

# Operating review

We continue to focus on our core wholesale and retail business activities, seeking to grow market share and profits of existing businesses.



## About the team

The executive committee, chaired by Geoff Cooper, consists of the executive Directors. Since December 2002, the executive committee has taken over responsibility for the day by day running of the Group, implement the decisions of the Board, and attend to all matters not reserved for approval by the Board.

01  
Stefano Pessina  
Chief Executive

02  
George Fairweather  
Group Finance Director

03  
Steve Duncan  
Retail Director

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Geoff Cooper  
Deputy Chief Executive

05  
Ornella Barra  
Director – Wholesale Southern Europe (Group Services Director designate)

## Divisional highlights

for the year ended 31 December 2002

	Turnover £million	Operating profit* £million	Year on year growth	
			Turnover %	Operating profit* %
Wholesale Northern Europe	2,770.5	77.4	+13.8	+9.0
Wholesale Southern Europe	4,988.9	73.8	+5.5	+5.1
Retail – Europe	972.5	65.4	+35.1	+16.0
Corporate	–	(11.7)	–	–
Intra-group	(708.4)	–	–	–
Group	8,023.5	204.9	+9.7	+13.0
Share of operating profit of associated businesses	–	21.5	–	+23.6
<b>Total</b>	<b>8,023.5</b>	<b>226.4</b>	<b>+9.7</b>	<b>+13.9</b>

\*Before amortisation of intangible assets.

In 2002, each of our divisions delivered strong growth in turnover and operating profits, demonstrating again the Group's ability to deliver good growth in financial performance. We continue to focus on our core wholesale and retail business activities, seeking to grow market share and profits of existing businesses through differentiating ourselves by providing superior customer service supported by ever-improving operational efficiencies.

During the course of the year we increased development activities on a number of cross-country business improvement projects, including the establishment of small central teams for logistics management, procurement and information technology, the benefits of which are already being seen.

## Markets

Overall, we estimate that the wholesale markets in which our businesses operate grew by around 5.1% year on year, weighted according to our wholesale turnover. The principal factors determining market growth continue to be demographics and government actions in each country. The 2002 average growth rate is in line with other forecasts and with rates seen in recent years.

Generic prescribing continues to increase, particularly in the UK and The Netherlands, reducing wholesale turnover growth as more expensive brands come off patent and are replaced by cheaper generic medicines which typically offer higher trading margins to us. Despite the lower sales growth, we have used our market position to improve our rate of growth and expect to be able to continue this success.

Parallel importing, continues to increase in several markets across Europe, despite manufacturers' efforts to curtail it through the implementation of quota systems on products and the restriction of product supply in certain markets. This growth is being encouraged in some markets by governments introducing or maintaining economic incentives or regulations to increase the incidence of dispensing of parallel imported products. Manufacturers' actions are subject to ongoing legal challenges by industry associations across Europe, as they

## Northern Europe: Highlights of the year

UK: New warehouse layout, developed as result of a Group-wide benchmarking process, trialled extremely successfully in Hinckley warehouse. Continued enhancements to our industry acclaimed loyalty schemes. Launch of the new Nexphase pharmacy management system.

The Netherlands: Further significant growth in market share. One new warehouse opened in 2002 to replace and update old facilities, with another

new opening since the year end, both using the new benchmarked warehouse layout.

The Czech Republic: New organisational structure implemented, strengthening focus on customer service.

Norway: Entry into the Norwegian wholesale market with acquisition of Holtung in June 2002.

are aimed at restricting free trade within the European Union. Overall, however, trade in parallel imports is limited.

### Wholesale

#### Northern Europe

Operating profit before amortisation of intangible assets was £77.4 million (€123.3 million), an increase of 9.0% on the previous year, on turnover up 13.8% to £2,770.5 million (€4,413.4 million). Underlying like for like sales growth was 10.7% on a constant currency basis. Operating margins decreased by 13 basis points to 2.79%, mainly as a result of lower gross margins in The Netherlands. In the second half, operating profit before amortisation of intangible assets was £42.9 million (€67.8 million), an increase of 10.9% on the second half of 2001 on turnover up 18.3%.

In the UK, turnover for the year was £1,923.2 million (€3,063.6 million). Underlying sales growth was 8.4%, representing a further increase in market share, the market growing, we estimate, by around 7.5%. As previously reported, a major supplier transferred the remaining part of its business from a wholesale to an agency basis in the first half, reducing reported year on year turnover growth to 4.9%.

Gross margins in the UK were higher than in 2001, following management action to increase sales of higher margin product categories and more effective management of customer and supplier relationships. Overall, the business achieved good profit growth.

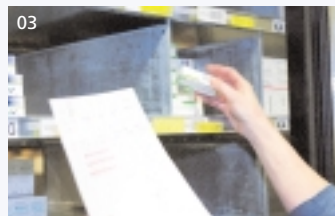
Having rationalised the UK warehouse network in recent years, further improvements in productivity are being sought through a Group-wide benchmarking initiative covering warehouse layout, operating procedures and related systems. In October, as part of this programme, we completed the process of re-laying our Hinckley facility to a new format. Early indications are that substantial improvements in productivity can be achieved and actions to roll out the programme to other facilities, both in the UK and other countries, are underway.



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**01** In June 2002 the Group completed the acquisition of Holtung, the third largest pharmaceutical wholesaler in Norway.

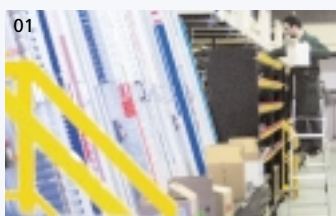
**02** The integration of the business into the Group is now complete, including the transfer of our Norwegian retail supply business, significantly improving sales, market share, and the underlying financial performance of the business.

**03** As elsewhere the close working relationship between pharmaceutical wholesale and retail pharmacy is already delivering benefits to both businesses.

**04** Based just outside Oslo, Holtung gives the Group a wholesale presence in Scandinavia for the first time.

## Operating review (continued)

During the course of the year we increased development activities on a number of cross-country business improvement projects.



**01** Our business is one of interdependence with our customers. It is not a simple customer-supplier relationship.

**02** We are not complacent about our service levels, and benchmark ourselves against the best in our industry to ensure that we provide the best service we possibly can.

**03** Areas of differentiation for our business include product sectors where we can add value through specialist advice and product ranges to enhance our customers own businesses.

**04** The pharmacist relies on his full line wholesaler. He depends on being able to get his pharmaceuticals delivered accurately and on time, every time.

**05** The initiatives underway in France are designed to increase customer loyalty, establish stronger relationships with pharmacist buying groups and go some way to counter competitor discounting.

We have also launched our new pharmacy management system software in the UK. Called Nexphase, this is the replacement for the highly successful market-leading Mediphase system, currently used by over 4,000 pharmacies in the UK.

In addition, we have continued to enhance our industry acclaimed loyalty schemes, including a series of enhancements to the popular "Community Pharmacy Initiative +" programme, designed to help independent community pharmacies take advantage of category management systems developed within the Group.

In The Netherlands, our turnover increased by 24.9% to £613.5 million (€977.3 million), up 23.4% on a constant currency basis. Sales growth accelerated in the second half of the year, despite estimated market growth slowing down to around 9% for the year, which was below our expectations at the half year stage. Despite strong competition, we continue to win significant market share by providing our customers with excellent customer service whilst matching discount conditions in the market. As reported in our interim results, competitors have increased discounts, resulting in lower gross margins.

Our pharmacist internet service, [pharmacy.com](http://pharmacy.com), was launched in The Netherlands during the year; it has been well received and attracted a large number of enthusiastic pharmacy users.

## Southern Europe: Highlights of the year

France: Further action to reduce costs, with a further two warehouses closed in 2002, completing the planned rationalisation process. Additional work on service initiatives, including the successful launch of the new Alphega independent pharmacy network concept in January 2002.

Italy: Significant work to reduce costs, with a review of operational strategy still underway to identify how best to improve performance.

Spain: Strong results further bolstered by the inclusion of a small regional wholesaler acquired in September 2001 and further cost reductions with two warehouses closed during the first half of the year.

Portugal: Gains in both market share and margin, with implementation of first warehouse re-formatted to new benchmark led warehouse plan to provide basis for future improvements in efficiency.

In December, the new warehouse and head office at 's-Hertogenbosch were successfully opened, replacing outdated facilities. Since the year end, a second warehouse has been similarly opened in Almere, again replacing an existing facility. The layout of both these warehouses incorporates benefits derived from the Group-wide benchmarking initiative.

In the Czech Republic, turnover increased by 27.6% to £140.1 million (€223.2 million), an increase of 14.0% on a constant currency basis, compared to a market which we estimate grew by around 9%. Large sales growth and market share gains were achieved in the hospital sector. Significant productivity gains more than compensated for gross margin pressures, resulting in higher operating margins and profits. This was a significant achievement, despite the disruption caused by floods in the autumn when one warehouse was severely damaged. During the year a new organisational structure was successfully implemented, strengthening our focus on customer service, and the principal warehouse in Prague was extended providing additional capacity.

In June, the Group completed the acquisition of Holtung, the third largest pharmaceutical wholesaler in Norway, based just outside Oslo, giving us a wholesale presence in Scandinavia for the first time. Turnover for the six months to 31 December 2002 was £93.7 million (€149.3 million). The integration of the business into the Group is now complete, including the transfer of our Norwegian retail supply business, significantly improving sales, market share and the underlying financial performance of the business. As a result, the business delivered profits, a year ahead of the business plan developed at the time of the acquisition.

## Wholesale

### Southern Europe

Operating profit before amortisation of intangible assets was £73.8 million (€117.5 million), an increase of 5.1% on the previous year on turnover up 5.5% to £4,988.9 million (€7,947.3 million). Underlying like for like sales growth was 3.3% on a constant currency basis. Operating margins for the year were at a similar level to 2001, but improved in the second half. As a result, second half operating profit before amortisation of intangible assets was £38.6 million (€60.9 million), an increase of 11.6% on the second half of 2001 on turnover up 8.4%.

In France, our largest business in the region, turnover increased by 6.4% to £3,198.3 million (€5,094.9 million), the growth rate being faster in the second half of the year following the acquisition of Ouest Répartition Pharmaceutique, a three branch regional wholesaler, which increased our market share. Our underlying organic sales growth was 3.7%, compared to a market which we estimate grew in value by around 3.5%, but declined in volume terms. As anticipated at the time of our 2002 interim results, this market growth was slower than in previous years. This reflects the full year impact of price reductions on branded ethical products announced in September 2001, increasing growth in generics, the marketing of fewer new medications and governmental efforts to reduce the number of prescriptions, including the delisting of certain medications available under prescription.

Despite the difficult market, operating profits in France grew substantially year on year, with operating margins improving through tight management controls and lower ACOSS healthcare taxes. Tough action has been taken to contain costs. Two warehouses were closed in the first half of the year; a further warehouse will be closed in the first half of 2003 to complete the rationalisation plan begun in 2001.

## Operating review (continued)

Our pharmacies are well located, with the overriding majority close to doctors' surgeries.

In addition to cutting costs, our French business continues to develop and enhance customer service initiatives designed to increase customer loyalty, establish stronger relationships with pharmacist buying groups and go some way to countering competitor discounting. In January 2002 Alphega, a network concept which independent pharmacies can join, was successfully launched. By the end of the year, 110 French pharmacies had joined the network. The business also continues to develop its professional services.

In Italy, turnover reduced by 7.0% to £848.1 million (€1,351.0 million), representing an 8.2% reduction on a like for like basis. This was mainly the result of a 5% reduction in prices imposed by the Italian government at the start of the second quarter and further governmental measures at the beginning of September, together with actions taken by ourselves in 2001 to withdraw from heavily discounted and unprofitable supply contracts with a number of municipal pharmacy chains. We estimate the comparable year on year market growth rate to be around 2.5%. Strong competition also impacted gross margins and contributed to lower operating margins and profitability. However, swift action was taken in the first half of the year to eliminate costs, resulting in a headcount reduction of 9% over the course of the year. As a result of these measures, operating profits in the second half of the year were over 50% higher than in the first half, matching the second half results for 2001.

Our review of operational strategy in Italy is continuing, to determine how best to improve longer term business performance in what is a difficult market from a regulatory and commercial perspective. This is being led by a new managing director recently appointed from within the Group.

In Spain, turnover increased by 18.6% to £639.7 million (€1,019.0 million). Like for like turnover grew by 13.3% on a constant currency basis, with growth also coming from the acquisition of a small regional wholesaler in September 2001. This compares with market growth we estimate to be around 9%. Operating profit for the year was ahead of 2001. This profit development was aided by a continued focus on costs, including the closure of two warehouses in the first half of the year.

Turnover in Portugal increased by 12.1% to £302.8 million (€482.4 million), up 11.6% on a like for like basis, compared to a market growth rate we estimate to be around 8%. Growth in the second half of the year was particularly strong, as the business gained market share while at the same time improving margins. Profitability increased year on year, despite a number of one-off costs in the first half, the most significant of which were redundancy costs as a result of our response to regulatory cost pressures experienced last year. Improvements in profitability should be assisted further by the introduction of the new format warehouse configuration being introduced into the first warehouse in Portugal as part of its implementation programme following its success in the UK.

### Retail

Operating profit before amortisation of intangible assets was £65.4 million (€104.2 million), an increase of 16.0% on the previous year, on turnover up 35.1% to £972.5 million (€1,549.2 million).

In the second half, operating profit before amortisation of intangible assets was £34.6 million (€54.6 million), an increase of 9.5% on the second half of 2001 on turnover up 27.7%. Operating margins in Norway, The Netherlands and Italy all rose year on year as these businesses grew in scale. Overall retail operating margins for the year were 112 basis points lower than in 2001; this was as a result of earlier government action to stabilise generic prices in the UK and a mix effect from having a greater proportion of sales in non-UK markets.

**Retail:**  
**Highlights of the year**

94 new pharmacies added to the network across Europe.

Further diversification of pharmacy portfolio, with expansion focus mainly outside the UK.

Implementation of new branch EPOS system underway.

New board representation with appointment of Steve Duncan as Retail Director to the Board during 2002.

Participation with UK regulatory enquiry into Pharmacy contracting and licensing, and detailed work to confirm the limitations of its potential impact on Alliance UniChem's business.

In the UK, turnover increased by 20.1% to £715.8 million (€1,140.3 million), like for like sales growing by 7.5%. Turnover from National Health Service prescription income increased by 24.9%. Operating profits increased year on year at a lower rate than sales, operating margins being lower for the reasons explained above. During the year we acquired 20 pharmacies and sold five, of which four operated in supermarkets. This brought our total UK chain, as at 31 December 2002, to 782 pharmacies and 62 other healthcare related retail outlets. As previously highlighted, we temporarily slowed down our pace of expansion in the UK, pending the outcome of the Office of Fair Trading review of pharmacy licensing and control.

The Office of Fair Trading, after a number of delays, finally published its recommendations on 17 January 2003. The report recommended the removal of the current contract system, introduced by the Department of Health in 1987. The Government is considering to what extent the Office of Fair Trading's opinions can be implemented, while ensuring the continued provision of appropriate distribution of pharmaceuticals and services to all communities across the United Kingdom. Alliance UniChem is actively participating in the Government's consultation process, the outcome of which is expected to be announced in mid-April.

We are confident that the recommended liberalisation of the regulations, if implemented in full, will have no overall negative effect on our existing business. Instead, it will provide new opportunities for further growth in our UK retail chain through the opening of new pharmacies – a process which has already been planned.

Alliance UniChem is committed to the concept of community pharmacy. Our pharmacies are well located, with the overriding majority close to doctors' surgeries, and would be largely unaffected by any new pharmacy openings in superstores, high streets or other destination shopping locations. Our typical customer is a patient requiring immediate fulfilment of a prescription or with a regular repeat prescription.



**01** When a patient enters a pharmacy to get a prescription filled they are placing a great deal of faith in that pharmacist, expecting them to ensure that they dispense the right product in the correct dose with adequate and accurate instructions for taking the medicines.

**02** During the year 11 new pharmacies were added to our network in Italy, including this newly refurbished 24 hour pharmacy in Lucca.

**03** Our pharmacists are given additional training in specialist areas of patient advice and counselling, and additional therapeutic skills or complementary treatments to enhance the service offering in our pharmacies.

**04** On-going training is both a professional requirement for our pharmacists, and a significant element of our strategy to differentiate our pharmacies through the quality and range of services offered.

**05** In addition to our own programmes to promote patient well being we participate in a wide range of national or industry programmes, such as this co-sponsored smoking cessation programme being promoted by the Norwegian government. Similar programmes are underway with governmental support across Europe.

## Operating review (continued)

Alliance UniChem is committed to the concept of community pharmacy. Our pharmacy offering is focused on customer service and advice.



**01** The community focus of our retail business has meant that our pharmacy chain has long been recognised as a leader, outside academic and hospital pharmacy, in clinical pharmacy and pharmacists professional development.

**02** When a patient chooses to enter one of our pharmacies, or one of our independent pharmacist partners, we must ensure that they get the highest possible level of service from that pharmacy.

**03** Provided our pricing is competitive it is the level of service that will provide the competitive advantage with the pharmacist, and so win their order.

**04** The quality and consistency of our service is a significant differentiator between ourselves and our competitors in many markets, and we believe it is the key to our success.

Our pharmacy offering is focused on customer service and advice, thereby attracting an enhanced market share of NHS prescription patients. This professional approach provides us with a competitive advantage in attracting and retaining qualified pharmacists who prefer to work with patients in an advice-orientated environment.

We will also seek to increase the number of pharmacies which our UK wholesale business serves as a result of any liberalisation of the pharmacy contract system. We do, however, believe that these proposals, if implemented in full, carry with them the risk of compromising the national pharmacy service by jeopardising the quality of pharmacy service available from the independently owned pharmacies in the UK.

We remain confident that our focused retail pharmacy offering will allow us to continue our strong growth and financial performance and to ensure that the intrinsic value of our UK pharmacy chain remains robust. The value of our pharmacy chain is reviewed each year on a discounted cash flow basis, in accordance with UK Generally Accepted Accounting Principles. Cash flows remain strong and no significant devaluation in the carrying value of pharmacies on the Group balance sheet is anticipated.

We continue to invest in the UK business; 98 pharmacies were refitted during the period, all in the latest Moss format. An investment is underway to install next generation information technology systems throughout the business; this includes the implementation of new branch EPOS and pharmacy management systems linked into new head office systems. This investment will facilitate the delivery of new pharmacy services in the future, and also enable us to manage the business even more effectively.

In Norway, turnover increased by 123.7% to £174.3 million (€277.7 million), as we continue to expand the business. 21 pharmacies were acquired during the year, three new pharmacies were opened and one closed, bringing the total chain to 89 outlets as at 31 December 2002. Operating margins almost doubled as the business achieved the scale necessary to operate effectively. As a result of these factors, operating profit levels were substantially higher than in 2001.

In The Netherlands, turnover increased by 111.3% to £61.9 million (€98.6 million), again reflecting the rapid expansion of the chain. 12 pharmacies were purchased during the year increasing the chain size to 39 outlets. Operating margins also increased as the business increased its scale. Together these factors, as with Norway, resulted in substantially higher operating profits. In August we acquired the remaining 30% minority interest in the business, giving us full ownership of all our retail outlets in that country.

In Italy, turnover increased by 22.8% to £20.5 million (€32.7 million), 11 pharmacies being acquired during the year and one merged pharmacy being returned to its municipality, bringing the total to 28 at the year end, including eight in associate businesses. Operating margins improved year on year.

Through our other associate retail business we now operate 83 pharmacies and seven other retail outlets.

#### Corporate costs

Net corporate costs totalled £11.7 million (€18.6 million), a £4.6 million reduction on 2001, which included higher internet technology costs.

#### Associate businesses

Our associate businesses contributed £21.5 million (€34.2 million) to total operating profit before amortisation of intangibles, a 23.6% increase year on year.

Hedef-Alliance, the largest pharmaceutical wholesaler in Turkey, contributed £6.9 million (€11.0 million), compared to £3.8 million (€6.1 million) in 2001. Business operating profits before amortisation of intangibles increased by 7.4% on an inflation adjusted US dollar basis, the balance of the increase in contribution mainly reflecting the timing of the purchase of our two-stage investment.

In September, we completed the purchase of a further 25% interest in Hedef-Alliance, taking our interest to 50%. This was done through the exercise of our option, the terms of which were renegotiated in recognition of the volatility in the Turkish economy. £20.8 million (€33.1 million) of the consideration was paid in 2002; the balance will be paid between 2004 and 2005, based on the business's performance, and will be met in cash or shares at Alliance UniChem's sole discretion. We continue to account for Hedef-Alliance as an associated undertaking.

Contributions from other associate businesses increased by 7.3% in total to £14.6 million (€23.2 million), a strong performance by Galenica of Switzerland being partially offset by the absence of operating profits from associate businesses in The Netherlands which were sold in 2001.

In the final quarter of 2002, we disposed of our associate interest in Sophasud in Morocco, as it did not meet our strict investment criteria for associate investments.