assortment mix is work from the buying department. From that side, I don't think we need a lot of money to do immediate changes, you know, to do a better job in giving the customer the right assortment, giving the customer the right fruit and veg quality, this is management, this is staffing issues. And here we will, from my side, latest till second quarter 2019 I want to have here the execution of all these points including the remerchandising of the stores, we're already in preparation of it.

Alexey Krivoshapko

Okay, that's clear. Are there any plans to open any stores?

Armin Burger

We want to open two stores next year and also enlarge two stores. This is in the budget and at the right time we will announce also the locations.

Alexey Krivoshapko

Thank you, that's clear.
