FINANCE DIRECTOR'S REPORT

Nick Wharton

FINANCIAL RESULTS

Group sales for the 52 weeks ended 30 March 2007 were £744.0m (2006: £681.7m), an increase of 9.1% on the comparable period last year and representing a like-for-like sales increase of 6.0%. The absence of an Easter in the 52 weeks ended 31 March 2006 has meant that the underlying like-for-like sales performance was 5.3%.

Gross profit at £376.1m (2006: £346.7m) is 50.6% as a percentage of net sales and compares to last year's figure of 50.9%. The 30 basis points ("bps") dilution in gross profit per cent represents a significant improvement on the 260 bps dilution reported at the preliminary results last year. With reported margin dilution in the first half of the year at 40 bps there was a second half improvement, which saw year-on-year dilution of 20 bps. This improvement reflects active margin management; the flow-through of Far East sourcing benefits and continued sales growth in higher margin categories.

Operating expenses as a percentage of revenue are 20 bps higher than last year at 38.0% (2006: 37.8%). Continued improvements in store labour productivity and a slowdown in rental inflation has been offset by the increase in administrative expenses driven by the costs associated with the three store Czech Republic pilot, increased costs of long and short-term incentives and legal costs associated with the Group's capital restructure.

Net finance costs for the year excluding exceptional interest were £10.0m (2006: £12.1m). Exceptional finance costs totalling £2.6m were incurred as part of the debt re-financing exercise. The write-off of previously capitalised loan fees arising from the repayment of the Group's term debt totalled £1.5m and the cost of closing out of an interest rate swap was £1.1m.

Profit before tax was £80.9m compared with £77.0m in the prior year, an increase of 5.1%, which rises to a year-on-year increase of 8.4% when excluding the exceptional finance costs noted above.

LANDLORD CONTRIBUTIONS

Halfords actively manages its store portfolio to maximise value creation through generating cash, making profits and increasing the ongoing contribution from each store. Halfords' high quality portfolio, with 60% of its superstores on retail parks with A1 planning consents, together with its destination status provides further potential from these activities and the Group anticipates a similar level of contributions in the current financial year. Landlord contributions during the year totalled £4.5m, compared to £6.9m last year.

OPERATING LEASES

All of the Group's stores are occupied under operating leases, the majority of which are on standard lease terms, typically with a 15-year term at inception. The Group has a total commitment under non-cancellable operating leases of £810m (2006: £795m).

TAXATION

The taxation charge on profit for the financial year was £23.5m (2006: £23.4m) resulting in a full year effective tax rate of 29.0% (2006: 30.4%). This tax rate has been driven by the treatment of intercompany Loan Notes raised at the time of the Group's refinancing. It should be noted that although there is expected to be a similar effective tax rate in 2007/08, the underlying tax rate is 31.6%, which reflects the non-deductibility of depreciation charged on capital expenditure in respect of mezzanine floors and other store infrastructure.

EARNINGS PER SHARE

Basic earnings per share (EPS) were 25.8 pence (2006: 23.6 pence). An alternative EPS measure, excluding exceptional items, reflects the Group's underlying performance. Consequently, basic EPS, excluding exceptional finance costs, were 26.6 pence (2006: 23.6 pence), a year-on-year increase of 12.7%. This level of EPS growth reflects the increase in earnings driven by a strong trading performance, a lower tax rate and the share buy-back programme.

CAPITAL EXPENDITURE

Capital investment in the period totalled £23.9m (2006: £27.5m), with a major focus on adding new selling space though expanding the store portfolio. The Group opened 25 new stores, of which seven were relocations, growing the portfolio from 408 to 426 stores. This financial commitment underpins our strategy of expanding the Superstore portfolio and rolling out new formats, including the introduction of two stand-alone Bikehut stores in Brighton and Putney. As noted in last year's report the Group continues to invest in the development of its infrastructure and particularly new store systems. After a trial period these systems are being rolled out nationally, successfully concluding the Group's five year programme to replace all of the core retail, operational and financial systems.

CASH FLOW, NET DEBT, AND CAPITAL STRUCTURE

Having undertaken a comprehensive review of the Group's capital structure, the Board took the decision to undertake a debt re-financing exercise, which was completed on 14 July 2006. The debt facility now comprises a £180m five-year term non-amortising loan, with a £120m revolving credit facility.

Total net debt at 30 March 2007 was £180.0m (2006: £173.7m) and includes £12.4m (2006: £12.5m) in respect of the head office finance lease.

The Group continues to generate strong net cash flows from operations, which were £112.6m to 30 March 2007 (2006: £100.9m) and included a working capital outflow of £4.5m (2006: £11.5m). Stock levels remain well managed at £141.6m (2006: £127.2m), an increase of 11.3%. This increase reflects stock investment in new stores, together with the seasonal stock build ahead of Easter, which fell in the second week of the new financial year.

DIVIDEND AND SHARE BUY-BACK

The Board is recommending a final dividend of 9.50 pence per share (2006: 8.75 pence per share), which, in addition to the interim dividend of 4.35 pence per share, generates a total dividend of 13.85 pence (2006: 12.75 pence).

Subject to shareholder approval at the Annual General Meeting, the final dividend will be paid on 1 August 2007 to shareholders on the register at the close of business on 29 June 2007.

At the preliminary results presentation on 8 June 2006, Halfords announced a share buy-back programme to purchase, for cancellation, up to £50m of share capital over a two year period. The strongly cash generative nature of the business allows the Group to maintain its investment in new stores and other strategic opportunities, while improving capital efficiency and total shareholder returns via this share buy-back. In the period from 8 June 2006 to 30 March 2007, Halfords purchased 9.0m of its own shares for an aggregate consideration of £30.0m, at an average of 333.2 pence per share.

PRINCIPAL RISKS AND UNCERTAINTIES

The Board considers risk assessment, identification of mitigating actions and internal control to be fundamental to achieving Halfords' strategic corporate objectives. The Corporate Governance report on pages 26 to 29 describes the systems and processes through which the directors manage and mitigate risks. The Board considers that the principal commercial and financial risks to achieving its objects are those identified below. The Board recognises that the nature and scope of risks can change and so regularly reviews the risks faced by the Group as well as the systems and processes to mitigate them.

(A) COMMERCIAL

ECONOMIC AND MARKET CONDITIONS

The economy is a major influence on consumer spending. Trends in employment, inflation, taxation, consumer debt levels and interest rates impact consumer expenditure in discretionary areas. Whilst many of the products that Halfords sell are non-discretionary in their nature and predicting future trends is difficult, Halfords reflects the latest independently sourced estimates in its internal plans.

Furthermore, international expansion not only provides opportunities for sustainable growth and returns but also economic diversification.

COMPETITION

The retail industry is highly competitive. The Group competes with a wide variety of retailers of varying sizes and faces competition from UK retailers, as well as international operators. Failure to compete with competitors on areas including price, product range, quality and service could have an adverse effect on the Group's financial results.

We aim to have a broad appeal in price, range and store format in a way that allows us to compete in different markets and to use service as a point of differentiation in each market segment. We have an established training infrastructure to ensure that our colleagues receive ongoing product and service training. We track performance against a broad range of measures that customers tell us are critical to their shopping experience and monitor customer perceptions of ourselves to ensure we can respond quickly if required.

DEPENDENCE ON KEY MANAGEMENT PERSONNEL

The success of Halfords' business depends upon its senior management closely supervising all aspects of its business, in particular the operation of its stores and the design, procurement and allocation of its merchandise. Retention of senior management is especially important in Halfords' business due to the limited availability of experienced and talented retail executives.

If Halfords were to lose the services of members of its senior management such as Ian McLeod, its Chief Executive Officer, Nick Wharton, its Finance Director, or Paul McClenaghan, its Trading Director, and were unable to employ a suitable replacement in a timely manner, its business could be adversely affected.

Our Remuneration Policy outlined on page 30 details the strategies in place to ensure that high calibre executives are attracted and retained. The Group also operates a "Talent Management" process to help individuals achieve their full potential within Halfords and to ensure that appropriate succession plans are in place to meet the future needs of the business.

REPUTATIONAL RISK

The Halfords name is a key asset of the business and as the largest retailer in its markets, expectations of the Group are high. Failure to protect the Group's reputation and brand could lead to a loss of trust and confidence. This could result in a decline in the customer base and affect the ability to recruit and retain good people.

The Group has a Quality Assurance team and legal and regulatory control processes both in-house and externally to advise and take action on existing and emerging risk management issues. We continually monitor loyalty to the Halfords brand through independent surveys and seek through activities such as Charity of the Year, to contribute to society more widely. Our various Codes of Practice regulate our behaviour in our dealings with all stakeholders including customers, suppliers and colleagues.

FINANCE DIRECTOR'S REPORT
continued

RESPONSIVENESS TO CHANGING CONSUMER PREFERENCES
Some of the products that Halfords sells, particularly in the car enhancement category, are subject to rapidly changing consumer preferences. Halfords has recruited experienced, knowledgeable colleagues who can identify and interpret trends and consequently respond in a timely manner to changes in consumer preferences. Some of the products Halfords sells, such as children's cycles, face competition from alternative products (such as games consoles) and our colleagues monitor developments in these areas.

INFORMATION TECHNOLOGY (IT) SYSTEMS AND INFRASTRUCTURE
Halfords is reliant on efficient IT systems throughout its business operations. Recognising the key role that IT plays in improving operating effectiveness and improving the customer experience in our stores, we continue to invest in upgrading our IT infrastructure. Any significant failure within our network during any systems change would potentially compromise our operational capability for a period of time.

Extensive controls are in place to maintain the integrity of our systems infrastructure and to ensure that any systems changes are implemented in a managed and controlled manner. Halford's core commercial and retail systems are sourced from leading global providers and continuity plans are in place for all core systems.

RELIANCE ON FOREIGN MANUFACTURERS
Halfords sources a significant proportion of the merchandise it sells in its stores from outside of the UK. Consequently, the Group is subject to the risks associated with international trade (particularly those which are common in the import of goods from developing countries), including, but not limited to the imposition of taxes or other charges on imports and exposure to different legal standards and the burden of complying with a variety of foreign laws and changing foreign government policies.

Extensive research is conducted before the Group procures product from any new country or supplier. The Group's strong management team in the Far East has been recruited from local nationals who understand the local culture, market regulations and risks.

(B) FINANCIAL TREASURY POLICY
The Group's Treasury Policy is structured to ensure that adequate financial resources are available for the development of its business whilst managing its currency, interest rate and counterparty credit risks. The Group's Treasury strategy, policy and controls are approved by the Board.

The main elements of Treasury activity and associated risk are outlined below:

FUNDING
The Treasury function arranges sufficient secure financial resources to enable the Group to meet its medium-term business objectives, whilst arranging facility maturities appropriate to its projected needs.

The Group successfully renegotiated a syndicated five-year term facility during the financial year and has committed bank facilities comprising a non-amortising five-year term loan of £180m and a revolving credit facility of £120m, which, together with cash surpluses, provide adequate funding for the Group's operations.

CURRENCY
The Group's main currency translation exposure is limited to movements in exchange rates to the extent that they affect balances held on its currency bank accounts. Foreign currency bank balances are controlled by the Treasury function and are actively managed to a level that minimises currency translation exposures. The Group's main currency exposure is its transaction exposure through movements in exchange rates on its purchases overseas that are not denominated in sterling. These are mainly imports from Asia denominated in US dollars and imports from Europe denominated in euros.

The Treasury Policy sets out a framework through which the majority of the Group's forecast foreign currency transactions are hedged.

INTEREST
The Group's bank term debt carries a variable rate of interest linked to prevailing LIBOR rates. In conjunction with the new syndicated loan facility and, in order to mitigate the risk of a rise in UK interest rates, the Group has entered into a single rate swap until 13 July 2011. As at 30 March 2007, 45% (2006: 83%) of net bank debt position carried a fixed rate of interest and the weighted average pre-tax cost of debt was 5.6% (2006: 6.2%).

The position is regularly reviewed and the Group's policy of hedging at least 40% of the following year's forecast interest rate exposure is satisfied for the period ending 30 March 2008. As at 30 March 2007, £86.0m (2006: £114.9m) of net bank debt was at a floating rate.

COUNTERPARTY CREDIT RISK
The Group actively manages its relationships with a panel of high quality financial institutions. Credit risk is controlled by the Treasury function setting counterparty credit limits by reference to published rating agency credit ratings, ensuring that such counterparties hold at least an A credit rating. The Treasury Policy recognises that an exposure to a counterparty arises in relation to investments, derivatives and financial instruments.

Nick Wharton, Finance Director
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