

# Operating review

## Justin King, Chief Executive



Our business is growing because we have responded quickly and effectively to a rapidly changing environment. Total sales for the year were up 5.7 per cent and like-for-like sales excluding fuel were up 4.5 per cent. In addition we have continued to drive cost efficiencies offsetting over 75 per cent of cost inflation and delivered further profit growth.

Fixing fundamental parts of our operation through our 'Making Sainsbury's Great Again' ("MSGA") recovery programme has placed the business in a strong position. Although consumer confidence in the UK has declined during the year, our performance improved as a result of the strength of the Sainsbury's brand and actions we have taken to adjust our offer to changing customer trends.

Sainsbury's is a long-established company and celebrates its 140th anniversary this month. It has a heritage of offering customers great products at fair prices, through a variety of economic trading periods, and we have developed our offer to compete and grow in what has been a very challenging period for the UK retail industry.

Our universal customer appeal and continued investment in price and quality have been fundamental to our growth, catering for a range of changing customer needs and trends. Over the past 12 months consumers have become increasingly 'savvy' and have responded to rises in the cost of living by making significant changes to the mix of products they buy. In an effort to manage their household budgets more tightly, people are eating out less and cooking at home more. They are shopping around to get the best prices and deals but also want the best quality they can afford and to stay true to their values.

Sainsbury's 'good, better, best' product range hierarchy has provided customers with the flexibility to change what they buy, rather than where they shop. Customer transactions have grown to over 18 million a week and basket size has also increased. Further improvements in service levels and product availability have been achieved and as customers increasingly compare the value offered in different supermarkets they are realising they can get both great products and fair prices at Sainsbury's. Investment in pricing, improved promotions and a range of marketing activities have all combined to significantly improve our customers' price perception.

We have continued to invest in our five areas of focus (outlined on page three), each of which has delivered over the past year and provides significant opportunities for future growth. The areas are to build and stretch our lead in food,

accelerate the development of non-food ranges and services, extend the reach of our brand via our online and convenience offers, to grow our store estate and actively manage our property assets.

Our progress in the past four years has made the Company a stronger business with a wide customer base and universal appeal. We are performing well and have significant opportunities for further growth. We expect the current economic environment to remain challenging but our focus on doing a great job for customers means we are well positioned to continue our good progress.

## Operating review

Sainsbury's performance over the past 12 months has been underpinned by the enormous changes made during the MSGA recovery programme. Sainsbury's is now a stronger business having delivered four consecutive years of sales growth and we continue to build on this strong foundation. Our focus on listening to customers and constantly working to improve their shopping experience has enabled us to successfully anticipate and respond to changing economic conditions during the past 12 months. The brand has been proven to be both resilient and flexible and we are competing effectively and growing sales in a particularly challenging economic environment.

There has been a considerable change in customer shopping patterns over the year as consumers have increasingly felt the need to manage household budgets more carefully. The grocery sector tends to be more resilient in such conditions as food purchasing is not as discretionary as many other product sectors, but Sainsbury's has still had to adapt to changes in how and where consumers want to spend their money. Our performance in the current economic climate shows we are in touch with our customers and capable of responding effectively to their changing needs and wants.

This year Sainsbury's is celebrating its 140th anniversary having set up shop in Drury Lane, London in 1869. The Company was founded on the principle of helping people in poorer parts of London eat a better diet, despite budget constraints, and over the years it has remained true to its value of offering great products at fair prices with a strong ethical approach to business. Getting value

for money is even more important to consumers when budgets are stretched. Basket size has increased as Sainsbury's 'good, better, best' product range hierarchy, the basis of our universal appeal, caters for the full range of customer needs and budgets. As requirements have changed, customers have been able to adapt their shopping within Sainsbury's stores.

Over 18 million customers now shop at Sainsbury's every week. Even though they are looking to economise, ethical and environmental concerns are growing in importance for customers. Sainsbury's provides a compelling offer and we take a leading stance on a range of such issues on behalf of our customers while still ensuring products are competitively priced. This has been the essence of Sainsbury's brand for 140 years and has relevance in all economic environments. Today our marketing campaigns are based around three themes. 'Shop and Save' provides customers with competitive pricing and a range of promotions. 'Switch and Save' highlights the quality and value of Sainsbury's own-brand products at significantly lower prices than equivalent leading brands and 'Cook and Save' helps customers make their household budgets stretch further with initiatives such as 'Feed your Family for a Fiver' and 'Love your Leftovers'.

Customers increasingly compare and contrast the offer available in different supermarkets, and are recognising the value they get at Sainsbury's. While further improvements to customer service and product availability have been achieved, of all the measurements tracked on a regular basis over the past 12 months, our price perception metric has seen the biggest improvement.

The entry level 'basics' range was extended during the year and now comprises over 650 products. A wider 'basics' products range was also made available in a greater number of stores across our estate. 'Basics' provides a compelling part of Sainsbury's own-brand range and is a clear way to save money when considerations such as size, shape or product appearance are not a primary concern. New products continue to be added to the range. Around two-thirds of the items are under £1 and over 200 are under 50 pence. Around 70 per cent of our customers now buy into the range helping to make 'basics' the Company's fastest growing sub-brand over the year. In the final quarter of the year sales were up over 60 per cent year-on-year.

Strong marketing campaigns have played a key role in showing customers that Sainsbury's understands the challenges they are facing and has solutions to help them. In October 2008 the Institute of Grocery Distribution presented us with its 'Award for Consumer Understanding' for delivering innovative and appropriate solutions for customers. In particular it acknowledged our 'Feed Your Family for a Fiver' campaign, launched in March 2008, which recognised the increasing trend towards cooking more from scratch and eating at home.

The campaign has been incredibly successful and customers also believe they have a better, healthier diet when cooking meals at home themselves. The campaign helps customers save money with simple meal ideas for a family of four, for £5 or under.

### Operations and cost efficiency

We have made significant progress in improving our operational efficiency as a result of the MSGA recovery plan. Major projects were completed to improve the performance of our supply chain and information technology infrastructure and there was significant investment to realign the customer offer. Ongoing operational improvements now ensure we continue to do a great job for customers in terms of product availability and service and are also delivering cost savings.

During the year, cost efficiency programmes have offset over 75 per cent of total cost inflation. Cost inflation was at the top end of our medium-term expectations of between two and three per cent and largely driven by increases in wages, property and energy costs despite hedging to help smooth the impact of the latter area of expenditure.

Efficiency programmes are focused on continued simplification of operations to deliver better processes and lower costs. Initiatives across all areas of our business are supporting sustained investment in the customer offer. New checkout equipment means faster scanning of items and new printers producing double-sided receipts are quicker and also provide environmental benefits. Over 100 stores now have self-scan tills providing customers with a choice of check-out options and this year we plan to roll-out self-scan tills to around 100 additional stores. Shelf-ready packaging continues to improve replenishment and further enhancements to store labour scheduling have been completed.

In August 2008 Sainsbury's opened its flagship 'green' store in Dartmouth, Devon. This has reduced its overall CO<sub>2</sub> emissions by 54 per cent through the use of renewable energy and has reduced energy consumed from the national grid by over 50 per cent. Rainwater harvesting has reduced mains water usage by 60 per cent saving around one million litres of mains water every year. Most of the energy-saving features identified in Dartmouth are now being replicated in new stores.

A project was launched in 2007 to further improve the energy efficiency of existing stores. This comprised the roll-out of new technology and enhanced 'housekeeping' initiatives and is delivering good pay-back. Over 200 stores have been completed, saving over 53,000 tonnes of CO<sub>2</sub> every year as a result. Stock loss has also been reduced through investment in security, management information and training and further improvements have been made in product availability.

During 2008 we redefined the role of deputy store managers eliminating duplicated activities and setting out new accountabilities and reporting lines. Comprehensive training is supporting the change so that we continue to grow while maintaining our customer focus and flexibility. The store HR structure has also been streamlined following the introduction of a shared HR service centre in Manchester in 2008. The centre assumes some administrative tasks previously undertaken within store and provides an online recruitment service allowing store HR colleagues to focus more time on mentoring, training and leadership.

In January 2009 we announced plans to restructure our store support centre in London, cutting out duplication of activities and simplifying structures across our Holborn, Manchester and Coventry support teams, aligning them for the future growth of the business. The new structures were in place by the start of the 2009/10 financial year.

There have been significant improvements within the distribution network which are delivering cost savings. The introduction of a new transport management system and processes are helping improve overall supply chain efficiency, reducing the requirement for temporary facilities at peak trading periods, and the benefits of investments made in the previous financial year are now coming through in lower costs. Our Waltham Point depot has now been reconfigured and new facilities have been opened in North Yorkshire and Kent to support our ongoing growth. To keep pace with the development of non-food, distribution of these ranges has transferred to a 350,000 sq ft site at Tamworth. Our depot in Corby, Northamptonshire, is currently undergoing refurbishment and will support the online non-food operation.

The full-year benefit of many of the initiatives to improve operations and drive cost efficiency will continue to come through in the current year and similar programmes are being introduced on an ongoing basis.

### Strong financial position

Sainsbury's balance sheet is well supported by significant property assets and long-dated debt. Retaining ownership of appropriate property assets is an important part of the Company's strategy and the estimated market value of these assets at the year-end was circa £7.5 billion, including the share of joint venture properties. In March 2006, Sainsbury's refinanced its debt book with low-cost long-term property-backed finance. The Company does not require any significant refinancing until 2018 and in addition to this funding has undrawn committed facilities which allows flexibility for working capital management and investment flows.

### Great food at fair prices

Great food at fair prices is integral to our approach to innovating and leading on ingredient standards and product quality while also offering competitive

prices. This month Sainsbury's celebrates its 140th anniversary. The 'Quality perfect, prices lower' strapline was on the front of the first store and has remained a guiding principle throughout Sainsbury's history. The first store stocked just butter, eggs and milk but provided these at a time when affordable quality food was scarce.

The Company pioneered the introduction of own-label lines in 1882 and our extensive heritage provides customers today with a unique proposition in Sainsbury's own-brand products. Over the years we have led the way on ingredient standards and product innovation and the quality of Sainsbury's own-brand products is widely recognised. Red Label tea is the oldest own-brand product still sold today and became Fairtrade in 2007. Customers have increasingly looked to own-brand products during the year to help them save money and they have unrivalled trust in Sainsbury's own-brand products.

Within our own-brand product ranges three tiers defined as 'good, better, best' are offered via the 'basics', standard Sainsbury's and 'Taste the difference' sub-brands. All tiers must adhere to Sainsbury's stringent policies concerning ingredients and sourcing so customers can be confident of the Company's attention to quality while ensuring products are tasty and as healthy as they can be. Sainsbury's front of pack multiple traffic light nutritional labelling is also applied to all relevant products, including 'basics', to help customers make easy, healthy and affordable choices at a glance. Sainsbury's has been advocating and supporting the use of colour and guideline daily amounts for four years as recommended by the Food Standard Agency, after extensive research, in April 2009.

Our attention to quality within own-brand product ranges is supported by competitive pricing. Prices are constantly benchmarked against key competitors. Over £450 million was invested during our MSGA programme and investment is ongoing. Promotions also play an important role in helping to reduce a customer's overall spend on everyday items. In April 2008 we refocused our promotional programme with simple, more family-oriented deals. New point-of-sale materials changed the look and feel of stores highlighting key offers to customers and a number of market-leading promotions were run over the year.

Advertising campaigns communicating value and quality have helped customers save money without compromising quality. 'Feed your Family for a Fiver', one of our most successful campaigns, uses a mix of 'Taste the difference', standard and 'basics' products in meal ideas. It helps customers manage tighter budgets as they make their own choices to substitute individual ingredients to get significantly below the £5 threshold or add more premium products if they wish.

In September 2008, we relaunched our standard own-brand range, which accounts for over 40 per cent of sales, with our 'Switch and Save' campaign. This offered savings of at least 20 per cent when selecting Sainsbury's equivalent product over the leading brand and followed a comprehensive appraisal and development programme for the top 200 products. In January the campaign focused on 'basics'. Growth during the four-week campaign was up nearly 80 per cent year-on-year. All these activities have significantly improved customers' price perception of Sainsbury's.

'Taste the difference' remains an important part of the product offer. In the current economic environment the range allows 'savvy shoppers' to make conscious decisions about the quality they want for different ingredients and meal occasions. In particular 'Taste the difference' ready meals are fulfilling a trend towards customers treating themselves at home rather than eating out or buying more expensive takeaways to eat at home.

Sainsbury's is committed to sourcing British products and we converted a number of own-brand ranges such as sandwiches and chilled ready meals to 100 per cent British during the year, with the exception of products used for authenticity reasons. We have also continued to innovate. 'Milk in a Bag' reduced packaging by 75 per cent compared to the two-pint plastic bottle and is now available in 126 stores. We also secured the first shipment into the UK of responsibly sourced palm oil ("RSPO") and have converted our entire frozen fish range to RSPO certified.

We strive to further animal husbandry standards and introduced a range of higher welfare meat, fish and poultry products during the year. In June 2008 we launched responsibly-sourced fresh and smoked salmon, and in September 2008 a new range of Freedom Food endorsed outdoor-bred pork was introduced and Freedom Food approval was granted for farms supplying 'Taste the difference' outdoor reared pork. In August 2008 we launched indoor-reared Freedom Food accredited chicken and in January 2009 'Taste the difference' Woodland Chicken. All birds are reared in a natural woodland environment and the range is independently audited to RSPCA-approved standards. Sales of RSPCA Freedom Food chicken are up 130 per cent year-on-year.

In February 2009 we became the first major retailer to stop selling eggs laid by battery hens. Two pence from every Woodland chicken and box of Woodland eggs sold is paid to Woodland producers to help promote sustainable free-range farming. Over £300,000 has already been donated to the Woodland Trust via this initiative. Sainsbury's was awarded the 2008 Compassion in World Farming Good Egg Award, the second year in a row, for our work in this area.

## Accelerating the growth of complementary non-food ranges and services

Food remains at the heart of Sainsbury's proposition but non-food ranges complement our core food offer and are now a significant business in their own right. There has been good growth in home and lifestyle and core ranges and the star performer remains Sainsbury's TU clothing range. As household budgets tighten, there are signs that customers are increasingly appreciating the value offered by supermarket non-food product ranges and choosing them over other specialist retailers. Sainsbury's brand values are just as relevant in non-food products as in food. Products follow the same principles of quality, value and innovation and the 'good, better, best' hierarchy.

The TU clothing brand, launched in 2004, is the most established part of our non-food offer. The infrastructure supporting TU is now well developed and in-house designers focus on quality and value while tracking the latest developments in fashion and clothing technology. Fairtrade T-shirts are the biggest selling volume line with over two million T-shirts sold in the last year and over 40 per cent of customers have bought a TU item over the past year, an increase of around 20 per cent. TU was introduced into a further 20 stores during the year and is now in 290 stores. However, less than a third of these stores carry an extensive range showing the sales potential increased space will deliver.

Other elements of Sainsbury's non-food range are in earlier stages of development. In April 2008, the TU brand was transferred to our standard home and lifestyle product range as 'TU home' launched in two stores. The full range comprises over 2,000 kitchen and home products. The majority of stores now carry varying elements of the range, which is performing well. New stores, particularly those over 50,000 sq ft, now offer customers comprehensive non-food ranges. In April 2008, Sydenham in Kent became our largest store at 87,000 sq ft and in November, the first two-floor store opened in Hayes in Middlesex where 13,000 sq ft of TU clothing is situated above TU home and lifestyle ranges.

Our non-food business is now being run by Luke Jensen, previously Sainsbury's strategy director, who was appointed to the new role of managing director for non-food in January 2009. The non-food operation is now fully established in our Non-Food Support Centre in Coventry where around 450 colleagues provide the support and infrastructure required for this area of the business. There is significant opportunity and potential for the growth of non-food ranges as systems and support services such as information technology and logistics are developed for the individual specialist areas. New stores are providing additional



sales area for the non-food products and wider ranges are being introduced as stores are extended. The importance and potential of our non-food business is demonstrated by half of our new space being allocated to non-food.

The performance of Sainsbury's Bank continues to improve. Our 50 per cent share of post-tax profit for our joint venture financial services operation is £4 million for 2008/09 (£3 million loss in 2007/08). The continued investment in product development and customer acquisition is focused on insurance products, savings and credit cards. The steps taken during the MSGA programme to stabilise Sainsbury's Bank have resulted in a tight focus on cost control, tighter risk management and a concentration on commission-based products and growing savings accounts to deliver multiple income streams. This has continued to enable Sainsbury's Bank to make good progress and maintain a strong and well capitalised balance sheet.

### Reaching more customers through additional channels

Our online food home delivery service continues to grow. Ongoing improvement to the service continues to deliver efficiencies and sales increased by over 25 per cent year-on-year through both customer retention and attracting new shoppers to the service. The operation is now annualising as a £500 million business and delivers over 100,000 orders a week. The service is available to 88 per cent of UK households. Over the year an additional 22 stores started running the service taking the total number to 169 stores. We believe there is significant growth potential in our online operation and plan to increase capacity in areas of high demand.

### Non-food online

As previously announced, we are planning to complement our in-store non-food offer with a service providing non-food products online. This is on schedule to launch in the first half of 2009/10 and will provide customers with the choice of a range of Sainsbury's own-brand and branded non-food products.

### Convenience stores

Convenience is a key part of our strategy and we believe there is potential to expand our presence in this market as our service and product offer is well received in convenience locations, where we complement and operate successfully alongside local individual specialist stores. Significant improvements in operating performance have been achieved through the integration with our core supermarket business during 2008 and the disposal of 57 stores and one closure during the year which did not fit our convenience operating model.

Under the leadership of Dido Harding, who joined Sainsbury's operating board in March 2008, a review of the convenience business was undertaken

during the first half of the year. In November 2008, we announced plans to significantly accelerate the growth of our convenience operation. Sixteen convenience stores opened during the year and 50 new stores are planned in 2009/10. A further 100 are planned in 2010/11 and will continue at a similar level each year on an ongoing basis. We have been testing different approaches to the convenience market in five stores during the second half of the year. These have been developed from listening to customers and centre on two distinct shopping missions which characterise the convenience market; 'food on the move' and a 'local neighbourhood' mission. These are providing insight which will be part of the accelerated expansion of the convenience operation.

### Growing supermarket space

New space growth opportunities are being developed as part of the plans outlined in May 2007. Half the targeted new space growth is set to come from new stores with the balance from extensions. Total new space will be split equally across food and non-food ranges enabling the continued development of a great food offer via expanded food halls as well as growing total non-food space. Over the three years from March 2007 to March 2010, more than 12 per cent gross new space will have opened compared to the original plan for ten per cent growth, for the same planned capital expenditure of £2.5 billion and with a higher proportion of freehold ownership than originally expected.

During the year, 13 supermarkets opened, two of which were replacements and a further 13 were refurbished. Twenty-one were extended during the year bringing total extensions over the last three years to 54. Total gross new space was over four per cent comprising two per cent from new stores and two per cent from extensions. We successfully operate a range of store formats and we are now opening and extending existing sites to create stores over 80,000 sq ft. In October 2008, we opened our largest new store in eight years in Milton Keynes, Buckinghamshire. At 60,000 sq ft this store provides customers with a full range of food and non-food products. In November 2008 the Hayes, Middlesex store became our first store over two floors and our largest extension having more than doubled in size from 34,000 sq ft to 82,000 sq ft.

In 2009/10 we expect to achieve gross new space growth of over five per cent, including the acquisition of 24 stores from the Co-operative Group. These are an excellent addition to the Company's store portfolio being mainly in the west of England, Wales and Scotland where Sainsbury's is less well represented. An extra 500,000 customers will now have a Sainsbury's store within a ten-minute drive. Nineteen of these stores are expected to operate as supermarkets.

The environment for growing space is changing as opportunities to acquire land for development and new stores are becoming more available and at more attractive rates than in recent years. We have increased our hurdle rates for property investments and have also developed our ability to deliver larger, more cost-effective store extensions and lower-cost new stores. We will seek to take full advantage of the unique opportunities available at the current time to acquire land and existing sites while ensuring we maintain a broadly stable debt position. Capital plans are flexible and constantly reviewed to target expenditure for the best long-term returns.

### Active property management

We believe that ownership of our property assets enables us to retain operational flexibility while exploiting potential development opportunities and maximising value for shareholders. The proportion of freehold or long-leasehold property has increased and is now at 65 per cent, including half the space of 50 per cent owned joint venture properties. We have a significant portfolio of properties with development potential. In addition to 297 freehold and long leasehold properties, the majority of which can be extended, there are 43 properties within joint venture ("JV") arrangements.

Sainsbury's has two strategic property JVs. The first with Land Securities, formed in November 2007, brings together undeveloped properties and development expertise. One property was added to the JV during the year and it now comprises five properties planned for future mixed use development. In March 2008, we created a JV with British Land to unlock the significant opportunity to develop a number of our most important stores and deliver an improved customer offer. The JV comprises 38 Sainsbury's supermarkets with 25 earmarked for development. One year on, of these 25, two extensions adding 30,000 sq ft have already been completed and ten further projects are now going through the planning consent process. These will deliver around 260,000 sq ft of additional space in the next few years. We will benefit from the enhanced trading performance of the extensions as well as retaining a share of the increased property value.

The strategy is broadly cash neutral with mature assets sold to fund development opportunities. During the year a number of key leasehold sites, in addition to the 38 sites within the British Land JV, have been acquired for development at a total investment cost of £392 million. This investment was funded by the disposal of mature assets through sales and leaseback transactions (including eight supermarkets) for £393 million resulting in a profit of £57 million.

### Corporate responsibility

With over 18 million customers each week, Sainsbury's has a real impact on UK consumers. Five principles underpin activities. As a leading

food retailer we focus on being the 'best for food and health' which is why we are committed to 'sourcing with integrity'. Because we source from all over the world and sell in the UK we have to show 'respect for our environment' and play an active role in the communities we serve 'making a positive difference to our community'. All this is possible through the commitment of our colleagues so that Sainsbury's is 'a great place to work'.

A more comprehensive account of our approach to corporate responsibility can be found on pages 12-15.

### Succession planning for role of Chairman

Led by senior independent director John McAdam, the Company is currently conducting a search for a new chairman and will announce the outcome of this process in due course.

### Competition Commission ("CC")

We welcomed the CC's finding in its report published in 2008 that the UK groceries market is 'delivering a good deal for consumers'. This is consistent with the significant improvements our customers have experienced in product quality, availability, service and price over recent years. We are playing a full part in continuing discussions with the CC and other parties, to ensure remedies are implemented in the most effective and efficient way to maintain choice and value for UK consumers. In April 2009, the CC published its formal undertaking for the appointment of an Ombudsman. We continue to believe the creation of this new role to undertake investigations and arbitrate disputes between suppliers and grocery retailers will introduce additional, unnecessary bureaucracy and cost, will increase the burden and disruption to retailers and will not be in the best interests of consumers.

### Office of Fair Trading ("OFT")

In April 2008 the OFT started an investigation involving suppliers and supermarkets including Sainsbury's on the basis that it had reasonable grounds to suspect co-ordination of retail prices. Sainsbury's has strict guidelines for compliance with competition law and is co-operating with the OFT in these enquiries.

### Outlook

Sainsbury's is performing well and has identified significant opportunities for future growth in all its five areas of focus. Our progress in the past four years has made us a stronger business and we now serve over 18 million customers a week with great product at fair prices. Sainsbury's universal appeal gives customers the flexibility to change what they buy rather than where they shop, helping them offset the current constraints on household budgets. We expect the current economic environment to remain challenging but we are well positioned to continue our good progress.