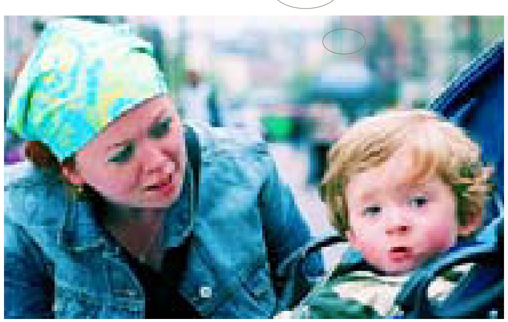
Operational review

As you've heard, 2003/04 was a year of massive root change for Boots. From rebuilding our entire management structure to laying the foundations of a new store-friendly supply chain, we focused our efforts on initiatives designed to transform our business over the next five years. Yet, while looking to the future, we continued to perform very solidly, in the here and now. Boots The Chemists delivered good sales growth throughout the year, holding market share. Boots Healthcare International recorded sales of over £500m for the first time, growing at around twice the rate of the market, and comfortably over-delivering on its strategic targets.



Boots The Chemists

As customers responded to lower prices on around 2,000 lines, wider choice and better availability, Boots The Chemists (BTC) made real progress in 2003/04. Sales grew throughout the year, and we enjoyed our second excellent Christmas in succession. With renewed focus on our core healthcare business, we had our best year since 2000. We were specially pleased to regain market leadership in vitamins. And, at the very heart of our business, our relaunched Prescription Collection Service helped us to secure the loyalty of many of our dispensing customers. In all, an encouraging year, as a visible improvement in our all-round customer offering began to produce results.

Strategy We believe the way forward for BTC is to build our future success on our traditional strength in healthcare. That, of course, is what has made the Boots brand so widely trusted; and it's also the common thread that runs through all our stores. No less important, it's a growing market with an exciting future.

Alongside our healthcare expertise, we need to offer the kind of products that give customers a compelling reason to shop at Boots. To this end, we're continuing to develop our own brand ranges, ensuring that within our product offering, there is a clear structure that enables customers to differentiate easily between 'good', 'better' and 'best', and choose the brand which meets their particular needs.

Next, we must ensure that our customers feel they can expect fair prices from us, and real value for money. Lower Prices You'll Love is a step in the right direction. Strong promotions and our massively successful Advantage Card will lend strong support in this key area.

A further plank in our strategic platform: better, more welcoming stores, offering the right product mix for the location. A very important development here, is our new focus on introducing three clearly defined

Boots The Chemists

Sales £m	4,475.7
Increase %	4.5
Profit £m (before exceptionals)	531.1
Decrease %	(6.6)

Sales split	£m
Health	1,806.7
Beauty & Toiletries	1,992.5
Lifestyle	676.5

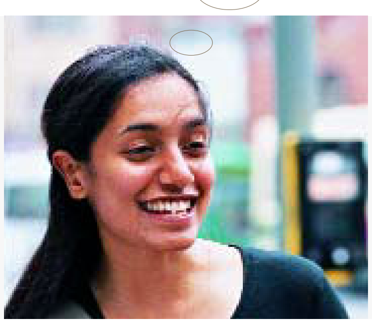
simple store formats: destination, convenience and community chemists. We're also beginning a major move into edge of town locations, where we see significant potential for sales growth. We opened 19 new stores last year, with around 40 more to follow in 2004/05.

Finally, it almost goes without saying that the outstanding level of expert customer care provided by our people will continue to give Boots a major competitive advantage.

Management structure A critically important change in the structure of BTC was introduced during the past year. We created a single commercial function, responsible for every aspect of our customer offer – product ranges; price and promotion; store environment; and communication. By integrating these key functions, we've been able to work in a far more efficient and co-ordinated manner to ensure that we're getting the retailing basics right in all our stores.

Trading Overall, BTC sales rose by 4.5% over the year (3.9% like-for-like). Sales grew in every quarter, and by 5.1% over the Christmas period, following on from an 8.1% increase the previous year.

Renewed focus on our healthcare business resulted in sales growth of 6.0%, our best performance since 2000. As more customers signed up for our relaunched Prescription Collection Service, dispensing was up by 6.3%, though this represented a small loss of market share, which we are addressing through the introduction of our new health centre-based pharmacies.



Beauty & Toiletries grew overall by 4.7%, with cosmetics and fragrances continuing to do very well, up in terms of both sales and market share. Growth of only 0.9% in toiletries reflects our very substantial price investment in this area.

Sales in other categories were flat overall. Our Baby business grew by 4.5% as we seek to broaden our ranges to provide a more competitive offer, including the successful launch of MiniMode clothing in our larger stores. Our Food business grew by 2.5% helped by the relaunch of our own Shapers brand. Our Photo business declined by 6.0% as the market for traditional film processing shrinks with the onset of digital photography. To offset this, we are leading the market in offering digital film processing.

Advantage Card The Boots Advantage Card has proved itself very well named in recent years and is a real bonus for customers. With over 16 million in circulation, it's one of the UK's most generous loyalty cards. Not only is it a major sales driver for us, but also a source of invaluable customer information.

In September last year, the introduction of a new instant Advantage Card gave us an even bigger competitive edge and a great incentive to our customers. Tempted by the opportunity to start collecting points on purchases immediately, over a million more Boots customers signed up for the card.

Health As you've read, we had an excellent year, as major investment in this key area of our business reinforced the traditional strength of the Boots brand in all matters health-related.

In particular, the very large sums we're spending on modernising our pharmacies enabled us to provide customers with a faster, more efficient service. A further 192 new-look, efficient and customer centred pharmacies were unveiled during the year. And our new SmartScript IT system, was installed in over 550 stores, greatly improving the quality of our dispensing operation.

We were very pleased, with the success of our advertising campaign for Prescription Collection Service. For people with busy lives, as well as those who find getting around difficult, the advantage of us collecting their regular repeat prescriptions from their GPs is obvious: all they have to do is pop into Boots when their prescription is ready. But there are real business benefits for us, too. Not only does the scheme greatly increase customer loyalty, it also means that we can dispense prescriptions at times planned to avoid the busy parts of the day when customers are wanting immediate service. As a result of these developments, dispensing sales were up 6.3%.

Good sales of over the counter (OTC) medicines – especially vitamins – were driven by product innovation, as well as more competitive prices and promotions.

Beauty & Toiletries The health of our customers may have been our highest priority, but we certainly didn't neglect their appearance. Beauty & Toiletries sales were strong throughout the year.

Cosmetics and fragrances were the star players here. New fragrance launches (for example, Chance from Chanel), and more stores with prestige brands, such as Clinique and Clarins, played a very important part. And our biggest Boots brand, N°7, had another excellent year, due to the continued success of Intelligent Colour Foundation, and some strong promotions.

Sales in toiletries were up slightly as a result of price deflation.

Lifestyle During the year we renamed this category which includes baby, food, photo and seasonal gift, to lifestyle. We considerably improved our baby offering. A number of our larger stores extended their baby departments, enabling them to carry a much wider product range, including clothing and accessories; and smaller stores now have a better selection of baby essentials. As a result, sales increased by 4.5%.

In food, where sales were up 2.5%, the year's biggest story was the relaunch of Shapers, our second biggest brand after N°7. The lunchtime market is very large, and getting larger all the time. And we believe that the new improved Shapers range, created with the help of top chefs, has the potential to grow substantially over three years. Customer reaction so far has been enthusiastic.

Photo sales were down by 6.0%, as the market for traditional film processing continued its inevitable decline. But even here, we have a positive story to tell: printing from digital cameras helped to offset the loss of sales. And, as we continue to roll out our new digital kiosks, we'll soon be able to process digital media cards in every store.

Products New and improved own brand products launched in the year included Boots Basics, an entry level brand which was launched in Spring 2004, offering best quality at supermarket prices. The new Soltan range was launched for summer 2004 with a market leading ★★★★★ claim, developed by inhouse suncare experts. The Shapers brand was relaunched in January 2004 and won the British Sandwich Industry Awards 2004 for Sandwich Retail Multiple of the year. New healthcare products included multivitamin gummy bears for children, and for adults, dissolve in your mouth vitamin strips.

Store development We know from customer feedback that our stores haven't been inviting enough, and we're addressing this through our store modernisation programme. But it's no less important to ensure that each of our stores does the job that customers need it to do, according to its location.

To this end, we have begun a programme of store development based on three simplified formats: community chemists, with healthcare at the heart of our offer; convenience stores, offering rapid turnaround shopping, with food heavily featured; and destination stores, offering the entire Boots shopping experience, and worth a special trip.

Introducing these new formats across our store portfolio will take time, but during the year, we made an encouraging start. July 2003 saw the launch of our Kingsway convenience store in London. And in February 2004, we opened a pilot new-look community chemists in Urmston, near Manchester. Both have been well received by customers.

The other major development last year was the rapid acceleration of our edge of town programme. In the high street, we have 35% of health and beauty sales, out of town just 5%. So we know that there's a great opportunity. During the year, we opened 19 new stores, and we'll be opening another 40 during 2004/05.

We also opened seven new health centre pharmacies giving Boots the opportunity to offer our traditional dispensing expertise where the patients need it.

Services including Opticians and Dentalcare For reasons of cost and efficiency, these businesses are now being integrated into BTC enabling us to cut costs by eliminating duplication of functions such as marketing. Previously, our opticians and dentists operated as stand-alone businesses, within our stores but largely independent of them.

Previously this was especially valuable in the case of Boots Opticians, which had a tough year in a highly competitive market. Sales were down by 3.0% like-for-like, but improved buying terms and costs control meant that profitability nevertheless improved.

Meanwhile, our decision to restructure our dentalcare business, began to pay off. Our dentists are now self-employed and their productivity has increased significantly during the year. Sales were up by 11.1% like-for-like.

boots.com Underlying sales increased by 59% to £14.8m, bringing the business close to break-even. A 67% increase in the Christmas period, rising average transaction values and high customer interest in the Boots online offer are strong indications of the potential for further sales growth.

During the current year, boots.com will develop a more compelling and complete offer with the addition of pharmacy medicines and prescription fulfilment online. This will have gone live by the time you read this report. Importantly, this initiative puts us in a strong position to benefit from the planned introduction of the new NHS IT systems, which will enable GPs to send their patients' prescriptions direct to pharmacies.

We will also provide our customers with even more choice in our larger stores by allowing them to access the extended range of products available at boots.com. This is achieved through the development of new in-store ordering technology to be launched in summer 2004.

Boots Healthcare International

Boots Healthcare International (BHI), over-delivered on year two of its four-year strategic plan, achieving sales of more than half a billion pounds for the first time. This represented sales growth of 7.8% and profit growth of 14.9% at comparable exchange rates.

Strategy BHI aims to become a top 10 global player in OTC healthcare, and to establish, through brand innovation, a top three leadership position in our three core consumer healthcare categories of analgesics (Nurofen), cough/cold (Strepsils) and skincare (Clearasil), while also developing new brands.

In February 2002 we announced a four-year plan to step up investment in marketing and new product development. In order to achieve growth targets as rapidly as possible, it was also part of this strategy to acquire brands with potential for rejuvination and development. At the same time we set out financial goals for the four-year period.

Trading With sales of £504.6m, we grew our business by 9.6% (7.8% at comparable exchange rates), roughly twice the rate of the total OTC market. Our core brands grew at 10.0% (comparable) fuelled in particular by the new product development.

Opticians and Dentalcare

Sales £m	241.6
Decrease %	(6.6)
Operating loss £m (before exceptionals)	5.1
Increase %	83.5

Boots Healthcare International

Sales £m	504.6
Increase %[1]	7.8
Profit £m (before exceptionals)	80.6
Increase %[1]	14.9

Core brand sales	£m	Increase %[1]
Nurofen	140.3	15.3
Clearasil	89.7	6.3
Strepsils	84.8	8.9
Dermocosmetics	51.3	5.7

[1]at comparable exchange rates

Operating profit was up by 14.9% (comparable) to £80.6m, and net margin grew by 0.8 percentage points to 16.0%. We maintained brand investment at 28.2% of sales, while operating costs reduced by 1.2 percentage points in relation to sales to 27.9%, compared with 29.1% last year.

Analgesics Sales of Nurofen grew to £140.3m, up 15.3% (comparable), against global analgesics market growth of just 3.1%. We achieved particularly strong sales, and increased market share, in Australia, UK, Ireland, Central Europe and Russia.

Key Nurofen product developments included a packaging relaunch; new easier to swallow tablets, and the launch of a new Migraine Pain variant. In Australia, the switch from pharmacy only to general sales list status gave a further boost to sales.

Nurofen for Children continued to grow rapidly, gaining share in all markets.

Cough & Cold Sales of Strepsils grew to £84.8m, up 8.9% (comparable), against global sore throat market growth of 5.8%. Here, sales and share grew most strongly in Western Europe and the Middle East/Africa.

Important brand developments included a global packaging relaunch, and the launch of Streps Douceur in France.

Skincare Sales of Clearasil grew to £89.7m, up 6.3% (comparable), in line with global market growth. Our strongest sales performances were in the UK, Australia, Russia and France.

North America shipments were flat, but understate strong in-market consumption growth of 14.2%, due to the timing of the launch of Total Control a year ago.

Country highlights BHI performed well in many of its established markets, particularly the UK, Ireland and Australasia. It was also a good year for BHI in development markets, with double digit growth in Poland, Russia and India. In Continental Western Europe, results were held back in part by uncertainties about healthcare reforms in France and Germany.

Outlook We're confident BHI will continue to deliver on its strategic targets. We'll also be pressing ahead with two important programmes: a major restructuring of our supply chain, which will cut product costs and release working capital; and the introduction of new business processes and systems, which will significantly improve our efficiency and speed to market.

Boots Retail International

We are starting to see if there's real demand all over the world for Boots own brand products, and our expert customer care. This was the year when Boots Retail International (BRI) began to make real progress towards meeting that demand, profitably.

Strategy Our long term vision is to help consumers throughout the world to look and feel their best. Originally, we aimed to achieve this by opening stores; but we have since developed a new implant strategy based upon taking the very best Boots own brand products – currently, around 600-800 of them – and offering them to shoppers in a Boots-branded environment, within a host-retailer's store.

The success of this strategy depends, crucially, on finding the right local partners. And since we started to evolve this new approach in 2000/01, we've made exciting progress. Our most notable achievements to date have been in Hong Kong where we now have just over 30 highly successful implants in Watsons' drugstores.

The challenge for BRI over the last year has been to continue to build on the success of this new model, while rationalising unprofitable elements of the business.

Trading Operating losses were down by 54.3% (comparable) last year. Our Asia and exports businesses are now profitable at a regional level, and we've grown sales by 16.1% (20.8% comparable), exceeding our projections.

In South East Asia, our business is now profitable. Our stores in Thailand are now trading profitably; a very significant milestone.

In the USA, BRI USA are trialling our implant concession business, in partnership with two leading retailers. We've now opened 18 implants with Target, mostly in Denver; and 12 with the drugstore chain CVS, in Connecticut. It's too soon to draw any conclusions, but early signs are encouraging.

Outlook We are gaining confidence in the strategy for BRI. We are starting to find that customers around the world like Boots products, and that our retail partners are seeing an enhanced offering with a Boots presence in their store.

Getting in Shape

In 2002, we announced Getting in Shape, a cost-cutting programme intended to save £100m. Moving forward with this initiative was among the most important steps in making our business more modern, competitive and efficient.

It was clear that our Nottingham head office had grown too large. With a headcount of over 3,000, there were too many people, too many layers of management and nowhere near enough scope for quick, responsive decision-making. Following a top-to-bottom organisational review, we announced in January that we would be cutting around 900 jobs, reducing numbers in virtually every department.

The expected cost of our redundancy programme is £45.5m. Cost savings related to those departures amount to £31.4m in total, of which we invested £5.8m in creating 290 new jobs in our stores.

By the time you read this, most of these jobs will already have gone, and we will be looking ahead to a further round of job cuts in the current year, with the aim of bringing our total head office team down to around 1,500 people.

We've worked very hard to make Getting in Shape as painless as possible for our people. We announced the changes as soon as we could, and maintained open and honest communication throughout the process. And, as well as financial support, we provided those affected with expert advice and counselling on job opportunities. As a result, we were able to achieve almost all the redundancies voluntarily.

Supply and support services

We want every customer to find exactly what they are looking for on our shelves, at a price they are happy to pay, every time they visit Boots. The massive programme of change necessary in order to deliver that gathered pace in 2003/04, as our supply chain, manufacturing operation and IT function all underwent transformation.

Store-friendly supply chain Despite fundamental restructuring of our supply chain, and the opening of 35 new stores, we held availability at high levels throughout the year.

Boots Retail International

Sales £m	43.0
Increase %[1]	20.8
Operating loss £m (before exceptionals)	(10.4)
Increase %[1]	54.3

[1] at comparable exchange rates

In 2002/03, we announced our plans to rebuild our supply chain which, rather like our head office, had become over-complicated. Working backwards from what our customers want, the ultimate aim was to create a supply chain capable of delivering any stock item, in any quantity from singles upwards, direct to the shelf in any of our stores, every day.

In the year under review, we made huge structural changes in preparation for rolling out our store-friendly supply chain.

Recognising the need for specialist logistical expertise, we outsourced our two largest Nottingham warehouses to Unipart in August. Under this deal, 600 Boots people were transferred to employment with Unipart, and an extra 300 jobs were created, to handle the greatly increased workload involved in picking, packing and delivering to stores.

The principle that underlies this modernisation is simple: all the hard work will now be done in the warehouse, enabling our stores to focus on selling, and caring for our customers. In addition, of course, stores will no longer need to hold large quantities of stock.

Even with the vast experience of Unipart, bringing our store-friendly supply chain into operation is a mammoth undertaking. But already, our stores – and, more importantly, our customers – are starting to see the benefits; and our plan is to ensure that the new system is fully bedded down in time for Christmas this year.

As part of our store-friendly supply chain initiative, we also transferred the management of Boots transport services to Tibbett & Britten. And the greatly increased efficiency of the new system is beginning to deliver important benefits in terms of better vehicle usage.

The new picking and packing system means that stock fits much better into delivery vehicles, and the fact that goods now go directly to the stores greatly reduces unnecessary mileage.

A further environmental benefit is that, with the vast majority of goods unpacked at the warehouse, we will improve the efficiency of our recovery and recycling operations.

Manufacturing In February 2003, we announced the closure of our factory in Airdrie. Transferring production of many key lines to other manufacturing facilities has been a major logistical exercise; and we were also anxious to give our employees as much time as possible to find alternative employment. So, for both these reasons, we scheduled the closure to take place over a two-year period.

Most of the Airdrie factory's production has now been transferred, with full supply being maintained throughout. To absorb this extra output, we've increased productivity at existing factories, without adding to headcount.

As a consequence, productivity in our Nottingham Beauty Care Operation is up by 40% and unit cost down by 20%. We've also taken the opportunity of these changes to organise the way we make our products. In many categories, we've been able to move from making large batches to short cycle production, which is enabling us to respond much more quickly to the needs of our stores, and the demands of our customers.

Finally, we've been able to improve our capacity utilisation quite markedly as we filled up our factories in Nottingham, France and Germany.

Purchasing Building on last year's success, we continued to make good use of innovative methods of purchasing, including internet auctions. As a result, we saved a further £30m on goods not for resale.

Making IT Easy The massive programme of organisational change and modernisation which you've read about in this report would not be possible without a company-wide IT infrastructure of the highest quality. During the year, we made very important progress towards putting that in place.

Throughout our business, our aim is to invest heavily in the IT systems. We need to make it easier for our people to do their jobs better, and to improve our customers' shopping experience. Our innovative outsourcing partnership with IBM and Xansa, now well established, is enabling us to move forward towards this goal around three times faster than was previously possible, and at much lower cost.

Our new SmartScript pharmacy system, for example, was implemented in over 550 stores during the year. Around 6,000 new generation touch-screen tills were installed in 2003/04 in nearly 500 stores, at a rate of eight stores per night and this will continue through 2004/05. (Importantly, these tills are also compatible with the new chip and PIN technology, currently being introduced to combat card fraud.)

In addition, we launched a series of initiatives aimed at making stores more efficient. Among these, we're installing an advanced high capacity wide area network, making our stores a truly integrated part of our business for the first time. All of our key systems – from finance and HR to space and range planning – can now be accessed from anywhere within our business.

In our Wolverhampton and Burton-on-Trent stores, we trialled new wireless stock management systems, enabling store staff to carry out stock and price checks in real time, without leaving the shop floor. The time savings were very impressive, so we'll certainly be pursuing this.

Two customer-facing IT successes during the year: our new gift card, an electronic version of the traditional Boots gift voucher, was well received; and the launch of an instant Advantage Card – enabling customers to start collecting points straight away – was an enormous success, contributing to the recruitment of around a million further Advantage Card holders.

There's still a lot to be done. But we're committed to making the necessary investment, and the benefits of our outsourcing partnership have already proved even greater than we hoped. We're well on our way to delivering upon the working title of our systems investment programme: Making IT Easy.