Tesco PLC - Q3 & Christmas Trading Statement

2022/23 Analyst Call

Thursday 12th January 2023

Transcript

Ken Murphy: Good morning everyone, and a very Happy New Year to you all. Thank you for joining us this morning. I'm here in Welwyn with Imran, and in a moment we'll be delighted to take your questions. Before we do that, I want to share a few highlights on the strong performance that we've announced in our trading update this morning.

I want to start by saying a huge thank you to every one of our colleagues for the brilliant Christmas they helped us deliver. As they have done consistently throughout the challenging conditions of the last few years, colleagues have once again gone above and beyond to make sure our customers could have a great Christmas. I'm really pleased with the strength of the performance we've seen in all our markets, especially given that we're trading over such a strong performance last year. By delivering relentlessly on the strategic priorities that we set out 18 months ago, we have made sure that customers benefit from great value and quality in every part of their basket, however they choose to shop with us.

The UK has had an exceptional quarter three and Christmas, driven by our continued investment and innovation in the full breadth of our offer. Our large and convenient stores served customers well throughout the entire period, with online proving to be very resilient and returning to growth over Christmas. We have seen customers continuing to trade down, but that has taken a number of different forms, and we are seeing growth at both ends of our offer, from the volume driven success of our Price Lock campaign, through to the growth of our Finest range. For some customers, it's trading down from national brands to great value Tesco products. For others, it's seeking out Tesco from one of the higher priced, premium focused retailers, or using our great range of ready meals to substitute for a takeaway or restaurant meal.

Our value proposition of Low Everyday Prices combined with exceptional value offered by Clubcard Prices and Aldi Price Match means that we are the most competitive we've been for many, many years. We've continued to make great progress on Clubcard across the Group. Clubcard Prices has been a great success in the UK, and is proving the same in Ireland and Central Europe following the more recent launches. Clubcard has helped millions of customers spend less, which now more than ever is really important. Across the period, we launched nearly 400 new products, including over a hundred new Finest festive products, and we continued to build out and enhance our ready meal range. We're really pleased that all these efforts have been recognised by customers, with a significant increase in quality perception once again.

All of this great work has culminated in us delivering a strong market share performance in the UK and Ireland. Booker has also continued to grow strongly, despite a particularly tough catering backdrop, and our Central European business delivered its highest growth in many years. As you'll have seen, we are reconfirming our guidance from October for retail adjusted operating profit between £2.4 and £2.5 billion, retail free cash flow of at least £1.8 billion, and bank adjusted operating profit of between £120 and £160 million.

We always expect customers to tighten their belts after Christmas, and that's certainly what we've built into the plan for this year. I am delighted that last week we announced a new Price Lock, guaranteeing that customers won't pay more on over a thousand lines all the way through to Easter. We have also further invested in our Dinner for Tonight range, offering customers amazing value alternatives to eating out or getting a takeaway. I'm confident that whatever customers are looking for in terms of value and quality, they will be able to find it at Tesco.

Our performance continues to be strong, and we go into the new calendar year with good momentum. We have the right focus on value, quality, and range, along with the right strategy and team to deliver a strong performance whatever challenges we face. And with that, let's go straight to questions and answers. Thank you.

Call Operator: If you wish to ask a question, please dial *1 on your telephone keypad now to enter the queue. Once your name is announced, please ask your question. If you would like to cancel your place in the queue, you can do so by pressing *2. So once again, that is *1 to ask a question. If you are asking a question, please remember to mute your online webcast to avoid any feedback. Our first question comes from Andrew Gwynn of BNP Paribas Exane. Please go ahead.

Andrew Gwynn: Good morning, and Happy New Year. So yeah, two questions if I can. Firstly, and I appreciate you're not going to give precise colour on next financial year, but help us with some of the building blocks. I think market's still very rational. Given the profit guidance essentially unchanged almost from the beginning of the year, seems to be you're in very good control, and maybe some of the cost pressure is slightly lower, albeit skewed towards SG&A, so wages and energy. So just help us out with some of those building blocks.

And then secondly, you touched on it there, but obviously an expectation that the consumer may tighten their belts after Christmas. Is that what you've seen in the data? Thank you very much.

Ken Murphy: Good morning Andrew, and thank you for the question. I think let's start with the second point, and maybe I'll hand over to Imran. I would say that customers tighten their belt every year in January, February. That's kind of a normal trading pattern. We've planned for that, and largely the customer trading behaviours and patterns are playing out more or less the way we've planned it. So I would say to you that we've had a decent start to the year, and that would be the first thing to say.

I think the second question, before I hand over to Imran, is that largely you've answered your own question. I think we would be looking at the same building blocks. Clearly we can't give you visibility beyond that, but let me hand over to Imran and he'll give you his sense of it.

Imran Nawaz: Morning Andrew, how are you? So just a few thoughts.

As you point out, we're coming off a very strong performance this year, and as you also said, guidance is pretty much largely unchanged throughout the entire year. And this year we faced quite a lot of opex costs, if you think about the energy, if you think about payroll, you think about the Covid unwind. And I would expect, as we've always been said, that next year we expect to see similar pressures continue.

Without going into detail, because I will absolutely give you guidance and an understanding of how we see next year when we meet in April, but I would say to you what gives me confidence is how well we've managed to do what we've been doing this year, the discipline on our Save to Invest program this year. We're in a good place also for next year, and clearly I feel we have, I would say the right offer, the right strategy, the right team to continue to do well. So when we meet in April and talk, we'll absolutely give you a fuller picture of how we see the world evolve.

Andrew Gwynn: Okay, thank you very much, and well done to you and the teams. Thanks.

Ken Murphy: Thanks Andrew.

Call Operator: Our next question comes from Clive Black, Shore Capital Market. Please go ahead.

Clive Black: Well, good morning gentlemen. Thank you for the update. And yeah, well done on a very strong trading period. A couple of questions for me therefore, Ken, you talked about trading down in your commentary, with quite a few moving parts there. I just wondered if you could maybe order the importance of those moving parts in terms of how you see it in the business. You mentioned switching out of restaurants into retail and so forth. And then just secondly, maybe a little bit of an anorak question, but I imagine volume across the whole business was hard to come by. I just wonder what that means for your working capital and how that feeds into your free cash flow given that supermarkets have tended to have negative working capital, they would be helpful to have updates on. Thank you.

Ken Murphy: Great, thanks very much Clive. I'll answer the first part of that question and then I'll ask Imran around to comment on the working capital part. I think what's been really important from a trading down perspective is that, as you say, we are seeing it happen in multiple forms. And what's been really pleasing is that, as the only full line grocer to grow market share from the pre pandemic point to today, we feel particularly pleased about the versatility in the strength of our proposition. And I see that playing out in a number of different ways.

The first of all, is that we provided that consistent value thread since before the pandemic started, through the Aldi Price Match, through the Low Everyday Prices, which we've now locked, and of course, through Clubcard Prices, which has really driven penetration of Clubcard. And that's had a fantastic impact on getting customers to trade with us and stick with us.

Now their behaviour, as you say, has modified within that, and we have seen people trading down from national brand to own brand. We've seen them trade from... And this is in order of importance, Clive, we've seen them trade from small packs into bulk packs. We've seen them trade from fresh into frozen. And I've said, we've seen them trade from eating out to eating in.

Now at the same time, we've seen Booker grow its catering sales really strongly throughout the period. So there's a slight contradiction in that. And of course when we dig under it, what we've found is that Booker has done a brilliant job in providing a great value proposition in supporting the best value caterers in the market. Consequentially, those caterers are growing market share, and because of Booker's service and its price point, it's growing its share within those best caterers. So, we've seen quite a outstanding performance from Booker during the year. So, the great news from our perspective, is we're winning at both ends and we're really pleased with that performance.

Imran Nawaz: Let me take maybe the second one on cash and working capital, Clive. So look, you remember when we spoke in October, we upgraded our guidance on cash flow for the year from £1.4 to £1.8 billion range to at least £1.8 billion, that was on the strength of the first half performance and also the confidence that we saw going into the second half. What I'd be pleased to say to you is, after having gone through the last 19 weeks, I'm even more confident on that cash flow number, which is good. As you say, it's at center to what we do, the cash flow delivery. And so, there's a very high level of discipline in the business. As it comes to specifically working capital, at the half we had a significant inflow aided by the higher payables that you would get from the inflationary pressure. But at the same time, our aim is to continue to have every year working capital at a positive level and we will do so this year as well.

Clive Black: That's very helpful. Can I just ask one supplementary on the working capital? Did you feel that you ended the year in a general merchandise apparel area in a relatively clean way?

Imran Nawaz: Yes. Yes. We felt good when we looked. We walked the shops during Christmas. But even now when we sort of did a review on inventories and how we landed, we exited very cleanly.

Ken Murphy: The cleanest I think for many years actually, Clive. So, we're particularly pleased with how well we exited Christmas.

Clive Black: Well done, that's very good hear. Thanks for your answering the questions.

Ken Murphy: Thank you, Clive. Happy New Year.

Call Operator: Thank you. And we move on to Izabel Dobreva of Morgan Stanley, please go ahead.

Izabel Dobreva: Hello, good morning and Happy New Year. Thank you for taking my questions. My first question is based on your negotiations with suppliers.

How do you think about the pass through of any future input cost inflation to customers? So, are you seeing any signs that with the falling volumes and the strong growth in private label, promotional activity starting to come back? So, any change in the negotiating balance there? And then my second question is, how do you perceive the pricing environment currently in your UK business? Do you expect that the pace of price investments for the industry is going to step up over the next 12 months as the volumes potentially get softer? Any comment on the competitive environment would be very helpful.

Ken Murphy: Thank you. So look, the competitive environment is clearly intense and will remain so, but it has always been that way. So I think that's not new news. I think that the relationship, our relationship with suppliers is excellent, and that's born out by the independent surveys where we score consistently in the top end of those surveys regularly. And that's because we are very respectful and have very objective relationships with our suppliers. We also have a very strong sourcing organisation, and they deconstruct all elements of a product and look at where inflation is coming through and how much inflation is coming through. And then we have that, as effectively, facts to argue the case for what is an acceptable pass through cost versus what isn't. And that's the way we operate. And then, really it comes down to kind of the negotiation to see where we end.

But what we do work really hard on, is trying to minimise the amount of cost that passes through to the consumer while making sure that we take the costs that are absolutely justifiable so we don't risk putting our suppliers out of business or putting their business model under pressure unnecessarily. And we have shown very proactive displays of support in key sectors, like the milk sector, the pork sector, and most recently the egg sector, where we know that those suppliers are in need of support and we have reacted really quickly. That's our policy and that policy will continue into the future.

Imran Nawaz: And then in terms of the environment, look, as Ken said, it's a very competitive environment out there. And I would also add that, so far it's also very rational environment and you've seen that throughout the entire year. I would expect to continue to see that going forward as well. Our job ultimately, as Ken said, is to avoid passing on cost increases to customers and fund as much as we can, whether it's Clubcard Prices, whether it's Low Everyday Prices or whether it's Aldi Price Match. That has worked well for us and will continue to do so, but I do expect, as an overarching principle, a rational environment.

Izabel Dobreva: Thank you very much. I had one very quick follow up on the Bank actually, given that the FCA yesterday warned that 200,000 UK households are falling behind on their mortgage payments. So overall 9% of households are at risk. So with that in mind, how would you describe your risk appetite in the bank and any early warning signs there?

Imran Nawaz: Look, we don't have a mortgage book at the Bank, that was disposed of. What I would say to you is, we are very tightly monitoring any credit risks at all times. We're able to confirm the guidance range that we put out there for the Bank simply because of the great credit control management that we have in place. In fact, I would say to you, the quality of the book that we have has improved over the years.

Izabel Dobreva: Thank you very much.

Ken Murphy: Thank you.

Call Operator: Thank you. Up next we have James Grzinic of Jeffries, please go ahead.

James Grzinic: Thank you. Good morning. Happy New Year, Ken, Imran. Couple of quick questions. I guess the first one, given this changing mix dynamics, can you please remind us or help us understand what the extension of the changing mix is from a margin profile perspective in terms of that own label business really accelerating beyond national brands? Secondly, can you perhaps tell us at what point you'll settle in terms of wages and where you're thinking in terms of your hourly rates, whether you're ahead?

Ken Murphy: Okay, thank you very much for the questions here. Let me take the second question first, because that's a relatively short one. We've just started the negotiations with our unions, so we wouldn't comment on that until we're in a position to announce an agreed position with the union out of respect for the union. So I think that's as much as I'd say on that. I think on the mix effect, I think what you're seeing is a lot of different moving parts. Very interestingly, before Christmas we saw really strong sales in health and beauty, which is really good margin. That was a combination of a great value proposition in our kind of health and beauty gifting, but also a resurgence of cough cold, because of course it's the first Christmas post pandemic, so everybody was catching a cold and we had had very strong availability relative to the market, so we outperformed on that.

That's kind of one example where you're seeing some very margin positive sales mix effects. Clearly you've got trade down to own brand and frozen more margin dilutive, but then you've got positive margin coming from premium mealtime and meal for tonight offers and through our finest range, et cetera. So you've got quite a mix of things playing out. I think where you should take a lot of confidence from was related to one of the earlier questions, which our guidance hasn't changed right through the year, which means that we've really got great control over our margin and we're able to manage it and hold our value position at the same time. We do that through great negotiation, great operating efficiency and real focus.

James Grzinic: That's very helpful. Can I just perhaps ask as a follow-up, many moving parts, would it be fair to assume that Net-Net, that changing consumer behavior is not helpful from a margin mixed perspective though, and clearly having a lot of success on the opex, on the cost of sort things to offset that?

Ken Murphy: I think what I would say is that we've just put in an outstanding Christmas and I think we have performed pretty consistently, not only through the cost of living crisis of the last nine months, but through the last three years through the pandemic and then pivoting into this crisis. What you're seeing here is a real strength in the Tesco business model across not only the UK, but also Booker wholesaling business and through the other markets in Ireland and Central Europe, which suggests that we have the weapons to basically adapt our business model and manage our mix and our margin to produce very good returns for shareholders.

Imran Nawaz: If I can build on that, I mean that's kind of almost our job if you wish to kind of balance out these competing forces, right? When you look, for example, anticipating that there would be people moving from out of home into in-home food consumptions as they replace restaurants with let's eat at home, the fact that we expanded our finest range by 20%, and so growth at 8%, that's actually a really good margin business. When we are gaining from our premium retailers, we've upped our quality. Again, that will be helpful because a, it's new business coming to us, but also very helpful.

The last point I'd say to you is you, you're right, in some cases you have margin dilutive own label brands. That is true. But at the same time, if you focus on how do you maximise the mix between sell more volume, gain more customers, and have the right portfolio, that's the balancing act we need to do and what I feel very happy about is the business. The team has done that brilliantly this year and we'll have to continue to do that next year again because as you say, it doesn't get easier.

James Grzinic: Yeah. Thank you very much and well done.

Ken Murphy: Thank you.

Call Operator: Thank you. We're now moving on to Sreedhar Mahamkali of UBS. Please go ahead.

Sreedhar Mahamkali: Hi, good morning both. I've got one question and two hopefully short follow-ups and please. First one, just in terms of the trading for Q3 and Christmas, would you say it was entirely in line with your expectations or perhaps a little ahead. A couple of follow-ups then, just in terms of Andrew's question, going back on the consumer, Ken, I think you pointed to a decent start to the year, but still remaining cautious. Have you seen any change in the sort of run rate just after Christmas already? Is that what you're sort of tighten the belt comment relates to? The last one is a follow-up to Clive's question earlier, Imran, you talked to £1.8 billion, I think you said, even more confident or a little more confident in your earlier comments. Is there any that you can give us there? Is an expectation closer to £2 billion, an unrealistic one? Any colour there?, Thank you.

Imran Nawaz: Maybe I take the first one and the cash one, because they're sort of linked. When we gave guidance for the year, this is only a few months ago, back in October, we were confident in what we were giving. The underpin, if you remember what we said was, we would expect a strong Christmas performance, right? Because we felt people would celebrate. That has played out pretty much in line with our expectations. The reality is we always set ourselves stretching targets and I'm pleased to say that we hit them. I'll be honest, maybe slightly even ahead on my own expectations, I'll be honest, because Christmas was very strong, slightly stronger than even I thought. But that's a good thing. Therefore, just to answer the question, maybe behind the question also, I feel good about being able to confirm the guidance range that we've laid out and maybe even more confident than I was back then.

On the cash flow side. Yeah, I mean look, it was a significant upgrade. If you think about the range, we had the low end of £1.4bn to £1.8bn, now at least £1.8bn. The idea is to let the profit fall through and make sure we continue on the discipline. I recognize cash flow is critical. As you know, we have our buyback program, our progressive dividend. We're well on track to finish the £750 million program by April.

It underpins what we do and we are doing it well. Clearly, where exactly we will land both on profit, Sreedhar, and on cash flow, I'll obviously tell you in April, but I'd say to you, we're feeling good about the full year outcome.

Sreedhar Mahamkali: I'm sorry, just one quick follow-up you mentioned about that. If you do end up with a number considerably run rate unexpected in terms of free cash flow and you've a got good line of sight into next year's free cash flow, would you rethink the £750 million run rate or is that how you want to position it as a more consistent room for maneuver there?

Imran Nawaz: When we talked about the buyback, we always talked about it's a multi-year program, i.e. we commence it. And we will have done a billion almost by the time we get to April or I say actually, ahead of a billion since starting this. But I want to, this is something that's important to us and we want to make sure it's sustainable and continues. The scale and the amount will always, always depend on the conditions. But we're feeling good about where we are and we'll have the conversation with the board that will ultimately be part of that key decision process.

Sreedhar Mahamkali: Thank you, both.

Call Operator: Thank you. As a brief reminder, that is questions today. We're now moving to Xavier Le Mene of Bank of America. Please go ahead.

Xavier Le Mene: Yes, good morning. Ken, Imran and the team here. Two follow-up questions actually, if I may. The first one, can you potentially help us to understand a bit more the performance you had in the recent months? Would be good potentially to have communication and on the inflation you were facing as well as the mix effect on the volume effect for the UK more specifically. That would be quite helpful.

And back to Andrew's question actually. I understand that you are not going to fiscal year '24. But can you potentially help us with the changes you're expecting year on year? You said covering cost unwind. Would be good potentially to have a number there. And are you expecting also any positive coming from business rates more specifically?

Ken Murphy: Great. Thank you for the questions. Specifically on inflation by volume, as you will have seen from Kantar inflation in the industry is running in quarter three somewhere between 11 and 14%. And we've been consistently inflating a little bit behind that as per our policy of a little bit less a little bit later. And so, that would be as much as I'd say on inflation.

If you look at our volume performance, versus pre-pandemic levels because there's an awful lot of noise and distortion on volume through the pandemic. We grew volumes in food in over the Christmas period, so we're really pleased with that performance. And at the same time, Booker grew it's catering volume, so we were winning at both end of the market, both in that food for consumption at home and the eat-out markets we won. We're really pleased with that performance.

We have seen a bit of a fall off in GM sales volume year on year. But that is partially cost of living driven, but also partially driven by the fact that we have been repurposing space in our stores over the last nine months, devoting more space to clothing and a little bit less to GM. And then consequentially, you've seen strong growth in clothing in the Christmas period.

Imran Nawaz: Maybe I'll take the business rate question. I mean, look, we welcome the government's business rate reform that they announced in autumn. I think the net benefit to Tesco is it's in the tens of millions. There's going to be a bit of an increase for Booker. But look, it's all helpful. It's against the backdrop of around £700 million of business rate taxes as you can imagine. It's all, it's helpful. And I'm happy that we are getting it, but it's in the tens of millions.

As it comes to next year. Look, the moving pieces that you know well, Xavier, between our save to invest program, very happy with the half a billion or so that we will hit this year. And planning to, we're in a good preparation phase to make sure we deliver on next year's half a billion as well. That's cumulative, £1 billion.

Payroll negotiation still to come. Obviously there's the energy headwind, but again, we have a strong hedging program in place. And how that then plays out, we will give you absolute clarity in terms of how we see the world at least when we meet in April. I wouldn't want to comment beyond that.

Xavier Le Mene: I understand. Thank you.

Imran Nawaz: Thanks, Xavier.

Call Operator: Thanks. Press *1 for your question today. We now take Nick Coulter of Citi. Please go ahead.

Nick Coulter: Hi, good morning. Just one for me please, if I may. Would you be able to share any insights from your teams on the outlook for COGS inflation and whether there are any signs that is beginning to roll over, or at least not going much higher? Any thoughts appreciated. Thank you.

Ken Murphy: Hi, Nick. Thanks very much for the question. Look, we'll start to lap the COGS inflation in quarter one of our new financial year. So kind of March, April onwards. And we are hopeful, though we can never be sure that we'll start to see inflation moderate in the second half of the year. All things being equal, that should happen, but clearly, there's a lot of variables out there. But that's broadly what we foresee.

Nick Coulter: Great, super helpful. Thank you.

Ken Murphy: Thanks, Nick.

Call Operator: Thank you. As there are no further questions, I'd like to hand back over to Ken for additional or closing remarks.

Ken Murphy: Thanks very much, Saskia. And thank you all for joining us this morning, taking the time and for all the great questions. As you can see, it's been a great Christmas for Tesco, a really strong, consistent performance from a really great team. I'd just like to say a huge thank you to them once more and to you for supporting us. And we look forward to seeing you all in April. Thank you.

ENDS