Our strategy, to lead sofa retailing in the digital age, is more relevant than ever.

Tim Stacey
Chief Executive Officer

2020 highlights

- Loss before tax of £81.2m as a direct result of business suspension during lockdown
- Comprehensive response to Covid-19, protecting colleagues, customers and the business
- Acceleration of growth strategy focused on DFS and Sofology
- Good progress on cost efficiency
- Development of our ESG strategy, which is embedded in our business
- Very strong demand since reopening

Overview

The decision to close our business down for the first time in 50 years on 23 March 2020, based on the Government guidance, was momentous but clearly necessary. We moved swiftly to protect colleagues and customers by temporarily closing all showrooms, manufacturing and distribution operations.

The way our people responded to this crisis was nothing short of exemplary, and I cannot thank them enough for their spirit, engagement and hard work throughout lockdown, ingredients that enabled us to come through the crisis. We also really appreciated the support we received from our key stakeholders, including our shareholders, our banking partners, our suppliers and our landlords. With their collective support, and the actions we have taken, I am very confident that the Group has emerged even stronger from this unprecedented period.

Re-opening the business safely has been a huge undertaking and we have put colleague and customer safety first. The careful re-opening through late May and June, together with the disruption through lockdown itself, has clearly impacted the financial performance in the year with revenue for the 52 weeks to 28 June 2020 declining by £271.7m to £724.5m compared to the 52 week unaudited pro forma prior year period.

This reported performance is based on the fact that the Group recognises revenues at the point of delivery of orders to customers, and consequently second half financial performance was particularly adversely affected. The Group traded very well online, but government lockdown restrictions from 23 March severely restricted customer deliveries for much of the remaining period.

Underlying loss before tax excluding brand amortisation[1] for the year on a pre-IFRS 16 basis was £56.8m compared to a profit of £50.2m in the comparative period. We ended the year with net debt on a pre-IFRS 16 basis[1] of £169.2m (2019: £176.3m), after raising £63.9m from shareholders as part of our measures to build financial resilience in response to the pandemic.

Since the year end, net debt has reduced significantly, due to a combination of the resumption of customer deliveries and very strong order intake, which has exceeded our expectations in the first few months of the new financial year. We have reviewed extensive external and internal data and we believe that the current level of performance is due to a combination of latent demand post lockdown, a shift of consumer behaviour towards spending on "home", the relative strength of our omni-channel offer and competitor market exits.

Based on data from Global Retail the upholstery market was relatively flat for three years from the start of 2017 to the end of 2019, driven by low consumer confidence and a subdued housing market caused by political uncertainty and relative macro economic weakness. There appeared to be some green shoots in the market after the December General election, pre-lockdown, as conversion and Average Order Value improved post Boxing Day, although footfall and web visitors remained fairly depressed.

Post-lockdown there appears to be a shift upwards in the market cycle, but it is only a few months of trading, and macro economic storm clouds are gathering, together with the next phase of Brexit and the threat of further disruption from Covid-19. Indeed, the current out-performance could be "pull forward" from the autumn as consumers fear a second wave of the virus. It is therefore impossible to call as to how sustainable this trend might be, and as such, to predict the future from the autumn onwards would be speculative at best. That said, given the start to the new financial year and the relative strength of our proposition, we are well positioned to take advantage if the current trends continue and we can also cope with potential further disruption.

1. Refer to pages 158 to 160 for APM definitions

"I am so proud of, and grateful to, every single one of our colleagues and stakeholders for the way in which we managed through the lockdown."

Prior to the arrival of Covid-19, we were making good progress on our strategic initiatives, despite the continued challenges from the relatively flat market. During lockdown we reflected on our progress, given the acceleration in consumer behaviour towards online shopping, and the underlying strengths of our well-invested omnichannel platform and unrivalled industry scale.

As I outline below, since the year end, we have taken further actions to reinforce the structure of the Group and we will continue to invest in core assets and key initiatives which support our long-term strategy and deliver improved shareholder returns.

Managing the Covid-19 pandemic

Our company values, allied to our rigorous risk management framework, helped shape our response to the Covid-19 pandemic. From January, Covid-19 evolved rapidly from a predominantly regional concern, disrupting our Chinese imports, to an international crisis affecting many elements of daily life, including every aspect of our own Group activities.

As the pandemic spread into the UK, our first actions were to prioritise the health and safety of our colleagues and customers. On 23 March, we closed all our showrooms, manufacturing and distribution operations in the UK, Republic of Ireland and Spain and immediately suspended all customer deliveries, with health concerns paramount. Despite severe restrictions on physical operations, we continued to support close to 5,000 furloughed colleagues at a time of growing financial uncertainty, fully protecting salaries in April and maintaining salaries at 80% of full pay until colleagues returned to work, in excess of Government salary caps. In solidarity with our teams on furlough, all our Group's senior leadership, including our Board Directors and senior executives, agreed an equivalent salary reduction.

We also amended our sick pay policy to take account of Covid-19 risks and the salaries of the Group's senior executives and Non-Executive directors were reduced while operations were suspended. We also provided valuable well-being support to employees via numerous avenues including our employee assistance helpline and The DFS Living Well Workplace platform. Government restrictions on our business began to be eased from the end of May, and our own operations resumed once we were confident that we had the correct measures in place to protect our colleagues and customers.

Safety concerns addressed, aided by our Group-wide Google technology infrastructure to facilitate remote team-working, we were able to enact recently updated business continuity procedures in order to protect the health of the business. We undertook a thorough financial review, significantly reducing expenditure, deferring new store openings and utilising the UK government's business rates holiday and the Coronavirus Job Retention Scheme to manage costs and cash.

In relation to key external stakeholders, we aimed to act with integrity in relation to our suppliers and landlords. Recognising their existential challenges, we prioritised payments to smaller, key long-standing suppliers. We acknowledge the support of our strongest landlords and suppliers in allowing us to secure temporary improvements to our payment schedules.

Our investors also deserve recognition for their support during the pandemic. With cash flows temporarily constrained as lockdown restrictions prevented us from delivering our growing customer order bank, we were able to secure a temporary £70m extension to our banking facilities. Our largest shareholders also participated in a £63.9m share placing which was also supported by our Board members. As dividend payments have been suspended to help manage the financial impact of the pandemic, we acknowledge our shareholders' support and will aim to recommence payments once the macroeconomic outlook is more certain.

At a time of unprecedented challenge, I have greatly admired how our various stakeholders and management teams have been able to work calmly together, allowing us to operate safely and preserve the long term value of the Group. The power of strong relationships is something that we value highly as a Group.

Review of strategic progress

The far-reaching consequences of the pandemic underline more than ever the importance of fully embracing digital channels as online penetration accelerates across the retail sector. In the upholstery market we believe that it is the combination of digital and the physical aspects of our showrooms that will continue to be successful . We know from our research that 90% of sofa buying decisions are made in the showrooms after the all important "sit test" as "comfort" is the number one reason why customers choose to buy a sofa or not. Showrooms are therefore at the centre of our business model and as such we believe that the Group is well placed if consumers reprioritise the home within their lifestyles and spending patterns.

Our strategy, to lead sofa retailing in the digital age, aims to generate, as previously announced, £40m of incremental profit before tax relative to FY18 and excluding the impact of normal market growth/decline, by focusing on three core pillars: (i) to drive the DFS core brand, (ii) to build group platforms to maximise efficiency, and (iii) to unlock new profitable channels of growth.

Drive the DFS core

The DFS brand is the largest and most profitable in the Group and the key priority of our strategy is to focus on driving this brand across all channels. We continue to invest in our infrastructure in order to further improve our omnichannel customer journey.

With a strong online offer and well-invested showrooms, DFS is well positioned to compete across all channels. Prior to the Covid-19 pandemic, our recent market research showed that 85% of customers began their sofa buying research online, with around 90% of customers subsequently visiting a showroom to conduct a "sit-test" before completing their purchase. As such we believe that the combination of digital and physical showrooms is the right business model for the upholstery sector.

We were pleased, however, to see that we could trade well online, even without the benefit of showrooms during the lockdown period. This performance underlines the strength of the DFS brand and our online proposition, as well as our reputation for supplying good value products.

Our showrooms performed strongly as they reopened in the final weeks of the financial year. This trend has continued into the current financial year, together with high levels of growth through our online channels. Our online penetration of total orders is up 3ppts to 22% over the last six months.

A greater proportion of our advertising expenditure was spent on digital marketing as we worked with Facebook, Instagram and Pinterest to develop increasingly targeted customer campaigns. We also improved our on site search capabilities, being the first sofa retailer in the UK to introduce "visual search". This functionality enables customers to take photos of any sofa they see in any setting and then compare that to our extensive ranges.

In the first half of the year, we re-platformed the DFS website onto Google Cloud, enabling improved functionality, a faster user experience and far greater user capacity. Furthermore, having been the first sofa retailer to launch augmented reality on an iPhone mobile browser, enabling a customer to view a sofa in their own

Chief Executive's report continued

home, we've launched a second generation service with a new software partner and have been increasing the number of ranges available on this service. These initiatives have had a positive impact, particularly when showrooms were closed during the lockdown period.

We continued to invest in our showrooms in the year, equipping our sales colleagues across the showroom estate with 1,200 new Google Chrome tablets. The tablets enable rapid access to key information in a convenient and secure way, utilising customer data from their online account with us to direct them to the products they've been browsing and similar products that may match their requirements. Working with our artificial intelligence partner, Satalia, we developed a model to predict footfall, based on local market trends, weather, promotional campaigns to ensure we can act at short notice to optimise our sales team scheduling to meet demand.

We continue to track customer satisfaction by monitoring Net Promoter Scores (NPS) at various stages of the customer journey. Our post purchase NPS score for the DFS brand was 85.7% (FY19 84.2%). Our established customer satisfaction score improved significantly to 42.9% (FY19 33.0%). This increase was driven by a combination of better digital communication with customers post purchase, improved product quality and new digital tools enabling customers to book their own delivery and access customer service and help.

We're using our data more efficiently to deliver timely insights into consumer trends and drive more effective product development. We continue to see above average sales growth from our licensed sofa brands including French Connection, House Beautiful, Country Living and Joules, with successful new model introductions driving sales as they roll out across the DFS store estate.

Towards the end of the financial year, we also introduced the DFS Chair Edit – a series of new colourful accent chairs that complement existing sofa product ranges and allow customers to indulge their own design talents and create a coordinated living room look. In the current year, we have recently launched new ranges targeting busy families and to attract additional style-focused customers with our exclusive Halo Luxe partnership, which showcases the very best leather products.

We are making great progress in modernising and driving the DFS core business and this remains the key priority of our strategy. We look forward to continuing our investment, particularly in digital capability, as the year progresses, as we look to strengthen DFS's market-leading position.

Build the platforms

This strategic pillar focuses on Group-wide benefits from utilising existing infrastructure and scaling systems, processes and data. As a market-leading, vertically-integrated business, we are targeting significant efficiency gains from our property, logistics, marketing and manufacturing activities.

We continue to make good progress securing property savings, through a combination of rent reductions on leases approaching renewal and downsizing some showrooms. Last year we secured a further £1.4m of annualised savings, bringing the total annualised saving since the program began to £4.3m. We are confident of achieving the £6-8m targeted annual savings by FY23 as previously communicated. In order to secure the maximum value benefit over the longer term, we only commit to new leases where appropriate terms are available, reflecting the rental market trend and the Group's strength as an anchor tenant on many retail parks. We are also well placed to strengthen our portfolio during a period of market disruption affecting our competitors.

We continue to seek efficiencies from our Customer Distribution Centre (CDC) network, with some of our CDCs now delivering multiple Group brands after a successful trial. In the year, we relocated our Belfast CDC from our retail site into a new standalone location, repurposing the space to house more of our brands with minimal incremental rent. Our relocated Belfast CDC now delivers more of our brands' products to customers' homes on the same vehicles under our 'The Sofa Delivery Co' branded group delivery network. This network will enable us to provide better and more consistent service to our customers at a lower cost to the Group by: increasing utilisation of our delivery fleet and reducing carbon emissions; reducing CDC operating costs; and leveraging DFS's proprietary routing and scheduling optimisation software. We have the opportunity to transition all the Group's sofa delivery operations to this model by the end of Financial Year 2022 with annualised savings of £3m+.

To improve customer experience, we have trialled seven days a week and later evening delivery slots in our Glasgow CDC. As well as providing greater customer convenience, the change in shift patterns has also generated positive feedback from our colleagues in relation to work life balance and rest periods. We are considering extending this trial to all CDCs over the next 24 months.

We target continuous incremental improvements in our customer facing technology platforms. In the year, we enabled DFS customers to book their delivery and installation slots online. Around fifty percent of our customers now use this online functionality resulting in both higher NPS scores and increased efficiency. Customers can also now track where their delivery vehicle is, in real-time, on the day of delivery.

Marketing has been a traditional DFS strength and a major area of investment for the group. However, we believe we can drive significant efficiencies by using increasingly granular data-led analysis, particularly in relation to our digital marketing investment. With the support of our expert partners, we have identified optimum amounts of investment by brand for the current financial year, which will be regularly reviewed to reflect prevailing market conditions.

Going forward we are reviewing our own manufacturing capacity and capability given our growth plans for both DFS, Sofology and Dwell, the clear margin benefits of vertical integration and the potential for increased control of end to end supply chain.

We recognise that world class retail businesses are moving to become more platform-based in order to enable future profitability and extract cost efficiencies. We are making good progress on our platforms and intend to deliver all of the cost savings identified by Financial Year 2023.

Unlock new growth

The third pillar of our strategy is 'unlock new growth' which targets profitable growth from our other brands. Most recently this was reflected in the acquisition of Sofology in 2017 for £25m, following on from opportunistic acquisitions of Dwell and Sofa Workshop in 2013 and organic expansion in the Netherlands and Spain .

Recent operational challenges, weaker results and the uncertain retail outlook, have led us to review our Group structure and re-assess the prospects of certain smaller Group businesses. As we recover from the pandemic, we believe that it is important that the Group retains the financial resilience to weather a period of economic uncertainty, and that the investment in individual brands matches future returns prospects. With a leaner, simplified structure, we believe the Group will be best placed to maintain its leading market position, while taking advantage of the significant Sofology profit growth opportunity.

Sofology

We plan to accelerate the development of Sofology, and see significant scope to expand the number of showrooms in the UK, driving further economies of scale. We were encouraged by the performance of Sofology during the year, particularly the online channels during the lockdown period and as showrooms re-opened towards the end of the financial year.

Sofology continues to lead the sector with its seamless omnichannel journey, and made further progress in this area in the last financial year. Recent developments include website enhancements such as a 'go-in-store' capability, whereby a customer browsing online can be connected to a colleague in a showroom via video, see the product live and have any questions answered, and the introduction of a 'sofa sizer', enabling a customer to enter the maximum height, width and depth of a sofa with the range immediately refined and presented to the customer. These initiatives have helped contribute to improved web and showroom conversion throughout the year.

We have developed significant new product ranges and refreshed the existing offer through the addition of new coverings. These new collections have been successful in driving improved Average Order Values and gross margins, and as such are driving strong sales and margin growth year on year post lockdown.

Sofology's NPS continues to benefit from investment in product quality and after sales service. Colleague engagement scores have also continued to improve and attrition has reduced significantly.

Sofology opened three new showrooms in the period including its first store in Northern Ireland. Despite disruption due to lockdown measures, we remain encouraged by the new store performance.

We continue to see the opportunity to grow the Sofology brand to 65-70 outlets in the medium term. In the current year, taking advantage of favourable lease terms, we are seeking to accelerate the showroom opening programme and plan to open 6-10 new showrooms in the next twelve months.

Sofa Workshop and Dwell

The disappointing performance by Sofa Workshop we outlined in our interim results deteriorated further in the second half. Following our strategic review, we decided to sell Sofa Workshop and the transaction was finalised and announced in August.

In a competitive homewares market, Dwell also reported a decline in sales and brand contribution during the year. We have restructured the Dwell operating model to enable its wide range of attractive products to be sold more seamlessly to DFS customers, as well as online. We believe that Dwell has a complimentary proposition to our sofa brands and is now set up to deliver profitable growth going forward.

International

Prior to lockdown, the performance of our six Netherlands showrooms was in line with expectations and we expect to conclude our review on growth options for this business in 2021. Our two Spanish showrooms continue to perform well despite potential uncertainty from the Brexit, which may have some effect in the areas they are located.

People, purpose and values

FY20 placed significant demands on our Group colleagues, including managing uncertainties around the government furlough programme, or working extended hours from home alongside domestic pressures and perhaps coping with anxiety around Covid-19. Using a variety of means, we have aimed to support our colleagues from a financial and wellbeing perspective as much as possible during this period. I genuinely appreciate all our colleagues for their efforts in the year.

Despite the growing importance of digital technology, retailing remains very much a 'people' business, and the industry remains the UK's largest private sector employer. I am proud to lead a Group with more than 5,000 passionate and dedicated colleagues. As a vertically-integrated omnichannel business, with a strong 'family' ethos, the Group offers a wide range of career opportunities across our manufacturing, retailing, distribution and support functions. We also provide a range of career development opportunities, from our award-winning apprenticeship programme to leadership skills workshops.

We continue to receive external recognition for our employment engagement, gaining a Best Companies™ accreditation for a fifth consecutive year, with colleagues highlighting positive manager relationships and an enjoyable team working environment as key attractions of the Group. We continue to benefit from colleagues' loyalty, with almost 40% of colleagues having more than five years' service with the Group.

As a successful UK-based company and the market leader in our sector, we also believe that, in addition to delivering long-term value for shareholders, we have a responsibility to contribute to the success of wider society and to be aware of our impact on the environment. To this end, we have spent time reflecting on our company purpose throughout the year:

Our Group purpose is to bring great design and comfort into every living room, in an affordable, responsible, and sustainable manner. Our customers and our people are at the heart of everything we do, reflected in our three core values of 'Think Customer', 'Be Real' and 'Aim High'. These values are firmly ingrained across the Group and are central to our strategy and our purpose.

Environmental, Social and Governance (ESG)

Reflecting our purpose and values, we are committed to acting in a responsible and sustainable manner into the long-term. Our Group-wide ESG initiative is led by Sofology CEO Sally Hopson and supported by Alison Hutchinson as Board sponsor. In the last twelve months, we have intensified our efforts in this critical area, and have developed a new ESG Strategy that will be announced alongside our preliminary results. The Strategy will detail specific multi-year targets for our brands across key areas of the business including sourcing, packaging, recycling, energy efficiency, gender diversity and flexible working. We intend to turn ESG leadership into a sustainable source of competitive advantage for the Group. Further details of our ESG Strategy can be found on page 48 of this Annual report.

Impact of the UK's exit process from the EU

In my 2019 CEO's report, I reported in detail on our work on the potential impact of the UK's departure from the European Union. Our preparations have continued, overseen by the Group Risk Team reporting to the Audit Committee. The UK is currently in a transition period until the end of 2020 while trade negotiations take place regarding the nature of the future relationship with the EU. The level of change required as part of any trade deal is unclear as yet. We have established a cross brand Working Group prioritising actions to address the "known knowns" surrounding the EU departure process. With governments prioritising the Covid-19 response, it is currently unclear whether the transition period will be extended and, on balance therefore, the risks of a 'no deal' departure have increased. We provide more detail on Brexit in our Risks & Uncertainties analysis on page 35.

As indicated in last year's report, the two principal risks to the Group from the EU departure remain consumer confidence related impacts on consumer demand, and border delays. As a result of the Covid-19 pandemic, consumer confidence is already low. We will continue our preparations to minimise the disruption as part of our risk management process, until the UK and EU's path forward is clear.

Outlook

While the reported decline in profit is undoubtedly disappointing in headline financial terms, a significant proportion of this profit has already been recovered in the current year as we resumed customer deliveries. We have also continued to make progress with our strategic agenda, strengthened our stakeholder relationships and worked hard to preserve the value of the Group.

The current year has started very strongly with all showrooms now open and our digital channels continuing to grow. Our year-on-year order intake growth over the last twelve weeks, combined with our previously announced higher opening order book, implies c.£226m of additional revenues will be realised in this financial year. We believe that this growth is due to a combination of pent up demand from lockdown, consumers spending relatively more on their homes and the strength of the DFS and Sofology propositions in particular.

In the absence of further lockdown impacts, we therefore look forward to reporting a strong first half sales and profit performance, although the full year outcome will be dependent on the effects of the pandemic and Brexit on consumer confidence, the housing market and levels of employment. Cash generation will continue to be a priority as we look to rebuild our financial resilience.

We remain focused on executing our strategy, with agility and pace, and believe that the Group is well placed to further strengthen our market-leading position in the medium term. The events of the past year have allowed us to build an even stronger sense of togetherness. We emerge from the crisis stronger and with renewed energy and purpose.

Tim Stacey
Chief Executive Officer
24 September 2020