halfords

Group Chief Executive Officer's Review

Matt Davies
Group Chief Executive

Introduction

Halfords Retail sales performance in FY13 reflected a demanding trading environment. Sales were affected by unseasonal weather in the first and last quarters and by a summer of sport in between which particularly benefitted cycle sales. In the year under review, Halfords Retail delivered three quarters of positive like-for-like ("LfL") sales growth, following a number of consecutive negative LfLs in preceding quarters, supported by online Retail revenue growth of 15.9%.

Our Autocentres performance was satisfactory against a backdrop of a declining market and particular challenges in the fleet sector.

Throughout the period the business has taken advantage of the opportunities presented and we have focused on improving our offer through service. Particular progress was made in the Car Maintenance category where we have invested in training and extra colleagues to carry out our ***we***fit fitting service; this has driven extra sales.

FY13 Review

Summary of Group Results

Sales were £871.3m, up 1.0% and up 0.3% on an LfL basis. Group gross margin was flat at 54.8%. Total underlying operating costs rose by 6.2% due to the continuing inflationary environment, our strategic investments to support our Retail service offer and the continued expansion of our Autocentres business. Underlying Group earnings before interest, tax and non-recurring items were £78.1m, which compares with £97.2m in FY12. Profit before tax and non-recurring items was £72.0m and earnings per share before non-recurring items were 27.7p, down 21.9% and 17.8% respectively.

Group inventory and capital expenditure continued to be managed tightly, with Retail stocks down 9.2% on the prior year. Autocentres inventory was £1.3m, flat on the prior year. The cash flow performance was robust with free cash flow of £71.8m generated against £70.4m in the prior year. Net debt at the year-end was down £28.6m to £110.6m, with net debt:EBITDA remaining at a ratio of 1.1:1.

The Board has recommended a final dividend of 9.1 pence per share, a reduction of 35.0% on the prior year (FY12: 14.0 pence). If approved, this will be paid on 2 August 2013 to shareholders on the register at the close of business on 5 July 2013. The proposed full-year dividend is 17.1 pence (FY12: 22.0 pence). The 35.0% reduction of the final dividend would have the effect of similarly rebasing future dividend pay-outs. It is anticipated that the FY14 full-year dividend would be reset to around 14 pence per share and that the full-year dividend would potentially remain around this level as the business approaches nearer 2x dividend/earnings cover over the medium term. This would reflect a more-sustainable level for the business, the requirement to invest as set out later and the maintenance of a robust balance sheet.

Retail

Sales for the year were £745.5m, down 0.9% on the prior year and down 0.7% on an LfL basis. The sales mix and continued focus on cash returns resulted, as expected, in a broadly-flat Retail gross margin.

Cycling

After a disappointing start to the year, it was a particularly strong summer for Cycling sales. The enthusiasm surrounding British successes in the Tour de France, Olympics and Paralympics helped fuel a stronger demand for cycles, cycle products and cycle accessories and we capitalised on this with our agile trading stance. The strong demand for premium cycles continued throughout the year, particularly our exclusive *Boardman* and *Pendleton* ranges. We were pleased to add to our ranges with the introduction of *Pinarello* cycles, the brand ridden by Team Sky and used by Sir Bradley Wiggins to win the Tour de France.

During the second half overall cycle sales were affected by a poorer Christmas for kids and mainstream bikes, which continued into the final quarter as the prolonged winter weather delayed the start of the family cycling season. Cycling LfL sales were down 0.6% for the year. Online Cycling Parts, Accessory and Clothing ("PACs") sales were up 26.5% in the final quarter as we began to introduce new ranges ready for a full-scale launch of our enhanced PACs proposition in the new financial year.

Car Maintenance

LfL sales of Car Maintenance products and services grew by 5.1%, helped by the prolonged period of winter weather. Demand for our ***we***fit service continues to build as we invest in this category and more customers look to us for expert help with basic Car Maintenance solutions. We fitted 35.2% of the bulbs, wiper blades and batteries we sold, up 890 basis points on last year. We invested in training, payroll, colleague numbers and national marketing to fulfil the demand and make more customers aware of our unique offer. The 3Bs parts and labour market is estimated to be worth around £950m and we only have a *c.*11% share*. In the year we also leveraged our market-leading position with timely promotions like our deals on Castrol oil.

“We now fit 35.2% of the bulbs, wiper blades and batteries (“3Bs”) we sell, up 890 basis points on last year.”


Encouraging engagement with qualified staff

Car Enhancement

In Car Enhancement LfL sales decreased by 4.2%. This was a much slower rate of decline than in previous periods. Sat Nav sales have been a significant drag on the business over the last few years but during the second half of the year sales were flat. We also made market-share gains in both Sat Nav and Car Audio. Audio sales grew by an encouraging 2.8% due to good execution and the authority of our range, established through our close partnership with the world’s leading technology brands. We are closer to the significant medium-term opportunity around Digital Radio and further share gains here mean we have now captured around three-quarters* of this growing market.

Travel Solutions

There was reduced demand for camping and touring products due to the generally poor weather both last summer and this spring. Our Travel Solutions category saw an LfL sales decline of 6.8%. One highlight was the sale of breathalysers during the summer and again this spring as they became a requirement for Continental travel and motorists visited Halfords for our exclusive Alcosense range. Child Car Seats remain a product range facing intense pricing and competitive pressure and, during the year, we continued to manage this category for cash.

Online

Online revenues grew by 15.9% and represented 10.3% of Retail sales which compares with 8.9% in the prior year. We continue to focus on improving our online experience for customers and we invested in website capability; for instance the launch of a new search engine, Fred Hopper, that will make it easier for online shoppers to search and navigate our site. We also introduced our new 24-hour *Reserve & Collect* service and rebalanced our promotions to focus more on product price rather than percentage discounting.

Autocentres

Autocentres sales were £125.8m, up 13.5% overall and represented a 7.0% LfL uplift on the prior year. The second-quarter LfL sales growth of 12.4% was the strongest since we acquired the business in February 2010 and the business has now enjoyed nine consecutive quarters of LfL growth.

Growth was driven by our investment in marketing, the development of our tyre proposition, our exclusive **brakes4life** offer and the contribution from new centres. The significant increase in lower-margin tyre sales resulted in a 221bps decline in gross margin, with margins in our non-tyre business benefitting from scale.

We continue to acquire new retail customers whilst retaining a high level of existing customers. However, fleet-customer acquisition has been less satisfactory with material short-term challenges in this sector. Twenty-three new centres were opened in the year bringing our total at the end of the year to 283 centres. We will continue to selectively and appropriately invest in new centres to significantly grow our network over the years ahead, targeting a further 20 to 30 new openings in FY14.

Halfords Business Review

Introduction

The fall in Group profitability over recent years illustrates the need for sustainable and profitable revenue growth over the medium and long-term to offset ongoing cost inflation. We must strengthen our proposition and customer offer in an environment where shopping patterns are changing and competition is increasing. As a result the Board asked me to carry out a review of the business with the management team and bring forward a plan to reposition Halfords to meet the challenges now and that lie ahead.

My conclusion is that Halfords is a good business with a clear strategic framework in place. However, there is some repositioning necessary to move Halfords from being good to being great; we must act now. Our single most important objective is to drive profitable sales growth and to do this through leveraging our expertise.

Following our review we have launched ***Getting Into Gear 2016***, a clear programme of operational plans designed to significantly improve our Retail customer experience. This programme will focus on supporting our colleagues to deliver consistent friendly expertise, improve our store environment, strengthen the authority of our offer and build our infrastructure and digital capabilities. The investment required is anticipated to reduce short-term Retail profitability but is designed to deliver sustainable revenue and profit growth together with sustainable shareholder value.

* (Source: management estimates)

Group Chief Executive Officer's Review continued

Three-Pillared Strategy

Last year Halfords launched a new strategy that focused on three core pillars:

- Friend of the Motorist
- Best Cycle Shop in Town
- Starting Point for Great Getaways

We believe this is the right strategic framework and the new programme of activity we are initiating is designed to support and drive these three pillars which we have redefined slightly to introduce a clearer purpose and more passion.

Our mission is to Help and Inspire Customers with their Life on the Move. The existing pillars have evolved to become:

- Supporting Drivers of Every Car
- Inspiring Cyclists of Every Age
- Equipping Families for their Leisure Time

Our two critical pillars are Auto and Cycling with the third pillar giving us the flexibility to extend our range, introduce innovative products and leverage space. Ninety percent of our focus needs to be on Auto and Cycling as these markets are significant and, with good execution, we can grow our share as well as the overall market.

Halfords Autocentres

A central part of our strategy of Supporting Drivers of Every Car is our newest business, Halfords Autocentres.

Halfords is a trusted brand in the automotive sector, so the move into garage servicing was a natural extension of the Halfords business model. We now offer customers end-to-end solutions, from car parts to the fitting of bulbs, blades and batteries in our Retail stores and full servicing, MOTs and repairs at our Autocentres.

Our review concluded that our strategy for Autocentres is sound and the Autocentres business provides a significant growth opportunity for the Group. However, we also concluded that the short-term profit expectations discussed at the time of acquisition were overly optimistic. These short-term expectations didn't fully consider the implications of a rapid expansion of the chain through new-centre openings, nor the impact of the auto-aftercare market environment which has been more difficult than expected in the period since acquisition. The economic down turn has particularly hit motorists through escalating fuel and insurance costs. In response motorists have reduced mileage and cut back on other costs where possible – including car servicing. As a result we estimate the overall market has contracted by around 5% in the last three years*.

Despite this Halfords has grown its Autocentre retail LfL sales by 4.3% in the same period, over 9% better than the market. This was achieved through better use of existing Autocentres capacity. We have recruited thousands of new customers by rebranding the estate and nationally advertising. We also offer customers a wider range of products like tyres and our innovative **brakes4life** offer.

The Auto-Aftercare market provides Halfords with an opportunity for further growth. It is estimated to be worth around £9bn* and Halfords only has a small share – our 283 centres represent less than 2% of the market.

The market is also highly fragmented and capacity is declining. There are some 22,000 garage sites and 1–2% leave the market each year. The complexities of new cars and the investments required make it more difficult for small operators to compete. By contrast Halfords has increased Autocentre chain numbers by around 27% since acquisition and invested heavily to support growth.

Halfords is well placed to take market share. We are a recognised strong brand in Auto-Aftercare which is a key advantage – as trust is one of the main factors affecting motorists' choice of garages. So our proposition of dealership quality work at more affordable prices, supported by a high level of customer service is a compelling one. We can also leverage national advertising and cross-sell between Retail and Autocentre customers.

The short-term issue for the business is the drag created by our new-centre opening programme. Our core centres are performing well and, as we expand, our buying leverage creates value. However, the contribution from new centres is outweighed by the investments needed for the opening programme. It is predominantly these new-centre investments that are holding back overall short-term profitability together with investments in the infrastructure to support a business growing at the pace of Autocentres.

Having reviewed the business, we believe that Autocentres is a great growth opportunity for us. We have a clear strategy for the future being executed by the Autocentres management team and we can build a business of significant scale. Operationally we will increase what we sell to our existing customers by focusing services on the "Big4": Service, MOT, Repair and Tyres. We will support these sales through innovations like Sunday openings, new product packages and refreshing our website to make booking a service or selecting a tyre even easier.

Through proven marketing routes we will drive more footfall to our Autocentres. We will grow our share of the fleet market by developing our presence with existing customers and attracting and developing new customers.

Our new-centre opening programme will continue with 20–30 new centres planned per annum requiring a capital investment of around £6m per annum. We also anticipate that the market will return to growth as maintenance and repairs return to more normalised levels. Over the medium-term we expect to see profitability build as critical mass is reached in the business.

* (Source: management estimates using data from Halfords Autocentres, SMMT, DFT and Castrol Trend Tracker)

Group Chief Executive Officer's Review continued

"Service is at the heart of our proposition as we estimate two thirds of our products require some level of assistance."

Halfords Retail

Our review of Halfords Retail addresses the significant challenges we face and sets out a programme of activity to reposition the business; to move us from good to great as we prepare Halfords for the future and put it on a path to consistently drive profitable top-line growth.

Halfords has a very strong place in UK retail. We have an excellent brand that shoppers in Britain have grown up with and there's no doubt in a customer's mind what Halfords stands for and what we sell. We are the nation's leading cycle retailer, selling over 1m cycles a year and we are the go-to destination for motorists. So our products and services are relevant for today's customers and key parts of our offer, especially those which are service related, are unique to Halfords.

The categories in which Halfords operates provide good opportunities for growth. For instance, the Cycle market is buoyant and the popularity of Cycling is growing. The market for Cycles is worth around £700m* and Halfords has a *c.*20–25% share*. The market for PACs is a similar size; we only have *c.*15% share in this market. Last year the entire Cycling market grew by 8.5% and over the next five years is anticipated will grow by around 23%**. In the Cycle Repair market, worth *c.*£100m*, we estimate having only a *c.*8% share. Our focus in FY13 on Cycle Repair produced sales growth of 25.3% and we are implementing a strategy for further growth in this category in FY14.

Halfords also has good potential for growth in Retail Car Maintenance. The 3Bs parts and labour market is estimated to be worth around £950m* and we only have a *c.*11% market share. ***We***fit is a unique offer and we have invested in colleagues, training, advertising and held ***we***fit weekends to raise awareness. The 50.5% growth this year in the number of 3B fitting jobs and the associated growth of 10.9% in parts sales illustrate how much customers welcome this service and what an area of ongoing opportunity it is.

Halfords is in a strong position to make the best of these market opportunities if we can present the right offer to customers. We have great expertise and heritage and a nationwide store network. Meanwhile our global sourcing infrastructure can supply excellent products from the world's leading manufacturers at least-cost to our customers – for instance our exclusive range of *Boardman* cycles, which combine industry-leading designs with prices that are around 15% lower than a cycle of comparable specification.

Our sales are supported by a core of colleagues who are knowledgeable experts. On our day the service we provide is hard to beat. However, our review shows that service levels are inconsistent and this and other aspects of the Halfords experience frustrate customers; many are now choosing to shop elsewhere.

One measure of this is the Halfords Net Promoter Score, which assesses the propensity of customers to recommend our services to others. The Halfords score was, until very recently, close to that of a value retailer; this is a long way adrift from the score of a specialist, where we ought to be.

Meanwhile the competition is escalating in our core categories, such as from online Cycling specialists. As a result our profitability is being eroded. In the last 13 quarters, 10 have seen Retail LfL sales declines. Our revenues have gone from *c.*£812m in FY10 to *c.*£746m in FY13.

Halfords must generate profitable revenue growth over the medium and long-term; the key action that will drive sales is better customer service. We have thousands of amazing people but we haven't supported them to do the job they aspire to. This was evident in the 12,000 comments we received in last year's Colleague Engagement Survey which was packed with suggestions on how to support colleagues in their roles and help them help customers.

Our conclusion is that we must focus on customer service and deliver a great customer experience. To do this we have to improve colleague engagement, develop their friendly expertise consistently across our estate and use it to drive sales. Through our colleagues' product knowledge and our range authority we can re-build our credentials as a specialist retailer. We must also improve our stock availability, retail disciplines, our store environment and overall customer experience. All these improvements must be made as we position ourselves for a digital future.

Our focus is to create a business with belief in the quality of its products and services and where friendly expertise is at its core.

To deliver this the ***Getting Into Gear 2016*** programme has been launched and is specifically designed to drive profitable and sustainable top-line growth. Whilst a lot of work is already underway the complete programme will take around three years to deliver.

* (Source: management estimates)
** (Source: Mintel 2013)