

Strategic review

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I am pleased to report that we completed the first year of our turnaround plan ahead of our expectations, having stabilised the Group's operating and financial performance and made good progress on all of the strategic initiatives contained within our three-year plan.

Protecting and revitalising our stores business

Our stores business performed strongly throughout the year, demonstrating the strength and resilience of our market leading brands. We continued to plan and adapt for structural change taking place in our markets by refocusing our mix of products to higher growth categories, improving the communication with our customers and enhancing our store environments.

HMV

HMV UK & Ireland is adapting to the changing ways in which entertainment is being consumed.

The HMV brand has been reinvigorated by new integrated in-store and online promotions, which invite our customers to 'Get Closer' to the content we sell. This powerful approach to advertising, combined with improved campaigns, especially around the key seasonal gifting periods, improved customers' perceptions of the HMV brand and helped us to significantly outperform the markets in which we operate. In music HMV UK & Ireland grew unit sales, even though during the period the market saw volume declines, and in DVD our sales volumes increased by over 18% in a market in which units grew 8%.

We also embarked on successful trials of a 'next generation' store format, featuring a social hub providing access to entertainment websites, multi-player games zones and transactional kiosks. All product lines in the trial outperformed the rest of the chain, providing a basis in the coming financial year to convert 10–15 stores and open all new stores in the new format. After the end of the period, HMV Canada also opened its first next generation store in Toronto.

HMV UK & Ireland successfully rolled out a range of technology products, predominantly MP3/MP4 players and related accessories, which have been very well received by our customers. We continued to enhance our credibility with customers and suppliers in the fast-growing games console and software market, and are planning to launch a pre-played games offer in 2008/09. Games and technology products now represent 21% of HMV UK & Ireland's sales mix, up from 14% in the prior year. By taking the key learnings from the UK, a similar focus has been applied in HMV Canada, where these products grew to 7% of sales from just 1% in the prior year.



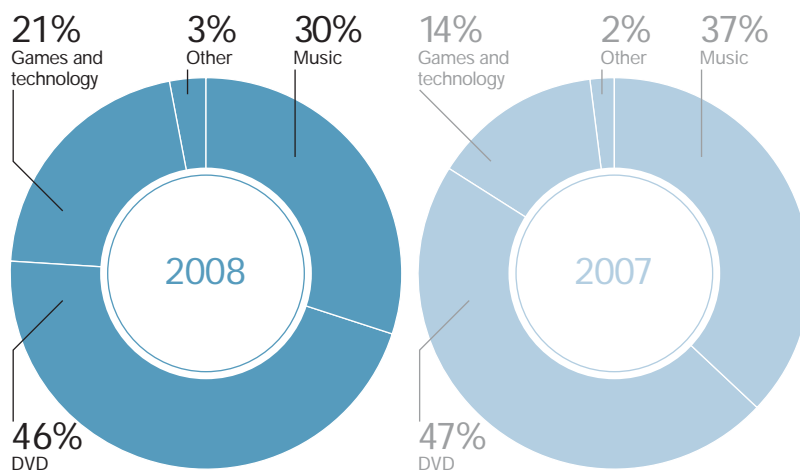


Above:
Trials of 'next generation'
stores have been a great
success, with more openings
to follow.

Right:
Multi-player gaming zones
attract customers to this
high growth format.



Below:
HMV UK & Ireland
mix progression



We acquired seven entertainment stores and various related trademarks from the administrator of Fopp, and opened our first new Fopp store in Bristol in March 2008. The differentiated customer offer and local appeal of these stores have been successfully preserved, offering the potential for a small number of future openings.

Waterstone's

Core to improving performance at Waterstone's was our focus on enhancing our engagement with customers, the emphasis on service in branches and the growth of our online business.

The biggest single initiative to help build links with our customers has been the Waterstone's multi-channel loyalty card, which launched in September 2007, and now has 1.5 million cardholders. The card enables Waterstone's customers to earn and redeem points in-store and online and to enjoy further benefits, such as meeting authors and the chance to receive and review pre-publication copies of new books.

Engagement with Waterstone's local communities was increased during the year through organising events and other activities in our stores. Over 6,300 events were held, including 1,700 children's events, and the launch of Harry Potter and the Deathly Hallows attracted over 250,000 visitors to midnight openings at our stores, which helped to double our market share over the previous Harry Potter book.

Below:
Waterstone's loyalty card had 1.5 million members after just nine months.

Right:
Waterstones.com functionality includes the ability to check stock availability in local stores.



Above:
Fopp's differentiated customer offer has been retained following the acquisition of seven shops and related trademarks.



The appeal of our product offer and store environment was enhanced during the year by the successful introduction of new children's departments and a high quality range of gift stationery into 100 stores, where these new ranges have performed well.

Growing revenue from new channels

The hmv.com website was enhanced during the period by new branding and customer communication, which contributed to growth of over 40% on the previous year and an increased share of the online market. CD and DVD sales from hmv.com are now approaching 10% of HMV UK & Ireland's total sales.

The choice to purchase physical or digital music albums from a single shopping basket is now integrated into hmv.com. This ensures that, as and when all of the major music suppliers make their catalogues available in the MP3 file format, the site is well positioned to sell downloads which are compatible with any portable digital music player. A subscription service, HMV Jukebox, was also launched to provide unlimited online access to over 3 million music tracks for a single monthly payment.

We commenced trials of a new social discovery website, getcloser.com, through which music and film enthusiasts can share their interests and experience user-generated and copyright content. The site, which will be supported by advertising, sponsorship and e-commerce, will launch in beta on 1 July 2008.

The competitiveness of waterstones.com was enhanced by changes made to delivery and customer communication, and sales from the site grew by over 140% on the prior year and customer registrations are now more than 850,000. The ability to check local store stock and collect orders from local branches is proving particularly popular with online customers, while the Waterstone's loyalty card has added a further, powerful multi-channel link between our stores and the website. Additional benefits to the operation and service of waterstones.com will follow as fulfilment for the site transfers to Waterstone's new book hub in the new financial year.

Driving cost efficiency

Good progress has been made on restructuring the Group's cost base and to deliver on our planned savings by 2010.

Combining the back office finance and IT functions of HMV UK & Ireland and Waterstone's and centralising – both businesses' – procurement of goods not for resale, successfully delivered the anticipated savings of £6m for the year.

Waterstone's appointed Unipart as its supply chain partner, leading to a new book hub serving all stores and fulfilment for waterstones.com becoming operational after the period end. The transition from direct-to-store deliveries to the book hub has been de-risked by the phased take on of stores, which will be completed by the end of the new financial year. Consequently, the delivery of cost savings from this initiative will be deferred until 2009/10. The programme to simplify HMV UK & Ireland's supply chain remains on track to become operational during the new financial year.

At the end of the period, Waterstone's total square footage had been reduced by 6.7% out of a three-year target of 10% by April 2010.

Creating value

At the beginning of the year a review of strategic options for HMV Japan concluded that greater value for our shareholders could be created through a disposal of this business. The price achieved of Yen17bn on a debt and cash free basis (£70.6m) was a multiple of 9.0 times historic EBITDA, and with the proceeds we significantly reduced the Group's debt.

Outlook

One year into our transformation programme, we are ahead of where we had planned to be, although there remains much more for us to do. Whilst we are mindful of the challenging economic outlook, the current financial year has started in line with our expectations, and we remain confident of achieving our medium-term targets for 4.5%–5% return on sales and 2.0 times dividend cover at the end of the financial year 2009/10.

Simon Fox Chief Executive Officer
30 June 2008

Below:
getcloser.com, our social discovery site, is now live.

