CHIEF EXECUTIVE'S REPORT

Strategic progress in a challenging environment

The Group has made good progress strategically and operationally throughout the year as we focused on executing our growth strategy and continuously improving our operating platforms. We have continued our long term track record of growing our market share in the UK upholstery sector with a significant 2% pts step up in the period, taking the Group's value share of the upholstery market to a record high of 38%. This has been achieved whilst rebuilding our gross margin rate back towards historical levels. We have also seen a step change in our customer experience scores through improved operational grip and the easing of the external supply chain crisis.

This progress has been made against a backdrop of a very challenging market environment with high levels of cost inflation and significant increases in interest rates. The combined impact of these macroeconomic factors reduced consumer confidence levels, which have remained at or close to record lows and reduced consumer real disposable income levels. Consequently the UK upholstery market has been under significant pressure and we estimate that market order volumes were down 15% or more relative to pre-pandemic levels. In addition, like most other businesses, we have had to tackle high levels of input cost inflation. As expected, we have seen improved efficiency in our operating platforms following historical investments and these, alongside careful management of our operating costs and selective retail price increases have helped to mitigate these cost headwinds.

IN BRIEF

- Continuing to win share in a very tough market, extending market leadership with 2% pts share gain to a record 38% of the UK upholstery market
- Brands continue to evolve: DFS range continues to broaden appeal to wider customer base; further three Sofology showrooms opened taking the total to 58 (38 at acquisition)
- Continue to strengthen the foundations for growth in the £3bn beds and mattresses market with drop-ship delivery solution launched and exclusive brand partnerships extended to bed ranges, driving online sales up 69% year on year
- Operationally in the strongest position since the pandemic, reflected in customer experience scores with supply chains, order banks and customer lead times all fully back to normal

TIM STACEY
Chief Executive Officer

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CHIEF EXECUTIVE'S REPORT CONTINUED

Despite the weaker than anticipated market environment the Group's underlying profit before tax and brand amortisation[1] performance of £30.6m was within the range we had guided to when we reported our interim results. In what we expect to be a challenging trading environment for at least the next financial year we are continuing to focus on executing our strategy, developing our customer propositions and adapting our cost base to bolster profitability in this period of subdued demand whilst ensuring we are well placed for the long term.

Market update
Proprietary data that we have access to indicates the upholstery market has been in significant decline in FY23 with market order volumes down 15% or more relative to the pre-pandemic period. Demand across the period was also volatile with weaker demand more pronounced in the first and final quarters of the year. As a result of the low demand in the final quarter, profits were constrained to the lower end of the range we had guided to.

Over the period as a whole the Group outperformed the market, growing its share by 2% pts across the year to a record level of 38% as tracked by GlobalData and our proprietary Barclaycard data. Market share was picked up predominantly from the independent and pure play competitors which now represents 26% of the market. We anticipate that this competitor set will continue to decline, providing opportunity for further market share growth for the Group.

With the cost of living crisis lingering on and consumers now also being impacted by higher property costs, we anticipate that market demand will drop further in FY24 before we start to see a recovery to pre-pandemic levels. We do however expect to continue our track record of growing market share underpinned by the Group's leading brands, scale and well invested integrated retail proposition.

Reflections on FY23 financial performance
Stepping back, when I consider FY23 as a whole, the fact that profits were delivered within our guided range despite the tougher than expected trading conditions our market faced is testament to the relative strength of our brands and our operational agility.

The reported profit before tax of £29.7m and underlying profit before tax and brand amortisation[1] of £30.6m however is a low point for the Group (outside the Covid lockdown impacted FY20 period) and reflective of a very weak market and high levels of input cost inflation. These headwinds were mitigated, to an extent, by the market share gains we achieved, gross margin rate improvement, effective operating cost management and the benefit of a high opening order bank that unwound in the period.

Our plan to recover gross margin rates to pre-pandemic levels of c.58% is making progress. Since FY22 where a margin rate of 51.9% was recorded we have seen steady improvement to 53.8% in H1 FY23 and 55.0% in H2 FY23 with the exit rate for the year being higher.

We anticipate that the margin rate will improve further through FY24 as we target an exit rate approaching 58% supported by the full year benefit of reduced Far East shipping rates (which have now returned to pre-pandemic levels), retail price increases implemented in March 2023, raw material input costs that are now reducing and improved sourcing strategies which I elaborate on further below. These will more than offset a headwind from Bank of England base rate increases that result in higher costs for providing our interest free credit (IFC) proposition. We took the decision to alter our IFC proposition in March to mitigate the cost increase by reducing the maximum credit term from 48 months to 36 months and our proposition still remains industry leading.

Led by our new CFO, John Fallon, and supported by external advisors we have carried out a full review of the operating cost base. A number of quick win opportunities have been enacted to date and the Group Leadership Team are each taking ownership to deliver projects which will drive multi-year cost improvements, starting in FY24, through operating more efficiently and effectively. More detail can be found in John's CFO report.

Strategic update
Our vision is to lead furniture retailing in the digital age. To achieve this vision our strategy is to profitably and sustainably grow our core upholstery brands across both our physical and online propositions and also our share of the £5bn non upholstery Home market. This growth is based on utilising and enhancing our enabling platforms; technology and data, logistics, sourcing and manufacturing, and people and culture.

Our brands
Our two retail brands, DFS and Sofology, have both performed relatively well in the period, each growing their market share.

During the year the DFS brand performed well, extending its leadership position as the largest UK upholstery retailer through focusing on the customer experience and expanding its proposition to appeal to a wider audience. Utilising our customer and marketing segmentation data the brand developed and launched ranges to appeal more to customer segments where we were under indexing. We've seen the benefits coming through via increased conversion rates and increases in our average order values.

Our new store format initiative has progressed well in the year with 11 DFS showroom refurbishments taking place. We have now refurbished our 58 top priority showrooms over the last four years and payback periods for the more recent investments remain strong at under two years.

During the year we opened three new Sofology showrooms, bringing the total to 58 (from 38 showrooms at acquisition). The new showrooms are performing well and the average return on investment of recent stores trading over 12 months is over 65%. We continue to see opportunities for a total of 65-70 showrooms across the UK and Ireland for the brand. The new leadership team at Sofology has also refined and developed a new three-year growth plan called 'Drive to 25' that has been approved by the Board and launched internally and which builds on the recent progress on performance and customer satisfaction. The ambition is for Sofology to become the UK's number 2 sofa retailer, behind DFS.

NPS performances across DFS and Sofology have improved through FY23 following a decline across the pandemic. This decline was driven by lead time delays due to factory lockdowns, global logistics challenges, raw material shortages and a drop in customer service levels driven by high levels of demand. We have since invested to improve our customer service levels which have contributed to DFS's established customer satisfaction NPS improving from 12 in FY22 to 19 in FY23 and in Sofology, which was materially impacted by Covid disruption, from -49 to -6 and we expect the improving trend to continue through FY24.

Both brands continue to build and strengthen their integrated retail business models, enabling our customers to shop seamlessly across all channels, online, in store and at every stage of their journey: from early-stage researching, to advice and support across their purchase decisions through to delivery, installation and after-sales support.

The home market opportunity
We have made good progress in laying the foundations to support the Group's growth in the £5bn Home market and are seeing early signs of success through increased sales levels.

We are targeting the £3bn beds and mattresses market first and have expanded our exclusive brand partnerships in the upholstery market with high quality brands such as French Connection, Grand Designs and Joules to cover bed frames. We have targeted sales of our ranges through our online channels and through dedicated spaces in a select number of showrooms. To fulfil these orders we have developed a drop-ship solution for beds and mattresses with Wincanton which went live in January of this year. Our beds and mattresses online sales have been in line with our expectations, up 69% year on year.

Our supporting platforms
Sourcing & Manufacturing: To support the gross margin improvements discussed above we have reviewed the relative end to end cost of sourcing products across our supplier base, including from potential new suppliers in alternative geographies. This review covered the cost of producing and shipping products along with risk and quality considerations and ESG matters such as suppliers' ability to align with our raw material sourcing requirements and ethical working practices.

1. Refer to pages 25 to 27 for definitions of APMs.

CHIEF EXECUTIVE'S REPORT CONTINUED

Following investment in our larger UK sites in recent years, we have determined that the Group will benefit from consolidating its UK manufacturing operations. As a result, in early September 2023 we commenced a consultation with our colleagues employed at our smallest manufacturing site and one of our wood mills. As part of that process we are working with colleagues to identify opportunities at our other manufacturing sites and within the wider Group if that becomes necessary.

We are continuing to build good relationships with partners internationally and there are opportunities to optimise our global supplier mix.

Data and technology: Data-backed decision making and utilisation of technology to support efficient operations across the business remains a critical enabler in supporting the Group's continued market share growth and driving bottom line profitability.

We are making good progress in developing our customer data platform that brings together data from a myriad of systems across the Group to provide a detailed customer view. Examples of where we are utilising this include multiple touchpoints from the initial purchase through to the delivery experience, where we are able to support and guide each customer, with timely communications that are personalised to their unique journey. We are also developing our Intelligent Lending Platform used by DFS to be used by our Sofology brand. This increases the likelihood of customers obtaining the interest free credit that meets their requirements and speeds up the process of completing orders enabling increased conversion rates at times of high demand.

To help ensure our colleagues utilise the data that is available we have launched a data apprenticeship programme. Starting with the Sofa Delivery Company we have 40 people enrolled on the course which is run in conjunction with a third party. Over the 13 month course our colleagues are developing their skills to utilise and transform data into insights to drive appropriate action.

Logistics: Following the formation of the Sofa Delivery Company in June 2021 that brought together the logistics functions of our two brands we now deliver all the Group's sofa sales through the same systems and physical infrastructure. Scale benefits are now being realised as a result of improved fleet utilisation, van fill and labour productivity. As part of this process, through the year we have also rationalised the number of distribution centres we operate from which will drive further savings over the short to medium term as a result of lower property costs.

People: Our colleagues are fundamental to the success of the Group. Looking after their wellbeing as well as their personal development has been a key focus in FY23. In what is a challenging time for many, given the cost of living crisis, our 'winter wise' support scheme was designed to support colleagues in a number of ways, for example through thank you vouchers at Christmas that could be used at a number of retail stores and access to a discounted health care scheme available to all employees. We have also seen 140 colleagues attend our leadership academies – these are targeted at middle management to provide the skills to develop into future leaders. Our sustainability report has further details on how we are supporting and developing our colleagues.

Sustainability

We have a dedicated section of our annual report that covers sustainability in detail set out on pages 39 to 61. The key elements I want to highlight here are in relation to: culture and governance; where we are on our net zero journey; and employee development.

The Group is guided by our purpose to bring great design and comfort into every home in an affordable, responsible and sustainable manner and has pledged to achieve net zero by 2040.

In the previous financial year we completed the model to capture our full carbon footprint. Like many other businesses, the majority of our carbon footprint sits within our scope 3 emissions (c.90%). Throughout this year a significant amount of progress has been made in developing our carbon reduction roadmap and we are on track to submit science based targets to the SBTI for approval by June 2024. We have developed a number of policies and targets to help reduce our impact on the environment covering key elements of the materials that make up the sofas we sell, for example leather, textiles and timber. Details, including the progress we are making on these alongside our other environmental and diversity and inclusion targets can be found in the Responsibility and Sustainability report.

A sustainability mindset is now fully embedded across the business and our sustainability and responsibility champions have proved to be a real driving force in developing ideas and initiatives, cultivating a diverse and open environment for all our colleagues from the ground up. We have a well-developed and effective governance structure (see page 60). This helps ensure we have a clear strategy, act with integrity and with transparency and hear a wide range of views with committee members representing all areas of our business.

Colleague wellbeing and development is very important to the Group to nurture and retain talent. One specific example that I am very proud of is the Sofa Delivery Company Driver School. This was launched late in the previous financial year and to date we have had nearly 70 colleagues graduate. The driver school provides career progression and improved pay for our colleagues, principally warehouse operatives and 3.5T drivers by funding their training to become 7.5T HGV drivers whilst addressing a business issue of recruiting this role given the competitive labour market.

Outlook

As mentioned above, upholstery market volumes are down 15% relative to pre-pandemic levels. We expect a further decline in the upholstery market order volumes in FY24 before they start to recover given the ongoing pressures on the consumer.

Based on all the data points we can see, our baseline assumption is that the market will decline by a further 5% in volume terms in FY24, with the Group continuing to outperform the market leveraging the strength of our brands, operating platforms and scale. Despite the continued pressure on revenues, we are targeting a modest year-on-year increase in underlying profit before tax and brand amortisation[1] supported by the continued delivery of our gross margin improvement plan and operating cost savings.

Following a mid-single digit year on year decline in the final quarter of FY23 in part linked to the hot weather, across the FY24 period to date order intake has strengthened back into positive growth in line with our expectations and helped by the expected opportunity from weaker prior year comparatives.

Conclusion

I want to sincerely thank our colleagues for their truly outstanding and consistently high level of determination and dedication to deliver at their best for the Group and for their help in getting us to the strongest position we have ever been in terms of market share.

The Group is operating in one of the toughest economic climates we have experienced. Whilst we are confident the upholstery market will recover, forecasting the specific timing and pace of the recovery is challenging.

We do, however, expect to generate a modest year-on-year increase in profit before tax in FY24 despite a relatively weak market in which we expect volumes will continue to decline across the next 12 months. Looking to the future as market volumes recover, we remain confident in achieving the financial performance set out at our Capital Markets Day in 2022 of £1.4bn of revenues at an 8% PBT.

TIM STACEY
Chief Executive Officer
21 September 2023

1. Refer to pages 25 to 27 for definitions of APMs.