CEO's report

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NICK GRAYSTON
CEO, The Warehouse Group

Report from the CEO (turn over)

Our way forward

The year ended 29 July 2018 has been a challenging one. Major change is always difficult for an organisation of our size, but the fact that we have begun to reposition the company is a material step forward for the future of this business.

We began a transformation programme to accelerate our strategy and improve our business processes and management disciplines, and we made a major change to The Warehouse with the transition from a Hi-Lo pricing model to Every Day Low Pricing (EDLP). We continued to integrate our operations across the Group and have started to see the benefits from that change. We also improved our direct sourcing capability and expanded our international operations to help provide better products at better prices for our customers.

The Warehouse Group remains a profitable company that creates significant value for New Zealand. We are cash generative, a major employer and a contributor to our country through our corporate citizenship activities.

I am proud of the hard work our people have put in to achieve the results for FY18, particularly given the difficult context of the year. I'm also satisfied that we are completing the groundwork to overcome impending competitive challenges.

KEY HIGHLIGHTS

7.4%

Online sales percentage of total sales. Up 6.6% on last year

No.1

Warehouse Stationery No.1 in Back to school products

8.6%

↑ Noel Leeming annual revenue growth in FY18

Competitive landscape

Each year sees new and stronger competitive challenges to our business and 2018 is no exception. Amazon arrived in Australia, offering a broader selection of categories than in any other launch country. While their arrival doesn't yet appear to have had significant impact, it would be unwise to underestimate their long-term potential in Australasia. However, it's not just Amazon that we need to be mindful of, other international e-commerce players are present in the New Zealand market, and traditional retail competitors such as Kmart are expanding their store footprint in this country, along with best-in-class international apparel retailers Zara and H&M.

We are highly focused on being able to resist those threats successfully. It's clear that omnichannel retailing is now the dominant form. As a legacy retailer with a comprehensive store footprint, we have an advantage–but not automatic success–within an omnichannel environment.

We are fortunate to have the existing benefits of scale and deep brand affinity with New Zealanders as a foundation on which to build our digital future. How we leverage these advantages to best serve our customers is now our critical opportunity. We must continue to get better at what we do, putting customer experience at the forefront of all of our channels and ensuring we are guided by more sophisticated data, insights and capabilities.

Our brand performance

The Warehouse's transition to EDLP has gone well and we are pleased that sales declined less than expected and customers responded positively to the clarity of our offer. We saw a 6.6% lift in unit volume across the year. During this time, we curated our product range, simplifying our portfolio of private-label brands from 136 to 30, and reduced the number of overall product SKUs by 9.8%.

'Noel Leeming has had a standout year. Operating profit increased by 61.8% from the previous year to $31.2m in FY18'

NICK GRAYSTON
CEO, The Warehouse Group

Revenue for **The Warehouse** decreased by 2.5% to $1.7b in FY18 and the retail operating margin reduced 0.6% from 4.8% to 4.2%. The drop in revenue was anticipated in response to the transition to EDLP. Although sales dropped, units sold increased and we are pleased with the lift in gross margin from 36.8% to 37.4%.

The grocery and apparel categories in The Warehouse have performed particularly well. Sales of affordable essentials in grocery have increased with a 14.0% uplift, showing that customers are responding well to the change.

In apparel, a warm summer led to excellent performance in seasonal categories. We experienced significant gross profit improvements because of a reduction in clearance.

There is still more work to be done in terms of refining prices, product range and assortment. But we have a solid base to tweak and improve on. We are also testing some new store formats, prioritising floor space to improve profitability and customer experience, and emphasising the enhanced quality and value to customers under EDLP.

Most of our private-label products in The Warehouse are designed by New Zealand designers at our Store Support Office in Northcote, Auckland. In FY18 we accelerated our direct sourcing model to reduce costs, improve the quality and speed to market of our products, and to ensure our ethical sourcing practices are adhered to.

While we continue to operate in China, India and Bangladesh are emerging as global powerhouses in the production of apparel and soft home goods. We recently expanded our operations into India. We began trading there in July 2017 and officially opened a sourcing office in New Delhi in February 2018.

A real highlight of FY18 has been **Noel Leeming's** performance. It has had what can only be described as a standout year. It continues to benefit from advantages of scale, both in terms of volume and store footprint, and the expertise offered through the assisted sales model. The business has delivered revenue growth of 8.6% to $880.5m in FY18. Operating profit rose by 61.8% to $31.2m in FY18 and operating margins increased from 2.4% in FY17 to 3.5% in FY18.

The first half set the platform for the year with solid trading results across both the retail and commercial divisions. The commercial division has performed well with sales up 10.5%; however, we still see room for growth.

The investment we made in the Noel Leeming Tech Solutions business back in FY15 and FY16 is starting to pay off. Services now make up 2.7% of all sales, up from 2.5% in FY17, and we expect this growth to continue. This was a very purposeful strategy that has been well-executed.

In July we announced the purchase of the key assets of the Appliance Shed, offering a larger store footprint to provide clearance goods and to help meet the customer demand seen at our expanded Penrose clearance store. Three Appliance Shed sites in Auckland will transition to Noel Leeming Clearance Centres and a fourth to a Torpedo7 store.

In contrast, **Warehouse Stationery** has had a poor year by its own high standards. The weaker result for FY18 was due to internal systems integration issues and an industry segment that is facing challenges as a result of changes in customer buying behaviour.

Revenue for Warehouse Stationery fell 5.2% from the previous year to $263.8m in FY18. The business experienced a decrease in operating profit from $15.7m to $10.6m in FY18, with the corresponding operating margins reducing from 5.7% to 4.0% in FY18.

The first half of the year was particularly challenging and saw a 7.1% decline in sales on H1 FY17. The operational integration of The Warehouse and Warehouse Stationery resulted in some internal systems and process challenges that impacted the availability of products in store, and significant time and resource was spent rectifying these issues.

However, this was completed in time for a successful Back to School period which saw Warehouse Stationery retain its position as number one in market share and customer service. As we continued the year we reduced our sales deficit to 5.3% decline in Q4.

While sales declined, margin improved–particularly in Q4, by 1.4%. This demonstrates that profitability for the business is in line with our expectations.

We are acutely aware of challenges in the stationery market globally, including

'The commitment and dedication of the executive leadership team is among the best I've seen.'

JOAN WITHERS
Chair, The Warehouse Group

the acceleration of the decline in heritage categories such as paper and manual-based office supplies, and the need to reposition the business ahead of structural changes in the industry.

We have been through a specific exercise to address both category and systems issues and develop a strategy for the future. This includes refocusing dedicated resource to the stationery business and a plan to continue to grow shoulder categories and the existing B2B market.

Torpedo7 had a disappointing year also but for different reasons. While revenue increased 3.6% to $163.4m, it made an operating loss of $1.4m because of ongoing challenges with a sub-scale operation and internal disruption connected with relocating parts of the business operations.

This year we recorded an impairment of the goodwill relating to Torpedo7 of $25.6m.

The integration of Torpedo7 into Noel Leeming management showed us the extent of the work we need to do to scale up from a niche offering to becoming a serious retailer. We recognise that developing capability, rebuilding processes and addressing stock issues will take time.

While it has been a difficult year for Torpedo7, it has also been a good opportunity to reset the foundation for the business. In FY19 we have confirmed the roll out of four additional Torpedo7 stores, bringing the total number of stores to 18, with additional stores in the pipeline. Torpedo7 stores are relatively profit-neutral in the first year, so the opportunity is significant, but it will take time to achieve scale.

FY19 will be focused on establishing brand clarity, getting our inventory right and scaling the business, both physically and online, and we expect to be operating from a strong foundation by FY20.

Torpedo7 has a secondary brand in No. 1 Fitness, which currently has one store in Christchurch. In FY19 we will integrate No. 1 Fitness into Torpedo7 and retire the brand to reduce complexity.

Group online sales were $221.1m, up 6.6% compared to the same period last year. Online as a percentage of total sales finished the year at 7.4% compared to 7.0% in the same period in FY17.

Investing in our digital future

While we are focused on fixing the retail fundamentals through our transformation programme as our priority, we are also investing in our digital future to get ahead of the curve. An efficient and frictionless e-commerce offering is no longer a differentiator. In FY18 we boosted our digital capability and established a world-class team, and did a considerable amount of work to bring our core IT infrastructure up to standard. In FY19 we will continue to invest in building a competent fulfilment capability and improving our infrastructure, systems and supply chain and distribution processes, setting the foundation for our future.

Focusing on our core business

In FY18 we completed the transition of The Warehouse Group Financial Services division to Finance Now, enabling us to free up capital and focus on our core business. It has a been a smooth transition with negligible impact on our customers, and we are fortunate to have good partners in Finance Now and SBS Bank. The nature of the financial services business meant that it required significant operating capital and the decision to divest has given us capacity to make the investments that support our strategy. Our planned investments can be funded through our existing capital envelope.

Leveraging our scale as a group

We are now able to capitalise on our scale as a group and reduce duplication with one Information Technology, People Support, Finance, Logistics and Marketing team. We are already realising the benefits of this new model. For example, in FY18 and through FY19 we will make a significant investment in a new Warehouse Management System that will improve our fulfilment and delivery capability across all brands. This will enable efficiencies that will save around $5.4m per year from FY20.

We appointed a single media buyer to serve all brands in the Group, replacing seven media and planning agency relationships. Similarly, we have appointed one domestic logistics partner in Toll New Zealand, which will be providing all store delivery services across all the brands from FY19.

Our transformation

Earlier this year we started our group-wide transformation programme focused on fixing the retail fundamentals and improving our financial performance. It began with

Left to right:
Tania Benyon, CEO Group Sourcing Support; Pejman Okhovat, CEO The Warehouse and Warehouse Stationery; Mark Yeoman, Chief Operating Officer and Chief Financial Officer; Nick Grayston, Group Chief Executive Officer; Tim Edwards, CEO Noel Leeming and Torpedo7 Group; Scott Newton, Chief Transformation Officer; Evelyn Ross, Chief People Officer; Jonathan Waecker, Chief Marketing Officer.

an independent assessment of the Group, which helped to quantify the opportunity for focused performance improvement. It was then followed by a process of idea generation with input across the entire business. Ideas were then distilled to 250 initiatives, which are now being implemented by our own teams. Although it's early days, we're already seeing success with a number of initiatives delivering value, increased engagement and collaboration across the Group.

While our transformation has components related to technology investment, it is mostly about fixing our business processes and improving management disciplines. We share more information about our transformation on pages 24–27.

We're on for the future

Ultimately, retail is still about two things – people and product. Having the right product and serving people how they want to be served, whether that's in a store or on a mobile device is key, together with the right customer service. We're working hard on improving these elements so we can deliver to our purpose of helping Kiwis live better every day.

FY18 has been a huge year of change for our company, and while there is still more work to be done, I'm pleased that we're on plan. We have entered FY19 with momentum behind our strategy to deliver a strong and sustainable future for our organisation. This is due to the efforts of our people and I want to thank each one of our team members for their contribution. Together, we're writing this story for the future of The Warehouse Group.

Nick Grayston
Group Chief Executive Officer