Rigorous cost and capital discipline

Rachel Osborne
Chief Financial Officer

SEGMENTAL PERFORMANCE

UK

Gross transaction value (GTV) for the UK segment decreased by 2.7% to £2,287.3 million and reported revenue decreased by 3.2% to £1,832.7 million. The GTV decline was a result of a volatile and highly competitive market throughout the year, exacerbated by weak consumer confidence, particularly seen through weaker demand in areas of more discretionary spend. Despite the difficult backdrop, we have made progress in our destination categories, in particular UK growth in food categories over last year of c10%. In addition our UK digital growth of 10.0% grew ahead of the online market.

EBITDA before exceptional charges decreased by 35.6% to £112.0 million as a result of the sales decline and additional markdown required to maintain competitive pricing and market position. The impact of markdown on margin was similar across the first and second half. Operating profit before exceptional costs for the year, after increased depreciation costs arising from increased capital investment in our Debenhams Redesigned strategy, decreased by 88.5% to £8.5 million.

International

In the International segment, gross transaction value of £613.1 million was 1.5% higher than last year and reported revenue increased by 0.5% to £444.3 million. This has been driven by an improvement in performance from Magasin du Nord and the Republic of Ireland, both of which have benefited from strong digital growth. Sales in the franchise business fell 4.6% as a result of the net five closures (nine closures and four openings) as we continue to optimise the number of partners, and close some of the low growth categories.

EBITDA grew by 5.3% to £45.3 million, with operating profit increasing by 4.2% to £34.9 million as a result of the sales growth.

Financial summary

£m	52 weeks to 1 September 2018	52 weeks to 2 September 2017	% change
Gross transaction value[1,2]			
UK	2,287.3	2,350.0	(2.7)%
International	613.1	604.1	1.5%
Group	2,900.4	2,954.1	(1.8)%
Statutory revenue[1,2]			
UK	1,832.7	1,892.9	(3.2)%
International	444.3	442.1	0.5%
Group	2,277.0	2,335.0	(2.5)%
Group like-for-like sales movement[3]			(2.3)%
Group gross margin movement[4]			(140 bps)
EBITDA[1,5,6]			
UK	112.0	174.0	(35.6)%
International	45.3	43.0	5.3%
Group	157.3	217.0	(27.5)%
Operating profit[1,6]			
UK	8.5	74.0	(88.5)%
International	34.9	33.5	4.2%
Group	43.4	107.5	(59.6)%
Underlying profit before tax[6]	33.2	95.2	(65.1)%
Cash exceptional items[6]	(12.3)	(8.5)	
Non-cash exceptional items[6]	(512.4)	(27.7)	
Reported (loss)/profit before tax	(491.5)	59.0	
Underlying earnings per share[6]	2.2p	6.4p	
Basic (losses)/earnings per share	(37.5)p	4.0p	
Dividend per share	0.500p	3.425p	

	1 September 2018	2 September 2017
Net debt (£m)	321.3	275.9
Net debt: EBITDA (last 12 months)[6]	2.0x	1.3x

Notes to the above table and to all references in this statement:
1 UK operating segment comprises stores in the UK and digital sales to UK addresses. International operating segment comprises the international franchise stores, the owned stores in Denmark and the Republic of Ireland and digital sales to addresses outside the UK.
2 Gross transaction value (GTV): sales on a gross basis before adjusting for concessions, consignments and staff discounts. Statutory revenue: sales after adjusting for these items.
3 Like-for-like sales movement relates to sales from stores which have been open for more than 12 months plus digital sales.
4 Gross margin: GTV less the value of cost of goods sold, as a percentage of GTV.
5 EBITDA is earnings before interest, taxation, depreciation and amortisation.
6 Before exceptional items, comprising costs associated with the strategic review, warehouse restructuring, provisions for impairment losses and onerous lease commitments, write-off of intangible assets and the impairment of goodwill.

GROUP SALES AND PROFITS

Sales and revenue

Group gross transaction value decreased by 1.8% to £2,900.4 million and Group revenue decreased by 2.5% to £2,277.0 million. Group like-for-like sales decreased by 2.3% on a reported basis and 2.7% on a constant currency basis.

The constant currency like-for-like sales performance reflects the difficult market conditions in FY2018 with lower footfall and heavier discounting having impacted our overall sales. The shift to digital also continued, with Group like-for-like digital sales growth of 12.3% representing 18.3% of Group gross transaction value (FY2017: 16.0%).

The like-for-like sales decline of 2.3% is shown by segment below:

UK stores	(6.3)%	
UK digital	10.0%	
International	0.2%	
Like-for-like-sales – constant currency		(2.7)%
Exchange rate impact		0.4%
Like-for-like sales – reported		(2.3)%

Group own bought mix decreased from 72.4% in 2017 to 71.3% mainly as a result of the movement in the UK mix, with the sales growth from concessions, especially in food, increasing at a faster rate.

Operating profit

In addition to the effect of lower sales, Group margin rate has been significantly impacted by the additional markdown in response to competitive discounting and to ensure cleaner positions as we transition between seasons. This has resulted in a gross margin rate reduction of 140 bps year on year.

Operating costs before depreciation were well controlled and we delivered additional cost savings in the year to manage to an overall decrease of 0.2% on a reported basis and 0.5% excluding the impact of exchange rate. The decrease reflected our cost savings initiatives of an annualised c£20 million, which were delivered through reorganisation and restructuring activity both in stores and the support centres. Of this c£12 million were delivered in FY2018 with the remainder annualising in FY2019. We introduced a cost saving programme which we expect to deliver a further £30 million (£50 million annualised) in FY2019.

Depreciation and amortisation (including loss on disposal of assets and excluding exceptional items) increased by 4.0% to £113.9 million, reflecting investment in the Debenhams Redesigned strategy.

As a result of the above, Group operating profit before exceptional costs was £43.4 million, a decline of 59.6% year on year.

Net finance costs

Net finance costs decreased by 17.1% to £10.2 million benefiting from a £2.0 million pension valuation credit associated with the pension surplus in accordance with IAS 19 "Employee benefits" (FY2017: £nil).

Exceptional items

During FY2017, the Group announced a new strategy, Debenhams Redesigned, and embarked on a period of significant change, investment and innovation. However, H2 2018 was a period of volatility and change in the retail market as a whole. Debenhams was not insulated from these challenging trading conditions and as a result the business delivered substantially lower profits year on year. This has resulted in revised future growth projections.

Total exceptional costs before taxation recognised during the year in relation to the strategic review, restructuring and a revised outlook of future growth were £524.7 million (FY2017: £36.2 million). Of this charge £12.3 million had an in year cash impact. The remaining £512.4 million are non-cash items. The exceptional costs are detailed below:

£m	Cash in year	Non cash	Total
Strategic review & restructuring	3.1	10.5	13.6
Warehouse restructure	9.2	1.8	11.0
Store impairment & onerous leases	–	117.5	117.5
Goodwill impairment	–	302.1	302.1
Asset write-offs	–	80.5	80.5
Total exceptional costs	12.3	512.4	524.7

a) Strategic review and restructuring

Exceptional costs of £13.6 million were incurred as a result of transforming the business in line with the new Debenhams Redesigned strategy including redundancies (including some senior management within the trading division and the support centres), professional fees, and store closure costs.

b) Warehouse restructure

During FY2017 we announced the closure of the distribution centre at Northampton and certain regional warehousing facilities. During FY2018 costs of £11.0 million were recognised relating to one-off transition costs including staff time, and inventory moves.

c) Non cash impairment, onerous lease charges
As a result of the FY2018 store performance and reflecting revised future projections, stores at risk of becoming unprofitable over time, and other stores where anticipated future performance would not support the carrying value of assets, have been identified. The overall costs charged in the year were £117.5 million (FY2017: £10.4 million).

In addition, management have assessed whether the goodwill intangible asset, created when the Group was privatised in 2003, will continue to deliver economic benefit in the future. Given the pace of change in retail and our view of future growth rates, previous estimates of future economic benefit have been revised and reduced. As a result a non-cash impairment charge to goodwill has been made of £302.1 million (FY2017: £nil).

d) IT systems write-off
As a result of the simplification of the organisation and improved consistency in ways of working, a review of IT systems and ongoing projects was undertaken. As a result, the decision was taken to write off a number of previously-established projects with a value of £80.5 million.

Profit before tax
Profit before tax before exceptional items decreased by 65.1% to £33.2 million (FY2017: £95.2 million). Reported profit before tax after exceptional items decreased from £59.0 million profit in FY2017 to a £491.5 million loss in FY2018.

Taxation
Taxation excluding the impact of exceptional items decreased from £17.2 million last year to £5.3 million, principally due to a decrease in reported profits and a lower effective tax rate. The effective tax rate decreased from 18.1% in FY2017 to 16.0% in FY2018 due to a reduction in the headline corporation tax rate and the impact of prior period adjustments.

Profit after tax
Profit after tax but before exceptional items decreased by 64.2% to £27.9 million. Profit after tax after accounting for exceptional items was a loss of £460.2 million.

Share of loss of associate
On 5 September 2017, the Group acquired a stake in blow LTD for a cash consideration of £7.5 million. For the period from acquisition to 1 September 2018, the Group incurred a £0.8 million charge relating to the share of losses of blow LTD.

Earnings per share
Underlying basic and diluted earnings per share, before exceptional items, decreased by 65.6% to 2.2 pence. The basic weighted average number of shares in issue remained at 1,227.8 million and the diluted weighted average number of shares increased from 1,229.0 million to 1,231.9 million due to issued share options.

Dividends
An interim dividend of 0.500 pence per share was paid to shareholders on 6 July 2018 (FY2017: 1.025 pence), in respect of the 26 weeks ended 3 March 2018 which equated to £6.2 million of shareholders' funds (FY2017: £12.6 million).

The board has decided not to declare a final dividend in order to prioritise generating cash and reducing net debt (FY2017: 2.400 pence).

CASH FLOW, USES OF CASH AND MOVEMENT IN NET DEBT
Debenhams remains a cash generative business delivering free cash flow of £117.9 million in the year. This was a reduction from £159.9 million in FY2017 as a result of lower EBITDA and increased capital investment. Cash flow generation, the uses of cash and the movement in net debt are summarised below.

£m	52 weeks to 1 September 2018	52 weeks to 2 September 2017
Operating profit before exceptional costs	43.4	107.5
Depreciation, amortisation and loss on disposal	113.9	109.5
Working capital	1.8	(0.7)
Cash Inflow from Operations	159.1	216.3
Taxation	1.3	(16.3)
Financing	(11.0)	(11.1)
Non-discretionary capital spend	(31.5)	(29.0)
Free Cash Flow	117.9	159.9
Development capital spend	(112.0)	(95.8)
Dividends	(35.6)	(42.0)
Exceptional items	(14.5)	(15.9)
Other movements	(1.2)	(3.1)
Change in net debt	(45.4)	3.1
Opening net debt	275.9	279.0
Closing net debt	321.3	275.9

Capital expenditure

Total capital expenditure was £143.5 million during the year compared to £124.8 million last year, reflecting the increase in development investment in the store environment in the second half of the year. Looking ahead, we will reduce capital spend and expect it to be c£70 million for FY2019. This reflects a change in priorities toward generating cash and reducing net debt.

BALANCE SHEET

£m	1 September 2018	2 September 2017
Intangible assets (inc. goodwill)	619.4	991.9
Property, plant and equipment	603.7	654.9
Inventory	396.0	374.1
Other assets	123.5	108.7
Trade and other payables	(615.6)	(579.6)
Other liabilities	(447.1)	(398.7)
Retirement benefit surplus	159.4	80.9
Net deferred tax liabilities	(28.6)	(38.7)
Net debt	(321.3)	(275.9)
Reported net assets	489.4	917.6

Intangible assets

The balance has reduced by £372.5 million in the year to £619.4 million due to the goodwill impairment of £302.1m and the write-off of intangible systems assets of £80.5 million.

Property, plant and equipment

The year end balance of £603.7 million (£654.9 million FY2017) has been reduced by an exceptional store impairment charge of £55.8 million.

Inventory

Stock levels increased by 5.9% to £396.0 million, primarily due to the two new stores and early intake of autumn/winter stock in order to improve availability for the new season. FY2017 stock and trade creditor balances have been restated to include owned stock in transit yet to reach the UK, which was previously excluded from the stock numbers; the corresponding entry being made in trade creditors. This has no overall impact on the profits, working capital or cash flows of the Group. Refer to note 2 to the financial statements for further details.

Terminal stock levels reduced to 2.7% from 2.8% in FY2017, and remain in line with our historical range of 2.5% to 3.5%.

Net debt

The Group's net debt position as at 1 September 2018 of £321.3 million increased by £45.4 million from the same point last year (FY2017: £275.9 million). The ratio of net debt to EBITDA has increased to 2.0 times from 1.3 times at the end of the previous year, as a result of the fall in profits.

The Group's revolving credit facility (RCF) of £320 million is in place until June 2020, with an option to extend until June 2021. During the year, the Company made an amendment to its revolving credit facility to increase headroom on the fixed charge cover covenant. In addition, the Group has a £200 million 5.25% Senior Bond in place until July 2021.

With the actions we have taken to step up our cost savings programme, reduce medium-term capital investment and suspend dividends we are focused on building a robust and sustainable financial platform from which to grow.

Pensions

The Group provides a number of pension arrangements for its employees. These include the Debenhams Retirement Scheme (DRS) and the Debenhams Executive Pension Plan (DEPP) (together "the pension schemes") which both closed for future service accrual from 31 October 2006. On an accounting basis, the net surplus on the Group's pension schemes as at 1 September 2018 was £159.4 million (2 September 2017: £80.9 million). The surplus was due to both the continued success of the returns being made on the assets and reduction in liabilities within the schemes.

On 6 October 2017, the actuarial valuation of the Group's pension schemes at 31 March 2017 was completed, concluding that DEPP was fully funded on a technical provisions basis and on the same basis DRS had improved since the previous actuarial valuation but remained in deficit. Therefore the Group agreed a recovery plan for DRS which was intended to restore the scheme to a fully funded position on an ongoing basis. Under that agreement, the Group agreed to contribute £5.0 million per annum to the pension schemes for the period from 1 September 2017 to 31 March 2022.

The agreement replaced an agreement made in 2015 under which the Group agreed to contribute £9.5 million per annum to the pension schemes for the period from 1 April 2014 to 31 March 2022 increasing by the percentage increase in retail price index (RPI) over the year to the previous December. Additionally during October 2017, the Group agreed to continue to cover the non-investment expenses and levies of the pension schemes, including those payable to the Pension Protection Fund.

PRINCIPAL RISKS AND UNCERTAINTIES

Whilst the impact of the UK's decision to exit the European Union cannot yet be fully quantified, Debenhams has identified a number of existing risks that would be sensitive to Brexit. These risks continue to be monitored carefully, with appropriate levels of mitigating action being considered as more clarity on the potential transition and end states emerge.

In light of recent press speculation which has encouraged certain credit insurers to hasten the reduction of cover for some of our suppliers, we are working closely with those suppliers to secure stock flows, whilst continuing to manage our working capital tightly. As a result, we have included this risk in our usual going concern stress tests.

GOING CONCERN

The Group finances its operations through a combination of committed long-term borrowing facilities and committed term debt in the form of senior notes. The Group's long-term borrowing facilities are structured as a revolving credit facility syndicated across a group of eight lenders, totalling £320 million and expiring in June 2020. The Group's senior notes total a further £200 million expiring in July 2021. There are two principal financial covenants relating to the Group's debt. The first tests the ratio of net debt relative to Group EBITDA and the second assesses fixed charge cover. Given recent trading, the level of headroom on fixed charge cover reduced over the course of FY2018 and as such the Group successfully renegotiated the fixed charge cover covenant level in July 2018 thus significantly improving headroom against this covenant for the foreseeable future. The net debt to EBITDA covenant level was deemed to be appropriate relative to current and anticipated levels of headroom.

As part of the board's assessment of going concern and ongoing liquidity, forecasts were prepared for the 18 months to February 2020 in order to support the board's conclusions of the ability of the business to continue to operate as a going concern for at least the next 12 months. These forecasts included sensitivities relating to a variety of downside trading outcomes, which recognised the uncertain UK retail environment and allowed the board to assess the level of liquidity and covenant headroom in such scenarios. In addition to these trading scenarios, given the actions of certain credit insurers in recent months, the forecasts were further sensitised for a number of extreme working capital scenarios, which while not seen to date, reflect the theoretical impact on liquidity should the Group experience a sustained deterioration in trade associated working capital.

Having assessed the Group's liquidity outlook on the basis of the above projections and sensitivities, the board concluded that the Group would continue to have sufficient headroom to its committed borrowing facilities to ensure it can operate as a going concern for the next 12 months. For this reason the board concluded it could continue to adopt the going concern basis in preparing the financial statements.

Rachel Osborne
Chief Financial Officer
25 October 2018

VIABILITY STATEMENT

The aim of the Viability Statement is for the directors to assess the prospects of Debenhams to meet its liabilities, taking into account its current position and principal risks.

Debenhams has developed an annual three year strategic plan, which considers the Group's cash flows and other financial key performance indicators over this period. The three year strategic plan takes into consideration sensitivities that encompass a wide spectrum of potential outcomes including changes in like-for-like sales, margin rate, costs, capital expenditure forecasts and working capital movements.

These scenarios are designed to explore the resilience of Debenhams to the potential impact of the Principal risks set out on pages 32 to 34, or a combination of those risks. The directors paid particular attention to the following principal risks:

- Competition for customers
- Financial, Liquidity and Credit
- Economic environment; and
- Business strategy & transformation

The three year strategic plan is reviewed each year by the directors. Once approved by the board, the plan is cascaded across the business and provides the basis for setting strategic priorities and detailed budgets that are subsequently used by the board to monitor and evaluate performance.

The directors have assessed the viability of Debenhams over the three year period to 28 August 2021. This period has been selected because it reflects the pace of change in retail; uncertainty surrounding the UK's decision to exit the European Union; aligns with the Group's plans under its Debenhams Redesigned strategy and its three year planning process; and presents the board and the readers of the annual report with a reasonable degree of confidence whilst still providing an appropriate longer-term outlook.

The board is in agreement that Debenhams is a viable business and the viability statement can be found in the directors' report on page 78.

In making this statement the directors have considered the resilience of Debenhams, taking account of its current position and historical financial performance, the principal risks facing the business in severe but theoretical scenarios, and the effectiveness of any mitigating actions. This assessment has considered the potential impacts of these risks on the business model, future performance, solvency and liquidity over the period. In assessing these impacts, the directors also considered specific supplier risks in relation to credit insurance and the potential impact that working capital may be impacted by such risks.

As noted in note 22 of the financial statements on page 121, the Group's revolving credit facility is due to expire in June 2020 and its issued senior notes expire in July 2021. While recognizing the challenging retail environment will increase the risks and costs around the future refinance of these facilities, based on current market conditions the directors believe Debenhams has the appropriate plans and mitigations in place to maximize the prospects of a successful refinance of these facilities in advance of the 2020 and 2021 expiries.

The financial position of the Group, including information on cash flow, can be found in the financial review section on pages 35 to 40.

In addition, the financial statements include notes on finance costs page 111 and financial risk management including treasury policies on interest rate, liquidity, currency and credit risk pages 122 to 127.

STRATEGIC REPORT

The strategic report was approved by a duly authorised committee of the board of directors on 24 October 2018 and signed on its behalf by:

Sergio Bucher
Chief Executive Officer
25 October 2018