



Press Release

13 October 2005

**WH Smith PLC
Preliminary Results Announcement
For the twelve months ended 31 August 2005**

SUBSTANTIAL IMPROVEMENT IN PROFITABILITY; RECOVERY PLAN ON TRACK

KEY POINTS

- **Profit before tax, goodwill amortisation and exceptional items on continuing operations, up 59% to £73m (2004: £46m); High Street Retail¹ up 87% to £43m**
- **Total Group profit before tax is £64m (2004: loss of £135m)**
- **Total sales of continuing operations down 1% to £2.5bn**
 - Retail like-for-like (LFL) sales down 2%
 - News Distribution LFL sales flat
- **Target cost savings delivered faster than planned; additional cost savings of £18m over next 3 years identified**
- **Strong free cash generation of £78m – increased from £12m last year**
- **Returned £205m to shareholders in September 2004 following completion of the sale of Hodder for £224m²**
- **Headline earnings per share³ from continuing operations up 121% to 31.6p (2004: 14.3p)**
- **Earnings per share of 26.0p (2004: loss per share 60.7p)**
- **Final dividend up to 9.2p (2004: 8.0p) making 13.7p (2004:12.0p) for the full year – an increase of 14%**

¹ High Street Retail profit is stated before defined benefit pension service costs, exceptional items, goodwill amortisation, interest and taxation

² £210m in cash and assumption of the Hodder Headline net pension deficit of £14m

³ Headline earnings per share: before exceptional items, goodwill amortisation and FRS17 pension interest – undiluted

Commenting on the results, Kate Swann, Group Chief Executive said:

“This is a good performance for the Group with a substantial improvement in profitability. One year into our plan to deliver value to shareholders we are on track, despite the challenging trading environment.

“In High Street Retail we have improved profitability by 87% versus last year. Our staff have worked hard to manage costs tightly and implement initiatives to increase product availability and choice and to raise store standards.

“Travel Retail has had another strong year delivering good sales and profit growth.

“News Distribution has made steady progress over the year delivering profit growth of 6%.

“Trading conditions on the high street remain challenging. As we approach Christmas, we remain cautious about consumer spending and have planned accordingly.”

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CURRENT TRADING

In the 6 weeks to 8 October 2005, Retail LFL sales were down 2% and gross margin was up on last year. News Distribution sales were down 1%.

FINANCIAL REVIEW

Operating activities

The Group's profitability has recovered significantly with strong performances from all businesses, despite the tough trading climate, particularly in the second half of the year. High Street Retail's profitability recovered substantially compared with the prior year. The focus in High Street Retail has been on good category mix management and tight cost control. Travel Retail delivered a strong performance through sales growth, margin growth and cost control and News Distribution delivered another solid result.

The Group generated a profit before tax, exceptional items and goodwill amortisation from continuing businesses of £73m (2004: £46m), an increase of 59% on the prior year. Profit before tax, after exceptional items and goodwill amortisation, was £64m (2004: loss of £135m).

During the year High Street Retail has delivered £18m of the 3-year cost saving programme, £3m more than the announced £15m target for this year. The business is on track to deliver the total £30m target over three years. We have identified a further £18m of cost savings, in support areas such as shared information systems, logistics and store

efficiencies. We have delivered £2m of these new savings in 2004/05 and the remainder will be delivered over the next three years. We expect the total cost savings broadly to mitigate inflationary pressures in 2006 and 2007.

Headline earnings per share³ from continuing operations increased by 121% to 31.6p (2004: 14.3p) with earnings per share from continuing operations of 30.5p (2004: loss per share of 20.5p).

Given the improvement in the Group's trading position, the Board has proposed an increased final dividend of 9.2p per share (2004: 8.0p), making a full year dividend of 13.7p (2004: 12.0p).

Cash generation was strong due to the improved trading performance in the businesses and good stock and debtor control. Group free cash flow was £78m (2004: £12m). The reduction in net assets to £42m (2004: £256m) reflects the return of cash to shareholders and an increase in the pension deficit as a result of falling bond yields.

Non-operating activities

In September 2004, the Group completed the disposal of Hodder Headline for £224m² and returned £205m to shareholders.

Following the disposal, the Group made a £120m cash contribution to the WHSmith Pension Trust. This payment was financed from the Group's own resources and new banking facilities.

In September 2005, the Trustees of the WHSmith Pension Trust adopted a new investment policy in order to limit the volatility in the underlying investment performance and reduce the risk of a significant increase in the deficit in the fund. A Liability Driven Investment approach has been adopted with 94% of the assets now invested in inflation and interest rate hedged investments (which change in value in line with changes in the underlying liabilities). The balance is in equity options designed to enable the fund to continue to benefit from any potential higher returns from the equity markets.

Following this change in the investment policy, the Board and the Trustees have agreed a new deficit funding agreement. This agreement provides the Company with greater predictability over the level of future pension deficit payments. The agreement replaces that reached last year and will result in pension deficit funding payments of £15m in 2005/06, £17m in 2006/07, £20m in 2007/08 and increasing by RPI (capped at 5%) thereafter until the deficit (as calculated under FRS17) is repaid.

GROUP PROFIT AND LOSS ACCOUNT

Group sales summary

£m	2005	2004	Growth %	LFL Sales Growth %
Sales				
Retail	1,423	1,453	(2%)	(2%)
News Distribution	1,187	1,182	-	-
Sales – continuing	2,610	2,635	(1%)	(1%)
Internal sales	(113)	(115)	(2%)	(2%)
Total sales	2,497	2,520	(1%)	(1%)
Discontinued businesses	11	314		
Reported sales	2,508	2,834	(12%)	

Continuing like for like sales were down 1% year on year. Retail like for like sales were down 2% in the first half of 2004/05 and were down 1% for the second half. News distribution sales were flat for the full year, with like for like sales up 2% in the first half and down 1% in the second half. Overall total sales including discontinued businesses were down 12%.

Group trading results

£m	2005	2004	Profit Growth %
Operating profit ⁴			
Retail	69	44	57%
News Distribution	37	35	6%
Trading profit ⁴	106	79	34%
Central costs			
Support functions	(16)	(15)	(7%)
Pension service costs	(10)	(14)	29%
Internal rents	1	1	-
Operating profit ⁴ - continuing	81	51	59%
Net finance charges – continuing	(8)	(5)	(60%)
Profit ⁴ before taxation - continuing	73	46	59%
Discontinued businesses	-	21	-
Profit ⁴ before taxation	73	67	9%

⁴ Stated before exceptional items and goodwill amortisation

Trading profit was up 34% to £106m.

Pension service costs were reduced by £4m compared to last year, as a result of the introduction of employee contributions, a reduction in certain scheme benefits such as early retirement terms and an overall reduction in pensionable salaries following the organisation review in 2004.

Group operating profit from continuing operations before exceptional items and goodwill amortisation was up 59% to £81m.

OPERATIONAL REVIEW

Retail

£m	2005	2004	Growth %	LFL Sales Growth %
Sales				
High Street Retail	1,112	1,152	(3%)	(3%)
Travel Retail	311	301	3%	4%
Total divisional sales	1,423	1,453	(2%)	(2%)
Divisional profit				
High Street Retail	43	23	87%	
Travel Retail	26	21	24%	
Total divisional profit	69	44	57%	

NB: All divisional profit and loss figures in this section are stated before defined benefit pension service costs, exceptional items and goodwill amortisation, interest and taxation. High Street Retail numbers incorporate the results of WHSmith Online, which has been integrated.

Retail sales fell by 2% to £1,423m (2004: £1,453m) with like for like sales down 2%. Gross margin increased by 240 basis points to 40.5%. Retail divisional profit increased 57% to £69m (2004: £44m).

Stationery sales were up 3% in the year, with sales up 4% in the first half and up 1% in the second half, as the anniversary of last year's initiatives was reached. Book sales for the full year fell by 2%. Book sales in the first half fell by 3% as we did not repeat the previous year's unprofitable promotions. In the second half sales were down by 1% year on year, with a strong performance from sales of *Harry Potter and the Half-Blood Prince*. News and Impulse sales were up 1% on last year; excluding the decline in sales of phone cards, sales grew 2%. In Entertainment, sales fell by 12% versus last year as a result of continued intense competition in the category and our focus on switching sales from low to high margin categories.

Despite difficult trading conditions, profit in the year increased by £25m to £69m with gross contribution increasing by £23m to £576m. Gross margin growth of 240 basis points reflected the shift from lower margin entertainment products to higher margin stationery products and improved buying terms.

High Street Retail has delivered £18m of the 3-year cost saving programme during the year, £3m more than the announced £15m target for this year. The business is on track to deliver the total £30m target over three years. During the course of the year, we identified a further £18m of cost savings, in support areas such as shared information systems, logistics and store efficiencies. We have delivered £2m of these savings in 2004/05 and the remainder will be delivered over the next three years. We expect the total cost savings broadly to mitigate inflationary pressures in 2006 and 2007.

As a result of these initiatives, net margin for Retail increased by 180 basis points to 4.8 per cent.

The Retail business now operates from 669 stores, which occupy 3.3m square feet (2004: 3.3m square feet). We opened five new stores in the year and closed nine stores.

News Distribution

Total sales of £1,187m (2004: £1,182m) were flat for the year. Newspapers sales were up 1%, with price increases and book promotions offsetting volume declines. Magazine sales were flat, with a steady weeklies market, fuelled by a number of new product launches, offsetting a slower monthly market. The number of part works and one-shots declined by 15%, following an exceptionally strong performance last year, including Euro 2004.

Gross contribution reduced by £1m, due to a shift in relative sales from magazines to newspapers.

With a clear focus on tight cost control, profit grew by £2m to £37m. Net margin improved to 3.1% (2004: 3.0%).

The OFT published their draft opinion into newspaper and magazine distribution in May this year. In it, they recognised the unique nature of the news supply chain and suggested current exclusive arrangements are likely to be seen as acceptable under EC competition law. For magazines, the draft opinion suggested that exclusive contracts would remain but would need to allow for passive sales.

We believe having different arrangements for newspapers and magazines may lead to inefficiencies in the market. However, the investments we have made in recent years in service and systems leave us better placed to adapt to any changes that may occur in the market and we are carefully assessing the possible implications as we await the final opinion.

Central costs

Centrally controlled support costs were £16m (2004: £15m) and internal rents on freehold property owned by the Group remained at the prior year level of £1m.

Pension service costs were reduced by £4m compared with the prior year, as a result of the introduction of employee contributions, a reduction in certain scheme benefits such as early retirement terms and an overall reduction in pensionable salaries following the organisation review in 2004.

Exceptional items

In the first half, the Group booked pre-tax exceptional charges of £8m, which related to discontinued businesses. Of this amount, £7m related to an impairment review of the loan notes received as deferred consideration in respect of the disposal of the Group's USA businesses in the prior year. The balance related to further closure and exit costs.

On 25 September 2004, the Group completed the disposal of its publishing business, Hodder Headline Ltd. The business was sold to Hachette Livre S.A. for £210m cash and the assumption of the Hodder Headline Ltd net pension deficit of £14m.

Net finance charges

The results include net interest of £8m (2004: £5m). The increase in the net finance charges from last year is primarily due to the drawdown of the term debt. Net finance costs of the pension fund under FRS 17 were £2m (2004: £4m). This represents the difference

between interest earned on pension scheme assets and interest charged on pension scheme liabilities.

Taxation

The tax charge for the year before tax on exceptional items and goodwill amortisation was £18m (2004: £23m). The effective tax rate on continuing activities, excluding exceptional items and goodwill amortisation, was 25% (2004: 30%).

The Group made significant progress in settling prior year corporation tax liabilities with the Inland Revenue. We expect our effective tax rate to be approximately 25% for some years.

Earnings / (loss) per share

The Group generated Headline earnings per share³ from continuing operations of 31.6p (2004: 14.3p) while earnings per share from continuing operations were 30.5p (2004: loss of 20.5p per share).

Dividends

The Board is proposing an increased final dividend of 9.2p per ordinary share (2004: 8.0p). The final dividend will be paid on 7 February 2006 to shareholders registered at the close of business on 6 January 2006. This will give a full year dividend of 13.7p (2004: 12.0p). The total cost of the dividend is £23m. Excluding exceptional items and goodwill amortisation, the equity dividend is covered 2.4 times by earnings.

As part of the capital reorganisation in October 2004, the Group paid a special dividend of £143m.

Fixed charges cover

Fixed charges, comprising operating lease rentals, property taxes, other property costs and interest, were covered 1.4 times by profit before fixed charges, excluding exceptional items and goodwill amortisation (2004: 1.3 times cover).

FREE CASH FLOW AND CASH BALANCES

The operating free cash flow amounted to £78m compared with £12m in the previous year.

£m	2005	2004
Profit before tax, exceptional items and goodwill	73	67
Depreciation & amounts written off tangible fixed assets	42	46
Cash profit	115	113
Working capital	4	(27)
Capital expenditure	(32)	(49)
Tax	(4)	(21)
Net provisions	(5)	(4)
Free cash flow	78	12

The movement in working capital for continuing businesses was £25m favourable to the previous year, principally as a result of the strong focus on stock levels and improved control of debtors. This can be further analysed as follows:

£m	2005	2004
Stock	6	(16)
Debtors	10	-
Creditors	(2)	5
Working capital – continuing	14	(11)
Discontinued businesses	(10)	(16)
Working capital movement	4	(27)

Capital expenditure

£m	2005	2004
New stores	4	8
Refurbished stores	14	16
Systems*	23	13
Other	4	6
Discontinued businesses	-	6
Total	45	49

* Within systems expenditure are assets funded by finance leases of £13m (2004: £nil) which is a non-cash movement

We have continued to invest in maintaining our retail properties. In High Street Retail we have invested £17m in upgrading our stores and our business systems infrastructure, including installing electronic point of sale (EPOS) systems in all stores.

Net Funds

The movement in the net funds position is as follows:

	£m
Opening net funds	45
Free cash flow	78
Equity dividends paid	(21)
Cash returned to shareholders	(205)
Net purchase of own shares	(7)
Pension deficit funding	(130)
Net disposals	203
Finance leases	(13)
Financing fees	(2)
Premium on issue of shares	2
Sale & leaseback proceeds	2
Closing net debt	(48)

The amount shown for pension deficit funding of £130m represents the difference between the cash contributions to the defined benefit pension scheme of £142m and the associated profit and loss charge, which comprised £10m for operating costs and £2m for financing.

The net disposals of £203m includes gross proceeds of £222m from Hodder Headline and WHSmith ASPAC disposals, less £10m of disposal transaction costs and £9m of advisory fees in respect of the bid approach received last year.

GROUP BALANCE SHEET

	£m	£m
Goodwill		14
Fixed assets		231
		<u>245</u>
Stock	162	
Creditors less debtors	<u>(192)</u>	
Working capital		(30)
Deferred tax asset		20
Corporation tax		(27)
Provisions		(31)
Dividends		(16)
Operating assets employed		161
Net debt		(48)
Net assets excluding pension liabilities		113
Net pension liability		(71)
Total net assets		42

The movement of net assets over the year is as follows:

	£m	£m
Opening net assets		256
Pre-tax profit before exceptional items and goodwill	73	
Tax on above	<u>(18)</u>	
		55
Return of cash to shareholders		(205)
Money returned to ESOP Trust after capital reorganisation		5
Dividends		(23)
Increase in pension scheme deficit		(30)
Purchase of own shares for employee share schemes		(12)
Employee share schemes		5
Net assets before exceptional items		51
Goodwill amortisation	(1)	
Provision for discontinued businesses	<u>(8)</u>	
		(9)
Closing net assets		42

Following the return of cash to shareholders and the increase in the pension scheme deficit as a result of falling bond yields, the Group's net assets declined substantially from £256m at the end of 2004 to £42m this year.

Return on Capital Employed (ROCE)

Total capital employed and ROCE were as follows:

	Operating Capital Employed £m	ROCE %	ROCE % with operating leases capitalised
High Street Retail	187	23%	13%
Travel Retail	24	108%	32%
Retail	211	33%	16%
News Distribution	(25)	-	-
Central items and property	(19)	-	-
Operating assets employed – continuing operations	167	48%	19%

For the prior year, comparable average returns were 37 per cent (14 per cent - after capitalised operating leases)

Pensions

During the year, the Group made significant cash contributions of £142m to its pension scheme. The payments have been funded from the Group's own resources and new banking facilities, now partially repaid. The gross deficit has reduced to £94m from £205m, a total reduction of £111m, with falling bond yields adversely impacting during the year.

In September 2005, the Trustees of the WHSmith Pension Trust adopted a new investment policy in order to limit the volatility in the underlying investment performance and the risk of a significant increase in the deficit in the fund. The assets in the investment fund were restructured in order to adopt this policy. This involved the expected liabilities of the scheme being matched by assets that will alter in value as interest and inflation rates change, matching the movements at the same rate as the pension liability changes ("a Liability Driven Investment 'LDI' policy").

The key features of this fund restructuring are as follows:

- 94% of the fund's assets are invested in an LDI structure with a leading international institutional fund manager
- 6% of the fund's assets have been used to purchase a portfolio of long-dated equity Call options. These represent a notional exposure to underlying equities of some £350m.

The impact of this change in investment policy is to limit the volatility in the fund and the resultant risk of a significant increase in the overall deficit whilst enabling the fund to continue to benefit from any potential higher returns in the equity markets. The overall expected rate of return from the portfolio under the new arrangements is 5% in the 2005/06 financial year.

Following this change in the investment policy the Board and the Trustees have agreed a new deficit funding agreement that gives the Company significantly greater predictability over the level of future deficit reduction payments. This agreement replaces that reached last year and, subject to certain limited conditions, will result in deficit funding payments of £15m in 2005/06, £17m in 2006/07, £20m in 2007/08 and increasing by RPI (capped at 5%) thereafter until the deficit (as calculated under FRS17) is repaid.

Return of Cash to Shareholders

On 27 September 2004 the Company undertook a capital reorganisation whereby existing ordinary shareholders received 18 new ordinary shares and 25 new non-cumulative preference shares of nominal value 85p ('C' shares) for every 25 existing ordinary shares. The new ordinary shares have a nominal value of 2 13/81p each. This capital reorganisation was effected by a bonus issue of approximately £78m, using the share premium account to pay up fully undesignated shares of 31p each, which were then allocated to shareholders on the basis of one undesignated share for every existing share held. The existing ordinary shares and undesignated shares were then consolidated and split, resulting in the issue of new ordinary shares with a nominal value of £4m and 'C' shares with a nominal value of £213m.

In accordance with the terms of the capital reorganisation, shareholders could elect to sell 'C' shares to the Company at 85p per share following which all such 'C' shares would be cancelled by the Company or to receive the initial 'C' share dividend of 85p per 'C' share following which all such 'C' shares would be converted into deferred shares. On 27 October 2004, as a result of these elections, the Company repurchased 73,182,358 'C' shares for their nominal value of 85p each, a total repurchase amount of £62m and paid an initial 'C' share dividend of £143m in respect of 167,686,994 'C' shares.

The remaining 10 million 'C' shares may be purchased by the Company (subject to the provisions of the Companies Act 1985) or converted into ordinary shares at the Company's option and carry a net non-cumulative dividend set at a rate that is the lower of 75 per cent of 6 month LIBOR and 20 per cent per annum. The 'C' shares have limited voting rights.

Financing

A three year £270m facility agreement was signed on 26 July 2004 between the Group, Lloyds TSB Bank plc, HSBC Bank plc and Royal Bank of Scotland plc under which up to £120m was available by way of a term loan facility and where amounts repaid or not drawn down may not be re-borrowed, and £150m is available by way of a multicurrency revolving credit facility. The agreement contains provisions, obligations and certain financial covenants, which are customary in such an agreement. The Group drew down £90m of the term loan facility and repaid £25m in the year, leaving a balance of £65m drawn down at the end of the year.

Operating leases

The Group's stores are held mainly under operating leases that are not capitalised and therefore are not included as a debt for accounting purposes. The High Street Retail leases are on standard 'institutional' lease terms, typically with a 15-year term subject to five-year upwards-only rent reviews. The Travel Retail stores operate mainly through turnover related leases, usually with minimum rent guarantees, and generally varying in length from five to ten years.

The business has an annual minimum net rental commitment of £139m (net of £11m of external rent receivable). The total future rental commitment at the balance sheet date amounted to £0.9bn with the leases having an average life of seven years. The net present value of these commitments is approximately £0.6bn. This is considered to be a satisfactory situation for, although large, these commitments are characteristic of the retail sector and the risks associated with them depend on their liquidity, influenced mainly by the quality and location of the sites.

Currency

Currency exposures mainly relate to the supply of products from outside the UK. The effects of fluctuations in exchange rates on operating profit before exceptional items and goodwill amortisation were minimal in the year.

INTERNATIONAL FINANCIAL REPORTING STANDARDS (IFRS)

The Group is required to prepare its financial statements for the year ended 31 August 2006 and all subsequent periods in accordance with IFRS. This will require an opening balance sheet as at 1 September 2004 together with the income statement and balance sheet for the year ended 31 August 2005 to be prepared under IFRS for comparative purposes.

The principal adjustments to the Group's financial statements will arise from changes to share based remuneration accounting, leases, pension assets, goodwill, accounting for financial instruments and the recognition of dividends. The net impact of the adjustments on the restated balance sheet as at 31 August 2004 is expected to be broadly neutral.

We plan to report our 2005 restated results under IFRS in late November 2005 and we will provide an analysis of accounting adjustments at that time.