Operational review: Argos Retail Group

Argos Retail Group

Argos Retail Group (ARG) had another successful year, with sales up 11% and profit up by 12%. Argos again performed particularly strongly, outperforming in its market, with annual sales exceeding £3 billion for the first time.

There has been significant corporate restructuring at ARG in the last 12 months:

- Homebase, a UK DIY and home furnishings retailer, was acquired for £902m in December 2002;
- Home shopping businesses in the United Kingdom, Ireland and Sweden, together with Reality, were sold for about £590m in May 2003; and
- other smaller, underperforming businesses were sold or closed during the year.

With its focus now on general merchandise, both Argos and Homebase have clear strategies and operational initiatives to deliver growth. This will be key in a period where growth in UK consumer spending is expected to be muted.

ARG generated £67m of operating cash flow, equivalent to 24% of operating profit. Investment in the year to March 2003 in supply chain, new stores and the Financial Services loan books will underpin future growth.

Argos

For the third successive year, Argos' sales grew faster than its market and it again grew operating margin. At the same time, customers' perceptions of the choice, value and convenience it offers also continued to improve. This improvement, along with Argos' own growth initiatives, should enable it to continue to outperform its market as consumer spending growth slows further in the current year.

Financial review

Excluding Argos Additions and jungle.com, Argos' sales in the full year increased by 13%, or 7% on a like-for-like basis. For the year as a whole, it grew share in all its major markets, with particularly strong sales growth in consumer electronics, mobile phones, electricals and home furnishings.

Gross margins for the year were firm, supported by better sourcing. Excluding integration costs of £8.7m relating to jungle.com, operating margin advanced by a further 0.5%.

Argos Retail Group

12 months to 31 March	Sales 2003 £m	Sales 2002 £m	Operating profit 2003 £m	Operating profit 2002 £m
Argos	**3,192**	2, 847	**238.2**	204.0
Homebase[1]	**251**	–	**2.2**	–
Home Shopping UK & Ireland[2]	**1,482**	1,607	**15.4**	33.6
Financial Services	**34**	11	**4.6**	(4.8)
Home Shopping Continental Europe	**275**	238	**24.7**	22.4
Total	**5,234**	4,703	**285.1**	255.2
Operating margin			**5.4%**	5.4%

[1] Homebase sales and profit consolidated for the period from date of acquisition (20 December 2002) to 28 February 2003, Homebase's new year-end

[2] 2002 Home Shopping UK & Ireland restated to include £74m sales and £0.5m profit previously reported by Reality

Argos

12 months to 31 March	2003 £m	2002 £m	Change
Sales[1]	**3,192**	2,847	12%
Operating profit[1]	**238.2**	204.0	17%
Operating margin	**7.5%**	7.2%	

[1] Includes Argos Additions and jungle.com

Argos continued

Operational review

As previously outlined, Argos has a clear strategy for growth and has made good progress this year against its objectives:

– *Argos plans to open about 35 new stores each year.* At 31 March 2003, Argos operated 523 stores, an increase of 33 in the year. These new stores contributed 6% to sales growth, ahead of expectations. Of the 33 stores, about two-thirds were second or third stores within a town or city. The opening of these new stores inevitably deflects some sales from existing stores and therefore had the effect of reducing like-for-like sales growth by an estimated 3%. In the current year, Argos plans to open an additional 35 stores, with potential for over 650 in four years time;

– *Argos is refurbishing its small stores.* By 31 March 2003, 340 stores had the modernised brand fit-out, with a further 100 planned for this year. Initiatives to improve customer service have also been made across the chain. For example, over 500 quick-pay kiosks have been installed in 190 stores. These enable customers to order and pay for goods without going to the till. Currently, over 4% of sales in these stores are going through the kiosks and customer usage is growing;

– *Argos is enhancing choice for customers by extending the range of products and services offered.* Range extension has been a key driver of sales growth in the year under review. Both the Autumn/Winter 2002 catalogue (11,400 lines) and the Spring/Summer catalogue (11,600 lines) have about 25% more products than the same catalogue the previous year. The additional lines are focused on areas such as textiles and bedding, furniture and homewares, with about two-thirds available in store and one-third for home delivery only. Sales of these new lines have met expectations in the year and aided gross margin. In addition, Argos' previous experience of range expansion suggests that sales of these lines should continue to increase as customer awareness of them grows.

  In January 2003, Argos initiated a test in the South West to expand its product range further. A new catalogue called Argos Extra, which added 4,500 lines to the existing range, is being tested in five of its larger stores and in five neighbouring smaller stores, where these goods are available for collection 48 hours after ordering. Although still at an early stage, the trial will be extended in July 2003 to an additional five larger stores and nine neighbouring stores in the North West;

– *Argos is investing £120m over four years in its supply chain.* The four-year programme initiated last year is on track, making improvements to IT, software systems and product sourcing. The new 560,000 square feet central distribution centre, which will handle all direct imports, opens in June 2003. Aided by the ARG Hong Kong buying office and the new IT systems, direct importing now accounts for 16% of sales (up from 12% three years ago).

  With prices on re-included lines in the current Spring/Summer catalogue 2% lower than last year, the supply chain investments made to date are already benefiting customers, while allowing Argos' margins to remain firm; and

– *Argos is growing capacity and improving customer service in Argos Direct, its delivery to home operation.* Sales via Argos Direct grew by 33% during the year and accounted for 18% of Argos' sales – up from 16% last year. Approximately £550m of sales were delivered to home. About one-quarter were products available in store and three-quarters were more bulky items such as furniture and widescreen TVs, which are only available for home delivery. The new 650,000 square feet Argos Direct warehouse in Bedfordshire has been operational since January 2003. This significantly increases Argos' capacity for two-man delivery of bulky items. Argos was the second most visited retail website over Christmas 2002, while the Internet contributed 3% of Argos' total sales in the year.

Sales at Argos Additions increased by 11% in the year to £144m. Following a slow first half, improvements were made to merchandising and the credit offer in the Spring/Summer catalogue. The Additions brand name has been sold to March U.K. Limited. The Autumn/Winter 2003 catalogue will be the last to use the Argos brand and to be distributed via Argos stores.

Homebase

Homebase, a leading UK DIY and home furnishings retailer, was acquired in December 2002 for £902m. It enhances ARG's long-term competitive position as:

– it brings to ARG a leading brand in fast growing markets, with good organic growth prospects;

– it is pursuing growth in the furniture and homewares market, where ARG already has considerable presence and skills; and

– there are operational benefits from combining ARG and Homebase, in terms of supply chain and infrastructure.

Period since acquisition

The priority in the period since acquisition has been to prepare for peak trading in April and May. The management team at Homebase has been strengthened with appointments from within ARG and actions to improve retail disciplines in the short term have been implemented.

Since the start of its new financial year on 1 March 2003, Homebase has traded in line with expectations. As is GUS' established practice, a more detailed comment on first quarter trading will be made on 23 July 2003. For Homebase, it will cover sales in the four months to 30 June 2003.

Operational review

During the current financial year, the priority at Homebase will be to create a platform for growth in 2004 and beyond, while delivering on profit expectations. The key initiatives are:

– *improving retail disciplines.* This includes improving the in-store experience, particularly stock availability, ease of shopping and customer service; strengthening the price proposition, by reinvesting some of the sourcing benefits into reducing prices on key lines; and improving category management skills, particularly for core DIY and decorating ranges;

– *increasing sales of kitchens, bathrooms and home furnishings.* In the twelve months to 28 February 2003, homewares, which includes these ranges, contributed 21% of sales – up from 18% in the previous year. They showed a year-on-year growth of 20%. Several trials are planned for this year to improve the offering in these categories, particularly in furniture and furnishings, building on development work already undertaken at ARG. Homebase is also developing plans to improve significantly its two-man delivery service, building on the expertise and success of home delivery within Argos;

– *opening more mezzanine floors and increasing their productivity.* At 28 February 2003, 36 stores had mezzanine floors, which are used to showcase kitchens, bathrooms and home furnishings. Their average size is 11,600 square feet, ranging from 7,000 to 17,000 square feet. On average, sales uplifts were about 15% in the year, contributing around 1% to total sales growth. As the return on investment on these mezzanines is attractive, an additional 35-40 mezzanine floors will be installed in the current financial year, at a capital cost of about £35-40m. Several trials are planned to modify the category mix in order to optimise the sales densities on and returns from mezzanines;

– *opening more new stores.* At 28 February 2003, Homebase had 273 stores. An additional nine stores are planned to open in the current financial year. The small store trial will be accelerated. These are 20-25,000 square feet stores, offering edited ranges in catchments which will not support a full range store; and

Homebase

	2003[1] £m	2002 £m
Sales	**251**	–
Operating profit	**2.2**	–

[1] Homebase sales and profit consolidated for the period from date of acquisition (20 December 2002) to 28 February 2003, Homebase's new year-end

Homebase continued

– *delivering integration benefits.* Given the degree of overlap between ARG and Homebase in products and suppliers, there are significant gains to be achieved over time from improved sourcing. Early benefits are being achieved through terms harmonisation and should generate savings of over £5m in the current year. Beyond that, increasing the percentage of direct importing and supply chain improvements will reduce sourcing costs at Homebase. Direct importing currently accounts for 8% of sales, but has scope over time to move to about 30%.

In addition, Homebase is working with ARG in certain areas such as e-commerce, financial services, IT and media buying to reduce costs and improve customer service.

The priority for the current financial year is to further strengthen the business and build a platform for future growth, while delivering on profit expectations. Capital expenditure at Homebase in the current financial year is expected to be about £65-70m, compared to £66m last year. As previously announced, re-organisation costs are expected to be about £10m in the current year.

Financial review

As already reported, Homebase's year-end has been moved to the end of February to avoid distortions relating to the timing of Easter and its associated promotions and trading patterns. January and February are seasonally quiet months. In its financial year to 31 March 2003, GUS has consolidated sales of £251m and operating profit of £2.2m for the period from acquisition on 20 December 2002 to 28 February 2003. This performance is in line with the same period last year.

For the twelve months to 28 February 2003, sales at Homebase were £1,444m, an increase of 4% over last year (3% like-for-like). Operating profit was £101.6m, giving an operating margin of 7.0%, compared to 5.9% in the previous year. This was driven primarily by improvements in gross margin and non-operational costs.

Home Shopping UK and Ireland

12 months to 31 March	**2003 £m**	2002[1] £m	Change
Sales			
Home Shopping	**1,409**	1,533	(8%)
Reality logistics	**73**	74	–
Total	**1,482**	1,607	(8%)
Operating profit	**15.4**	33.6	–
Operating margin	**1.0%**	2.1%	

[1] 2002 Home Shopping UK & Ireland restated to include £0.5m profit previously reported by Reality

Home Shopping UK and Ireland

The agency home shopping market deteriorated during the year under review. As a result, both sales and profit at Home Shopping UK & Ireland were below the level of last year.

Reported sales in Home Shopping were 8% below last year. During the year, management has continued to sell or close peripheral businesses, including Family Hampers, Innovations and McCord. Excluding these peripheral businesses, the sales decline was 5%.

Agency sales fell by 9% in the year (H1 –5%; H2 –13%) although GUS maintained market share. The number of active customers was further reduced to 2.5m, with a small increase in average spend per customer. Sales from continuing direct catalogues, mainly Marshall Ward and Abound, account for 15% of sales. They saw continued strong growth (up nearly 40% in the year).

Gross margins at Home Shopping were in line with last year. However, the sharp slowdown in sales in the second half more than countered the benefits of the cost reduction programme that has been underway for the past three years. An additional 250 redundancies were announced during the second half.

Reality's sales to third parties were flat year-on-year. However, this masked 7% growth in the core logistics business, offset by the withdrawal from or sale of peripheral activities such as packaging and fleet management.

Financial Services

Financial Services reported a profit in the year, with the improvement largely driven by the continued build-up of the Argos store card. This resulted in more interest income as the number of active accounts and the size of the debtor book both grew.

At 31 March 2003, there were about 630,000 active Argos store card accounts, up from 460,000 a year earlier. The gross loan book increased by £50m to £155m. Over 7% of sales at Argos were made via the store card. Argos' personal loan offer was first included in the Autumn/Winter 2002 catalogue and the gross loan book had grown to £37m at 31 March 2003.

The contribution to profits from Home Shopping customers was £17m in the year. Following the disposal to March U.K. Limited, this profit stream is no longer part of ARG Financial Services.

Home Shopping Continental Europe

At constant exchange rates, sales from European Home Shopping increased by 10% and profit by 5%. This was driven by Wehkamp, the leading home shopping brand in Holland, which accounts for over 80% of sales. It benefited from improved promotional activity, higher service levels and strong growth in branded clothing sales and electronics. 16% of Wehkamp's sales were through its website.

Halens, the Scandinavian operation, has been sold to March U.K. Limited. In the year to March 2003, its sales were £46m and its profit was about £5m. Sales grew by 4% in local currency, while profits benefited from the expansion of its financial services offering.

Financial Services

12 months to 31 March	2003 £m	2002 £m
Sales[1]	**34**	11
Operating profit/(loss)	**4.6**	(4.8)

[1] Sales represent interest income, fees and commissions relating to the Argos store card and Argos personal loans

Home Shopping Continental Europe

12 months to 31 March	2003 £m	2002 £m	Change at constant FX rates
Sales	**275**	238	10%
Operating profit	**24.7**	22.4	5%
Operating margin	**9.0%**	9.4%	