

# Operating and financial review

## OPERATING REVIEW

### Introduction

For much of the year trading has been tough but the Group has returned to growth and has continued to invest in its businesses. The Enterprise Business System (EBS) was implemented successfully in France, South Asia and Australasia. We continued to develop our e-Commerce functionality leading to good growth and proven incremental sales. We increased investment in sales activities and marketing to drive higher sales. In the second half of the year, market conditions improved and our sales, profit and cash flow performance benefited. Sales growth rose towards the end of the year, most notably in North America and the UK, and the Group exited the year growing at about 5%.

### Group results

Group	2004	2003
Turnover	£759.3m	£743.7m
Operating profit*	£108.3m	£102.1m
Operating profit	£98.1m	£90.8m
Interest	[(£1.4m)]	[(£1.2m)]
Profit before tax*	£106.9m	£100.9m
Profit before tax	£96.7m	£89.6m
Earnings per share*	17.5p	16.5p
Earnings per share	15.1p	13.9p
Dividend per share	18.2p	17.0p

Key statistics	2004	2003
Gross margin %	53.8%	52.7%
Operating return on sales %*	14.3%	13.7%
Effective tax rate %*	29.0%	29.0%
PBT on net assets*	30.9%	26.0%

Growth %	2004	2003
Turnover	2.1%	(2.1%)
Operating profit*	6.1%	(6.1%)
Profit before tax*	5.9%	(4.4%)
Earnings per share*	6.1%	(4.6%)
Dividend per share	7.1%	6.9%

\*Before amortisation of goodwill

Group turnover increased by 2.1% (reported) to £759.3m. Before goodwill amortisation, operating profit rose 6.1% to £108.3m, profit before tax rose 5.9% to £106.9m and earnings per share increased 6.1% to 17.5p. After goodwill amortisation, earnings per share rose 8.6% to 15.1p.

Exchange rate movements had a notable impact on Group turnover and profit in the year, with the strengthening Euro overcoming the impact of the weakening US Dollar. At constant exchange rates, the sales increase would have been £9.7m less and the operating profit increase £2.3m less. After adjusting for exchange rates, trading days and the withdrawal from the specialist telecommunications supply activity in the United Kingdom in 2002/03, like-for-like sales grew by 0.9% and operating profit by 1.4%.

The performance in the second half was much stronger than in the first: like-for-like sales grew 2.2% in the second half but declined 0.4% in the first half; like-for-like the operating profit grew 11.3% in the second half versus a 9.4% decline in the first half.

The gross margin was 53.8%, up 1.1 percentage points on last year. In the first half, the increase against the first half of last year was 0.9 percentage points to 53.5% and, in the second half, the increase was 1.1 percentage points to 54.0%. The Group manages carefully all the



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elements of gross margin, including discounts and sales credits, rather than just selling prices and cost prices. We have continued to take action on some elements that increase the gross margin, but in other areas, where effective for sales growth, we have reduced margins. The gross margin increase this year was lower than in 2002/03 and, as we continue to invest in sales growth, we anticipate that overall gross margin increases will slow.

Sales and marketing costs were increased by £3.7m over last year, particularly in the UK and the US, as we continued to invest in growing the businesses.

Process costs were £77.8m or 10.2% of sales, compared to £74.6m and 10.0% respectively last year. Before the impact of projects, these costs are expected to flatten and then decline as a percentage of sales over time. The implementation of the EBS projects in Europe and Asia has resulted in increased cost and higher depreciation charges of £8.6m, an increase of £4.1m. After adjusting for these costs, activity withdrawal costs last year and higher pension contributions, Process costs declined to 9.0% of sales from 9.2%.

Reported operating margins (before amortisation of goodwill) increased to 14.3% from 13.7%, although the like-for-like increase was much smaller (from 14.2%). In overall terms, the increase in gross margin offset the selling, marketing and systems cost increases.

The interest charge of £1.4m was £0.2m higher than last year, mainly due to changes in interest rates. Consequently, profit before tax and goodwill was £106.9m, a reported increase of 5.9%, but like-for-like the increase was 1.1%. The tax rate of 29%, based on profit before tax and goodwill amortisation, was the same as last year.

In accordance with FRS10, the £214.8m (at acquisition exchange rates) of goodwill that arose on the acquisition of Allied is being written off over 20 years. Taken together with the amortisation of goodwill on another small prior year acquisition, the total goodwill amortisation in the year was £10.2m.

Profit before tax and after goodwill amortisation was £96.7m and the effective tax rate on this profit was 32.1%. After tax, the profit for the year amounted to £65.7m, up 9.0%. Earnings per share before goodwill

## Operating and financial review (continued)

amortisation increased 6.1% to 17.5p from 16.5p; after goodwill amortisation the increase was 8.6% to 15.1p.

With the recommended final dividend of 12.6p per share, dividends rose 7.1% to 18.2p.

### UK

RS UK	2004	2003
Sales (by destination)	£348.2m	£353.7m
Like-for-like sales decline	(0.8%)	(6.7%)
Sales (by origin)	£361.0m	£366.9m
Like-for-like sales decline	(0.9%)	(6.5%)
Contribution	£117.8m	£119.1m
Contribution %	32.6%	32.5%

RS UK sales in the year declined by 0.9% (like-for-like: adjusted for trading days and the prior year withdrawal of the specialised activity serving the telecommunications sector) to £361.0m. This reflected the continued erosion of customers in the manufacturing sector, only partly offset by growth in the service sectors. The rate of decline improved through the year, being 1.6% in the first half and 0.2% in the second half, and the business exited the year growing at a rate approaching 3%.

Customer numbers increased by 1.8% following the increased spend on sales and marketing during the year. It takes time to build customer loyalty so increases in customer acquisition rates will reduce the overall average order frequency for a period of time. Our challenge is to build the ordering frequency of acquired customers as quickly as possible.

We have continued to make progress in attracting customers from outside our traditional manufacturing sectors. Based on our analysis of these customers, we believe they have the same propensity to buy from our offer as customers in manufacturing, as reflected by their similar average order values. The market potential is large in all sectors.

The investment in a larger sales force (50% increase) will allow more time for customer acquisition and development in smaller territories. Around half of all territories have achieved year on year growth. As expected, growth has been highest in the areas where the sales presence has been most established.

Trade counters opened in South Wales and Aberdeen last year have performed well and the network now consists of 15 trade counters. These provide face-to-face contact with customers, immediate service and they also support differentiated services such as the successful Managed Stock Replenishment (MSR) programme. MSR involves our management of the customer's inventory requirements at the customer's site, supported by local stock in the trade counters.

e-Commerce has continued to grow strongly, rising year on year by 38%. e-Commerce now accounts for around 20% of sales, up from 15% at the end of last year. An indication of the Group's great success in this area was the e-Business Strategy of the Year Award for 2003 at the prestigious National Business Awards. This complemented other awards for our multichannel approach and catalogue activities.

The review of the structure of the offer of 130,000 products has continued and has already demonstrated that more focused product ranges can increase overall sales by making it easier for customers to make their choice.

Exports from the UK to third party distributors and direct to overseas customers were slightly lower than last year, depressed by the war in Iraq and the strength of Sterling against the US Dollar.

Despite lower overall sales, the UK contribution margin improved slightly to 32.6%, notwithstanding the increased investments in sales and marketing. Not only is our RS UK business highly profitable, it also remains highly cash generative and is now back in growth.

### Rest of Europe

RS Rest of Europe	2004	2003
Sales	£241.1m	£224.3m
Adjusted sales growth	(1.4%)	1.5%
Contribution	£51.0m	£44.1m
Contribution %	21.2%	19.7%

Rest of Europe sales declined by 1.4% (adjusted for trading days and at constant exchange rates) to £241.1m but the reported growth in Sterling was 7.5%, reflecting the stronger Euro. Trading conditions that were not easy throughout the year were made more difficult by disruptive third party strikes and the hot summer, with prolonged business shutdowns in the first half. The rate of decline slowed in the second half and by the end of the year the region was in growth. The region had flat customer numbers year on year and the number of products offered to the market was similar to last year.

e-Commerce sales continued to rise quickly in every market. Overall, e-Commerce sales were 15% of the total (up from 10% last year). In March, e-Commerce accounted for nearly 18% of sales (up from 12% last year).

The Enterprise Business System was implemented in France in June 2003. The implementation was successful though some teething problems had an impact on customer service, which constrained sales during the second half, and led to some additional costs. Normal service levels have now been restored and these are expected to further improve in the future. Lessons have been learned from this first implementation and will be deployed in future rollouts across Europe. Our next rollout will be in Germany later in 2004/05.

Sales by Radiospares in France showed a slight decline, partly due to the disruption associated with the systems implementation. Following the experience gained in Italy, France reduced its catalogue to one issue per year but increased its circulation and also issued more 'specialogues.'

In Germany, the new warehouse at Bad Hersfeld was operational for the full year and is working well. Sales grew throughout the year at a rate that increased as the year progressed. The business has strengthened its sales force and broadened its customer base to support further growth.

In Italy, there was a sales decline in the first half reflecting the difficult economic conditions and the very hot summer. We continued to develop our customer base in more attractive sectors and sales exited the year in growth.

The smaller businesses had varying results. Spain continued its strong growth, Ireland and Benelux increased their growth rates while Austria continued to grow. Scandinavia suffered a slight decline.

The contribution margin increased to 21.2% from 19.7%. In 2002/03, the contribution was after the £1.5m cost of the move to the new

warehouse in Germany, whilst in 2003/04 there has been the disruption of the EBS implementation in France with a similar profit impact.

We remain confident of the growth potential of this region and that it will continue to be an important component of the successful execution of the Group's strategy.

#### North America

Allied North America	2004	2003
Sales	£102.8m	£103.4m
Adjusted sales growth	9.7%	(0.4%)
Contribution	£13.3m	£14.4m
Contribution %	12.9%	13.9%

Having experienced a lengthy and deep electronics recession, Allied is now starting to benefit from the continuing investments made in its sales, marketing and customer service activities. Sales in Allied grew by 9.7% (adjusted to constant exchange rates) although the weakness of the US Dollar resulted in a reported decline in Sterling of 0.6%. Allied grew by 4.2% in the first half before accelerating to 15.2% in the second half of the year, with an exit rate of around 20%.

e-Commerce in Allied is under review and we believe that there are significant opportunities for improvement.

Allied has an extensive national branch network of about 60 offices. Allied has rolled out its 'Customer First' programme during the year to increase sales effectiveness and this has had a positive impact. The initiative included: targets for customer numbers and gross margins; local sales initiatives; training; and an improved structure of commissions. It was also supported by increased marketing programmes to build more awareness of the Allied offer.

In the October 2003 edition, the catalogue format and content were improved to make the catalogue more user-friendly and customers responded well. The catalogue production system was also improved to make the content management process more effective. The combination of the new catalogue and the sales activities helped drive the second half sales growth.

Allied has worked increasingly closely with both existing suppliers and new ones to broaden its product offer in certain areas and to provide deeper ranges in others. The recent buoyancy of demand is leading to some lengthening of lead times but Allied's strong supplier relationships should stand it in good stead.

The contribution margin fell to 12.9% from 13.9% last year. In the first half, the contribution margin was 11.3% but this improved with the stronger sales in the second half of the year to 14.5%. The gross margin fell by about two percentage points, mainly in the first half, due to the growth of 'not in catalogue' sales, the introduction of higher ticket price products at lower gross margins and the greater emphasis on price negotiation in the order taking process. The gross margin stabilised in the second half at about 38% and is expected to improve as the experience from Europe in improving gross margin is applied.

#### Japan

RS Japan	2004	2003
Sales	£14.4m	£11.3m
Adjusted sales growth	28.4%	31.6%
Contribution	£0.0m	(£3.3m)

Sales grew by 28.4% (adjusted for trading days and at constant exchange rates) to £14.4m with a second half growth rate of 27.4%. The Japanese market environment was weak for much of the year, but targeted actions in marketing and e-Commerce generated the good growth. Customer numbers grew by 13%.

e-Commerce is becoming the most important way to market in Japan. Sales through e-Commerce are now 43% of total sales, up from 35% at the end of last year and grew by 59% over last year.

The business broke even for the year at the contribution level, in line with the original plan, following its first monthly break even in September 2003. A successful and profitable business has been established: we are confident that RS Japan will grow to be a major contributor to the Group.

#### Rest of World

RS Rest of World	2004	2003
Sales	£40.0m	£37.8m
Adjusted sales growth	2.8%	5.7%
Contribution	£4.0m	£2.4m
Contribution %	10.0%	6.3%

Sales in Rest of World grew by 2.8% (adjusted for trading days and at constant exchange rates). There were many negative external pressures, including the SARS epidemic in Asia, that made for a difficult trading environment during the year. China was the exception, with very high economic and manufacturing output growth rates.

Sales in China, including Hong Kong, grew by 9.4% (adjusted). During the year, the Same Day Offer (SDO) project was developed in the Shanghai area. The key customer benefit is that we can now despatch the product on the day the customer makes the order. This allows delivery the next day or soon after. This has required considerable preparation and the co-operation of customs and VAT officials and bankers. The SDO procedures were tested thoroughly from August 2003 and demonstrated good customer reaction and high sales growth. The full launch in the Shanghai area took place in April 2004 and rollout to other regions in China is being considered for later in 2004/05. The SDO project has been supported by additional marketing expenditure and stock. Enhanced e-Commerce capability was also successfully introduced into China.

During the year, however, sales in China have been constrained by the continued tightness of import regulations, particularly product safety compliance restrictions (Compulsory Product Certification System) and the more rigorous application of the Metrology Law (in which products that measure have to be calibrated in China). We work continually with our suppliers to meet these regulations and will not sell products that do not conform, but this compliance takes time. Our operations in China broke even in the year, though the further development of the SDO project may require some additional investment.

## Operating and financial review (continued)

Elsewhere in Asia, sales in the Philippines and Malaysia both grew though our sales in Singapore declined reflecting the difficult local conditions. Sales in Australasia continued to grow well and profitability continued to be good.

The Enterprise Business System was implemented in Singapore, the Philippines, Malaysia and Australasia during the year. As expected, there were some minor initial problems but these have now been overcome.

Sales in South Africa declined, partly due to the impact of foreign exchange fluctuations.

### e-Commerce

e-Commerce sales were about 15% of total Group sales for the year (up from 11% last year) and exited the year at around 17% (13% at the end of last year). Sales were £114.8m, a growth of 43%. Our leadership is reflected by this growth and in the various industry awards won during the year.

The continuation of the strong sales growth and the demonstrated incremental sales means that the additional gross profit from e-Commerce more than covered the ongoing development and marketing costs. Development costs of about £5m were similar to 2002/03.

The advanced e-Commerce capabilities developed in Europe were rolled out successfully across Asia during the year where they produced a step change in e-Commerce sales. The website was also introduced to our third party distributors so that we now serve a total of 66 countries.

The website continued to be the primary way that our customers access our e-Commerce capability. We have improved the search functionality within the website so increasing the 'browse-to-order' conversion rates.

The PurchasingManager™ application was developed further by adding more functionality and is now used by 800 customer accounts in ten countries. PurchasingManager™ is a powerful tool in acquiring new customers in new accounts and increasing penetration of existing accounts. The combination of online control and lower transaction costs is a major customer benefit.

Our e-Procurement 'punch-out' capability was also in strong demand in certain markets.

The website, PurchasingManager™ and e-Procurement services are the powerful combination that generates our leadership in e-Commerce. Our focus is on driving the sales opportunities arising from this leadership.

### GROUPWIDE PROCESSES

	2004	2003
Total cost	£77.8m	£74.6m
Cost as a % of sales	10.2%	10.0%

The Groupwide Processes support our global network of operating companies. They ensure that the Group has the infrastructure and expertise to provide the consistently good service demanded by our customers.

The total cost of Processes in the year was £77.8m, up 4.3% from last year. After adjusting for EBS costs, the costs of withdrawing from an activity last year and pension charge increases, Process costs declined to 9.0% of sales from 9.2% last year.

### Information Systems

The combination of numerous customers and small average order values creates a very large number of transactions that must be managed accurately and quickly. This is achieved through very reliable information systems. Information Systems, including the costs of the EBS projects, accounted for just under half of total Process costs.

The EBS projects are now well into the implementation phase. These projects are wide ranging and involve our enterprise, customer contact, sales force, product information, stock management, warehouse operation and e-Commerce activities. The projects drive a higher level of standardisation and effectiveness in our operational procedures and this requires significant change management. EBS was implemented in South Asia in March 2003 followed by France in June 2003 and Australasia in October 2003. Future rollouts are currently planned for Germany in late 2004/05 and the UK in 2005/06. The system will subsequently be rolled out to the other European countries and China.

Around £51m has been spent on the projects to date, over 80% of the estimated total capital expenditure. The total spend has increased since last year based on our experiences to date.

In 2003/04, the revenue cost, including depreciation charge, of the EBS projects was £8.6m, up £4.1m from 2002/03. Our current view is that the depreciation charge will peak at about £9m per year by 2006/07, which is approximately £5m higher than in 2003/04.

EBS will provide wide-ranging benefits. The most immediate will be the removal of the maintenance costs of the legacy systems. Secondly, the availability of regional information on detailed product demand will allow more effective management of stock levels, improvement in stock turn and more robust customer service. The new capabilities will support extra services to customers and drive significant internal operating efficiencies. We remain confident that the cost of the investment will be more than covered by the benefits.

### Supply Chain

The role of Supply Chain is to ensure that whenever orders are placed by customers the required products can be shipped the same day. The priority is high customer service, but efficient management of stock and product movement costs are also important. High levels of customer service were maintained during the year, although there was some disruption following the EBS implementations.

The stock turn improvement to 2.7x from 2.6x was achieved through a number of initiatives. In the UK, there was a major upgrade of our forecasting and stock replenishment systems, whilst new systems were also implemented in Japan and (as part of EBS) South Asia and Australasia. We continue to work closely with our suppliers to improve their ability to deliver to us on time and in the form that we require. Stock investments have been made to support projects, most notably in Shanghai where over £1m of additional stock was put in place to support the launch of the SDO.

The rollouts of EBS to Germany and the UK will be supported by additional stock over the period of the rollout to ensure that we maintain customer service. Our current view is that around £20m of additional stock will be built up in 2004/05 and will be maintained for part of 2005/06.

### Product Management

The total number of products on sale through RS and Allied worldwide is approximately 300,000. Product Management has to ensure that the product selection for each market matches customer requirements. Range effectiveness is a continued focus, to ensure that the product offer in each category is credible and comprehensive.

Supplier relationships are increasingly important and many more joint activities have been developed. Our suppliers recognise that we can be an important part of their sales and marketing efforts. In the light of new regulations suppliers are becoming more aware of the damage that can be done to their brands unless they maintain tight controls. We continue to invest considerable time and resources in making sure we understand all of the evolving compliance requirements in the markets we serve, so that we can support our customers and suppliers. In Europe, the Restriction of Hazardous Substances Directive, which will take effect in July 2006, is already starting to have an impact on the demand for electronic components. Similar regulations apply in other markets.

### Media Publishing

The Media Publishing Process manages and delivers all the major media for the Group: catalogues, 'specialogues', CD-ROMs and websites.

An area of significant change has been the catalogue frequency. Following customer research, Italy moved to an annual catalogue in 2002/03, accompanied by increased investment in direct marketing activity such as 'specialogues' and France followed suit in 2003/04.

We continue to invest heavily to develop more effective customer media. During the year, the catalogue was extensively redesigned to ensure the indices and the layout facilitate more easy location of products. The CD in the UK has been upgraded and now mirrors the layout on the website. This new form CD will be rolled out to other markets. A large exercise was undertaken to develop the quality and quantity of our product data and information, which will support future media developments.

An increasingly efficient desktop publishing team now enables the internal production of highly effective market communications, ranging from 'fliers' to 'specialogues'. Most critically, 'time to market' has been dramatically reduced and, by sharing across more than one market where appropriate, the unit costs are also reducing.

### Group Facilities

The warehouses in Germany, Italy, Japan and Spain that were developed during the last two years are all operating efficiently. The Group is now in a position where there is sufficient static and dynamic capacity to last for a number of years and no substantial investments are foreseen. Upgrading has continued to take place, for example, there has been investment in our UK sites to enhance the security and workflow procedures.

### FINANCIAL REVIEW

Turnover and profit have been reviewed in the section on Group results, above.

Cash flow and balance sheet	2004	2003
Decrease in stocks	£1.0m	£2.7m
Increase in debtors	(£8.4m)	(£0.2m)
Increase in creditors	£10.9m	£9.9m
Working capital	£3.5m	£12.4m
Operating cash flow	£134.8m	£133.6m
Capital expenditure	(£22.8m)	(£31.3m)
Free cash flow	£83.0m	£68.2m
Net debt	(£34.5m)	(£46.9m)

Key statistics	2004	2003
Stock turn	2.7	2.6
Trade debtor days	52.8	49.4
Trade creditor days	43.9	38.7

Operating cash flow was £134.8m, up from £133.6m last year. Cash conversion remained high as operating cash flow was 124.5% of operating profit, before amortisation of goodwill (2002/03: 130.9%).

Working capital inflows amounted to £3.5m compared to £12.4m last year. The higher sales were largely supported by maintained stock levels, hence the increase in stock turn to 2.7x from 2.6x last year. Debtors increased by £8.4m and trade debtor days were 52.8, largely due to the acceleration of sales at the end of the year. The cash inflow from creditors was £10.9m and trade creditor days were 43.9, as a result of increased stock purchases required to support the higher demand at the end of the year. In 2004/05, there will be a build up of about £20m of additional stock to support the systems implementations and this will be retained for part of 2005/06.

Free cash flow increased by 21.7% to £83.0m mainly reflecting the lower capital expenditure.

Capital expenditure was £22.8m, significantly down from £31.3m last year and £47.2m the year before. Of this, £9.9m was on EBS projects, down from £12.5m last year. The Group has now passed the capital expenditure peaks of the new warehouses and the systems investments. Capital expenditure is expected to remain low in total for the foreseeable future. Capital expenditure as a multiple of depreciation has declined to 1.0x from 1.6x last year and 2.4x the year before. During the year, a building was sold for its book value of £3.1m.

Interest and tax payments amounted to £32.6m. The tax payments were about £2m lower than expected due to tax payment deferrals late in the year which will reverse in 2004/05. The outflow on dividends was £75.4m, up from £70.6m last year. Exchange rate movements benefited net debt by £4.7m to give an overall decrease in net debt of £12.4m to £34.5m.

Gearing improved to 10.0% from 12.1% last year but interest cover (before amortisation of goodwill) declined to 77x from 85x due to the higher interest charge.

The weakening of the US Dollar during the year had a significant exchange rate impact on the balance sheet, particularly on goodwill. The overall translation impact on net assets was to reduce net assets by £29.2m (reduction of £10.8m in 2002/03).

## Operating and financial review (continued)

### Financial returns

Profit before tax and goodwill on net assets was 30.9%, up from 26.0% last year and the highest for five years. These returns remain substantially higher than the Group's cost of capital.

### Pensions

The Group has defined benefit schemes in the UK (closed to new entrants in April 2003), Ireland (closed to new entrants) and Germany. Elsewhere, schemes are defined contribution.

SSAP 24 remains the accounting standard applied to pensions as described in Note 6 to the Accounts. The last triennial valuation of the UK defined benefit scheme was carried out as at 31 March 2001 and showed a surplus of £22.1m. The triennial valuation as at 31 March 2004 is under way. However, approximate funding updates are carried out each year. As at 31 March 2003, there was a deficit of £64.1m, though this is likely to have reduced since that date. The statutory minimum funding position of the scheme remains good with a Minimum Funding Ratio estimated at between 125% and 130% as at 31 March 2004 (2003: 120% to 125%). The cost of the UK defined benefit scheme in the year was £5.7m, up from £3.9m last year, reflecting an additional cost of £1.8m following a decision not to reflect the March 2001 surplus in the pension charge during the year. From 2004/05, we anticipate a further additional charge of ca £3m to recover the expected deficit over an appropriate period. The charge for all of the defined benefit schemes during the year was £6.1m (2003: £4.3m).

Note 6 also indicates the impact of Financial Reporting Standard 17 'Retirement Benefits' on the Group. FRS 17 was due to replace SSAP 24 in 2005 but we have not implemented it as we anticipate moving to IAS 19 in 2005/06. Under the FRS 17 rules, the defined benefit schemes showed a combined deficit of £34.6m (net of deferred tax) compared to a deficit of £30.1m at the end of last year. Under FRS 17, the charge to profits arising from these schemes would have been £10.4m (2003: £5.4m).

### Business risks

In looking forward, the most significant potential business risk is that the RS 'business model' of high service, low volume distribution has diminishing relevance to our customers so that they are less willing to pay the price levels implied by providing such service. We monitor this risk through the actual results of our business, in particular the development of the customer base, and through market research. These indicate that our model is robust and has relevance in all our markets.

The sales decline in the UK and Europe in recent years could suggest a risk that the market potential available to us in the UK and elsewhere might be smaller than anticipated, partly due to our exposure to the manufacturing sector. Our customers have been disproportionately in manufacturing and in particular some of our most frequently buying customers have been in sectors such as telecommunications and electronics. These sectors have been hardest hit by the restructuring of industry in the UK and Europe in recent years. Although the pressures on manufacturing will continue to some degree our focus on broadening our customer base in the service and

public sectors should mitigate the risk but could take longer than anticipated. Our return to growth in the UK and Europe as 2003/04 progressed is an encouraging sign of success. We have also recently developed an advertising and marketing programme initially in the UK to make prospective customers more aware of RS and to reinforce the value we provide to existing customers. Also, over the longer term our businesses in China and other low cost economies will benefit from the migration of manufacturing.

Our price levels are scrutinised for 'competitiveness' and we make adjustments to our catalogue prices to ensure that our offer is priced attractively to customers for the products and services that are provided.

The large projects we have underway inevitably carry implementation risks. The quality of the project teams and of the business' commitment and engagement in the projects are the main risk mitigating factors. The largest and most risky of the projects is the systems project in Europe. The first implementation in France has shown that the operational change requirements can incur disruption to customer service. The lessons and implications are being applied to future rollouts with the intent of there being no impairment of customer service during the future implementations. To this end the training of all employees engaged in the change process has been intensified and other support, such as more project team support and substantially increased stock levels, are in hand.

The Board has had a vigorous risk review process for some years, including a specific annual meeting to consider the major risks and management's mitigating actions. Risk management techniques are widely employed across the Group, especially in projects. Business continuity, disaster recover and other preventative practices are well developed and appropriately tested. Appropriate insurance is also carried.

Financial risks are considered in the Treasury section below.

### Capital structure and treasury policy

Treasury operates as a centralised service centre. Its ethos remained the managed reduction of the Group's financial risks. The Treasury Committee continued to oversee any policy or procedural changes.

Treasury manages the Group's foreign currency transaction risks. These typically arise because the Group's purchases in currencies other than Sterling are much less than its receivables from catalogues with fixed prices in those currencies. Substantial hedging of net currency exposures over the catalogue lives was once again implemented in order to 'shelter' forecast gross profits through the catalogue lives. In this way the impact of currency fluctuations are smoothed until selling or cost prices can be changed in light of the changed exchange rates. The hedges are enacted through forward currency contracts entered into by Group Treasury on the basis of trading projections provided by local businesses. Note 24 to the Accounts gives a summary of the Group's hedging positions at the year end.

During the year, the Euro on average was stronger and the US Dollar weaker. Over time this will tend to increase our gross margins because a large part of our product supply is directly or indirectly sourced in US Dollars whilst a large part of our currency receipts are from sales in Sterling or Euros.

Specific cash flows relating to material transactions in currencies other than the functional currency of the local business are hedged when the commitment is made.

Foreign currency translation exposures are not explicitly hedged, but local currency debt is used where economic and fiscally efficient in the financing of subsidiaries and this provides a partial hedge. This was particularly so of the US Dollar over the year as a large part of the debt of the Group is in US Dollars arising from the acquisition of Allied and the exchange rate movements relating to this debt offset the impact on underlying assets. Treasury guidelines are in place for reviewing the impact of translation exposures should there be any material changes. Note 24 to the Accounts summarises the financial assets and liabilities by major currencies at the year end.

Multi-country cash pooling is in place across the Group with our banks to ensure daily netting of almost all the Group's cash flows in all currencies with consequent improvements in liquidity and reduced interest costs.

At the year end the Group had net debt of £34.5m. Total debt was £107.8m, including £54.5m denominated in US Dollars, £32.4m in Yen and £20.9m in other currencies. Financial assets comprised short term investments of £65.4m and cash of £7.9m. Of total financial assets within net debt, £13.7m were denominated in Euro, £57.0m in Sterling and £2.6m in other currencies. The net interest charge was therefore relatively low compared to net debt. Borrowing requirements are seasonal and peak borrowing during the year was £108.2m. Although net debt declined, total debt and total financial assets both increased during the year following a review of, and a change in, the intercompany financing structure and its consequent management. During the year and at the year end, the Group had just one interest rate swap, which was used to convert a fixed interest rate on a long term debt instrument to floating.

Group policy on investment management is to maximise the return on net funds subject always to the security of the principal and the liquidity of the Group. The Group has established policies to identify counterparties of suitable credit worthiness and has procedures to ensure that only these parties are used, that exposure limits are set and that these limits are not exceeded. Note 24 to the Accounts provides a summary of the deposit structure of the Group at the year end.

The Group does not intend to materially change its Treasury policies as a consequence of International Accounting Standard 39 and is now well placed to deal with the accounting requirements of this Standard.

### International Financial Reporting Standards

For the year ended 31 March 2006, the Group will report under International Financial Reporting Standards along with all EU listed companies. The Group is currently undertaking an implementation project to ensure that the full impact of the transition is understood. The International Standards are being reviewed and new Group accounting policies are in the process of being developed.

It is not appropriate to indicate the impact on either Group results or shareholders' funds as our detailed analysis is not yet complete. However, the most significant areas of change for the Group include accounting for defined benefit pension schemes, share options, dividends and goodwill.

### Summary

Sales and profit growth have been achieved despite trading conditions remaining difficult for much of the year. Our businesses in North America and Japan have grown particularly strongly and the UK has exited the year in growth. e-Commerce has been another area of notable success.

There have been further investments in sales and marketing and also in systems to further drive sales growth. Our systems projects are demanding and require careful risk management. Improvements in gross margin continued but these are now beginning to slow.

Our belief in the potential of the Group remains strong. Sales, profits and cash flows have all increased during the year and our net debt position was significantly better than at the end of last year.

Ian Mason

Richard Butler

Jeff Hewitt