Tesco's US Gamble: A Call for Review and Reassessment of Fresh & Easy

Statement in connection with the Annual General Meeting of Shareholders of Tesco, PLC to be held at 11.00 a.m. on 29 June 2012

CtW Investment Group

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Information Concerning the Proponents

The CtW Investment Group works with pensions and benefit funds sponsored by unions affiliated with Change to Win, a coalition of U.S. unions, to enhance long-term shareholder value through active ownership. These funds collectively hold over $200 billion in assets, or £129 billion, and are substantial long-term Tesco shareholders.

Introduction

This briefing sets out the evidence in support of three amendments to the accounts and reports of directors and auditors which will be presented at the Annual General Meeting of Tesco PLC to be held at 11.00 a.m. on 29 June 2012.

We are circulating this briefing to certain fellow shareholders of Tesco because we believe that continued losses and serious operational challenges in the company's Fresh & Easy United States business require the Board of Directors to reassess the strategy for this division. In its nearly five years of operations, Fresh & Easy has a deeply troubling track record including:

- Repeated shifts in strategy and revised benchmarks, leaving investors unable in our view to predict future performance;
- Total investment and losses of £1.94 billion from Fresh & Easy operations;
- Inadequate disclosure of the costs associated with the US operations, further frustrating investors who seek to understand this risky venture.

We believe an evaluation of Fresh & Easy by the Board is urgently needed to protect shareholder value and ensure the United States business does not weigh on Tesco's results during a crucial period of the company's United Kingdom-focused turnaround program.

See page 6 for voting instructions.

Challenges at Home and Abroad

Following a profit warning in January and several years of languishing sales trends, Tesco recently announced a plan to refocus on its United Kingdom stores to achieve renewed long-term growth. The new effort includes a £1 billion investment in the existing store base and a slowing of store expansion. Management acknowledged that they previously cut store labour too much in the UK, and recently stated, "It all starts with putting more staff in the stores so that we get the products on the shelf in the right way, in the right quality, at the right time"[1]. Therefore, a major component of the investment is the hiring of 20,000 new employees over the next two years to improve the customer experience and store operations.

In this context, we believe Tesco can ill afford international ventures that do not reach sustainable returns. Yet Tesco still stands behind its struggling Fresh & Easy banner, even while the US business has accumulated losses of £708 million and investment of £1.23 billion in its four years of existence. Those costs are nearly double the £1 billion budget allocated to turn around the UK business, which contributes 66% of total revenue. Meanwhile, the US format is built on a low service, low labour-cost model that is suffering from operational problems similar to those experienced in the UK, as we detail below.

Tesco's US Proposition

Tesco opened its first US store with great fanfare in October 2007. The parent company saw Fresh & Easy as introducing "a new and different form of retailing"[2] in the US that offered the "convenience of Walgreens, the value of Wal-Mart, the fresh food quality of Whole Foods, and the differentiated product range of a Trader Joe's"[3]. Management's vision for growth was ambitious, and US CEO Tim Mason saw the potential to make Fresh & Easy as ubiquitous as Starbucks[4]. Tesco also introduced a highly centralized proposition for the new store's supply chain: it built a distribution and manufacturing centre and encouraged two of its vegetable and meat suppliers from the UK to set up operations in the United States.

Missed Targets, Mounting Losses

At the outset, Tesco said trading losses would diminish each year, and the business would move into profitability in the third year of operation. However, Fresh & Easy is still seeing substantial trading losses in its fifth year of operation, with an operating margin of -24.3%. Management's optimistic outlook that Fresh & Easy is "on track for another significant reduction" in losses this year[5] is difficult to evaluate when investors do not have information on cost of sales or operating expenses.

Tesco has repeatedly pushed back the date by which Fresh & Easy will stop losing money. This spring, the timeframe to break even was moved to the 2013/14 fiscal year from the end of 2012/13, a delay management attributes to another slowdown in store openings. Tesco initially planned to open 200 stores by the end of 2008, and its infrastructure was designed to support 1,000 stores, but as of February 2012 it had only 185 stores open. Not only has it failed to meet its initial ambitious target, in each year the company has made forecasts about store openings, it has failed to reach those targets. In our view, the need for enhanced disclosure and accountability is clear given this track record of missed targets, revised projections and continued losses.

Repeatedly Revised Strategy

Tesco sought to pioneer a new US retail model with Fresh & Easy, but as its losses have mounted it has veered from one strategy to another. Fresh & Easy initially relied on an "Every Day Low Price" strategy, but then switched to heavy discounting via coupons and promotions to draw in customers. Despite trumpeting the depth of its research into the American consumer, Tesco misjudged several key aspects of its offering. It took the company until 2009 to increase pack size to be more appropriate for a supermarket consumer and to offer a sufficient range of frozen food. Its latest efforts to introduce bakeries, loose produce, and additional product ranges appear to us to continue a pattern of reconfiguring the stores after strategic missteps.

Along with store-level resets, Tesco has had to reconfigure its supply chain at great cost. As its planned expansion in Northern California has been repeatedly scaled back, it has left a new distribution centre unused. And Tesco acquired its two dedicated suppliers in 2010 for £116 million, incurring significant integration costs and ending up with overhead costs of 5% of sales, compared to 1.5% in the UK. One analyst estimates that Tesco has spent three times as much as it should have to establish Fresh & Easy[6].

Inadequate Disclosure

Fresh & Easy may become the largest failure in Tesco's history, dwarfing the £250 million investment before it left Japan. While management announced the first year of improvement in 2011/12, with losses lower by 18%, that figure overstates the progress because the previous year included significant one-time expenses associated with acquiring and integrating its two suppliers, Wild Rocket Foods and 2 Sisters Food Group. Omitting the one-time expenses lowers the improvement for 2011/12 by more than half[7].

As management tries to make the case for continuing in the US market, we believe that investors have insufficient information about costs and performance to assess the constantly changing projections and targets.

New Store Survey Raises Operational Concerns

Despite its vertically-integrated, low-staff, low-cost premise, only 16% of Fresh & Easy stores are earning enough revenue to cover store costs. Given the dearth of detailed information from Tesco that would allow investors to assess Fresh & Easy's operations, we conducted original research last month at Fresh & Easy stores in all three states where it operates. Our research, summarized below, points towards significant operational problems, which may reflect the limitations of this pared-down operating model.

Out of stocks

In visiting more than one-third of Fresh & Easy stores, we found it was common for the sale items advertised in the store circular that we searched for to be out of stock. More than 85% of surveyed stores were missing at least one of the advertised items we looked for during one of our visits.

Out-of-stocks can result in an immediate missed sale opportunity and discourage return visits. An industry study found that when shoppers cannot find a product they are looking for, the retailer loses the sale 40% of the time[8]. Another study shows that no other factor impacts supermarket customer satisfaction as much as out of stocks[9]. The company has indicated that it does not provide customers who encounter out-of-stock advertised product with rain-checks, vouchers to obtain the product at a later date, which are available at most of its major competitors. Given its extensive control over its supply chain, we believe Fresh & Easy should be able to plan and stock adequate inventory for its own promotions.

Product freshness and store maintenance

In visits to more than half of Fresh & Easy's stores, CtW found spoiled products and products past their sell-by date in a great majority of stores visited. We found visibly spoiled produce in nearly every store we visited and we found at least one product past its sell-by date in 85% of stores visited, most of which were perishable goods. This runs counter to Fresh & Easy's brand proposition which is highly focused on providing "fresh, wholesome" products to customers. We also surveyed these stores for cleanliness and found more than three-quarters had signs of insufficient cleaning. Health inspection records from several counties and cities uncovered similar problems, including cleanliness violations and problems with mishandled or past their sell-by date foods at some Fresh & Easy locations.

In a study by the National Grocers Association, over 90% of consumers said the availability of high quality fruits and vegetables was "very important" in their selection of a supermarket store more frequently than any other factor. The factor rated as "very important" by the second largest number of respondents was selling non-expired products, followed by store cleanliness[10].

Low staffing

Fresh & Easy's failure to keep sale items stocked, rotate and remove expired and spoiled food, and keep stores clean may reflect the downside of a low level staffing model. In visits to more than one-third of Fresh and Easy stores, we observed an average of 3.7 employees per store at a given time. Indeed, Fresh & Easy's ratio of FTEs per thousand square feet is just 2.4, not adjusting for non-store employees. This is half of one analyst's estimate for Tesco's United Kingdom 2011 store staffing level[11], which the company is now investing in increasing.

Self-checkout assistance

At the core of Fresh & Easy's low-staff model is its register system, which, in contrast to Tesco's UK operation and any other U.S. grocer, is exclusively made up of self-checkout stations. During more than 34 cumulative hours of observation in stores, we found that customers using self-checkout machines required assistance from an employee nearly every 4 minutes, excluding alcohol purchases. For many customers, the final—or perhaps only—interaction with Fresh & Easy staff is problem-based, rather than service-based.

Trading on Deep Discounts

An examination of promotions by Fresh & Easy since the beginning of the current fiscal year shows that the company offered flat discount coupons of 20% off a minimum purchase amount ($30 or $50) to members of its loyalty program in 11 out of 15 weeks, along with significant additional weekly product sales and daily specials. Almost four years ago, a competitor CEO called Fresh & Easy's flat coupon offers "extraordinary" and added, "no retailer that I know of in the conventional space has sustained a $10 off $50 or a $20 off $100 for any extended period of time. No one's ever done it in all of their stores. And so I refer to that as renting sales"[12]. This ongoing practice of deep discounting raises questions about the cost and sustainability of Fresh & Easy's efforts to increase traffic.

Action is Needed

Given the serious concerns raised by our findings and the increasing skepticism among investors about the viability of Fresh & Easy, we believe the time is now for greater disclosure regarding performance and a transparent decision-making process on the future of the US business. The board should take the lead in assessing Fresh & Easy and ensure that investors gain greater visibility into this troubled segment.

Recommendations

We therefore recommend that shareholders support the following request to the Board to consider and if thought fit make three amendments to the Directors' Report:

Amendment A: "To amend the Directors' Report by replacing the phrase 'and we anticipate that we will reach the break-even point during 2013/14' on page five in the second paragraph of the strategic review of US operations, with the phrase 'However, given the significant challenges that remain, we cannot reasonably predict a break-even point at this time'".

Amendment B: "To amend the Directors' Report by replacing the first sentence of the section titled 'The Journey to Profitability' on page nineteen with the sentence, 'Much remains to be done to achieve profitability, and we must address challenges of scale and operational execution before we are confident about the outlook for Fresh & Easy'".

Amendment C: "To amend the Directors' Report by inserting the following text immediately following the section titled 'The Journey to Profitability' on page nineteen:

"Some shareholders have already called for Tesco to exit the United States. Others have called for a definitive decision to be made on the future of the US operations. To answer these concerns, some members believe that a higher degree of transparency is necessary and that a committee of non-executive directors should review the current strategy and issue a report that discloses the metrics and timeframe the board will use to evaluate Fresh and Easy's future performance'".

Actions to be Taken

We intend to seek amendments to Resolution 1 at the forthcoming AGM in order to demonstrate shareholder support to encourage the Board to give effect to the recommendations above. The resolution, as amended, will state that the accounts and reports of the directors and the auditors for the financial year ended 25 February 2012 be received, provided that the Directors consider and if thought fit make Amendments A, B and C to the Directors' Report as set out above (the "**Amendments**"). The Amendments will be lodged with the Company in accordance with the Company's articles of association prior to the AGM.

If the Company determines that the Amendments are fit and proper, it will put them to a vote of shareholders at the AGM. The Amendments will require approval by a simple majority of shareholders voting in person or by proxy. If the Amendments are approved, Resolution 1 as amended will be voted on in the normal way. If the Amendments are not approved, Resolution 1 in its original form will be voted on in the normal way.

If you intend to attend the AGM and wish to support the Amendments we would urge you to cast your votes in favor of the Amendments and, if approved, in favor of Resolution 1 as amended, and if not approved, against Resolution 1 in its original form.

If you intend to vote by proxy and wish to support the Amendments we, the Change to Win Investment Group, would be willing to act as your proxy at the AGM.

If you have not already appointed a proxy and would like to designate the Investment Group, or have already appointed the Chairman or some other person as your proxy but wish revoke their appointment and to designate the Investment Group instead, you should do so in accordance with the instructions on page 5 of the notice of AGM and in the notes to your personalized proxy form provided to you with the notice of AGM. In particular:

1. Please state the name of Michael Zucker as your proxy, who is a representative of the Change to Win Investment Group. If you leave the appointment box empty, by default the Chairman will be appointed as your proxy and he may not exercise his discretion to vote in favor of the Amendments on your behalf;

2. You should provide proxy voting instructions by checking the relevant voting box to reflect your voting wishes. However please do not check the voting box in relation to Resolution 1 in order that we may exercise discretion to vote on your behalf in favor of the Amendments, and either in favor of Resolution 1 if amended, or against Resolution 1 if not amended;

3. Please ensure that your completed proxy form is returned to Equiniti Limited, Aspect House, Spencer Road, Lancing, West Sussex BN99 6DA to arrive at least 48 hours before the appointed time of the meeting, that is to say no later than 11.00 a.m. on 27 June 2012. If you wish to appoint us as your proxy electronically or through CREST, please follow the instructions on page 5 of the notice of AGM. In the case of electronic proxy voting, please ensure that the proxy appointment and voting instructions are received by Equiniti by no later than 11.00 a.m. on 27 June 2012. In the case of CREST voting please, ensure that your CREST proxy instruction is received by the issuer's agent (ID RA19) by no later than 11.00 a.m. on 27 June 2012;

Shareholder enquiries

If you have any questions on this statement, including on the actions to be taken, please contact Nell Geiser on +1 212-341-7064.

Notes:

[1] Tesco PLC, FY2011-2012 Earnings Call, 18 April 2012, p.14.
[2] Tesco PLC, 2009 Annual Report, p.5.
[3] Credit Suisse, Food Retail Sector Review, 29 November 2007, p.5.
[4] *The Observer*, “Cheshunt comes to sunny California,” 8 December 2007.
[5] Tesco PLC, 2012 Annual Report, p.19.
[6] Citigroup Global Markets, “Tesco: Letting the Days Go By,” 19 April 2012, p.6.
[7] Because Tesco attributes the bulk of its loss to the integration costs, we compare 2011/12 to 2009/10 instead of to 2010/11.
[8] Thomas W. Gruen, Ph.D. and Dr. Daniel Corsten, “A Comprehensive Guide to Retail Out-of-Stock Reductions In the Fast-Moving Consumer Goods Industry,” Grocery Manufacturers Association (GMA), Food Marketing Institute (FMI), National Association of Chain Drug Stores (NACDS), The Proctor & Gamble Company (P&G) and The University of Colorado at Colorado Springs, 2007, p.1.
[9] Food Marketing Institute, “Food Retailing Industry Speaks 2011,” p. 44.
[10] National Grocers Association, “2012 Supermarket Guru Consumer Panel Survey,” pp. 6-7.
[11] Morgan Stanley Research, “Tesco: We see more downside to Tesco’s UK profits,” 29 March 2012, p.11.
[12] *Fair Disclosure Wire*, Safeway Inc. at Goldman Sachs Global Retailing Conference – Final, 4 September 2008.