Company: **Magnit**

Conference Title: **4Q and FY 2019 Operating and Unaudited Financial Results Conference Call**

Date: **Thursday, 6th February 2020**

Operator: Good day and welcome to the Magnit Q4 2019 Financial Results Conference Call. Today's conference is being recorded. At this time, I would like to turn the conference over to Mr. Albert Avetikov. Please go ahead, sir.

Albert Avetikov: Thank you, Operator. Good evening, good afternoon, and good morning, ladies and gentlemen. Thank you for joining us to discuss Magnit's operating and unaudited financial results for the fourth quarter and full year of 2019. With me to review the results are our CEO, Jan Dunning, and CFO, Elena Milinova.

The announcement and presentation are available on our website. And, of course, after our remarks, we look forward to taking your questions. I would like to remind you that today's financial results are based on the management accounts and may slightly differ from audited financial statements under IFRS to be reported by the company on March 16th. I will now turn the call over to Jan Dunning. Jan, please.

Jan Dunning: Thank you, Albert. Good day, everyone, and thanks for joining us. Let me start, as usual, with the key highlights before we jump into the deep details. First, we have opened around 2,400 stores on a net basis and redesigned more than 2,300 stores in 2019. The selling space growth slowed down a bit while it still remained double-digits despite high base. Sales growth in the fourth quarter accelerated, on stronger trading in the like-for-like stores driven by traffic improvement. We've seen like-for-like traffic increase each consecutive month of the quarter across all formats. Positive momentum continued in January with even stronger like-for-like sales growth despite much lower promo activity.

Gross profit margin in the fourth quarter weakened on the back of price investments to drive sales combined with slightly lower supply chain efficiency. Notably, both logistic costs and shrinkage were improving throughout the year. SG&A costs remained under control with higher depreciation and amortization expenses, utilities and rental costs were partially compensated by a reduction in advertising, packaging, and staff costs.

EBITDA margin came below our expectations, mainly driven by stronger promo intensity and the introduction of our loyalty card. I'll get back to that later. Net income significantly shrunk due to gross profit dynamics, higher depreciation and amortization, and increased finance costs. Our guidance for 2020 reflects greater focus on efficiency of business processes, stricter return requirements, proper capital allocation, and value creation for all shareholders.

Now, I will run you through main achievements and development of the quarter. The sales growth was supported by like-for-like improvements on sustainably better traffic. Despite slower selling space growth of 12.7%, sales growth in the reported quarter accelerated to 11% and was supported by improvements in the like-for-like stores. The like-for-like sales growth was positive during two months of the quarter despite negative quality of days in December. So, normalized like-for-like sales growth would be around one percentage point higher.

Like-for-like traffic was the key driver of sales growth and was recovering steadily each month of the quarter across all formats. In December, it turned positive, including in core convenience format for the first time for the last three years. This was driven by further improvements in assortment, shelf availability, and the loyalty card rollout. What we actually did, we have invested to get traffic up to show that our stores have improved. I would like to note that very significant contribution to like-for-like traffic came from matured stores – actually, those that have opened before 2018. At the same time, the younger stores continued delivering strong double-digit like-for-like sales growth.

Traffic was well supported by increased frequency of visits, which is partly related to the rollout of the loyalty program. Growth in the number of unique customers was another contributor to the hike in traffic. In the second half of the year, we have finally started seeing positive net inflow of new customers coming predominantly from larger formats, regional chains in traditional retail, evidencing positive customer reaction to our initiatives.

Promo intensity remain elevated in the fourth quarter while significantly reduced in the beginning of the year. Promo share picked up in the reported quarter due to seasonal year-end effects. However, such growth is also explained by further inventory sell-off, deeper discounts not fully covered by suppliers, and faster-than-expected growth in loyalty card penetration. Although these price investments put additional pressure on ticket growth and margin – they are not fully covered by suppliers – it allowed us to get customers in and show all the changes and initiatives we have implemented in the stores.

We saw quite aggressive behavior from some of the competitors, including large formats and some market disruptors. We believe that at the moment, our pricing is pretty relevant and attractive. Promo share growth slowed down in December without any impact on traffic, which continued improving. In January, the promo activity in our stores was much less visible compared to the fourth quarter, while both like-for-like traffic and sales growth showed further pickup.

In January, like-for-like sales growth exceeded CPI level. And given that this year, we don't have any effect from VAT changes, which was 0.6% last year, that makes our trading results even stronger. Of course, I would like to see this as a sustainable trend supported by both strong consumer and quality improvements in our stores combined with healthy promo activity.

Then, active rollout of the loyalty cards adds incremental sales. We continue actively rolling out our multi-format loyalty card. The very first results came above our initial expectations and we have reached already 58% of penetration in sales, provided by around 20 million active cardholders, and

penetration is even bigger in the large formats. Rollout is expected to be completed within the first quarter 2020.

At the moment, this is a pure price investment from our side, which is aimed to drive customers' loyalty, retaining, and regaining new customers. We are targeting further quick uplift in penetration this year, which will allow us to start transformation of these investments into better supply chains and better customer proposition. And of course, having lots of information on customer transactions will bring us new knowledge to improve marketing, category management, etc., to satisfy changing customer needs.

Like-for-like ticket growth remained positive although it deteriorated to 0.3% in the fourth quarter, primarily driven by lower average number of articles in the basket. Shelf price dynamics was negative and in line with the official food inflation. Although record low on shelf inflation put pressure on ticket growth, it wasn't the key reason for weaker check. Negative average number of SKUs in the basket was the main factor for such a trend, specifically pronounced in December due to the high base of comparison of last year.

In the last month of 2018, we had the promo campaign 'The Nutcracker', which stimulated consumers to buy larger basket and we didn't repeat it in 2019. Trading up trend continued and was even more pronounced quarter-on-quarter as a result of ongoing improvements in the assortment. Now, I would like to turn the call to Elena to comment on the financial results.

Elena Milinova: Thank you, Jan. Gross profit margin dynamics was negative in fourth quarter, driven by high promo intensity, further rollout of the loyalty program, weaker supply chain efficiency, and high shrinkage. Higher level of promo activity with deeper discounts led to increased investments into prices, not fully covered by suppliers.

The pace of the loyalty card rollout was faster than originally planned. And what is more important, we achieved higher-than-expected penetration ratio. This was another addition to price investments not yet covered by suppliers. Although at this stage with penetration of 58% in sales, we still consider this is a pure investment, the loyalty card becomes one of the major CVP elements.

Growing on-shelf availability, assortment change in large formats, and other factors resulted in weaker year-on-year supply chain efficiency and higher shrinkage in fourth quarter. However, looking into quarterly development, we see gradual reduction of logistic costs on the back of several initiatives launched in the second half of 2019. For example, tender for external transportation, review of delivery scheme, relations with suppliers, etc.

It's the same dynamics we see in shrinkage. We have started the year with a very high base. So, although it increased by 55 bps in 2019 versus 2018 on high share of fresh and ultra-fresh products availability, in fourth quarter shrinkage already reduced by 39 bps quarter-on-quarter. We were seeing step-by-step reduction in shrinkage throughout the year. Since September, the gap between 2019 and 2018 has almost disappeared and this trend has to be supported by further growth of the share of drogeries.

SG&A expenses remained under control. As you have seen from the announcement, SG&A, as a percentage of sales, increased by 38 bps year-on-year. And this was predominantly driven by increased depreciation and amortization, higher rent, and country-wide indexation of tariffs. Personnel costs slightly improved both year-on-year and quarter-on-quarter, thanks to continuous automation of key business processes and the optimization of the headcount. Staff turnover constantly improves, thanks to reduction of workload, optimization of induction program, and yet we are well on track with organizational changes related to decentralization of front-office functions and centralization of back-office functions.

Growth in cleaning expenses was caused by increased tariffs and higher frequency of cleaning as a result of higher standards applied to the stores in accordance with the new CVP. Increase in electricity costs was related to annual indexation in July 2019. While on a year-on-year basis rental costs increased by 23 bps due to growth in share of leased selling space 77% in fourth quarter 2019, we see steady quarter-on-quarter improvements of leased stores, resulting in lower rental cost per square meter of selling space. And another factor is definitely related to better quarter-on-quarter sales density across all formats.

Depreciation reported in the fourth quarter 2019 was 50 bps higher year-on-year due to changes in the management judgment of useful life of assets and impairment of assets in the amount of RUB1 billion recorded in the reported period. Operating expenses increased predominantly due to insurance costs as a result of introduction of an insurance program covering all network of source and distribution centers. The above increases were well offset by the optimization of marketing and advertising expenses and improvements in packaging and raw material expenses.

Reported EBITDA margin came below our expectations in the fourth quarter resulting 6.1% for the full year. EBITDA adjusted for one-off, LTI expenses came at 6.8% for 2019. As a result of the gross profit margin dynamics not fully offset by SG&A improvements, EBITDA margin in the fourth quarter came below management expectations. LTI expenses contributed 0.12% in the reported period, resulting in a pre-LTI margin of 5.5%, while for the full-year, LTI expenses amounted to 0.15%, leading to EBITDA pre-LTI of 6.2%. As no one-off expenses were recorded in the fourth quarter, adjusted EBITDA matched pre-LTI level while for the full-year, it stood at 6.8% as a result of previously announced one-offs.

Net interest expenses in the fourth quarter increased by 50%, or 27 bps year-on-year, due to a combination of larger average amount of borrowings and higher costs of debt compared to the previous year. As a result of factors mentioned above, net income in the fourth quarter decreased to RUB4 billion with the margin of 1.1%. Effective tax rate was negative as a result of amended

tax declarations for the previous years with regards to deductible expenses. I would like to mention that the normalized effective tax rate of Magnit stands at around 22% in line with the full year 2019.

Net debt increased year-on-year on higher total debt and lower cash balance. You may have seen from our announcement that at the end of the year, we had a total debt of RUB184 billion and the cash position of around RUB9 billion, resulting in a net debt of RUB175 billion. This year-on-year increase was driven by first-half billings while in the second half, total debt declined. Such dynamics was mostly attributable to the acceleration of the redesign program and store openings, investments in buyback program, and two dividend payments within 2019 versus one within 2018.

The net debt increase was due to higher gross debt and lower cash position related to different calendarization of payment days in 2019 vs 2018. Net debt to EBITDA ratio was 2.1x, unchanged versus end of the first half of 2019. In 2020, we see room for improvement in cost of debt with positive effect on the bottom line.

CAPEX in 2019 amounted to around RUB59 billion. CAPEX in the reported year was slightly higher than a year ago due to more store openings and redesigns completed in 2019. At the same time, it was lower than the guidance range as a result of stricter return requirements implied for all projects in the fourth quarter and global investments per square meter of selling space. A detailed discussion of CAPEX expenditures as well as the debt portfolio will be provided on March 16th when Magnit reports full-year audited IFRS financials.

Inventories showed some increase within 2019 as the result of structural changes. You have noticed from the announcement that inventory level reached the RUB 219 bn at the year-end, increasing versus beginning of the year. This was partially related to the continuous focus on on-shelf availability on the back of ongoing assortment review resulted in additional purchases. On-shelf availability improved across all formats. And other factors included organic growth of the company's store network, inflation in purchasing prices and assortment mix.

Fast growing drogerie business had an impact as well. Cosmetic segments reached a record high of 8.7% of net retail sales in the fourth quarter. With a more expensive assortment in that format and lower rotation of such items, it had an impact on total inventories. The team achieved good results in reducing old stock bought before 2019 with insignificant amounts left. As to the passive matrix, we've now reached a comfortable level of around 8-10% of inventories, which is in line with the industry practice.

As you may remember, we had more aggressive plans last year. However, we underestimated the impact from assortment change, uplift of on-shelf availability, and other factors. Going forward, we are not going to lower the stock in absolute terms, but we will target organic reduction of turnover days without pressure on promo share and margin. In 2019, we managed to improve payable days turnover year-on-year by three and a half days to 45 days.

And now, I will give the floor back to Jan for guidance and closing remarks.

Jan Dunning: Thank you, Elena. The 2020 forecast reflects greater focus on operating efficiency and optimization of key business processes rather than on faster growth. Before I go through the figures, I'd like to tell you what the key here is. It is definitely prioritization of our efforts on profitable growth and returns and to create additional value for stakeholders. Yes, there is a slowdown in our organic expansion to a moderate level, which is visible in our net opening targets for 2020 versus 2019, but it is still 1,300 stores with a focus on the best projects in the strongest regions where we have a high confidence of reaching acceptable returns. And we will continue our redesign program with another 1,300 stores planned for refurbishment as well in 2020.

Of course, we will also continue to look for bolt-on acquisitions of small to medium size, if such value-accretive opportunities arise. Our closure program is well-analyzed. A considerable part is actually a replacement of older stores by better locations as well as some closures in the weak

catchment areas. In 2020, we plan to close around 480 stores. Notably, over 80% of closures will happen in the first half-year and more than 90% will be in the convenience segment.

The intention to slow down expansion in 2020 should not be seen as a lack of confidence in the long-term attractiveness of the market, nor does it indicate a lack of opportunities. It is a sign of our confidence in Magnit's market position and our greater focus on value creation for shareholders. If the environment becomes more favorable and our trading continues improving, we may revise these targets.

With this, you see us spending from RUB60 billion to RUB65 billion of CAPEX while investments in organic expansion redesign will slightly reduce. We will increase spending on efficiency projects focused on business development such as optimization of supply chain and IT infrastructure and others. Our key focus here will be on further development of the loyalty program, balanced promo with better coverage by suppliers, continuous improvement of supply chain, expenses, shrinkage, further optimization of SG&A costs, and reduction of cost of debt to drive margins. All this is aimed to improve our ROICs and create additional shareholder value.

Speaking on cash distribution to shareholders, Magnit has a long track record of dividend payments, which we do twice a year. This is definitely an authority of the Board and Shareholder Meeting to decide on dividend payments. Meanwhile, I don't see any reason – business reason to expect lower absolute amounts, going forward.

Some closing remarks from my side. We remain fully committed to fulfilling customer needs via the implementation of our adjusted CVP. We are focused on fixing and improving the processes of our core business while continuing to enhance cross-functional cooperation to ensure effective decision-making. We will invest in developing our human capital, private label offering, direct import, and we will upgrade and modernize our IT infrastructure to optimize business processes.

We're taking the first steps in the development of our omnichannel digital concept focused on new trends and overall customer journey, with all the relevant instruments allowing to identify customers and their consumption patterns to structure proper advanced analytics and personalization, as well as to enrich our overall omni experience, including different potential ecosystem elements. Our main focus is now on profitable growth with efficiency gains made in all the areas and business processes, aimed at higher returns and value creation for stakeholders.

Thanks for listening. And I think we are ready for questions.

Albert Avetikov: Thank you. Operator, we are ready for the Q&A session.

Operator: Thank you. If you would like to ask a question, please signal by pressing star one on your telephone keypad. If you are using a speakerphone, please make sure your mute function is turned off to allow your signal to reach our equipment. Again, press star one to ask a question. We'll pause for just a moment to allow everyone an opportunity to signal.

We will take our first question today from Victoria Petrova from Credit Suisse. Please go ahead. Your line is open.

Victoria Petrova: Good afternoon, everyone. Thank you very much for allowing me to ask the questions. Jan, you have been with the company for one year now. In this one year, I've noticed that operating profit dropped by 31.5%, net income by 50%. I can imagine that with your also relatively recent role, you have been discovering some news related to the company business model. And obviously, the guidance given on October 29th of 6.5% EBITDA margin for the full year has not come through. Could you please share what was new, surprising? What went wrong in November and December this year, and what can be fixed in the next two quarters? That would be my first question.

Jan Dunning: Thank you, Victoria, for this encouraging introduction.

Victoria Petrova: No, no –

Jan Dunning: No, to be quite honest with you – please go ahead.

Victoria Petrova: It's not what I meant.

Jan Dunning: To be quite honest, it didn't go wrong in November-December. It was already wrong earlier. And what is wrong was that we have not anticipated enough investments that had been done in an increase of promo share. It is clear that we have not optimized supplier compensation for those. Due to this, the Commercial team experienced too late the debt gap was not able to close.

And then on top, as you have seen, as of September, we have also started to rollout the loyalty program. And that was – by the way, a deliberate investment into margin. But we simply anticipated a different number. We thought that the penetration would be lower, looking as well at the – market experience with other businesses, we found ourselves, all of a sudden, at a 58%. And that was a margin invest that we didn't anticipate. And that, therefore, especially in November-December when we saw that hiking up, we came to realize that, 'Listen, this is where we have to make sure for the next year that we close that gap.'

Those are actually the most important elements. The good thing though is that – because I'm an eternal optimist – the good thing though is that this has at least translated into a pretty big traffic increase, which we haven't seen for a long time. And we see as well that now in – and in December and in January – especially in January and the first couple of days in February –that translates well in like-for-like sales. So, I think our main objective –

Victoria Petrova: But traffic was negative for the first quarter.

Jan Dunning: Sorry?

Victoria Petrova: Oh, I thought – but from the results, I see that traffic for the first quarter is still negative.

Jan Dunning: For the first quarter in total, yes. But, for example –

Victoria Petrova: – 0.2%.

Jan Dunning: Yeah. But for this –

Victoria Petrova: It's positive.

Jan Dunning: – for December, not anymore. No.

Victoria Petrova: Okay.

Jan Dunning: And we see that that has translated into better dynamics. So, I think our objective for this year has to be to make sure that the activities that we develop on the Commercial side are well enough covered by funding of suppliers or by different scenarios of getting margin balance difference. And I think that's one of the things that we work on now, and I trust that it's going to work.

Victoria Petrova: Oh, thank you. Thank you very much. So, basically, you expect positive traffic in the next quarter sometime, and then you can ask for some rebates from suppliers to finance your loyalty card?

Jan Dunning: The normal procedure is – the normal procedure, Victoria, is that if you're planning certain activities, which you go and sit with suppliers and ask for, 'Okay, what kind of programs we can run? What kind of compensation do we get? Do we get that on invoice or do you do that in a different way by exclusivity or whatever?' Those things have not been covered enough.

Victoria Petrova: Understood. Thank you very much.

Jan Dunning: It's part of the learning curve of category management because that's what we haven't been too strong at.

Victoria Petrova: Thank you very much. My second question is on gross profit. I also noticed that the gross profit is down versus third quarter when you had already this inventory sell-off. And we treat it as – it's sort of as a third quarter one-off, but it appears again and it's also treated as a one-off when I look at your definition of adjusted EBITDA. What exactly is this? How much is left? How should we look at it, going forward, for the next year?

Jan Dunning: Entering the third quarter, we had around RUB17 billion of old stock. Finishing the year, we had RUB3.8 billion of old stock. So that's part of the estimation.

Victoria Petrova: Is it the same as passive stock or is it…?

Jan Dunning: No. No. This is the stock which was really old, bought before 2019. So, it's not the passive stock. The other ones are, of course which came as a surprise is simply the not-fully-compensated promo increase. I think that's a tough lesson and that was not well-organized.

Victoria Petrova: So, it should be really treated as a one-off and should disappear in the first quarter next year?

Jan Dunning: Yes. We work on that day by day. So, that will not happen as it did in the fourth quarter.

Jan Dunning: The gross profit impact in fourth quarter was a higher promo share, a higher loyalty than we expected and not sufficient funding of supplies in earlier months like October, September.

Victoria Petrova: Thank you very much. If I may just also clarify on EBIT and the EBITDA margin, do I understand it correctly that there was about RUB2 billion full-year LTI and around RUB400+ million for the fourth quarter?

Victoria Petrova: Is it linked to the share price? Should we expect the first quarter LTI to be higher, given that the share price performance, at least so far, has been quite strong?

Elena Milinova: Okay, let me answer this question. You're right. So, LTI's total amount is RUB2 billion and that's a fixed amount, yeah? If the share price will go up/down, that will not influence at all LTI expenses. That's all.

Victoria Petrova: And is it not subject to the number of team members?

Elena Milinova: No, no. It could be increased only if the other members will be included into the LTI program. But it's immaterial, as we currently see. So, that's fixed and it will not be increased due to share price increase. Okay?

Victoria Petrova: So, we should assume RUB2 billion for the next year?

Elena Milinova: Right.

Victoria Petrova: Thank you very much. My last question is related to a comment on page number 13. You are saying that you changed methodology to account for rebates allocation between closing

inventories and cost of goods sold. I don't understand why the adjustment for 2019 was significantly higher for 2018.

Elena Milinova: That depends on the amount of bonuses, but by types here – by category which accumulated each year. And second, that depends on the amount of inventory which is on the balance sheet. Because it's increased, the impact in 2019 is higher than in 2008.

Victoria Petrova: But inventory should not increase by over 50%, as the adjustment has.

Elena Milinova: It depends on the structure, as I said. So, it depends which type of category, the structure of inventory in the balance sheet, and the structure of bonuses which were collected. For example, if in the fourth quarter more bonuses related to drogerie or detergents where we have higher bonus, then that means that the impact will be high. And this year, we have increased in our sales of these non-food categories where the bonuses are higher.

Jan Dunning: It was also the format that was growing the fastest.

Elena Milinova: Yes.

Jan Dunning: So, that had impact.

Victoria Petrova: Yes. I also noticed that, obviously, your drogeries were growing and wholesale related to mostly non-food, if I understand it correctly, has demonstrated significant growth in the fourth quarter. Can you disclose anything on the margins there?

Elena Milinova: We do not disclose the segment's financial results, as you know, but I could say that it's a low single-digit number for that format, or for that type of sales, profitability.

Victoria Petrova: Thank you very much. And my very last question is related to dividends. You mentioned that absolute dividends, business-wise, should remain flat. So, decrease in net income would not affect dividends, basically? So, your payout ratio would double?

Jan Dunning: One thing I want to state very clear. The dividend payments and the policy is defined by the Board of Directors and the Annual General Meeting (AGM). But from a business perspective, I do not see any reasons that we will see changes in the dividend policy as we've seen over the last couple of years.

Victoria Petrova: Thank you very much for your answers.

Jan Dunning: Okay.

Operator: As a reminder, if you wish to ask a telephone question, please press star zero on your telephone keypad. If you find your question has been answered, you may remove yourself from the queue by pressing star two. Once again, it is star one to pose a question. We'll pause for just a moment to allow everyone an opportunity to signal.

Operator: And as a reminder, please press star one on your telephone keypad to ask a question. We have received a question from Yulia Gerasimova of Goldman Sachs. Please go ahead, your line is open.

Yulia Gerasimova: Yes. Good afternoon. I have two questions, please. The question number one is about the traffic dynamics. So, when I actually see these key factors such as high promo, as you mentioned, material decline in gross margin, and low back-end growth, to me these three factors actually point to a very high intensity in price investment. And that actually could have contributed also to the traffic improvement that you have seen.

And I wanted to understand how dependent Magnit traffic for is for the further price investments, going forward. Do you really have to continue to invest that heavily to keep the traffic in the positive territory? And also to that, what actually gives you confidence that this positive momentum is going to continue? It was not just a temporary event driven by the easy base effect and more active promos? That's my first question.

Jan Dunning: Thank you, Yulia. Just to give you a bit of dynamics, I do think that the promo investments that we have done in October has led to an inflow of customers. But I think what happened after that was that our promo intensity came down. And in December, actually, it was, in comparison to the year before, just a bit higher, but not that much as we had in October. But we saw in the first time in the year that we had traffic plus in December.

So, what I think what happened is that customers that have come into our store in October have seen that the new initiatives in CVP (Customer Value Proposition) that we put in place is something that brought them back. Because if we look at the dynamics of new customers, we saw that actually in December the traffic increase was primarily led by new customers coming inside the store.

And looking more specific at January – this period, we see the trend of slowing down of promo, but we see that traffic keeps growing. So, what I do think, in a nutshell, is yes, the promo intensity in September-October has helped, that it has helped to convince customers that Magnit is, again, a place to go to. If you look at the dynamics in November-December-January, you see that that is confirmed. And that's also obvious because the efforts on category management, the efforts on attractive assortment and relevant assortment have clearly been recognized by consumers and that's why they're coming more.

Yulia Gerasimova: Thank you very much, Jan. And just a clarification to that. If I recall correctly, last year, from November to February, you had a special promo action which actually was aimed to increase the average basket size, and which actually negatively affected the traffic. Could this easy base be

also the factor that contributed to the fact that you have seen November-December-January as good months as that promo activity lasted until February 2019?

Jan Dunning: No. Of course, we had to look at this because we took the decision not to repeat that action as we saw already that margin investments was already done. So, why do additional work? That action was 'The Nutcracker' in which customers spending a certain amount were getting a scratch card to get additional discount on an additional item that they will buy. So, that that action was more stimulating the bill, but it was not traffic-related.

Yulia Gerasimova: Okay. Understood. And my second question would be on the margins. This year – in 2019, you had the 6.1%, but adjusted for the certain one-offs 6.8%, if I recall correctly. So, do you think this 6.8% is more like a normalized level we should expect the company to be at, given there are no – assuming no one-offs will be taken, moving forward? And do you think that we are already going to see like a further decline from that level? It's more like we are talking about stabilization of the margins, given that your initiatives over efficiency and cost optimization.

Jan Dunning: Yulia, as you probably have noticed, we are actually not more – not giving any indication on EBITDA. I think what you can expect from us to do is that we will be focusing on profitable growth, that we will be focusing on getting more control on income, that we are also focusing on which activities that we do – commercial activities, investments – that do make sense. And the last but not the least, we're also now focusing on, 'Okay, the loyalty card is so successful. How can we get more knowledge out of this in order to be more efficient in reaching out to customers, but also more efficient in allocating margins to certain activities?'

So, you've got it right that the normalized EBITDA was 6.8%. But I'm not going to give you any indication. But in transformation, we think that we are in the right tone that the business is picking up. And it might partly be also the macro. But it's good to see that we are at least exceeding sales

growth – like-for-like sales growth now. So, we're doing better than CPI, which I think is pretty encouraging.

Yulia Gerasimova: Sorry. And my last question. I just wanted to check about the inventory. I think it's been already mentioned some comments about that. But I'm actually still surprised that I think in the beginning of 2019, there were big expectations about the release in working capital and inventory. And you have been selling off some of the old stock during the year. I mean, why this guidance was – at first, it was lower and then not realized at all relating to inventory. Why – and what should we expect, going forward?

Because if I recall correctly, one of the factors that should contribute to the return improvement was actually improvement in the working capital. And inventory management is a key of that parameter. So, how should we look at the working capital and especially investment management in 2020? Should we continue to increase inventory levels because of the structural cyclicity of business or we should expect some positive impact in the free cash flow?

Jan Dunning: I think part of the growth is connected to the mix change of assortment due to the growth of the cosmetics. You've seen it as well that we will continue growing our cosmetics business this year, but we have at least set ourselves a target to not grow the stock levels any longer. We should try to be the more efficient and get more rotation numbers in. So, the idea is to, with the same amount of stock, run simply higher sales.

Yulia Gerasimova: Thank you so much for your comments.

Jan Dunning: All right.

Operator: We will take our next question from Elena Jouronova of JP Morgan. Please go ahead. Your line is open.

Elena Jouronova: Hi. Good evening. I also have a few questions. First of all, Jan, Elena, I have to note that, in my opinion, there was some lack of consistency in the message of the management during 2019 and quite a lot of unexpected developments and one-offs. And forgive me for that message, but I think I have to say this. So, understandably, I know that you're quite cautious right now on guidance. But I would like to understand why, in principle, we have this situation. Is it because Magnit's business is so incredibly complex that forecasting reliably where the margins could be and where the working capital could be is just very difficult?

And if that is the case, why do you need to see an improvement of that? Because, frankly, when we were talking at the start of the year about potentially a very strong improvement in the working capital and I believe the market was already penciling that in in the DCS and the earnings expectations and now we see that effectively, you most likely had a cash outflow from working capital instead of an inflow.

And the same comment on margins whereas you're giving guidance at the end of Q3 about the promo intensity, your plans to reduce that and your plans for the margin, and it's still not there. So, apologies for taking so much of your time. But in essence, why is it so difficult to simply – to forecast correctly what the results are going to look like and how can it improve in the future in 2020?

Jan Dunning: Elena, you don't need to apologize. I think the apology should be from us, right? I think what you mentioned is correct. We have had difficulties to forecast. Part is the mix change that we have underestimated, which had an impact on margins. Part was the loyalty program that was bigger than we expected. I think also the mix change has taken us by surprise, with regards to stock. I think it took the team a while to understand if you push in that direction, then that happens on other sides. And also, on the agreements with suppliers, not everything was covered with the activities that we were doing.

And therefore, there's, from my view, a lot to improve. The forecasting problem is also, by the way, is something that we tried to resolve as well with – we've started with Hyperion. We tried to resolve now with investments in IT and ERP because it's clear that the level of ability that we have there now is not sufficient and cannot be tolerated.

So, what our focus of the current management team is, is to get our hands on the business to start to control so that we also know, 'Okay, what's happening if we increase our share of cosmetics? What does that do to the margin? What does that do to the stock?' Because I think overall, that has not been anticipated well enough. And a similar thing you can say about the promo activities. We simply didn't cover our back with the suppliers and that's not smart.

Elena Jouronova: Okay. Thank you. And then, I had some smaller questions. First of all, the accounting change. Does it mean that we should now expect a sustainably lower gross margin for Magnit or no? Because I didn't fully get the rationale for the change – or rather not the rationale, but the details of it. But since it has a negative impact on the margin and the P&L, does that mean a slightly lower gross margin, going forwards, or not really? I mean, I understand the impact is very small but still, for me to understand what's going on there.

Elena Milinova: Let me take that question. I think that the impact on marginality of accounting change will not have material effect in the future at all. Especially if we keep our stock not growing, in absolute terms, then it's zero impact or close to zero. Jan?

Jan Dunning: Yes. The only thing what might need is the mix change there.

Elena Milinova: Yeah.

Jan Dunning: That's what we're analyzing at the moment as well. Okay, what's the impact there? So, the composition of the stock will change as the format growth is changing. And we are currently in the process of analyzing and we get a good feel that that has to be done.

Elena Jouronova: Okay. And also, I would like to know how are the sales densities of the stores with new CVP and the new design, how are they performing versus, like, similar stores that have not been redesigned, that still have an old CVP? Can you give some numbers on that, please?

Jan Dunning: Yeah. Elena, what we have seen – and that's more historically. What we saw is that in 2018, the remodels were actually not delivering what we expected. But we see now that in 2019, in the combination of end operational and commercial improvements that the uplift gets stronger. And that depends as well a bit on the areas where you look. If you look at Moscow, we see a pretty big uplift. But on average, it's 8-9% of uplift that we see at the moment.

So, we think that's encouraging, which means that the combination what we did in the past – only the navigation plus hygiene – of course didn't give the uplift than now in combination with the assortment. And we believe that now with the implementation of the loyalty card, that we actually will see even a better uplift, going forward, as the loyalty card clearly is appreciated.

Elena Jouronova: All right. And the final one from me is if you are indeed seeing better performance of these revamped stores and the CVP is actually working, you're seeing better like-for-like traffic in December and January is also looking forward, as you say, so why actually cut the store openings guidance?

I understand the point about closures. I see that. But it doesn't make sense to me right now. Are you just simply too cautious because you want to see a few more months of sustainable improvements? Or are you not sure that improvements come from the CVP or that they're just driven by price investment?

Jan Dunning: Elena, maybe you recall your first question. So, yes, there is a certain cautiousness on our side. And the guidance cannot be based on January only. So, yes, we have – we are influenced by what happens in 2019. But, trust me – and you know me – if this is sustainable, we do not think that the market is limiting us in opportunities.

What we do think is that we need, at the moment, a bit of different priorities with regards to getting control, higher efficiency, get less complexity in our business, and make sure that we focus on like-for-like and EBITDA improvement. And that's what we currently aim to get to. If that in a couple of month is sustainable, then I hope I won't surprise you with a bit of a bigger CAPEX number because then, at least returns are secured. But for the time being, I'm cautious.

Elena Jouronova: Okay. And if, actually, you have to increase – not have to, but if you decide to increase CAPEX because things are looking better and you have a higher degree of conviction, is that a risk to dividends?

Jan Dunning: That is connected. If our results are improving, as they do, then I can assure you the dividends will, for sure, be there. But what will happen – it's a good point that you raised. We are limited in spending because we want to pay dividends coming out of a positive cash flow.

So, we don't think it's sustainable to pay dividends when we're having negative cash flow. So, we, as a management team, we have to make sure that the business develops in such a way that we generate cash in order to invest. And if there is a decision to pay dividends, we have to take that into account as well.

Elena Jouronova: And can you remind us up until which level are you prepared to lever the balance sheet, if you want to accelerate growth and continue paying dividends?

Elena Milinova: That is about governance.

Jan Dunning: Are you asking about the governance or what do we feel comfortable with?

Elena Jouronova: No. What do you feel comfortable with, as a management team?

Jan Dunning: I think we are not really set to increase the lever. So, I think we are on 2.1x. And last year as well, and that's the level, 2-2.5x where we feel comfortable.

Elena Jouronova: 2.0x-2.5x?

Jan Dunning: Yeah.

Elena Jouronova: Okay. All right.

Jan Dunning: Lower is also good.

Elena Jouronova: Thank you very much.

Jan Dunning: Yeah. Lower is also good.

Elena Jouronova: Thank you.

Jan Dunning: But looking at the opportunity in the market, I think it's – we should take that.

Elena Jouronova: I just don't remember, Jan, if you've had that kind of leverage in the lever-adjusted basis at previous organizations you've worked. Because 2.0x right now means 3.5x lever-adjusted. And we always used to look at that on a lever-adjusted basis. So, it's at the borderline. But that's my view. Thanks a lot again, and I do wish you very good luck in 2020.

Jan Dunning: Thanks.

Operator: We will take our next question from Maxim Nekrasov from Goldman Sachs. Please go ahead. Your line is open.

Maxim Nekrasov: Yes. Good evening. Thanks for the presentation. I have a few questions on CAPEX. So, despite fewer organic openings, you target a slight increase of CAPEX in 2020. Can you please comment if you include any CAPEX for small M&As in your guidance? And maybe you could provide examples of the efficiency projects that you plan to invest more this year?

Jan Dunning: No, M&A is not included. If you have the opportunity with M&A – because M&A is difficult to plan. But if they arrive, then we see, of course, how we balance it out with organic growth.

Getting to the second part of the question – the efficiency investment, so we are currently running a WMS implementation in order to be better in the whole goods management. We are doing a replenishment and forecasting effort to get better control about automatic reordering of stores plus the connection to the suppliers. We are investing in SAP, ERP. We signed, at the end of last year, 2019, a contract which will lead to higher efficiency as well in accounting.

So, I think we are trying to look at the time management and workforce systems so we also become more efficient in controlling the number of hours and make sure that we pay the correct number of hours, and that's less CAPEX-intense, but we do a top-down and bottom-up process analysis by department to see how we can slim and get better and quicker decision-taking, but also information.

We're investing into big data, which should help us to, at least on the cash management side, but also on the supply chain and logistics side, to be able to better understand customer demands and therefore improve our business. There's actually a continuous process ongoing currently also in

the controlling to help the business understand the business better. And yes, I think that will help us improve our results.

Maxim Nekrasov: Thank you very much. Also, you mentioned in the press release that you will be seeking for small and medium-sized M&A and I was wondering if you would consider a large scale M&A if such opportunity appears on the market?

Jan Dunning: I think what you've – we – just in a nutshell, what are we doing, we're downsizing our growth because we think that we should focus on our existing business. In that scenario, real bigger acquisitions would not be logical.

Maxim Nekrasov: Okay. Thank you very much.

Operator: At this time, we have not received any further telephone questions. I would like to hand our conference back to our host for any additional or closing remarks.

Apologies, we have just had additional questions. Would you like to take them?
We will take our next question from Victoria Petrova from Credit Suisse. Please go ahead.

Victoria Petrova: Thank you very much for taking just one very short follow-up question. Obviously, with some cut in openings, you will be much more dependent on your like-for-like sales growth performance. Has this decision on the number of openings been made with an assumption of positive like-for-likes and especially positive traffic through entire 2020? Thank you very much.

Jan Dunning: We took a decision to downsize the number of store openings already earlier, as you understand that the first quarter – this quarter, openings are initiated in October-November. So,

there is no connection to currently trading. What I answered to Elena is if this is sustainable development, we will come back and might adjust.

Victoria Petrova: Understood. Are you comfortable with below double-digit sales growth? Because obviously, your sales growth has been driven by openings in the last years, not by like-for-like.

Jan Dunning: Yeah. But the good thing is – and that's what I commented already in the script – if we see now what is the main driver of the like-for-like, that are the stores before 2018. It's the old stores, not the newer ones. The newer ones perform well. But in the past, you saw that the new stores were actually driving the like-for-like. Now, we see that like-for-like is also driven by older stores.

Victoria Petrova: Understood. Thank you very much for clarification.

Jan Dunning: All right.

Operator: We will take our next question from Alexey Krivoshapko from Prosperity. Please go ahead.

Alexey Krivoshapko: Hello, gentlemen. Finally, the questions. Is it possible that you quantify this kind of decrease in gross margin in Q4 versus Q3? Because it came down a lot – like 200 basis points. Can you break it down between high share of promo, loyalty, and losses maybe, if possible?

Jan Dunning: Alexey, no. In principle, no. We do not provide the bridges of margin. I think the components that have led to it are mentioned and I think that's important to know.

Alexey Krivoshapko: Can you just please tell us what was the promo share in Q4?

Jan Dunning: Yes, it was in the mid-30s. But we got the idea, Alexey, that we also sold down old stock.

Alexey Krivoshapko: I guess that you mentioned.

Jan Dunning: That has led to an impact as well.

Alexey Krivoshapko: But one thing I wanted to understand. You said it came from like RUB18 billion to RUB3.6 billion, but I guess the starting number was not entirely clear. Was it end of Q4 or it was the end of Q3? I didn't quite get that, to be honest, during the call.

Jan Dunning: It was end of Q4.

Alexey Krivoshapko: Okay. So it was from RUB18 billion to RUB3 billion? Minus RUB 15 million? Clear.

I guess my other question is like this. If you do the estimates of CAPEX line by line on gross openings, rebranding and what have you and at the map, it's actually quite far from RUB60-65 billion. I mean, like really far. Maybe half the number. Where is the other half?

Jan Dunning: The other half is in IT, supply chain, maintenance CAPEX. So, like I mentioned that this time, that we spent energy on the existing business to improve in order to get to a better customer value proposition and that's what we do.

Alexey Krivoshapko: And just out of curiosity, like, how many, I mean, trucks do you plan to buy? How many DCs do you plan to open? Because again, there is quite a lot of money. It was not so much of a space – of selling space growth. I understand the long-due IT investment, but I guess the rest looks quite oversized, to be honest.

Jan Dunning: There is also, Alexey – as usual, there is an overflow of CAPEX from 2019 into 2020. We have to finish the DC in Surgut, which we plan for this year, and the DC in Novosibirsk, which we

plan for this year. And yes, there's also a substantial amount of CAPEX reserved for internal transportation in the DCs and trucks. The exact number I do not know by heart, but I know that that's part of the supply chain CAPEX.

Alexey Krivoshapko: I see. And I guess the final question to Elena is if we look at the current debt portfolio, what is the current cost of debt for the portfolio overall? You did mention the recent bond issues, which also we see on the screen. But what is the current cost of debt weight of the portfolio?

Elena Milinova: The current portfolio cost is 7.6% on average.

Alexey Krivoshapko: That is quite good.

Elena Milinova: And we are planning to decrease further because we see that we are in negotiation process with the banks where we have a long-term loan. And there, I see that we have an opportunity to go down further in the first quarter.

Alexey Krivoshapko: Clear. Thank you very much.

Operator: We will take our next question from Artur Galimov. Please go ahead. Your line is open.

Artur Galimov: Thanks so much for the conference call. I've got a question about like-for-like in January, which is pretty good and apparently is around 2.5%, mostly driven by traffic, as far as I understand. So, Jan, I think the question is what makes you think – what makes you feel confident that those improvements in like-for-like sales, particularly in like-for-like traffic you observe in January, are driven by improvements in assortment, product availability, logistics and so on, so forth, all those operating initiatives, rather than being just a function of a pretty low base of last year and in the beginning of 2019? And also the function of increased frequency of visits not necessarily due to internal company-specific reasons?

So basically, could it be the case that we are just seeing a reversal of the trend of last year when there was a high average spending per visit and lower frequency of visits, which is being reversed in January? So, what do you think could be the split of the factors that drive current performance, if you look at operating improvements and, like, more statistical base of that?

Jan Dunning: Thanks for the question. First of all, by not reacting on the like-for-like level, I'm not confirming the number that you are mentioning. Getting more to the question, what we've seen now out of the data is that we – as of October, we see an inflow of new customers. If you would see a reverse of last year, then that would actually exclude those people. So, we need to find a reason why they come.

So, I think the first reason in October was the promo share increase. But in November-December, we have lowered that down and we've seen the dynamics of new customer inflow actually growing. And we've seen the dynamics of traffic improving up to the level that it's in December, positive – and in January as well.

So, I think, and I am also, like you, convinced that there are a lot of elements that have impact. But I do think, genuinely, that the CVP, or the hygiene, the operating, the availability, but also the category management are leading to a better shopping experience for our customers. Having said that, we also have the system of NPS (Net Promoter), and we've seen that that number has grown as well in the second half of last year. So, people start speaking more positive about Magnit. And that, I think, is the biggest cause of them visiting us. And yes, we are gaining traction with regards to the commercial proposition.

Artur Galimov: Right. Thanks for this. And just to clarify on like-for-like number, I think you mentioned it's running above CPI in January and I think the CPI number announced today was 2.4% growth in January year-on-year. Is that the number you had in mind?

Jan Dunning: No. What I have told you is that it's exceeding, so, it's better than CPI.

Artur Galimov: Okay.

Jan Dunning: If CPI is 2.4%, we have a higher like-for-like in January.

Artur Galimov: Well, that's what I meant. That's just a benchmark I referred to. And actually, the second question is – well, I admit it's pretty theoretical. So, I do not expect you to give the precise answer, but maybe just to give some sort of an indication. In terms of assortment improvement, in terms of the rollout of the new federal SKUs which are in the new federal assortment matrix you approved I think in the first half 2019, do you have a rough idea in what percentage of stores this federal assortment is at least close to what you'd like it to have in that entire chain, given the sellout of illiquid and passive matrix stocks in Q3 and Q4?

Jan Dunning: I have a view there. So, what's happened is that the category management efforts were done in the second quarter, and that continued in the third. What was our problem in the second quarter with the implementation of the new assortment was actually that on the shelf, we had relatively a lot of old stock. So, we had to clean that. The fact that we cleaned that in the third quarter led immediately to an inflow of new assortment federal. And continuing forward with the sell-down of old stock, we have been able to get more and more of the active matrix on the shelves.

If you look then federal-wise, we know by region what is actually the availability levels of the active matrix or the targeted matrix and that is close to 86-87%. So, there is still assortment that has been selected, which still has to get into the stores, or first into the DCs. But that's a big, big step forward to where we were at the end of the second quarter, which was close to 72-73%.

Artur Galimov: Okay. And just to clarify, this is the percentage of SKUs in the total assortment that basically comes from the new matrix – from the active matrix?

Jan Dunning: So, there is – the category manager has a targeted matrix in mind, 'So this is what my range should look like.' And then, of course, because you were asking of the federal – to which extent can I get that range in the stores that I want it to be in. And that depends on availability of all the big locations in the distribution centers, and that depends on the availability of shelf space inside the stores. Now, we've done a big effort on cleaning up shelf space inside the stores, and we also have done similar activities inside the DCs to make sure that we have better and higher capability for all the big locations. Now, that has gone from low-70% to end of 80%.

Artur Galimov: Okay. Understood. Well, thanks very much. And good luck for this year.

Jan Dunning: Thank you. Thank you, Artur.

Operator: This will conclude today's question and answer session. I would now like to turn the conference back to our hosts for any additional or closing remarks.

Albert Avetikov: Thanks, everyone, for listening. And the next reporting is on March 16th. Thank you.

Operator: This will conclude today's conference call. Thank you all for your participation. You may now disconnect.