

Chief executive's review

Boots is consolidating its leadership in health and beauty retailing. We have one of the most trusted brands on the high street and we've backed it with investment in attractive stores, innovative products and effective promotion. Our aim is to be *the* place for health and beauty.



Over and over again in this report you'll see one word: 'simplify'. Throughout the transformation of the business, our central aim has been to eliminate complexity.

Complexity wastes time and resources. It slows us down. It gets between our customers and us. We are simplifying our activities, our structure, our systems, our processes. All in pursuit of a single, simple ambition: to strengthen our position as the leader in health and beauty.

Fulfilling that simple ambition is not easy in a competitive marketplace. To maintain our leadership, we have to do two things: focus resolutely on health and beauty, with no distractions, and make sure we really are the best.

Focusing on health and beauty

Now that we've sold Halfords, Boots is dedicated to health and beauty. Halfords is a good business – and we got a good price for it – but it was diverting attention from our core activity. We are now a single company with two core businesses: BTC and BHI.

Health and beauty is an attractive market – our core categories have been growing at 4-5% a year over the last three years. It's also a broad one, encompassing services as well as products. In the past couple of years we've been running trials to discover just how much of that ground we can cover under the Boots brand. We've

had some successes, but also some disappointments.

Boots Dentalcare addresses a fast growing market with clear profit potential. We are making operational improvements that will accelerate its progress towards profitability. Footcare is a smaller opportunity but, like dentistry, fits comfortably with our brand; customers trust Boots to provide primary healthcare advice and services from qualified professionals. Our LASIK laser eye correction clinics have seen strong demand from customers and we're now integrating this business more closely with Boots Opticians.

Our broader range of services, piloted in 12 Wellbeing Services Centres, proved less successful. BTC stores were not the right environment for 'pampering' beauty services, and the alternative therapy market is currently too small to be attractive for a mainstream brand like Boots. So we have decided to withdraw from this part of our offer.

We opened six Pure Beauty stores to pilot a specialist premium cosmetics offer. Customers liked it, but the returns simply didn't justify rolling it out. We are closing the stores but will apply successful elements of the offer in larger BTC stores.

Pharmacy is a fundamentally important part of our offer. It represents about a quarter of BTC's sales and is the foundation of our authority and credibility. It's a market with attractive long term growth prospects, driven by ageing populations and the prescribing of higher cost drugs. In the UK it's growing at 7-8% a year. We are a UK leader in pharmacy, and as the market place changes we will react quickly to strengthen our position further.

BHI is our channel into the international consumer healthcare market. It's an attractive, growing

brands business that we've created through sustained investment over the past decade. Now it's fast becoming a material contributor to group profits with excellent growth prospects. Our target is for the business to make £100m of operating profit within the next three years from organic growth alone. It has built significant management capability and is delivering strong growth from a strategy of focusing investment on selected strong brands – primarily Nurofen, Strepisils, and Clearasil. It plans to accelerate that growth by acquiring more brands and revitalising them, as it's currently doing with Clearasil.

Overseas, Boots Retail International (BRI) is becoming a simpler business. Our original concept – a full drug store offering – proved too capital intensive to establish and too complex to support. We now have a low risk, low cost export model, based around Boots own brands and exclusives, which involves opening small implants in host retailers' stores. Having refined this model, we can now greatly simplify the BRI business. We are closing operations in Europe, slimming support operations and streamlining activities in South East Asia to concentrate on rolling out the new model in selected markets.

Being the best Today's consumers want excellent store environments, advice, service and products. To meet customer expectations we have to invest in all aspects of retail excellence while reducing costs so that we can offer real value for money.

In the past year we've been encouraged by how quickly customers respond when we start to get it right; we've already stabilised the long term decline in transaction numbers, our indicative measure of the number of customers in our stores.

We've begun a major investment programme to refurbish all our stores over four years. In the past year we've improved some 239, mainly in Central London, and a further 300 will follow this year.

We've stepped up our investment in staff. Our customers tell us that they really value the knowledge our store staff have. We intend to build on that strength. After increasing training and introducing new pay packages we've seen a measurable improvement in staff satisfaction and motivation.

At the start of the year our on-shelf product availability was just not good enough. A concerted effort raised availability of key lines from 90% to over 98% in time for the Christmas season. Across all lines, including key lines, availability is now over 98%. In one year we've moved from a clearly unacceptable performance to one of the best in the retail sector. We've changed policies and procedures and retrained 12,000 people throughout the supply chain and stores to make sure everyone could play their part.

The improvement in on-shelf availability so far has come from fixing our existing system. We're now in the second year of a three year programme to completely overhaul the supply chain to deliver a step change in efficiency.

To satisfy customers' appetite for new products, we brought some 1,400 new lines to market. We increased the distribution of premium cosmetics and now have them in 125 stores. We joined forces with Adams, the leading childrenswear specialist, to launch a new 0-4 years baby and toddler clothing range – mini mode – exclusive to Boots. We launched Healthy Living in over 100 stores, offering over 550 products ranging from exercise equipment to detoxing systems, and we significantly broadened our Christmas and seasonal ranges.

As promised last year, we invested over £17m in product innovation to sustain our own brands. Launches included new brands like Starlet, Essentials and Advanced Plus. We introduced over 500 new products under existing Boots brands and over 120 under Boots-exclusive brands such as TONI&GUY and Charles Worthington. We'll maintain substantial investment in new product development to create additional sales opportunities.

The other essential action last year was to sharpen our price competitiveness in commodity toiletries. This reduced margin, but it was a decisive factor in stemming the decline in transaction

numbers and driving sales up. We'll continue to offer value for money this year. We've also expanded points for the Advantage Card offer to include healthcare sales. Since relaunching the card last year we've issued one million new cards. It's one of the world's largest loyalty schemes, with nearly nine million active users. We will continue to use the information the Advantage Card gives us to better anticipate customer needs in the future.

We continue to invest in our pharmacy business. Last year we opened a new automated warehouse and distribution system costing £10m that replenishes pharmacies every morning. To improve the speed of our dispensing we're also investing in innovations such as our carousel dispensaries. By reducing the time it takes to dispense a prescription, it allows our pharmacists, who are highly skilled healthcare professionals, to spend more time with our customers. Customers value the difference, and a typical installation brings a pharmacy sales uplift of up to 6%.

To deliver all these improvements while making good returns for shareholders, we have to make changes behind the scenes as well as in the stores. We've made great strides in simplifying the Boots organisation and driving out costs, and in November we started a new programme aimed at saving a further £100m in costs.

Our purchasing continues to become keener, and we believe there are major savings to be made through outsourcing. Last year we outsourced our IT, which will bring savings of £100m over 10 years. The proposed closure of the Airdrie manufacturing plant was announced in February, as part of a plan to simplify and rationalise production capacity. And in May this year we announced plans to outsource transport and some of our warehousing.

Where next? Last year's sales boost was just the start. Boots is beginning to reap the benefit of recent investments. But if we want to continue to be the best place for health and beauty, we need to be in the right places.

We have an unrivalled presence on Britain's high streets but are underweight on edge of town sites. If we're going to achieve sustained strong growth, we have to address this. Our pilot implants in edge of town Sainsbury stores were profitable; but we were unable to agree mutually acceptable terms for reaping the potential benefits. Instead, we've accelerated our opening programme

for suitable standalone sites. We opened two edge of town stores last year and we intend to open a further 20 this year.

To return to the theme of simplification, a simpler organisation is faster and more agile. Boots has a strong management team and under the leadership of Sir Nigel Rudd and Richard Baker I look forward to seeing sustained and profitable growth.

Steve Russell
Chief Executive