Tesco PLC - Q1 Trading Statement 2023/24

Analyst Call

Friday 16th June 2023

Transcript

Please note, this transcript has been prepared by our third party webcast provider and is not reviewed by Tesco

Ken Murphy: Good morning, everyone. Thank you for joining us today. I'm here in Welwyn with Imran. In a moment, we'll be delighted to take your questions.

Before I share a few key highlights, I'd like to start by thanking the entire team for the fantastic contribution that they make every single day. Their ongoing hard work is evident in the strength of our offer and ensures we can deliver brilliantly for our customers. I'm really pleased with the performance of the entire business in what continues to be a competitive and challenging market. This strong performance has been underpinned by our ongoing and relentless focus on value and quality, ensuring customers can benefit in every part of their basket.

It's really important that we continue to support customers as they face ongoing and significant cost of living pressures. I'm therefore really pleased that we have led the way in cutting prices on the everyday essentials that customers rely on, such as milk, pasta, and cooking oil. To give you a sense of the scale of the impact of our recent price cuts on some of our most popular owned brand products, bread is now 12% cheaper, broccoli is 16% cheaper, and pasta is 16% cheaper also than it was just a few weeks ago.

Our overall focus on value is, of course, much broader and we have continued to invest in our offer through our powerful combination of Aldi price match, low everyday prices, and Clubcard prices. Our price index has strengthened not only against the discounters but also versus the whole market.

I'm also very pleased that our continued focus on quality is reflected in nine consecutive periods of switching gains from premium retailers as we help customers who want to celebrate or treat themselves to something special. We've made further progress in developing our finest offer, launching 126 new products with nearly 70 in our barbecue and picnic ranges including summer-inspired sweet treats and chill desserts. The recent launch of our finest signature vegetable dishes is a great example of increased focus on innovation, health, and convenience and, of course, fantastic tasting food that our reinvigorated product team is delivering.

Overall, I'm really pleased with our progress in the first quarter. Our performance is strong on every front. Our in-store execution is best in class. We're the most competitive we've ever been for our customers, and we continue to make meaningful strategic progress. This all means we are well positioned for the months ahead. I'm therefore confident in our ability to deliver again for all of our stakeholders, and we are reiterating our guidance for the full year.

With that, I'll hand the call back to the operator for Q&A. Thank you.

Call Operator: If you would like to ask a question, please press star one on your telephone keypad. Please ensure your line is unmuted locally as you'll be advised when to ask your question. Once again, that's star one, if you would like to ask a question.

The first question comes from the line of William Woods from Bernstein. Please go ahead.

William Woods: Hi, good morning. Thank you for taking question. I've got two, if that's okay. The first one's just on the price cuts that you've talked about. Do you think we'll see wholesale deflation over the next couple of months? Is what you're talking about kind of month-on-month deflation? Are you deflating any products year-on-year? And then the second question is, obviously, in the Groceries Code survey that came out recently, your position has come down over the last year. How are your relationships with suppliers at the moment? Thank you.

Ken Murphy: Well, thank you for the questions. Let me answer the second question first.

The supplier relationships are really strong. We continue to be seen as leaders in terms of transparency and fairness in the way we deal with our suppliers. Although we've slipped a couple of places in the rankings, there's literally one or two percentage points that separate the top six, and we're still voted as compliant with the GCA by over 95% of suppliers.

You can take that as an indicator that, while conversations are very robust around cost of goods and the pass through of inflation and making sure that we only pass through the prices and the costs that we absolutely have to, to our consumers, what you can rely on is us to take a long term strategic view for us to always act in a fair and transparent way with our suppliers. The fact that we are a more demanding partner is not necessarily a bad thing in my view.

In terms of inflation, I'll pass over to Imran for his view in one second. My point simply put is you just have to differentiate between structural and transitory inflation. Structural inflation such as energy and wages appear to be here for some time. Who knows what will happen to energy over the next 12 to 24 months, but wages will persist. But on commodities, it's much harder to judge.

Imran Nawaz: The deflation that you're seeing is really the month-on-month, to your question. Clearly, our mantra has always been that we want to be there on value. The good thing is, as of today, we are stronger than ever on our price index versus all key competitors, and that's important to us. I think it's reflected therefore as well in how we delivered quarter one. Look, where commodities continue to ease, clearly, our goal will be to make sure we can pass those on, but there will also be some that go the other way. The reality is we need to judge it month by month, and that's sort of part of the day job.

William Woods: Perfect. Thank you.

Ken Murphy: Thanks Will.

Call Operator: The next question comes from the line of Nick Coulter from Citi. Please go ahead.

Nick Coulter: Hi, good morning. I just wonder if I may, for Imran, please. I know it's a trading update, but could you talk about how the onset of disinflation or lower inflation will impact the business and whether that presents any challenges for you further down the income statement please. Thank you.

Imran Nawaz: It's a little bit like what we've just gone through. What we've demonstrated over the last two years is that, as you're dealing with inflation on whether we save, whether you drive the mix, whether we invest in value, similarly as we start to see deflation or disinflation, as you refer to it, we need to continue to make sure that we keep winning, making sure we get the right volume, protecting our market share, and doing it in the right way for customers. Then we'll call it just day job. Obviously, everything on the way up and on the way down, you need to handle it. But so far, we've demonstrated that ability to manage as prices move.

Nick Coulter: Thank you. But just to be clear, you don't see an increased risk of margin squeeze as we see lower inflation coming through?

Imran Nawaz: Now, look, I think what we are seeing at the moment is the moving pieces are pretty much playing themselves out. As we talked around six weeks ago when we met in April, we continue to ensure that we drive our savings. We continue to drive the mix where we have seen some disinflation. We have passed it on, but protecting our margin. I don't actually see that as a big challenge. Remember the one thing, and this is critical for us, the way we run the business is for absolute profit delivery. And that's always a combination of getting the best volume we can get at the best price for our customers to maximise profitability and cash returns. So far, that's played out well. If you ask me at this stage, do I see anything different than what I told you six weeks ago? Absolutely not, and I feel quite good after the first quarter of where we are.

Nick Coulter: Brilliant. Thank you so much.

Ken Murphy: Thanks, Nick.

Call Operator: The next question comes from the line of Andrew Gwynn from BNP Paribas. Please go ahead.

Andrew Gwynn: Good morning. Two questions but one very quick clarification. Could you just clarify if you are seeing actually deflation across the whole basket sequentially at present? You've called a few products, but across the whole basket, presumably, we're still seeing a little bit of even inflation versus where we were a few weeks ago.

And then the two questions firstly on suppliers, we've already touched on that briefly, is there any evidence that suppliers are potentially hanging on to some of the price increases that they've already pushed through and are reluctant to sort of move downwards? Then the second question, Central Europe clearly very subdued given where food inflation is, so some more comments beyond what you can see in the press release would be welcomed. Thank you.

Ken Murphy: On deflation, Andrew, the first thing I'd say is that I go back to my earlier point around structural versus transitory. I would say that we see structural wage inflation in the system through our producers, our supply chain, and our own retail operations, and that is a combination of, obviously, inflation-driven demand and also a reduced supply of labour on the back of Brexit, et cetera. So, there are two factors at play in the UK. One is specific to the UK, the other is much more general. The second point is that a lot of energy cost inflation has been hedged into the system, and so that will persist for some time even though energy prices on the spot rate are falling.

In terms of the transitory inflation, actually, you're seeing a bit of a mixed bag. So where there has been commodity inflation in the areas of dairy and cereals, you are seeing us take prices down. That is evidenced by the price drop on milk and butter, and the price drops on bread and pasta, and oils. In other areas, you are seeing actually some persistent inflation in the areas of rice and potatoes. It's not all straightforward, and some of that is driven by weather-related crop yields, et cetera. It's not really across the board. It's very different by commodity sector.

In terms of our suppliers, the first thing importantly is that where we've seen the greatest levels of inflation has been typically in fresh categories, and that's because they are the most exposed to wage inflation and energy inflation, and also to feed cost inflation. They are the ones who've experienced the most significant spikes in prices. But for the majority of those, we operate open book contracts, which means that we had to take those prices up quickly when the inflation was coming through their books. But equally, as commodities come down in some of those areas, we're able to take the prices back down. That is where I have a high degree of confidence that we will see deflation reflected in prices when the actual deflation occurs.

I think it's harder to see what will happen in the rest of the sector because it depends on the individual efficiency of that supplier and of the strength of their brand, et cetera. That is where it becomes a more judgment-based negotiation. What really helps us is we have a fantastic sourcing model, which basically we call it very imaginatively should-cost, but it gives us a breakdown of every product in terms of its components and its composition. Therefore, we can judge reasonably accurately what the product should cost, and that is where we get into fairly robust conversations with suppliers, and we push all of us, including Tesco, for greater efficiency so that the customer doesn't bear the brunt of the impact of inflation.

Imran Nawaz: Maybe I'll take the question on Central Europe. Look, as you pointed out, like for like sales were around 1.1% up for the quarter. The way we think about this going into the year, we knew that we would be lapping a extremely strong quarter one last year where we had a very resilient volume and performance as well as relatively high inflation.

Now, last year, as background, there was a lot of government stimulus, especially in Hungary, that went straight into people's bank accounts, if you wish, and that really propped up the volume performance in quarter one. The inflation in general is much higher in Central Europe than it is in the rest of Europe. Clearly, that does bring with it some sort of softness on the discretionary spending side as well. So, it's not really a surprise. I feel, overall, the team's in a good place. We've put in place the right price cut promotions, the similar low everyday prices campaigns that we have been running in the UK, similarly in Central Europe, and they're doing the job. We feel good about where we are in Central Europe, but, clearly, lapping an extraordinary year last year, it was always going to be a bit more of a challenge this year.

Andrew Gwynn: Just following up on that, would you anticipate a material improvement as we go into the second half or even Q2 for Central Europe?

Imran Nawaz: Look, the team is certainly feeling good about as we sequentially go into the second half of the year, yes.

Andrew Gwynn: Okay, clear as always. Have a great weekend. Thank you.

Imran Nawaz: Thank you.

Ken Murphy: Thank you.

Call Operator: The next question comes from the line of Izabel Dobreva from Morgan Stanley. Please go ahead.

Izabel Dobreva: Hello, good morning, and thank you for taking my questions. From your comments, so far, it sounds like we'll likely see quite different pricing dynamics in some of the private label and fresh categories relative to the brands where some of the CPGs are still talking about price increases. My question is, do you see more willingness from the brand manufacturers to fund promotions and any changes in your supplier income?

My second question is around volumes. In the release, you pulled out a strong volume response to the price lock campaign. The question is how do you expect the volume elasticity to behave as pricing starts to roll over in food? Is there a risk that the volumes might remain muted due to wallet mix shifts back into non-food?

Ken Murphy: Thanks, Izabel. Let me start by addressing the second question first, which is that there are a number of dynamics at play here. First of all, again, back to the points on structural inflation, is that the elements of inflation are unlikely to ease in the next six months or so, but we would hope commodity prices will start to ease more, and then you'll start to see a kind of steadying, if you like, and a slow decline of inflation over the course of the rest of the year. But that remains to be seen. Whatever happens, given the huge savings programs and efficiency programs that we've undertaken over the last two years, we are a much leaner business coming through this cost of living crisis, and those structural savings will persist.

The other thing we've demonstrated, firstly, through the pandemic, then through the supply chain crisis, and now through the cost of living crisis is an incredible agility and an ability to respond. I feel particularly pleased about the fact, that despite of all the inflationary pressures, we have managed the balance incredibly well. We're the most competitive we've ever been in the market relative to competition on pricing. We are rewarding colleagues at the highest rate we've done for many years. Our suppliers remain confident that we're a great partner to work with.

Of course, we've done a great job for investors as well, and that kind of balance is something that we will seek to maintain the way through my tenure in the business because, I believe, that is super important for the long term health and sustainability of the company. And it's proven to work for us as a business where we've chosen to do the right thing at each juncture.

Sorry, your second question again, Izabel, just remind me.

Izabel Dobreva: It was around volume elasticity as price of food inflation rolls over.

Ken Murphy: Volumes have been suppressed through the cost of living crisis and is evident by the delta between inflation and sales growth. Albeit by the way, the true rate of inflation that consumers see through shopping at Tesco is significantly lower than the headline rate of inflation that you're seeing quoted in Kantar, et cetera. Of course, that's because they were able to trade down to cheaper alternatives and different types of protein and fresh to frozen, eating out, eating in. They're using a number of different tricks in their repertoire to manage that budget. Of course, they are cutting down on discretionary spending.

Now, general merchandise and clothing is 7% of our sales in the quarter. We are less exposed to those discretionary categories but, equally, we would start to expect a gentle trading up and a gentle volume improvement as cost pressures increase because, clearly, wages have also increased meaningfully over the last 12 months, and we are still in a full employment market. We feel reasonably good that we're well able to manage any future dynamics in the market, including deflation.

Call Operator: The next question comes from the line of Clive Black from Shore Capital. Please go ahead.

Clive Black: Good morning, gentlemen. Thanks for your time. Two quick ones, if I may then. Just interested in a period where volumes are sustainably lower, how you manage the traditional working capital dynamics of the business.

Secondly, just intrigued about what you said on the online market in your statement gaining market share. Just wondered, could you give us some colour where you're gaining that from, do you think, but also how the contribution from online is evolving for you? Thank you.

Ken Murphy: Great, thanks very much. Let me handover to Imran to talk working capital.

Imran Nawaz: Look, as you know, cash flow and working capital, in particular, are key focus areas for the last two years and continue to be. As you point out, managing lower volumes is critical in that work that we do. Maybe two areas. One is we've been very, very disciplined on ensuring that the stock levels, the complexity that we have, the SKU management doesn't lead to any inefficiencies and has actually been a positive contributor to working capital improvement. So, have been the areas with our suppliers on the payable side. I actually feel really good even when I look at quarter one where we landed on cash and working capital. It's all in the right place from that angle.

Clive Black: Thank you.

Call Operator: Next question comes from the line of Sreedhar Mahamkali from UBS. Please go ahead.

Sreedhar Mahamkali: Hi, good morning. Thanks for taking my questions. I've got one follow up from Clive, and a couple of other questions, please. Just on Clive's question on working capital, the fuel sales down quite meaningfully, does that change anything in the way? I suppose you're thinking about working capital flow for the year around about that hundred-million mark as the follow up?

Second... well, a couple of other questions. Going back to the commodity during price cut you pointed to, just wanted to understand the timing and the quantum of these price cuts, they are reflecting the commodity price decline or is there a greater willingness, I suppose, is the question in the market and for yourselves to trade a bit of margin for better sales and market share. The second question was just in terms of channel performance, growth in large stores seems to be very strong, well ahead of convenience, if you could explain that a little bit more, is that just to do with comps from last year or consumers getting back into larger stores and fuller shops? That would be superb Thank you.

Imran Nawaz: Let me take the first one on fuel. Clearly, fuel prices is something we deal with every year, right? Last year was one direction. This year, prices have come down, so have volumes.

To be fair, we sort of assumed that within our guidance range that that would be the case, so it doesn't give me an additional headache versus the guidance we laid out. I feel actually quite good so far on how we're dealing with that.

On the channel performance, Ken, I don't know if you wanted to-

Ken Murphy: Yeah. The channel performance really is, as you suggested, mostly a reflection of incredibly strong performance in the convenience channel this time last year and, to a certain extent, in normalising therefore of customer behaviour. There is also shoppers increasingly buying with a view to batch cooking. They're buying more in bulk. They're cooking two, three days worth of meals in a go, and then therefore, that does lend itself to larger format shopping. They're probably being a bit more planful, which I think is no bad thing.

Sreedhar Mahamkali: And then maybe just on the commodity price cut sorry.

Ken Murphy: On the commodity price cuts, I think I mentioned earlier, for those particular commodities and areas, most of our fresh areas, we operate at an open book policy and, therefore, as I said, when there was inflation, that inflation flowed straight through to us. Conversely, when you see deflation that flows back straight through the other way, and so our policy has been to pass that saving on straight on to the customer.

Sreedhar Mahamkali: And that's what is broadly reflected in the market. I think one of the questions we keep getting is the market remained phenomenally rationalised the way the inflation went on the way down in the disinflation period, is it still calculated as being rational?

Ken Murphy: I would. I think it's exactly that. I think that everybody is behaving responsibly and rationally because people realise that this is an important time for the industry. It's a time for the industry when you have to be as efficient as possible to make sure that you're minimising the impact on your customers. But you have a lot of other stakeholders that you need to look after at the same time, and that includes your colleagues, includes your supplier base and, of course, your investors. I think everybody is mindful of that and, therefore, we are seeing a very rational market right now.

Sreedhar Mahamkali: Thank you.

Ken Murphy: Thank you.

Call Operator: Before we move to the next question, as a reminder, please press star one if you would like to ask a question.

The next question comes from the line of James Anstead from Barclays. Please go ahead.

Ken Murphy: Good morning, James.

James Anstead: Good morning, Ken, Imran. Two questions as well, please. Firstly, Booker catering sales up by almost 11%. I just wondered if Booker serve the range of catering customers from reasonably high end to fast food. I wonder if you are seeing the cheaper priced customers growing faster. That would be the first question. The second one would be, I've read various articles in the trade press talking about the work you are doing on refreshing the look and feel of your stores, particularly in the fresh areas. I wonder if that's a fair representation of you increasing your focus, and does that suggest your customer feedback implies your stores looking a bit tired?

Ken Murphy: Thanks, James. Two very good questions. Yeah, very strong growth in Booker across both retail and catering, by the way. It's been successful in both parts of its market; catering particularly strong. The watch word here is not necessarily price per se, but value for money. What Booker has been incredibly successful at doing is helping caterers manage the value for money equation, which is supplying great product and meal combinations, menu combinations that allow restaurants, pubs, and bistros to maintain their margin but offer a great value proposition to customers. They're the customers that are particularly doing well in the market, and they're customers that seem to be in a sweet spot with Booker and, they're driving their mutual performance.

In terms of the fresh refresh, fresh is an area which... look, as I came into the business, I was very conscious that fresh drives the quality perception of the whole shop. We, by the way, have a very comprehensive refit program that we follow, and we put north of £300 million a year into our refit program.

It's something that we stick to pretty religiously for two reasons, first of all, because we want to avoid our estate getting tired, so it's an essential part of doing business. Secondly, it's because it drives our ESG program because, as we replace our refrigeration, we do so with much more energy efficient and much better emission stats on the refrigeration. So that's the first thing.

The second thing is that we did a lot of work in Ireland in terms of completely reinvigorating our bakery and fresh areas. That's had a big impact on sales. We've taken a lot of the learnings from that, and applied them to our UK business. We're in the process now of trying to optimise the fresh, particularly around areas of produce and bakery to really elevate the customer experience, and that's something that we're feeling excited about.

James Anstead: Just to check, I presume any additional work you're doing is stuff that you can accomplish within the Capex envelope that Imran set out?

Ken Murphy: Yes.

James Anstead: Yeah, just to be clear. Thanks very much.

Ken Murphy: Thanks, James.

Call Operator: We have no further questions in the queue, so I'll now turn the call back over to Ken Murphy for some closing remarks.

Ken Murphy: Thank you. Listen, thanks everyone for joining us this morning. We really appreciate it. As you see from the numbers, it's been a really good first quarter and I'm really proud of how we continue be to be the customer's champion with great value and great quality. We look forward to seeing you all in October, if not before. Thanks very much for your time and interest in the business and have a great summer.