Managing through the recession by Ian Dyson, Group Finance and Operations Director

Ian Dyson Group Finance and Operations Director

125 YEARS OF INNOVATION

Above: New & Improved We opened 75 stores and modernised a further 24 in 2008/09.

Underlying cost savings

£148m

5.7%

During 2008/09 we took decisive actions to manage the business through the recession. We invested in price to support our customers, reduced our costs and managed our cash flow and balance sheet tightly. These actions have enabled us to deliver adjusted profits of £604.4m in 2008/09 and to reduce our net debt to £2.5bn. More importantly they have positioned us to move the business forward in 2009/10 and beyond.

Results

Group revenue was up 0.4% to just over £9bn. UK sales were down 1.7% and were clearly impacted by the difficult market conditions. International sales were up 25.9% reflecting the integration of our acquisitions in Greece and the Czech Republic, and space growth.

Adjusted operating profit was down 29.4% to £768.9m, reflecting a reduction in UK gross margin of 1.7 percentage points as we invested in price for the benefit of our customers, and cost growth of 4.3%. Profit before tax was £604.4m, down 40.0% and adjusted earnings per share was 28.0p, down 35.8%.

Investment in margin

We responded to the economic downturn and the effect that this was having on our customers by making significant investments in pricing and promotions. While this has resulted in even better value for our customers and has been a major factor in retaining their loyalty to our brand, it has adversely impacted our UK gross margin, which was 170 bps lower than last year at 41.3%.

Food gross margin was down 235 bps at 31.5%. This reflects significant investment in prices across our range, but with particular emphasis on staple goods, and a higher level of promotions. GM gross margin was down 70 bps with further gains in buying margin being more that offset by higher levels of price promotion and markdowns.

Cost management

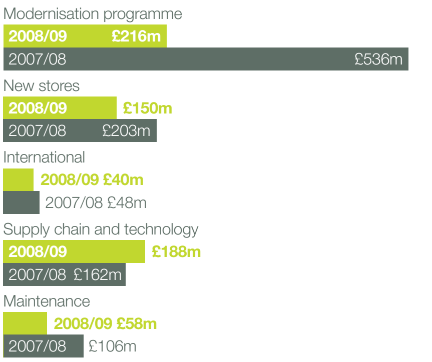
As the economy worsened and our sales performance deteriorated, we took a series of actions to reduce our costs in 2008/09 and to help support profitability going forward. Total UK operating costs were £2,740.6m which was up 4.9% (excluding bonus). If we take out the impact of new space opened during the year, cost inflation and increased depreciation costs arising out of the capital expenditure programme of the last few years, underlying costs were down 5.7% – representing an underlying saving of some £148m.

Staff costs Retail staff costs were £863.3m which was up only 1.9% reflecting substantial improvements in productivity and staff scheduling, without affecting service levels. This can be seen in our monthly customer service tests – our mystery shopping programme. Our staff consistently scored highly, achieving an average of 84% in 2008/09. Our compliance audit scores, that measure our legal and safety performance, improved from 80 to 92%.

Distribution We made significant changes to our logistics operations during the year as part of a long-term programme to radically improve the operating efficiency of our supply chain. These changes benefited costs this year, but will have a more significant impact in 2009/10 and beyond.

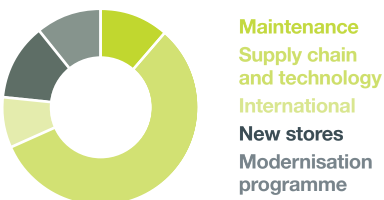
Group capital expenditure 2008/09

£652m
-38.2%



Group capital expenditure 2009/10

c £400m



Key actions included changes to the management structure of logistics to bring GM and Food together, renegotiation of our key third party logistics contracts, rationalisation of our warehouse network, the introduction of mechanisation in two of our food warehouses, and the streamlining of our international distribution systems.

Marketing Our marketing costs were 8.6% lower in 2008/09 at £127.4m and should be lower again in 2009/10. We will continue to be more effective in our targeting and use of this spend.

Support We reduced spend in support areas by 2.4% to £391.6m, through disciplined control of expenditure and reduction in wasted activity.

During the year we made additional changes that will reduce our cost base in 2009/10. We closed 26 of our smaller, under-performing stores in order to focus on sites better suited to our customers needs. We also reduced headcount across our Head Offices by 15%, redeploying as many colleagues as possible; and made changes to our UK defined benefit pension scheme. These actions together with ongoing tight cost control mean that we expect costs in 2009/10 to be 1% below 2008/09 (excluding bonus).

Investing in the business

Following significant investment in the business over the last three years, we reduced capital expenditure to £652m in 2008/09 from over £1bn in 2007/08.

Stores We opened 75 stores during the year in out-of-town, retail park and high street locations, while continuing to review the portfolio to ensure it is working to its fullest potential. These openings included our 100th BP Simply Food store, with our franchise ‘travel hubs’ continuing to perform well in service stations, train stations and airports. We also improved the look and feel of 24 stores, with 80% of our portfolio now in the new modernised format. We will complete the remaining 20% of the portfolio in the next few years.

IT We are delivering new tills and point of sale software, which will speed up customer transactions and allow store colleagues to spend more time on the shop floor and less time carrying out office duties. We are also improving our trading and administration systems.

Logistics Construction is underway on a distribution centre in Bradford that will open in late 2010 – consolidating our stock holdings and improving our speed and flexibility in getting product into stores. Following two trials we are also investing in mechanising our food distribution centres to improve accuracy and efficiency in picking chilled goods.

International We are investing in systems and infrastructure so that goods produced overseas can now be transported directly to all of our markets without the need to first come through the UK. This will dramatically reduce export costs and speed up distribution.

We will spend c£400m in 2009/10, shifting the focus of our capital expenditure from our property portfolio, where we have made considerable investment over the last three years, to our IT and supply chain infrastructure.

This will support our international expansion plans and our continued growth online. It will also increase efficiency in the supply chain leading to lower costs, as well as better product availability in-store.

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Net debt
£2.5bn

125 YEARS OF SERVICE

1939 At the outbreak of World War II M&S stores totalled 234. By 1945 over 100 of these had been damaged by bombs and 16 had been completely destroyed.

During World War II 1,500 of M&S' 2,000 male employees fought in the war earning a total of 124 medals and distinctions and all of our employees took part in fire watch duty every night, with specialist training in first-aid and anti-gas precautions.

Balance sheet management

We took a number of actions to improve our cash flow in 2008/09. In addition to reducing capital expenditure to £652m from over £1bn in the previous year, we generated a working capital inflow of £194.0m and raised £58.3m from the disposal of non-trading stores. As a result we generated a net cash inflow of £107.5m after paying interest, tax, dividend and share buy back of £661.2m. In addition we agreed certain changes to the property partnership with the pension fund that provide us with discretion around the annual payments from the partnership to the fund. This gives us additional cash flow flexibility and reclassifies the obligation from debt to equity.

As a result of our good cash flow management and the changes to the property partnership, net debt at year-end was down to £2.5bn from £3.1bn at the end of 2007/08.

Like many businesses, during 2008/09 we took steps to manage the cost of providing our defined benefit pension scheme. We wanted to ensure that pensions can be paid out to members when they need it and at a price we can afford. From 1 October 2009 only pay increases up to 1% will count towards the pensions of our existing members. Amendments were also made to the early retirement factors for members who joined the scheme before 1 January 1996 and are still active in the scheme. These changes reduced the Group's pension liabilities by £231.3m.

The retirement benefit valuation showed a deficit of £152.2m under IAS 19. The triennial actuarial valuation of the fund is underway with the results expected by the end of the calendar year. This valuation will form the basis of funding discussions with the pension trustee.

Looking forward, and with the economy still fragile, further strengthening of our balance sheet is a priority for the Group. We want to retain our investment grade credit rating, we want the ability to continue to invest in our business, and we will need to continue to manage our pension obligations.

In view of these requirements, the Board has taken the decision to re-base the Group's dividend payment to 15.0p per share from the current level of 22.5p per share, a reduction of 33.3%. This will be achieved through a 33.1% reduction in the 2008/09 final dividend to 9.5p per share, followed by a reduction in the 2009/10 interim dividend to 5.5p per share. Having re-based the dividend to 15.0p per share, the Board's policy regarding future dividends is to re-build cover towards two times and thereafter, to grow dividends in line with adjusted earnings per share.

Outlook

The economy remains uncertain and we will continue to manage accordingly, focusing on margins, costs and cash flow so that we maximise our profits in the short term, but also position our business to move forward in the medium to longer term.

Ian Dyson Group Finance and Operations Director