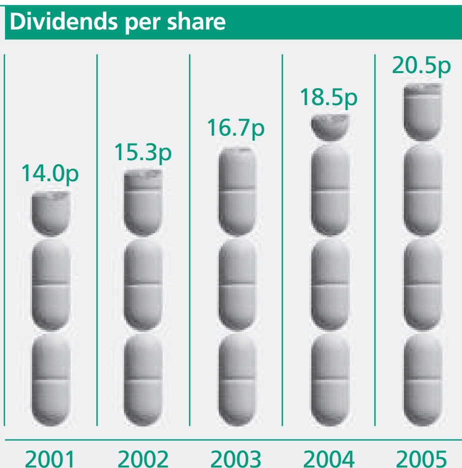
Financial review

Dividends per share



Accounting policies
The financial statements have been prepared in accordance with International Financial Reporting Standards (IFRS) for the first time. Previously the financial statements were prepared under United Kingdom generally accepted accounting principles (UK GAAP). The disclosures required by IFRS in relation to the transition from UK GAAP to IFRS are provided in note 50 to the financial statements on pages 109 to 114. These disclosures provide reconciliations from UK GAAP to IFRS of the equity at the transition date of 1 January 2004 and 31 December 2004 and of the profit for the year ended 31 December 2004.

The principal accounting policies adopted by the Group under IFRS are set out in note 2 to the financial statements on pages 69 to 73.

Results for the year
Group turnover was £9,171.2 million, a year on year increase of 3.1% (up 2.0% on a constant currency basis).

Operating profit increased by 7.1% to £261.0 million, with operating margins increasing by 11 basis points to 2.85%. Including our share of operating profit from associated undertakings (which grew by 53.6% to £70.8 million) operating profit increased by 14.5% to £331.8 million.

Shareholders' return and dividends
Diluted earnings per share before exceptional items and IAS 39 timing differences increased year on year by 14.0% to 54.6 pence. After exceptional items and IAS 39 timing differences, diluted earnings were 58.3 pence, a year on year increase of 10.4%. The Board is recommending a final dividend of 13.6 pence per share, making a total dividend for the year of 20.5 pence per share. The proposed final dividend is 11.0% higher than the final dividend in 2004, the total dividend for the year being 10.8% higher than the total dividend for 2004. The total dividend is covered 2.7 times by basic earnings per share before exceptional items and IAS 39 timing differences and 2.9 times after exceptional items and IAS 39 timing differences.

Exceptional items
Exceptional items, which are items classified by Alliance UniChem as exceptional in nature, totalled £9.1 million of after tax gains in 2005, compared to £17.3 million of after tax gains in 2004. The composition of the net gains in 2005 was as follows:

£3.8 million of costs before tax were incurred in the second half of the year in relation to the Group's proposed merger with Boots.

A net profit before tax was made on the disposal of businesses totalling £7.8 million. The principal transactions which made up this amount were the sale of 51% of Alliance UniChem Farmacêutica, our Portuguese wholesale business, the disposal of our 50% direct interest in the GaleniCare Swiss pharmacy chain and our 20% direct interest in the Swiss part of the Alloga pre-wholesale and contract logistics business both to our associate, Galenica, and the disposal of Elvetec in France.

The Group also disposed of its small investment in the German wholesaler, Sanacorp Pharmahandel A.G., for a profit before tax of £2.1 million, as it no longer considered the investment to be of strategic importance following the increase in its investment in ANZAG in Germany in 2004.

These transactions resulted in a net tax credit of £3.0 million.

Net finance costs
Net finance costs were £33.5 million. Excluding IAS 39 timing differences from hedging interest rate and currency exposures (comprising £5.2 million of gains which were mainly due to the strengthening of the US Dollar versus the Euro), underlying net finance costs were £38.7 million, a 7.6% reduction on the comparable figure in the previous year when there were no IAS 39 timing differences (due to the Group electing to adopt IAS 39 from 1 January 2005). The underlying reduction was mainly due to a lower level of fixed interest rate cover and the benefits from the ongoing working capital efficiency programme. Interest cover, which we define as operating profit before exceptional items divided by underlying net finance costs, was 6.7 times, compared to 5.8 times in 2004.

Tax
The Group's underlying rate of tax, defined as the underlying tax charge (i.e. excluding tax on exceptional items and IAS 39 timing differences), expressed as a percentage of operating profit net of underlying net finance costs, was 31.4%. This was 1.0 percentage points lower than in 2004, due to the settlement of a number of disputed items with tax authorities in respect of prior years which resulted in a 1.4 percentage points reduction in the underlying rate of tax, partially offset by an increase in tax on our share of earnings remittable by associates.

We expect the underlying tax rate for 2006 to reduce further by approximately one percentage point. This is partly due to corporate tax rate reductions in The Netherlands and France and is subject to change as it is based on our budgeted mix of profits by country and assumes no further changes in tax rates in individual countries.

Cash flow

for the year ended 31 December 2005

	2005 £million	2004 £million
Cash generated by operations	**275.1**	311.1
Tax and interest	**(98.3)**	(94.4)
Dividends (net)	**(30.6)**	(27.5)
Acquisitions and disposals	**(34.1)**	(103.4)
Net capital expenditure	**(75.8)**	(58.9)
Other investments (net)	**(29.6)**	10.8
Other	**4.9**	(7.2)
Total cash inflow	**11.6**	30.5
Currency and fair value adjustments on financial instruments	**36.9**	(9.9)
Decrease in net borrowings*	**48.5**	20.6

*2005 decrease with reference to IAS 39 adjusted opening borrowings.

Cash flow

The Group has continued its well established track record of generating free cash flow to fund investment in growth.

Net cash generated by operations was £275.1 million compared to £311.1 million in 2004. Working capital net outflow was £24.5 million, which was £53.5 million more than in 2004 due to lower levels of working capital at the beginning of the year compared to the start of 2004. Year on year, trade working capital efficiency improvements totalled approximately £25 million.

Cash inflow from lower inventories was £17.3 million, inventories reducing year on year by 0.6 days. Cash outflow from higher receivables was £11.6 million, trade receivables reducing year on year by 0.4 days. Cash outflow from lower payables was £30.2 million, trade payable days remaining the same year on year.

The net cash outflow on acquisitions and disposals of businesses, associates, and available-for-sale investments was £34.1 million, including £38.8 million of borrowings acquired with businesses. The principal cash outflows within this net number were £81.2 million for the acquisition of Bairds Chemists in Northern Ireland, £41.1 million for the purchase of other retail pharmacies, and £28.3 million for the Farmacen and CERFC wholesale businesses in Spain. The principal cash inflows were £91.5 million arising on the disposal of 51% of Alliance UniChem Farmacêutica in Portugal, £15.7 million for the Galenica restructuring and £12.0 million of deferred consideration receipts from the sale of non-core UK businesses in 2004.

Net capital expenditure was £75.8 million of which £56.9 million was for growth and efficiency projects. These included investment in the opening, relocating, re-fitting and upgrading of retail pharmacies, investment in new wholesale and retail systems, and new bulk warehouse capacity for Alloga in France.

Other investments (net) of £29.6 million mainly comprised £30.6 million of net expenditure on acquiring shares in Alliance UniChem Plc for the 1992 Employee Trust.

Shareholders' equity

Shareholders' equity at 31 December 2005 totalled £1,173.8 million, a year on year increase of £145.5 million after adjusting for the adoption of IAS 39 on 1 January 2005 which reduced shareholders' equity by £12.1 million.

Financial position

At 31 December 2005 net borrowings (which we define as borrowings, net of cash and cash equivalents and derivative financial instruments) were £779.6 million, which was £48.5 million lower than at the beginning of the year after adjusting for the adoption of IAS 39 on 1 January 2005 which increased borrowings by £22.3 million. Currency translation differences and fair value adjustments on financial instruments reduced borrowings year on year by £36.9 million.

Treasury policies

The Group's treasury policies which have been approved by the Board, 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 utilises derivative financial instruments to hedge interest rate and currency risk. The Group's policy is not to engage in speculative transactions.

Where possible, the Group seeks to apply hedge accounting to financial instruments transacted for the purpose of hedging underlying exposures. However, the practical application of IAS 39 means that, in some circumstances, timing differences in the recognition of financial instruments are recorded in the Group income statement. These unwind over the life of the instruments.

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.

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.

During the year £140 million of committed borrowing facilities matured and £89 million of committed borrowing facilities that were due to mature in October 2009 were cancelled. These were replaced by committed facilities totalling around £570 million which mature on 26 October 2006, although at the Group's election the term may be extended for a further year. These new facilities were put in place to ensure that the Group can meet its liquidity requirements over the next 12 months, recognising that it would be inappropriate for the Group to seek to renew its £100 million UK securitisation programme when the current programme ends in June 2006 or to seek long term funding in advance of its proposed merger with Boots.

Cash management is an important part of managing liquidity. The Group operates a pan-European cash pool as well as local cash pooling in each business. The policy on the investment of cash is to restrict it to money market instruments with a maturity of three months or less.

At the year end 45% of borrowings were repayable in more than five years compared to 49% at the end of 2004. Undrawn committed borrowing facilities at the year end totalled £489.6 million compared to £126.6 million at the end of 2004.

Interest rate risk management

The Board's policy is to limit the impact of interest rate volatility on profits. The policy fixes the interest cost (either directly through fixed coupons or synthetically through the use of interest rate swaps) on that proportion of the total of the Group's average projected net borrowings and financing linked to securitisation that will give a minimum 95% statistically significant confidence level that the Group's interest cover will not fall below four times projected total operating profit (including share of associates) before 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 the total of net borrowings and financing linked to securitisation that is to be hedged, but this can be increased to protect profits.

At 31 December 2005, after taking account of cross-currency and interest rate swaps, 29% of the total of the Group's net borrowings and financing linked to securitisation was fixed, which compared to 41% at the end of the previous year when financing linked to securitisation was classified as non-recourse receipts. The lower percentage cover at the end of 2005 reflects the introduction of a new interest rate policy in 2004, a 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 one percentage point in interest rates would have theoretically reduced 2005 adjusted profit for the year by about 4% before taking into account the impact of mitigating actions.

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 2005, 87% of the total of the Group's borrowings, related currency swaps and financing linked to securitisation was in Euros, which is the same percentage as at the end of 2004.

Approximately 63% of the Group's 2005 adjusted profit for the year attributable to equity shareholders was earned in Sterling (compared to 57% in 2004) and 21% was in Euros (which was the same percentage as in 2004).

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

The Group's total retirement benefit obligations, before tax adjustments, at 31 December 2005 were £69.1 million compared to £53.0 million at 31 December 2004. The increase in the gross obligations is principally due to a reduction in the long term bond yields used to discount estimates of future pension obligations and an allowance for future improvements to longevity, both of which have been partially offset by contributions to the schemes and the returns on the pension schemes' assets. The total pension charge against profit before tax (excluding associates) was £15.8 million, a year on year increase of £3.2 million.

Share price

The mid-market price of the Company's shares ranged during 2005 from a low of 689 pence on 25 February to a high of 910 pence on 3 October. On 31 December 2005 the mid market price was 800.5 pence giving a market capitalisation of approximately £2.9 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.