Financial review

Howard Dodd

'The year is characterised by success in driving higher sales and by substantial costs to modernise, improve competitiveness and make Boots more efficient. Clear business plans together with rigorous monitoring of performance have made a significant contribution to progress in the year. We were able to report that all the initiatives to drive growth were implemented within cost targets.

The Group have operated a revised process to approve investments and allocate capital over the last year. By adopting a broad range of measures it has enabled a better analysis of the risk and return associated with each proposal. We have also seen a significantly higher proportion of capital spend directed towards the two core businesses Boots The Chemists and Boots Healthcare International. To underpin the discipline and focus with which capital will be used within the Group, we intend to return £700m of surplus share capital to shareholders. It improves the efficiency of the balance sheet and it will be in two equal tranches over the next two years. The second £350m is dependant upon the cash flow performance of the Group and this is a major area of focus over the next 24 months.'

We have reviewed our financial strategy during the year and intend to increase our debt levels over the next couple of years by returning surplus capital to shareholders through our on-going share buyback programme. This will improve the efficiency of our balance sheet and enhance Earnings Per Share. Whilst balance sheet efficiency is important, we do intend to maintain a strong investment grade credit rating and will be targeting a range of financial measures, in particular cash flow, to ensure that this is achieved.

During the year we continued our share buyback programme and have now completed the return of the Halfords disposal proceeds. Since 1997 we have returned over £1.1bn of surplus capital by repurchasing shares.

We also implemented a new investment appraisal process based upon a range of cash flow and accounting measures to assess value and risk. These include cash flow based criteria such as net present value and payback, as well as return on capital employed and time to break even. This process is being rigorously applied to our store-opening programme in particular. It is targeting over 80 new stores at a capital cost of approximately £104m over the two years 2003/04 and 2004/05.

Turnover from continuing operations increased by 4.7% to £5,326.4m. This reflects the continuing good progress being made in Boots The Chemists where sales increased by 4.5% and the strong growth in Boots Healthcare International where sales were up by 7.8% (in local currency).

Operating profit from continuing operations including share of joint ventures grew by 6.0% to £550.1m. Growth initiatives drove up costs and higher Getting In Shape costs represented a major non-comparable cost increase. However, operating profit in the year benefited from significantly lower losses from businesses either closed or rationalised a year earlier. As you have read, during the year we announced a reduction in the head count at our head office. Around 1,000 of our people applied for voluntary redundancy – considerably more than we expected. The cost of these redundancies, which was £45.5m, has been taken against profits in 2003/04, although the people will actually leave during the current year. In total over 1,500 will have left the business under the Getting in Shape programme since it began last year.

All of the actions taken to date under the Getting in Shape programme will deliver benefits of £93m in 2004/05, with full year benefits of £132m for 2005/06. We intend to explore the scope for additional productivity and efficiency improvements during this year.

Profit before tax was up 18.0% to £581.0m. This has been helped by an exceptional gain of £36.4m, primarily relating to the disposal of property. In addition, last year included £123.2m loss on the sale of Halfords and £34.5m costs for the closure of part of the wellbeing services offering. These were both shown as exceptional items and were partially offset by an exceptional interest credit last year of £92.1m arising from the closure of interest rate swaps.

Taxation Excluding non-operating exceptional items, the effective tax rate for the group was 30.9%, slightly lower than last year's rate of 31.7%. We continue to focus on reducing the effective tax rate, but any actions to bring it down must fully support business priorities and avoid complexity in group operations.

Basic earnings per share before exceptional items increased by 7.1% to 48.2p (basic earnings per share increased by 47.8% to 52.9p). The weighted average number of shares in issue decreased in the year from 838.1m to 780.0m as a result of the continuing share buyback programme.

Dividend The board has confirmed a policy of sustainable dividend growth and we will be targeting a dividend cover ratio of 1.75 times over the medium-term. Consistent with this policy the board has proposed a final dividend of 21.0p. This brings the total dividend for the year to 29.8p, an increase of 4.2% over last year and in line with the last three years' dividend growth. On the share price at 31st March 2004 of 619.5p this represents a yield of 4.8%.

Working capital has increased by £47.5m in the year. This was mainly due to additional stock as a result of opening 19 new edge of town stores.

Cash flow The group continues to generate significant cash flow from operating activities. Cash flow from operating activities before exceptionals was £655.1m (2003 £590.4m) and cash flow before the effect of share repurchases and other financing was £175.4m (2003 £556.3m, including £358.1m from acquisitions and disposals).

Share price Our share price had a substantial range during the year. It rose from 530.5p, near its year's low of 525p, to a peak of 753p before ending the year at 619.5p. This performance reflects a general upward trend in the stock market during the year in conjunction with substantial volatility due to the arrival of and anticipation of results from the new executive team. The share price underperformed the FTSE100 by 4.6% over the year.

Pensions

When the Accounting Standards Board extended the transitional regime of FRS17 'Retirement Benefits' in July 2002, the Company decided to continue to account for pensions under SSAP24. The Boots Pension Scheme cost for the year under SSAP24 is £28m (2003 £31m). Disclosures under FRS17 are included in note 26 to the accounts.

On an FRS17 basis the scheme has now moved into a small deficit position of £58m at March 2004 from having a surplus of £154m last year. While the asset values have increased, the liabilities of the scheme have increased faster as a result of market conditions, particularly higher long term inflation expectations when bond yields have come down.

The pension fund investment strategy is to match the cash flow and inflation characteristics of the pension liabilities with assets to reduce the impact of market movements. The fund has increasingly matched the maturity and inflation profile over the last three years with bonds and index-linked instruments. Whilst maintaining this principle, it is intended to refine its implementation further to include a small proportion of the fund's investments in other asset classes, which may include property and equities. This will better match long term liabilities arising from current employees, which extend beyond the available maturities of bond investments.

Accounting standards

In November 2003 the Accounting Standards Board issued requirements on revenue recognition, in the form of Application Note G to FRS5 'Reporting the Substance of Transactions'. This application note has limited impact on Boots as existing accounting policies largely complied with the new provisions. In particular, revenue has been recorded net of staff and promotional discounts for some time. The full impact is disclosed in note 1 to the accounts.

International Financial Reporting Standards (IFRS) become mandatory for the consolidated financial statements reported by all EU listed companies from 2005 onwards. For Boots this means adoption for the year ended 31st March 2006. An impact assessment has been undertaken and work is underway to ensure that systems and data requirements can be met, in order to make Boots IFRS compliant for the 2005/06 financial year. The areas identified where IFRS will have the greatest impact is from changes in accounting for pensions, property, deferred tax, financial instruments, development costs and intangible assets.

Treasury policy and controls

Treasury policies are reviewed and approved by the board. Treasury has responsibility for the group's funding and cash management, and manages the group's counterparty credit, interest rate and currency risks. It enters into financial instruments solely for the purpose of managing these risks. It does not act as a profit centre and the creation of new exposures to generate profit is not permitted.

Note 19 to the accounts shows further details under the disclosure requirements of FRS13 'Derivatives and Other Financial Instruments: Disclosures'.

Liquidity and funding The group finances its operations through a mixture of retained profits, capital markets funding, bank borrowings and leases. The objective is to ensure that the group has access to liquidity at all times and can raise debt in a cost-effective manner. This is achieved through arranging funding ahead of requirements, maintaining sufficient undrawn committed facilities to meet unanticipated needs and maintaining good access to the capital markets through a strong investment grade credit rating.

At 31st March 2004, the group had undrawn committed facilities of £462m with seven banks, which mature in March 2005. High quality bank deposits are held to meet most short-term financing requirements, with uncommitted bank borrowings being drawn to meet peak seasonal needs.

Lease liabilities In common with other UK retailers, the group has liabilities through its obligations to pay rents under property leases. The following table shows the maturity profile of these lease obligations.

Maturity of commitment	Annual rent Commitment at 31st March 2003 £m	**Annual rent Commitment at 31st March 2004 £m**
1 to 10 years	69.1	**86.3**
10 to 20 years	79.4	**76.3**
20 to 30 years	10.1	**7.9**
Over 30 years	5.6	**5.0**
Total	164.2	**175.5**

The capitalised value of these liabilities is £1,242.2m (2003 £1,234.1m) based upon discounting the rentals, after taking into account assumed rental growth of 2.5% per annum, at the group's long-term cost of borrowing 5.85% (2003 5.70%). This year we have adopted the more conservative approach of including rental growth in our lease capitalisation valuation.

The Group, in common with the credit rating agencies, treats its lease liabilities as being 'debt like' when evaluating financial risk and investment returns.

Counterparty credit risk The objective is to reduce the risk of loss through default by counterparties. The risk is managed by spreading financial transactions, including bank deposits, across an approved list of high quality banks. Counterparty credit positions are monitored on a regular basis. Dealing in interest rate and foreign exchange instruments is controlled through dealing mandates, independent confirmation processes and the use of standard settlement instructions.

Interest rate exposure Short-term interest rate movements currently have an immaterial effect on the group's net interest rate charge. Gross debt comprises a mixture of fixed rate £182.9m (2003 £1.1m) and floating rate, with approximately 50% of the fixed rate debt with maturity greater than one year being converted into floating debt through the use of interest rate swaps. The resultant floating rate exposure on gross debt is offset by that on cash and money market assets, leaving the net interest charge relatively immune to interest rate movements.

Currency exposure Sales are made from the UK in a range of currencies for the Boots Healthcare International and Boots Retail International businesses and in Euros for Boots The Chemists in Eire. In addition, purchases are made in a range of currencies, but particularly Euros and US Dollars, for Boots The Chemists and Boots Manufacturing. The net currency exposures are modest and do not materially impact the group's profit before tax. The group has entered into limited currency hedging using forward contracts of its committed future purchases for Boots The Chemists. The group does not hedge currency exposures arising from future uncommitted transactions. The group principally borrows in sterling, but has entered into US Dollars 93m and Euro 118m foreign exchange contracts to create currency debt in these currencies. Currency debt is held to partially hedge the group's currency assets and to create a long-term hedge against future cash generated in US Dollars and Euros.

Capital structure The company has continued its policy of returning surplus capital to shareholders by repurchasing shares in the market. This amounted to £259.9m in the year to 31st March 2004 (2003 £462.8m), of which £191.1m completed the return of the Halfords disposal proceeds to shareholders.

Surplus share capital has been identified and a £700m return of surplus cash to shareholders over the next two years through share buybacks is planned. This is viewed as prudent and demonstrates the determination to deliver the growth plans for Boots in a focussed and disciplined way. £350m will be returned in 2004/05 but clearly the second tranche will depend upon the performance of the business and its generation of net cash flow.