Financial review

During the year we announced and completed two major transactions, the disposal of BHI for £1.9bn and the sale and leaseback of 312 secondary properties for £298m. The prices obtained for these transactions were both at the high end of expectations.

In addition, following the completion of the BHI disposal, we returned £1.4bn to shareholders by means of a special dividend and consolidated our shares in the ratio 39 for 58. Of the £400m retained proceeds from the sale of BHI, we announced in February 2006 that we would inject an additional £85m into the Boots Pension Scheme in order to make it one of the best funded in the FTSE 100 index of leading companies, despite adverse movements in long-term interest rates. Further, in March 2006 we announced that we would invest £250m of the retained BHI proceeds into automating and centralising our supply chain, modernising 700 of our smaller stores and opticians practices, and significantly reorganising our IT arrangement with IBM to make it more efficient. We anticipate these investments will yield material savings by 2010/11.

Primarily as a result of these major transactions, the group moved from a net debt position of £641.2m at 31st March 2005 to a net cash position of £100.0m at 31st March 2006.

Our share price had a substantial range during the year. It rose from 623.5p at the start of the year and fell to a low of 583.5p, before rising to a peak of 737.0p just before ending the year at 719.5p. On 13th February 2006 the group undertook a share consolidation issuing 39 new shares for every 58 owned. This was done at the same time as paying the special dividend of 200p per share to return the proceeds from the BHI disposal to shareholders. Based on the actual price that existed over the period the share price underperformed the FTSE 100 by 6.5% over the year.

Trading profit[1]

Revenue from continuing operations increased by 1.9% to £5,027.4m. Sales in Boots The Chemists increased by 1.7%, mainly as a result of new space with like-for-like sales down 0.1% in the year, although broadly stable on an underlying basis.

Gross margin for Boots The Chemists declined by 20 basis points with better buying and mix improvements largely offsetting the impacts of the continuing strategy of price reductions.

Trading profit[1] from continuing operations fell by 17.6% to £335.9m.

Operating profit

Items included in operating profit (but not in trading profit) include the profit in respect of the sale and leaseback transaction of £150m and the £124m costs associated with the recently announced investment programme.

Profit after tax from continuing operations

Net finance costs in the year fell by 50.4%. This fall was caused by the reduction of net debt as a result of the sale and leaseback and the disposal of BHI, and the reduction in net financing costs of the Boots Pension Scheme from £17.0m to £3.4m as a result of the change in investment strategy in 2005.

Taxation. The effective tax rate for the continuing group was 12.8%, lower than prior year because the sale and leaseback transaction attracted no tax charge due to the utilisation of capital losses (previously unrecognised for deferred tax), and also resulted in a release of deferred tax liabilities held against properties sold which had previously been revalued. The tax rate on group operating profit before other operating income and expenses and before prior year tax items was 31%, an increase of 1.2% on the prior year.

Profit after tax from continuing operations increased by 19.4% to £304.4m.

[1] Trading profit is used to measure on-going operational performance. It is defined as operating profit before net finance costs, excluding items the directors consider one-off or unusual and profit/losses on sale of non-current assets.

Profit for the year

Discontinued operations contributed significantly to the overall profit for the year. BHI's 10 month trading profit of £85.2m was an increase of 0.6% on the full year performance in the prior year and a 46% increase on a 10 month basis. The profit on disposal of £1.4bn on proceeds of £1.9bn represented a highly successful outcome for Boots and its shareholders.

Principally as a consequence of the BHI disposal the profit for the year increased to £1,773.7m (2005 £266.4m).

Based on continuing trading profit, basic earnings per share decreased by 1.2p to 33.9p per share. The weighted average number of shares in issue decreased in the year from 739.8m to 684.2m primarily as a result of the share consolidation of 39:58 that took place on 13th February 2006 as a result of the special dividend.

Dividend. The final dividend proposed is 21.0p making the full dividend for the year 30.1p, unchanged from last year. In addition, a special dividend of 200p was paid.

Cash flow summary

	2006 £m	2005 £m
Net after-tax cash flow from continuing operations	**266.9**	88.9
Net after-tax operating cash flow from discontinuing operations	**57.6**	28.3
Disposal proceeds	**2,152.5**	–
Net finance costs	**(20.1)**	(22.0)
Special dividend	**(1,425.9)**	–
Dividend	**(214.4)**	(225.7)
Repurchase of shares	**(50.0)**	(303.3)
Other movements	**(25.4)**	(34.8)
Movement in net debt	**741.2**	(468.6)

Working capital in continuing operations reduced in the year by £31.0m (2005 an increase of £109.3m) primarily as a result of the improved management of stock where weeks' cover in BTC reduced from 11 weeks to 10 weeks. Capital investments in the continuing operations of £181.1m (2005 £276.5m) were made in the year, predominantly in the stores portfolio, although significant investments were made in the infrastructures of information systems and supply chain. Despite the reduction in trading profit for the year, the net after-tax cash flow from continuing operations increased substantially from £88.9m in 2005 to £266.9m in 2006, reflecting the improved working capital management and lower capital investments.

The other key drivers of cash flow were the major corporate transactions undertaken during the year. There were net disposal proceeds of £2,152.5m, comprising £298.0m from the sale and leaseback transaction and £1,854.5m from the sale of BHI, offset by the special dividend of £1,425.9m. Share repurchases in the year were £50.0m, reduced from £303.3m in the previous year.

The net impact of cash flow movements in the year was to reduce net debt by £741.2m from a net debt position of £641.2m at 31st March 2005 to a net cash position of £100.0m at 31st March 2006.

Accounting policies

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. The restated net assets at 31st March 2005 under IFRS are £10.4m higher than under UK GAAP.

Capital structure

We remain committed to having a strong balance sheet and maintaining an investment grade credit rating. 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.

	31st March 2006 £m	31st March 2005 £m
Financial assets (excluding trade receivables)	**(858.6)**	(130.2)
Financial liabilities (excluding trade payables)	**758.6**	771.4
Balance sheet net (cash)/debt	**(100.0)**	641.2
Property operating lease liabilities*	**1,388.0**	1,237.7
Pension fund deficit/(surplus)	**56.2**	37.6
Total adjusted indebtedness	**1,344.2**	1,916.5
Equity and reserves	**1,651.5**	1,620.9
Total funding	**2,995.7**	3,537.4

* Capitalised as below

> Financial review

At 31st March 2006, the group had long term investment grade credit ratings from Standard & Poor's of BBB+ and from Moody's of Baa1, both on creditwatch. Earlier in the year the group had been downgraded from A- and A3 to BBB+/Baa1 stable outlook respectively as a result of the weaker trading environment for Boots The Chemists. At the announcement of the proposed merger with Alliance UniChem in October 2005, both rating agencies put the group on creditwatch due to their uncertainty over the future business and financial strategy of Alliance Boots. The 3rd October press release concerning the proposed merger stated that Alliance Boots intends to have an investment grade credit rating.

We have returned over £3.6bn in the form of dividends and share repurchases over the last five years, including the special dividend of £1.4bn following the disposal of BHI. This was consistent with our commitment to return surplus cash to shareholders and get an efficient balance sheet. Earlier in the year we completed the first £350m tranche of the £700m share buyback programme announced in 2004. Given the proposed merger with Alliance UniChem the second £350m tranche will not now go ahead.

Dividend. The board currently has a policy of sustained dividend growth with a target dividend cover of 1.75 times over the medium term. Dividend cover had fallen to 1.6 times in the previous year so it was felt prudent to maintain a constant dividend of 30.1p during the year, especially given the substantial changes arising from the BHI disposal, special dividend and share consolidation, until earnings per share on the continuing business resumed growth. The 3rd October press release concerning the proposed merger stated that Alliance Boots expects to target a dividend cover of 2.0-2.5 times in setting its initial dividend.

Lease liabilities. In common with other UK retailers, the group has liabilities through its obligations to pay rents under property leases.

Maturity of commitment	Annual rent commitment at 31st March 2006 £m	Annual rent commitment at 31st March 2005 £m
1 to 10 years	112.0	104.8
10 to 20 years	86.1	73.2
20 to 30 years	5.9	5.1
Over 30 years	3.7	5.1
Total	207.7	188.2

The capitalised value of these liabilities is £1,388.0m (2005 £1,237.7m) 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 of 5.7% (2005 5.8%).

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

Pensions

The Boots Pension Scheme regular service cost for the year under IAS 19 was £61.7m (2005 £75.6m), being 19.5% of scheme members' payroll (2005 21.6%).

On an IAS 19 basis, the UK defined benefit pension arrangements had a deficit position of £56.2m at March 2006 (2005 £37.6m). The value of the liabilities of the scheme has increased faster than the value of the assets during the year as a result of substantial decreases in real bond yields, despite the fact that 85% of liabilities are matched with bond assets.

The pension fund investment strategy is unchanged, with 15% of assets in equity and property to match long-term liabilities and 85% of assets in a diverse portfolio of high quality bonds to match liabilities up to 35 years. The overall asset allocation provides a relatively good hedge against liabilities on an actuarial basis and an accounting IAS 19 basis. During the year, the group agreed to make a further additional £85m contribution to the scheme from the BHI disposal proceeds. This was in addition to the additional contributions (over and above the normal accrual rate) of £11.7m over 10 years agreed at the last full actuarial valuation in April 2004. The £85m additional contribution was completed in April 2006 and put the Boots Pension Scheme into a fully funded position on an IAS 19 basis.

Liquidity and funding

Liquidity 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 an investment grade credit rating.

The policy is to spread maturity of debt and have sufficient undrawn committed facilities such that there is greater than £400m liquidity

headroom at any time over the next 12 months. At 31st March 2006, the group had undrawn committed facilities of £600m under a syndicated committed facility which matures in July 2009.

Maturity of financial liabilities (excluding trade payables)

Matures in:	31st March 2006 £m	31st March 2005 £m
1 year	**(183.4)**	(183.8)
1-2 years	**(231.5)**	(35.6)
2-3 years	**(27.8)**	(224.9)
3-4 years	**(309.6)**	(23.2)
4-5 years	**(2.4)**	(303.9)
Over 5 years	**(3.9)**	–
Total	**(758.6)**	(771.4)

Maturity of financial assets (excluding trade receivables)

Matures in:	31st March 2006 £m	31st March 2005 £m
3 months	**856.0**	128.7
3-12 months	**0.9**	0.2
Over 1 year	**1.7**	1.3
Total	**858.6**	130.2

No new long term debt was raised during the year. At 31st March 2006, there was £773.5m of short term deposits and money market funds arising from the substantial proceeds from the sale and leaseback and disposal of BHI.

The group's net debt varies throughout the year in a predictable seasonal pattern. In particular, net debt peaks in the period September to December due to the working capital requirements of Christmas trading. The increase in borrowing at this time is met through drawing committed and uncommitted facilities or by reducing surplus cash.

Treasury policy

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. Boots operates systems and procedures to monitor and control foreign exchange, interest rate, liquidity, credit and other financial risks.

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. Short term cash investments are also made in an approved list of AAA credit rated money market funds. Counterparty credit positions are monitored on a regular basis.

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 31st March 2006, gross borrowings excluding finance leases, including the impact of derivative financial instruments, comprised fixed rate £167.4m (2005 £186.3m) and floating rate £523.7m (2005 £530.2m). The high proportion of floating rate debt in 2006 provided a match with the high levels of floating rate financial assets at 31st March 2006 following the receipt of the BHI disposal proceeds.

Based on the net debt and hedging position of the group at 31st March 2006, and assuming no changes, a 1% increase in interest rates would decrease the annual interest charge by £2.8m.

Currency exposure. Sales are made from the UK in a range of currencies for 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 of its committed future purchases using forward contracts 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. The amount of Euro denominated debt was decreased from £155.7m equivalent to £38.7m equivalent during the year following the disposal of BHI, which significantly reduced the amounts of Euro assets and Euro exposure.

Based on the hedging position and currency mix of earnings of the group at 31st March 2006, movements in exchange rates against Sterling on the group's reporting currency, would not have a significant impact on the group's earnings.