

## financial review

**Our financial strategy was reviewed during the year to March 2004 and we announced in May 2004 that we intended to increase our debt through returning £700m of surplus capital to shareholders in order to make our balance sheet more efficient and enhance earnings per share. At the same time, we intended to maintain a strong investment grade credit rating. The surplus capital was to be returned in two tranches, with the second tranche dependent on future business performance.**

During the year we have implemented this strategy and returned £300m of surplus capital. Net Debt for the group has increased from £148.5m to £594.1m as a result of this and an increase in working capital. The first tranche of share buy back amounting to £350m was completed in May 2005. In April 2005, we announced that the second £350m tranche would be returned over a two to three year period, slower than originally anticipated due to the worsened short-term market prospects and consequent reduced cash generation for Boots The Chemists.

In April 2005, the company announced its intention to sell the Boots Healthcare International business and return a significant amount of the proceeds to the shareholders. We also exited the loss making dentistry, laser eye correction, laser hair removal and chiropody businesses during the year, from which an exceptional loss of £57m resulted. Both of these decisions enable resources to be even more focused on the core Boots The Chemists business in future, and enable the business to maintain an efficient balance sheet, whilst still retaining a commitment to a strong investment grade credit rating.

During the year, we have invested substantially in the Boots The Chemists business with £225m of capital expenditure and £115m of revenue investment to make the business more modern, competitive and efficient. We continued with our store development programme with 47 new stores opening in the year, including 23 in edge-of-town locations. We have also continued to invest in lower prices and in longer opening hours to make the offer more competitive. Significant investments have also been made in the logistics and information technology infrastructure and both of these programmes have equipped the company to compete more efficiently in the modern retail environment. We believe these investments were necessary to enable Boots The Chemists to achieve long-term sustainable growth.

We also announced in April 2005, the group's intention to sell and lease back approximately 300 of its secondary freehold properties with anticipated proceeds in excess of £250m. This transaction will crystallise the value from a very strong retail property market, whilst at the same time providing the group with flexibility to manage its store portfolio. The proceeds will be used to repay short-term debt.

**Turnover** from continuing operations increased by 2.9% to £5,441.9m. Sales in Boots The Chemists increased by 3.8%, despite a decline in consumer confidence during the second half of the year. Boots Healthcare International also achieved strong growth with a like for like sales increase of 5.8%.

**Operating profit** from continuing operations fell by 10.9% to £508.2m. Gross margin in Boots The Chemists was down 80 basis points in the year and operating costs were £100m, 7% higher. Inflation of £40m, higher sales volumes increasing store and distribution costs and additional pension charges were offset by productivity improvements and savings from the 'Getting-in-Shape' programme resulting in underlying costs being lower for the year. However, the costs of new stores and improving existing stores was £80m and investment in IT and infrastructure added £35m.

**Profit before tax** declined by 26.3% to £427.6m. This included an exceptional loss of £56.7m relating to the exit and disposal of the dentistry and LASIK businesses. In addition, last year included an exceptional gain of £36.4m, largely relating to the disposal of property. The interest charge for the year has increased from £5.5m in the previous year to £19.8m, as a result of increasing debt to improve balance sheet efficiency.

**Taxation** Excluding non-operating exceptionals, the effective tax rate for the group was 29.6%, reduced from 30.9% last year as a result of a number of prior year credits.

**Basic earnings per share** before exceptional items decreased by 4.8% to 45.7p per share. Basic earnings per share decreased by 22.5%. The weighted average number of shares in issue decreased in the year from 780.0m to 739.8m as a result of the continuing share buy-back programme.

**Dividend** The board has a policy of sustainable dividend growth with a target dividend cover of 1.75 times over the medium-term. Consistent with this the board has proposed a final dividend of 21.0p, in line with the previous year, bringing the total dividend for the year to 30.1p, an increase of 1.0% over last year. On share price at 31st March 2005 of 623.5p this represents a yield of 4.8%.

**Working capital** has increased by £118m in the year. This was mainly due to growth in the business, including new store openings and strong final quarter sales in Boots Healthcare International. Also contributing to the increase was the payment of £42m relating to 'Getting-in-Shape' redundancies during the year, which utilised the provision in the balance sheet at March 2004. The provision at March 2005 is £10.8m.

**Cash flow** from operating activities before exceptionals was £529.4m (2004 £655.1m), weaker than the previous year due to the lower operating profit and larger increase in working capital. Cash outflow before the effect of share repurchase and other financing was £151.5m. In 2004 this was an inflow of £173.1m due to proceeds from the sale of property and lower expenditure on the purchase of fixed assets.

**Share price** Our share price rose from 619.5p, near its year's low of 596.5p, to a peak of 700.5p before ending the year at 623.5p. The share price underperformed the FTSE100 by 10.9% over the year.

#### **Pensions**

The Boots Pension Scheme cost for the year under SSAP24 is £54m (2004 £28m).

On an FRS17 basis the scheme is in a deficit position of £83m at March 2005 (2004 £58m), with the increase in the year primarily due to cash contributions being lower than the FRS17 Profit & Loss charge. Disclosures under FRS17 are included in note 27 to the accounts.

The Pension Scheme's 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 Pension Scheme intends to allocate 15% of its assets to equities and

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property to match longer-term liabilities. The remaining 85% of assets will be invested in a diverse portfolio of high quality investment grade bonds of varying maturity, with interest rate and inflation-linked swaps used to improve the matching characteristics with liabilities. At 31st March 2005, the implementation of this investment strategy was almost complete. The overall asset allocation provides a relatively good hedge against liabilities on an actuarial basis, and on an accounting basis under FRS17, and under IAS19 going forward. The triennial valuation as at April 2004 of the Pension Scheme has now been completed and the Trustees have agreed a new contribution schedule with the group. Under the actuarial assumptions used, there was a funding deficit of £83m which the group has agreed to make good with additional contributions (over and above the normal accrual rate) of £11.7m over 10 years.

### Accounting Standards

The Accounting Standards Board issued new standards on accounting for own shares. Previously any own shares purchased were capitalised as fixed asset investments and amortisation charged to the profit and loss account. The new standards require the cost value of own shares to be deducted from reserves and for the fair value of shares and options to be charged through the profit and loss account. The impact on profit to Boots is negligible, although there is a £74.7m reduction in

reserves as a result of the new balance sheet treatment. The full impact is explained in note 21 to the accounts.

### International Financial Reporting

**Standards (IFRS)** became 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 and work is well underway to migrate Boots to the new standards. The full analysis of impacts is now complete and has confirmed that the impact on the profit and loss account is unlikely to be significant. A number of balance sheet restatements will be made with an overall impact on net assets of £4m, the key ones being (with March 2005 estimates):

- > Pension Fund deficit will be included on the balance sheet and the SSAP24 debtor previously reported removed. The impact on net assets is a reduction of £136m.
- > Deferred Tax will be provided on revalued buildings, rolled over capital gains, leases and brand expenditure. The impact on net assets will be a reduction of £4m.
- > Proposed Dividends will no longer be provided for in the financial statements. This will increase net assets by £150m.
- > Leases. The classification of certain leases as finance leases (previously treated as operating leases) and the different treatment of lease incentives reduces net assets by £11m.

Other smaller charges will arise as a result of charges to financial instruments and site fee income.

### 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 undertaking of speculative transactions is not permitted.

Note 19 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 fund 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.

During the year, the group set up a 5 year £600m committed facility and a £2bn Euro Medium Term Note (MTN) programme. Under the MTN programme it issued a publically placed €300m 3 year Floating Rate Note and 5 small privately placed MTNs between 3 and 4 years totalling £26m in order to fund the share repurchase programme. At 31st March 2005, there was £520m undrawn committed facilities.

At 31st March 2005, the group had long-term investment grade credit ratings of A- from Standard & Poor's and A3 from Moody's. During April 2005, the group's credit rating was changed by Standard & Poor's to BBB+. These ratings are consistent with our commitment to a strong investment grade rating.

**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 2004	Annual rent Commitment at 31st March 2005
	£m	£m
1 to 10 years	86.3	104.8
10 to 20 years	76.3	73.2
20 to 30 years	7.9	5.1
Over 30 years	5.0	5.1
<b>Total</b>	<b>175.5</b>	<b>188.2</b>

The capitalised value of these liabilities is £1,237.7m (2004 £1,242.2m) 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 5.8% (2004 5.85%).

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** The group's interest rate policy is to maintain a mix of fixed and floating interest rates reflecting a balance between the certainty of interest rate cost, the expected interest cost, and the need for flexibility to repay debt. At March 2005, gross debt comprises fixed rate £191m, (2004 £183m) and floating rate £531m, (2004 £315m). The higher proportion of floating rate debt in 2005 reflects the increased need to maintain flexibility given that the anticipated proceeds from the proposed sale and leaseback transaction will reduce the level of debt.

**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 any currency exposures arising from future uncommitted transactions. The group principally borrows in sterling and euros. Euro debt is held to partially hedge the group's euro assets and to create a long-term hedge against future cash generated in euros from its Boots The Chemists business in Eire and from Boots Healthcare International.

**Capital structure** We remain committed to achieving an efficient balance sheet and returning surplus cash to shareholders, whilst maintaining a strong investment grade credit rating. We have returned over £1.7bn in the form of dividends and share repurchases over the last three years, and will continue to return surplus cash over the coming year, both as part of the £700m programme and from the sale proceeds of Boots Healthcare International, consistent with maintaining acceptable credit rating ratios.