

# Operating review

## Divisional highlights

for the six months ended 30 June 2004

	Turnover £million	Operating profit* £million	Growth over first half of 2003	
			Turnover %	Operating profit* %
Wholesale – Northern Europe	1,475.0	42.9	+6.0	+8.3
– Southern Europe	2,858.1	38.1	+3.6	+12.4
Retail – Europe	579.5	45.5	+11.4	+26.0
Corporate	–	(7.3)	–	–
Intra-group	(432.2)	–	–	–
Group	4,480.4	119.2	+4.6	+12.9
Share of operating profit of associates	–	18.2	–	+7.7
<b>Total</b>	<b>4,480.4</b>	<b>137.4</b>	<b>+4.6</b>	<b>+12.2</b>

\* before amortisation of intangible assets.

The turnover growth rate is based on 2003 published interim figures adjusted for the accounting policy change made at the end of 2003 following the amendment to the accounting standard FRS 5.

Our wholesale division performed well, all businesses increasing sales, operating margins and operating profits

## Markets

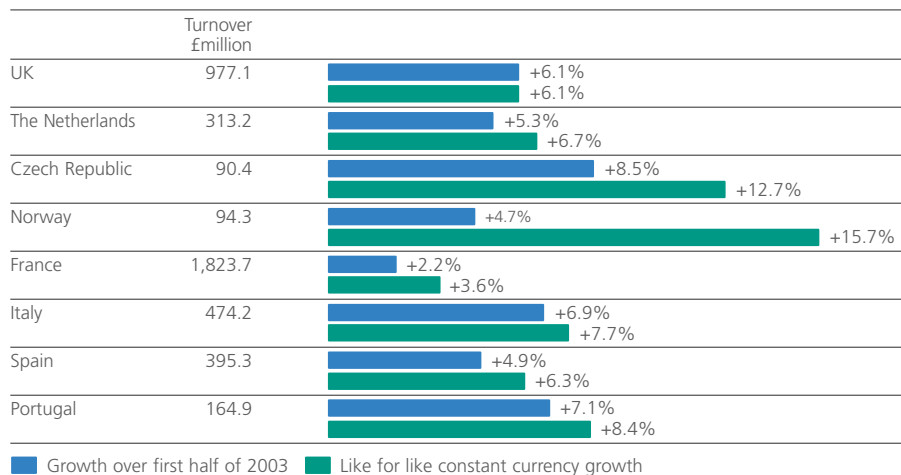
The wholesale markets in which our businesses operate grew, we estimate, by 6% against the first half of last year, this growth being weighted on the basis of our wholesale turnover. This was ahead of our forecast at the beginning of 2004. The principal factors determining market growth rates in individual countries continue to be regulatory actions and demographics.

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 further during the period as a result of manufacturers' efforts to curtail it through the implementation of quota systems on products, the restriction of product supply in certain markets and patent expiry of some high volume products.

## Wholesale

for the six months ended 30 June 2004



## Wholesale

### Northern Europe

Operating profit before amortisation of intangible assets was £42.9 million (€63.4 million), an increase of 8.3% on the first half of last year, on turnover up 6.0% to £1,475.0 million (€2,178.6 million). Overall market growth was better than predicted, primarily as a result of higher growth in the UK. Sales were up 7.3% on a constant currency basis, market share gains being achieved in every country. Operating margins increased by 6 basis points to 2.91%, improvements being achieved in every country, reflecting the success of the Group-wide performance improvement programme.

In the UK, turnover increased by 6.1% to £977.1 million (€1,443.2 million), reflecting gains in market share, with estimated market growth of 4% being higher than we had predicted at the start of the year. We continue to focus on increasing the proportion of higher margin product categories and on the more effective management of customer and supplier relationships. 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.

Progress continues on rolling out the Group-wide benchmarking initiative designed to increase warehouse productivity. Projects at the Preston and Livingston warehouses were completed in February with Letchworth scheduled for completion by the year end.

We significantly improved our service and availability levels for non-prescription medicines during the period. We also continue to develop our portfolio of added value services and industry-acclaimed loyalty schemes to independent community pharmacies.

Our range of generic drugs, branded "Almus", continues to grow, with just under 100 products now being available. The running rate of sales is currently around £30 million per annum.

In The Netherlands, turnover increased by 5.3% to £313.2 million (€462.6 million), up 6.7% on a constant currency basis, compared to a market which we estimate grew by 4%, this rate reflecting the price cuts of generics at the beginning of March. We continue to win market share by providing our customers with excellent customer service. Operating efficiencies, including the closure of the Rotterdam warehouse in March, more than compensated for lower gross margins due to regulatory changes, resulting in higher operating margins and good profit growth.

In the Czech Republic, turnover increased by 8.5% to £90.4 million (€133.5 million), an increase of 12.7% on a constant currency basis, compared to a market which we estimate grew by around 12%. As in The Netherlands, operational efficiencies more than compensated for increased customer discounts, resulting in higher operating margins and profits.

In Norway, turnover increased by 4.7% to £94.3 million (€139.3 million), up 15.7% on a constant currency basis, compared to a market which we estimate grew by 7%. Operational efficiencies again more than compensated for a reduction in gross margins as a result of the retail deregulation of what were primarily pharmacy-only medicines. As a result, operating margins and profits increased.

# Operating review (continued)

## Southern Europe

Operating profit before amortisation of intangible assets was £38.1 million (€56.3 million), an increase of 12.4% on the first half of last year on turnover up 3.6% to £2,858.1 million (€4,221.4 million). Like for like sales growth was 4.9% on a constant currency basis. Operating margins increased by 10 basis points to 1.33%, improvements being achieved in every country, as in Northern Europe.

In France, turnover increased by 2.2% to £1,823.7 million (€2,693.6 million) compared to the first half of last year. Sales growth was 3.6% on a constant currency basis, compared to estimated market growth of 5% in the wholesaling sector. We estimate that the total market grew in value by 6.5% with the proportion of products which manufacturers distribute direct to pharmacies continuing to increase. This reflects the growing importance of generic products. We continue to work closely with a number of generic manufacturers to increase our market share in this category.

At the start of the year the French government introduced tough regulatory changes aimed at reducing its expenditure on medicines. In response to this we implemented necessary actions, including launching further initiatives to improve efficiencies. We also benefited marginally from the introduction of a new, fairer methodology for determining ACOSS healthcare taxes. In common with our other businesses, in France we have seen an increase in participation by our pharmacy customers in collective buying arrangements, which we offer as a key component of our commercial strategy.

We continue to enhance other aspects of our commercial offering in France, including the development of new added value services for independent pharmacies which are members of Alphega, our virtual pharmacy network. During the half year, the number of Alphega members increased by 32 to 214. These factors meant that, despite the government reducing its expenditure on drugs, we were able to increase operating margins and profits compared to the first half of last year.

In Italy, turnover increased by 6.9% to £474.2 million (€700.4 million), an increase of 7.7% on a like for like constant currency basis. This compares with a market which we estimate grew by 5.5%, market share gains being achieved for the first time in a number of years. Operating margins and profits increased compared to the first half of last year due to an improved commercial performance and the benefits of minor restructuring in the first half of last year. Good progress was made during the period in establishing our new virtual chain of pharmacies. By the end of the half year 35 pharmacies had joined, with a further 16 signed up to join shortly.

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

In Spain, turnover increased by 4.9% to £395.3 million (€583.9 million), up 6.3% on a constant currency basis, with domestic sales growth of 7.1%. This compares with a domestic market which we estimate grew overall by 8%, but with significant regional variations. Operating margins improved, mainly due to currency related improvements in gross margins and lower operating costs, resulting in increased operating profits.

Turnover in Portugal increased by 7.1% to £164.9 million (€243.6 million), up 8.4% on a constant currency basis, with domestic sales growth of 10.4% in line with our estimate of market growth. Operating margins and profits increased compared to the first half of last year, mainly due to productivity improvements resulting from the closure of a warehouse last year.

## The Alliance UniChem network

Country	Wholesale depots at 30 June 2004
UK	11
The Netherlands	4
Czech Republic	6
Norway	1
France	57
Italy (including associates)	48
Spain	26
Portugal	7
Turkey*	58
Switzerland*	3
Germany*	23
Total	244

\* Associate interest

Country	Retail pharmacies at 30 June 2004
UK	838
The Netherlands	56
Norway	113
Italy (including associates)	28
Switzerland*	95
Total	1,130

\* Associate interest



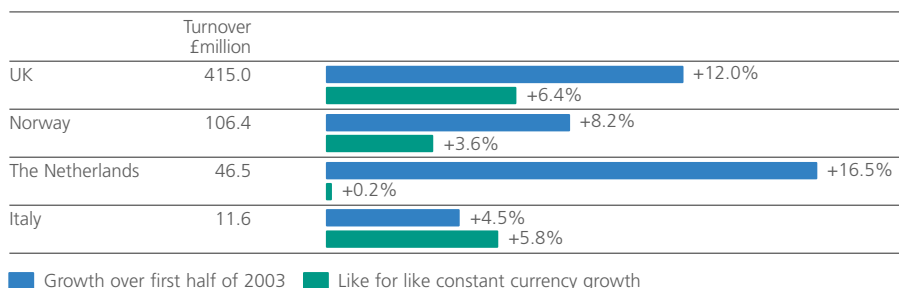
## Operating review (continued)

Trading performance in our retail division continues to be excellent, resulting in a significant overall increase in sales, operating margin and operating profit



## Retail

for the six months ended 30 June 2004



## Retail

Operating profit before amortisation of intangible assets was £45.5 million (€67.2 million), an increase of 26.0% on the first half of last year, on turnover up 11.4% to £579.5 million (€855.9 million). Like for like sales on a constant currency basis increased by 5.4%. Overall retail operating margins at 7.85% were 91 basis points higher than in the first half of last year, as a result of operating margin improvements in the UK and Norway.

In the UK, turnover increased by 12.0% to £415.0 million (€613.0 million), like for like sales growing by 6.4%. Our National Health Service prescription income increased by 13.3%. Operating margins were higher than in the first half of last year as a result of increased revenue from enhanced patient and manufacturer services and improved efficiencies. During the period, 21 pharmacies were acquired, two opened and one sold. Six branches were relocated and four pharmacies refitted, the latter being at a lower rate than normal due to uncertainties over the exact government requirements for new private consultation areas. The total UK chain, as at 30 June 2004, comprised 838 pharmacies and 52 other healthcare related retail outlets.

Moss Pharmacy continues to play a leading role in the development and implementation of pharmacy services in the UK. Our strategy is to develop services in close liaison with local healthcare authorities and the pharmaceutical industry. This ensures that we develop our business in a way that is aligned with local healthcare objectives,

enabling us to earn a return on our investment in training and facilities. Today our branches offer a tailored range of services, which can include lifestyle assessments, supervised methadone treatments, blood pressure testing, nicotine replacement schemes and full cardiac risk assessments.

We still await the detailed procedures on implementation of the government's policy on the control of entry regulations for new pharmacy contracts. This policy recognises the vital role that community pharmacies, such as Moss Pharmacy, play in providing primary care and patient services. The Pharmaceutical Services Negotiating Committee and the Department of Health have also not yet reached agreement on the proposed new contract covering reimbursement for prescriptions and services. As soon as it becomes clear what requirements pharmacies will have to meet, in terms of training and physical facilities, in order to be reimbursed under the new contract, we will accelerate the roll out of our services strategy.

Work continues on the programme to install advanced branch EPOS and pharmacy management systems, linked into new head office systems. This investment, which is on target to be completed in 2005, will facilitate the delivery of new pharmacy services and enable us to manage the business even more effectively.

In Norway, turnover increased by 8.2% to £106.4 million (€157.2 million), up 19.6% on a constant currency basis, like for like sales increasing by 3.6%. Three pharmacies were acquired during the period and one opened, bringing our total chain to 113 at

30 June 2004. Operating margins continue to grow as the business benefits from increased scale, both in terms of commercial and cost leverage. In June the management teams of our retail and wholesale businesses were combined, recognising that the Norwegian retail market is now highly concentrated into three major chains, each with their own wholesaler. This change will lead to further operational synergies between the two businesses.

In The Netherlands, turnover increased by 16.5% to £46.5 million (€68.7 million), an increase of 18.3% on a constant currency basis, reflecting the expansion of the chain. Like for like sales increased by only 0.2%, due to generic price cuts and changes to the clawback system introduced in March 2004. Like for like prescription volumes increased by over 4%. During the period ten pharmacies were acquired, increasing the chain size to 56. Operating profits increased, but operating margins were lower due to regulatory changes.

In Italy, turnover increased by 4.5% to £11.6 million (€17.1 million), an increase of 5.8% on a constant currency like for like basis. No pharmacies were acquired during the period, leaving a total of 28 at 30 June 2004, including eight in associate businesses. Operating margins and profit were lower due to costs incurred in strengthening the management team mid-way through last year.

Through other associate retail businesses, the Group operated 95 pharmacies and six other retail outlets at 30 June 2004, one pharmacy being acquired during the period and one opened.

# Operating review (continued)

## Corporate

Net corporate costs totalled £7.3 million (€10.8 million), a £3.3 million increase on the first half of last year, but at a similar level to the second half. This increase was primarily due to a strengthening of the corporate office management team to run pan-European business improvement projects, the results of which are increasingly being shown through improved operational performance.

## Associates

Associates contributed £18.2 million (€26.9 million) to total operating profit before amortisation of intangible assets, a 7.7% increase over the first half of last year.

Hedef Alliance in Turkey contributed £5.9 million (€8.7 million), compared to £7.5 million in the first half of last year. Business operating profits before amortisation of intangible assets reduced by 9.3% on an inflation adjusted basis, high inflation in the first four months of the year impacting Hedef Alliance's inflation adjusted results. The Turkish Lira also depreciated by 9.3% against Sterling over the first six months of the year. Six satellite warehouses were opened during the period.

Contributions from other associate businesses increased by 30.9% in total to £12.3 million (€18.2 million), the Group accounting for its 29.99% investment in ANZAG as an associate from the beginning of February this year. Excluding ANZAG and other changes to associate investments, contributions were at a similar level to the first half of last year on a constant currency basis.

## Interest

Net interest payable was £21.9 million (€32.3 million), an 18.0% decrease on the first half of last 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, was 6.3 times, compared to 4.6 times in the first half of last year.

## Taxation

The Group's effective rate of tax, based on profit before taxation and amortisation of intangible assets, was 33.7%, an increase of 2.0 percentage points on the first half of last year. This increase is primarily due to the addition of ANZAG, German tax rates being relatively high, and a higher effective tax rate in Turkey, inflation accounting monetary adjustments not currently being tax deductible, partially offset by a higher proportion of profits in the UK.

## Cash flow and balance sheet

Net cash inflow from operating activities at £88.5 million (€130.7 million) benefited from an estimated £25 million inflow from improved trade working capital ratios, building upon the efficiencies achieved last year. Working capital net outflow was £47.3 million (€69.9 million), of which just over £45 million was the usual half year timing difference on UK prescription receipts, five monthly payments normally being received in each first half. Year on year, on a balance sheet basis, the improvement in trade working capital efficiency was approximately £55 million.

Cash inflow from lower stocks in the first half was £93.8 million (€138.5 million), part of which was seasonal, stock levels at 30 June reducing year on year by 2.0 days. Cash outflow from debtors was £14.2 million (€21.0 million), trade debtors at 30 June reducing year on year by 0.8 days. Cash outflow from creditors was £126.9 million (€187.4 million), mainly reflecting seasonal variations in stock levels and the timing difference on prescription receipts for previously securitised receivables. Trade creditors at 30 June reduced year on year by 0.4 days, due to variations in the timing of discounts.

Net capital expenditure on tangible fixed assets was £26.9 million (€39.7 million), including £13.4 million (€19.8 million) of gross expenditure on replacement fixed assets.

Total cash paid for the purchase of businesses was £36.6 million (€54.1 million). This expenditure was mainly on the acquisition of retail pharmacies. In addition, £54.0 million (€79.8 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.

Under FRS 17, the net pension liability reflected in the balance sheet was £28.0 million (€41.7 million) at the end of June compared to £34.3 million at the end of December 2003. The movement in liability is principally due to an actuarial gain arising from an increase in the discount rate applied to the liabilities, partially offset by deferred tax thereon. The total charge against profit before taxation was £4.3 million (€6.4 million), a decrease of £0.2 million on the first half of last year.

At 30 June 2004, net borrowings were £854.9 million (€1,274.7 million) compared to £827.2 million at the end of last year. This increase was primarily due to the acquisition programme and seasonal working capital variations, partially offset by a £42.6 million (€62.9 million) currency translation gain on borrowings hedging continental European assets.

Shareholders' funds at the half year were £979.2 million (€1,460.0 million), compared to £929.8 million at the end of last year.

## International financial reporting standards

The Group's international financial reporting standards implementation programme has continued throughout the first half of 2004 and the Group remains on track to meet the requirements to prepare its financial statements on this basis from 2005 onwards.