

FINANCE DIRECTOR'S REPORT

Financial results

Every fifth year the Group reports on a 53-week financial period. In the financial period to 3 April 2009, the 53rd week represented £14.8m of revenue, £2.1m of operating profit and £2.0m of profit before tax. Throughout the Finance Director's Report, references to 2009 relate to the 53 weeks ended 3 April 2009 and for 2008, relate to the 52 weeks ended 28 March 2008, unless otherwise stated.

Group revenue for the 53-weeks to 3 April 2009 was £809.5m. On a 52-week basis Group revenue was £794.7m (2008: £797.4m), a decrease of 0.3%, representing a like-for-like sales decrease of 3.3%, where like-for-like sales are sales from those stores that had traded for more than 365 days.

Gross profit at £421.4m (£402.5m) is 52.1% as a percentage of revenue and compares to last year's figure of 50.5%. The 160 basis points ("bps") accretion in gross profit margin reflects the continued mix effect delivered through the relative sales growth in higher margin categories, such as car maintenance and cycling, compared to the sales decline in lower margin categories, most notably In-car technology. This benefit has been further enhanced by the trading strategies delivered by management within each category, including, increased accessory sales, the flow-through of Far East sourcing benefits and improved penetration of the Group's fitting services.

Operating expenses, excluding exceptional costs, as a per cent of revenue was 140 bps higher than last year at 39.2% (2008: 37.8%). Management recognise that cost control is imperative at this stage of the economic cycle where retail sales are forecast to either decline or grow at rates lower than historic levels, which for Halfords has seen revenue, until 2008, grow at an average of 7% over a 20 year period. This becomes particularly pertinent where the two biggest cost components, store payroll, driven by the increase in the national minimum wage, and store rent and rates, with the majority of stores located on premium park locations, grew significantly above the rate of retail price inflation. Ongoing operational productivity improvements, which have seen our underlying labour costs as a percentage of sales reduce by 50 bps during 2008, together with the close scrutiny of cost throughout the Group, have ensured that underlying cost inflation, excluding the impact of new space, is less than 1%.

Management intervention has now also been undertaken to deliver a step change in the cost base and the details of the measures taken are included in the Exceptional Item section below.

Net finance costs before exceptional finance costs for the year were £9.6m (2008: £10.8m). Finance costs on bank borrowings were £1.5m lower than the prior year reflecting a lower level of average net debt and the fall in LIBOR, during the second half of the year, in response to Base Rate reductions. Similarly, falling LIBID rates have impacted finance income which has fallen to £2.3m from last year's reported £2.7m.

Profit before tax and exceptional items for the 53 weeks to 3 April 2009 was £94.4m. On a 52-week basis, profit before tax and exceptional items for the 52 weeks to 27 March 2009 was £92.4m, an increase of 2.4% on the previous year's £90.2m. Profit before tax for the 53 weeks to 3 April 2009 after exceptional items was £77.5m (2008: £90.2m).

Exceptional items

As noted above in the Business Review, during 2008, the business completed a detailed review of its operating cost base and identified and executed two key elements of an ongoing plan which will deliver benefits progressively over the next two financial years and significantly increase profitability once completed. The costs associated with these initiatives, which have been accounted for as exceptional items in the 53 weeks to 3 April 2009, total £16.9m and are represented by the following:

- (a) Headcount reductions announced in November 2008 were completed to plan, with a further tranche of store-based reductions implemented during the fourth quarter of the financial year. These changes reflect, in part, the efficiencies arising from our investment in core enterprise systems over the past four years. The cost of these staffing reductions was £2.8m, with the associated full year reduction in operating costs in excess of £4m, being delivered in the financial year to 2 April 2010.
- (b) The Group has commenced the next phase of operational improvement, to reconfigure and consolidate its distribution infrastructure. This programme will incur restructuring costs of approximately £8.3m with anticipated efficiencies from space and transport and improved labour productivity reducing annual distribution costs by approximately £4m from the financial year to 31 March 2012.
- (c) The decision to integrate the Group's premium cycle offer into its existing superstore portfolio has led to exceptional costs associated with the closure of the stand-alone cycle stores. Recognising Halfords' disciplined approach to such investments, exit costs total £1.2m, and include costs associated with exiting leases and asset impairment.
- (d) As a consequence of the current low interest rate environment and given the medium term forecasts for Base Rate, prior to the year end, the Group closed out its existing interest rate hedging instruments, which were contracted until 2011. At anticipated future interest rates, this will reduce finance charges in the current financial year by approximately £2.0m. The exceptional cost associated with the close out of these instruments was £4.6m.

Landlord contributions

The Group continues to actively manage its store portfolio to maximise value creation through generating cash, making profits and reducing the ongoing rental charge. Landlord contributions from the five transactions completed during the year totalled £2.7m (2008: £4.5m). The year-on-year decline in quantum reflects a reduction in the risk profile of landlords who are now less likely to undertake speculative development in favour of back-to-back deals, which, by their nature, introduces delay in the contract exchange process. This activity still represents a sustainable opportunity for the Group, with in excess of 200 superstores located on A1 parks where demand remains high. The Group expects a similar level of contributions in the forthcoming financial 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 £778.5m (2008: £818.6m).

Taxation

The taxation charge on profit for the financial year was £21.7m (2008: £26.2m), including a £4.6m credit in respect of the tax on exceptional costs, and results in a full year effective tax rate of 28.0% (2008: 29.0%). In this financial period the UK corporation tax standard rate was reduced by 2% to 28% and the tax rate was further reduced due to the release of prior year tax liabilities following the favourable settlement of prior years tax computations.

The underlying tax rate was 29.7% (2008: 31.7%), principally due to the non-deductibility of depreciation charged on capital expenditure in respect of mezzanine floors and other store infrastructure.

Earnings per share ("EPS")

Basic EPS, excluding exceptional items, for the 53 weeks to 3 April 2009 was 32.5 pence, a 10.9% increase on the prior year (2008: 29.3 pence). On a 52-week basis, basic EPS, excluding exceptional items, was 31.8 pence (2008: 29.3 pence), a year-on-year increase of 8.5%. Basic EPS for the 53 weeks to 3 April was 26.6 pence (2008: 29.3 pence).

Capital expenditure

Capital investment in the period totalled £19.4m (52 weeks to 28 March 2008: £29.5m). The Group remains committed to operating at an average level of capital expenditure at £25m per annum, with its peak level of expenditure in financial year 2008 reflecting the investment in completing the roll-out of new store-based systems, together with a higher level of store openings achieved in a more benign property environment. In 2008, reflecting worsening economic conditions, a prudent approach with regard to capital investment has seen a step up in management focus on investments generating the highest returns. This includes reduced investment in new stores within the UK where, as noted in the portfolio section of the Business Review, the marked decline in the supply of quality locations and expected improvement in commercial terms over time each favour a reduced capital programme at this time.

Inventories

The Group continues to manage its stock holding to ensure high levels of availability and range breadth and inventories at 3 April 2009 were £147.0m (2008: £151.6m). Over the economic cycle the Group would intend to increase stocks at approximately 50% of the rate of sales increase adjusted for the necessary inventory investment in new stores. In the current economic climate the Group will seek to reduce inventories in order to protect against obsolescence and enhance working capital. Stock levels have been carefully managed and have reduced year-on-year by 3.0%, 5.7% after inventory investment in new stores, with a consequential improvement in stock turn.

Cash flow, net debt and capital structure

The debt facility comprises a £180m five-year term non-amortising loan, falling due for repayment in July 2011, with a £120m revolving credit facility which also falls due for renewal in July 2011.

Total net bank debt at 3 April 2009 was £164.0m (28 March 2008: £169.3m) and there are further borrowings of £12.2m (2008: £12.4m) in respect of the Head Office finance lease.

The Group continues to generate strong net cash flows from operations, which were £114.2m in the 53 weeks to 3 April 2009. After adjusting for cash flows of £2.3m, in respect of exceptional items, this represents 90.2% (2008: 91.2%) of earnings before exceptional items, interest, tax, depreciation and amortisation ("EBITDA") and after a working capital outflow of £12.7m (2008: £12.1m).

Reflecting the significant cash outflows in the 53rd week of the financial year, total net bank debt at 27 March 2009, which provides a more appropriate comparison to the prior year, was £154.1m (28 March 2008: £169.3m). Excluding cash outflows related to the exceptional items outlined above, total net bank debt at 27 March 2009 was £151.8m. Net cash flow from operations for this more comparable 52-week period to 27 March 2009 totalled £121.8m (2008: £111.6m) representing 95.9% of EBITDA.

Dividend and share buy-back

Halfords remains strongly cash generative. The Company is committed to both a progressive dividend policy and continued investment in the growth of the business, both through organic development and other business development opportunities as they might arise.

The Board is recommending a final dividend of 10.90 pence per share (2008: 10.35 pence), which, in addition to the interim dividend of 5.00 pence per share (2008: 4.75 pence), generates a total dividend of 15.90 pence (2008: 15.10 pence), an increase of 5.3%.

Subject to shareholder approval at the Annual General Meeting the final dividend will be paid on 5 August 2009 to shareholders on the register at the close of business on 19 June 2009.

During the year, Halfords purchased 4.7m of its own shares at a consideration of £13.1m, an average of 276.9 pence per share. In the period from June 2006, when the share buy-back programme commenced, to 3 April 2009 the Group has purchased 23.1m shares at an average of 315.7 pence per share. The Board's intention remains to maintain an efficient capital structure. In the current economic climate, the Board has a preference for financial flexibility and lower gearing whilst pursuing high return investments. The Board has therefore decided, in the short-term, to suspend the share buy-back programme by which excess capital has been returned to shareholders.

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 41 to 46 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 objectives 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.

FINANCE DIRECTOR'S REPORT CONTINUED

(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 the 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 David Wild (Chief Executive Officer), Nick Wharton (Finance Director) or Paul McClenaghan (Commercial Director) and were unable to employ suitable replacements in a timely manner, its business could be adversely affected.

Our Remuneration Policy outlined on page 48 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 and the Corporate Social Responsibility report details the Group's attitudes toward such areas as the environment and ethical trading. Ultimately the protection of the Halfords brand and position in its core markets will be sustained by a high service based customer proposition, unique and extensive product offering and a multi-channel approach to sales.

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.

Reliance on foreign manufacturers

Halfords sources a significant proportion of the merchandise it sells in its stores from outside of the UK, either directly or via third-party suppliers. 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, inflation, currency fluctuation, 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.

Information technology (“IT”) systems and infrastructure

In common with most retail businesses, Halfords is reliant on the reliability and suitability of a number of important IT systems where any sustained performance problems, particularly with regard to store or warehouse and distribution systems, could potentially compromise our operational capability for a period of time.

Extensive controls are in place to maintain the integrity of our systems and to ensure that systems changes are implemented in a controlled manner. Halfords’ key trading systems are hosted within a secure data centre operated by a specialist company remote from our Head Office. These systems are also supported by a number of disaster recovery arrangements including a comprehensive back-up strategy and access to a further data centre elsewhere in the UK in case of a major incident.

Furthermore, the planned reconfiguration to the Group’s core distribution structure is a significant and operationally complex change activity. Having successfully replaced each of its core business systems over the past five years, the Group has significant experience in managing the risks associated with such activities.

(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 has a syndicated five-year term facility, maturing with a “bullet” repayment in July 2011, totalling £300m of committed bank facilities, comprising a non-amortising 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 transaction exposure is 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 the Eurozone denominated in euros.

The Treasury Policy sets out a framework through which the majority of the Group’s forecast foreign currency transactions are hedged. Historically the Group has operated at a forward purchase of 75% of future dollar requirements for the ensuing 15 months. This policy was extended during 2008 to 18 months and 80% of requirements when dollar exchange rates were at their most favourable and with dollar appreciation against sterling in the final quarter of 2008 the policy returned to its historic norm. The Group’s policy continues to be monitored by the Board and the Treasury Committee.

Interest

The Group’s bank term debt carries a variable rate of interest linked to prevailing LIBOR rates and at 3 April 2009 operated at a weighted average pre-tax cost of debt at 2.4% (2008: 5.9%) with the full year weighted average at 3.9% (2008: 4.3%). As a consequence of interest rate movements during the latter half of 2008, the Group amended its policy in respect of hedging and closed out its interest rate swaps. As at 3 April 2009 the Group had none (2008: 59%) of its bank debt position carrying a fixed rate of interest and consequently £164.5m (2008: £100m) of net debt was at a floating rate. It remains the Board’s policy to protect a material proportion of the Group’s borrowing from movements in interest rates and will continue to monitor prevailing and projected interest rates with a view to adopting a hedging instrument where deemed necessary and appropriate.

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 and the Corporate Default Swap market. All such counterparties, which constitute the syndicated bank group, held at least an ‘A’ credit rating at the time of the facility agreement. The Treasury Policy recognises that an exposure to a counterparty arises in relation to investments, derivatives and financial instruments.

NICK WHARTON
FINANCE DIRECTOR
10 JUNE 2009