

President and CEO Matti Halmesmäki's answers to questions at Kesko's Q3/2012 media and analyst briefing on 24 October 2012

Nina Törnudd, STT: What kind of impacts do you expect the new competition law, now circulating for comments, to have on your operations?

MH: It is a very ambiguous law. I see that it has been prepared to serve political purposes, rather than based on an analysis of the actual situation, or the means by which changes are proposed to be made. The impacts are really impossible to see. In consequence of the ambiguity, there would be all kinds of complaints and official inquiries about whether some procedure in, let's say, competitive tendering of suppliers has been acceptable or not, because all suppliers must be given equal possibilities to be included in product selections. This is quite far from a competitive environment. But one effect is for sure: prices will go up. Drawing a line between an acceptable and an unacceptable procedure is really very difficult. We have been especially critical about the draft law, because it completely ignores the fact that retailers have a freedom of purchasing. If Kesko Food and a supplier are unable to reach an agreement, the supplier will sell the product directly to a retailer. In other words, Kesko Food does not use the authority granted by the retailers' combined 35.3% market share. What is more, within the EU, dominant position is considered to stand at 40%. Therefore, in practice, the proposed new competition law would only refer to the K-Group, and for us, it's difficult to see this draft law accepted, as I highly value Finnish legislation and the Finnish legal system. Nevertheless, I understand political pressures and the operating model, typical of both the EU and Finland, that when you have a problem, you enact a law. A case in point is emissions allowances, which only raised energy prices, while emissions fell as a result of the depression.

Nina Törnudd, STT: So, do you think it's possible that the legislative proposal will be rejected at the draft stage or in Parliament?

MH: The fact is that political pressures exist and retail operators are being blamed. There is also the mantra of the Finnish retail market being dominated by two operators. In fact, there are 900 independent K-food retailers in Finland. For me it's difficult to understand why their competitive role is not accepted. K-retailers in a given area also operate in a keen competition with each other. And because the stores share the same loyalty programme, it's easier for customers to change from one K-store to another, rather than from one group to the other. Therefore, I find it difficult to believe that measures paralysing and weakening this kind of entrepreneurial operation could be taken. All the more so, because our Prime Minister comes from the National Coalition Party.

Arto Jaakkola of Kehittyvä Kauppa: In your opinion, how should government then promote competition in the trading sector?

MH: By reducing regulation. Those who believe in this country and this business sector are also willing to invest. For example, Kesko made a €100 million capital expenditure in the

Veturi shopping centre. The project was completed in no more than five years. We also have projects which take 10 years to complete and cost money throughout the whole period. There aren't many operators in our country who have equal potential. And the situation has developed through competition. The Finnish Competition Authority is against the new law and for good reasons. In Finland, the number of retail operators has fallen, businesses have run into difficulties and the Finnish Competition Authority has intervened in some of the resulting business transactions, but not in all of them, which is somewhat strange because we have seen the situation coming for the last 5-10 years. In terms of efficiency of logistics and purchasing and diversity of selections, the Finnish retail sector is very competitive and efficient. Excluding the impacts of our high tax rates on food, construction, energy etc., food is actually very cheap in Finland. In comparisons, we must not forget that income level in Finland is quite different from the Estonian wage level. In the developing EU states, food represents a much bigger proportion of household spending than in Finland. Another thing is that in cooperation with the Finnish food manufacturing industry, we offer a high degree of domestic origin, and our food manufacturing industry is a major employer compared to exporting industry where jobs have been cut. Customers are also willing to pay for domestic origin, but not too much. In the meat industry product development is needed in order to avoid direct price competition from abroad. In this context, it is very important that the operating environment of primary sector is in order. Regulation would not serve their purpose.

Anssi Kiviniemi, SEB Enskilda: Profit performance of your food trade was positive and it improved on the third quarter contrary to the first and second quarters of 2012. How was the improvement generated? Have you exceeded the critical mass in new store openings so that your food trade can be expected to continue the improvement in the coming quarters, although it takes some time for new stores to get on the right side of zero. Or was there something special about the past third quarter in the food trade?

MH: There were no exceptional single items behind the result. Kesko Food is such a large operator with lots of small things generating the result. It has good cooperation with supplier partners and K-retailers. The decisive factors are the performance of healthy sales and customer satisfaction which are composed of a multitude of elements. Kesko Food's share of the value chain, calculated from retail prices, is less than three percent. Minor changes and store site fees etc. have an impact of the result. Certainly not without significance in recent years has been the development of information systems, with which the big machine with its logistics, warehousing, deliveries, automated replenishment etc. is controlled. This is one of the permanent elements. Another is the good sales performance of Pirkka private label products which has continued. Although Pirkka products are 15% or even 20% cheaper to customers, they are supported by efficient logistics and purchasing.

Anssi Kiviniemi, SEB Enskilda: Your department store division's performance was weaker than last year due to new K-Citymarket hypermarkets but also Intersport

operations in Russia. What exactly is happening in Russia, what costs reflect on the result, what is your target level and for what timeframe?

MH: We aim at significant adjustments on all cost lines, we close stores which have no profitability potential, we open new ones, we introduce our top class sports store concepts there and compose a new selection adapted to local needs. The Russian market is dominated by major brands' own stores, but our good cooperation with Intersport International and in Finland enables us to offer those big brands in Intersport stores also in Russia. This year, sales have increased by 60%. On the whole, a major restructuring process is underway. The Russian market is different and Intersport's position is not as good as in Finland. There are a couple of strong competitors with higher sales per square metre compared to Intersport. Selling 'hard' products, like bicycles and skis, has been especially difficult because of different sports culture, which is why sales are mainly composed of clothing and footwear.

Anssi Kiviniemi, SEB Enskilda: Will restructuring be continued throughout 2013?

MH: Active measures have already been taken, but I expect some sort of adjustments to continue. We naturally plan to achieve growth level when we'll also open a number of new stores, because 30 stores are not enough for such a market.

Heino Ylisipola of Kaleva, Turun Seudun Sanomat and Väli-Suomen Media: Returning to your food trade figures, sales growth for July-September was 2.8% while for the first nine months of the year, it was 3%. In view of the around 3% rate of inflation, why are the growth figures so modest? And secondly, have you managed to reduce the gap in the food trade market share between S Group and Kesko?

MH: It goes without saying that retailers would always like to sell more and we are not quite happy about the sales performance especially when we have made significant capital expenditures. We have succeeded in taking the market share back to growth. Last year and the year before last, the market share of the existing K-food stores was higher than S Group's - next time market share data is published in March. The statistics compiled by The Finnish Grocery Trade Association don't show direct comparisons between competitors, but based on other sources, the competitor's sales growth figures have been somewhat higher. Food prices have also risen by at least the 3% you mentioned. In the food trade, the composition of customers' food basket is also significant: what is the share of products on special offer compared to expensive whole meat products, for example.

Heino Ylisipola of Kaleva, Turun Seudun Sanomat and Väli-Suomen Media: Does this financially difficult time already reflect on customers' shopping behaviour?

MH: Today, customers' seem to be making smaller purchases at a time. This has reflected very positively on our K-market and K-extra stores. In global terms, hypermarkets have no longer continued increasing their market shares. In Finland, however, K-citymarkets with

their wide selections and affordable prices appreciated by customers are so well accessible. K-markets are our biggest neighbourhood store network.

Pekka Pansu, Yle Uutiset: How would the new competition law, if enacted, impact Kesko's structure and operations?

MH: We operate in compliance with local legislation in all of our operating countries and do what the legislator wants. It's been quite difficult to conduct surveys and draw conclusions of any practical consequences. After the acquisition of Tuko when we could not acquire the Spar stores, we began a very open cooperation with the Finnish Competition Authority. We continuously carry out self-assessments and present them to the Finnish Competition Authority for auditing. We can also negotiate with the manufacturing industry at any time. In fact, increasingly many manufacturers would nowadays like to receive fixed order quantities as early as possible so that they could fix their production plans because of the very integrated systems of their own. And as for the argument that the concentration of the retail trade has contracted the offer, there is clear evidence that there has been a 20% increase in the selection during the last three years. There can be occasional shortages of organic or low-carb products and the like as trends in consumption come and go rapidly. And when, let's say, a transfer to organic farming takes three years, it's not always simple and easy to serve customers as well as we want.

Pekka Pansu, Yle Uutiset: With what size of store are you starting your food business in St. Petersburg, what are your expansion plans there, and were you encouraged or intimidated by S Group's first experiences in the Russian food trade?

MH: Russia is by no means an easy market. It skips many development stages as it goes straight to the top and to top class stores, although the purchasing power of their middle class is quite low, yet increasing. And regardless of all difficulties, I want to emphasize that Finland is the best country for entrepreneurs. We can make forecasts and anticipate developments and the systems work. In Russia, we plan to open around 20 food stores quite soon in order for efficient logistics, synergy benefits and recognition rate. We cannot talk about invasion in an area with five million inhabitants and a wide geographical area. Prisma stores have had no significant role in our plans; we went international with our building and home improvement stores, followed by Intersport stores. We launch food stores into Russia according to our own plans. The stores will be like K-citymarkets, but their home and speciality goods departments will be smaller, around 1,000-2,000 square metres, because those product lines belong to another Kesko Group organisation and would have needed a separate sourcing system. The food section will be like K-citymarket's, around 3,000-4,000 square meters. It's possible that we test the smaller format of supermarket in some suitable location. Without an established logistics system and central warehousing for a relatively small number of stores, the stores must have quite large backrooms. And the combination of a small store and a large backroom is not efficient. Also in Russia, we put quality first and aim at superiority with our fruit&vegetable and bread departments, as well as the fresh meat and service counters.

Nina Törnudd, STT: How does a customer know which online store of yours, netanttila.com or citymarket.fi, sells, let's say, coffee makers?

MH: Our online stores have cooperation but also competition. The retail websites have different profiles and Anttila's online store has been tested and proved efficient, which also benefits citymarket.fi. They use the same warehouse, but some products sell better online than others, which is why the selections are never completely the same. Many of our chains already have a retail website and all of them will have one in the future. There are foreign competitors, but the market is growing: while sales increase by 5% in year, online sales grow by 15% although it is divided between many operators. Comparisons between physical and online stores, but also between online stores are being made, which means that competition will tighten and price transparency will improve. We are a reliable online operator with regard to payments and product returns. In addition, products are delivered free of charge to a K-citymarket designated by the customer. In the future in a smaller K-citymarket, the online store could be a tool for the sales assistant who could help customers choose some special products at citymarket.fi.

Nina Törnudd, STT: Do these different online stores cannibalise each other?

That happens too. As a rule, different types of stores are needed and competition decides where customers want to shop. Customer information is like a new kind of oil: you must know your customers and analyse what kind of interaction they want from the retailer. We're moving from store specific to customer specific selections.

Pekka Pansu, Yle Uutiset: Are the percentages between ordinary sales and online sales the same at Kesko as in general in Finland?

MH: There lots of stores which specialise in e-commerce and only operate one or two physical stores. Kesko is a traditional retail operator and I expect that online food sales will remain very low, because it costs customers so much. But, for example, in home electronics, the share of online sales has grown markedly, which has made physical stores review their operating practices. Clothes and shoes are also sold a lot online, but the profitability is compromised by a high return rate. Composing an online selection can also be difficult.

Thank you!