Operating and financial review

This operating and financial review analyses the performance of Tesco in the financial period ended 27 February 1999. It also explains certain other aspects of the Group's results and operations including taxation and treasury management.

Group summary

	1999 £m	1998* £m	Change %
Group sales (including value added tax)	**18,546**	17,447	6.3
Group operating profit (prior to integration costs and goodwill amortisation)	**965**	895	7.8
Profit on ordinary activities before tax†	**881**	817	7.8
Adjusted diluted earnings per share†	**9.37p**	8.70p	7.7
Dividend per share	**4.12p**	3.87p	6.5

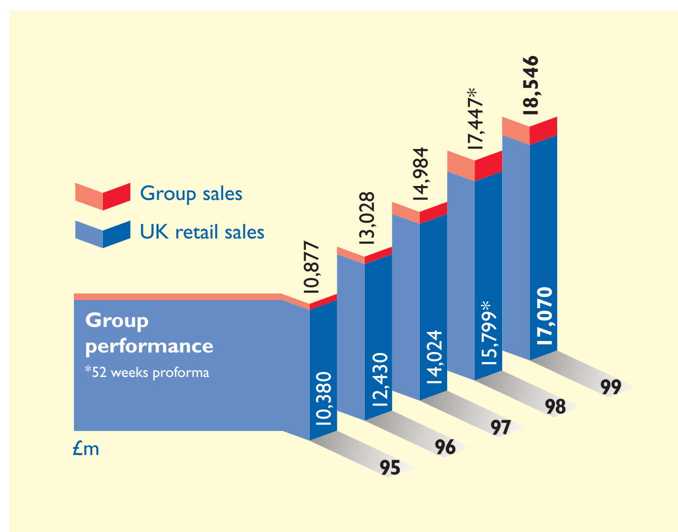
*52 weeks proforma

†Excluding net loss on disposal of fixed assets and discontinued operations, integration costs and goodwill amortisation

The financial period to 28 February 1998 was a 53 week trading year compared to a 52 week trading period this financial year. All comparisons in this operating and financial review are based on a 52 week proforma profit and loss account for 1998.

Group performance

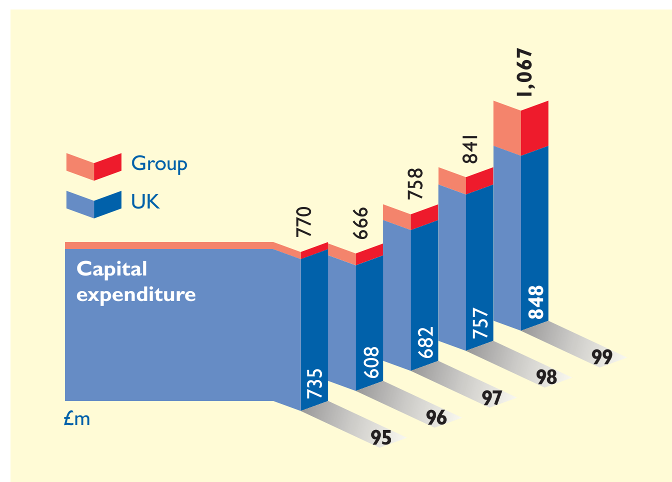
Group sales including VAT increased by 6.3% to £18,546m (1998 – £17,447m). Group sales from continuing businesses increased by 10.1% (1998 – £16,847m).



Group operating profit (prior to integration costs and goodwill amortisation) rose by 7.8% to £965m (1998 – £895m).

Group profit before tax rose by 7.8% to £881m (1998 – £817m). This excludes the net loss on disposal of fixed assets and discontinued operations of £8m (1998 – £9m), integration costs of £26m (1998 – £63m) and goodwill amortisation of £5m (1998 – nil).

Group capital expenditure was £1,067m (1998 – £841m) with £848m in the UK, £27m in Thailand, and £192m in Europe. In the current year, supported by our strong cash flows, Group capital expenditure will rise to around £1.3bn. The increase in 1999 relates mainly to our development plans in the rest of Europe and Asia.



Change in net debt

Total net debt at the year end amounted to £1,720m (1998 – £1,191m). This reflects the cash outflow from our net capital expenditure and acquisitions of £1,260m (1998 – £1,082m), partly offset by strong cash generation from the main business of £1,321m (1998 – £1,156m). As a result, gearing at the year end has increased to 39% (1998 – 31%).

Interest and taxation

Net interest payable was £90m (1998 – £72m) with the increase on last year primarily due to the financing costs of our acquisition in Thailand.

Corporation tax has been charged at an effective rate of 28.1% (1998 – 30.0%). Prior to accounting for the net loss on disposal of fixed assets, integration costs and goodwill amortisation, our underlying tax rate was 27.8% (1998 – 28.7%).

Profit-sharing increased by 8.6% to £38m (1998 – £35m). In addition staff have continued to benefit from profit related pay.

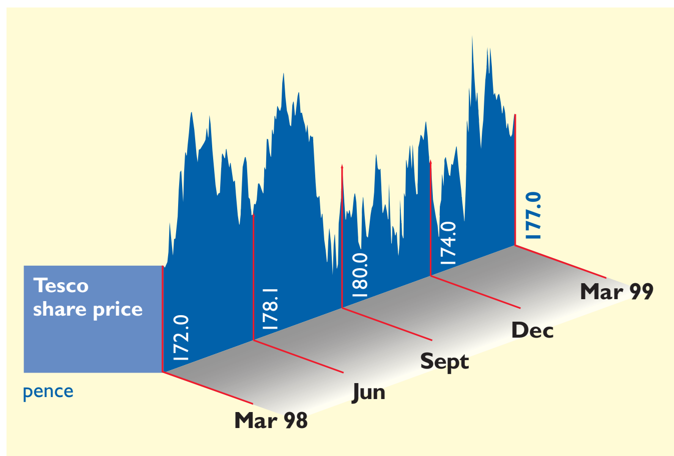
Shareholder returns and dividends

Adjusted diluted earnings per share (excluding the net loss on disposal of fixed assets and discontinued operations, integration costs and goodwill amortisation) increased by 7.7% to 9.37p (1998 – 8.70p).

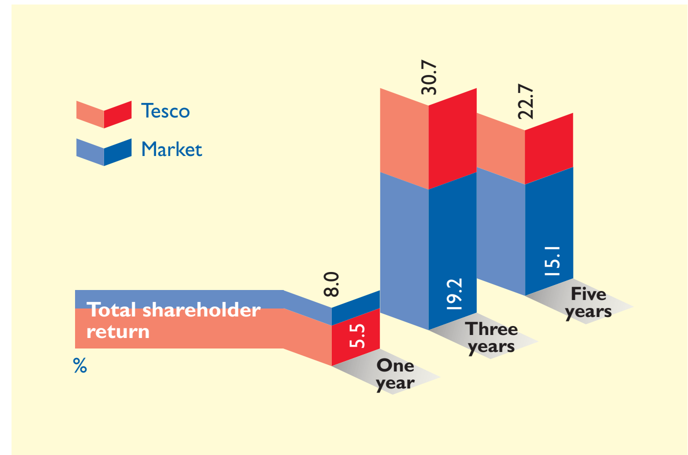
The Board has proposed a final net dividend of 2.87p giving a total dividend for the year of 4.12p (1998 – 3.87p). The dividend is covered 2.27 times by earnings.

Shareholders' funds, before minority interests, increased by £479m. This was due to retained profits of £329m and issue of new shares less expenses of £169m, offset by losses on foreign currency translation of £19m. As a result, return on shareholders' funds was 21.3%.

The share price rose from 172p at the start of the financial year to 177p on 27 February 1999, giving a market capitalisation of approximately £11.8bn (1998 – £11.4bn). The share price reached a high of 202p on 2 July 1998.



Total shareholder return, which is measured as the percentage change in the share price plus the dividend, has been 22.7% over the last five years, compared to the market average of 15.1% and has been 30.7% over the last three years, compared to the market average of 19.2%. In the last year, total shareholder return in Tesco has been 5.5% compared to the market average of 8.0%. This reflects our efforts to grow the business while ensuring returns to shareholders are improved.



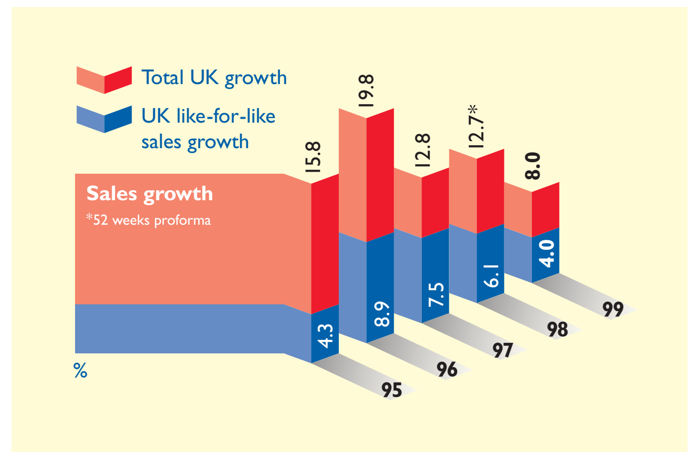
UK performance

	1999 £m	1998* £m	Change %
Food retail sales (including value added tax)	**17,070**	15,799	8.0
Operating profit	**919**	859	7.0

*52 weeks proforma

Sales growth for the industry has again been slow, as expected, reflecting lower inflation and a modest slowdown in volume growth from the very high levels of recent years. Our market share, based on estimates of IGD data, increased again to 15.8% in the year to December 1998, from 15.2% last year. Overall, it has been a challenging year for the industry, but our business has remained focused on our customers and has achieved good results. Over the last six years, sales volumes have grown by 22%.

UK retail sales have grown by 8.0% to £17,070m (1998 – £15,799m), of which 4.0% came from existing stores including volume growth of 2.5%. New stores contributed a further 4.3% to total sales growth before closures of 0.3%.



Operating and financial review continued

UK operating profit was 7.0% higher at £919m (1998 – £859m) and the operating margin fell 0.1% to 5.8%. This reflects our strong trading performance in a very competitive and challenging environment. We continue to invest to cut prices and increase customer service, particularly through longer opening hours and more service counters.

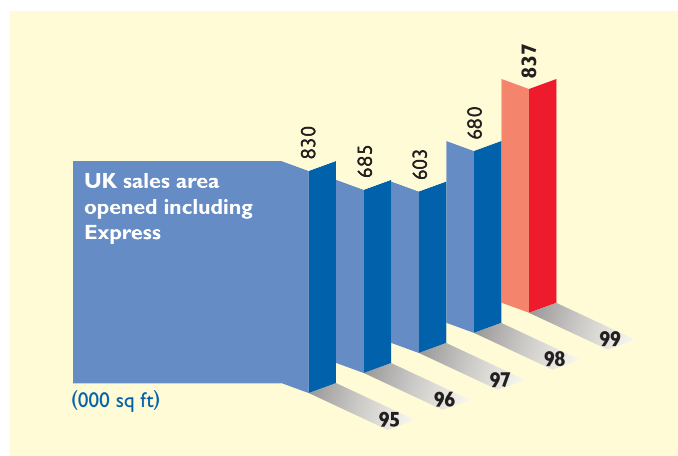
Store development and capital expenditure

In the UK we spent £350m on opening 25 new stores with a total sales area of 635,000 sq ft. This comprised 20 superstores and compact stores, one Metro, two Expresses and two Extras. As part of our programme to improve our stores and introduce non-food products, we have added over 200,000 sq ft through extensions. We also completed major refits at an additional 18 stores.

In the year, we continued to build on the success of our first Extra in Pitsea, Essex. We now have five Extras, including the latest store at Peterborough, providing one-stop shopping convenience for customers.

Express is also proving to be a promising format. We have 17 stores and during the year we announced our joint venture with Esso to develop more petrol sites, the first of which opened recently on the Fulham Road, Chelsea.

In 1999/2000, we plan to open around 26 stores with over 700,000 sq ft of new space, including 23 superstores and compact stores, one Metro store and two Express stores.



European performance

	1999 £m	1998* £m	Change %
Retail sales (including value added tax)	**1,285**	1,029	24.9
Operating profit	**48**	38	26.3

*52 weeks proforma

Europe

In the rest of Europe (Central Europe and Republic of Ireland), total sales rose by 24.9% to £1,285m (1998 – £1,029m).

In Central Europe, a fast growing market, we successfully opened six more hypermarkets during the year, creating almost 600,000 sq ft of new modern retailing space. This included three hypermarkets in Hungary, two in the Czech Republic and one in Poland. In 1999/2000 we plan to open 10 more hypermarkets adding a further one million sq ft.

In the Republic of Ireland our acquisition was nearly two years ago and we have achieved the milestones we set ourselves whilst meeting the undertakings made to the Government. We have rebranded 30 stores and our customers have responded well. Next year we expect to rebrand a further 20 stores and start to build two new stores.

The business is performing strongly and remains full of potential for the future.

Asian performance

	1999 £m	1998 £m	Change %
Retail sales (including value added tax)	**170**	–	–
Operating loss	**2**	–	–

Asia

In May we acquired a controlling interest in Lotus, a chain of 13 hypermarkets in Thailand with 1.6m sq ft of selling space. In the 32 weeks to 31 December 1998, Lotus contributed £170m to Group sales and reported a small operating loss of £2m. In December 1998 we added a 14th store and over the next three years we will develop the business further by doubling the number of stores and providing a strong base for profitable long term growth.

The purchase price of our 75% stake was £206m, including £89m debt. Goodwill amounted to £117m after fair value adjustments of £38m on net assets acquired of £127m. Goodwill will be amortised over 20 years in accordance with FRS10, resulting in a charge to the Group profit and loss account of £5m this year.

After the financial year end, we announced on 23 March 1999 that we were to form a partnership company with Samsung Corporation to develop hypermarkets in South Korea. This company will initially have net assets of £160m, comprising two existing Homeplus hypermarkets, three development sites and £80m cash. Tesco will invest a total of £130m, prior to costs, for an 81% controlling interest.

South Korea is a large developed market of 46 million people with GDP per capita already 70% of that in the UK but, in contrast, modern retailing is underdeveloped with only around 25 hypermarkets. The potential for us to build on the two successful Homeplus stores we now own is significant, and we plan to open a further 12 stores by the end of 2002.

We are continuing with our research in Taiwan and Malaysia.

Joint ventures

The Group operates several businesses as joint ventures with external partners including property joint ventures and Tesco Personal Finance, our financial services joint venture. The total share of profits of our joint ventures was £6m (1998 – loss of £6m).

Tesco Personal Finance has been an important part of our business strategy now for two years and is in good shape. Products launched to date, including savings, loans, visa, insurance and pensions have all been popular and over one million customers now use our financial services. This year our share of the Tesco Personal Finance operating loss was £12m. This was slightly better than expected reflecting significant improvements in efficiency and we aim to break even towards the end of the 1999/2000 financial year.

Property joint ventures contributed an operating profit of £18m principally comprising rental income on properties owned by our joint ventures with British Land and Slough Estates.

Treasury management and financial instruments

The Group's treasury operations are managed by Group Treasury within parameters defined formally and regularly reviewed by the Board. Group Treasury's activity is routinely reported to members of the Board and is subject to review by the internal and external auditors.

Consistent with Group policy, Group Treasury does not engage in speculative activity. Financial instruments, including derivatives, are used to raise finance and to manage financial risk arising from the Group's operations.

The main financial risks faced by the Group relate to credit, interest and foreign exchange. The Board reviews and agrees policies for managing these risks as summarised below.

The Board establishes annually the policy which Group Treasury follows in managing credit risks. Limited exposures are permitted only with banks or other institutions meeting required standards as assessed normally by reference to the major credit rating agencies. Deals are authorised only with banks with which dealing mandates have been agreed.

Finance and interest rate risk

The Group's policy is to finance its operations by a combination of retained profits, bank borrowings, commercial paper, medium term notes, long term debt market issues and leases.

Derivatives, predominantly forward rate agreements and interest rate swaps and caps, are used to manage the mix of fixed and floating rate debt. The policy is to fix or cap between 30% and 70% of the interest cost on outstanding debt, although a higher percentage may be fixed within a 12 month horizon. At the year end, after taking account of interest rate swaps, £649m (1998 – £614m) or 38% of our net debt was fixed at an average rate of 8.2% for a period of five years. A further £100m (1998 – £170m) or 6%, was covered by interest caps at an average rate of 8.3% for a period of three years.

The average rate of interest paid during the year was 7.1% (1998 – 8.1%). Excluding capitalised interest, interest is covered 7.8 times by profit before interest (1998 – 8.5 times). A 1% rise in market interest rates would reduce profit before tax by less than 2%.

The Group ensures continuity of funding by arranging for short term bookings and commercial paper issuance to be fully backed by committed bank facilities, by limiting the amount of debt repayable in any one year, and by managing the average debt maturity in line with gearing levels. At the year end undrawn committed facilities amounted to £510m (1998 – £645m) and the average debt maturity of net debt, including these facilities, was over five years.

Operating and financial review continued

Foreign currency risk

The Group's policy is to use foreign currency borrowings, forward foreign currency transactions and swaps to offset part of the impact on the Group's balance sheet of exchange rate movements on the 12% of its net assets before financing which are held overseas.

The Group does not hedge exposure to currency movements on the translation of the 4.8% of profits made overseas except to the extent that those profits are matched by foreign currency interest costs.

Significant transactional currency exposures resulting predominantly from purchases in currencies other than the subsidiaries' reporting currencies are hedged by forward foreign currency transactions, currency options and by holding foreign currency cash balances.

Year 2000

Tesco has been working on the Year 2000 issue for over three years with the specific objective of ensuring business continuity under the banner of 'Shopping as Normal for our Customers'.

A central dedicated team has been co-ordinating the project across all countries and reports to the Board every month. Accountability has been firmly placed with line directors for defining and actioning their work programme, co-ordinated through this central team.

The work has concentrated on taking corrective action across systems, embedded chips and working with our many suppliers to ensure product supply and continuity of services.

The activities involved have been to:
- identify the problem
- take corrective action
- re-test new systems and processes
- validate external suppliers of goods and services
- categorise risk and develop contingency plans
- ensure good communication within the business and to external suppliers and stakeholders

The main areas of work lie within:
- computer systems
- suppliers of products for re-sale
- suppliers of equipment and services
- the supply chain and our distribution network

There is a risk to the Group, as with all companies, that suppliers may experience Year 2000 failures. We have held five major supplier conferences involving over 2,000 firms and are currently fine tuning contingency plans to ensure the transition is smooth and trade is unaffected.

We have made the necessary changes and re-tested all our business critical computer systems.

The Board have agreed store trading times over the millennium period and all areas of the business will have created staffing and contingency plans by the end of August 1999.

The approach developed within the UK has been used in Europe and Asia where compliance is also well advanced.

The programme was estimated to cost £30m over three years and we expect to spend within that budget.

We have worked closely with Government and Action 2000 as well as the Retail Industry bodies, sharing information for the good of the consumer in order to achieve 'Shopping as Normal'.

Economic Monetary Union

Our aim is for all the relevant parts of the Group to be able to handle business in euros when required. Tesco has project groups addressing the issues arising from EMU and is working with external consultants.

Going concern

The directors consider that the Group and the company have adequate resources to remain in operation for the foreseeable future and have therefore continued to adopt the going concern basis in preparing the financial statements. As with all business forecasts the directors' statement cannot guarantee that the going concern basis will remain appropriate given the inherent uncertainty about future events.