TESCO

15 February 2019

TESCO PLC: INTRODUCING IFRS 16

Tesco PLC is hosting a briefing for analysts and investors at 9.00am UK time today relating to the introduction of IFRS 16, the new financial reporting standard on accounting for leases. Tesco will explain the nature of the standard and the associated changes to the presentation of the Tesco financial statements and performance measures using its most recently reported 1H 2018/19 results.

The standard has no economic impact on the Group. It has no effect on how the business is run, nor on cash flows for the Group. It does however have a significant impact on the way the assets, liabilities and the income statement of the Group are presented, as well as the classification of cash flows relating to lease contracts.

IFRS 16 is effective for all accounting periods beginning on or after 1 January 2019. As such, Tesco's first reported accounting period under IFRS 16 will be the 2019/20 financial year, which runs from 24 February 2019 to 29 February 2020. As previously indicated, the Group intends to adopt the standard fully retrospectively.

In summary, IFRS 16 seeks to align the presentation of leased assets more closely to owned assets. In doing so, a right of use asset and lease liability are brought on to the balance sheet, with the lease liability recognised at the present value of future lease payments. Whilst the right of use asset is matched in value to the lease liability at inception, it differs in value through the life of the lease.

From an income statement perspective, the pre-IFRS 16 rental charge is replaced by depreciation and interest. IFRS 16 therefore results in a boost to operating profit, which is reported prior to interest being deducted. Whilst depreciation reduces on a straight-line basis, interest is charged on outstanding lease liabilities and therefore for any given lease, interest is higher in the earlier years and decreases over time. As a result, the impact on the income statement below operating profit is highly dependent on average lease maturity. For an immature portfolio, depreciation and interest are higher than the rent they replace and therefore IFRS 16 is dilutive to EPS. For a mature portfolio, they are lower and therefore IFRS 16 is accretive.

Our 1H 2018/19 financial statements, restated for IFRS 16, will form the prior period comparative numbers for the first published IFRS 16 accounts in October 2019. The headline impacts of IFRS 16 on these statements can be summarised as follows:

- Group sales and total cash flow are completely unaffected.
- Group operating profit[1] increases by £188m to £1,121m as rent is removed and only part-replaced by depreciation; Group operating margin[2] increases by 59 basis points to 3.53%.
- Profit before tax and Diluted EPS[3] both decrease, by £(101)m and (0.91)p respectively, due to the combination of depreciation and interest being higher than the rent they replace. This is due to the relative immaturity of the Group's lease portfolio, with leases being around one-third expired on average. The proportion of EPS dilution will reduce as the portfolio matures and, most notably, as underlying earnings increase.
- Net assets reduce by £(1.4)bn to £13.0bn, as a 'new' lease liability of £(10.6)bn and 'new' right of use asset of £7.8bn are recognised and onerous lease provisions and other working capital balances are derecognised.
- Total indebtedness increases by £(3.3)bn to £(15.8)bn due to lease extensions and contingent commitments being included and lease-specific discount rates being applied.

Further detail on the impact of IFRS 16 on our 1H 2018/19 financial statements can be found in Note 1.

The introduction of IFRS 16 has no bearing on the plans or financial ambitions Tesco has shared with the market. We will continue to provide sufficient disclosure to translate progress against our 2019/20 ambitions back to a pre-IFRS 16 basis.

Our 2018/19 preliminary results will continue to be reported on a pre-IFRS 16 basis, accompanied by a headline summary of the impact of the new standard. The full 2018/19 financial statements prepared on an IFRS 16 basis will be shared shortly after the preliminary results.

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1. Excludes amortisation of acquired intangibles and exceptional items
2. Group operating profit before exceptional items and amortisation of acquired intangibles divided by Group Sales
3. Excludes exceptional items, amortisation of acquired intangibles, net pension finance costs and fair value re-measurements of financial instruments

Today's briefing will include a short presentation and Q&A. Access will be by invitation only. There will be a live webcast available on our website at www.tescoplc.com/investors. This will include all Q&A and will be available for playback after the event. All presentation materials, including a transcript, will be made available on our website. No new material disclosures will be made during the event.

Disclaimer

This document may contain forward-looking statements that may or may not prove accurate. For example, statements regarding expected revenue growth and operating margins, market trends and our product pipeline are forward-looking statements. Phrases such as "aim", "plan", "intend", "should", "anticipate", "well-placed", "believe", "estimate", "expect", "target", "consider" and similar expressions are generally intended to identify forward-looking statements. Forward-looking statements involve known and unknown risks, uncertainties and other important factors that could cause actual results to differ materially from what is expressed or implied by the statements. Any forward-looking statement is based on information available to Tesco as of the date of the statement. All written or oral forward-looking statements attributable to Tesco are qualified by this caution. Tesco does not undertake any obligation to update or revise any forward-looking statement to reflect any change in circumstances.

Note 1

These condensed consolidated financial statements for the 26 weeks ended 25 August 2018 and as at 25 August 2018 and 24 February 2018 do not constitute statutory accounts as defined in section 434 of the Companies Act 2006. A copy of the statutory accounts for the 52 weeks ended 24 February 2018 has been filed with the Registrar of Companies. The auditor's report on those accounts was not qualified, did not include a reference to any matters to which the auditor drew attention by way of emphasis without qualifying the report and did not contain statements under section 498(2) or (3) of the Companies Act 2006.

Income Statement restatement for the 26 weeks ended 25 August 2018 (unaudited)

	26 weeks ended 25 August 2018 reported				26 weeks ended 25 August 2018 restated		
	Before exceptional items and amortisation of acquired intangibles £m	Exceptional items and amortisation of acquired intangibles £m	Total £m	IFRS 16 impact £m	Before exceptional items and amortisation of acquired intangibles £m	Exceptional items and amortisation of acquired intangibles £m	Total £m
Continuing operations							
Revenue	31,734	–	31,734	–	31,734	–	31,734
Cost of sales	(29,783)	(86)	(29,869)	185	(29,598)	(86)	(29,684)
Gross profit/(loss)	1,951	(86)	1,865	185	2,136	(86)	2,050
Administrative expenses	(1,010)	(41)	(1,051)	3	(1,007)	(41)	(1,048)
Profits/(losses) arising on property-related items	(8)	13	5	–	(8)	13	5
Operating profit/(loss)	**933**	**(114)**	**819**	**188**	**1,121**	**(114)**	**1,007**
Share of post-tax profits/(losses) of joint ventures and associates	20	11	31	(2)	18	11	29
Finance income	7	–	7	2	9	–	9
Finance costs	(293)	–	(293)	(289)	(582)	–	(582)
Profit/(loss) before tax	**667**	**(103)**	**564**	**(101)[1]**	**566**	**(103)**	**463**
Taxation	(160)	22	(138)	13	(147)	22	(125)
Profit/(loss) for the year from continuing operations	**507**	**(81)**	**426**	**(88)**	**419**	**(81)**	**338**
Discontinued operations							
Profit/(loss) for the year from discontinued operations	–	–	–	–	–	–	–
Profit/(loss) for the year	**507**	**(81)**	**426**	**(88)**	**419**	**(81)**	**338**
Earnings/(losses) per share from continuing and discontinued operations							
Basic			4.40p	(0.91)p			3.49p
Diluted			4.37p	(0.90)p			3.47p
Earnings/(losses) per share from continuing operations							
Basic			4.40p	(0.91)p			3.49p
Diluted			4.37p	(0.90)p			3.47p
KPIs and APMs							
Operating margin	2.94%			0.59%	3.53%		
Diluted adjusted EPS	6.36p			(0.91)p	5.45p		

1. £(101)m PBT impact comprises: £522m rental charge removal, £(340)m additional depreciation, £(287)m additional net interest charge and £4 million other net gains.

Balance Sheet restatement at 25 August 2018 (unaudited)

	25 August 2018 reported £m	IFRS 16 impact £m	25 August 2018 restated £m
Non-current assets			
Goodwill, software and other intangible assets	6,463	(10)	6,453
Property, plant and equipment	18,808	145	18,953
Right of use assets[1]	-	7,878	7,878
Investment property	92	-	92
Investments in joint ventures and associates	702	(37)	665
Other investments	648	-	648
Trade and other receivables	169	52	221
Loans and advances to customers	7,547	-	7,547
Derivative financial instruments	1,199	-	1,199
Deferred tax assets	137	59	196
	35,765	8,087	43,852
Current assets			
Other investments	42	-	42
Inventories	2,821	-	2,821
Trade and other receivables	1,608	(113)	1,495
Loans and advances to customers	4,846	-	4,846
Derivative financial instruments	194	-	194
Current tax assets	-	-	-
Short-term investments	760	-	760
Cash and cash equivalents	3,243	-	3,243
	13,514	(113)	13,401
Assets of the disposal group and non-current assets classified as held for sale	123	-	123
	13,637	(113)	13,524
Current liabilities			
Trade and other payables	(9,749)	240	(9,509)
Borrowings	(2,534)	14	(2,520)
Lease liability[2]	-	(712)	(712)
Derivative financial instruments	(117)	-	(117)
Customer deposits and deposits from banks	(8,842)	-	(8,842)
Current tax liabilities	(333)	-	(333)
Provisions	(465)	117	(348)
	(22,040)	(341)	(22,381)
Net current liabilities	(8,403)	(454)	(8,857)
Non-current liabilities			
Trade and other payables	(399)	19	(380)
Borrowings	(5,403)	111	(5,292)
Lease liability[2]	-	(9,975)	(9,975)
Derivative financial instruments	(522)	-	(522)
Customer deposits and deposits from banks	(3,041)	-	(3,041)
Post-employment benefit obligations	(2,574)	-	(2,574)
Deferred tax liabilities	(311)	253	(58)
Provisions	(739)	579	(160)
	(12,989)	(9,013)	(22,002)
Net assets	**14,373**	(1,380)	**12,993**
Equity			
Share capital	490	-	490
Share premium	5,163	-	5,163
Retained earnings and other reserves	8,741	(1,380)	7,361
Equity attributable to owners of the parent	14,394	(1,380)	13,014
Non-controlling interests	(21)	-	(21)
Total equity	14,373	(1,380)	**12,993**
KPIs and APMs			
Net debt[3]	(3,126)	(10,527)	(13,653)
Total indebtedness[4]	(12,472)	(3,325)	(15,797)

1. The right of use asset of £7,878m includes £109m assets held under finance leases, previously included in 'PP&E'.
2. Total lease liabilities of £(10,687)m include £(125)m finance lease liabilities previously included in borrowings.
3. Net debt comprises bank and other borrowings, lease liabilities, net derivative financial instruments, joint venture loans and other receivables/payables, offset by cash and cash equivalents and short-term investments. It excludes the net debt of Tesco Bank (which has lease liabilities of £35m).
4. Total indebtedness pre-IFRS 16 comprises Net debt plus the IAS 19 deficit in the pension schemes (net of associated deferred tax) plus the present value of future minimum lease payments under non-cancellable operating leases. Post-IFRS 16, lease liabilities are included in Net debt, replacing the present value of future minimum lease payments under non-cancellable operating leases.

Summary Retail Cash Flow Restatement for the 26 weeks ended 25 August 2018 (unaudited)

	26 weeks ended 25 August 2018 reported £m	IFRS 16 impact £m	26 weeks ended 25 August 2018 restated £m
Operating profit before exceptional items and amortisation of acquired intangibles	933	188	1,121
Less: Tesco Bank operating profit before exceptional items	(89)	(1)	(90)
Retail operating profit from continuing operations before exceptional items and amortisation of acquired intangibles	844	187	1,031
Add back: Depreciation and amortisation	596	339	935
Other reconciling items	1	(9)	(8)
Pension deficit contribution	(142)	–	(142)
Underlying (increase) / decrease in working capital	(29)	17	(12)
Retail cash generated from operations before exceptional items	1,270	534	1,804
Exceptional cash items:			
Relating to prior years:			
– Shareholder Compensation Scheme payments	(27)	–	(27)
– Utilisation of onerous lease provisions	(32)	32	–
– Restructuring payments	(58)	–	(58)
Relating to current year:			
– Restructuring Payments	(30)	–	(30)
Retail operating cash flow	1,123	566	1,689
Cash capex	(459)	–	(459)
Net interest & tax	(274)	(286)	(560)
Property proceeds	134	–	134
Property purchases – store buybacks	(35)	–	(35)
Market purchases of shares (net of proceeds)	(139)	–	(139)
Acquisitions and disposals and dividends received	(693)	–	(693)
Deduct: Booker acquisition	747	–	747
Repayments of obligations under leases	(7)	(280)	(287)
Retail free cash flow[1]	397	–	397

1. Retail cash flow has been redefined to include repayments of obligations under leases due to IFRS 16. This results in a minor adjustment of £7m, restating reported retail cash flow of £404m to a represented retail free cash flow of £397m. There is no overall impact to cash / cash equivalents at the end of the period.

Transition Balance Sheet restatement at 24 February 2018 (unaudited)

	24 February 2018 reported £m	IFRS 16 impact £m	24 February 2018 restated £m
Non-current assets			
Goodwill, software and other intangible assets	2,661	-	2,661
Property, plant and equipment	18,521	191	18,712
Right of use assets	-	7,527	7,527
Investment property	100	-	100
Investments in joint ventures and associates	689	(35)	654
Other investments	860	-	860
Trade and other receivables	186	31	217
Loans and advances to customers	6,885	-	6,885
Derivative financial instruments	1,117	-	1,117
Deferred tax assets	116	285	401
	31,135	7,999	39,134
Current assets			
Other investments	68	-	68
Inventories	2,264	-	2,264
Trade and other receivables	1,504	(89)	1,415
Loans and advances to customers	4,637	-	4,637
Derivative financial instruments	27	-	27
Current tax assets	12	-	12
Short-term investments	1,029	-	1,029
Cash and cash equivalents	4,059	-	4,059
	13,600	(89)	13,511
Assets of the disposal group and non-current assets classified as held for sale	149	-	149
	13,749	(89)	13,660
Current liabilities			
Trade and other payables	(8,994)	221	(8,773)
Borrowings	(1,479)	12	(1,467)
Lease liability	-	(712)	(712)
Derivative financial instruments	(69)	-	(69)
Customer deposits and deposits from banks	(7,812)	-	(7,812)
Current tax liabilities	(335)	-	(335)
Provisions	(544)	128	(416)
	(19,233)	(351)	(19,584)
Net current liabilities	(5,484)	(440)	(5,924)
Non-current liabilities			
Trade and other payables	(364)	-	(364)
Borrowings	(7,142)	110	(7,032)
Lease liability	-	(9,560)	(9,560)
Derivative financial instruments	(594)	-	(594)
Customer deposits and deposits from banks	(2,972)	-	(2,972)
Post-employment benefit obligations	(3,282)	-	(3,282)
Deferred tax liabilities	(96)	14	(82)
Provisions	(721)	592	(129)
	(15,171)	(8,844)	(24,015)
Net assets	**10,480**	(1,285)	9,195
Equity			
Share capital	410	-	410
Share premium	5,107	-	5,107
Retained earnings and other reserves	4,985	(1,285)	3,700
Equity attributable to owners of the parent	10,502	(1,285)	9,217
Non-controlling interests	(22)	-	(22)
Total equity	10,480	(1,285)	9,195
KPIs and APMs			
Net debt[1]	(2,625)	(10,114)	(12,739)
Total indebtedness[2]	(12,284)	(3,183)	(15,467)

1. Net debt comprises bank and other borrowings, lease liabilities, net derivative financial instruments, joint venture loans and other receivables/payables, offset by cash and cash equivalents and short-term investments. It excludes the net debt of Tesco Bank (which has lease liabilities of £36m).
2. Total indebtedness pre-IFRS 16 comprises Net debt plus the IAS 19 deficit in the pension schemes (net of associated deferred tax) plus the present value of future minimum lease payments under non-cancellable operating leases. Post-IFRS 16, lease liabilities are included in Net debt, replacing the present value of future minimum lease payments under non-cancellable operating leases.