Financial review

> Our business model remains unchanged and our balance sheet remains robust on the adoption of IFRS 16 next year.

John Bason
Finance Director

Group performance

Group revenue increased by 2% to £15.8bn and adjusted operating profit was 1% higher at £1,421m. In calculating adjusted operating profit, the amortisation charge on non-operating intangibles, profits or losses on disposal of non-current assets, transaction costs, amortisation of acquired inventory fair value adjustments and exceptional items are excluded.

The income statement includes exceptional items of £79m this year. Following the termination of our largest private label bread contract in December 2018, the carrying value of the assets of the Allied Bakeries business was no longer supported by our forecasts of its discounted future cash flows and a non-cash impairment charge of £65m has been recognised. Following a High Court ruling regarding the equalisation of Guaranteed Minimum Pensions in October 2018, a pension service cost of £14m has been taken for members of the company's defined benefit pension scheme for service between 1990 and 1997. On an unadjusted basis, operating profit was 5% lower than last year at £1,282m.

The weakening of sterling this year, particularly against the US dollar, resulted in a translation benefit of £9m. The movement in the US dollar exchange rate has a transactional effect on Primark's largely dollar-denominated purchases but taken for the year as a whole the effect was broadly neutral, with a favourable effect in the first half offsetting a negative effect in the second half.

Next year we expect the weakness of sterling during this financial year to have a negative transactional effect on the Primark margin in the first half but, at current exchange rates, a minimal effect in the second half.

Net finance expense reduced from last year following the maturity of $310m of private placement senior notes in March and lower debt in high interest markets. The increase in other financial income reflected the increase in the surplus of our defined benefit pension schemes between the 2017 and 2018 year ends.

Losses on disposal of businesses were £94m, higher than last year, and mainly comprised an impairment charge to the assets of AB Mauri's businesses in China which are affected by the formation of the proposed joint venture with Wilmar International, described in further detail below. Taking this into account, statutory profit before tax was down 8% to £1,173m. On our adjusted basis, which excludes these items, profit before tax rose by 2% to £1,406m.

Acquisitions and disposals

In September 2018 we acquired Yumi's, an Australian producer of premium chilled dips and snacks. AB Agri acquired a small manufacturer of piglet starter feed based in Poland. Our Ingredients business disposed of its underutilised torula yeast facility in Hutchinson, Minnesota and acquired Italmill, a supplier of specialist bakery ingredients based in the north of Italy. On 6 September 2019 ACH in the US acquired Anthony's Goods, a California-based blender and online marketer of speciality baking ingredients.

In August we signed an agreement to form a yeast and bakery ingredients joint venture in China with Wilmar International, with completion subject to regulatory approval. The joint venture will see us build a major new low-cost yeast plant in the north east of China and will combine AB Mauri's existing commercial activities and technical expertise in China with Wilmar's extensive sales and distribution capability. As a consequence, a non-cash impairment charge of £88m against AB Mauri's assets in China has been included in losses on closure of businesses in the income statement.

Taxation

We recognise the importance of complying fully with all applicable tax laws as well as paying and collecting the right amount of tax in every country in which the group operates. Our board-adopted tax strategy is based on seven tax principles that are embedded in the financial and non-financial processes and controls of the group. This tax strategy is available on the group's website at: www.abf.co.uk/documents/pdfs/policies/abf_tax_strategy.pdf.

This year's tax charge on the adjusted profit before tax was £302m at an effective rate of 21.5% (2018 – 21.3%). We expect next year's adjusted effective tax rate to increase slightly from this level.

The total tax charge for the year of £277m benefited from a credit of £25m (2018 – £35m) for tax relief on the amortisation on non-operating intangible assets, amortisation of acquired inventory fair value adjustments, profits on disposal of non-current assets, losses on disposal of businesses and exceptional items.

Earnings and dividends

Earnings attributable to equity shareholders in the current year were £878m and the weighted average number of shares in issue during the year, which is used to calculate earnings per share, was 790 million (2018 – 790 million). Given the loss on closure of businesses and exceptional items charged this year, earnings per ordinary share were 13% lower than last year at 111.1p. Adjusted earnings per share, which provides a more consistent measure of trading performance, increased by 2% from 134.9p to 137.5p.

The interim dividend was increased by 3% to 12.05p and a final dividend has been proposed at 34.3p which represents an overall increase of 3% for the year. The proposed final dividend is expected to cost £271m and will be charged next year. Dividend cover, on an adjusted basis, remained at 3.0 times.

Balance sheet

Non-current assets of £8.2bn were £0.2bn lower than last year driven by a decrease in employee benefits assets as the surplus in the UK defined benefit pension scheme declined. The investment in property, plant and equipment and intangible assets was in line with last year, with capital expenditure and acquisitions made in the year offset by depreciation and impairments.

Average working capital as a percentage of sales increased from 7.2% last year to 7.8% this year, while working capital at the year end was also higher than last year due principally to higher inventories at Primark. Net cash at the year end was £936m compared with net cash at the end of last year of £614m reflecting the strong operating cash flow in the year.

The group's net assets increased by £0.3bn to £9.6bn. Return on capital employed for the group which is calculated by expressing adjusted operating profit as a percentage of the average capital employed for the year, was lower this year at 19.3% compared with 20.1% last year, mainly driven by the reduction in the return on capital at AB Sugar.

Cash flow

Net cash inflow from operating activities increased slightly to £1,509m. Capital expenditure reduced compared to the prior year with lower spend at Primark this year reflecting the planned later phasing of next year's store openings and the consequent timing of store fit out costs, while lower spend in the food businesses followed the recent completion of some major capital projects. £12m was realised from the sale of property, plant and equipment. The net cash outlay on acquisitions was £100m, including debt assumed, and related principally to the acquisitions of Yumi's and Anthony's Goods.

Tax paid in the year amounted to £269m. Generally in the UK, 50% of the corporation tax due in respect of an accounting period is payable in that period with the remaining 50% being paid in the following accounting period. Changes made by HMRC which come into effect next year will result in all of the tax due for a financial year being paid in that financial year. Accordingly, the group's tax cash outflow in 2020 will be higher than 2019.

Financing

The financing of the group is managed by a central treasury department. The group has total committed borrowing facilities amounting to £1.6bn, which comprise: £0.3bn of US private placement notes maturing between 2021 and 2024, with an average fixed rate coupon of 4.4%; £1.2bn provided under a syndicated, revolving credit facility which matures in July 2021; and £0.1bn of local committed facilities in Africa. At the year end, £412m was drawn down under these committed facilities. The group also had access to £564m of uncommitted credit lines under which £162m was drawn at the year end. Cash and cash equivalents totalled £1.5bn at the year end.

Pensions

The group's defined benefit pension schemes were in surplus by £33m at the year end compared with a surplus last year of £435m. The UK scheme accounts for 91% of the group's gross pension assets. The decline in long-term UK bond yields during the year, which are used to value defined benefit pension obligations for accounting purposes, had a material impact on the discounted value of pension liabilities. The lower pension surplus will result in reduced interest income next year in respect of defined benefit pensions, and is reported in other financial income.

The most recent triennial valuation of the UK scheme was undertaken as at 5 April 2017 which determined a surplus of £176m on a funding basis. As a result there is no requirement to agree a recovery plan with the trustees.

The charge for the year for the group's defined contribution schemes, which was equal to the contributions made, amounted to £80m (2018 – £77m). This compared with the cash contribution to the defined benefit schemes of £50m (2018 – £39m).

New accounting standards

The accounting policies applied during this financial year, and details of the impact of adoption of new accounting standards in future financial years, are set out in the Significant accounting policies.

During this financial year we adopted IFRS 9 *Financial Instruments* and IFRS 15 *Revenue from Contracts with Customers* with no material impact arising on adoption. On transition, comparatives were not restated. Under IFRS 15, Grocery revenues would have reduced by £31m last year as certain payments to customers which were previously expensed as incurred would instead have been deducted from revenue. This reduction represents 0.9% of revenue in the Grocery segment and would have had the effect of increasing Grocery operating margin by 8 basis points last year. This had no effect on the timing or amount of operating profit.

IFRS 16 *Leases*

The group will adopt IFRS 16 *Leases* in the 2020 financial year, which is the most significant accounting change for our group for many years. It affects many aspects of the group's financial statements, including operating profit, earnings per share and net debt, as well as return on capital employed.

The effects of adopting IFRS 16 at our transition date of 15 September 2019 are set out in the Significant accounting policies section. We will recognise lease liabilities at transition of £3.6bn and right-of-use assets of £3.1bn.

The vast majority of the lease liabilities relate to Primark's leasehold store estate. The effect on our food businesses, where many of our properties are owned under freeholds, is much less significant.

We will transition using the 'modified retrospective' approach, under which the comparative period is not restated. We have set out below our estimates of selected 2019 financial information, on a pro forma IFRS 16 basis, in order to illustrate the effects on the income statement and key metrics for Primark.

Effects on the group financial statements and metrics:

- The balance sheet would have shown net debt of £2.7bn.
- Gearing (expressed as debt as a proportion of debt plus equity) would have been 31% at the balance sheet date.
- Adjusted operating profit would have increased by £64m, with rental expense replaced by depreciation of right-of-use assets.
- Interest expense would have increased by £90m of interest charged on lease liabilities.
- Interest cover would have been 14 times.
- Adjusted profit before tax would have reduced by £26m.
- Adjusted earnings per share would have reduced by 2% from 137.5p to 134.8p.

There is no change to overall net cash flows and while this is a significant change in financial reporting, our business model remains unchanged and our balance sheet remains robust.

Effects on Primark metrics:

- Primark's margin would have increased from 11.7% to 12.5% due to higher adjusted operating profit, with store rental expense replaced with a depreciation charge on right-of-use assets.
- Primark's return on capital employed would have decreased from 29% to 15%, as right-of-use assets are now included in capital employed.

John Bason
Finance Director