

*The following information should be read in conjunction with the more detailed information appearing elsewhere in this document, including the financial and other information in Part IV (Operating and Financial Review and Prospects) and Part V (Accountants' Report on the Group). The financial information included in this Part I (Business of the Group) has been extracted without material adjustment from Part V (Accountants' Report on the Group) and Part VI (Pro Forma Statement of Net Assets of the Group), or has been extracted without material adjustment from Halfords' accounting records, which formed the underlying basis of the Accountants' Report.*

## 1. BUSINESS OVERVIEW

Halfords is the UK's leading retailer, on the basis of turnover, in each of the four product markets in which it operates, being:

- car maintenance (including car parts, servicing consumables (such as oil), workshop tools and body repair equipment);
- car enhancement (including in-car entertainment systems, cleaning products, accessories, interior and exterior car styling products, navigation systems and alloy wheels);
- travel solutions (including roof boxes, cycle carriers, child car seats and outdoor leisure equipment); and
- cycling (including cycles and cycle accessories).

The Directors believe that Halfords differentiates itself from its competitors through its national store portfolio, its broad product range, competitive pricing (achieved through scale of purchasing power), customer service offerings performed in-store by staff (e.g. fitting and repair services) and its strong brands. These strengths allowed Halfords to achieve turnover of £578.6 million in the 2004 financial year (2003 financial year: £525.8 million), and operating profit before goodwill amortisation and exceptional costs of £79.2 million in the 2004 financial year (2003 financial year: £50.8 million).

Halfords' store portfolio comprised 387 stores across the UK as at 2 April 2004, and represented a total of some 2.9 million sq. ft. of selling space. Of these stores, 343 (representing approximately 2.8 million sq. ft. of selling space) were out-of-town superstores and 44 (representing approximately 0.1 million sq. ft. of selling space) were small stores located in high streets and other urban locations.

Halfords is in the process of upgrading its out-of-town superstores to a new format known as "Arcade" and is also upgrading its small stores. As at 2 April 2004, 238 superstores and 11 small stores were in the new formats. The upgrades to Halfords' stores have proven successful with Halfords' existing core customer base, whilst attracting new customers from the growing number of car and cycle enthusiasts, whom the upgrades were particularly designed to attract.

## 2. HISTORY OF THE GROUP

Halfords has its origins in a business founded in 1892 in Birmingham by F.W. Rushbrooke, which operated as the Halfords Cycle Company Limited from 1907. In the mid-1980s, the business was one of the first UK retailers to migrate from high street locations to newly developed out-of-town retail parks, recognising customers' demand for more store space to accommodate larger product ranges, easier car access and better parking facilities.

In 1984 the Halfords business was acquired by Ward White Group plc, which in turn was acquired by Boots in 1989. Following a strategic review under Boots' ownership, the Group started a programme to refine the product offering, to develop new brands (which included the acquisition of the established "Ripspeed" brand in 1998 and the introduction of the "Bikehut" concept) and during the 2001 financial year to upgrade certain of its stores by installing a modern, open-plan "Arcade" format in out-of-town superstores.

In August 2001, Halfords sold its garage business, comprising 129 servicing and repair outlets located on existing superstore premises, to the Automobile Association, a subsidiary of Centrica plc.

In August 2002, Halfords Limited was acquired by the Company in a leveraged buy-out backed by the CVC Shareholders. Since the CVC Acquisition, Halfords' new management team has undertaken key strategic initiatives which have significantly improved the operating and financial performance of the business and laid the foundation for future growth.

The success of these initiatives has been reflected in a significant increase in turnover and operating profit before goodwill amortisation and exceptional costs. Turnover increased from £525.8 million in the 2003 financial year to £578.6 million in the 2004 financial year, and operating profit before goodwill amortisation and exceptional costs increased from £50.8 million to £79.2 million, resulting in an increase in operating margins before goodwill amortisation and exceptional costs, from 9.7 per cent. to 13.7 per cent. over the same period.

Halfords achieved this significant increase in turnover primarily through a shift in marketing focus which included greater emphasis on price and promotional activity, expansion into new product areas and service differentiation. The management team also refined the Arcade format by extracting and implementing the most successful elements of the original Arcade format in a more cost effective manner, known internally as SMART Arcade. Operating profit also benefited from streamlining head office and operational structures and reducing headcount, as well as from improving purchase price and payment terms across key areas of expenditure.

### 3. MARKET OVERVIEW AND COMPETITIVE ENVIRONMENT

Halfords targets four distinct retail product markets: car maintenance, car enhancement, travel solutions and cycling, which together represent a combination of large, relatively stable or needs-driven markets and higher growth niche markets. The Directors estimate that the total size of the retail market in which Halfords operates was worth approximately £3 billion in 2003, and that this retail market has grown at a compound annual rate of 3 per cent. in the three calendar years 2001 to 2003. Halfords is the UK's leading retailer, on the basis of turnover, in each of these product markets.

The following table contains the Directors' estimates of the size of the product markets in which Halfords operates in 2003 and growth in each of such product markets for the periods shown. The table also shows Halfords' turnover growth within these product markets for the financial years shown and the proportion of Halfords' turnover represented by Halfords' own-brand products in each of these product markets:

Product Market	Size of Market 2003	Market growth 2000-2003	Halfords turnover 2004 financial year	Halfords turnover growth 2001-2004 financial years	Halfords own-brand turnover 2004 financial year
	(£ million)	CAGR (%)	(£ million)	CAGR (%)	(%)
Car maintenance	944	(0.1)	172	3.4	63
Car enhancement	837	7.3	202	14.3	20
Travel solutions	700	4.1	82	8.4	47 <sup>(1)</sup>
Cycling	508	1.1	123	1.8	49
Weighted average	–	3.0	–	7.0	43 <sup>(1)</sup>
Total	2,989	–	579	–	–

(1) Own-brand information excludes child safety and outdoor leisure products, and scooters and accessories where Halfords currently has no own-brand products.

The Directors believe that Halfords' market-leading position reflects the Group's comprehensive product range, competitive pricing, the provision of specialist advice by staff and Halfords' customer service offering. The largest national competitor to Halfords which focuses its operations on each of the four product markets in which Halfords operates is Motor World Limited, which operates through approximately 230 stores, mostly situated in high street locations. Motor World's turnover (as reported in statutory accounts filed at Companies House) was approximately £43.3 million in the year to 30 April 2003.

#### Car maintenance and car enhancement market

The Directors estimate that the UK market for aftermarket expenditure on cars was approximately £11 billion for the calendar year 2003. This figure includes product markets in which Halfords does not participate, including servicing and repair labour (estimated at £5.0 billion for that year) and replacement parts delivered through main car dealers and fast-fit centres (estimated at £3.5 billion for that year). Accordingly, the Directors estimate that Halfords' addressable market was £1.8 billion in 2003, representing the direct-to-consumer segment of this market for sales of car maintenance and car enhancement products.

During the three calendar years 2001 to 2003, the car maintenance market is believed by the Directors to have declined marginally in size due to improvements in part quality and the increased complexity of cars and car parts, which has led to consumers being less able, or less inclined, to perform their own maintenance. However, Halfords has been well positioned to exploit a degree of price elasticity in certain elements of the car maintenance market, and has also continued to benefit from growth in the car enhancement sector over this period, reflecting an ongoing shift in expenditure towards enhancement activities. The Directors estimate that Halfords' overall addressable market in car maintenance and car enhancement products has grown over this period at a compound annual rate of 3.1 per cent.

The Directors believe that the key drivers of growth within the car maintenance and car enhancement market include:

- the growing number of vehicles registered in the UK (known as the "UK car parc"). Due to UK population growth, increasing numbers of two-car families and the relative affordability of cars, the car parc has grown consistently at a compound annual rate of approximately 2.4 per cent. in the three calendar years 2001 to 2003 (*Source: Mintel*). The Directors expect that growth in the car parc will continue to drive demand for car maintenance and car enhancement products;
- favourable trends within the UK car parc:
  - the car parc is continuing to age as cars become more durable, resulting in a longer period over which maintenance occurs and during which owners invest in the appearance of their vehicles. Older vehicles are also less likely to be supported by original equipment manufacturers' warranties, resulting in greater reliance on other providers, such as Halfords;
  - private car ownership is increasing, driven in part by changes in UK taxation policy. The Directors believe that private owners are more likely to spend on vehicle improvements and enhancement than company car drivers;
  - the proportion of drivers covering over 10,000 miles per annum increased from 35 per cent. to 42 per cent. in the three calendar years 2000 to 2002 (*Source: BMRB*). The Directors believe that this increase in the amount of time spent in cars, together with the trend towards replicating home entertainment systems in-car, has driven growth in in-car entertainment products;

- technological improvements which have extended part life and car reliability have also increased the sophistication and complexity of car parts and of motor oils, and consequently their cost. The Directors consider that the resulting price inflation has partially offset any decline in volume of sales of car parts due to extended part life and car reliability; and
- a growing "enthusiast" segment, focused on car enhancement.

In addition, the relatively non-discretionary nature of vehicle repairs and servicing provides some protection against macro-economic conditions in the car parts segment (the largest element) of the car maintenance and car enhancement market.

Halfords' overall share of the car maintenance and car enhancement market is estimated by the Directors to have increased from approximately 18 per cent. to approximately 21 per cent. over the three calendar years 2001 to 2003. The market is highly fragmented, with a large number of small, independent retailers, although competition within the market varies by product group. In relation to car parts, Halfords' main competitors are dealers or independent stores, whilst in relation to in-car entertainment and car styling products, Halfords' main competitors are specialist stores or mail order/online operations. There is a wider range of competitors in product groups such as oils, cleaning products, workshop tools and body repair products due to the more universal nature of the products. These competitors include independent retailers, garage forecourts, DIY stores and certain supermarkets.

#### Travel solutions market

The total market for travel solutions products (including car travel equipment such as roof boxes and cycle carriers, travel accessories such as batteries, safety equipment, child travel and safety products (including child car seats) and outdoor leisure equipment) is estimated by the Directors to have been worth approximately £700 million in 2003.

The Directors believe that this market has grown at a compound annual rate of 4.1 per cent. over the three calendar years 2001 to 2003, driven by an increase in the number of short break holidays and the growing popularity of outdoor leisure activities. The Directors estimate that Halfords' market share in 2003 was approximately 12 per cent. (approximately 17 per cent. excluding the outdoor leisure market that Halfords only entered during the 2004 financial year), which they believe Halfords has captured through the broad product range it is able to offer in its superstores (which have an average size of approximately 8,300 sq. ft. of selling space), as well as the Group's fitting service.

Competition within this market is fragmented, and includes independent and general retailers and car dealers with few offering the same breadth of range as Halfords. In relation to child safety products, Halfords competes principally against retailers such as Mothercare and Toys R Us. In relation to outdoor leisure products, Halfords' main competitor is Blacks Leisure Group plc.

#### Cycling market

Halfords also operates in the UK retail cycling market, which comprises the sale of new cycles and cycle accessories (such as lights, locks and cycle safety helmets). The UK retail cycling market was worth £508 million in 2003, of which £308 million (*Source: GfK*) related to sales of cycles and £200 million (*Source: GIA*) relates to sales of cycle accessories. The cycling market has grown at a compound annual rate of 1.1 per cent. in the three calendar years 2001 to 2003 (*Source: GfK and GIA*).

The new cycle market is mature, with between 2.3 million and 3.0 million cycles sold per annum in the nine calendar years 1995 to 2003 (*Source: GfK*). The Directors believe that factors such as the increasing popularity of cycling as a leisure activity and for commuting,

recent Government initiatives encouraging cycling and an increasing number of higher-spending enthusiasts, have underpinned sales of cycles over this period.

Sales can also be (and have been) affected by factors such as:

- product innovation – e.g. the introduction of new or retro products (such as the Raleigh Chopper bike), which can provide periodic stimulus to the market, whilst product developments in other leisure categories, such as games consoles, may adversely impact the market;
- weather conditions and one-off occurrences (such as the foot-and-mouth epidemic which impacted the market in 2001 and 2002); and
- manufacturing overcapacity, which has contributed to price deflation, particularly with respect to lower specification cycles, leading to greater accessibility to the market for new consumer entrants.

The cycle accessories market is estimated by the Directors to have grown in volume terms in the three calendar years 2001 to 2003, with price deflation limiting value growth to an annual compound rate of 3.8 per cent.

The Directors believe that Halfords had a market share of approximately 24 per cent. in the UK retail cycling market in 2003. Competition at the low specification end of the new cycle market comes from supermarkets, such as Tesco and Asda, and large retailers such as JJB Sports and Toys R Us. Higher specification cycles are also available from these large retailers, but the principal competition in the premium end of the market comes from small independent retailers.

#### 4. COMPETITIVE STRENGTHS

The Directors believe that Halfords has a number of competitive strengths, which mean it is well-positioned to take advantage of current and future market opportunities. These strengths include:

- a balanced mix of defensive and growth markets;
- leading market positions;
- distinctive brands with national recognition and broad appeal;
- a national store portfolio which would be difficult to replicate;
- a strong track record of earnings growth and cash generation; and
- strong bargaining positions with suppliers.

##### Balanced mix of defensive and growth markets

Halfords operates in a combination of historically relatively stable product markets (albeit modestly declining in the case of car maintenance) and in higher growth niche product markets (such as car enhancement).

The Directors consider that the car maintenance segment provides a strong and reliable core customer base for Halfords stores, and a solid financial foundation for the Group. Further, they believe that Halfords' competitive position has allowed Halfords steadily to increase sales from car maintenance products over more than 10 years, demonstrating the relative stability and resilience of this product market during different stages of the overall UK economic cycle. In the 2004 financial year sales of car maintenance products represented 29.7 per cent. of Group turnover.

The Directors believe that the cycling market has been relatively stable over the nine calendar years 1995 to 2003, although sales were negatively impacted in 2001 and 2002 by the foot-and-mouth epidemic. Halfords' sales from cycling products, which totalled £123.1 million in the 2004 financial year, have increased by an average compound rate of 1.8 per cent. during the three financial years to 2 April 2004.

Halfords' sales in the car enhancement and travel solutions markets have seen higher growth rates than sales in the car maintenance and cycling markets in the three financial years to 2 April 2004. The Directors believe that sales in these higher growth product categories are driven primarily by changes in consumer spending habits towards car enhancement and leisure products and services and general increases in disposable income in the UK. The Group seeks to leverage its strong brand, scale of operations, competitive pricing and service differentiation to capture new market share in these niche product markets.

The Directors believe that the defensive market dynamics of the car maintenance market, when combined with the growth characteristics of the other product markets in which the Group operates, give Halfords a strong and resilient platform from which to respond to changing consumer trends and to continue to grow sales.

#### **Leading market positions**

Halfords is the UK's leading retailer, on the basis of turnover, in each of the four product markets in which it operates. Competition in these markets is fragmented and the Directors believe that Halfords enjoys a leading market share in each of these four markets. They estimate that Halfords' market shares were approximately 18 per cent., 24 per cent., 12 per cent. and 24 per cent. for car maintenance, car enhancement, travel solutions and cycling respectively in the 2003 calendar year.

Halfords aims to attract customers with an extensive service offering and competitive pricing (achieved through scale of purchasing power) to compete with small independent stores, whilst offering skilful and knowledgeable customer service to differentiate itself from other large retailers.

The only other national retailer which focuses its operations on the four product markets in which Halfords operates is Motor World. Halfords' turnover is more than twelve times larger than MotorWorld's turnover (based on its latest published accounts) and Halfords has a more comprehensive store portfolio with convenient out-of-town sites, whereas Motor World operates mostly from high street locations.

The Directors believe that the limited availability of good quality out-of-town sites and the high cost of establishing an extensive store and associated distribution network creates a significant barrier to prospective new market entrants and limits the potential growth of current high street competitors. The Directors also believe that the Group is well-positioned to capture additional market share as small independent retailers continue to exit some of the highly fragmented markets in which the Group operates.

#### **Distinctive brands with national recognition and broad appeal**

Market research conducted by the Group suggests that approximately 11 million people visited Halfords stores in the 2003 calendar year, being the equivalent of approximately 24 per cent. of the UK adult population. This research indicates that customers associate the Halfords brand with qualities such as trustworthiness, high product quality, reliability and a broad product range. Market research also suggests that the Halfords brand, which has been in existence for nearly 100 years, is the most recognised UK store brand in the cycling, car maintenance and car enhancement product markets.

In the 2004 financial year, approximately 43 per cent. of turnover by value consisted of products marketed under Halfords' own-brands. The Directors believe that this extensive

range of own-brand products, when combined with Halfords' scale of operations, provides it with a significant cost advantage over its competitors.

The strength of the Halfords brands has allowed, and the Directors believe it will continue to allow, Halfords to leverage its brands into new products and product categories, with recent examples being outdoor leisure and child safety.

The Directors believe that the Ripspeed and Bikehut sub-shops in the Group's Arcade superstores are perceived by both mainstream and enthusiast customers as shopping destinations in their own right, due to the broad product range, expertise and specialisation they offer.

#### **National store portfolio which would be difficult to replicate**

As at 2 April 2004, Halfords operated 387 stores (343 of which were superstores) across the UK, servicing major UK conurbations, cities and towns. In the non-food sector, the Directors believe that only Halfords and Carpetright Plc operate under a single fascia from more than 340 out-of-town stores. Halfords is represented in 95 of the UK's top 100 retail catchments listed by Experian Limited.

The Directors believe that Halfords enjoys a considerable advantage over many of its competitors that are predominantly based in high street locations, as its out-of-town superstores offer a broad product range, parking facilities and longer opening hours. This portfolio of superstores, built up since the mid-1980s, would be difficult for those existing competitors or potential new entrants without such a portfolio to replicate.

Halfords' portfolio strategy is to continue to improve the quality of its store portfolio by closing less attractive stores and opening new ones in more profitable locations. Of the Group's 387 stores, 99 per cent. were cash profitable in the 2004 financial year.

#### **Strong track record of earnings growth and cash generation**

The Directors believe that Halfords' strong track record of turnover growth over the past 15 years demonstrates the strength of the business within the UK economic cycle. The Directors also believe that Halfords' consistently high level of conversion of earnings to cash flow allows it to support the Group's growth strategy and provides the Group with further financial flexibility.

#### **Strong bargaining positions with suppliers**

As the UK's leading retailer, on the basis of turnover, serving each of the product markets in which it operates, the Directors believe that Halfords is the largest UK customer of many of its key suppliers and therefore is well-positioned to negotiate preferential terms of supply and volume discounts. During the 2004 financial year Halfords renegotiated terms with approximately 350 of its suppliers. The Directors estimate that this resulted in a one-off reduction in working capital in that year of approximately £25 million from the extension of payment terms and ongoing annual cost reductions of approximately £4 million.

The Directors consider that Halfords' portfolio of stores also offers suppliers an attractive selling platform for bringing new and innovative products to the UK market, and this strength enables Halfords to secure periods of exclusive distribution of certain new product lines (recent examples being Kawasaki-branded children's cycles and Michelin tyre inflators).

### **5. GROWTH STRATEGY**

Halfords' strategy is to maintain and leverage its core strengths and develop new opportunities for growth. Halfords' new management team has significantly improved the Group's financial performance since the CVC Acquisition, and is now focused on delivering additional sales growth and improving operating margins by:

- developing its property portfolio by converting existing stores and opening new stores;
- continuing to introduce effective and complementary marketing and trading practices;
- leveraging its brands into new product and service categories;
- improving product sourcing channels; and
- increasing operational efficiency.

#### **Developing its property portfolio by converting existing stores and opening new stores**

The Group has considerable experience in both converting existing stores and opening new stores. The Directors believe that this experience means that they can continue to convert and open stores efficiently and cost-effectively going forward.

##### ■ *Store Conversions & Mezzanines*

The Group is continuing to roll out its Arcade format into its superstores. This format is designed to offer customers an attractive selling environment. The Arcade format was originally introduced in the 2001 financial year and has been refined by the new management team since the CVC Acquisition into the more cost-effective SMART Arcade model. As at 2 April 2004, approximately 69 per cent. of the Group's superstores were in the Arcade or SMART Arcade formats, and the Directors intend to roll out SMART Arcade to a further 65 superstores in the current financial year.

Dependent on store size, existing format and estimated market potential, future Arcade conversions may include the introduction of a supermezzanine floor and mezzanine floors in existing Arcade superstores may be extended to supermezzanine proportions. These mezzanines increase space for proven ranges (such as in-car entertainment products) and for new ranges (e.g. the introduction of an expanded range of child safety and play products). The Directors believe that, through both new mezzanines and mezzanine extensions in over 200 superstores, Halfords has the potential to increase its retail selling space by approximately 20 per cent. without, in general, any concurrent increase in rent. The Directors intend to introduce supermezzanine floors in 35 of the 65 superstores referred to above in the current financial year.

Halfords has also created a refined version of the SMART Arcade format, known internally as "Metro", for its small stores which are located in high streets and other urban locations. The new format offers a range of products which appeal to the high street consumer but which the Group had previously only sold in Arcade superstores. The first four small stores which Halfords converted into this format in the period between July and September 2003 have delivered significant sales uplifts following conversion. Following the performance of the trial stores, Halfords converted a further six small stores to this new format during the remainder of the 2004 financial year. The Directors intend to roll out this new store format to the remaining small stores (other than those held on short leases which the Directors choose not to renew) in the current financial year.

##### ■ *New Stores*

Halfords intends to continue opening new out-of-town superstores in the low-cost SMART Arcade format as part of its store portfolio development strategy. This is likely to involve a small number of new superstores each year, as suitable properties become available. These new superstores will include a supermezzanine floor, where appropriate. The Directors have identified a further 70 locations for new superstores in the UK where they believe that further market capacity exists and intend to open superstores in eight of these locations in the current financial year.

The Directors also believe that additional new format small stores, of approximately 3,000 sq. ft., provide another potential source of sales growth. The Directors have identified approximately 80 high street and other urban locations as being the most

suitable for new small stores. In the 2004 financial year, Halfords opened one small store in this new format and the Directors intend to open at least a further six in the current financial year.

The Directors believe that the Halfords customer offering may be attractive to certain overseas markets. The Group plans an initial expansion into the Republic of Ireland, centred upon Dublin, and it is evaluating eight potential out-of-town locations with a view to opening two superstores in the SMART Arcade format in the current financial year. However, international expansion is not a core element of the Group's strategy and the "Halfords" name is registered as a trademark by another proprietor in a number of European countries.

#### **Continuing to introduce effective and complementary marketing and trading practices**

Halfords' marketing and trading strategy is designed to maximise like-for-like sales growth and to develop a customer offering that distances the Group from its competitors.

The marketing strategy focuses on the communication of discounted product promotions to increase footfall and enhance the perception of Halfords as a price leader, whilst also promoting its sub-brands, such as Ripspeed and Bikehut, to increase and diversify the customer base.

Halfords' trading strategy is aimed at increasing the number of products purchased by customers on each visit to a store through dynamic use of store space in order to sell products which are seasonally relevant or which are otherwise being specifically promoted. The Directors have also increased staff participation in sales-related incentive schemes and have implemented specific incentives at peak trading periods. The Directors believe that this strategy will drive like-for-like sales growth, primarily through increasing average transaction value (£18.10 in the 2004 financial year), and will reinforce customers' perception of brand value.

#### **Leveraging its brands into new product and service categories**

The Directors intend to continue to leverage Halfords' brands into new categories and product ranges, thereby increasing like-for-like sales, such as:

- *outdoor leisure* – recognising the close fit to Halfords' existing product range and the fragmented nature of this market, the Group trialled a range of outdoor leisure products (including tents, camping equipment and sleeping bags) in certain of its superstores during the 2004 financial year. The trial was successful and the range was rolled out to all of its superstores in March 2004. The Directors intend to introduce own-brand products into this product category in due course;
- *child travel and safety* – sales in this category, which consists primarily of child car seats, increased by 78 per cent. during the 2004 financial year to approximately £12 million, to become one of Halfords' fastest-growing product areas. The Directors believe that customers are attracted to Halfords' stores because they associate the Halfords name with reliability and safety, and because the stores offer a wide range of child car seats and an in-store fitting service. The Group's strategy is to leverage the success of this category into contiguous product ranges such as child play items;
- *expanded and new customer service offerings* – the Directors believe that its "We'll fit it" and "We'll repair it" service offerings differentiate Halfords from its competitors, and that these customer service offerings attract customers to its stores. The Directors intend to grow the "We'll fit it" offering by increasing the penetration of the current offering (e.g. through staff training and focused advertising) and expanding the range of products for which fitting is available. The Directors also intend to expand the range of customer service offerings available. For example, Halfords is currently trialling in

certain of its superstores a dedicated automotive advisory service known as “Auto Clinic” which offers a range of services, including valeting and scratch and dent repair services provided by third parties;

- *business-to-business* – the Directors believe that non-retail customers, such as independent car mechanics and small owner-managed garages, provide a potential new customer base for the Group. Halfords is currently targeting this customer base through the roll out of the Halfords tradecard discount programme together with its in-store trade counters in a number of superstores. In addition, the Group is expanding its market by supplying products direct to businesses. For example, Halfords supplies a focused range of Halfords and independently branded car-related products to BP to be retailed through BP Connect forecourts; and
- *in-car electronics* – the Group closely follows market trends such as the introduction of CD and DVD systems and satellite navigation and updates its product ranges and fitting capability accordingly. In addition, given the Group’s purchasing power for products in this category, Halfords has the ability to offer very competitive prices on new products as they come to market, if it chooses to do so.

#### Improving product sourcing channels

Halfords has historically been able to use its buying power to negotiate preferential terms of supply and volume discounts with most of its key suppliers. The Group’s intention is to review its sourcing of merchandise with the objective of using its scale advantage to reduce its total number of suppliers where doing so improves buying terms and provides the opportunity to increase margins.

The Directors believe that sourcing products directly from the Far East represents a significant opportunity to further expand the Group’s margins, particularly in respect of own-branded products. The Directors intend to increase the volumes of products that Halfords imports directly, particularly those from the Far East from approximately 7 per cent. (measured by cost of purchases) in the 2004 financial year to approximately 20 per cent. in the medium term. Recent changes in Far East sourcing have provided cost savings for the Group of up to 25 per cent. in respect of the products concerned.

#### Increasing operational efficiency

Since the CVC Acquisition, the new management team has reduced store and administration costs significantly, thereby enhancing operating margins, and the Directors intend to maintain the existing focus on cost and working capital control going forward. There are three areas in which the Group is maintaining specific focus: distribution and sourcing costs, information technology costs and packaging related expenditure.

In order to maintain the current level of distribution and sourcing costs as a proportion of sales, a series of measures to increase both throughput and storage capacity are being implemented. These measures include:

- increasing delivery frequency to key stores, through consolidation across Halfords’ distribution centres to be achieved through cross-docking and the extension of working hours at the distribution centres; and
- introducing origin consolidation for products sourced in the Far East, with the option for direct-to-store deliveries particularly for seasonal and promotional products.

Furthermore, the Group is considering the consolidation of the distribution network into two centres (rather than three) to drive greater operational and service efficiencies.

In addition, as discussed above, the Directors intend to source merchandise, particularly own-brand merchandise, from fewer suppliers and, to a greater extent than previously, directly from the Far East, thereby improving buying terms.

The Group is also investing in a three-stage IT strategy to upgrade its systems in key commercial operations and to eliminate its reliance on the Boots mainframe computer systems. Whilst this is likely to result in an increase in IT costs in the current financial year, IT-related costs are expected to reduce in subsequent years primarily due to lower staffing costs. In addition, this new IT platform is designed to improve store replenishment capability and increase on-shelf availability, whilst lowering stockholding costs, improving warehouse efficiency and providing a more modern and flexible infrastructure.

Halfords recently performed a review of the packaging specification appropriate to each of its product ranges. This review has highlighted areas where future packaging costs can be reduced.

## 6. BUSINESS DESCRIPTION OF THE GROUP

### Store formats

As at 2 April 2004, Halfords operated 387 stores across the UK encompassing approximately 2.9 million sq. ft. of selling space. The store network comprised a number of different store formats, as follows:

Store location	Store format	No. of stores	Total selling space ('000 sq. ft.)
Out-of-town superstores:	Arcade – flat	125	1,006
	Arcade – mezzanine	102	989
	Arcade – supermezzanine	11	124
	Unconverted superstore	105	735
Small stores in high street and other urban locations		44	105
<b>Total as at 2 April 2004</b>		<b>387</b>	<b>2,959</b>

Since the end of the 2004 financial year, Halfords has opened a further four stores, comprising two superstores, each with supermezzanines, and two small stores. Halfords has also completed the conversion of three superstores in the SMART Arcade format.

#### *Out-of-town superstores*

The Arcade format was originally introduced in the 2001 financial year when Halfords was under Boots' ownership. The format was designed to gain credibility with car and cycle enthusiasts, and by so doing to improve the appeal of the brand generally. Halfords has implemented the Arcade format in existing out-of-town superstores by:

- expanding existing ranges and introducing new ranges;
- creating designated sub-shops under the Ripspeed and Bikehut brands for the car enhancement and cycling product offerings, respectively;
- introducing specialist staff to provide customers with enhanced product knowledge, customer service and service provision (e.g. cycle repair); and
- enhancing in-store layout, complemented by orange and black Halfords corporate branding.

Dependent upon the size of the store, turnover and demographic catchment, some original Arcade conversions included the construction of a mezzanine floor of approximately 2,200 sq. ft., which generally housed the Bikehut sub-shop. The mezzanine was introduced to increase space for new ranges, giving customers a feeling of increased scale within the store.

The new management introduced the SMART Arcade format following the CVC Acquisition. SMART Arcade is a refined version of the original Arcade format designed to deliver the principal sales generating elements of the Arcade format at significantly reduced capital expenditure. SMART Arcade focuses investment on the introduction of a meaningful display of the key product range extensions within the original Arcade concept, whilst streamlining investment in the store environment and specialist staff to areas of highest customer impact.

Halfords implemented the supermezzanine initiative in August 2003. It involves the introduction of a larger L-shaped mezzanine floor of on average approximately 3,800 sq. ft. (compared with on average approximately 2,200 sq. ft. standard mezzanine size in Arcade stores) in superstores which do not have a mezzanine floor or extending mezzanine floors in existing Arcade stores to the increased proportions. These supermezzanines provide increased space for proven ranges and for the introduction of new product categories. Halfords introduced supermezzanine floors into 11 superstores during the 2004 financial year.

Since September 2003, all new superstores and superstore conversions have been in the SMART Arcade format. Going forward, the Directors intend that all new superstores and any conversions of existing superstores will be in the SMART Arcade format, with supermezzanine floors where appropriate.

The Directors' estimates of the average capital costs associated with future SMART Arcades and supermezzanine floors, and the historic initial sales uplifts associated with the new formats in the case of conversions, are set out below. Prospective investors should note that the sales uplift figures in the table below represent historic performance in respect of a limited number of Halfords stores and should not be used as an indicator of uplifts on future store conversions.

Store format	Conversion of existing stores		Opening of new stores
	Average estimated capital cost of conversion <sup>(1)</sup>	Sales uplift after conversion (%)	Average estimated capital cost of new opening <sup>(1)</sup>
SMART Arcade – flat	£40,000	8 <sup>(2)</sup>	£350,000
SMART Arcade – supermezzanine (introduction)	£235,000	29 <sup>(3)</sup>	£520,000

(1) The estimated average capital cost of a conversion or of a new opening is calculated using the historic average capital cost of such conversions/new openings in the 2004 financial year, adjusted to reflect the Directors' estimates of the economies of scale which may be gained from the roll out of the conversion/new opening programme in the current financial year.

(2) The sales uplift for SMART Arcade flat stores represents the average uplift from the first 26 of a total of 66 SMART Arcade flat store conversions undertaken by the Group to date. The sales uplift for a store measures the difference between the relative sales growth of the store in the 26 week trading period before conversion activity commenced, as against the period post-conversion to 5 March 2004 (representing an average of 23 weeks of trading). The relative sales growth of a store is measured as the differential between sales growth at the relevant store compared to the average sales growth over the relevant period of a control group of unconverted stores selected by the Directors to best mirror the sales performance and demographic profile of the particular store. The 26 stores were chosen for this calculation on the basis that they constitute all stores that at the end of the 2004 financial year, had been in operation for a minimum of 26 weeks following conversion. The first two weeks post-conversion are excluded from the calculations to eliminate the favourable impact on sales related to increased promotions available at the newly converted stores during this period.

(3) The sales uplift for SMART Arcade supermezzanine stores (introducing new mezzanine) represents the uplift from the first of a total of six conversions achieved to date. This first conversion also involved the relocation of the store within the same out-of-town site. The sales uplift measures the difference between the relative sales growth of this store in the 26 week trading period before conversion activity commenced, as against the period post-conversion to 5 March 2004 (of approximately 20 weeks). The relative sales growth is measured as the differential between sales growth at this store compared to the average sales growth over the period of a control group of unconverted stores selected by the Directors to best mirror the sales performance and demographic profile of the store. The one store to which this uplift calculation relates has been chosen by the Directors on the basis that it is the only store that had been trading for a significant period of time as at 5 March 2004. The first two weeks post-conversion are excluded from the calculations to eliminate the favourable impact on sales related to increased promotions available at the newly converted store during this period.

In addition to the SMART Arcade flat conversions and supermezzanine introduction referred to above, the Directors have identified the possibility of extending existing mezzanine floors in Arcade superstores by approximately 1,600 sq. ft. to become supermezzanines at an estimated capital cost of £170,000 per store. As at 2 April 2004, three Arcade superstores had been converted to supermezzanines in this way. Whilst the proposed superstore development in the current financial year is centred on the introduction of new supermezzanine floors, the Directors believe that a source of growth could be achieved through mezzanine extensions in the remaining 102 Arcade stores with standard mezzanine floors.

#### *Small stores*

Halfords has created a refined version of the SMART Arcade concept known internally as "Metro" for the Group's stores in high streets and other urban locations. This new format introduces relatively high sales intensity products, previously only stocked in Arcade superstores, together with orange corporate branding consistent with the Arcade superstores, and involves a low capital expenditure outlay. Halfords completed the first conversion in July 2003, and as at 2 April 2004, ten small stores had been converted into this format. In addition, Halfords opened one new store in this format.

The Directors' estimates of the average capital costs associated with new format small stores, and the historic initial sales uplifts associated with the new format in the case of conversions, are set out below. Prospective investors should note that the sales uplift figures in the table below represent historic performance in respect of a limited number of Halfords stores and should not be used as an indicator of uplifts on future store conversions.

Store format	Conversion of existing stores		Opening of new stores
	Average estimated capital cost of conversion <sup>(1)</sup>	Sales uplift after conversion (%)	Average estimated capital cost of new opening <sup>(1)</sup>
Metro	£17,500	17 <sup>(2)</sup>	£230,000

(1) The estimated average capital cost of a conversion or of a new opening is calculated using the historic average capital cost of such conversions/new openings in the 2004 financial year, adjusted to reflect the Directors' estimates of the economies of scale which may be gained from the roll out of the conversion/new opening programme in the current financial year.

(2) The sales uplift for Metro stores represents the average uplift from the first four of a total of ten Metro store conversions undertaken by the Group to date. The sales uplift for a store measures the difference between the relative sales growth of the store in the 26 week trading period before conversion activity commenced, as against the period post-conversion to 5 March 2004 (representing an average of 30 weeks of trading). The relative sales growth of a store is measured by the Directors as the differential between sales growth at the relevant store compared to the average sales growth over the relevant period of a control group of unconverted stores selected by Directors to best mirror the sales performance and demographic profile of the particular store. The 4 stores were chosen for this calculation on the basis that they constitute all stores in operation for a minimum of 26 weeks following conversion. The first two weeks post-conversion are excluded from the calculations to eliminate the favourable impact on sales related to increased promotions available at the newly converted stores during this period.

#### *Online store*

Halfords operates an online "store", where customers can purchase approximately 2,750 products. The online offering is particularly popular for the purchase of expensive and/or bulky products, such as roof boxes, and products that customers can purchase having researched their requirements online at Halfords' website. The online store has received an average of 190 orders per week, and had sales of approximately £750,000, in the 2004 financial year, which represented an increase of 112 per cent. on the previous year.

*Motorway stores*

Halfords also operated stores within 12 service station complexes at Moto roadside sites. The Directors did not consider these stores to be core to the Halfords business proposition and two were closed in the early part of the 2004 financial year. The remaining ten ceased trading in March 2004, their leases having expired on 31 May 2004. All associated closure costs were provided for in the accounts for the 2004 financial year.

**Halfords products and services**

The Halfords product range comprises four core product categories – car maintenance products, car enhancement products, travel solutions products and cycles and cycling accessories. A Halfords superstore carries an average of 11,000 product lines, with the ability to access a further 1,000 to 2,000 product lines by special order (excluding the parts database referred to below). The split of turnover (and the percentage of total turnover) in the 2004 financial year was as follows:

	<b>Halfords turnover FY 2004  (£ million)</b>	<b>Halfords turnover FY 2004 (%)</b>	<b>Halfords own-brand turnover FY 2004 (%)</b>
Car maintenance	172	29.7	63
Car enhancement	202	34.8	20
Travel solutions	82	14.2	47 <sup>(1)</sup>
Cycling	123	21.3	49

(1) Own-brand information for travel solutions products excludes child safety and outdoor leisure products and scooters and accessories where Halfords currently has no own-brand product.

*Car maintenance*

The car maintenance category comprises products required to keep motor vehicles in good working order. Products include parts (such as oil filters, brakes, batteries and windscreen wipers), consumables (such as oils, screen wash and antifreeze), workshop tools and body repair equipment (such as paint and dent repair items). Halfords' turnover for this category has grown at a compound annual rate of 3.4 per cent. in the three financial years to 2 April 2004, which the Directors believe is principally due to the largely non-discretionary nature of car maintenance purchases and increased average transaction values as a result of higher replacement costs for improved technology. The Directors also believe that over this period investment in staff training, to ensure that the customer is sold the correct oil for their car, led both to improved sales of oils and a shift towards selling a greater proportion of more expensive premium synthetic products. Sales of body repair products also improved, due to new product developments, for example, the Halfords scratch repair system and in-store paint mixing service, which provides customers with 48,000 colour options.

Halfords carries approximately 3,400 spare parts in stock in its superstores at any one time and, through its electronic car parts database has access to over 3 million fitments by special order. In the car parts category, 68 per cent. of sales in the 2004 financial year were of Halfords' own-branded products.

*Car enhancement*

Car enhancement products appeal to owners who seek to enhance and individualise the image of their vehicle. Products include in-car entertainment systems (including audio and DVD systems), telematics (satellite navigation and hands-free mobile phone kits), car styling products (such as alloy wheels and exhausts), car cleaning materials and accessories (floor mats and seat covers).

The car enhancement category is currently the fastest growing of Halfords' product categories, with sales increasing at a compound average rate of 14.3 per cent. in the three financial years to 2 April 2004 and growth in this area has centred on car styling products and in-car entertainment and telematics. The Directors believe this growth has been driven by

the extension of technology from the home to the car (e.g. the substitution of CDs for cassettes), the improved affordability of technology suitable for the car (e.g. satellite navigation), a recent UK legislative change regarding the use of mobile phones in cars and the increase in the number of second-hand car transactions.

All of the Group's stores stock car enhancement products including own-brand products, but car enhancement products are particularly prominent in the Arcade superstores, where the Ripspeed sub-shop provides a large area devoted to in-car entertainment, telematics and car styling products, particularly alloy wheels. Halfords is increasingly introducing its own Ripspeed branded products into these sub-shops.

#### *Travel solutions*

The travel solutions category includes products designed to make car owners' journeys safer and less stressful, such as roof boxes, cycle carriers and child car seats, together with outdoor leisure products.

Growth in this category has centred on child car seats where Halfords significantly increased its market share in the 2004 financial year. The Directors believe that Halfords' reputation in this area has grown in the 2004 financial year and that this, together with Halfords' heritage in children's cycles, allows a natural extension into a broader range of outdoor play products aimed at children. This extended range is being trialled, and, if successful, will be rolled out, under the Kidszone sub-brand.

The Halfords offer includes travel equipment carrying the Halfords brand and other brands, such as Thule. Halfords also offers a range of branded child car seats, such as Britax. The Group's superstores provide a full fitting service by trained staff for such products (currently free for child car seats) which differentiates Halfords from many of its competitors in this area.

Following a series of successful trials, Halfords rolled out a range of outdoor leisure products including tents, camping equipment and sleeping bags into all of Halfords' superstores in the 2004 financial year.

#### *Cycling*

Halfords offers a selection of cycles and cycle accessories in all of its stores. These products are particularly prominent in the Group's Arcade stores, where there is a Bikehut sub-shop, offering a wide range of premium brand cycles (e.g. Kona and GT) in addition to other independent mid-priced ranges and Halfords' extensive own-brand ranges including Apollo and Carrera. Bikehut is staffed by trained specialist sales personnel and also offers a pre-delivery inspection and free six week post-purchase inspection for all cycles sold in its stores. In addition, all superstores provide a service and repair offering for all cycles, whether or not purchased at Halfords.

To further enhance the Bikehut offering, Halfords plans to roll out "Bikecare", an annual maintenance plan for cycles, in the first half of the current financial year. For a fixed annual fee, customers will be entitled to an annual service and inspection, paying only for any new parts fitted.

Halfords' own-brand cycle sales centre on the mainstream Apollo brand and the premium positioned Carrera brand. The Apollo brand was, based on turnover, the number two brand for cycles in the UK in 2003 (*Source: GfK*).

#### *Customer service offerings*

Halfords' service offering is focused upon leveraging the skill-set of its staff to provide a range of good value fitting and repair services to its customers. These services are respectively branded to customers as "We'll fit it" and "We'll repair it".

The “We’ll fit it” service offers customers the option of having a range of products fitted on-site to their vehicles. Generally, this service is available on demand, but for more complex fittings an appointment at a time convenient for the customer may be necessary. The products that can be fitted range from consumable products such as car bulbs (for a price of £1.99) and windscreen wipers (for a price of up to £2.49) to more sophisticated electronic items that do not require hard wiring to the car’s power source such as audio units (for a price of up to £64.99) and integrated hands-free mobile phone kits. Generally, Halfords prices the “We’ll fit it” service separately from the product purchase, but in some circumstances (e.g. for child car seats) the fitting service is currently free. To ensure Halfords provides a complete range of services for the most technically demanding electronic fitting requirements, a limited number of third party providers are also used. Such third party providers’ service to the customer is monitored to ensure that Halfords’ reputation for quality and trustworthiness is not compromised.

The Directors believe that the “We’ll fit it” offering is well-positioned to address the increasing complexity of car parts and is ideally suited to the increasing number of “time poor/money rich” consumers. By utilising available store staff, the offering is significantly cheaper than comparable services offered by car dealers and also has the advantage of generally being available on demand. As discussed in “Growth Strategy” above, this area is one which the Directors have identified for increased future investment.

The “We’ll repair it” cycle service offers customers a fee-based service and repair facility in respect of all cycles, whether or not purchased at a Halfords store. Halfords offers “We’ll repair it” in all of its superstores.

### Marketing and communications

Halfords’ marketing strategy aims to differentiate Halfords from existing competitors and potential new entrants by emphasising the combination of competitive pricing, a broad overall product range, enhanced customer service delivered by specialist staff and the availability of fitting services for certain purchased products. In particular, with respect to price competitiveness, Halfords emphasises its price guarantee programme, offering to match the price of any product found at a lower price within a 20 mile radius of any Halfords store. In addition, the Group’s marketing strategy is increasingly to promote its “We’ll fit it” service.

Halfords principally uses press and television advertising to support the price competitive image of its brand, and generally increases television advertising during key trading periods. In general, Halfords’ television and press advertising is national, with local press advertising primarily used at times of new store openings or store conversions.

A further element of this marketing strategy is Halfords’ sponsorship of certain high-profile events whose image complements Halfords’ Ripspeed and Bikehut sub-brands (e.g. British Touring Car Championship team and Cycle Downhill Racing team) as well as the development of marketing relationships with publications, such as “Max Power”, which appeal to targeted customer groups, to add credibility to the Halfords brand or sub-brands.

Halfords has also increased spending on in-store communications (such as point of sale and product displays) to enhance the profile of promotional offers and service offerings.

Total marketing and communications spend in the 2004 financial year was £13.4 million, or 2.3 per cent. of total turnover.

### Supply

In the 2004 financial year, Halfords sourced 83 per cent. of its products from suppliers based in the UK. Halfords sourced a further 10 per cent. from manufacturers or suppliers based outside the UK or from import agents and imported the remaining 7 per cent. through its Far

East operation, established in the 2004 financial year. As discussed under “Growth Strategy” above, the Directors intend to increase the amount of Far East sourcing in order to achieve cost savings.

Halfords has approximately 570 suppliers for retail products based on Group purchases in excess of £1,000 per annum. In the 2004 financial year, the top 20 suppliers accounted for approximately 42 per cent., and the top five suppliers (Tradewinds UK Ltd, Sony UK Limited, JVC Limited, Raleigh Industries Limited and Merida Bicycles Limited) accounted for approximately 20 per cent., of product purchases respectively. None of Halfords' suppliers supplied more than 5.8 per cent. of its merchandise purchases by value during the 2004 financial year. Halfords enters into trading agreements (which are predominantly annual) with most of its key suppliers, which set out the main commercial terms and Halfords' trading policies, such as its commitment to ethical trading practices. The Directors consider the Group's trading relationships with key suppliers to be strong and long standing, with 18 of the top 20 suppliers having traded with Halfords over the five financial years to 2 April 2004. Halfords has not experienced any significant supply disruption in the past five financial years.

To protect product quality, Halfords maintains an in-house quality control function in the UK and the Far East, which provides technical support to new product development and supplier quality assessment (including factory audits).

Whilst Halfords sources many products from single suppliers, alternative products are generally available from other suppliers at short notice. Sourcing products from a single supplier allows Halfords to extract greater discounts by purchasing greater volumes and simplifies the ordering process with little perceived additional risk.

During the 2004 financial year, Halfords established Halfords Asia as a stand alone branch sourcing operation based in Hong Kong. The operation has 12 employees and the Directors believe that this operation will be the base for increasing the level of products Halfords sources from the Far East on a direct basis (see “Growth Strategy” above).

### **Warehousing and distribution**

Halfords operates two distribution centres in Redditch. The larger centre is located at the Group's head office in Washford, where Halfords stores, picks and despatches the majority of product groups. The other distribution centre is in Lakeside which Halfords uses for cycles and bulky items such as roof boxes. Halfords also uses a third distribution centre at Cowley, Oxfordshire, which is operated on a third party basis by Unipart Logistics Limited and is used for storage of car parts and winter fluids such as de-icer. For over-flow storage, Halfords uses appropriate additional warehouses on a spot hire basis.

Halfords generally spreads deliveries to stores across the week (Monday to Friday to avoid peak trading days), and stores have fixed delivery windows and delivery days. The majority of stores receive a minimum of two deliveries per week (one originating in the Washford distribution centre and one in the Lakeside centre), while the 30 stores with highest turnover receive two deliveries per week from each of these two distribution centres. The Lakeside and Washford distribution centres act as delivery points to the stores for products picked in the Cowley distribution centre in order to consolidate vehicle utilisation and minimise store disruption. In Scotland and Northern Ireland, stores receive consolidated deliveries of all product categories enabling lower transport costs to be achieved.

Halfords has a contract with TDG (UK) Ltd, a third party which operates a fleet of 74 trailers and which provides stock deliveries from the Group's distribution centres to the Group's stores. TDG also delivers picked products from the Cowley distribution centre to the Redditch centres on return journeys to Redditch from stores. At peak demand times (e.g. cold weeks in winter when demand for anti-freeze and de-icer is high, or during promotional periods) certain products are shipped from Cowley direct to stores.

Wherever possible, Halfords seeks to distribute all products using its own infrastructure in order to maximise cost efficiencies and minimise store disruption. However, certain suppliers deliver direct to stores. Suppliers bear the cost of these direct deliveries and they do not form part of Halfords' warehousing and distribution costs.

## 7. INFORMATION SYSTEMS

Prior to the CVC Acquisition, the Group's core systems were part of the Boots mainframe infrastructure. At the time of the CVC Acquisition, the Group entered into a transitional services agreement to continue this arrangement for a period of time after the CVC Acquisition. The Group is implementing a three-stage programme to migrate these systems away from the Boots mainframe. The first stage was completed in January 2004 and the second, more technically demanding, stage was completed in May 2004.

Currently, certain of Halfords' replenishment and warehousing systems and certain other less critical systems are dependent on the Boots mainframe. The last stage of the programme which will end this reliance on the Boots mainframe is planned to be achieved by December 2004, in advance of the expiry of the transitional services agreement in March 2005. The Directors believe that the new systems will deliver cost efficiencies in future years and will improve Halfords' ability to replenish store shelves, improve product availability and therefore turnover, whilst reducing inventory. These new systems, which combine SAP Retail™ and PkMS™ software, will replace over 100 existing legacy applications.

In the first stage of the programme, SAP Retail™ was rolled out to Halfords finance and HR functions. In the second stage the majority of the key applications used within the buying and marketing departments were replaced. In the third stage, the replacement of buying and marketing applications will be completed and the distribution centre replenishment systems will be replaced.

Halfords replaced the legacy warehouse management system in its largest warehouse, Washford, with PkMS™ in September 2003, and has scheduled the roll out of PkMS™ to its other warehouses in the current financial year.

Following the completion of the three stage programme outlined above, Halfords plans to improve in-store systems to leverage the initial investment in an integrated systems architecture.

Halfords' information systems department has a low staff turnover, with a 14-year average length of service, resulting in a stable internal base of systems knowledge. Halfords expects its new systems infrastructure will decrease its reliance on its internal information systems department, allowing for cost savings through headcount reduction in the future.

## 8. PROPERTY

The majority of the Group's stores occupy short leaseholds with lease expiry ranging from those currently under negotiation to more than 20 years. The average unexpired lease term is approximately 13 years for superstores and approximately five years for small stores. Only 28 per cent. of the Group's stores have leases expiring within the next ten years.

Store leases typically have a five yearly rent review cycle. Over the three financial years to 2 April 2004, the average increase in rent across the store portfolio has been in the 27 to 40 per cent. range (equating to between five and seven per cent. per annum). At the end of the 2004 financial year there were 55 rent reviews outstanding in respect of which the Group provided for an average rent increase of 37.1 per cent. A total of 90 stores have rent reviews falling in the current financial year and 82 stores have rent reviews falling in the 2006 financial year.

Halfords leases its head office and Washford distribution centre in Redditch on a 25-year lease, expiring in 2029 and rent reviews are at five yearly intervals. The Lakeside distribution centre is held under a lease expiring in 2010.

As a result of the disposal of its garage business in 2001, the AA, a subsidiary of Centrica, is the sub-tenant of the Group in respect of 125 leases as at 2 April 2004. In the 2004 financial year, the rent received from the AA was £6.3 million.

## 9. EMPLOYEES

As at 2 April 2004, Halfords had approximately 9,200 full and part-time employees, representing approximately 6,000 full time equivalent employees ("FTE"). In the head office there are 467 employees, with 232 employees in the distribution centres and the remainder being store employees. The number of part-time personnel is key to ensuring greater availability and flexibility of staff during peak trading periods in the evenings and at weekends and provides a key source of cost control. Recognising this, by reducing the absolute number of contracted hours offered to new employees, Halfords has reduced the proportion of contracted hours worked as a proportion of total hours worked from 81.7 per cent. in the 2003 financial year to 77.8 per cent. in the 2004 financial year.

Staff turnover is a key performance indicator for the Group with total staff turnover in the 2004 financial year being 37.2 per cent. This analysis is segmented by employment type with turnover ranging from nil within the distribution operation, 8.9 per cent. for head office employees to 34 per cent. for full time sales advisors (and 45 per cent. representing part-time sales advisors). The Directors consider the store staff turnover to be below the average for UK retail staff. Significantly, the turnover of specialist sales staff is, at 30 per cent., lower than the company average.

The Group recognises three trade unions in respect of a total of approximately 580 FTE employees. The TGWU represents distribution centre staff, AMICUS represents store managers and the GMB represents head office clerical staff. However, membership of the latter is low and there is no formal agreement in place and no formal negotiations. The Directors believe that relations with all trade unions are generally good; for example, there has been no industrial action in the past five years.

The extent to which individual employees receive incentive-based compensation has increased significantly in the 2004 financial year. Halfords introduced specific sales based bonuses for all store and head office staff who were not previously included within a bonus scheme. Specifically, store staff now participate in a sales based scheme that can yield a maximum payment of £150 per quarter. These continuous bonus programmes are augmented at peak trading periods with specific incentives focused on reinforcing key selling activities prioritised at that time.

Halfords' staff receive product information and selling and customer service skills training. Store staff receive in-house service training (e.g. fitting skills) which is developed in collaboration with internal and external Health and Safety bodies.