

Review of operations

Both core businesses reaped the benefit of increased investment. Boots The Chemists increased market share in key areas and had its best Christmas for a decade. Boots Healthcare International's four-year growth strategy delivered the promised boost to sales and profits ahead of schedule. Meanwhile Wellbeing Services and Boots Retail International cut out less promising activities to focus on those with greatest potential for profitable growth.

Boots The Chemists

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| Sales £m | 4,284.4 |
| Increase % | 5.2 |
| Profit £m (before exceptionals) | 568.6 |
| Decrease % | (6.0) |
| Sales split | £m |
| Health | 1,716.4 |
| Beauty & Toiletries | 1,891.9 |
| Other | 676.1 |

Boots the Chemists showed strong sales growth in the year, particularly in the second half. The business held or grew market share by value in all counter health and beauty categories. The Christmas trading performance was the best for a decade, and the decline in transaction numbers was stemmed. Our prices in commodity toiletries and healthcare became more competitive, in part passing on the benefits of better buying and cost efficiencies. This, together with investment in store refits and higher pension costs, resulted in a fall in operating profit to £568.6m (before exceptionals).

Strategy BTC's customer appeal is founded on the trust and heritage of the Boots brand, broad choice of own brand and proprietary products, innovative new product development

and expert service and advice. We are focused on the health and beauty markets and are confident of growing with them. We will maintain our leadership position through innovation, continued development of our store portfolio, understanding of consumer needs reinforced by analysis of Advantage Card data, and clear value positioning supported by tight control of operating costs.

Trading Sales rose 5.2% over the year (4.8% like for like). The increase was stronger in the second half than in the first, and growth over the Christmas period was the best for ten years – third quarter sales were 8.1% up on the previous year.

Healthcare sales rose by 5.1%, led by our prescriptions business. Beauty & Toiletries grew by 6.8%, with a particularly strong performance from cosmetics and fragrance. Sales in other categories, including baby, food, photo, seasonal and Digital Wellbeing, grew by 1.3%, driven by our enhanced Christmas range and a strong performance in baby products.

We held market share in all counter health and beauty categories with improvements in cosmetics (where we saw particularly strong sales growth),

baby and over the counter (OTC) healthcare. Market share in toiletries was maintained and we saw a slight decline in our dispensing market share.

The number of transactions was slightly down for the year as a whole, but the long term decline stabilised in mid-year. The Advantage Card was a key driver. Since relaunching it last year, we have issued a million new cards.

Operating profit was affected by investment in stores, keener promotions and increased pension charges. Underlying margins were down by about 1.1 percentage points, due largely to pricing, promotions and a slightly adverse change in the sales mix, partially offset by savings in the cost of goods.

Health The regulation of the pharmacy market is under review by the Department of Trade and Industry (DTI). At the time of writing it is unclear what the outcome of the review will be, however the DTI are known not to favour total deregulation. We believe that some degree of regulation is necessary to secure convenient access to community pharmacy for all. We are keen to work with all the relevant authorities to ensure that any changes to the current regulations

deliver an enhanced service, offer wide access to convenient community pharmacies, and play a fuller role in the nation's primary health care.

During the year, although we increased the number of prescriptions dispensed, we saw a slight decline in market share because the pattern of prescribing changed to favour older people.

We began a substantial investment programme in our pharmacy operations, installing more carousel style dispensing units which speed-up customer service and let pharmacists spend more time consulting with patients. We have begun a programme to double the number by March 2004. We also began to introduce our new pharmacy system, SmartScript, which will further enhance customer service and give us more detailed information on our dispensing business.

Since the abolition of Resale Price Maintenance on OTC medicines we have gained market share on the back of an attractive programme of promotions.

Beauty & Toiletries Sales grew strongly throughout the year but particularly over Christmas which saw an increase of over 10% overall and sales of beauty gifts up almost 40%. Sales of premium cosmetics grew by over 15% increasing market share by 1.5% in the year. We now sell them in 125 stores and we are the leading UK retailer of a number of major cosmetic brands.

Within our own brands N°7 continued to perform strongly with sales up 14% following the launches of Intelligent Colour Foundation and the Skincare Vitamins range. The pre-Mothers' Day week was the biggest in the brand's history.

Toiletries grew in line with the market supported by a combination of innovation and promotion. New own brand ranges included Mediterranean Essentials and fcuk® branded toiletries for women.

Boots is also the partner of choice for launching and promoting new proprietary products, and last year we continued to emphasise this area. Boots led the launch of the new Gillette Mach III Turbo blades in January attracting immediate share of 60%. Some 4 months later we continued to sell more than our expected share. During the year we ran strong promotions in the toiletries category including 99 pence price points, and were successful in maintaining market share.

In sun preparations sales were up over 14% and we gained 4% of market share, helped by the strong performance of the St Tropez self tan range.

Other Sales grew by 1.3% reversing the trend of the last two years.

Baby had a good year, with sales up 4.7%. We are supporting this category with stronger promotions because they are very effective in raising overall footfall. As a further boost we have developed the mini mode childrenswear range in conjunction with Adams. Launched in February, it is making encouraging progress.

Food sales showed no growth over the last year and we saw a decline in sales in London affected by increased competition and the downturn in tourism. We relaunched our sandwich packaging in May 2003 to enhance customer perceptions of our range. Photo sales were down 7.6% in a rapidly declining market, reflecting customers switching to digital photography and the associated reduction in spending on films and similar products. In response we are broadening our range of digital cameras and installing instore technology to produce photo quality prints from digital memory cards.

Growth in sales of seasonal merchandise was due largely to an enhanced range of Christmas lines. The inclusion of a broader assortment of products is valued by our customers and helps us to become a destination shop at Christmas. We intend to place more emphasis on seasonal lines in the future – for example, broadening our range of summer related products such as swimwear to sell alongside sun preparations.

During the year we brought the wellbeing.com website in-house and renamed it boots.com.

Total online sales grew 120% in the year, and average order value grew 17% as customers became more confident online shoppers. In November 2002 independent research reported a record 592,000 unique visitors, making it the UK's tenth busiest retail website.

Products Product innovation played an important role in the year's sales growth. N°7 had the best sales in its history, with Intelligent Colour Foundation proving to be its most successful product launch ever. This innovative foundation is a unique silicone gel/pigment blend which promises to match the skin tones of all women with just three shades. Sales have exceeded forecast by almost 40%. Other N°7 debuts included the relaunch of DailyV Skincare, which is outperforming the old range by 34%.

The most successful addition to the 17 range was Fat Lash, a volumising mascara in an innovative tube pack format which achieved excellent sales in its first six months. Over a third of

to shorten the time it takes to bring new practices to profitability.

We have changed the model, moving into line with standard industry practice by transferring our dentists to self-employed status. This will make it easier to recruit and incentivise dentists while making the professional staff cost base more flexible. We believe this will shorten the period to breakeven.

Footcare continues to operate from 44 locations, in association with dental practices.

Insurance Services Health and travel cover is a small but profitable business. Sales and profits were in line with the previous year.

Boots Retail International

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| Sales £m | 37.0 |
| Decrease % | (8.2) |
| Loss £m | (22.3) |
| Increase % | 7.5 |

We have found that there is significant demand for Boots own brand and exclusive products in some overseas markets. We will meet this demand through the use of a low cost export model with retail partners who host Boots brand implants in their stores.

Strategy BRI has 66 stores and 106 implants, almost all in South East Asia. Our strategy is now based on export sales through low cost, low risk implants selling a select range of about 800 Boots own brand and exclusive products through selected host retailers. This simplified approach enables us to focus on managing the instore offer, controlling costs and building scale.

Performance Overall sales were in line with the previous year, in a period of major change involving the closure of stores and opening of many implants. In Thailand like for like sales grew 7%. The operating loss of £22.3m includes £5.5m for exiting the loss making European operations and restructuring our business in Asia.

South East Asia A year ago we announced agreement with Watsons, South East Asia's leading drugstore chain, to open implants in Taiwan. We now have 54 implants in Watsons stores. We are now simplifying our Taiwan operation, growing to around 100 implants, closing our Boots stores and shipping direct to Watsons.

In October we launched a similar arrangement with Watsons in Hong Kong, where we now have eight implants and performance to date is encouraging.

In Thailand, we have had a very successful year in turning the business around. Strong like for like sales growth of 7%, margin growth and cost reduction have significantly improved the results of the business.

Supply and support services
The simplification of the organisation has enabled us to integrate our supply chain, logistics, procurement, IT, manufacturing, properties, engineering and facilities management activities and our retail buying operation in Hong Kong into a single support organisation serving all our retail operations and BHI.

The year's principal achievements were the dramatic improvement in on-shelf availability – without which our sales growth would not have been possible – and the outsourcing of IT, which will save £100m over 10 years.

Supply chain Now that on-shelf availability is running at acceptable levels, we can begin to reduce the large distribution inventories that we currently hold around the country.

In June we opened a new automated single-picking warehouse on our Nottingham site to support our dispensing operations. This now provides top-up deliveries to all our pharmacies every morning. It is the biggest system of its kind in Europe and has enabled us to close our Aldershot warehouse and downsize Heywood, reducing total headcount by 700.

This year we have launched a supply chain transformation programme involving long term structural change, including rationalisation of manufacturing. The aim is to deliver best in class on-shelf availability in parallel with reductions in cost and working capital.

We are working towards a supply chain that will replenish stores' stocks of most lines every day – delivering straight to the shelf. We will only hold inventory in store stockrooms for the few lines such as nappies and seasonal items that need replenishing more than once a day. This will deliver significant savings in store staff time, and reduce inventory. Trials of the new replenishment system begin this year.

Currently there are multiple locations holding balanced stocks around the country. Vehicle capacity utilisation is low because of inherent inefficiencies in the system. We are moving towards category-specific warehouses supplying regional distribution centres which will crossfeed into delivery vehicles for stores. Transport will be better

