Financial review

Alan Stewart
Chief Financial Officer

The reported year has been both an extremely challenging year for Tesco and a year in which we began a process of considerable change. Against this backdrop we delivered sales of £70bn in 2014/15, (1.3)% below last year on a 52 week basis at constant currency. Trading profit declined by (58.1)% to £1.4bn principally as a result of a fall in like-for-like sales, the accumulated costs of inefficiencies within our operations and the changes we have made in the second half to stabilise the business. Our statutory loss before tax was £(6.4)bn, after charging one-off items of £(7.0)bn. Of these one-off items, £(0.6)bn will result in a direct cash outflow, with the remaining amounts being non-cash adjustments to balance sheet carrying values.

Group results 2014/15 (on a continuing operations basis)

On a continuing operations basis	2014/15	52 week % change** (actual exchange rates)	52 week % change** (constant exchange rates)	*53 week % change (actual exchange rates)*
Group sales (including VAT)*	£69,654m	(3.0)%	(1.3)%	*(1.7)%*
Sales growth excluding fuel		(3.2)%	(1.3)%	*(1.9)%*
Group trading profit	£1,390m	(58.2)%	(57.5)%	*(58.1)%*
–UK	£467m	(78.8)%	(78.8)%	*(78.7)%*
–Asia	£565m	(18.4)%	(15.3)%	*(18.4)%*
–Europe	£164m	(31.9)%	(31.1)%	*(31.1)%*
–Tesco Bank	£194m	0.0%	0.0%	*0.0%*
Underlying profit before tax	£961m	(68.4)%		*(68.5)%*
Statutory loss before tax	£(6,376)m	n/a		*n/a*
Underlying diluted earnings per share	9.42p	(70.5)%		*(70.6)%*
Diluted losses per share	(70.24)p	n/a		*n/a*

* Group sales (inc. VAT) exclude the accounting impact of IFRIC 13 (Customer Loyalty Programmes).
** 52 week growth rates exclude week 53 (the 7 days ended 28 February 2015) for the UK and Republic of Ireland.

Protecting and strengthening our balance sheet

Upon our arrival as a new management team we identified protecting and strengthening the balance sheet as one of our three priorities. This resulted in a number of steps to begin to address our balance sheet leverage of £(21.7)bn, which we define more broadly to include net debt, discounted rent or lease commitments and our IAS 19 net pension liability:

- **Liquidity and funding:** We have underpinned our liquidity and funding position with access to £5bn of credit facilities, which remained undrawn at the year end. These facilities are secure, multi-year credit lines ensuring we have the flexibility to address our three immediate priorities over an appropriate timeframe.
- **Capital expenditure:** In 2014/15 we reduced our capital expenditure from £2.7bn to £2.0bn. Based on a comprehensive analysis of the Group's requirements we expect to further reduce our capital expenditure to £1.0bn in 2015/16, net of disposals, without adversely affecting our business.
- **Dividends:** Following the reduction in the interim dividend, the Board has recommended not to pay a final dividend.
- **Pension:** A plan to fund the deficit has been agreed with the Trustee with a payment of £270m per annum and we are consulting with our colleagues to replace our defined benefit pension scheme with a defined contribution scheme.
- **Property:** We have undertaken a detailed review of our property portfolio, including where appropriate to review our lease commitments. In addition we have taken the difficult decision to close 43 unprofitable stores and not to proceed with 49 new store developments. In March 2015 we also announced an asset swap with British Land, regaining sole ownership of 21 superstores and reducing our exposure to indexed rent reviews.
- **Portfolio:** In October we said that we would review our portfolio. To date, this process has resulted in the sale or the closure of Blinkbox and Tesco Broadband and the appointment of advisors to review our options for dunnhumby. This process is on track.

In 2015/16, we will retain our focus on financial discipline.

Enhanced disclosure

Restoring trust and transparency is also one of our three priorities and part of this objective will be met by progressively enhancing our disclosure. In this review we provide greater clarity around commercial income and the valuation and ownership of our property. The Notes to the accounts also include enhanced disclosure of segmental assets (in Note 2 on page 94), net debt (in Note 30 on page 135), JVs and associates (in Note 13 on page 110) and operating leases (in Note 34 on page 137).

Importantly, for 2015/16 we will also move to a simpler profit measure based on operating profit adjusted only for large and distorting impacts.

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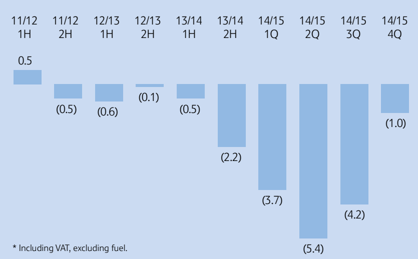
Segmental results
UK

		52 week % change
UK sales* (inc. VAT)	£48,231m	(1.7)%
UK revenue* (exc. VAT)	£43,573m	(1.8)%
UK trading profit	£467m	(78.8)%
Trading margin (trading profit/revenue)	1.07%	(394)bp

* Excludes the accounting impact of IFRIC 13.

Full year UK sales declined by (1.7)% on a 52 week basis. This included a 1.8% contribution from new space. Following the year end we completed the closure of 43 stores which we expect to impact our 2015/16 sales by around (0.4)%.

UK like-for-like sales performance* (%)

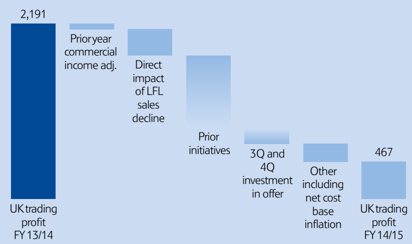


* Including VAT, excluding fuel.

Like-for-like sales, including VAT and excluding fuel, fell by (3.6)%. This reflected a challenging and deflationary market back drop – and our own underperformance.

We've seen some improvement recently with fourth quarter like-for-like sales performance of (1.0)% driven by positive volumes which represents an encouraging response to the customer-focused initiatives launched in the third quarter.

UK trading profit (£m)



Our full year UK trading margin was 1.07%, a reduction of almost four percentage points year-on-year. The decline principally reflected the combination of the deterioration in like-for-like sales and the impact of previous initiatives. The fundamental change to the way we do business with our suppliers, with significantly less focus on commercial income, further impacted profitability. The investment we have made in service, availability and, selectively in price in the second half is also a contributing factor.

Financial review continued

Asia

		52 week % change at actual rates	52 week % change at constant rates
Asia sales* (including VAT)	£10,501m	(4.1)%	(0.9)%
Asia revenue* (excluding VAT)	£9,884m	(4.1)%	(0.9)%
Asia trading profit	£565m	(18.4)%	(15.3)%
Trading margin (trading profit/revenue)	5.72%	(100)bp	(97)bp

* Excludes the accounting impact of IFRIC 13.

Sales in Asia declined by (4.1)% including a (3.2)% impact from foreign exchange. Like-for-like sales were (4.4)%. In South Korea, the impact of the DIDA regulations has remained significant whilst in Thailand the recovery in consumer spending has been slower to materialise than initially anticipated. Our trading performance in Malaysia has been impacted by protests against some Western-owned businesses and a challenging economic environment. Our trading profit in Asia was (15.3)% lower year-on-year at constant rates, primarily due to the operational gearing effect from the impact of negative like-for-like sales performances in all three markets.

Europe

		52 week % change at actual rates	52 week % change at constant rates
Europe sales* (including VAT)	£9,898m	(8.5)%	(0.6)%
Europe revenue* (excluding VAT)	£8,515m	(8.5)%	(0.7)%
Europe trading profit	£164m	(31.9)%	(31.1)%
Trading margin (trading profit/revenue)	1.93%	(66)bp	(64)bp

* Excludes the accounting impact of IFRIC 13.

Sales in Europe reduced by (8.5)% on a 52 week basis including a (7.9)% foreign exchange effect as the Euro fell to seven-year lows against Sterling by year-end. Whilst we saw some improvement in the fourth quarter, the like-for-like sales performance was mixed over the course of the year. We have seen strong competition from discount retailers and this held back our sales performance, particularly in Ireland which saw a like-for-like sales decline of (6.3)%. The profitability of our Central European businesses continued to be under pressure and in Turkey included a £(30)m charge relating to the write-off of a fuel debtor.

Recent legislative changes in Hungary, including mandated store closures on Sundays and the introduction of a 'food supervision fee' from 1 January 2015, will have a material impact to ongoing market profitability.

Consultation started in March 2015 on a significant restructure of the leadership team for Czech Republic, Hungary, Poland and Slovakia to move from operating as individual country teams to one regional team. This restructuring will create substantial buying and operational synergies, helping us to unlock more opportunities to invest in the customer offer.

Tesco Bank

	TY	LY	YOY Change
Revenue	£1,024m	£1,003m	2.1%
Trading Profit	£194m	£194m	0.0%
Lending to customers	£7,720m	£6,915m	11.6%
Customer deposits	£6,913m	£6,079m	13.7%
Net interest margin	4.2%	4.4%	(0.2)%
Underlying cost: income ratio	65.0%	64.0%	(1.0)%
Bad debt asset ratio	0.7%	1.0%	+0.3%
Risk asset ratio	18.8%	17.7%	+1.1%
Loan to deposit ratio	111.7%	113.8%	+2.1%

In highly competitive market conditions, Tesco Bank's revenue was up 2.1% to £1,024m driven by strong growth in lending to customers. We have expanded our range of mortgage and loan products and, in June 2014, we launched our personal current account. Our motor and home insurance business has seen 3% growth in accounts having expanded our underwriting providers and implemented digital improvements to enhance the customer experience. Trading profit was £194m, in line with the prior year, with strong underlying growth offset by our ongoing investment in personal current accounts.

One-off items

	TY	LY*
PPE impairment and onerous lease charges	£(4,727)m	£(636)m
Goodwill and other impairments	£(878)m	–
Stock	£(570)m	–
Restructuring	£(416)m	–
Commercial income adjustment		
–Recognised in 13/14	£(53)m	–
–Recognised in years prior to 13/14	£(155)m	–
Other	£(223)m	£(165)m
Total one-off items	**£(7,022)m**	**£(801)m**

* Last year's number is before a £(540)m write-down of goodwill relating to discontinued operations.

During the year the Group incurred £(7.0)bn of one-off and restructuring charges, largely reflecting the weak industry environment and the initiation of a number of measures to turnaround the performance of the Group. Of this amount, £(0.6)bn will result in a direct cash outflow, with the remaining amounts being non-cash adjustments to balance sheet carrying values. These charges included:

- **Fixed asset impairment and onerous lease charges:** At each balance sheet date we review the carrying value of our stores to ensure that they are supported by their value in use or their fair value less the costs of disposal. Against the backdrop of challenging industry conditions and the decline in our profit, our review resulted in an impairment and onerous lease charge of £(3.8)bn against our trading stores. A further impairment charge of £(925)m is recognised in property related items, relating to the impairment of work-in-progress balances and charges relating to the closure of stores.
- **Goodwill and other impairments:** We have booked further goodwill and other impairments totalling £(878)m. These include an impairment of £(630)m relating to our investment with China Resources Enterprise Ltd (CRE), £(116)m relating to Dobbies and other UK businesses, and an impairment of £(82)m in our investment in joint ventures which principally relates to the strategic decision to slow the roll out of Harris + Hoole and Euphorium sites.
- **Stock:** The one-off items include a £(570)m charge to the Group inventory position, principally due to the adoption of a forward-looking provisioning methodology. The charge also includes a £(168)m impact of a reduction in the level of in-store costs capitalised to inventories.
- **Restructuring:** We have described a restructuring of central overheads, a simplification of store management structures and increased working-hour flexibility, which will deliver ongoing savings in the region of £400m per year. These efficiencies will result in a one-off cost of £(350)m of which around £(300)m has been recognised in our 2014/15 results. The remaining balance includes a further £(41)m relating to restructuring in the first half and a £(20)m one-off cost relating to UK store closures.
- **Commercial income adjustment:** The commercial income adjustment refers to the impact on prior years of the commercial income issues that we announced last September. At the time of the interim results, the impacts on prior years were estimated as resulting in the profit before tax for the year ended 22 February 2014 being overstated by £70m, and for the years prior to this being overstated by £75m – a combined total of £145m relating to prior years. Subsequent to October 2014, we continued to focus on this area and identified some further amounts, bringing the total one-off adjustment to £208m for our UK and Irish businesses.

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Joint ventures, interest and tax

Joint ventures and associates

Losses from joint ventures and associates were £(13)m, down from a profit of £60m last year. The movement was primarily driven by a loss from our partnership with China Resources Enterprise Ltd (CRE) which was formed in May 2014. UK property joint ventures also made lower profits.

Net finance costs

	TY	LY
Interest receivable and similar income	£90m	£132m
Interest payable on short term bank loans and overdrafts	£(101)m	£(68)m
Finance charges payable under finance leases	£(9)m	£(10)m
Interest payable on medium term notes and bonds	£(433)m	£(448)m
Capitalised interest	£44m	£79m
Underlying net finance costs	£(409)m	£(315)m
IAS 32 and IAS 39 effect	£(26)m	£(11)m
Non cash element of IAS 19 Pensions charge	£(136)m	£(106)m
Net finance costs	£(571)m	£(432)m

Underlying net finance costs increased to £(409)m from £(315)m last year. The increase in net finance costs reflected a higher level of debt and the set up costs relating to new credit facilities. Finance income reduced primarily reflecting the redemption of a medium term note and the expiry of the associated hedging instrument resulting in lower derivative income. Capitalised interest reduced by £(35)m to £44m, in line with reduced levels of work-in-progress.

Taxation

The effective rate of tax for the Group was 20.7%, with a charge of £(199)m based on underlying profit. Last year's rate of 15.4% reflected the one-off effect of a lower UK corporate tax rate on deferred tax liabilities.

Earnings per share

Underlying diluted earnings per share were 9.42p, (70.6)% lower year-on-year at actual tax rates ((70.5)% lower on a 52 week basis), driven by the decline in our trading profit performance. Statutory losses per share were (70.24)p reflecting one-off items.

Dividend

As announced in January, the Board has taken the decision not to recommend a final dividend, with the full year dividend charge solely reflecting the interim dividend of 1.16p paid on 19 December 2014. Future dividends will be considered within the context of the performance of the Group, free cash flow generation and the level of indebtedness.

Capital expenditure

	TY	LY
UK	£1.3bn	£1.6bn
Asia	£0.4bn	£0.7bn
Europe	£0.2bn	£0.3bn
Tesco Bank	£0.1bn	£0.1bn
Group	**£2.0bn**	**£2.7bn**

Capital expenditure was £2.0bn, a decrease of £0.7bn year-on-year, with lower spend in each region. As we described in January, we are planning a significant reduction in Group capital expenditure for the current year to £1.0bn.

We opened 1.6m square feet of gross new space in the year, but this was offset by the closure of 1.1m sq. ft. of space, primarily in Turkey and Hungary and the repurposing of 0.6m sq. ft. of space, mainly in Asia. We continue to grow our franchise store network. In the year, we opened 1m sq. ft. of space in our franchise stores, mostly in South Korea, and are planning to open a further 0.6m sq. ft. this year.

Property

As at the year end, the estimated market value of fully-owned property across the Group was £22.9bn. This represents a reduction of £7.6bn year-on-year driven mainly by the weakening of the UK and Central European property markets. This represents an estimated surplus of £2.7bn over the net book value.

The estimated market value excludes our share of property joint ventures. Including this, the valuation would increase by £0.9bn, net of the debt in the joint ventures. Last year's disclosed property valuation of £34.1bn included £1.2bn relating to our Chinese operations now disposed to our joint venture and £2.4bn from our share of joint venture property, before deducting debt.

In March 2015, the British Land asset swap added a further £0.7bn to the value of our property as we took ownership of 21 superstores. Including this increase, our Group freehold ownership percentage is now 55% by value and 60% by selling space.

	UK	Asia	Europe	Group
Property* – wholly owned				
–Estimated market value	£10.5bn	£8.3bn	£4.1bn	£22.9bn
–Net book value**	£10.5bn	£6.1bn	£3.7bn	£20.2bn
Proportion of owned net selling space	41%	66%	75%	59%
Proportion of owned space by value***	40%	71%	74%	53%

* Stores, malls, investment properties, offices, Distribution Centres, fixtures and fittings and WIP. Excludes JVs.
** Property, plant and equipment excluding vehicles.
*** Excluding fixtures and fittings.

Retail cash flow and net debt

	TY £m	LY £m
Cash generated from retail operations before changes in working capital*	715	**4,327**
(Increase)/decrease in working capital	1,145	**280**
Interest paid	(609)	(490)
Corporation tax paid	(347)	(612)
Net cash generated from retail operating activities	904	**3,505**
Cash capital expenditure	(2,244)	(2,774)
Free cash flow	(1,340)	**731**
Other investing activities	253	66
Net cash used in financing activities and intra-Group funding and intercompany transactions	239	160
Net (decrease)/increase in cash and cash equivalents	(848)	**957**
Exclude cash movements in debt items	(1,010)	(374)
Fair value and other non-cash movements	(26)	(583)
Movement in net debt	(1,884)	**–**

* Includes both continuing and discontinued operations.

Reflecting the lower level of underlying profitability, £(0.6)bn in interest paid due to underlying finance costs and the timing of interest payments, and £(0.3)bn of cash corporation taxes, net cash generated from retail operating activities was £0.9bn. After cash capital expenditure of £(2.2)bn this resulted in a free cash outflow in the year of £(1.3)bn. This, combined with other movements led to a net debt movement of £(1.9)bn.

Pension

On an accounting basis, the Group's net pension deficit after tax increased from £(2.6)bn last year to £(3.9)bn at the year end. This was driven by a reduction of 80 basis points in real corporate bond yields, leading to a corresponding reduction in the discount rate used to measure our long term liabilities, partially offset by a strong asset performance. On an actuarial basis, the deficit at 31 March 2014 was £(2.8)bn and a plan to fund the deficit with cash contributions of £270m per annum has been agreed with the Trustee. We are consulting with our colleagues to replace our defined benefit pension scheme with a defined contribution scheme.

Total indebtedness

We define our balance sheet leverage more broadly to include net debt, discounted rent and lease commitments and our IAS 19 pension liability. On this basis our total leverage or indebtedness was £(21.7)bn, an increase of £(3.1)bn driven by increases in both net debt and our pension liability.

	TY £m	LY £m
Net debt* (excludes Tesco Bank)	(8,481)	(6,597)
Discounted operating lease commitments	(9,353)	(9,419)
Pension deficit, IAS 19 basis (post-tax)	(3,885)	(2,559)
Total indebtedness (including lease commitments and pension deficit)	(21,719)	**(18,575)**

* Includes both continuing and discontinued operations.

Our discounted minimum operating lease commitments were broadly unchanged at £(9.4)bn, whilst our operating lease expense in the year increased by £72m to £1,486m. Around £35m of this expense related to inflation-indexed rent which will not recur as a result of the British Land asset swap entered into post year end. The transaction will also result in the consolidation of net debt of around £450m.

Outlook

The market is still challenging and we don't expect this to change in the immediate future. Over the next 12 months we will continue to focus on our three priorities: regaining competitiveness in our UK business; protecting and strengthening the balance sheet; and rebuilding trust and transparency in the business and the brand.

We are already making good progress on these initiatives and on the basis of actions already undertaken they will deliver significant cost savings in 2015/16. The immediate priority for these and any other savings delivered is reinvestment in the customer offer in order to further restore UK competitiveness.

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