

Questions and President and CEO Matti Halmesmäki's answers at Kesko's Q2/2014 media and analyst briefing on 22 July 2014

Janne Soisalon-Soininen, Taloussanomat:

How have the K-Menu products you launched in April been selling and what is their role in the performance of your food trade?

Matti Halmesmäki:

It's too early to say very much about their contribution to the overall performance, but they have been well received by customers. The launch was a right move, with respect to point of time and type of product family. Naturally, the products for the range are designed and chosen very carefully and the current selection is not very wide yet. The demand has been a surprise also to suppliers with whom we have had to negotiate how to ensure a sufficient supply. We see that the new product range is a good addition to the Pirkka range and well suited to the present situation. In the K-Menu range too, we aim at excellent quality coupled with value for money. When making price comparisons, the price-quality ratio should not be forgotten, because the quality within a branded range is not always consistent from one product to the other. The K-Menu range has got off to a very promising start and we will expand the selection. We are confident that customers who come looking for Pirkka products will also start choosing K-Menu products.

Paavo Rautio, Helsingin Sanomat:

How do you estimate the number of Kesko employees will change in the future in Finland? And how do you think the retail sector in general will be able to offer jobs to Finnish people?

MH:

Jobs in the trading sector are important in the sense that it's the sector that employs the most people, also the most young people and women and in areas with practically no other jobs. When I congratulated our new Prime Minister, I told him that I was pleased about the reinstated tax deductibility of representation and entertainment expenses. The tourist and restaurant industry is the only livelihood in many areas, providing employment to young people and women in particular. It's difficult to see any future increase in the number of jobs in the retail sector because e-commerce has taken its toll. Moreover, we'll have to carefully consider the services provided by the trading sector in order that physical stores are not used as "fitting rooms" in which we just provide the service and sales area. Naturally, we hope that Finnish consumers shop at physical stores in which service is our competitive advantage, also in terms of wide selections and service counters. I see no rapid changes ahead in the food trade, although price transparency and e-commerce are gaining ground there too. But in the home and speciality goods trade, in fact in all non-food trade, radical

changes can be expected to take place. It may well be that service oriented stores in the building and home improvement trade will continue to play a role in project customer relationships, because whole building sites cannot be put to competitive tendering or purchased online, because purchases are made as the project progresses and a reliable retailer is needed. A couple of years ago, when I chaired the Board of the Federation of Finnish Commerce, I said that that the trading sector employs more than 300,000 people and in the coming years, up to 10% of these jobs would be at risk. Without doubt, the transition of the trading sector, coupled with recession, has a strong impact on the employment situation.

PR:

The figures show an increase in the number of your personnel. Has it taken place in your foreign operations only?

MH:

There are always more jobs in retailing than in wholesaling. All of our Russian businesses are Kesko's own retailing and we have recruited employees for new stores also in the other countries, Lithuania and Belarus.

Sofia Holmlund, Hufvudstadsbladet:

Do you see department stores disappearing from downtown areas altogether in the future? Stockmann is in difficulties while Zalando is gaining ground, for example. How should Kesko respond to the challenge?

MH:

Good shopping centres will succeed, the relative proportion of online food trade will remain limited and within a limited geographical area, but nevertheless, it will grow and we want to have our share of it. Shopping centres driven by strong stores offering good brands and good accessibility will survive. Our shopping centre Veturi in Kouvola has increased its sales, but the figures for Lappeenranta, as a result of fewer visitors from Russia, have fallen. In other words, I wouldn't say it's a categorical development. The more purchases are made at online stores, Finnish or foreign, the more it tightens the competition and affects physical stores. Another factor is price transparency: shopping centres have high lease payments, staff costs, car park costs, maintenance costs etc. which must be included in prices. In comparison, e-commerce involves high numbers of product returns, and there are also the logistics costs. And recently, there have been lots of disappointed customers who have returned products and realised that they would have to pay VAT and customs duties on them. I have understood that the Customs are now taking a more serious attitude to consumers' grey imports, and I believe Finnish consumers want to do things right, so that in the end, the Finnish online stores could gain a certain competitive advantage. We are well aware of the transition taking place in the trading sector, as e-commerce benefits from

the possibility of price comparisons and automated logistics. In 2009, e-commerce with electronic operating systems was included in Kesko's strategy and since then, we have reported on their development. But while taking account of competitors' actions and changes in customers' shopping behaviour we should be implementing changes more rapidly than we have been able to do.

Minna Pantzar, Ylen TV-uutiset:

You said that enhancement measures must continue. You have already cut costs, reduced personnel, closed properties etc. What will happen next?

MH:

The situation is different in our different divisions which operate as very independent profit centres in a variety of different product lines. But perhaps the most radical enhancement project will now be implemented in the support functions that are not directly visible to customers. For example, functions are combined in shared service centres for improved efficiency. We must examine every line of expenses, unit by unit and make analyses. At first, some unit will argue that no more savings can be achieved. But sooner or later, when there is will, there is a way. Another important thing is the efficiency of stores' selling areas especially because Kesko's balance sheet is heavy with store properties. Modification of product selections is one way. But in K-citymarkets, for example, the space allocated to home and speciality goods is relatively limited compared to food products. That's the reason why K-citymarket's financial performance is in the black. At the same time, we have to develop our IT systems, which requires a variety of competences. In other words, we have to speed up and slow down at the same time, which is not very simple. We have a certain expense ratio for everything, which at Kesko level is about 19%. It has not changed to any material extent although there have been difficulties with sales. In addition, it seems that Kesko is a very welcome tenant in these days. Many firms are having difficulties with their long-term lease payment capacity. It's possible for a reliable leaseholder like Kesko to lease premises at lower rents compared to competitors. And it's quite right. In fact, lessors haven't always taken this risk factor into account. Recession is a good thing in the sense that suppliers, lessors and service producers incur credit losses and Kesko, being an operator with good solvency, may benefit from it. The situation is not easy; it would be much more simple to recruit more people and open new stores than control costs to ensure a good business result.

Heikki Arola, Helsingin Sanomat:

You have lowered your target for net sales in Russia. You also aim at a positive business result by 2017. Could you specify the meaning of 'a positive business result'? Do you also need to lower your target for EBIT?

MH:

The operating profit of the building and home improvement trade for 2013 in Russia was positive. The number of old stores is big. In Finland, it takes around three years for a new store to achieve profitability. In the food trade, profitability requires a certain volume. We have calculated that in Russia, we need a store network with sales of €500 million in order to cover the fixed costs. As long as the local establishing organisation is as big as the commercial organisation, profit making is difficult. The stores now open are slightly ahead of the target and three more new stores will be opened by the end of the year. It will be a major effort in the recruitment of personnel and in terms of marketing and building costs - a heavy burden for a small unit. The loss is included in Kesko Food's result. As the number of old stores grows, the loss will stop increasing within next year and start decreasing. The building and home improvement trade has exceeded this milestone. K-rauta stores like those in Finland attract customers, whereas the old small ones in downtown areas have been losing sales, which is why they have to be redeveloped. That is not so significant, because they are individual stores. All in all, we see that Russia is a natural direction for growth, its retail market will grow in the long-term. It is to be hoped that a more serious political risk will not be involved. We are keeping an eye on the situation, both in the retail and the property market.

Janne Soisalon-Soininen, Taloussanomat:

What is the contribution of Russian operations to the Group's operations as a whole? And now that it is possible that more sanctions are imposed on Russia, do you think that Kesko would be forced to reconsider its capital expenditure plans for Russia?

MH:

Naturally, we operate in a responsible manner and with a long-term perspective. Panic reactions must be avoided, but it is difficult to say in this kind of situation without precedence. We have seen that inside Russia, the administration is firm and their national self-esteem is high. The national opinion is that Putin has acted like he should and we have actually had to say to our Russian directors that his actions cannot be simply ignored. Inside a nation with a relatively short history of democratic development, political risks are also involved. After the collapse of the Soviet Union, the nation has remained surprisingly united without significant internal crises. We have a lot of local sourcing in Russia, but Russians value Finnish foods very highly and Pirkka products are added to the selections. Concerning these, there may be some restrictions or delays at the border, but nothing so far. Russian operations contribute 3% to the Group's operations.

Pekka Leiviskä, Kauppalehti:

What are your plans for your home and speciality goods trade as a whole: will you let it die out little by little or abandon it to competitors?

MH:

The department store trade has been undergoing a global crisis which has lasted for 20 years. Very few operators have survived. Anttila had a good period in the first years of the 21st century. Its strongest product lines, music and films, have now almost completely gone online, where Anttila has strengthened its market share. And home electronics is another product line which has experienced a major change. Indoor is doing very well and the change is not being felt so strongly at Kodin1. But change is needed in the two-floor department stores in downtown locations. One good thing is that all Anttila department stores operate in leased properties on short-term leases. Major changes are planned for selections and the brand, which will not be easy to put into practice. One advantage is perhaps the most modern online store operating system in Europe in the automated warehouse in Kerava. The kind of online trade of food or non-food in which you have store costs, orders are picked at store, goods are delivered to customers, customers return goods is no business. It can be a good service business but e-commerce cannot be based on it. Profitable online stores will be more or less in the order of so-called dark stores where goods are picked and packaged and delivered in an automated system, which saves store staff costs and rents, transport and shelving. But we are undergoing a period of transition, because volume is a prerequisite for an automated online store system. Our Kerava warehouse is very modern indeed including an automated picking for department stores, wholesale warehouse operations and individualised picking. I see this transition period also as an opportunity but for many operators, it will be difficult in many ways. It doesn't matter how good a visionary or an expert an operator of a store network is, he will have to bear the costs keeping the space empty or trying to make good use of it. There are matters of will but there is also the reality, albeit different for different companies.

In case there are no more comments or questions, we'll meet again after three months at the latest. Hopefully we have as good news as today. Like I said, we are satisfied with the Q2 results. Thank you!