Review of finance and operations

FINANCIAL REVIEW

Financial results for 2016

The information presented here relates to the 52 weeks to 24 December 2016 and the 52 weeks to 26 December 2015, unless otherwise stated.

The financial performance of the Group during 2016 benefited from the Group's competitive position and the continuing focus on improving operational performance.

Total Group revenue increased by £87.1m to £1,307.3m.

Revenue £m	2016	2015
Group	1,307.3	1,220.2
comprising:		
Howden Joinery UK depots	1,281.7	1,203.8
Howden Joinery continental Europe depots	25.6	16.4

Howden Joinery UK depot revenue rose by 6.5% to £1,281.7m, increasing by 4.2% on a same depot basis (excludes depots opened in 2015 and 2016).

This growth was achieved through several factors and is a testament to the strength of the Howdens business model. In particular, we have continued to open new depots and increased the number of customer accounts, while maintaining focus on pricing discipline, which enabled us to grow turnover in existing depots of all ages.

Sales in continental Europe rose by £9.2m to £25.6m, primarily reflecting the expansion of the trial in France.

Gross profit rose by £55.5m to £839.9m. The gross profit margin for the year of 64.2% was virtually unchanged (2015: 64.3%). This was despite an increase in costs of goods sold of £23m that arose from the weakening of the pound against the euro and US dollar.

Selling and distribution costs, and administrative expenses increased by £40.2m to £602.7m. The increase reflects the costs of new depots, investment in both short and longer term growth, and the impact of inflation, including on payroll costs.

Operating profit increased by £15.3m to £237.2m.

The net interest charge fell by £2.1m to £0.2m, reflecting a lower finance expense in respect of pensions. The net result was profit before tax rose by £17.4m to £237.0m.

The tax charge on profit before tax was £51.4m, an effective rate of tax of 21.7%.

Basic earnings per share were 29.5p (2015: 27.3p).

At 24 December 2016, the pension deficit shown on the balance sheet was £106.0m (26 December 2015: £49.2m). The increase in the deficit was due to higher liabilities arising primarily from a decrease in the discount rate, partly offset by the Group's contribution to fund the deficit (£35m) and higher than expected asset returns.

We saw strong cash flow in 2016, with a net cash inflow from operating activities of £207.2m, after the cash contribution to the Group's defined benefit pension scheme.

Within this, working capital decreased by £1.5m. Increases in stock and trade debtors were more than offset by an increase in trade creditors. In addition, net tax paid totalled £28.8m.

Payments to acquire fixed assets totalled £63.5m (2015: £45.9m), reflecting increased investment in our supply operations (see Operational Review).

In line with the announcements of a £70m share repurchase programme made in February 2015, of which £45m was returned in 2015, and a £55m share repurchase programme made in February 2016, £80.0m was spent acquiring the Group's own shares during 2016, concluding both programmes.

Reflecting the above, there was a net cash inflow of £0.5m in 2016, the Group having net cash of £226.6m at the end of the year (26 December 2015: £226.1m net cash).

Dividend and return of surplus cash to shareholders

The Group's dividend policy is to target dividend cover of between 2.5x and 3x, with one third of the previous year's dividend being paid as an interim dividend each year.

In light of this policy, given the operational performance of the business in 2016, the Board has decided to recommend to shareholders a final dividend of 7.4p, giving a total dividend for the year of 10.7p (2015: 9.9p). This equates to a dividend cover of 2.75x.

As previously stated, the Board intends to target a capital structure that is both prudent and recognises the benefits of operational and financial leverage, and, after considering our capital requirements, to return surplus cash to shareholders as appropriate. The Group has significant property leases for the depot network, and continues to have a material deficit in the Group pension fund and a small number of remaining legacy liabilities related to the Group's former ownership of MFI. Taking into account this underlying level of gearing, the Board believes it is appropriate for the Group to be able to operate through the annual working capital cycle without incurring bank debt.

The Board has reviewed the cash balances in light of the Group's future investment opportunities, expected peak working capital requirements and trading outlook. As a result, it has decided to return up to £80m of cash to shareholders by way of a share repurchase programme. This is expected be implemented over the course of the next two years.

Shares that are bought in the market by our brokers will either be held in treasury, to use to satisfy future obligations for company share schemes, or cancelled.

OPERATIONAL REVIEW

The mission statement of Howden Joinery is "To supply from local stock nationwide the small builder's ever-changing, routine, integrated kitchen and joinery requirements, assuring best local price, no-call-back quality and confidential trade terms … and to provide the builder's customer with enough choice, advice and aftersales to make a home to be proud of".

Since it started in autumn 1995, the business has opened new depots and increased turnover continuously, except for a 12-month period in 2008–9. At the end of 2016, the business had 642 depots across the UK and has small operations in continental Europe, where it has 24 depots. Around one-third of the products the business sells are made in its own UK factories.

Even today, we continue to see the opportunity to transform the scale of the business, seeing scope for up to 800 UK depots. We continue to invest in all aspects of the growth and performance of the business, including new depots and depot operations, existing and new employees, product development, and manufacturing and distribution.

UK depot network and operations

During the course of 2016, 23 new depots were opened, bringing the total number of depots trading at the end of the year to 642. In addition, five depots were relocated and 22 were extended.

It is important that we have the optimal number of regional and area managers leading and supporting our UK depot operations. The continuing growth of the number of depots has led us to introduce a new region, which consists of five areas, bringing the number of regions to nine.

Our account base continued to grow, increasing by over 30,000 net new accounts in 2016. While there has been a significant increase in accounts, our debt collection performance continues to be robust.

Review of finance and operations continued

Product and marketing

Continuing to enhance our product offering is crucial to our competitive position. In 2016, we introduced a number of new products across all product categories, albeit the programme was less intensive than in recent years. Notable amongst these were:

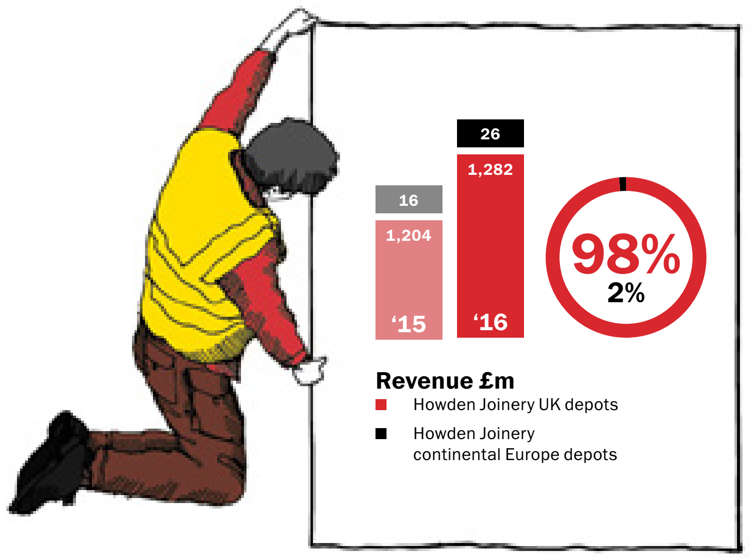
- three new Burford ranges with textured wood grain finish, as a lower priced option to the Tewkesbury family;
- three new grey kitchens in our Greenwich and Clerkenwell families and an ivory Greenwich Shaker door, following the growing popularity of these colourways.

In addition, a number of successful tests were undertaken, including pre-finished doors which make the builders life more time-efficient.

It is planned that 2017 will see a larger new product introduction programme, including around 20 new kitchen ranges and a number of products that were tested in 2016.

We continued to invest in our marketing communications and brand advertising with a number of initiatives. These included:

- a series of Rooster News flyers distributed to our small builder customers, which have been used to help drive footfall and sales in our depots; and
- to further raise awareness of the Howdens brand, we attended eight county shows and agricultural fairs throughout the UK during the summer.



Manufacturing and logistics operations

Our UK-based manufacturing and logistics operations play a vital role in ensuring that we are able to supply our small builder customers from local stock nationwide at all times. This requires us to have the space and the flexibility to respond to each depot's individual needs, even during our critical 'period 11', when sales are more than double the level seen in other periods.

In February 2015, we said that we had undertaken a review of the medium and longer-term growth prospects for the business and had identified more opportunities than previously foreseen. On the basis of this, we said that we had considered how to ensure that we are best placed to deal with and take advantage of what the future might bring. One outcome of this work was the identification of a programme of investment in our supply operations.

During 2016, a number of projects were progressed as follows.

Manufacturing operations

At our Howden site, the refurbishment phase of a new cabinet production facility has been completed, assembly lines have been installed and the installation of machining lines has commenced. When complete, this will improve our cabinet manufacturing capability.

At our Runcorn site, installation of a new cabinet component line is complete and this has been commissioned. Production on the line is now being ramped up.

Logistics

A new 650,000 sq ft warehouse that has been built near Raunds, which is to the east of our existing national distribution centre in Northampton, was handed over to us in July. Fit-out has been completed and IT systems integration is underway.

Continental Europe

In France, we opened two new depots in the north and one in the south, meaning that we now have 20 depots in the country. In Germany, we opened one depot, our first in the country, which will allow us to learn about the market.

GROUP DEVELOPMENTS

Pension scheme funding

In July 2015, we announced that agreement had been reached in relation to the schedule of payments towards the funding of the Group's defined benefit pension scheme's deficit from April 2015. At that time, it was agreed that the Group would continue to make deficit contributions equivalent to £35m per annum until 30 June 2017. However, in light of movements seen in discount rates since this agreement was reached, it has been agreed that the Group will also make an 'interim' payment of £25m over the period June 2017 to March 2018. This will mean a deficit contribution of £30m in 2017.

CURRENT TRADING AND OUTLOOK FOR 2017

Our 2017 financial year will include a 53rd week, which will increase operating costs by around £10m but will not contribute to revenue.

Current trading

Howden Joinery UK depot sales in the first two periods of 2017 (to 18 February) were up 3.6% on the same period last year (this excludes the first trading week, which had one fewer trading days in 2017 than in 2016). Along with the evidence we have of trading prospects, this would suggest that the softer market conditions seen in the second half of 2016 have continued, with volumes having weakened slightly in the early part of this year. To offset cost pressures, a price increase was put through towards the end of 2016, and the early signs are encouraging.

Outlook

The Group remains committed to its view that the number of depots in the UK can be increased from the 642 operating at the end of 2016, seeing the opportunity for up to 800 depots. During the course of 2017, we are currently planning to open around 30 depots in the UK, one already having been opened.

As already mentioned, 2016 saw us take possession of a new warehouse and invest in our manufacturing operations. As well as impacting operating costs in 2016, we anticipate that operating costs will rise by around £15m in 2017 as a result of these developments and a larger new product introduction programme. In addition, the pension cost charged to the P&L account will increase by around £5m, around half of this relating to the pension interest expense.

2016 also saw the pound weaken against both the euro and US dollar. At rates of €1.15 and $1.25 to the £, this would increase our costs of goods sold in 2017 by around £20m (relative to 2016), other things being equal.

These cost increases, the larger proportion of which will affect the first half of 2017, are in addition to higher costs that will arise from the on-going growth of the business and inflation.

Our supply operations encompass our own UK manufacturing of around one third of the products that we sell, primarily cabinets and worktops, and warehousing and delivery to our depots of manufactured and bought-in products. Investment in the resilience and capacity of manufacturing and warehousing means that capital expenditure is expected to be around £65m in 2017. Thereafter, given the opportunities we see ahead, we expect to continue to invest in the profitable growth of the business and will provide more detail in due course.

CONCLUSION

As we sit today, market conditions seen so far in 2017 appear broadly unchanged from the softer ones seen in the second half of 2016, with volumes having weakened slightly. We are seeing weakness in London being offset by performance elsewhere. At this early stage, we are encouraged by the progress our price increase has made.

While we are on track with our plans and our expectations are unchanged, we are mindful of the risks to the UK economy and we are well positioned to respond to changing conditions.

KEY FINANCIAL PERFORMANCE INDICATORS

We measure the Group's performance and progress of our strategic priorities against four key performance indicators (KPIs) as we aim to deliver growth, profitability, cash and depot expansion. As we execute our strategic priorities, we look to create sustainable value for the Group and its stakeholders. Our financial highlights are shown on the inside cover of this Annual Report, while our non-financial indicators are discussed in the corporate social responsibility report.

Total sales growth

Growth in sales of the UK Howden Joinery depots is key to enhancing shareholder value. We believe that there remain considerable opportunities to grow the Company based on the long-term opportunities for the business. In addition, we believe there are economies of scale in the business which will allow us to grow long-term profitability as we grow sales. This measure, along with monitoring our programme of depot openings, tracks our ability to grow the business. We saw total sales of £1,307m in 2016, representing a growth of 7% compared to 2015.

Review of finance and operations continued

Profit before tax

We target profit before tax as it captures how much profit we have generated after taking account of major expenditure items such as costs of sales, selling and distribution costs, administrative expenses and finance costs. We grew profits before tax from £219.6m in 2015 to £237.0m in 2016, representing a growth of 7.9%.

Cash

We are committed to generating cash flow performance through the operating cycle. Our aim is to retain at least one year's requirement for working capital after capital expenditures and after paying a dividend in line with our stated dividend policy, which is outlined in more detail on page 14. We ended 2016 with £226.6m of cash and cash equivalents, in line with this KPI.

Depot openings

Our business model is based on individual depots providing kitchens to small builders within a local community. We believe that there is some way to go before the UK market is saturated and therefore the continuing drive to open new depots in new localities is a key driver to the Group's prospects. We opened 23 new UK depots in 2016 and continue take account of economic conditions in order to phase our growth taking account of our other KPIs.

USE AND MANAGEMENT OF FINANCIAL INSTRUMENTS, AND EXPOSURE TO FINANCIAL RISK

The Group holds financial instruments for one principal purpose: to finance its operations. The Group does not currently use derivative financial instruments to reduce its exposure to interest or exchange rate movements. The Group finances its operations by using cash flows from operations, and it has access to an asset-backed loan facility if additional financing is required. Treasury operations are managed within policies and procedures approved by the Board. The main potential risks arising from the Group's financial instruments are foreign currency risk, counterparty risk, funding and liquidity risk and interest rate risk, which are discussed below.

No speculative use of derivatives, currency or other instruments is permitted. The Treasury function does not operate as a profit centre and transacts only in relation to the underlying business requirements.

Foreign currency risk

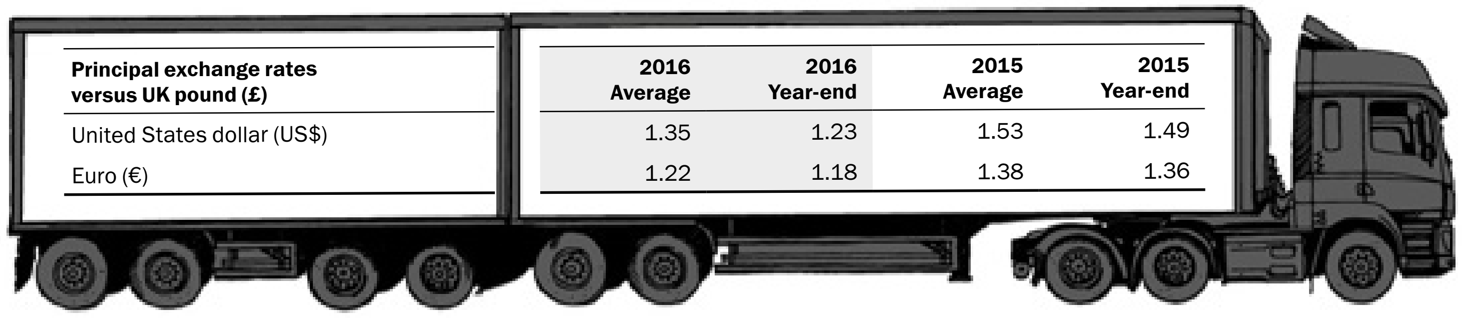
The most significant currencies for the Group are the US dollar and the Euro. It is the Group's current policy that routine transactional conversion between currencies is completed at the relevant spot exchange rate. This policy is reviewed on a regular basis.

The net impact of exchange rates on currency transactions in the year was £22.9m. The Group does not have many overseas assets/liabilities, so the impact of currency translation on these items is not material.

The principal exchange rates affecting the profits of the Group are set out in the table on the next page.

Counterparty risk

Group Treasury policy on investment restricts counterparties to those with a short-term credit rating at least equivalent to Standard and Poor's A-1 or Moody's P-1. It also places limits on the maximum amount which can be invested with a single counterparty. Investments mainly consist of bank deposits, UK Treasury bills and liquidity funds. The Group continuously reviews the credit quality of counterparties, the limits placed on individual credit exposures and categories of investments.



Principal exchange rates versus UK pound (£)	2016 Average	2016 Year-end	2015 Average	2015 Year-end
United States dollar (US$)	1.35	1.23	1.53	1.49
Euro (€)	1.22	1.18	1.38	1.36

Funding and liquidity

The Group's objective with respect to managing capital is to maintain a balance sheet structure that is both efficient in terms of providing long-term returns to shareholders and safeguards the Group's ability to continue as a going concern. As appropriate, the Group can choose to adjust its capital structure by varying the amount of dividends paid to shareholders, the returns of capital to shareholders, the level of capital expenditure, or by issuing new shares.

The Group has an asset-backed bank facility which allows borrowing of up to a maximum of £140m, dependent on the actual levels of stock and trade debtors held at any time. The facility was not used at any point during 2016 and is due to expire in July 2019.

The Group's committed borrowing facility contains certain financial covenants which have been met throughout 2016. The covenants are tested every four weeks and are based around: (i) fixed charges; (ii) tangible net worth; and (iii) earnings before interest, tax, depreciation and amortisation (EBITDA) for Howden Joinery Limited.

In addition, our pension trustees, who carry a charge over the share capital of Howden Joinery Limited, have a separate covenant test around the EBITDA of Howden Joinery Limited.

The Group's latest forecasts and projections have been stress-tested for reasonably possible adverse variations in trading performance and show that the Group will operate within the terms of its borrowing facility and covenants for the foreseeable future.

At the 2016 year end, the Group had £139m of cash, £87m of short term investments, and £138m of funds available to borrow under the committed borrowing facility (in line with the levels of stock and trade debtors at the year end).

Interest rate risk

The Group has not had any borrowings during 2016 and does not consider interest rate risk to be significant at present.

NEW ACCOUNTING STANDARDS

None of the new accounting standards that came into effect during 2016 had a material implication for the Group.

CAUTIONARY STATEMENT

Certain statements in this Annual Report are forward-looking. Although the Group believes that the expectations reflected in these forward-looking statements are reasonable, we can give no assurance that these expectations will prove to have been correct. Because these statements contain risks and uncertainties, actual results may differ materially from those expressed or implied by these forward-looking statements. We undertake no obligation to update any forward-looking statements whether as a result of new information, future events or otherwise.

By order of the Board

Mark Robson
Deputy Chief Executive
and Chief Financial Officer

22 February 2017

Strategic report
Governance
Financial statements
Additional information