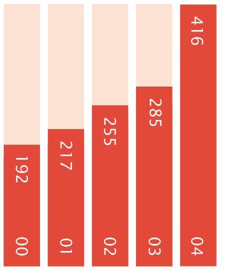
Operational review



ARG operating profit
£ million

Argos Retail Group

- Sales up 10% to £5.2bn and profit up 19% to £416m on pro forma basis (including Homebase for a full year in 2003); operating margin up to 8.0%
- Argos outperformed its market for the fifth consecutive year
- Argos Extra to be in about 150 stores in July 2004
- Homebase repositioning on track; good progress on synergies
- Argos store card now profitable; about a further £150m to be invested in loan book in 2005
- ARG capital expenditure approximately £250m in 2005 (2004: £159m), with investment in Argos Extra, Homebase mezzanines and new Argos and Homebase stores

Following the disposal of the home shopping businesses and Reality in May 2003, Argos Retail Group is now focused principally on selling general merchandise through a multi-brand, multi-channel offer. Argos and Homebase are targeted at different customer groups but combined, consumers are spending about £5bn each year with ARG on a wide range of hard goods.

While the individual brands focus on the needs of their own customers, the core competencies and infrastructure supporting the brands are, where appropriate, increasingly centralised and shared. These core competencies are sourcing and supplier management, multi-channel ordering and home delivery, as well as financial services. The shared services include IT, finance, human resources and property. This central infrastructure has been further strengthened during the year and is now starting to deliver benefits derived from ARG's scale.

Argos Retail Group

12 months to 31 March	Sales 2004 £m	Sales 2003 £m	Operating profit 2004 £m	Operating profit 2003 £m
Argos	**3,384**	3,017	**297.4**	240.8
Homebase	**1,483**	246	**102.2**	2.2
Financial Services	**60**	34	**(5.5)**	(13.1)
Wehkamp	**235**	226	**21.4**	19.9
Total	**5,162**	3,523	**415.5**	249.8
Operating margin			**8.0%**	7.1%
Operating cash flow			**44**	96

Notes (relevant to all ARG tables):

2003 sales have been restated for FRS 5. 2003 figures exclude discontinued home shopping and Reality operations.

Homebase's year-end is 28 February. For 2004, sales and profit are for the twelve months to 28 February 2004. For 2003, sales and profit are for the period from date of acquisition (20 December 2002) to 28 February 2003.

In the area of sourcing and supplier management, the central ARG team has been tasked with identifying and realising benefits from the combined sales of Argos and Homebase. In the key overlapping areas of DIY, gardening, furniture and homewares, sales are about £2.7bn. A programme is under way to realise benefits from reducing product costs, increasing supplier rebates, rationalising supplier numbers and cutting distribution costs. This has been initiated through joint negotiations, common product sourcing and utilisation of the ARG buying office in Hong Kong and the recently-opened office in Shanghai. The bulk of supply chain gains are being re-invested in the businesses and in reducing prices further for our customers.

Argos

In an increasingly competitive general merchandise market in the UK, Argos aims to win more customers and a greater share of their spend by offering the most compelling combination of choice, value and convenience.

Argos again clearly outperformed its market. Sales grew by 12% year-on–year as Argos made strong share gains in many product categories, especially consumer electronics, white goods and toys.

Argos has maintained its reputation for excellent value during this period of price deflation and a more competitive environment. Prices of products re-included in catalogues during 2004 were reduced by 3% on average. About 20% of sales last year were made at promotional prices, reflecting Argos' strong promotional stance during the life of a catalogue. Supply chain benefits, together with operational cost improvements, funded these lower prices.

Argos

12 months to 31 March	2004 £m	2003 £m	Change
Sales	**3,384**	3,017	12%
Total growth	***12%***	*13%*	
Like-for-like growth	***5%***	*7%*	
Operating profit	**297.4**	240.8	24%
Operating margin	**8.8%**	8.0%	
At 31 March			
Number of stores	**556**	523	
Of which: Argos Extra stores	**75**	11	

Operating profit in 2003 is after a charge of £8.7m relating to integration of jungle.com.

The convenience of the multi-channel offer at Argos continues to drive outperformance. Argos offers customers the ability to order or reserve goods in store, by phone or on the Internet, for delivery to store or home. Further investments will be made in 2005 to expand these capabilities:

- a further 35 new stores are planned in 2005, following the 33 stores opened in 2004;
- the store refit programme was largely completed during 2004. Quick pay kiosks, which reduce the time it takes for customers to order and pay for goods, were in over 230 stores at the year-end and will be rolled out further during 2005. 8% of sales in those stores with kiosks were processed through the kiosks, with this percentage improving throughout the year; and
- Argos Direct grew by 21% compared to last year and accounted for 20% of sales in 2004 (2003: 18%). Building on this success, a decision has been made to invest in a third two-man delivery warehouse in Darlington. This will become operational in calendar year 2005.

Sales ordered via the Internet grew by over 50% year-on-year, accounting for 4% of total sales. An additional 7% of sales were reserved remotely by phone or Internet for purchase and collection later in store.

Improved choice through product range expansion remains a key driver of sales, with 13,000 lines in the current catalogue, 12% more than a year ago. The combination of more choice, together with Argos' multi-channel offer, is driving market share growth. Argos' ability to offer additional ranges using the catalogue, improved in-store stock management and home delivery, rather than adding retail space, is a competitive cost advantage.

Argos Extra is to be rolled out to about 150 stores in July 2004. The Argos Extra catalogue, which was first trialled in January 2003, provides a major increase in choice through the addition of new and extended product ranges. It currently offers 17,000 lines, 4,000 more than the main catalogue, with increased ranges in Leisure, Home and Electricals. The current trial has 43 Argos Extra stores where the additional 4,000 lines are stocked-in. The facility to order the extended range for collection is available in a further 32 neighbourhood stores.

To date, a high single-digit percentage sales uplift has been achieved in the Argos Extra stocked-in stores. Gross margins on Extra ranges are in line with the main catalogue. As a result, Argos Extra will be introduced into a further 73 stocked-in stores in July 2004. These will be a combination of new store openings (14 stores) and the conversion of existing stores, where stockroom space is being extended.

The use of a catalogue to offer the additional range, as well as improved in-store stock management, home delivery and better utilisation of existing space, means no extra retail space is required. Capital investment of about £25m in 2005 will be used to reconfigure the current space (for example, by adding mezzanine stockrooms) and provide distribution infrastructure.

The neighbourhood stores trial will continue, as will various systems developments and testing nationwide home delivery of Argos Extra products.

Financial review

Sales for the year of £3.4bn increased by 12%, of which 7% came from new stores which continue to exceed their investment hurdle rate. Like-for-like sales growth was 5%, following on from the previous year's 7% like-for-like performance.

Gross margin was slightly up on the year, with supply chain benefits continuing to fund lower prices and to offset an adverse product mix, mainly caused by increasing sales of lower margin consumer electronics.

Operating profit grew by 19%, excluding costs of £8.7m in 2003 relating to the integration of jungle.com. Expense levels as a percentage of sales were again reduced despite continuing investment in growth initiatives (such as Argos Extra) and in the infrastructure (including two new distribution centres opened during the year). Operating margin, excluding the £8.7m costs in 2003, advanced by a further 50 basis points to 8.8%.