

OUR GOVERNING OBJECTIVE IS TO MAXIMISE THE VALUE OF THE COMPANY FOR THE BENEFIT OF ITS SHAREHOLDERS



Philosophy At Boots we have a single overriding management objective – we call it the governing objective. This objective means ensuring that shareholders will get the best possible return on their investment in Boots over time, through dividend payments and share price increases.

This management objective is central to the way we do business and it is embedded in all our activities and decisions, through a managing for value (MFV) framework. This framework enables a consistent approach to be adopted for strategic planning and for everyday decision making at all levels in the organisation, harnessing the skills and knowledge of all our staff. We are, therefore, able to take rational decisions, strengthening and growing the company over time for the benefit of all our stakeholders. It also establishes a clear link between shareholder returns, the performance of our businesses and individual rewards by providing an unambiguous measure of our achievement.

Measures of performance

Primary measure We believe the single unambiguous measure of shareholder value and, therefore, group performance, is total return to shareholders. It is calculated from the movement in the share price and the value of dividends as if reinvested in the company when paid. We monitor our performance on a rolling five year basis against ten peer companies.

Long term bonuses for the executive directors and other senior management

are also tied to total shareholder return (TSR) measured currently on a rolling four year basis.

Cash flow The maximisation of cash flow over time is the key factor in value creation and cash management is one of the key performance measures used by the company to monitor businesses, and is used to determine the level of reward to senior management through short term bonus schemes in the majority of businesses.

Economic profit The primary determinant of the level of investment in our businesses is economic profit. This is the return we expect to make for shareholders after charging an appropriate amount for the capital invested. Currently, this cost of capital for most of the group is 8.5%, after tax and after discounting separately for specific risk.

Growth rates We use growth rates to measure past performance and to set targets not only for sales, operating profit and cash flow but also importantly for economic profit and TSR.

Returns Return on capital invested, measured both before and after capitalising the value of off-balance sheet leases, is a key measure of ongoing business performance.

Cash generation £m

01	60.2
00	376.2
99	95.0
98	203.2
97	138.5

Group performance**Total shareholder return (TSR)**

We ended the year at position seven in the following TSR table with a return in the five year period of 27.8%, which represents 5.0% on an annualised basis.

Shareholder returns of The Boots Company compared with peer companies

Returns are calculated using average listed share prices over the three months to 31st March.

Five years to 31st March 2001	%
1 Tesco	208.3
2 Alliance UniChem	151.3
3 Smith & Nephew	127.1
4 Kingfisher	101.8
5 Reckitt Benckiser	54.3
6 W H Smith	39.4
7 Boots	27.8
8 J Sainsbury	15.1
9 GUS	(13.4)
10 Marks & Spencer	(38.8)

Changes in our competitors cause us to review the peer group from time to time and during the year we have replaced SmithKline Beecham with Debenhams. However, as Debenhams has been a listed company for only just over three years it will not appear as a peer company in the rolling five year TSR monitor for another two years.

Over a ten year period our equivalent annualised return was 10.1%.

Share price Our share price rose from 537p at the end of last year to 627p on 31st March 2001. The price ranged from a high of 649p to a low of 479p.

Turnover Sales from businesses, including £5.3m share of joint ventures' turnover, increased by 0.7% to £5,226.2m.

Profit Operating profit from continuing operations before exceptional items and share of operating loss of joint ventures, increased by 5.2% to £603.1m. Profit before tax and exceptionals rose 1.8% to £581.1m.

Earnings per share Basic earnings per share before exceptional items increased by 2.6% to 46.6p.

Dividend The board has proposed a final dividend of 18.5p. This brings the total dividend for the year to 26.3p, an increase of 4.4% over last year.

Interest Net interest receivable for the year was £1.1m compared with £5.9m net receivable in 2000.

Taxation The effective tax rate, before exceptional items, for the group was 29.6%, the same as last year.

Cash flow The following summary of cash flow demonstrates the company's ability consistently to generate a healthy free cash flow that is defined as the cash flow available to all the providers of capital.

The group generated cash from operating activities before exceptionals of £693.6m, a decrease of £79.4m on last year mainly arising through an increase in debtors, including pension prepayments.

Summary of cash flows

	£m	£m
	2001	2000
Operating cash flows before exceptionals	693	773
Exceptional operating cash flows	(29)	(19)
Acquisition/disposal of businesses	(33)	(3)
Purchase of fixed assets	(462)	(266)
Purchase of own shares	–	(58)
Disposal of fixed assets	49	93
Disposal of own shares	8	10
Taxation paid	(167)	(154)
Other items	1	–
Free cash flow	60	376
Repurchase of shares	–	(95)
Dividends paid	(224)	(216)
Net interest	(22)	(10)
Net cash flow	(186)	55

The acquisition of the Clearasil brand in October 2000 for a consideration of £237m was the major factor in reducing the free cash flow by £316m to £60m.

No shares were repurchased during the year as part of a share buy back nor were any shares purchased on behalf of the QUEST.

The chart at the top of the page shows the amounts of free cash flow generated by the group for each of the last five years.

Qualifying Employee Share Trust (QUEST) and All Employee Share Ownership Plan (AESOP)

The company decided not to make any further offers under the Save As You Earn share option scheme for the time being and no further shares were therefore purchased by the QUEST. The company established the QUEST in 1999 to enable the company to use existing shares to satisfy SAYE options.

As a result, there have been no new options to charge to the businesses. The purchase of 5.7m shares last year resulted in a charge to operating costs in the businesses of £9.8m. These costs represent the difference between the market value at the time of purchase of the shares bought by the QUEST and the option price payable by employees.

However, in the current year £7.8m (2000 £6.8m) has been charged to the businesses for interest on borrowings to finance the shares already held in the QUEST.

The AESOP was set up during the year. Under this plan all employees had the opportunity to be allocated, in March 2001, a number of shares based on the average number of contracted hours that they worked. A total of 1.7m shares were purchased by the AESOP from the QUEST, making use of shares held in the QUEST where options have lapsed. The shares, in most cases, will be held in the AESOP on behalf of the employees for at least three years, at which time the employees will become entitled to the shares.

The purchase of the shares by the AESOP from the QUEST was undertaken at a price of 589p, being the closing market price ruling on the day before transfer. The cost of the shares in the AESOP is being amortised over three years, the period at the end of which the employees become unconditionally entitled to the shares.

Pensions We welcome the publication of Financial Reporting Standard (FRS) 17, the new accounting standard for pensions, which introduces valuable consistency and transparency into a complex area of financial reporting.

FRS 17 gives a present value of

pension liabilities by discounting pension commitments, including salary growth, at an AA bond yield. The FRS17 value of liabilities at the year end is £2.05bn and the market value of assets is £2.3bn, giving a pension scheme surplus of £250m.

The service or operating cost for the full year under FRS17 would have been about 14% of pensionable salaries, or about £70m. The cost after net investment returns would be about 10% of pensionable salaries, or about £50m.

New members of the pension scheme now join a Defined Contribution scheme for five years, before having the opportunity to join the Defined Benefit scheme. Over the next five years this will reduce the service cost to about 12%.

We support the Government's proposals on Security for Occupational Pensions, published during the year. These envisage stricter conditions on wind-up of any pension scheme sponsor, which will improve security for all pension scheme members and lead to more direct involvement by sponsors in the activities of their pension schemes.

Treasury policy and controls Boots has substantial borrowing capacity due to its strong credit ratings.

Treasury focus is primarily on the balance sheet, including items such as property lease commitments, which are economic assets and liabilities, but which current accounting convention does not recognise.

Note 19 on pages 59 and 60 shows further details under the disclosure requirements of FRS13 'Derivatives and Other Financial Instruments: Disclosures'.

Controls Controls seek to prevent fraud and other unauthorised transactions as well as counterparty risk. The group's risk assurance and audit staff reviews annually the effective operation of key controls. Strict guidelines for cash investments apply worldwide, with cash held only in high quality bank deposits and commercial paper. Swaps, which the company uses to manage interest rates and currencies, are strictly

controlled and monitored, with each transaction specifically authorised by the deputy chief executive and finance director.

Liquidity and funding The company has good access to the capital markets due to its strong credit ratings from Moody's and Standard and Poor's (P1/A1 and A1/A+). It is policy to maintain credit ratings that give good access to the capital markets.

The group has ten identical credit facilities, totalling £600m, which mature in 2004. These facilities remained undrawn during the year, with short term needs being met from uncommitted bank lines.

Lease liabilities In common with other UK retailers, the group has liabilities through its obligations to pay rents under property leases. Rent commitments on property leases are the economic equivalent of fixed rate debt. The following table shows the capitalised value of the committed after tax rents payable at 31st March 2001, excluding any likely increase in rents at rent reviews, discounted at the group's after tax cost of borrowing of 4.5% (6.4% before tax).

Maturity of commitment	Rent commitment at 31st March 2001 £m	Capitalised value £m
1 to 10 years	59.5	192
10 to 20 years	113.6	850
20 to 30 years	21.0	207
Over 30 years	5.6	76
Total	199.7	1,325

The analysis of rent payable commitments at the year end for businesses is:

	£m	%
Boots The Chemists	136.8	68
Halfords	49.2	25
Other	13.7	7
Total	199.7	100

Interest Policy is to maintain a balance between debt, including leases, at fixed and floating rates, but we do not hedge against the impact of short term interest rate movements.

The total value of lease-related

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swaps is £1.1bn, which now have an average maturity of eight years and a weighted average fixed rate receipt of 7.4%.

The company's other fixed rate borrowings have all been swapped into floating rate.

Given the overall cash, borrowing and interest rate swap position, each 1% increase or decrease in short term interest rate, changes the net interest figure by about £14m.

Currency exposure With the acquisition of the Clearasil brand during the year, our overseas business is becoming significant. We therefore put in place swaps, creating currency liabilities matching the economic value of the main overseas businesses acquired as a result of Clearasil. Modest sales and purchases are also made from the UK in a range of currencies, but hedging them into sterling does not add value.

Capital structure Value can be achieved for shareholders by managing capital structure. Increasing debt lowers the after tax cost of capital and, since 1994, we have exploited this by distributing £1.3bn to shareholders in the form of share repurchase and special dividend, in addition to normal dividend payments. A balance has to be struck, however, between the advantages of debt and the resulting reduction in financial flexibility. As with other financial assets, we do not take positions on the company's share price, which is determined by the market with access to all relevant information. When we repurchase shares it is only with the intent of maintaining an efficient capital structure.

The company's strategy envisages expansion in a number of areas, illustrated by the Clearasil acquisition during the year. We therefore wish to retain financial flexibility, and have no current intention of buying in more shares as part of the repurchase programme.

Economic and Monetary Union (EMU) Our businesses are well prepared for the introduction of euro notes and coins. Many of our businesses

have reported internally in euros this year and will operate fully euro compliant systems well ahead of January 2002. Our retail customers in the Republic of Ireland will see the introduction of dual pricing in stores over the summer. We are working hard to ensure a smooth transition and we have detailed plans in place to manage the practical challenges presented by the new currency. To minimise the potential confusion for customers and staff there will be a major investment in staff training and education prior to conversion.

Overall, the total cost of implementing the euro remains close to 1% of turnover. If UK entry to the EMU is determined, we would benefit greatly from the experience of our businesses in nine of the first wave countries.

Accounting standards The company fully supports the objectives of the Accounting Standards Board (ASB) to improve the quality and consistency of financial statements.

Current UK accounting ignores the material economic costs and liabilities of operating leases, pensions and employee share options, all of which the group's internal management accounting attempts to recognise. We are pleased to note that the ASB has each of these at different stages of development. We particularly welcome the publication of FRS 17 on Retirement Benefits. However, this new standard along with FRS 18 'Accounting Policies' and FRS 19 'Deferred Tax', that were also issued in the current year, do not become effective until the report and accounts for the year to 31st March 2002.



David Thompson
Deputy Chief Executive and
Finance Director

Payment to shareholders £m

01	224.0
00	311.7
99	207.1
98	563.3
97	469.8

2000 and 1997 include share repurchases of £95.4m and £300m respectively, 1998 includes the special dividend of £400.5m.