

Operating review

Divisional highlights

for the six months ended 30 June 2003

	Turnover £million	Operating profit* £million	Growth over first half 2002	
			Turnover %	Operating profit* %
Wholesale Northern Europe	1,514.1	39.6	17.1%	14.8%
Wholesale Southern Europe	2,821.7	33.9	15.3%	(4.8)%
Retail – Europe	519.6	36.1	13.9%	16.5%
Corporate	–	(4.0)	–	–
Intra-group	(418.4)	–	–	–
Group	4,437.0	105.6	13.9%	9.7%
Share of operating profit of associated businesses	–	16.9	–	74.2%
Total	4,437.0	122.5	13.9%	15.6%

*before amortisation of intangible assets.

Markets

Overall, we estimate that the market in which our businesses operate grew by around 5% against the first half of last year, weighted according to our turnover. This was just ahead of our forecast but towards the lower end of the range we have seen in recent years. The principal factors determining market growth continue to be demographics and regulatory actions in each country.

Generic prescribing continues to increase, reducing wholesale market growth as more expensive brands come off patent and are replaced by cheaper generic medicines which typically offer higher trading margins to us.

The growth of parallel trade slowed during the period as a result of efforts to curtail it through the implementation of quota systems on products, the restriction of product supply in certain markets, patent expiry of some high volume products, and the strengthening of the Euro compared with Sterling. This adversely affected the competitiveness of shortline wholesalers, who dominate this market, and our full-line businesses benefited as a result.



Wholesale Northern Europe

Operating profit before amortisation of intangible assets was £39.6 million (€57.9 million), an increase of 14.8% on the first half of last year, on turnover up 17.1% to £1,514.1 million (€2,213.6 million). Like for like sales growth was 7.5% on a constant currency basis, market share gains being achieved in every country. Operating margins decreased by 5 basis points to 2.62%, as a result of the acquisition of the lower margin Holtung business in Norway in June last year. On a like for like basis, operating margins increased by a similar amount.

Growth in Northern Europe wholesale markets slowed in the first half of the year as expected, in part due to increased penetration of generic products in the UK and The Netherlands as a number of pharmaceuticals come to the end of their patent life. While this trend impacts sales growth, we have been able to counter this by leveraging our buying power.

In the UK, turnover increased by 5.9% to £986.1 million (€1,441.7 million), reflecting a further increase in market share, market growth slowing down, as anticipated, to we estimate around 3.5%. The focus on increasing the proportion of higher margin product categories and on the more effective management of customer and supplier relationships continues. This, together with productivity gains achieved in implementing the results of our Group-wide benchmarking project, resulted in higher operating margins and good profit growth, despite the strong Euro squeezing margins on certain product segments and competitive discounting.

In April, we launched a range of generic drugs, branded "Almus", exclusive to Alliance UniChem, following research and a commercial programme we initiated between the manufacturers of these products, licence holders and packaging designers. Initial reaction from pharmacists and patients has been very positive and the range will be expanded later this year. Also during the first half of the year, Pharmacy Alliance, our virtual chain organisation, was awarded the Pharmaceutical Care Award by The Pharmaceutical Journal for care in the community, in recognition of work undertaken with Hillingdon Primary Care Trust Diabetics' Medicine Support Service.

Following the successful re-laying of the Hinckley warehouse last year, as part of the Group-wide benchmarking initiative designed to increase warehouse productivity, the Croydon warehouse was re-laid in the first half, with two further UK facilities scheduled for completion by the end of the year as part of building extension projects.

In The Netherlands, turnover increased by 21.0% to £355.2 million (€519.3 million), up 9.9% on a constant currency basis, estimated market growth slowing down to around 8%. We continue to win market share by providing our customers with excellent customer service whilst matching discount conditions in the market. Operating margins were in line with the first half of last year, resulting in good profit growth.

In January, a new warehouse in Almere was successfully opened, replacing outdated facilities, the layout of which incorporates benefits derived from the Group-wide benchmarking initiative. Customers will in future be serviced from one of four modern facilities in The Netherlands, which will integrate volumes from the fifth, smaller, warehouse in Rotterdam early next year.

Operating review (continued)



In the Czech Republic, turnover increased by 21.6% to £82.9 million (€121.2 million), an increase of 12.9% on a constant currency basis, compared to a market which we estimate grew by around 10%. Operating profits in local currency were at a similar level to the first half of last year, gross margin pressures offsetting the benefits of higher sales. One warehouse was closed during the first half following the extension of the principal facility in Prague late last year.

In Norway, turnover was £89.9 million (€131.4 million), the business having been acquired at the end of June last year. Sales for the half were significantly higher than in the same period last year, profitability being in line with the second half of 2002.

Wholesale Southern Europe

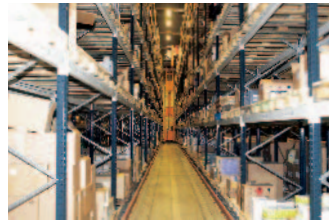
Operating profit before amortisation of intangible assets was £33.9 million (€49.6 million), a decrease of 4.8% on the first half of last year on turnover up 15.3% to £2,821.7 million (€4,125.3 million). Like for like sales growth was 3.5% on a constant currency basis. Operating margins decreased by 26 basis points to 1.20%.

Growth in Southern Europe wholesale markets has been slightly ahead of our expectations. However, these markets continue to prove difficult, margins being impacted by a combination of regulatory, competitive and economic pressures. In response to these pressures, our businesses have taken further action to reduce costs and, as a result, incurred minor restructuring charges. Excluding these charges, profits on a comparable basis were ahead of the first half of last year.

In France, turnover increased by 18.5% to £1,836.1 million (€2,684.4 million) compared to the first half of last year, the high growth rate reflecting the acquisition of Ouest Répartition Pharmaceutique, a three branch regional wholesaler, in the second half of last year. Like for like sales growth was 4.0% on a constant currency basis.

The total French market grew, we estimate, by around 5%, growth being significantly weighted towards the second quarter. We largely attribute this increase to the forthcoming introduction of a new reference pricing system for branded pharmaceuticals that compete with generics, which resulted in a temporary overstocking by pharmacies. As a result, we have accrued ACOSS healthcare tax at the top rate for the second quarter. We estimate that market growth in the wholesaling segment of the market was only around 3%, the proportion of products which manufacturers distribute direct to pharmacies rapidly increasing. This reflects the growing importance of generic products in the French market, which itself has accelerated due to the forthcoming reference pricing system. We are working closely with a number of generic manufacturers to increase our market share in this category.

Operating margins were lower than in the first half of last year, mainly due to the higher level of ACOSS healthcare tax and to the acquisition of the lower margin Ouest Répartition Pharmaceutique business. Excluding these, underlying operating profits were at the same level as in the first half of last year.



The closure of one warehouse during the period completed the rationalisation plan begun in 2001. Following the successful launch last year of Alphega, a network concept which independent pharmacies can join, the number of pharmacies in the programme rose by 27 to 137.

In Italy, turnover was £442.5 million (€646.9 million), almost the same as in the first half of last year, but down 9.2% on a constant currency basis. This compares with a market which we estimate was flat as a result of central and regional government action taken over the last 18 months to reduce healthcare expenditure. Measures introduced in January this year included a 2% price cut on reimbursable medicines and a new national directory of prescription products, prices having been already cut by 5% at the start of the second quarter of 2002.

The like for like sales decline in Italy reflects a continuation of our programmed withdrawal from heavily discounted and unprofitable supplies to a number of municipal pharmacy chains when long-term contracts expire and the impact of aggressive competition, particularly in southern Italy, where competitors offer customers longer payment terms.

Operating profitability was slightly lower than in the first half of last year, mainly due to minor restructuring charges and ongoing debtors' securitisation costs following the securitisation programme launched in June last year. Excluding these, underlying operating profitability improved, reflecting the benefits of swift action taken last year and a continuing focus on gross margin management and cost control.

We continue to review operational strategy in Italy, to determine how best to improve longer-term business performance in what is currently a particularly difficult market from a regulatory and commercial perspective.

In Spain, turnover increased by 21.1% to £376.4 million (€550.3 million) compared to the first half of last year. Turnover grew by 10.4% on a constant currency basis, export sales growing at a slower rate than domestic business. We estimate domestic market growth to be around 10%, small market share gains being achieved in the period. Operating profitability and margins were lower than in the first half of last year as a result of minor restructuring charges to streamline the management structure.

Turnover in Portugal increased by 15.8% to £166.7 million (€243.7 million), up 5.1% on a constant currency basis, compared to a market growth rate we estimate to be around 3%. Operating margins and profits increased compared to the first half of last year, continuing the positive trend in the second half of last year.

Operating review (continued)



Retail

Operating profit before amortisation of intangible assets was £36.1 million (€52.8 million), an increase of 16.5% on the first half of last year, on turnover up 13.9% to £519.6 million (€759.7 million). Like for like sales on a constant currency basis increased by 3.5%. Overall retail operating margins at 6.95% were 15 basis points higher than in the first half of last year, as a result of operating margin improvements in individual countries.

In the UK, turnover increased by 7.8% to £370.3 million (€541.4 million), like for like sales growing by 5.3%. Turnover from National Health Service prescription income increased by 9.4%. Operating margins were higher than in the first half of last year as a result of increased service incomes and operational efficiencies. During the period, one new pharmacy was opened adjacent to a health centre and 12 pharmacies were acquired. The acquisition rate was relatively slow, as potential vendors awaited the finalisation of the review of pharmacy licensing in the UK. The total UK chain, as at 30 June 2003, comprised 795 pharmacies and 58 other healthcare related retail outlets. During the period, 52 branches were refitted and four pharmacies were relocated, three to new healthcare developments.

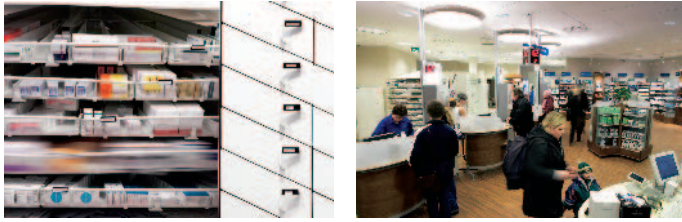
During the period the governing bodies in Scotland, Wales and Northern Ireland rejected the Office of Fair Trading's recommendation to fully deregulate the present NHS contract arrangements. In July the Department of Trade and Industry countered these recommendations, proposing instead further changes to pharmacy regulation in England. These recognise the vital role that community pharmacies, such as those operated by Moss Pharmacy, play in providing primary care and patient services.

We believe that the proposals offer significant opportunities for community pharmacies, be they in chains or independent pharmacies. The easing of restrictions on granting pharmacy contracts, which will only be permitted where a full range of services are to be provided and where it does not damage smaller existing community pharmacies, is likely to improve patients' access to pharmacy services. The Group is well placed to support this development and to promote the enhancement of pharmacy services, both through our own chain and through the support we provide to our independent customers.

The Group will play an active role in the consultation process on the legislative changes being proposed, and will continue to work closely with the Department of Health and the professional pharmacist bodies to develop the role of the pharmacist as a core member of the UK's healthcare infrastructure.

The vision, recently developed by Moss Pharmacy, "Leading at the Heart of Healthcare", defines our ambition to be at the forefront of future changes to the role of pharmacy in the UK through the development of services on offer beyond the core dispensing activity. In advance of the new Pharmacy Contract, expected in April next year, we are investing in training our employees to deliver new pharmacy services. Contracts to supply and dispense medicines to a further four prisons have recently been won, and a pilot scheme is underway to offer help and support in the home provided by trained care workers.

In Norway, turnover increased by 34.7% to £98.3 million (€143.7 million), an increase of 23.6% on a constant currency basis, reflecting our continued expansion programme. Our like for like sales reduced by 3.1%, an increase in the total number of Norwegian pharmacies putting pressure on like for like comparisons across the market. We acquired four pharmacies and opened two during the period, bringing our total chain to 95 at 30 June 2003. Operating margins continued to grow as the business benefits from increased scale, both in terms of commercial and cost leverage. As a result, operating profit levels were close to double that achieved in the first half of last year.



In The Netherlands, turnover increased by 38.1% to £39.9 million (€58.3 million), an increase of 25.6% on a constant currency basis, again reflecting the rapid expansion of the chain. Like for like sales increased by 6.3%. During the period seven pharmacies were purchased, increasing the chain size to 46 outlets. As in Norway, operating margins increased as the business increased its scale, resulting in substantially higher operating profits.

In Italy, turnover increased by 2.8% to £11.1 million (€16.2 million), a decrease of 7.0% on a constant currency and like for like basis, reflecting the many regulatory changes experienced. No pharmacies were acquired during the period, leaving the total at 28 at 30 June 2003, including eight in associate businesses. Operating margins and profit were lower as a result.

Through our other associate retail business, we operated 89 pharmacies and seven other retail outlets at 30 June 2003, six pharmacies having been acquired during the period.

Corporate costs

Net corporate costs were £4.0 million (€5.8 million) in the first half of 2003, a £0.8 million reduction on the first half of last year, primarily due to lower pharmacy.com costs. Included in corporate costs was income from the sale of 30% of the Alloga prewholesaling associate, which was almost completely offset by costs for the settlement of litigation relating to the Group's former investment in Rx.com and related internet technology businesses.

Associate businesses

Associate businesses contributed £16.9 million (€24.7 million) to total operating profit before amortisation of intangible assets, a 74.2% increase over the first half of last year.

Hedef Alliance in Turkey contributed £7.5 million (€11.0 million), compared to £2.5 million in the first half of last year. Business operating profits before amortisation of intangible assets increased by 66.7% on an inflation adjusted US dollar basis, reflecting strong sales and gross margin growth. The balance of the increase in contribution from Hedef Alliance reflects the purchase of the second 25% shareholding in the business in September 2002, partially offset by adverse translation differences, Sterling having strengthened against the US Dollar.

Contributions from other associate businesses increased by 30.6% in total to £9.4 million (€13.7 million), an increase of 12.6% on a like for like constant currency basis. In June, the Group reduced its direct investment in its Alloga prewholesaling associate from 50% to 20%, the share being sold to our partner, Galenica, which is in turn 25.5% owned by the Group.

Operating review (continued)

Interest

Net interest payable was £26.7 million (€39.0 million), an increase of 19.7% on the first half of last year. On a constant currency basis, net interest payable increased by 7.6%, principally reflecting acquisition funding costs and higher interest margins applicable on longer maturity borrowings, partially offset by the effect of the share placing at the end of the third quarter last year and lower interest rates, to the extent that interest was not previously hedged. Within net interest payable is a charge of £0.6 million (€0.9 million) being the difference between the expected return on pension scheme assets and the interest on pension scheme liabilities in accordance with FRS 17; this compares to £nil million, restated, in the first half of last year. Interest cover, calculated before the amortisation of intangible assets, was 4.6 times in the first half of 2003, equivalent to 4.7 times on a pre FRS 17 basis.

Cash flow and balance sheet

Net cash inflow from operating activities was £138.1 million (€201.9 million). This compared to £156.7 million in the first half of last year, which included £82.5 million inflow from the Italian securitisation programme, partially offset by a £37.0 million non-recurring variance on the timing of UK securitisation receipts at the end of 2001. Working capital net inflow was £19.7 million (€28.8 million). Cash inflow from lower stocks was £80.0 million (€117.0 million), an improvement of around four days since the start of the year, part of which was seasonal, the major reductions being in France, Portugal and UK Wholesale. Cash outflow from debtors was £24.2 million (€35.4 million) reflecting increased sales. Cash outflow from creditors was £36.1 million (€52.8 million), partially as a result of stock reductions towards the end of the half year. Net capital expenditure on tangible fixed assets was £15.9 million (€23.2 million), including £9.7 million (€14.2 million) of gross expenditure on replacement fixed assets.

Total consideration for acquisitions was £26.2 million (€38.3 million), comprising cash paid of £25.8 million (€37.7 million) and loan notes. This is mainly for the purchase of retail pharmacies. In addition, £1.2 million (€1.8 million) was incurred in the further purchase of shares in associated undertakings.

Under FRS 17, the net pension liability reflected in the balance sheet was £26.8 million (€38.5 million) at the end of June compared to £23.8 million at the end of December 2002. The movement in liability is principally accounted for by an actuarial loss arising from a revision of actuarial assumptions, partially offset by deferred tax thereon. The total charge against profit before taxation was £4.5 million (€6.6 million) compared to £3.2 million, restated, in the first half of last year.

At 30 June 2003, net borrowings were £904.3 million (€1,299.5 million) compared to £880.2 million at the end of last year. Of this increase, £46.0 million related to currency translation differences on borrowings hedging continental European assets.

Shareholders' funds at the half year were £903.9 million (€1,298.9 million), compared to £847.1 million at the end of last year, the latter having been restated for the adoption of FRS 17, with a prior year charge of £19.6 million being made.