

Financial review

Accounting policies

The principal accounting policies adopted by the Group are unchanged.

Results for the year

Group turnover was £8,898.4 million (€13,125.1 million), a year on year increase of 1.1% (up 3.0% on a constant currency basis).

Group operating profit before amortisation of intangible assets increased by 8.3% to £245.3 million (€361.8 million), Group operating margins on the same basis increasing by 18 basis points to 2.76%.

The share of operating profit in associated undertakings before amortisation of intangible assets grew by 25.3% to £46.1 million (€68.0 million), resulting in total operating profit before amortisation of intangible assets growing by 10.6% to £291.4 million (€429.8 million). Amortisation of intangible assets increased by 14.0% to £15.5 million (€22.9 million). Total operating profit increased by 10.4% to £275.9 million (€407.0 million).

Net exceptional gains totalled £11.7 million (€17.3 million) compared with £nil in 2003. These comprised a profit of £13.6 million (€20.1 million) on the disposal of non-core businesses, principally in UK wholesale, and a provision of £1.9 million (€2.8 million) against the Group's residual US investment in a central dispensing business. Assets disposed of included £17.6 million (€26.0 million) of goodwill, of which £11.1 million was capitalised in intangible fixed assets and of which £6.5 million had been previously written off directly to reserves.

Net interest payable was £39.4 million (€58.1 million), a 26.4% decrease year on year due to lower interest rates and the benefits from the ongoing working capital efficiency programme. Interest cover, calculated before the amortisation of intangible assets and exceptional items, was 7.4 times, compared to 4.9 times in 2003.

Profit on ordinary activities before taxation, amortisation of intangible assets and exceptional items increased by 20.1% to £252.0 million (€371.7 million), and profit on ordinary activities before taxation increased by 26.4% to £248.2 million (€366.1 million).

The Group's effective rate of tax, based on profit before taxation, amortisation of intangible assets and exceptional items was 32.1%, a year on year increase of 0.1 percentage points.

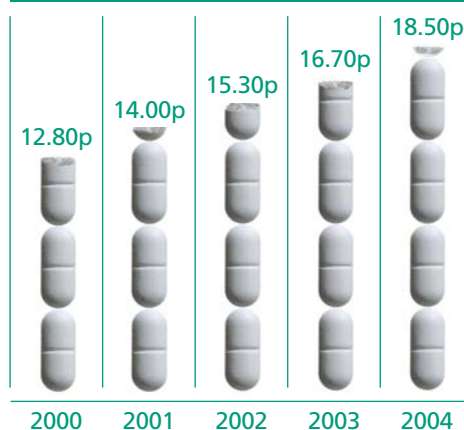
The Directors consider that the effective tax rate on profit before taxation, amortisation of intangible assets and exceptional items is a useful indication of the tax charge on the Group's underlying performance.

The effective tax rate, based on profit before taxation was 32.6%, a year on year decrease of 1.6 percentage points. The reduction primarily reflects the tax exempt profit on the disposal of businesses.

Shareholders' return and dividends

Diluted earnings per share before amortisation of intangible assets and exceptional items increased year on year by 17.0% to 48.2 pence. After amortisation of intangible assets and exceptional items, diluted earnings were 47.1 pence, a year on year increase of 26.3%. The Board is recommending a final dividend of 12.25 pence per share, making a total dividend for the year of 18.50 pence per share. The proposed final dividend is 11.4% higher than the final dividend in 2003, the total dividend for the year being 10.8% higher than the total dividend for 2003. The total dividend is covered 2.6 times by basic earnings per share before amortisation of intangible assets and exceptional items and 2.6 times after amortisation of intangible assets and exceptional items.

Dividends per share



Cash flow for the year ended 31 December 2004

	2004 £million	2003 £million
Operating cash flow	310.1	322.3
Interest and dividends	(72.1)	(78.2)
Tax	(49.0)	(46.2)
Maintenance capital expenditure	(32.2)	(24.1)
Free cash flow	156.8	173.8
Growth capital expenditure and financial investment	(118.6)	(65.5)
Cash flow before financing	38.2	108.3
Financing	(12.1)	1.3
Translation differences	(9.9)	(56.6)
Decrease in net borrowings	16.2	53.0

Cash flow and investment

The Group has continued its well established track record of generating free cash flow to fund investment in retail pharmacies, wholesale acquisitions and associates.

Net cash inflow from operating activities at £310.1 million (€457.4 million) benefited from an estimated £39 million inflow from improved trade working capital ratios, building upon the efficiencies achieved in 2003. Working capital net inflow was £28.5 million (€42.0 million).

Cash inflow from lower stocks was £33.3 million (€49.1 million), stock levels reducing year on year by 1.2 days. Cash inflow from debtors was £67.6 million (€99.7 million), underlying trade debtors reducing year on year by 1.4 days. Cash outflow from creditors was £72.4 million (€106.8 million), trade creditors decreasing year on year by 1.1 days, due to variations in the timing of discounts.

Net capital expenditure on tangible fixed assets was £58.9 million (€86.9 million), including £32.2 million (€47.5 million) of gross expenditure on replacement fixed assets.

Total cash paid for the purchase of businesses was £88.7 million (€130.8 million). This expenditure was mainly on the acquisition of retail pharmacies. In addition, £54.0 million (€79.7 million) of cash was spent on associates, the major elements being the purchase of 19% of the equity of ANZAG for a consideration of £41.7 million (€60.5 million) and the cash element of the balance of the consideration for the second 25% shareholding in Hedef Alliance, half being satisfied by the issue of equity.

Shareholders' funds

Shareholders' funds at the year end were £1,071.1 million (€1,513.5 million), a year on year increase of £141.3 million, principally reflecting £102.1 million (€150.6 million) of retained profit and £17.1 million (€25.2 million) of shares issued.

Financial position

At 31 December 2004, net borrowings were £811.0 million (€1,145.9 million), which were £16.2 million lower than at the end of 2003, despite £9.9 million of currency translation losses on borrowings hedging continental European assets.

Treasury policies

The Group's treasury policies seek to ensure that appropriate financial resources are available for the development of the Group, whilst managing interest rate, currency and counterparty risks. The Group treasury department acts as a service centre operating within clearly defined parameters approved by the Board. The Group's policy is not to engage in speculative transactions. During the year the Group completed a major review of its treasury policies, introducing a number of refinements in order to improve the management of risk further.

The Group seeks to maintain levels of interest cover that are commensurate with an implied investment grade debt rating.

Liquidity and funding

The Board's policy is to diversify its sources of funding so as not to be reliant on any one financial market. Currently, the Group finances its borrowings from the bank and private placement markets and it uses the securitisation market to finance part of its trade receivables.

During the year, £140 million of committed borrowing facilities were renewed for a further year. These facilities mature on 27 October 2005, although at the Group's election the term may be extended for a further two years. In addition, the Group replaced £89 million of committed borrowing facilities that mature in 2007 with five year committed borrowing facilities that mature in October 2009 on more favourable terms.

In managing its liquidity requirements, the Group aims to balance certainty of funding with a cost-effective and flexible borrowing structure. In particular, the policy is to have at least 70% of its maximum anticipated net borrowings over a 12 month forward period covered by term loans or committed facilities. Furthermore, forecast undrawn committed borrowing facilities over a three month forward period are targeted to be not less than £100 million.

At the year end, 49% of total borrowings were repayable in more than five years compared to 54% at the end of 2003. Undrawn committed borrowing facilities at the year end totalled £126.6 million (€178.9 million) compared to £173.7 million at the end of 2003.

Interest rate risk management

The Board's policy is to limit the impact of interest rate volatility on earnings. During the year, a new policy was introduced that is designed to reduce risk further at a marginally lower cost over the long term. Previously the Group hedged up to 60% of average projected borrowings over a three-year horizon, with borrowings beyond that period on a floating rate basis. The new policy fixes the interest cost (either directly through fixed coupons or synthetically through the use of interest rate swaps) on that proportion of the Group's average projected net borrowings (plus non-recourse receipts) that will give a minimum 95% statistically significant confidence level that the Group's interest cover will not fall below 4 times projected earnings before interest, tax, depreciation, amortisation of intangible assets and exceptional items over a three year forward period. This is determined using Monte Carlo simulation techniques, taking into account the Group's three year business plans, forward interest rates and implicit volatility derived from options pricing. The simulation model determines the minimum amount of net borrowings (plus non-recourse receipts) that is to be hedged, but this can be increased to protect earnings.

At 31 December 2004, 41% of the Group's net borrowings (plus non-recourse receipts) were hedged, which compared to 48% at the end of the previous year. The lower percentage cover at the end of 2004 reflects the introduction of the new policy, the higher level of interest cover and a low prevailing interest rate environment in particular in relation to Euro to which the Group has most exposure.

Assuming no change to the Group's net borrowings and hedge cover, it is estimated that a rise of 1 percentage point in interest rates would have theoretically reduced 2004 earnings before amortisation of intangible assets and exceptional items by about 3%, before taking into account the impact of mitigating actions.

Financial review

Currency risk management

The Group owns significant businesses and investments in continental Europe, which it partly hedges with borrowings denominated in the same currency, either directly or through the use of cross currency swaps. At 31 December 2004, 87% of the Group's total borrowings (including the impact of currency swaps plus non-recourse receipts) were in Euros.

Approximately 43% of the Group's 2004 earnings before amortisation of intangible assets and exceptional items were in currencies other than Sterling, of which 49% was in Euros. Adjusting these earnings for interest and tax, the Euro proportion increases to 70%.

The Group has a policy of hedging foreign currency denominated transaction exposures, other than those offset by corresponding translation exposures, by entering into forward foreign exchange sale and purchase contracts where such exposures arise.

Counterparty risk

The Group monitors the distribution of its cash assets, borrowings and other financial instruments against predetermined limits so as to limit exposure to any institution.

Pensions

FRS 17 "Retirement Benefits" was adopted early in full in 2003. Under FRS 17, the net pension liability reflected in the year end balance sheet was £36.3 million (€51.3 million) compared to £34.3 million at 31 December 2003. The year end balance comprises deficits of £36.4 million for the UK defined benefit pension scheme and £16.1 million for other European defined benefit pension schemes, partially offset by £16.2 million of deferred tax assets.

The liability for the UK scheme has decreased slightly over the year with returns on pension scheme assets and contributions more than covering the increase in liabilities due to a decrease in the discount rate applied to the liabilities and changes in the actuarial assumptions. The net pension liability of the other European schemes has increased over the year principally due to actuarial losses arising because of decreases in discount rates.

In Norway, many employees participate in an industry-wide multi-employer agency scheme operated by a government agency. During 2004, for the first time, the agency provided an allocation of the assets and liabilities of the scheme to the participating members. The allocation was based on the proportion of total member contributions to the scheme. The Group's notional share of the surplus at 31 December 2004 calculated using this method was £2.1 million.

The total pension charge against profit before taxation was £13.6 million (€20.1 million) compared to £14.0 million in 2003.

Share price

The Company's share price ranged from a low of 488.0 pence to a high of 758.5 pence during the financial year. On 31 December 2004, the mid market price was 754.5 pence, giving a market capitalisation of approximately £2.7 billion.

Financial reporting and going concern

The Directors have acknowledged their responsibilities in relation to the financial statements in the Directors' responsibilities statement. The Directors are also responsible for the publication of unaudited interim reports of the Group that provide balanced and understandable assessments of the Group's financial position for the first six months of each accounting period.

After making appropriate enquiries, the Directors consider that the Company has adequate resources to continue in operational existence for the foreseeable future and have therefore continued to adopt the going concern basis in preparing the financial statements.

International Financial Reporting Standards

From 1 January 2005 the Group will report its financial statements in accordance with International Financial Reporting Standards (IFRS), and the Group's transition project to prepare itself for this has continued during 2004. Other than the additional disclosures and presentational differences, IFRS will have the most impact for the Group in the following areas:

- Profit
- Share-based compensation
 - Goodwill amortisation

- Total equity
- Goodwill amortisation
 - Deferred taxation
 - Proposed final dividend

On pages 85 to 89 we have provided reconciliations from UK GAAP to IFRS of certain financial information for the year ended 31 December 2004. Accompanying the reconciliations are explanations of the principal differences, as well as a description of the exemptions taken by the Group on adoption of IFRS as set out in IFRS 1 "First-time adoption of International Accounting Standards". The financial information below has been prepared on the basis of IFRS expected to be applicable for 2005 reporting. These are subject to ongoing review and endorsement by the European Union (EU), possible amendment by interpretative guidance from the International Accounting Standards Board (IASB) or emerging industry practice and therefore subject to change. A summary of the reconciliations is provided on page 29.

	Before amortisation of intangible assets and exceptional items £million	Amortisation of intangible assets £million	Exceptional items ⁽⁶⁾ £million	Total £million
Profit for the financial year ended 31 December 2004				
Profit for the financial year under UK GAAP	170.9	(15.5)	11.7	167.1
Adjustments to conform to IFRS				
Share-based compensation ⁽¹⁾	(2.2)	–	–	(2.2)
Goodwill amortisation ⁽²⁾	–	15.1	–	15.1
Exceptional items:				
– net assets disposed	–	–	(0.9)	(0.9)
– reversal of recycling of goodwill from reserves ⁽³⁾	–	–	6.5	6.5
Deferred taxation				
– unremitted earnings of associated undertakings ⁽⁴⁾	(2.6)	–	–	(2.6)
– other ⁽⁵⁾	4.1	–	–	4.1
Other	0.2	–	–	0.2
Profit for the financial year under IFRS	170.4	(0.4)	17.3	187.3

	Before amortisation of intangible assets and exceptional items pence	Amortisation of intangible assets pence	Exceptional items ⁽⁶⁾ pence	Total pence
Earnings per share				
Earnings per share under UK GAAP				
Basic	48.7	(4.4)	3.4	47.7
Diluted	48.2	(4.4)	3.3	47.1
Earnings per share under IFRS				
Basic	48.6	(0.1)	4.9	53.4
Diluted	48.0	(0.1)	4.9	52.8

(1) A charge equivalent to the fair value of share-based compensation awards is recognised under IFRS.

(2) There is no goodwill amortisation under IFRS rather goodwill is tested for impairment annually.

(3) Goodwill previously written off directly to reserves is not recycled to the profit and loss account on subsequent disposal.

(4) Under IFRS deferred taxation on unremitted earnings of associated undertakings is provided where incremental tax would be due regardless of whether there is a commitment to remit the earnings.

(5) Predominantly relates to changes in tax rates and indexation on the deferred taxation adjustments described in the notes to the total equity reconciliation below.

(6) Under IFRS the Group will continue to identify separately items referred to as exceptional items under UK GAAP where such a presentation is relevant to an understanding of the Group's performance.

Total equity at 31 December 2004	£million
Total equity under UK GAAP	1,081.5
Adjustments to conform to IFRS	
Goodwill amortisation in 2004	15.1
2004 exceptional items – net assets disposed in 2004	(0.9)
Deferred taxation:	
– unremitted earnings of associated undertakings	(7.4)
– pharmacy licence acquisitions prior to 1 January 2004 ⁽¹⁾	(64.7)
– rolled over capital gains ⁽²⁾	(13.4)
– other	(3.2)
Proposed 2004 final dividend ⁽³⁾	43.5
Other	0.3
Total equity under IFRS	1,050.8

(1) A deferred taxation liability arises on the acquisition of retail pharmacy licences when the acquisition is through the purchase of shares, since a temporary difference arises between the book value ascribed to the licence and the tax base cost. Under UK GAAP deferred taxation is provided on timing differences, and initial recognition of pharmacy licences as a fair value adjustment does not create a timing difference. A consequence of the Group's decision to take up the option not to restate prior business combinations before the IFRS opening balance sheet date (1 January 2004) is that this deferred taxation liability is adjusted through retained earnings rather than as an adjustment to capitalised goodwill. The taxation will not be payable as long as the licences are not sold. The reduction in total equity is a one off effect on IFRS transition and going forward the deferred taxation liability will be an adjustment to capitalised goodwill.

(2) Deferred taxation on rolled over capital gains must be provided in full under IFRS. Under UK GAAP provision is not necessary when there is no commitment to dispose of the asset.

(3) Under IFRS, dividends are not provided for until the dividend recommended by the Board is approved by shareholders, and so the proposed 2004 final dividend recorded under UK GAAP is reversed.