

operational review

Boots has taken enormous strides forward in the past 12 months. We have been talking about change for more than two years now. But the progress made in 2004/05 has really moved the business on. We have, among other things, cut prices on a further 2,000 lines by about 14%, changed opening hours, put more stores in places where customers want to shop and relaunched key lines. We have re-engineered our supply chain, rebuilt our IT systems and shut a major manufacturing plant.

We have been working to 'put the chemists back in Boots' – a recognition that healthcare has always been at the heart of our business and will continue to be. It has not all been straightforward. The changes have been made as the trading environment has worsened and our sales line did not perform as well as we hoped in the last quarter of the year. But nothing that has happened has knocked our faith in our strategy. We are building a platform for a better Boots; one that is true to its heritage, a company trusted by successive generations because it is the health and beauty expert.

Boots The Chemists

Boots The Chemists (BTC) made real progress this year. Customers responded to 2,000 lower prices that over two years mean 3,300 lines are on average 18% lower. Sales grew throughout the first half and, although the second half was below our initial expectations – largely due to the consumer downturn that hit retailers across the high street – we still enjoyed our third successful Christmas in a row. Overall, we were encouraged by a year in which we took further important steps on our journey.

2,000

further lower prices in the year

Boots The Chemists	
Sales £m	4,651.1
Increase %	3.8
Profit £m (before exceptionals)	470.0
Decrease %	(11.8)
Sales split	£m
Health	1,862.5
Beauty & Toiletries	2,054.7
Lifestyle	733.9

Strategy We have developed a very clear strategy for Boots The Chemists. Central to the strategy and its success is our healthcare offer. Why? Because this is the thread that ties all our stores together; big or small, urban or rural, central or edge-of-town. We have 1,400 stores and in nearly every store there is a pharmacist able to offer guidance and expertise on healthcare matters. Healthcare is a growing market as the population ages and the need to make health provision easier and more convenient means the role of the pharmacist is increasing in our everyday lives.

Of course, beauty and toiletries will continue to be key markets. Our expertise in beauty and our growing number of beauty halls has delivered market share growth. In toiletries, the most competitive area and where our rivals are strongest and pushing hardest, we have competed well and held market share.

3.8%

increase in
BTC sales

These are encouraging trends and give us confidence that all our efforts are being appreciated by the customer.

Next, our stores. We are making them look better; we are opening more stores, particularly edge-of-town, we are improving our record on availability and we are investing in our people. Key here is a fresh focus on improving our already excellent level of expert customer care. That is one of the things which gives Boots a major competitive advantage, we are one of the few stores where people expect and receive expertise.

For example, changes to the healthcare system means that Boots can now offer a comprehensive, integrated approach to lifestyle health issues such as stopping smoking and losing weight. One of our stores in Birmingham recently helped 1,000 people start on the journey to give up smoking with a series of classes that look at the problems they face in a rounded way. Those who want to lose weight can sign up for a course offering expert health and advice and an effective weight loss medicine along with discounts on our Shapers food ranges and exercise equipment.

Being competitive on price is vital. We have lowered prices and will continue to offer greater value.

Finally, we will continue to improve our ranges. We will develop new products that make people feel that shopping at Boots is an exciting as well as a necessary thing. We will improve and update ranges where they need it.

Trading Overall, BTC sales rose by 3.8% over the year. On a like-for-like basis, the underlying measure which strips out the effects of changes to the selling space, sales were 2.4% higher. Over the crucial Christmas period sales grew by 4.2%, on top of increases of 5.1% and 8.1% in the two previous years. Our healthcare business enjoyed a sales increase of 5.0% with dispensing up 6.1% – our best performance since 2000. Beauty and toiletries were up 2.9% and 0.1% respectively.

Prices You'll Love Our focus on cutting prices for consumers has meant an overall reduction of more than £200m. This commitment to offering better value has started to show results. We are still in the early stages, but in the year we saw growing numbers of transactions as well

6.1%

best dispensing
performance in
five years

as a small increase in the average spend of our customers. Our strategy is clear. We will offer people fair prices on everyday lines, offer strong promotions on a rolling basis and bolster our customers' perception of our value with the Advantage Card.

This comes alongside attempts to ensure that we offer customers a range of price points to suit all purses. We are offering our customers goods that they can easily differentiate as being 'good', 'better' and 'best' so they can pick the goods that suit them in each product category. Everyone these days wants value – but they want to be able to choose it when it suits them. It is common to see customers putting top-of-the-range products from one product area in their baskets alongside something from our 'Basics' range. Already in its first year, the Basics range has attracted 250,000 new toiletry customers to Boots.

Our stores It has been a major year in stores development. We opened more stores – on average nearly one a week – than we have done in a decade. The main focus here has been on boosting our presence on edge-of-town retail parks.

> operational review

At the same time we have been looking closely at the type of stores we open. Much of our thinking came together with the opening of our 20,000 sq ft store on the outskirts of Glasgow. We have also worked on opening new stores as cheaply as possible. For example, our new store opening on the edge of Merthyr Tydfil was developed to run on much lower operating costs – and is already operating above its original sales plan.

And just opened is a premier store for London. Our portfolio in London has not been what it should be for some time, with so many small stores – and this is what many of the key opinion formers who comment on our business see on a day-to-day basis. But our new store, in the middle of Oxford Street with four floors of selling space, represents the very best of modern Boots. Our London corporate offices will also be moved there – so we will be living right above the shop. We have also extended and refitted our store in High Street Kensington as we right our portfolio in London. Already sales in this store are up over 20%.

We have also been designing new ways to get the best out of our current stores. We have adopted a new space management

1,000

stores now with
Smartsript IT system

system and changed space where suitable to make sure the right goods are being displayed in the most appropriate way.

We have worked hard on improving store navigation, with better signage, so customers can find their way around quickly and easily.

In April we announced plans to sell 300 of our smaller stores and lease them back. This does not mean we are not committed to these stores – quite the reverse. Small local stores will continue to be an essential part of the Boots offer. Sale and leaseback arrangements are common in retail and the money that we raise, expected to be in the region of £250m, will be used to pay down short-term borrowings.

Advantage Card We have been working hard to ensure that more people appreciate the excellent value offered by the Advantage Card. We are also working hard on using the information we get from the card to drive sales. The importance of the card is obvious. Cardholders visit stores more often than customers without a card – and spend more. We already have 14 million active cardholders – but that still leaves many of our regular customers without one. Through the year we have added one million new cardholders.

We also started to tailor our direct mailings more than ever before. Towards the end of the year we sent out our most personalised mailing yet. We used card data to work out which of our shops our customers used and which goods they bought most often – and sent them coupons we thought they were most likely to use based on their spending patterns.

Health Our core pharmacy business had its best year for five years, with our dispensing business issuing 94 million items. That means that every second we dispensed nine items from our pharmacies. The business is growing in line with the market, for the first time in five years. But in a growing and changing market there is much more to go for – and as we have said, health is the very heart of Boots.

Over the past year we opened 80 new pharmacies and over 1,000 of our stores now have the 'Smartsript' information technology system to aid customer choice and put us in a strong position for the future changes to the way in which prescriptions will be dispensed from GPs' surgeries. Among other highlights was our growth in the Prescription Collection Service (PCS) – where we pick up prescriptions from

750,000

customers signed up
to the Prescription
Collection Service

doctors for patients and have their medicines ready and waiting when they visit stores – which enjoyed a 17% increase. We now have almost 750,000 people signed up. That represents over a quarter of our customer base. On the Monitored Dosage System (MDS), under which we provide pre-packaged drugs for safe and easy use by care homes, we have seen huge success with growth of 12%.

Beauty and toiletries Beauty continues to be a growth market and the investment in the year in new beauty halls was rewarded with a good performance in our cosmetic and fragrance category where growth of 5.3% was seen. We continue to have the widest range of cosmetics in the UK as well as the biggest range of fragrance and more beauty consultants than any other retailer.

The year saw the introduction of new-style fragrance display cabinets in 178 stores, these not only improved the merchandising of the product and their sales, but also helped to reduce theft in stores. This was in addition to the 72 new premium accounts opened, the 24 beauty halls we refurbished and the 198 stores that got new self-selection cosmetic fixtures.

February saw the relaunch of N°7 – our biggest own brand and the nation's leading cosmetic range – in an overnight operation. More than 60% of the product underwent new formulation, to ensure it was delivering even greater benefits to our customers.

In toiletries, one of the most competitive areas we operate in, growth was up 0.1% as a result of price deflation. But encouragingly market share was held as we worked on refining our promotions and giving greater authority to our ranges. On promotions, we decided it was important to have fewer, simpler offers; a move which our customers seemed to appreciate. Our own-brand innovation included the successful relaunch of the Soltan skincare ranges which restored the product to the number one slot in the market and the new Hackett products. We ensured that where possible we got exclusive deals on the launches of other people's products, for example, the Mach3 Power razor.

Lifestyle This category continues to benefit from a renewed focus on our baby and food offering.

94m

items dispensed
in Boots pharmacies
in the year

The performance in baby was largely driven by our ongoing expansion of the category into clothing, toys and everyday items. We continue to offer customers the broadest range of baby food and specialist milks, one of the widest range of small baby accessories and exclusive clothing through our mini mode and Molly and Jack ranges. We are also the biggest retailer of the OskKosh kids clothing brand in the UK. Crucially, we offer our customers own brands with real choice and a real differential: skincare products that have been paediatrician-approved and toys that are tested to a level in excess of British Safety Standards.

Our food ranges have been completely revamped over the last 18 months and this year we have sold more than 40 million sandwiches and salads to our customers. First, our relaunch of the Shapers range helped re-establish the brand as a healthy food option. We have not stopped there and new lines such as salads, smoothies and dried fruit and nuts have been added. We also relaunched our remaining food ranges under the Delicious label, incorporating guidance from the Government regarding daily salt, fat and calories content. We are committed to helping the customer eat

> operational review

more healthily, while not compromising on taste. We also relaunched our meal deal to offer the best combination of value and choice on the high street.

In photography, we continued the process of shifting more towards digital cameras and processing as the traditional photo market declined further. We expanded our digital offer in larger stores to concentrate on that growing market and grew our range to include the latest in phone camera technology. We were the first to install self-service digital kiosks in our stores as we sought to ensure that we are at the forefront of offering customers the opportunity to take advantage of the technological advances in this growing area.

But not everyone has gone digital yet, and Boots will continue within the traditional photography arena. We took market share in traditional processing in every month since July and over the year sold 16 million rolls of film.

Services This year saw the final stage of our gradual withdrawal from our services offering. The exit from laser eye correction, dentistry, chiropody and laser hair removal was part of the continuing focus on the business of Boots The Chemists. In spite

of improvement in productivity across the services, there was little prospect of the businesses making acceptable returns for the group going forward.

Boots Opticians

It continued to be a tough year for our opticians business as we have continued the process of integrating it back into the core Boots The Chemists chain. In spite of selling more than one million pairs of glasses a year we continue to face increasing competition as well as lower consumer spending on fashion items. We have stepped up our game and begun to compete more on value and range as well as continuing to focus on the quality of our offer and the expertise that we provide.

Opticians	
Sales £m	182.5
Decrease %	(8.6)
Operating profit £m (before exceptionals)	4.2
Decrease %	(67.4)

boots.com

Last year, boots.com managed to deliver sales growth of more than 30%, despite some operational challenges, as we worked to make the site easier to shop and our back-shop more efficient.

£87.8mprofit delivered
by BHI

Premium beauty products have continued to sell well online, with boots.com one of the few official online stockists of the full ranges of brands such as Estee Lauder, Clinique, Chanel and Clarins. Gifts had another year of strong sales with new areas such as toys and outdoor gifts performing particularly well. We also had excellent sales growth in extended online ranges in areas such as home entertainment and photo, with web-only deals driving significant volumes.

This year we will work to eliminate the operational constraints and continue to grow in confidence that boots.com represents an area of strong potential for future growth.

Boots Healthcare International

BHI has enjoyed further success – reporting its third record year of organic growth by delivering sales and profits above plan. The business is now entering the final phase of a four-year plan and is in great health.

Boots Healthcare International		
Sales £m		522.7
Increase %		5.8
Profit £m (before exceptionals)		87.8
Increase %		12.7
Core brand sales	£m	Increase%
Nurofen	150.4	8.1
Clearasil	91.4	6.0
Strepsils	91.0	9.3

400

BRI implants
operating in
nine countries

Strategy BHI is aiming to become one of the top global players in the over the counter healthcare market. Over the past three years, the business has become one of the fastest growing consumer healthcare businesses in the world, through a focus on rapid innovation and a 'must have' brand strategy.

In April we announced plans to sell BHI – a move which will allow the management and employees to tap into the resources of a dedicated owner committed to its longer-term development.

Trading Sales in the past year continued to be driven by the core brands of Nurofen in analgesics, Strepsils in cough and colds and Clearasil in skincare. Total sales increased by 5.8% to £522.7m, with profit up 12.7% to £87.8m. Cash flow from operations rose by 15.9% to £89.6m.

In analgesics, an 8.1% growth in sales of Nurofen was driven by expansion in Australia, New Zealand, Central Europe, Russia, Italy, Spain and Ireland. Growth was driven by increased support for the Nurofen Plus Strong Pain offer, the continued expansion of Nurofen for Children and the roll out of new products for migraine and period pain.

In skincare, sales of Clearasil rose by 6% driven by the USA with new advertising, the launch of Clearasil Ultra, the launch of a specialist male product line and geographical expansion of the brand in Spain, Italy, Mexico and Thailand.

Meanwhile, Strepsils enjoyed growth of 9.3%, with the new advertising featuring Mr Throat proving very successful. Geographically, sales rose on the back of new product developments in Europe and Asia.

Our dermocosmetics business, however, did not perform so well. Overall, sales for the year were down by 6.6%, sales of E45 in the UK were impacted by reductions in government contracts for the product. Lutsine also declined in France, but did better in Spain and Portugal. Our German business, Hermal International, saw a decline of 3.1% as a result of the German healthcare reforms, despite our building of market share.

Outlook BHI is on track to hit its target of making £100m in annual profits by the end of this year. Managing the sales process and the concerns of our people will be an important part of the year. But we remain confident that the business is on the right path to succeed outside of the group.

Boots Retail International

Our international operations carried on their careful path towards taking Boots own-brand products to consumers around the world – and began to make real progress towards the goal of making such expansion profitable.

Boots Retail International	
Sales £m	48.3
Increase %	19.9
Operating loss £m (before exceptionals)	(8.2)
Decrease to loss %	28.2

Strategy The core business model for Boots Retail International (BRI) is to offer consumers the chance to buy Boots own-brand products and where possible replicate the Boots reputation for service by opening implants in stores run by other retailers. We now have more than 400 of these implants in nine countries as well as 77 stand-alone stores in Thailand.

The products are taken from our most successful ranges such as N°7, Botanics and Mediterranean, and are offered to customers in a Boots-branded environment in host retailers' stores.

Trading Operating losses were down by 28% (at comparable exchange rates) on last year. All countries, excluding our pilots in the

> operational review

USA, are now profitable and we have grown sales by 20%, exceeding our projections.

Outlook We are gaining confidence in the demand for Boots brand products around the world and are making good progress in our ability to meet that demand profitably.

Getting in shape

We have continued to pursue our plan, announced in 2002, to cut costs, with an intended target of saving £100m per annum. This year we have made more progress than ever before as the full impact of changes that have been in train for some time really started to take effect.

Over the past year we have implemented our plan to remove 1,000 head office jobs – about one in three of our people there. Under the old system there were too many layers of management and too much duplication. The organisation had become too slow to react to today's fast-changing retail environment. Now jobs have gone from almost every department at every level.

The challenge has been to make the changes as painless as possible for our people. And to ensure that those left are not demoralised by the process and can

90%

re-employment
achieved on
closure of our
Airdrie factory

continue to work towards delivering a better Boots. We take seriously the task of doing things the right way. If trust is an important element of our brand for consumers, we can only deliver that fully by being a good employer. That means supporting our people through change; helping them find new jobs, or preparing them for retirement. We provide financial support, expert careers advice and counselling on job opportunities. As a result of these efforts, most of the redundancies were achieved voluntarily.

Manufacturing We have faced huge change in manufacturing with the closure of our Airdrie plant in Scotland. The decision made sound commercial sense, but we were keenly aware of the potential impact on the local community and were determined to do everything in our power to minimise it. Over a two-year closure period, which ended in February, we worked in partnership with local authorities to bring new employment opportunities to the area and to stimulate the local economy. Our partnership with Lanarkshire Council and Scottish Enterprise Lanarkshire means that 90% re-employment was achieved. We continue to work in partnership for the regeneration of Airdrie.

At the same time, the move of production to our other facilities went smoothly. And we had a successful relaunch of N°7, the cosmetic product made there.

A store-friendly supply chain Twelve months ago we knew we had a lot to do to make sure that all our customers could find the goods they wanted when they wanted them. Today we know we have made huge strides. To sum up our approach, we wanted to make sure that the deliveries to stores are what our customers are actually buying on a day-to-day basis – not what head office thought it might be. We have totally re-engineered the supply chain and are now about 80% of the way through the programme. The remaining 20%, to be achieved this year, will be a focus on making sure that the stores know how to get the very best out of their systems and ways of working.

Purchasing As we continue to deliver lower prices to our customers, our costs become ever more critical and in particular our spend with suppliers. Over the past year we have put in place a 'Better Buying' programme which has delivered more than £30m of savings. This has been achieved through

80%

of deliveries now
operating under
store friendly
supply chain

a variety of means including more sourcing from the Far East, electronic auctions and a more structured approach to negotiating with suppliers. Next year we plan to deliver even more savings but always making sure that we remain true to the Boots way of doing business, which means working with our suppliers.

Making IT easy We have been working for some time now on bringing our information technology systems into the modern era. The work that has been done is complex and has taken a long time – and there is more to do. But it has started to make a real difference to our people. First, we have been fixing what we call our ‘backbone’ – the core suite of systems that supports everything else. This year we have been in the fourth phase of this. Most of the final implementation work was done over weekends in order to ensure that the day-to-day business of Boots was not disrupted.

Perhaps the biggest programme this year was the re-tilling – with the completion of the project to put 14,000 new tills into our stores. In a modern retailer the till is the absolute anchor of the business. It is not just the place the money goes in, it is the

14,000

new tills now
operating across
all our stores

fulcrum around which the whole company operates. It drives replenishment through its link into systems, so is key for availability. It is crucial for transactional security. You cannot do chip and pin on a 20-year-old till system. You cannot tailor your offer to your customers if you do not have all the data on them that comes from tills.

That was not the only change for stores. We also started the roll out of radio frequency hand-held terminals to help stock management in stores – a modern system which helps reduce the level of stockholding and gives instant information on what goods are being held where.

Stores have also started to use the new MyStoreNet intranet site. This is full of useful information delivered on a daily basis – against the old method where store managers got information up to a week later.

The major elements of the systems architecture are now in place. Going forwards we will see evolution rather than more revolutions and focus on driving benefits from investments already made.