Review of operations

Both core businesses reaped the benefit of increased investment. Boots The Chemists increased market share in key areas and had its best Christmas for a decade. Boots Healthcare International's four-year growth strategy delivered the promised boost to sales and profits ahead of schedule. Meanwhile Wellbeing Services and Boots Retail International cut out less promising activities to focus on those with greatest potential for profitable growth.

Boots The Chemists

Sales £m	4,284.4
Increase %	5.2
Profit £m (before exceptionals)	568.6
Decrease %	(6.0)
Sales split	**£m**
Health	1,716.4
Beauty & Toiletries	1,891.9
Other	676.1

Boots the Chemists showed strong sales growth in the year, particularly in the second half. The business held or grew market share by value in all counter health and beauty categories. The Christmas trading performance was the best for a decade, and the decline in transaction numbers was stemmed. Our prices in commodity toiletries and healthcare became more competitive, in part passing on the benefits of better buying and cost efficiencies. This, together with investment in store refits and higher pension costs, resulted in a fall in operating profit to £568.6m (before exceptionals).

Strategy BTC's customer appeal is founded on the trust and heritage of the Boots brand, broad choice of own brand and proprietary products, innovative new product development and expert service and advice. We are focused on the health and beauty markets and are confident of growing with them. We will maintain our leadership position through innovation, continued development of our store portfolio, understanding of consumer needs reinforced by analysis of Advantage Card data, and clear value positioning supported by tight control of operating costs.

Trading Sales rose 5.2% over the year (4.8% like for like). The increase was stronger in the second half than in the first, and growth over the Christmas period was the best for ten years – third quarter sales were 8.1% up on the previous year.

Healthcare sales rose by 5.1%, led by our prescriptions business. Beauty & Toiletries grew by 6.8%, with a particularly strong performance from cosmetics and fragrance. Sales in other categories, including baby, food, photo, seasonal and Digital Wellbeing, grew by 1.3%, driven by our enhanced Christmas range and a strong performance in baby products.

We held market share in all counter health and beauty categories with improvements in cosmetics (where we saw particularly strong sales growth), baby and over the counter (OTC) healthcare. Market share in toiletries was maintained and we saw a slight decline in our dispensing market share.

The number of transactions was slightly down for the year as a whole, but the long term decline stabilised in mid-year. The Advantage Card was a key driver. Since relaunching it last year, we have issued a million new cards.

Operating profit was affected by investment in stores, keener promotions and increased pension charges. Underlying margins were down by about 1.1 percentage points, due largely to pricing, promotions and a slightly adverse change in the sales mix, partially offset by savings in the cost of goods.

Health The regulation of the pharmacy market is under review by the Department of Trade and Industry (DTI). At the time of writing it is unclear what the outcome of the review will be, however the DTI are known not to favour total deregulation. We believe that some degree of regulation is necessary to secure convenient access to community pharmacy for all. We are keen to work with all the relevant authorities to ensure that any changes to the current regulations deliver an enhanced service, offer wide access to convenient community pharmacies, and play a fuller role in the nation's primary health care.

During the year, although we increased the number of prescriptions dispensed, we saw a slight decline in market share because the pattern of prescribing changed to favour older people.

We began a substantial investment programme in our pharmacy operations, installing more carousel style dispensing units which speed-up customer service and let pharmacists spend more time consulting with patients. We have begun a programme to double the number by March 2004. We also began to introduce our new pharmacy system, SmartScript, which will further enhance customer service and give us more detailed information on our dispensing business.

Since the abolition of Resale Price Maintenance on OTC medicines we have gained market share on the back of an attractive programme of promotions.

Beauty & Toiletries Sales grew strongly throughout the year but particularly over Christmas which saw an increase of over 10% overall and sales of beauty gifts up almost 40%. Sales of premium cosmetics grew by over 15% increasing market share by 1.5% in the year. We now sell them in 125 stores and we are the leading UK retailer of a number of major cosmetic brands.

Within our own brands Nº7 continued to perform strongly with sales up 14% following the launches of Intelligent Colour Foundation and the Skincare Vitamins range. The pre-Mothers' Day week was the biggest in the brand's history.

Toiletries grew in line with the market supported by a combination of innovation and promotion. New own brand ranges included Mediterranean Essentials and fcuk® branded toiletries for women.

Boots is also the partner of choice for launching and promoting new proprietary products, and last year we continued to emphasise this area. Boots led the launch of the new Gillette Mach III Turbo blades in January attracting immediate share of 60%. Some 4 months later we continued to sell more than our expected share. During the year we ran strong promotions in the toiletries category including 99 pence price points, and were successful in maintaining market share.

In sun preparations sales were up over 14% and we gained 4% of market share, helped by the strong performance of the St Tropez self tan range.

Other Sales grew by 1.3% reversing the trend of the last two years. Baby had a good year, with sales up 4.7%. We are supporting this category with stronger promotions because they are very effective in raising overall footfall. As a further boost we have developed the mini mode childrenswear range in conjunction with Adams. Launched in February, it is making encouraging progress.

Food sales showed no growth over the last year and we saw a decline in sales in London affected by increased competition and the downturn in tourism. We relaunched our sandwich packaging in May 2003 to enhance customer perceptions of our range. Photo sales were down 7.6% in a rapidly declining market, reflecting customers switching to digital photography and the associated reduction in spending on films and similar products. In response we are broadening our range of digital cameras and installing instore technology to produce photo quality prints from digital memory cards.

Growth in sales of seasonal merchandise was due largely to an enhanced range of Christmas lines. The inclusion of a broader assortment of products is valued by our customers and helps us to become a destination shop at Christmas. We intend to place more emphasis on seasonal lines in the future – for example, broadening our range of summer related products such as swimwear to sell alongside sun preparations.

During the year we brought the wellbeing.com website in-house and renamed it boots.com.

Total online sales grew 120% in the year, and average order value grew 17% as customers became more confident online shoppers. In November 2002 independent research reported a record 592,000 unique visitors, making it the UK's tenth busiest retail website.

Products Product innovation played an important role in the year's sales growth. Nº7 had the best sales in its history, with Intelligent Colour Foundation proving to be its most successful product launch ever. This innovative foundation is a unique silicone gel/pigment blend which promises to match the skin tones of all women with just three shades. Sales have exceeded forecast by almost 40%. Other Nº7 debuts included the relaunch of DailyV Skincare, which is outperforming the old range by 34%.

The most successful addition to the 17 range was Fat Lash, a volumising mascara in an innovative tube pack format which achieved excellent sales in its first six months. Over a third of buyers are new to the 17 brand.

We continued to extend the popular Botanics range. Its Face Renewal Cream was named best anti-ageing cream by *M* magazine. And the simple idea of bundling miniature packs of Botanics products into themed kits – such as the Facial Pamper Kit and Weekend Pamper Kit – has been a great success in introducing new customers to the brand.

The new Mediterranean range proved a good example of turning consumer insights into popular products. It capitalises on the popular appeal of Mediterranean diets and lifestyle to create innovative toiletries that already have annual sales of over £4m.

Innovation and style are part of the whole Boots brand offer, not confined to our premium products. We have grown the volume sales of our everyday value products by bringing them together under the Boots Essentials brand, which has won an award for its packaging design. Essentials now covers all major toiletry categories – washing and bathing, haircare and men's.

Store development In addition to our store reinvigoration programme, we undertook other schemes including the refitting of our Victoria Centre, Nottingham store. Although we reduced the product sales area by 22%, we increased weekly takings by £35,000 per week, representing a sales intensity increase of almost 40%.

Over the next 12 months we will accelerate our store development programme. We have restarted our edge of town programme and aim to open 20 more stores by April 2004. In addition, we will undertake many projects within our existing portfolio of high street stores. To respond to evolving customer shopping patterns these will be a combination of opening new stores, space changes and closures. Taken together, these changes represent a significant increase in our development programme to enhance the quality of our store portfolio.

Boots Healthcare International

Sales £m		460.4
Increase %		13.0
Profit £m (before exceptionals)		70.1
Increase %		5.1
Core brand sales increase%*	**£m**	
Nurofen	117.8	21.7
Strepsils	77.8	7.7
Clearasil	86.9	14.4
Dermacosmetics	61.5	10.0

*at comparable exchange rates

In February 2002 Boots Healthcare International (BHI) announced a four-year plan to step-up investment in marketing and new product development, to deliver a new strategy of building major international consumer healthcare brands. A pause in profit growth was predicted for 2002/03 while we regenerated organic sales growth through the increased brand investment. Nevertheless, we have delivered sales growth of 12.3% at comparable exchange rates and delivered a 5% rise in operating profit.

Strategy BHI aims to become a top ten global player in OTC healthcare. We aim to achieve this by developing six to eight leading consumer healthcare brands. We are driving brand innovation to capture a top three leadership position in our three core OTC categories of analgesics (Nurofen), cough/cold (Strepsils) and skincare (Clearasil), while also developing new brands. To fulfil our aspirations more rapidly, we will also seek to acquire brands to which we can apply our brand rejuvenation and development capabilities.

We are aiming to accelerate organic growth through increased marketing and new product development expenditure. We will have greater focus on both our development pipeline and in-market execution. In 2002/03, over half our organic growth was generated from products launched during the year.

The year's largest product launch was a major extension of the Clearasil brand, Clearasil total control, targeting the high-value 'young skincare' market. We also broadened the Nurofen brand by launching indication-specific products for conditions such as menstrual pain. These projects were brought from marketing concept to launch within 14 months.

We remain on track to deliver the financial projections we communicated to the City in February 2002. However, to reach our goal of being a top ten player more rapidly we intend to supplement organic growth with acquisition.

Results Sales of £460.4m represented top line growth of 13% (12.3% at comparable exchange rates). Profit of £70.1m was 5.1% ahead of the previous year.

In line with the growth plan, brand investment (including brand marketing and new product development expenditure) increased by £27.3m, moving from 25.1% to 28.3% of sales. Brand marketing expenditure rose by 26%, while new product development spend was up 42% to rebuild the three-year product innovation pipeline.

Operating margin of 15.2% reflected effective control of operating costs, which fell as a percentage of sales by 1.5 percentage points, and cost of goods, which fell by 0.6 percentage points.

Our research and development programme made significant progress in developing products that will continue to build our brands and take us into new therapy areas. Clinical trials have progressed well.

Organisational change is focused on four goals; breakthrough brand innovation, streamlined decision making, building high performance teams, and clear leadership.

Analgesics Sales of Nurofen grew 21.7% at comparable exchange rates, driven by strong performances in the UK, Australia and Eastern Europe.

Growth was driven by new products, new packaging such as handbag packs to offer convenience, and quality new advertising. Key launches were Nurofen for Children Singles, and Nurofen Recovery in the UK, and Nurofen Menstrual in Poland. Nurofen Plus strong painkillers led us to pharmacy market leadership in Australia. The continuing success of Nurofen for Children is growing our share of the children's market in several parts of Europe.

Cough & Cold Strepsils' worldwide growth was 7.7% at comparable exchange rates. The roll-out of Strepfen benefited from the wide distribution of Strepsils internationally. We also had early signs of success with our entry into the cough segment in Asia, extending the brand beyond sore throats.

Skincare Overall sales of core skincare products grew 12.6% at comparable exchange rates, led by strong progress in revitalising Clearasil.

Clearasil sales grew 14.4%, advancing strongly in the US, UK and Australia.

Growth has been accelerating, from 4% in the first half to 26% in the second, backed by new TV advertising and extensions of the base range into body wash, cleansing wipes, overnight treatment gel and sensitive face wash. We have switched the brand from decline to growth in all major markets (except Germany and France) and expect stronger growth this year from these markets as investment increases.

In the fourth quarter this growth was supplemented in the US and UK by the launch of the Clearasil total control range, which extends Clearasil from spot control to young skincare. Targeting women aged 16-24, it provides products for the five most important needs of young skin; shine reduction, moisturisation, blemish control, sun protection and evenness of skin tone. These have received very positive trade reaction as we have built the distribution pipeline.

In dermacosmetics, total sales rose by 10%. E45 sales benefited from new product launches including the E45 Junior range. Lutsine continued to grow strongly in Italy and Spain, but in France sales were disappointing – they will improve as we benefit from the more unified global platform, further product innovation, and improved in-market execution.

Opticians & Eyecare, Dentalcare and Wellbeing Services

Sales £m	262.5
Increase %	13.6
Operating loss £m	(28.6)
Increase %	13.6

During the year we decided to close our Wellbeing Services while retaining Dentalcare and Footcare. The Opticians & Eyecare business continues to rebuild profits in its core market. The exceptional costs of closing Wellbeing Services were £34.5m.

Opticians & Eyecare The UK optical market is a mature one – highly competitive and growing at only 2-3% a year. Our strategy is to achieve modest sales growth and stable market share, while controlling costs tightly to enhance profits. After a period of moving upmarket we are returning to a broad appeal, in keeping with the overall Boots brand.

Sales for our core business grew 7% in the first half, but were weak in the second , with a year on year decline of 1% bringing growth for the full year to 3% – roughly in line with the market. Tight cost control held profits level at £9.6m.

LASIK sales grew 84% increasing our market share from 15% to 18%. We opened 4 new clinics during the year – at Bluewater, Bristol, Glasgow and Nottingham making a total of nine. The business made a trading loss largely due to higher marketing costs in a more competitive market. We are now integrating LASIK more closely with the core Opticians business to reduce costs and increase cross-referral.

Dentalcare While we have closed our Wellbeing Services we have decided to retain our Dentalcare business. Private dentistry is a £2bn market in the UK and may have the potential for Boots to develop a profitable business model. Sales rose 64% to £21.8m and we increased the number of registered patients by 75% to 175,000. The business is growing well, but we want to shorten the time it takes to bring new practices to profitability.

We have changed the model, moving into line with standard industry practice by transferring our dentists to self-employed status. This will make it easier to recruit and incentivise dentists while making the professional staff cost base more flexible. We believe this will shorten the period to breakeven.

Footcare continues to operate from 44 locations, in association with dental practices.

Insurance Services Health and travel cover is a small but profitable business. Sales and profits were in line with the previous year.

Boots Retail International

Sales £m	37.0
Decrease %	(8.2)
Loss £m	(22.3)
Increase %	7.5

We have found that there is significant demand for Boots own brand and exclusive products in some overseas markets. We will meet this demand through the use of a low cost export model with retail partners who host Boots brand implants in their stores.

Strategy BRI has 66 stores and 106 implants, almost all in South East Asia. Our strategy is now based on export sales through low cost, low risk implants selling a select range of about 800 Boots own brand and exclusive products through selected host retailers. This simplified approach enables us to focus on managing the instore offer, controlling costs and building scale.

Performance Overall sales were in line with the previous year, in a period of major change involving the closure of stores and opening of many implants. In Thailand like for like sales grew 7%. The operating loss of £22.3m includes £5.5m for exiting the loss making European operations and restructuring our business in Asia.

South East Asia A year ago we announced agreement with Watsons, South East Asia's leading drugstore chain, to open implants in Taiwan. We now have 54 implants in Watsons stores. We are now simplifying our Taiwan operation, growing to around 100 implants, closing our Boots stores and shipping direct to Watsons.

In October we launched a similar arrangement with Watsons in Hong Kong, where we now have eight implants and performance to date is encouraging.

In Thailand, we have had a very successful year in turning the business around. Strong like for like sales growth of 7%, margin growth and cost reduction have significantly improved the results of the business.

Supply and support services

The simplification of the organisation has enabled us to integrate our supply chain, logistics, procurement, IT, manufacturing, properties, engineering and facilities management activities and our retail buying operation in Hong Kong into a single support organisation serving all our retail operations and BHI.

The year's principal achievements were the dramatic improvement in on-shelf availability – without which our sales growth would not have been possible – and the outsourcing of IT, which will save £100m over 10 years.

Supply chain Now that on-shelf availability is running at acceptable levels, we can begin to reduce the large distribution inventories that we currently hold around the country.

In June we opened a new automated single-picking warehouse on our Nottingham site to support our dispensing operations. This now provides top-up deliveries to all our pharmacies every morning. It is the biggest system of its kind in Europe and has enabled us to close our Aldershot warehouse and downsize Heywood, reducing total headcount by 700.

This year we have launched a supply chain transformation programme involving long term structural change, including rationalisation of manufacturing. The aim is to deliver best in class on-shelf availability in parallel with reductions in cost and working capital.

We are working towards a supply chain that will replenish stores' stocks of most lines every day – delivering straight to the shelf. We will only hold inventory in store stockrooms for the few lines such as nappies and seasonal items that need replenishing more than once a day. This will deliver significant savings in store staff time, and reduce inventory. Trials of the new replenishment system begin this year.

Currently there are multiple locations holding balanced stocks around the country. Vehicle capacity utilisation is low because of inherent inefficiencies in the system. We are moving towards category-specific warehouses supplying regional distribution centres which will crossfeed into delivery vehicles for stores. Transport will be better integrated, greatly improving vehicle utilisation. On the upstream side, we will also move closer to just-in-time delivery from suppliers. All these changes will use proven technology and should result in better customer service at much lower cost.

We will also outsource all our transport services and the management of a major Nottingham warehouse.

Manufacturing We have completed a review aimed at simplifying and rationalising production capacity, and in February 2003 we announced proposals to close our Airdrie manufacturing facility over the next two years. Savings from the closure will amount to £16m a year. About 1,000 people work at the site and we have declared our determination to minimise the social impact of any closure. Closure of Airdrie will allow us to realign production resources in favour of short-cycle manufacturing. Until now, big-batch production has meant that some lines are made infrequently – resulting in large inventories, exposure to forecasting errors and slow response to changing fashions. The investment cost of switching to short-cycle manufacturing will be relatively low because we will be able to adapt existing equipment, including some transferred from Airdrie.

Purchasing During the year we reduced purchasing costs by £30m, mainly in buying goods not for resale. We are continuing to make effective use of global internet auctions, saving money on purchases ranging from TV advertising to plastic bags.

IT In 2001/02 we reorganised our IT function, bringing 14 groups into one and establishing an integrated business process and information systems blueprint for the future. In the past year we have made real progress in the development and implementation of that blueprint, Project Backbone, and announced investment of £79m in the coming year.

To support our new IT strategy we have outsourced our IT operations under contracts worth a total of £800m, transferring over 600 staff to IBM and Xansa. The result will be annual savings of £8m immediately, and a total of £100m over the ten-year contract period.

These savings will help to offset investment in new systems and processes that support the organisational change going on across the business. By the end of this year we will have made substantial progress in implementing new finance, human resource, space and range planning systems, and will be about to begin deploying a new merchandising and supply chain system.

We have installed 2,290 new touch-screen tills in 218 stores as part of the store reinvigoration programme. This year we will add a further 3,000 new tills in 109 large stores in time for the Christmas season.

We continue to develop the Advantage Card's capabilities, upgrading the instore kiosk system to generate more personalised offers based on individual customers' spending patterns. Very few retailers anywhere are able to use their loyalty cards in this way, and we are continuing to add enhancements.

Property Our property team has greatly simplified its processes, to improve the efficiency of its acquisition, construction and maintenance operations. It is now clearly focused on servicing the Boots The Chemists and the disposal of its investment and development portfolios is almost complete. Last year we realised £61m from disposals, £23m from investment properties and £38m from Halfords sites. The only sites remaining to be sold are the shopping centres at Hastings and Kendal. The plan is to dispose of these in the current financial year.