

Operating review

Group sales increased by 5.8% (adjusted for exchange rates and trading days) over the same period last year. Unadjusted sales increased 2.9% to £379.5m from £368.8m, whilst profit before tax and goodwill amortisation (£4.8m) increased by 13.7% to £51.5m from £45.3m last year. Return on sales thereby increased by 1.3 percentage points to 13.6% from 12.3%.

Changes in exchange rates, particularly the Euro, had an impact on the Group's reported sales and profits. At constant exchange rates, the increase in sales would have been £11.5m higher and the increase in profit before tax and goodwill, £0.7m higher.

The gross margin of 53.5% was the same as in the first half of last year though this partly reflects the high sales growth of Allied, which has a gross margin lower than that of the rest of the Group.

Progress on our enterprise business system (EBS) projects continued during the half year. The UK business, which encompasses our world-wide Supply Chain and other Groupwide Process activities, is preparing to implement the new system during the second half of calendar 2005. Implementations carried out in France, Australasia, and South Asia last year continue to operate well. Process costs fell to 10.0% from 10.8% of sales.

Cash flow has remained strong and the conversion of operating profit (before amortisation of goodwill) to operating cash flow was high at 109%, although lower than the 117% of last year. This followed a working capital cash outflow of £6.1m arising largely from the stock build to support higher sales growth and the beginning of the stock build to support the forthcoming implementation of EBS in the UK, as well as the high service initiative in China. Capital expenditure increased to £12.2m from £11.8m reflecting expenditure on the EBS and catalogue systems projects. Free cash inflow of £28.3m was £1.2m higher than last year.

Closing net debt was £61.1m, an improvement of £8.2m over last year. Exchange movements since 30 September 2003 had a positive impact of £6.0m mainly as a result of the weaker US Dollar. As in previous years, financial ratios remained strong with high interest cover and low gearing.

United Kingdom

Sales in our UK business showed a welcome return to growth of 2.3% (against the first half of last year) to £180.0m. The first half sales growth was depressed by lower growth in September, partly due to a rephasing of the catalogue launch to 1 October from 1 September.

We have continued to broaden our presence in the growing service and public sectors of the economy, though the overall impact on sales was modest in the half year. We have seen growth in some manufacturing sectors, despite the continued difficulties faced by our manufacturing customers.

Our investment in sales and marketing was sustained and there was a small increase in customer numbers. Our 'Do Great Things' advertising and promotional initiatives continued during the half year and, together with the announcement of Britain's Hero at Work 2004 and further press activity, had a positive impact in increasing awareness of 'RS'.

e-Commerce has continued to show strong growth in the UK and increased 32.3% over last year, reaching 22.2% of sales in September.

The catalogue still remains our most important sales channel. In a project extending over much of the last 12 months, the UK catalogue has been fundamentally redesigned to make it easier for our customers to use. The number of volumes was reduced from seven to five. Products are presented in ranges making it easier for customers to find, select, and buy the products they need. The catalogue was launched a month later than last year on 1 October 2004 and has been well received by customers, although it is too early to judge its overall impact on sales.

Our 15 trade counters have shown significant growth during the half year. The Managed Stock Replenishment service, whereby we manage customers' stocks in their warehouses on a regular basis from a local trade counter, has again been successful as it reduces the customers' cost of managing their stock.

A small decline in gross margin, further investment in selling costs and higher pension costs reduced the profit contribution to £54.8m from £56.8m, being 30.4% and 32.3% of sales respectively.

Rest of Europe

Sales in the Rest of Europe grew by 2.6% (adjusted) to £114.3m although the weakening of the Euro resulted in flat reported sales in Sterling. With the exception of France, Europe returned to good growth of around 6%. In particular, Austria, Spain, and the Benelux countries, recorded double-digit growth.

Sales in France were impacted by the implementation of EBS in June 2003. The problems have now been resolved and customer service levels restored. Day adjusted sales declined by 3.5% in the second half of last year, 2.6% during the first half of this year, but were at the same level as last year in September. Whilst we have not lost customers in France our service problems have meant they have placed less of their business with us and it is taking time to win this business back. The profitability of the business has improved year on year.

In our growing German business, e-Commerce has expanded strongly, now accounting for over a quarter of all sales. PurchasingManager™ has been particularly successful with installations and sales increasing significantly. Sales grew well in Italy, driven by an increase in both customer numbers and increased sales to larger customers. Our smaller businesses all performed well.

Overall, e-Commerce sales grew by 52.9% reaching 23.2% of total Rest of Europe sales in September.

The profit contribution increased to £25.0m from £21.7m, being 21.9% and 19.0% of sales respectively, due to a further increase in gross margin and effective cost management.

North America

Sales in our North American business, Allied, grew by 23.5% (adjusted) to £56.2m although the weakening of the US Dollar resulted in reported Sterling growth of 9.8%.

The sales increase reflects both the impact of our continued sales and marketing initiatives and improvements in the US economy. The Customer First programme launched last year to revitalise the branch network has continued to be successful and the new format catalogue issued in October 2003 also had a positive impact. We have been particularly

active in penetrating larger accounts with our improved product and service offers. e-Commerce remains underdeveloped in our North America business and we are intent on increasing our sales via this channel.

Allied's gross margin remained at around 38% though the increasing average order value in the business from our larger customers has put pressure on gross margins. Profit contribution increased to £7.5m from £5.8m and as a percentage of sales increased to 13.3% from 11.3%, reflecting the operating leverage of the business.

Japan

Sales in Japan grew by 29.7% (adjusted) to £7.8m with a further increase in both customer numbers and the frequency with which customers buy. The reported growth in Sterling was 23.8%.

e-Commerce continues to grow rapidly reaching 47.5% of total sales in September, up from 39% last year. Sales through our PurchasingManager™ and e-Procurement applications have also grown rapidly.

Following recent positive experiences in Europe, catalogue issue frequency has been reduced from twice a year to once a year commencing September 2004, with interim product updates. As in Europe, the number of catalogues issued has been increased. The number of products offered was increased to 50,000 from 47,000 to broaden further the business base.

The business achieved a profit contribution of £0.6m during the half year; an improvement of £1.2m from the loss of £0.6m during the same period last year.

Rest of World

The Rest of World region achieved sales of £21.2m, an increase of 7.0% (adjusted) though reported growth in Sterling was 1.0%.

The main businesses are in Asia where double-digit growth was achieved with China performing strongly. Total sales in North Asia (China/Hong Kong) grew by 14.3% (adjusted), whilst in China sales grew by 17.5% and reached over 30% in September, enhanced by our high service same day offer project in the Shanghai region. This offer will be extended to Beijing in the second half. South Asia enjoyed a return to significant

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growth whilst Australasia maintained its good rate of growth. e-Commerce is developing rapidly in Asia and jumped to 19% of sales in September from 7% last year. Elsewhere, sales in South Africa declined due to the impact of exchange rate fluctuations on our selling prices.

e-Commerce

The Group's e-Commerce sales continued to grow strongly by 42.3% (adjusted) to £71.1m or 18.7% of sales for the half year, whilst in September they reached 20.3% of sales. In the first half of last year, e-Commerce accounted for only 13.9% of sales.

The usual way for customers to access our e-Commerce offer is through our 68 websites in 16 languages around the world. However, our PurchasingManager™ application has continued to show strong growth and there are now 2,700 customer accounts, an increase of around 240% since March 2004.

Enterprise Business System

We are progressing with our systems and change management projects in Europe, including the UK, and in Asia. Through these projects we will standardise our operating procedures and data structures on robust systems platforms so as to support our business growth strategies. The core systems will be common for the businesses in Europe and for the businesses in Asia, with ancillary applications to manage customer contacts, sales force planning, product information, stock forecasting, and warehouse operations. Legacy systems, which are increasingly costly to maintain, will be replaced.

The projects started four years ago with an initial phase to determine the best operating practices that should form the template. France, our second largest RS business, was chosen for the first European implementation of this template with the initial build, testing, and training completed with the go-live in June 2003. Though there were initial operating problems in some areas, which had an impact on service levels, the template works well. The system and operations are robust and service levels have been restored to the previous high levels.

The next European implementation will be in the UK, encompassing our Groupwide Supply Chain and other Process activities, and we expect this to take

place in the second half of calendar 2005. Follow-on rollouts will be in Germany, Italy, and the remainder of Europe. These implementations will benefit from the availability of the system operating in France as users can see how the system works in practice ahead of their own go-live. Testing and training can therefore be more hands-on, more operational and so will be more extensive than was possible in France.

To achieve successful implementations elsewhere in Europe, starting with the UK, additional costs of around £3m this year and around £8m next year will be incurred together with a stock build above normal requirements of £13m in the current year. These additional costs include extra staff to support customer service levels during the testing, training and post go-live phases together with the costs of further developing the template to meet the particular requirements of the UK implementation. This implementation will trigger an increase of depreciation of about £5m on an annualised basis.

In North Asia the project has made good progress, following the successful implementations in South Asia and Australasia during 2003.

Around 81% of the planned capital expenditure for completion of the overall EBS project has been spent. When fully implemented the new systems and procedures are expected to generate significant operating and financial benefits. The maintenance and support expense of legacy systems will be eliminated immediately. After a settling-in period, stock turn improvements and operational efficiencies will be realised. Customers will benefit from improved and wider services, for example by having access to more information on product availability and product choice.

Groupwide Processes

Process costs declined 4.5% to £38.1m from £39.9m, partly due to lower systems costs in this half year. Process costs will rise with the implementation of EBS in the UK next year, due to additional costs and higher depreciation.

Our Supply Chain management has continued to be effective as shown by the higher stock turn of 2.6x (last year 2.5x) whilst at least maintaining customer service levels. The stock build to support the UK implementation will result in a temporary reduction in the stock turn.

In Media Publishing we have invested in a new

catalogue publishing and content system first used to launch the UK catalogue on 1 October 2004. This allows the presentation of products in ranges rather than the previous modular format so that the products are much easier to find and compare. More information on each product is provided together with links to complementary products. Our aim is to make it easier and quicker for the customer to find the product they require from more coherent and relevant ranges.

Pensions

The triennial valuation of the defined benefit section of the UK pension scheme was carried out during the half year and the draft valuation is currently under review. This shows a deficit of £47.7m, or £33.4m net of deferred tax as at 31 March 2004. We have not adopted FRS 17 and do not intend to do so, as we expect to move to International Financial Reporting Standards next year. Under FRS 17 the estimated net deficit would be £28m.

We expect that UK pension costs will increase by £2.8m this year as a result of the valuation. Of this, £1.4m has been included in the first half results.

International Financial Reporting Standards

We will implement International Financial Reporting Standards for the year ending 31 March 2006 and our preparations are well advanced. We plan to indicate the impact of the transition to IFRS on both the opening balance sheet and ongoing profit and loss account after our next year end when our application of the accounting policies will have been fully determined.

Summary

Both sales growth and operational gearing have been demonstrated by these results, most notably in North America and Japan. e-Commerce has again grown strongly.

Our enhanced selling and marketing activities are important continuing investments. The EBS projects gather pace with the UK implementation during next year. This is a critical implementation for the Group as a whole and is being managed and resourced as such.

Our investments reflect our commitment to realising the profitable opportunities available to the Group, as reflected in the first half results.



Ian Mason, Group Chief Executive



Richard Butler, Chief Process Officer



Jeff Hewitt, Deputy Chairman and Group Finance Director

9 November 2004

Note: The term 'adjusted' relating to sales growth means adjusted for exchange rates and trading days.