Introducing IFRS 16.

15 February 2019

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TESCO

Agenda.

- Introduction
- Key principles of IFRS 16
- Impact on reporting of our financial statements
- What happens next?
- Q & A

Key messages

- No impact on:
  - Our economics
  - How we run the business
  - Cash

- Significant impact on reporting of our financial statements:
  - Leases brought on balance sheet, including extensions (where ‘reasonably certain’) and contingent commitments
  - Shape of income statement changes significantly:
    - Operating profit and margin go up
    - PBT and EPS go down, due to relative immaturity of lease portfolio

- Applies to all annual reporting periods beginning on or after 1 January 2019
  - 2018/19 Prelims will be reported on pre-IFRS 16 basis
  - First Tesco results published on IFRS 16 basis: 2019/20 Interims (2 October 2019)

- No bearing on our plans or financial ambitions

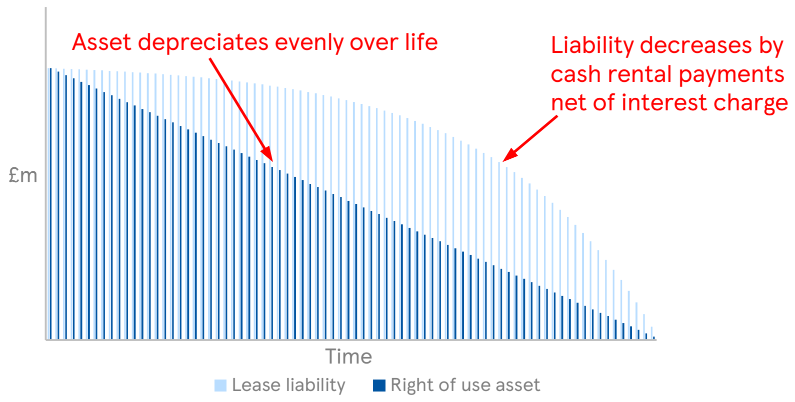
Our approach

- Two options available for IFRS 16 adoption:
  - Fully retrospective and modified retrospective
- Elected to use a fully retrospective approach
  - As if IFRS 16 had always applied
  - Most comprehensive and representative view
  - Comparative year (2018/19) accounts restated
- Comprehensive and detailed process
  - Over 9,000 lease contracts individually reviewed and assessed
  - c.360,000 data points, including commercial terms and historic inputs dating back to lease inception
  - Two and a half year programme from launch to implementation
- Balance sheet transition occurs as at 24 February 2018
  - Focus today on 1H 2018/19 - will form prior period comparatives for October 2019 Interims

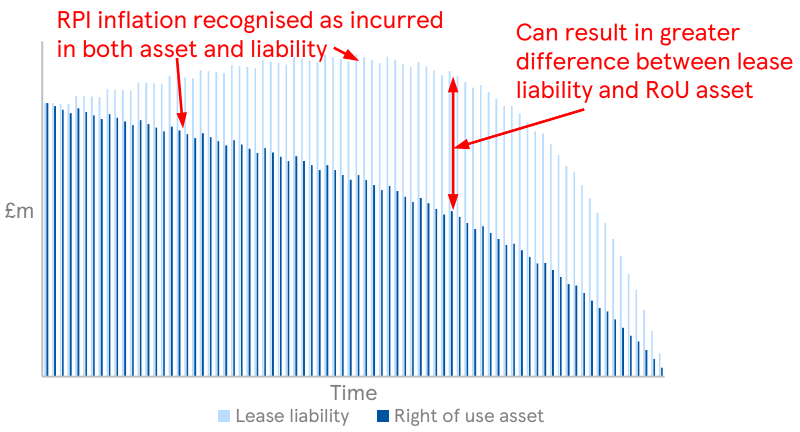
IFRS 16 key principles - Balance sheet

- Aligns presentation of leased assets more closely to owned assets
- Brings both an asset and liability on balance sheet
  - Lease liability equal to present value of future payments
  - At inception right of use asset equals lease liability[1]
- Over the lease term, the asset and liability differ in value
  - Right of use asset depreciates evenly
  - Lease liability decreases by cash rental payments, net of interest charged (which reduces over time)
  - Assets subject to annual impairment testing
  - Asset and liability also revalued following:
    - Non-predetermined changes in rent – e.g. RPI-linked rental uplifts or renegotiation
    - A reassessment of lease term

Example 1: 20 year lease with fixed annual rentals



Example 2: 20 year lease with RPI-linked[2] rental uplifts

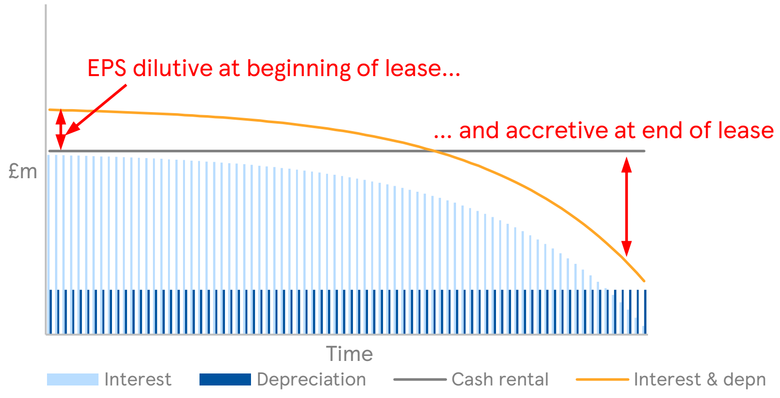


1. The right of use asset is also adjusted for prepayments, legal fees, dilapidations and incentives already received
2. Example assumes 3% RPI inflation per annum

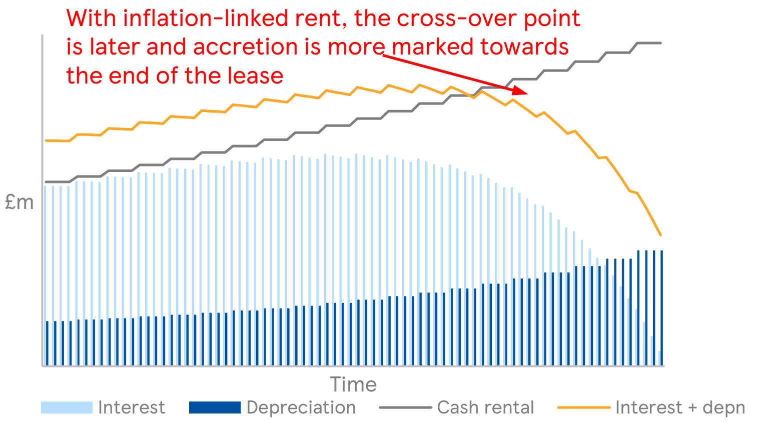
IFRS 16 key principles - Income statement

- Straight-line operating lease rental expense replaced by:
  - depreciation on right of use asset, straight-lined over lease term
  - interest charge on lease liability which reduces over lease term
- Over the life of any lease, the total charge to the income statement is the same as total cash rent paid both pre- and post-IFRS 16
- Operating profit and margin <u>always</u> increases as the rental charge is removed and only partly offset by depreciation
- However, the impact on PBT and EPS depends on lease maturity:
  - <u>IFRS 16 is dilutive to EPS at the beginning of a lease and accretive to EPS at the end of a lease</u>, as interest charged is higher in the earlier years and reduces over time
  - This effect is more marked if rent increases during the lease e.g. due to RPI-linked rental uplifts

Example 1: 20 year lease with fixed annual rentals



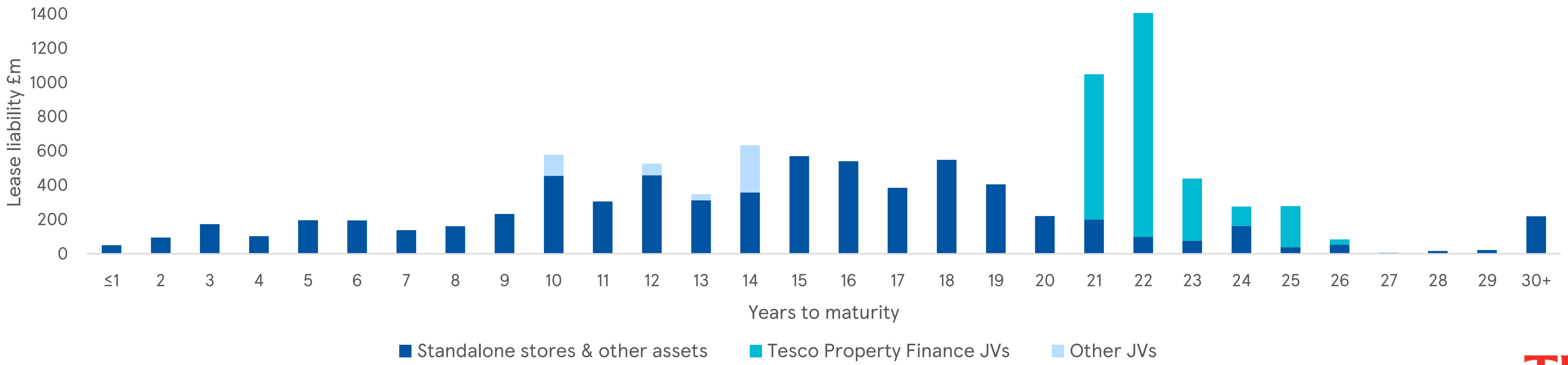
Example 2: 20 year lease with RPI-linked[1] rental uplifts



1. Example assumes 3% RPI inflation per annum

Understanding our lease portfolio

- Relatively immature:
  - Around one-third expired
  - Average total lease length of 26 years
- 67% of liabilities relate to standalone leases, 33% to leases with JVs
- 77% of liabilities subject to RPI-linked rental uplifts



Calculating our IFRS 16 lease liability

- The lease liability is greater than currently disclosed minimum lease commitments due to:
  1. Inclusion of contingent lease commitments
  2. Inclusion of extension or post-break periods, where reasonably certain
  3. Application of lease-specific discount rates

1 Inclusion of contingent lease commitments

Note 21 Lease commitments continued

Operating lease commitments represent rentals payable by the Group for certain of its retail, distribution and office properties and other assets such as motor vehicles. The leases have varying terms, purchase options, escalation clauses and renewal rights. Purchase options and renewal rights, where they occur, are at market value. Escalation clauses are in line with market practices and include inflation linked, fixed rates, resets to market rents and hybrids of these.

The Group has lease-break options on certain sale and leaseback transactions. These options are exercisable if the Group exercises an existing option to buy back, at market value and at a specified date, either the leased asset or the equity of the other joint venture partner. No commitment has been included in respect of the buy-back option as the option is at the Group's discretion. The Group is not obliged to pay lease rentals after that date, therefore minimum lease commitments exclude those falling after the buy-back date. The current market value of these properties is £2.8bn (24 February 2018: £2.8bn, 26 August 2017: £2.9bn) and the total undiscounted lease rentals, if they were to be incurred following the option exercise date, would be £2.9bn (24 February 2018: £2.6bn, 26 August 2017: £2.6bn) using current rent values, as shown below.

The additional lease rentals if incurred following the option exercise date would be as follows:

	25 August 2018 £m	24 February 2018 £m	26 August 2017 £m
Within one year	–	2	14
Greater than one year but less than five years	339	265	198
Greater than five years but less than ten years	746	738	717
Greater than ten years but less than fifteen years	746	659	660
After fifteen years	1,114	935	976
Total undiscounted contingent additional lease rentals	**2,945**	**2,599**	**2,565**
Total discounted contingent additional lease rentals at 7%	1,353	1,159	1,151

Extract shown: Note 21 of the 2018/19 Interim Results statement

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2 Inclusion of extension or post-break periods, where reasonably certain

- Currently, disclosed lease commitments are based on rent due during the non-cancellable period of leases – i.e. the minimum amount required to be paid
- The IFRS 16 lease liability includes all amounts ‘reasonably certain’ to be paid under any given lease
- As such, in addition to minimum commitments it also includes:
  - Periods after break clauses if we are reasonably certain we will not break
  - Extension periods if we are reasonably certain we will extend

POST-IFRS 16 LEASE LIABILITY

PRE-IFRS 16 LEASE COMMITMENTS

Non-cancellable period (up to break point) + Periods after break if ‘reasonably certain’ not to break + Extension periods if ‘reasonably certain’ to extend

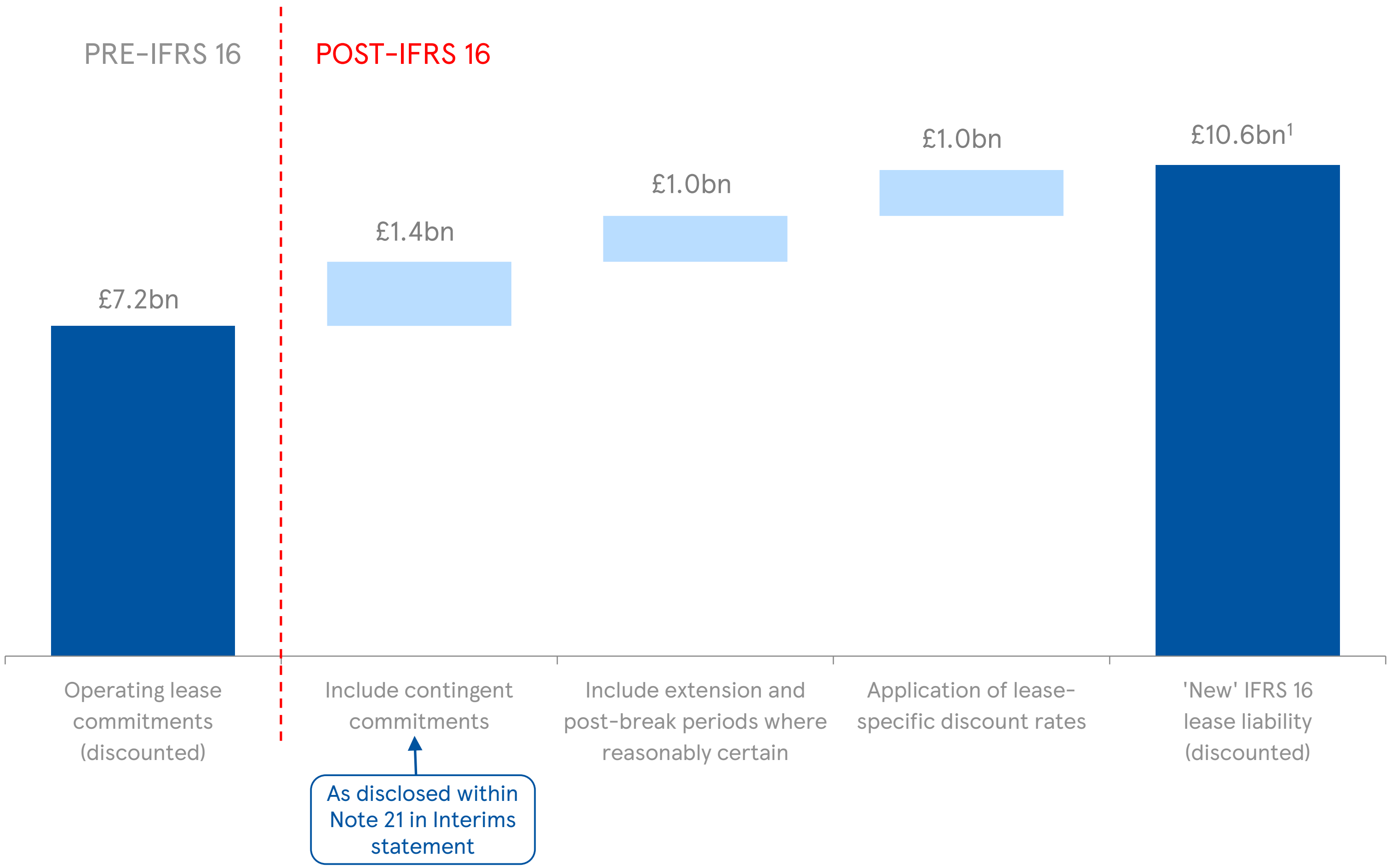
❸ Application of lease-specific discount rates

- Discount rate for each lease dependent on:
  - lease start date
  - lease term
  - currency
- Based on rate implicit in lease if can be determined (e.g. where Tesco is involved in the related property JV)
- Otherwise based on incremental borrowing rate
  - as at the time we entered into the lease
  - calculated using multiple data inputs

Weighted average discount rate across all leases is 5.8% at Feb 18

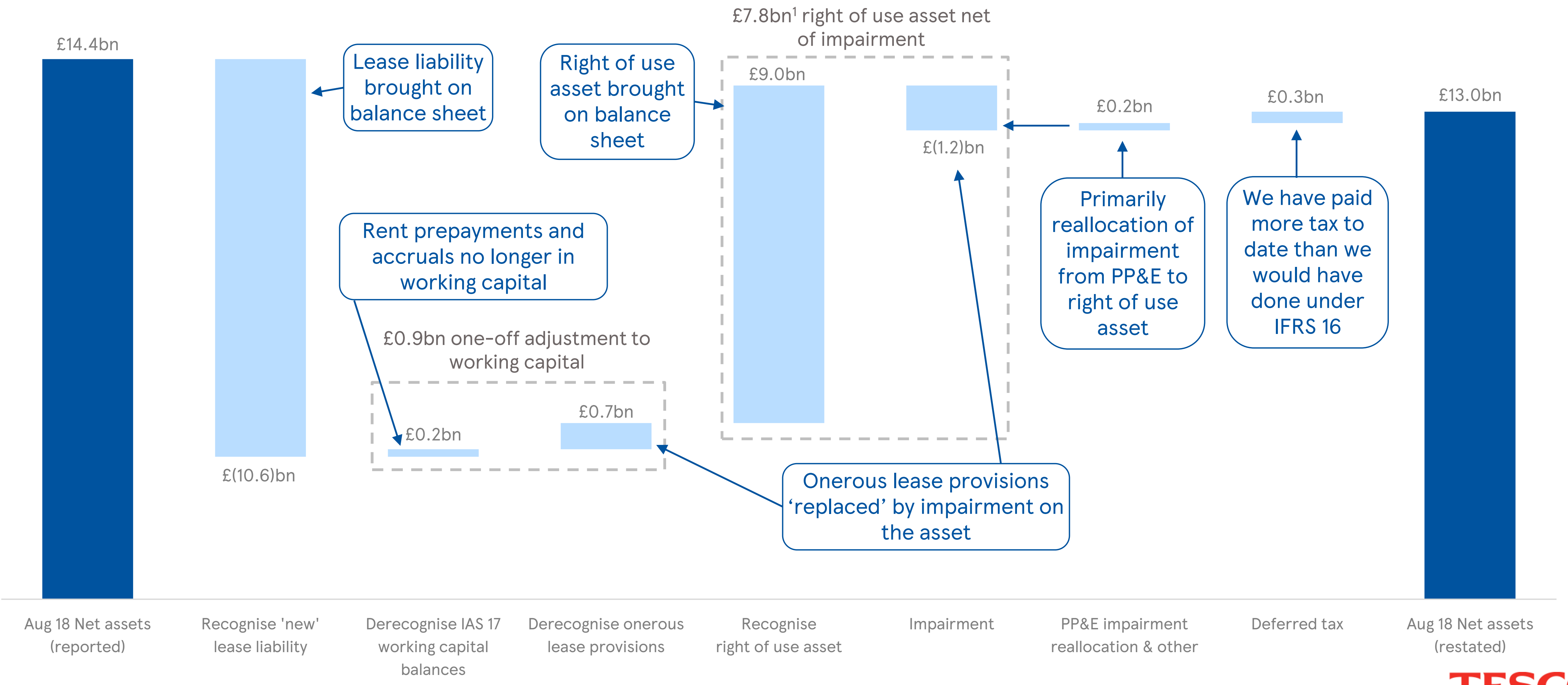
1. Organisation for Economic Co-operation and Development

Our lease liability – as at 25 August 2018



1. Total current and non-current lease liabilities of £(10,687)m recorded on Balance Sheet as at 25 August 2018 includes £(125)m finance lease liabilities previously included in 'Borrowings'

Balance sheet – as at 25 August 2018



1. The right of use asset of £7,878m recorded on Balance Sheet as at 25 August 2018 includes £109m assets held under finance lease previously included in 'PP&E'

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Income statement – for 26 weeks to 25 August 2018

- Rental charge replaced by depreciation on right of use asset and interest on lease liability

£m	Pre-IFRS 16[1]	IFRS 16 impacts (non-cash) Exclude: rent	Include: depn.	Include: interest	Other	Post-IFRS 16[1]	
Revenue	31,734					31,734	No change
Other operating costs	(29,584)				6	(29,578)	Principally relates to gain on disposal of leases
Operating lease rentals	(538)	522				(16)[2]	Operating lease rentals removed
Depreciation	(679)		(340)			(1,019)	Straight-line depreciation charge added
Operating profit	**933**	**522**	**(340)**		**6**	**1,121**	**Operating profit rises**
JVs and associates	20				(2)	18	Principally impact on Gain Land associate
Finance income	7			2		9	Interest on finance sub-leased property included
Finance costs	(293)			(289)		(582)	High interest charge, reflecting lease immaturity
Profit before tax	**667**	**522**	**(340)**	**(287)**	**4**	**566**	**Profit before tax reduces**

1. Before exceptional items and amortisation of acquired intangibles
2. Relates to leases not brought on balance sheet by IFRS 16 e.g. short-term leases and leases on low value assets

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Retail cash flow – for 26 weeks to 25 August 2018

- Cash flows reclassified between operating and financing activities
- No change to net cash flow

£m	Pre-IFRS 16	Reclassify rent payment…	… as 'interest' & 'capital repayments'	Post-IFRS 16	
Retail operating cash flow	**1,123**	**566**		**1,689**	**Operating lease rental removed**
Net interest and tax	(274)		(286)	(560)	Interest element of lease payments added
Repayments of obligations under leases	(7)		(280)	(287)	Capital element of lease payments added
Retail free cash flow	**(397)**	**566**	**(566)**	**(397)**	**No change. Definition updated to include repayments of obligations under leases**
Net increase / (decrease) in cash	**(848)**	**566**	**(566)**	**(848)**	**No change to net cash**

Note: Select lines of cash flow shown

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Impact on KPIs

- All current KPIs maintained
- Retail free cash flow definition amended to include cash rental payments

		Pre-IFRS 16	Change	Post-IFRS 16	
Income statement	Operating margin[1]	2.94%	0.59%	3.53%	Rent removed and only part replaced by depreciation
	Diluted EPS[2]	6.36p	(0.91)p	5.45p	Due to combination of depreciation and interest being higher than the rent they replace, driven by relative immaturity of lease portfolio
Balance sheet	Net debt	£(3.1)bn	£(10.5)bn	£(13.7)bn	Addition of 'new' lease liability
	Total indebtedness	£(12.5)bn	£(3.3)bn	£(15.8)bn	Due to lease extension and contingent commitments being included and lease specific discount rates being applied
Cash flow	Retail operating cash flow	£1,123m	£566m	£1,689m	Rent removed
	Retail free cash flow	£397m	-	£397m	No change. Free cash flow measure redefined to include repayments of obligations under leases

1. Before exceptional items and amortisation of acquired intangibles
2. Excludes exceptional items, amortisation of acquired intangibles, net pension finance costs and fair value remeasurements of financial instruments

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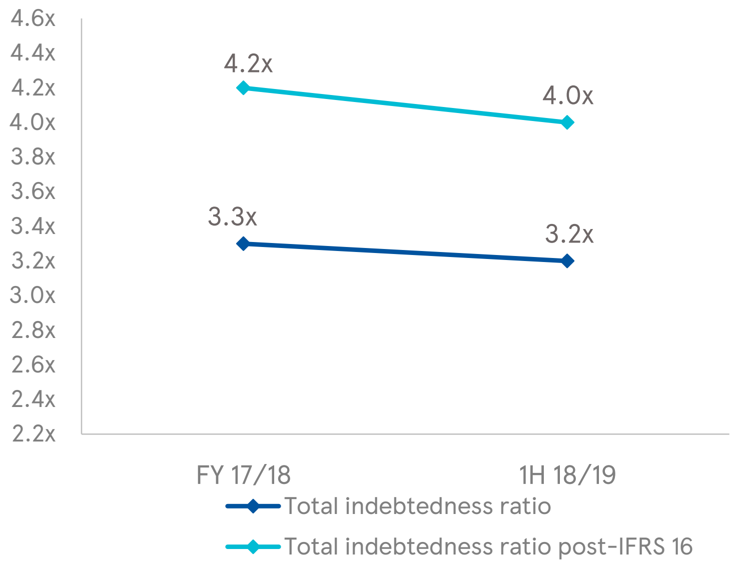
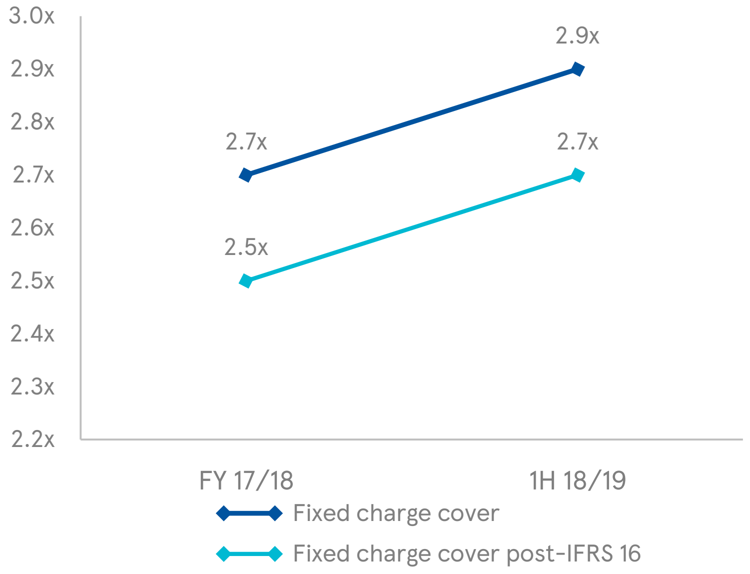
Impact on debt metrics

- Metrics redefined post-IFRS 16:
  - Total indebtedness ratio = Net debt + defined pension deficit (net of tax) / EBITDAR
  - Fixed charge cover = EBITDAR / (Net finance costs[1] + cash rent)

Total indebtedness ratio[2]



Fixed charge cover[3]



1. IFRS 16 Definition: Net finance costs (before exceptional charges, net pension finance costs, fair value re-measurements) and adjusted to remove IFRS 16 interest expense
2. Pre-IFRS 16 Definition: Net Debt + defined pension deficit (net of tax) + discounted operating lease commitments / EBITDAR
3. Pre-IFRS 16 Definition: EBITDAR / (Net finance costs (before exceptional charges, net pension finance costs and fair value re-measurements) + Retail operating lease expense)

What happens next?

Today

- Sharing 1H 18/19 income statement and cash flow on IFRS 16 basis
- Sharing opening (Feb 18) and 1H (Aug 18) balance sheet on IFRS 16 basis

18/19 Prelims (10 April 2019)

- Results continue to be reported on pre-IFRS 16 basis
- Headline summary of IFRS 16 impact on FY18/19 financials to be provided

Post Prelims

- Full FY 18/19 financial statements published on IFRS 16 basis

19/20 Interims (2 October 2019) and beyond

- Financial statements (including comparative period) prepared on IFRS 16 basis
- Sufficient disclosure provided to translate progress against our 2019/20 ambitions back to a pre-IFRS 16 basis

Key messages

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Q&A.

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