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Krasnodar, Russia

MAGNIT 1Q 2021 TRADING UPDATE AND FINANCIAL HIGHLIGHTS CONFERENCE CALL

Operator:

Good day and welcome to the Magnit Q1 2021 trading update and financial highlights conference call. Today's conference is being recorded. At this time. I'd like to turn the conference over to Albert. Please go ahead, sir.

Albert Avetikov (Chief Investor Relations Officer):

Thank you. 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 first quarter of 2021. With me to review the results are our acting CFO, Dimitry Ivanov, and our CEO, Jan Dunning. The announcement and presentation are available on our website. And after our remarks, as usual, we look forward to taking your questions. I would also like to remind you that today's financial results are based on the management accounts. And with that, I will now turn the call over to Magnit's CEO Jan Dunning. Jan, please.

Jan Dunning (President and CEO):

Thank you, Albert. And good day, everyone. Thanks for joining us. Let me start with reiterating our priorities for the year – further enhancement of CVP leading to higher sales densities. The second one is strict cost control and efficiency gains to support profitability. Third - continuous optimization of the working capital cycle, and fourth - smart growth linked to strict return requirements. Now, having said that, I'm delighted to see healthy development of the underlying operating and financial metrics. This quarter results were affected by, as you all obviously know, the 2020 pandemic impact, namely we had a very high base for comparison. Despite that, we observed exceptionally strong performance across all formats. We continue working on qualitative improvements in the assortment, in-store and supply chain operations, procurement processes, working capital optimization and many more. I believe we're in a very good shape to deliver further strong trading results and sustainable margin levels. Our cash generation is solid, working capital cycle is improving and financial position remains strong. This actually supported the Board's recommendation to shareholders to approve second tranche of dividends in the amount of 25 billion rubles leading to a total payout of 50 billion rubles for 2020.

Now, let me take you through the key highlights for the first quarter before we move into details. Sales growth slowed down to 6% as a result of the stockpiling and leap year effect of last year. Underlying sales growth adjusted for these impacts would be 11%, driven by performance of old vintages and at a much lesser extent by selling space growth. In line with previous communication, we accelerated our expansion and redesign program. In the next one to two months, we will reach normalized speed of expansion. Like for like sales growth stood at 4.1%, while adjusted for stockpiling effect, like for like would have been 7.5%. Our LTM sales density increased by 5.3% year-on-year. EBITDA margin improved by 91 basis points on better commercial terms, efficiency gains and positive operating leverage. This overcompensated some cost inflation and pressure coming from stores in the ramp-up phase. Our working capital cycle improved by eight days year-on-year, primarily on more efficient inventory management. Our financial position remains strong with by the end of the quarter a leverage of 1.4 and, important, a historically low cost of debt. And finally, we've achieved very promising progress in our ESG initiatives. We issued our second Sustainability report disclosing our key achievements in 2020. And these were as an example: we've seen a 6.9% reduction of greenhouse gas emissions last year, a 5.4% increase of procurement from local suppliers and producers, and a 72.6% rate of employee satisfaction.

With that, I will now add some color to the quarter developments. <u>We achieved strong like for like sales growth in the mature stores and accelerated expansion</u>. The total sales growth stood at 5.6%. Adjusted for the stockpiling and leap-year effects the underlying sales growth was 11%, like I mentioned before. Reported like for like sales growth was 4.1%. However, adjusted like for like sales growth was 7.5% - in line with the fourth quarter 2020 average and despite much stronger base, as we showed you last year already a strong like for like performance. In the first quarter we accelerated our expansion program underpinned by strong return dynamics and opened more than 400 stores on gross basis. So, our full year store opening guidance remains unchanged. Same to previous quarters, the main contribution to like-for-like sales growth came from mature stores. Younger stores continued delivering a strong double-digit like-for-like sales growth, but the share of these "first year" stores in the like-for-like panel was just 1.4%, so actually negligible. Like-for-like sales growth was positive across all regions and all vintages. All formats, except for the superstores, demonstrated positive like-for-like sales growth, and the superstores result is explained by the extraordinary high base of last year, explicitly visible in this particular format. The key convenience format demonstrated leading like-for-like sales growth of 4.9%.

Other company-specific trends included: a weak frequency of visits due to pandemic, partly offset by continuous inflow of unique customers, higher average spends per visit. Drivers of the like-for-like ticket were volume growth, trading up and on-shelf inflation. Trading-up was a result of ongoing assortment changes and also an inflow of more affluent customers. We estimate that large part of these new richer customers traded down to Magnit thanks to our value offering and improved assortment. We continue to attract customers from larger formats, some small players and unorganized retail. Number of active loyalty cardholders increased by 50% up to 46 million customers. On-shelf inflation peaked in February and started to decelerate in March. And this trend we saw a first time in the last two years. We now observe on-shelf inflation below officially reported food CPI. All regions demonstrated sound like-for-like results in a mid-single digit zone.

<u>Promo intensity actually remained flat year on year</u>. The promo activity in the industry remained, I would say, rational. Quarter-on-quarter it obviously decreased due to seasonal factors, while year-on-year promo levels didn't really change. We continue to focus on our CVP improvements to drive sales in the first place. At the same time, we see potential for higher efficiency in promo going forward.

<u>We continue to develop our e-commerce activities and initiatives.</u> Since the second half of 2020 we've launched seven e-com pilots, including own express and regular delivery and partnerships. In the first quarter, we started express deliveries from two mini dark stores in Moscow and those are expected to achieve a higher operational efficiency. Our plan is to open up to 20 mini dark stores in the capital.

Today, over 1,300 stores in 58 regions and 94 cities are covered by online options. The run rate for Magnit's online segment stands at 4.1 billion rubles based on the last week of March. Around 60% of the current revenues are generated outside Moscow and St. Petersburg. The average ticket for Magnit's own delivery service was about 1.4

thousand rubles, which is almost four times higher than in the offline stores primarily driven by larger number of items per order. We fulfilled around 9.5 thousand orders a day, and about 50% more than in the previous quarter. According to our data, most of the orders were actually placed by customers who were not our brick-and-mortar store customers. During 2021, we plan to expand online delivery, adding at least 1,500 stores in more than 50 regions across Russia.

Now a bit on the recent trading. The first three weeks of April, till the 26th of April, were also affected by high base effect. It started easing since the second half of the month. Retail sales growth for that period was absolutely in line with the first quarter average driven by slightly higher selling space growth and almost similar like-for-likes. The like-for-like composition was opposite to what we reported for the first quarter. We had positive double-digit traffic growth and negative basket growth for the first time in 12 months. Inflation continued easing, and promo activity was down vs the first quarter but up year-on-year due to the base effect of the pandemic outbreak last year. All formats continued delivering positive like-for-like sales growth with drogerie at the double-digit level. Our superstores also are catching up and are in the green like-for-like zone. Moving into the summer period, we may expect some benefits from full-scale domestic tourist season and governmental support to the consumers. Now, let me pass the floor to Dmitry to walk you through our financial results.

Dmitry Ivanov (Chief Financial Officer):

Thank you, Jan. Good day, everyone. Let me start with gross profit margin. Our gross profit margin improved by 74 basis points and stood at 23.4%. We had positive impact from the following factors: first of all, improved commercial terms with suppliers. We also had better promo finding from suppliers and higher promo margin. Shrinkage improved significantly by 61 basis points despite increased share of fresh food in sales and acceleration of store openings. We also had favorable format mix on higher share of the drogerie business. These positive factors were offset by several negative factors. They were higher penetration in sales of loyalty card resulting into 10 basis points of additional investments year-on-year and slightly higher supply chain costs due to continuously improving on-shelf availability and increased transportation rates.

SG&A expenses remained under strict control. SG&A as a percent of sales were down 10 basis points despite some cost inflation and growing number of stores in the ramp-up phase. We had negative COVID impact of around 200 million rubles or 8 basis points predominantly related to ongoing provision of means of sanitary protection to customers and employees. Staff costs went up 3 basis points. Higher productivity of in-store personnel and record low staff rotation didn't fully offset additional pressure from new stores in the ramp-up phase. Lease expenses improved by 6 basis points on increased sales density, better rates per square meter and closing of inefficient stores. That more than offset growing share of leased space and already mentioned ramp-up effect. Advertising expenses increased by 9 basis points on higher marketing activities including loyalty campaigns as well as digital marketing. Depreciation of assets improved by 31 basis points driven by growing sales density and the fact that most store openings are leased. Some other costs were affected by inflation and compensated by positive operating leverage effect.

As a result, EBITDA margin expanded by 91 basis points year-on-year and stood at 7%. For the fifth consecutive quarter EBITDA margin is improving driven by gross profit margin recovery and strict cost control. Adjusted for LTI expenses, EBITDA margin would be 8 basis points higher - in line with reported EBITDA margin.

Net interest expenses improved by 31 basis points thanks to reduced cost of debt and debt repayments leading to lower total amount of borrowings. As a result, net income increased 2.6 times year-on-year to 10.9 billion rubles. Net income margin expanded by 162 basis points up to 2.7%. Effective tax rate was 23.3%.

We are on track with working capital cycle optimization. Working capital as Jan mentioned decreased by 14.1 billion rubles year-on-year. Rotation in the first quarter 2021 improved by 8.1 days. Inventories reduced by 12.2 billion rubles year-on-year, resulting into faster rotation by 7.6 days, despite acceleration of store openings, increased share of drogerie format, higher on-shelf availability and suppliers' inflation. Followed by inventory decrease, trade and other payables reduced by 5.1 billion rubles. On the other hand, accrued expenses and taxes payables increased year-on-year by 8.0 billion rubles. As a result, accounts payables turnover in days remained almost flat.

Trade accounts receivables decreased year-on-year by 1.8 billion rubles, improving the rotation by almost 0.1 days. This came as a result of ongoing optimization initiatives, including weekly tracking of overdue debts and clearing activities as well as launch of electronic document flow with suppliers. We continue to focus on further improvement in the working capital in days, and further benefits may be expected this year.

CapEx increased on acceleration of expansion. CapEx in the first quarter of 2021 was 7.9 billion rubles, or 16% higher vs last year due to faster expansion. In the first quarter we opened 407 stores on gross basis, which is 2.5 times more than in the first quarter of last year.

We also continue with our redesign campaign, and this quarter we covered 100 stores. We reiterate our guidance for the year to open around 2,000 stores on gross basis, redesign about 700 stores and spend 60-65 billion rubles. With this you might expect us to accelerate expansion and redesign program in the next quarters.

Our financial position is stable on comfortable leverage, historically low cost of debt and extended duration. At the end of first quarter our gross debt was 168 billion rubles which was broadly flat versus year-end. With 6.6 billion rubles of cash on hand, net debt stood at 162 billion rubles. As of now, long-term bank debt and bonds account for 98% of total portfolio and all are at fixed rates. 2021 is well secured for us, only 3% of debt portfolio to be refinanced this year. Cost of debt dropped to historical lows of 5.9%. Net debt to EBITDA ratio was 1.4x. That was a bit higher versus year-end due to some seasonality in cash position and dividend payment in January.

Now I will give a floor back to Jan for some closing remarks. Thank you.

Jan Dunning (President and CEO):

Thanks, Dima. Just a few notes before we move to the Q&A. 2020 forced Magnit to change even more rapidly, and in the end it made us actually stronger and more flexible. The changes observed in 2020 tend to be structural, while our business model and scale allow us to further enhance our leading position. We're more than satisfied with the progress we're making so far as underlying results are exceptionally strong. We continue to keep focus on our key priorities and are determined to deliver long-term targets. With strong balance sheet, cash generation and further upside in working capital we see enough flexibility to fulfill our growth ambitions in a combination with cash distribution to shareholders. Thanks for listening, and I think we're ready for the questions.

Albert Avetikov (Chief Investor Relations Officer):

Operator, thanks, we're ready for the Q&A session.

Operator:

Thank you. [Operator instructions]. And we will take our first question from Henrik Herbst with Morgan Stanley. Please, go ahead.

Henrick Herbst (Morgan Stanley):

Yeah, thanks very much. I had just one sort of clarification and I had just two questions. The first one was your comment around on-shelf inflation versus CPI. I didn't really hear what you said. So, maybe you could repeat that? It would be great. And secondly, I just wondered, you're saying that your online customers are mainly not shopping at Magnit's offline? Do you have any idea where those customers are coming from? And then the last question is around all your new pilot formats and if you can share some details on the sort of results; and also whether you see scope for any of those pilots to have an impact on the business in the near term. Any of them you feel a bit extra excited about, and what is the impact both in terms of revenue and profit contribution (positive and negative)? Thank you very much.

Jan Dunning (President and CEO):

Let me start with the first question on on-shelf inflation. What we normally see is that there is an official CPI food inflation announced by the official bodies; and what we normally see is that in a normal environment the CPI and this on-shelf inflation are close to each other. What we've seen in the part of the first quarter was that actually the food CPI that was announced was lower than the actual on-shelf inflation that we've seen. But as of beginning of March we see that picture changing, and we see actually that the on-shelf inflation that we have on our shelf is below the official reported food inflation. That was about the first one. I hope I clarified that.

Then the second question is on online. What we've discovered is when you do shopping online with us, we ask you to use your customer, your loyalty card, and we also ask you whether you are familiar with Magnit offline. And out of that information, it's clear that the majority of customers that we serve on our platform of online are actually not our offline customers, so they come from somewhere else. Now, your question is also a bit our question: where do they come from? That's actually what we're trying to figure it out — what kind of customers are those and where do they come from? We do not know yet. But what we do know is that the expected cannibalization or suggested cannibalization of online customers is actually not happening on our offline business. And I think that's quite exciting.

Then the last question on the pilots. We do run a couple of pilots in which we try to test if there is a market for this format, where you very often are more into the COVID trends. And if there is a market, how big is this market, how sizable? And is it something that we should pursue? Out of the test, and I can give you a couple of them, we have the Magnit City, which is a grab-and-go concept which is quite popular in the more urban environments in Europe. We see that this is actually a feasible model, it gives us the proper returns. But we think in the current environment, that's the model that we should extend or we should not start running and opening too many. I want to see a bigger pilot. And we've just taken the decision to open up to 50 and see how that works. Because one of the criteria is that the locations should really be urban and partly affluent because it's a real model of "I go in and I take a couple of snacks, coffee and a hot dog and walk further". Then the more promising concept that we see is our Moya Tsena (My Price), which is our discount model which we started in the fourth quarter last year and where we have decided now that we would like to see 100 to 200 stores this year, because they come with clearly a lower EBITDA margin, but looking at the investments, a pretty good return. We also feel that in the market there's clearly a demand for that model. Currently we've transferred existing convenience stores into discounters and we see actually more than double-digit like-for-like growth. That's clearly a model that we should try more and it's also a model that we feel is more scalable in Russia than Magnit City. Then the last one is the Magnit Kiosk, so to call. There, we are looking at the business itself. It runs very well and it has very good returns. We're actually now looking with cooperation of some of the authorities to get licenses to open those kiosks in places where we think the kiosks should be opened. I think also if that comes we will be opening kiosks quite a lot because the returns are really fantastic.

Albert Avetikov (Chief Investor Relations Officer):

Henrik, I hope that answers your question. Just a bit of more color on the hard discounter pilot. We currently operate 51 stores, and as Jan mentioned we will add more till the end of the year. Like-for-like sales growth is around 20% mainly via traffic increase, as assortment is much narrower than in the convenience, so one should not expect this come via basket. All pilot stores operated with positive EBITDA and net income since opening. We see 30–40% higher inventory turnover and much lower CapEx spent compared to standard convenience format. So, returns are extremely attractive.

And finally, you've seen the announcement on opening of the first store of Magnit Master pilot. The first store was opened in Krasnodar, and since its opening we see very promising results, which are 300% higher than our original expectations. But of course, it's just one store which is not a representative mark. Thanks. I hope that gives you more color, right?

Henrick Herbst (Morgan Stanley):

Yes, great. Thanks so much.

Operator:

Thank you. We'll now take our next question from Nikolay Kovalev with VTB Capital. Please, go ahead.

Nikolay Kovalev (VTB Capital):

Yes, thanks for the presentation. I have two questions. The first one will be on inventories. We see quite a good track record of a number of quarters for the improvement. I was wondering, how much of the further improvement you can assume on inventories and what should be done on the nearest-term agenda to achieve that?

The second question is on your e-commerce. The run rate is already quite noticeable. I wanted to clarify, are you able to share with us a negative contribution of digital business to your EBITDA in the first quarter and how much of the capital expenditures you scheduled for 2021 for this segment? Thanks.

Dmitry Ivanov (Chief Financial Officer):

Let me start with the inventories question. We do some follow up on inventories. Frankly speaking, we still continue collecting low hanging fruits. What we did in the second half of 2020, we were just streamlining processes, setting up proper flow types in supply chain and looking very much carefully at inventories split by ABCD classification, at slow-moving stock and at promo in-outs. Making these simple steps, we were able to deliver, in our opinion, quite good results in inventory reduction. Still, there is quite a big potential for, in our opinion, inventories improvement, and we believe that there is some potential also in slow-moving stock production and in improvement of in-outs management. And the biggest potential still should come with implementation of modern IT solutions, with F&R - forecast and replenishment system, with ERP system, which can help us to improve demand-focused accuracy, to improve store master data, to improve store inventory data, which can also make quality of orders to store better and also stock takings better. Also, higher sales, which we see now with improving sales densities, are helping us to improve stock rotation. Overall, we expect the further improvement in stock rotation and some cash release out of inventories till the end of the year. Now I think with e-com I would pass to Jan.

Jan Dunning (President and CEO):

If you make a bit of a calculation, you will notice that actually the online is around 0.2% of sales. So the impact of EBITDA is actually very, very low. By the way, we also have reserved some budget for this, and I know that we do not even manage to spend it. One of the reasons is that a big part of our e-grocery is actually done with the help of partners. Actually, the partners take care of the last mile. So, the model currently is that there are even much less losses than we expected initially in the budget process.

Albert Avetikov (Chief Investor Relations Officer):

Nikolay, does that answer your question?

Nikolay Kovalev (VTB Capital):

Okay. Yes, that's clear. Thanks a lot.

Operator:

Thank you. [Operator instructions]. We hear next from Kirill Panarin with Renaissance Capital. Please, go ahead.

Kirill Panarin (Renaissance Capital):

Hello, everyone. Thanks for taking the questions. Two from me. Firstly, just on the Other Income line. I think it was up almost 60% year-on-year in Q1. I wonder what drove that and whether it is a sustainable trend.

Secondly, I wanted to ask on your supermarkets. They continue to underperform the other formats, so could you give us an update on the impact of recent initiatives: how the redesigned stores are doing versus the segment average and whether you expect the format to catch up in terms of like-for-likes and other metrics? That is it. Thank you.

Dmitry Ivanov (Chief Financial Officer):

Kirill, thank you for your questions. In Other Income line, we post practically too big P&L lines. First one is sublease income. Last year during the beginning of pandemic, we provided certain rent holidays to our tenants. Now we see that situation is much better and we don't do this, and therefore we came back to normal level of sublease income in this line. It is sustainable.

Second one, also quite weak income line in this P&L line is advertising income. This is mostly coverage of our investments into loyalty cards which we collect partly from suppliers, partly from different agencies. And this is what we use and plan to use to fund our loyalty program, loyalty card. Also, income from Magnit magazine. That's practically too big contributors to this P&L line.

And the second question I will pass to Jan.

Jan Dunning (President and CEO):

The question is more connected to the superstore. Like I mentioned in my previous introduction, the superstore, like we see in the whole industry, of course last year had incredible uplift because it's non-food. The malls were closed, a lot of stores were closed. For non-food people actually had to rely on the hypermarkets, the superstores in our case. So we've seen last year quite a big uplift, and we've seen this year actually very good January and February, but poor two and a half weeks in March, leading to this slight minus like-for-like. And the good thing is now that I see there is a turnaround. As of today, in April, we see that we've recovered and we move into a positive like-for-like direction.

Then more specific on your question of the remodeled stores. We've done the remodeling of some stores, and they are clearly outperforming the existing portfolio. We see double-digit like-for-likes in those stores. It's not only a matter of remodeling, it's also a matter of getting the right assortment, because whereas the convenience store is quickly fixable, in the superstore you need time to get the ranges right, the price hierarchy right, and also to get your non-food right, because the timing takes a bit longer. But like I mentioned before, I think we are actually on track. We've got a plan and strategy for the superstores: how they should look like, what should be the focus and why would customers come. I think we should just roll that out based on the current results because they're good.

Albert Avetikov (Chief Investor Relations Officer):

Just to add to this, Kirill. At the moment, looking at supermarkets and superstores, we have 32% of all the stores working on their new concepts or redesigned. Definitely, the share of such stores is lower in this format compared to convenience and drogerie. Just to remind you, most of our attention this year and in the next periods in this format will be specifically put on redesigns, not on new openings, as the openings will be limited in the range of 5–15 stores a year. Looking at the recent openings, we're quite excited, as we see good traffic which increases like-for-like. For example, we've opened just this month a redesigned store in Orsk and Tuapse as well, and expect soon the one in Krasnodar to come. So, the program is on the way.

Kirill Panarin (Renaissance Capital):

Great. That's helpful. Thanks very much.

Operator:

Thank you. [Operator instructions]. We'll take our next question from Marat Ibragimov with Gazprom Bank. Please, go ahead.

Marat Ibragimov (Gazprom Bank):

Thank you very much for spending time answering our questions. Here's a short question on store openings in February. I noticed that the store openings were much lower than in January and in March. What's the reason for that? You opened only 90 stores on gross basis versus 211 in March. Thank you.

Jan Dunning (President and CEO):

That might just be an issue of calendarization in the sense of when the contracts are signed, what we had as a program. In February, specifically, maybe you noticed that as well, there were big issues of supply of equipment, as steel was very expensive, but also inputs were very complicated. So we had issues of getting the equipment in and the suppliers of equipment had huge problems to get the right amount of steel in to produce the shelves. That has affected partly January and February and we see now that issue recovering. It also led to new negotiations on the shelving and on the fridges, etc. because the initial pricing which we acquired from tendering was of course not feasible anymore for suppliers, because it didn't make sense for them to deliver. Also that was part of the February dip. But I see that the February dip was actually bigger than normal, but sometimes you have this calendar impact of that openings of one month planned actually move into the other or are earlier opened. What I see is if I look at the pipeline and I see the development of the new objects coming in the pipeline, I feel quite confident that we're opening the number of stores that we have in mind. Of course, there is a bit of concern, if you see that there is a bit of slippage into a different period, as that might affect your budget at numbers on total sales. But looking at the like-for-like performance, we are actually doing better than we expected. I think that covers that quite well.

Albert Avetikov (Chief Investor Relations Officer):

Marat, just to add on this. You’ve seen us opening slightly more than 400 stores on gross basis in 1Q. We have not yet reached in 1Q the normalized speed of expansion. We will do that in the next 1-2 months. That's why we are confident in our full-year guidance of 2,000 stores on gross basis. Yes, currently like-for-like sales growth is the key dominant driver of our total sales growth. By the way, again, as Jan mentioned, it's above our original expectations especially in April. But going forward, we will see selling space growth contributing more and more to total sales growth, especially in the second half of the year. Thank you.

Marat Ibragimov (Gazprom Bank):

But what you're saying is that your CapEx is inflating, which may affect your return on invested capital. Am I right? And if it is inflating then by how much per store?

Jan Dunning (President and CEO):

Currently, what we're looking at is around between 2.5 and 3.4%, depending on the size of the store, of course. By the way, this inflation impact, we also have, of course, inflation on sales. So on the returns, which we then of course adjust, we don't actually see a lot of adjustment, as we also see higher like-for-like sales coming in, so projected that balances are quite well. And trust me, if we feel uncomfortable with the returns coming in, we will simply, like we did last year when we were not secure on how the pandemic would evolve, then we would not mind stepping down. But for the time being we don't see any reason to do. Actually, we're more encouraged with the sales development to continue expansion in the speed that we had and actually accelerate partly because we would like to open those 2,000 stores.

Of course, the returns are a result of CapEx, top line, but certainly also earnings. You see, our earnings as well growing. In this respect, we actually have seen quarter by quarter a growth of return on invested capital. I'd like to remind you of last year, where we moved quickly from a return on invested capital of 7.9, end of 2019, to 13.9 or 14 point something by the end of 2020. I think with the priorities that I set in the beginning is CVP so to make stores more attractive and have stores and sales coming in. Pay attention to earnings, so your EBITDA and your cost and working capital — that are the drivers for returns of the business.

Marat Ibragimov (Gazprom Bank):

Thank you very much.

Operator:

Thank you. We'll take our next question from Alexey Krivoshapko from Prosperity.

Alexey Krivoshapko (Prosperity):

Albert, Dmitriy, Jan, hello. Thank you much for the call and very detailed answers, and of course congratulations with pretty good results. Guess, we are back to pre-crisis profit levels. A few questions, if I may. Firstly, do you mind breaking down 2021 CapEx by, maybe, maintenance, IT, logistics and some kind of expansion so we can better understand how these numbers add up together?

Dmitriy Ivanov (Chief Financial Officer):

Alexey, good evening. I will take your first question. As we just guided our overall CapEx for 2021 within the range between 60–65 billion rubles, and around 60% of this amount we plan to spend on expansion, including new stores, redesign and maintenance, and the rest we plan to spend on logistics, IT and some efficiency projects. Expansion will be around 30–35%, redesigns around 15%, and maintenance around 9–10% roughly.

Alexey Krivoshapko (Prosperity):

Okay, so the remainder would go into logistics, kind of headquarter in IT, yes?

Dmitriy Ivanov (Chief Financial Officer):

Right.

Alexey Krivoshapko (Prosperity):

Okay. And do you plan to invest anything in your own production?

Dmitriy Ivanov (Chief Financial Officer):

We have certain improvement projects, for which we plan to allocate up to 10% of CapEx budget, 3% to projects related to in-store production, mostly in our big boxes and in superstores to develop our quality in our culinary and bakery, mostly, and just to add more experience in line with new CVP concept. For example, the last case is Murmansk where we have several stores, from Evroros . And we have the DC where we plan to develop our own production facilities to source the stores with nice, tasty products.

Alexey Krivoshapko (Prosperity):

Okay. Do you mind sharing how much would go into IT and how much would go into logistics?

Dmitriy Ivanov (Chief Financial Officer):

In IT we plan to allocate between maybe 9 and 13–15%, and into logistics up to 15–18%, roughly.

Alexey Krivoshapko (Prosperity):

Thank you. This is clear, very helpful. And I guess another question is on ongoing inflation.

Jan Dunning (President and CEO):

I just wanted to remind you as the IT investments are, of course, a result of the ERP transformation. We're doing an implementation of SAP, which of course comes with a certain amount of CapEx. And on top we are on the supply chain as well. And I think there's also an IT cost, not in supply chain cost, CapEx, we do F&R and WMS. So, that is quite a lot of activity ongoing.

Alexey Krivoshapko (Proseprity):

Thank you. Can I ask another question, if possible, on kind of cost inflation? Do you see any kind of wage inflation for in-store employees for this year and other stock costs like cleaning, maintenance, etc.? I would say on a like-for-like basis, how we would envisage it to go up this year versus 2020 in ruble terms?

Dmitriy Ivanov (Chief Financial Officer):

We see some inflation in maintenance costs, in labor costs. But you know, the general rule in retail is to fund all this kind of inflation of fixed costs by improvement of productivity and service quality. This can help to maintain first profitability and proper returns on invested capital. We have quite tough cost control and we follow these rules. So all indexations or acceptance of price increase only when we see that we can fund this by improved efficiency in our stores. This is in general.

Jan Dunning (President and CEO):

Also, just to remind you of the numbers that I mentioned. If you see last year, in the first quarter y-o-y, we have a 5.3% of sales density increase, and that’s clearly much higher than the cost inflation that we've seen last year coming through. And I think that's what Dima is referring to, as long as you can compensate that by density and productivity, then actually, it's potentially even healthy to feed that back to your employees. Because also they are, of course, confronted with inflation and cost increase.

Alexey Krivoshapko (Prosperity):

Certainly, that's how the economy works. Unless you're in Japan. My final question is do you mind talking a little bit about other formats? You talked about hard discounters, kiosks, Magnit City. There was some news about your kind of experimenting with DIY, unless we're confusing Master with something else? And do you mind giving us an update on the pharmacies? Where do you stand in those two experiments, or what kind of return criteria you would apply if you were to either rollout pharmacies or cannot get into Master more seriously.

Jan Dunning (President and CEO):

The Master is indeed the idea to open up smaller units where people can have their primary "do yourself" smaller repairs at home merchandise. And essentially I meant it especially as a regional phenomenon. We have cooperated with the existing "do it yourself" retailer "220 Volt" to get access to their purchasing conditions and assortment. But we want to extend this as well with our own import and own sourcing with regards to the range, the first results are much better than we expected. Despite the fact that we feel that we can still improve it quite a lot. We're now in a phase to improve the pilot until we feel okay, this is the way we would like to see it and then we'll come back to you to say "okay, let's roll out". But there's work to be done.

Then the other part, which you wanted to know is the pharmacy. I have been always a bit reserved with the pharmacy. But what I do see now is on the like-for-like panel we actually see a continuous double-digit growth. We're starting to get control over that. I also think that with the improved commercial offer we will start opening pharmacies as of the second quarter. You remember that we mentioned that pharmacy itself, we were actually too thinking in systems instead of the customer. I think that's turned around, we have a better offer. And we see also that the business gets a bit better on the control. So I think that moves into the right direction now.

Alexey Krivoshapko (Prosperity):

Okay, clear. And final, some sort of theory question, if I may. How should we think about dividends? I mean, obviously, you refer here that kind of 50 billion was distributed from last year's results, which were actually higher than reported profit. How do you look at it? Is it some sort of cash sweep within certain debt/EBITDA covenants, is it payout ratio or some combination of both? How do you can get to the number which you then recommend to the Board as sort of quarterly, semi-annual and final.

Jan Dunning (President and CEO):

The first thing I would advise you because that was your question, how do you see dividend? If I were you, I would reinvest in Magnit store. First of all, and that's also what we've mentioned before is that we as a company do a proposal to the Board, and the Board itself proposes to the shareholders a payout. And the payout, of course, depends on a lot of factors. Partly also, strategically, what do we see as a management team as opportunities in the market? Do we still like what we're announcing here at the call, as well that we still believe that we should open up stores because we see big returns? If over time we see less opportunities or less opportunities that come in with the right returns, then, of course, the company starts to generate more cash and then we'll have a different discussion with the shareholders. I think that the current level that we see is a solid one, where we as a company and with our plans do not see really issues of adjusting them. You heard and Dima also explained that our leverage is actually very comfortable, and to a certain extent continuing our projections we feel actually it's potentially very low. So we might want therefore to do something to see how we can balance it out. Dima I don't know maybe you would like to add something to this.

Dmitriy Ivanov (Chief Financial Officer):

I would say with our return thresholds, return criteria for new projects, which we apply for all new projects, improvements that we have already achieved and plan to achieve in working capital and cash flow generation, potentially, we will continue to generate quite strong free cash flow. And then question for us is about further deleveraging or invest more. I think I also would like to correct you, Alexey, that we pay dividends from net income based on Russian accounting standards, which for 2020 was slightly about 50 billion rubles. Also, we made this payout from free cash flow of 2020, which was slightly above 85 billion rubles. So we generate 85 billion rubles of cash in 2020.

Alexey Krivoshapko (Prosperity):

Certainly. Okay. Well, I guess that's very clear. Thank you very much.

Operator:

Thank you. We'll take a follow up from Henrik Herbst from Morgan Stanley.

Henrik Herbst (Morgan Stanley):

Thanks very much. If only go back to the inflation, I guess you talked about how you offset inflation in the SG&A base. But in terms of on-shelf inflation falling below the reported food CPI, should we be concerned about gross margins? Or how should we think about that? Then the other thing I wanted, I guess it's a follow up from your strategy update and last quarterly results, but I think you were mentioning it at that point: you saw increasing opportunity for M&A. If you could just give an update on where you're now, that would be very helpful. Thank you very much.

Albert Avetikov (Chief Investor Relations Officer):

Henrik, just a couple of remarks in the beginning from my side and then I pass to Jan. When we talk about on-shelf inflation being below the food CPI, specifically right now, it means that this dynamics is the one we see for the first time for many years, normally we are more or less in line. The key reasons for such low on-shelf inflation is (1) the base, as last year, specifically March, was the first time with positive inflation, before that we were in a deflationary environment; and (2) definitely lower promo activity. With that, I pass to Jan on the impact on the gross profit.

Jan Dunning (President and CEO):

I think what Albert was just saying makes a lot of sense. There's another thing as well. What you do as a commercial guy, you check your on-shelf inflation and your procurement inflation. And that's the way you measure your gross margin impact. If we are not able to transfer to the customer that inflation which we try to fight as much as possible, we of course also try to fight the suppliers by raising their prices without an explanation. I think we've been throughout the quarters that we've seen actually quite strong inflation. We've been very successful in controlling suppliers. And make sure that at least this phenomenon has no impact on our gross margin.

Then your second question is the M&A. What I said before is we believe, although I have nothing to mention on specific activities, but we believe that we should look into the market to see, are there any opportunities coming up? We have been looking at certain activities, clearly expectations and our willingness to pay. So it's just a matter of waiting and seeing how things are developing. For the time being, we don't see any big activities in the market. As far as I know, there's also nothing been announced so far. I think just waiting. But to me the features and the reason why I believe that it's that consolidation should start to come are the same like I mentioned before, there are winners currently in the industry and there are people, especially when your leverage is higher, when it gets difficult with the interest rates moving up again. So the competitiveness, what they feel or the pandemic impact, what they see, there is more appetite for people to sell their business.

Henrik Herbst (Morgan Stanley):

Thanks very much.

Dmitriy Ivanov (Chief Financial Officer):

Thank you, Henrik for the questions.

Albert Avetikov (Chief Investor Relations Officer):

Operator, if there are no more questions, then we conclude the call. Thanks everyone for listening, and we'll speak to you when we report second quarter results at the end of July. Thank you.

Operator:

Thank you. That does conclude today's conference. Thank you for your participation.