

Business Review

Operating Review

Chief Executive's Operating Review

In what has been an extraordinary year, we have made excellent progress towards our strategic goals, including new contract wins that will transform our scale and competitive position, and the acquisition of Bertrams, which is an important first step towards diversifying the Group. In August we took responsibility for 20 depots and associated staff from Dawson News, bringing forward the implementation of our contract wins. The transfer has been implemented with the high standard of service for which we are known. As a consequence, the business finishes the year materially stronger, with new opportunities for growth and diversification.

I am pleased to report a solid financial performance in difficult market conditions. Underlying profit before tax of £30.5m decreased by 6.2%, a reflection of the tough market conditions in newspapers and magazines. The Group continued to generate a strong cash flow of £23.7m. Total dividend for the year of 6.8p represents an increase of 1.5%.

In March, the Group acquired the business and assets of Bertrams from the Administrator of the Woolworths Group, our first significant entry into a complementary market. Bertrams, the UK's longest established book wholesaler, has similar characteristics to Smiths News, serving a diverse customer base with an offer based on service and efficiency. Bertrams has an approximate 45% share of the book wholesaling market. It is a business that fits well with the Group both culturally and strategically. We are pleased with the early progress of Bertrams and its integration into the Group.

Early in 2009 the majority of the national newspaper and magazine publishers invited tenders for new distribution contracts. Smiths News was successful in its overall approach to the tenders, increasing its market share of newspaper and magazine distribution from circa 39% to 55%. This was a spectacular result and a clear endorsement of the strategy we have pursued over the last three years. The contract wins will transform the scale of Smiths News, offering new opportunities for efficiency savings as well as providing retailers and publishers with a more consistent and higher standard of service.

In July, Smiths News commenced distribution to the new contract areas awarded by News International in June 2008. The News International contract expanded our operating areas to include Bristol, Brighton, Coventry Harlow, Luton, Swindon and Warrington. This expansion of our network involved 2,900 new customers and increased our market share of News International business from 24% to 39%. As the time of transfer neared, at News International's request, we started delivery to some areas two weeks ahead of schedule. The planning for the News International contracts also helped us to prepare for the further new territories that would unexpectedly follow in August.

Following the award of the publisher contracts, Dawson News (having been unsuccessful in the contract tender process) carried out a strategic review, concluding it needed to seek an orderly exit from the market. It was equally clear that the financial difficulties of Dawson News risked an immediate and damaging failure of the supply chain. As a consequence, in August 2009 Smiths News assumed responsibility for the leases of 20 depots and connected staff from Dawson News, reaching parallel agreements with our publishers for the associated distribution contracts.

In effect, this meant our entry into the new territories would commence up to 18 months earlier than expected. This was a huge undertaking, carried out with minimal notice and requiring a massive collective effort from everyone in the business. It is a tribute to the dedication and professionalism of our staff, including our new colleagues from Dawson News, that we achieved such a major transition with minimal disruption.

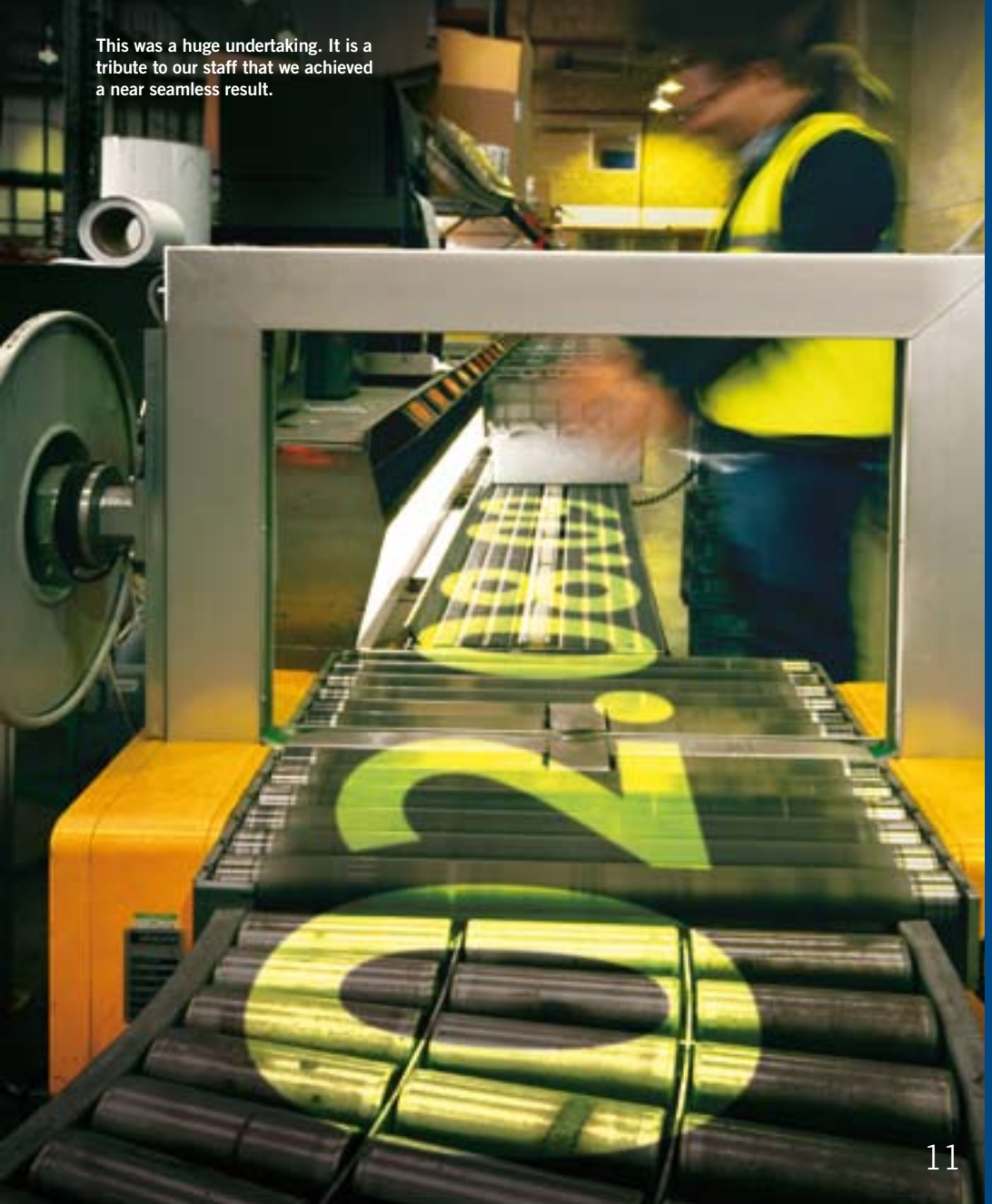
The new contract gains will increase our revenues in 2010. However, the integration of the new contracts will result in a series of one-off costs covering redundancy payments, IT and process changes. These will impact on our costs and cash flow over the next 12 to 18 months. The new depots are currently reliant on legacy processes and technology; this is significantly less efficient than our core business, which is supported by SAP. We have already begun installing SAP into the new depots, as this is essential to reducing their operating costs and raising service standards.

In such a remarkable year it is easy to forget the progress we have made on the core operation. Our tight control on costs has continued, with cost savings of £3.3m achieved throughout Smiths News. Service too improved, with more depots achieving the highest standards of performance and consistency. I have no doubt that our relentless drive in these core objectives has been the foundation of our success. We continue to target, at a minimum, the offset of inflation as a benchmark for efficiency improvements, and we have much work to do to ensure the new depots are operating to the market leading standards we expect.

Looking ahead, the prospects of the Group are stronger than ever. Despite the toughest market conditions for some years we returned a solid financial performance, demonstrating our resilience and determination to succeed. As we enter our new financial year, the Group is transformed from its position 12 months ago, with new opportunities and the ambition to match. Most importantly, we can take confidence in our people, whose drive for excellence is demonstrated daily. They can be justly proud of what they have achieved and I would like to thank them all for their contributions this year.

On Sunday 2 August we took on 20 depots and 5,000 retailers all in one go.

This was a huge undertaking. It is a tribute to our staff that we achieved a near seamless result.



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Markets

Newspapers and Magazines

The market for newspaper and magazine distribution has been tough, sales being affected by the general reduction in consumer spending. Newspaper price increases failed fully to compensate for volume declines but the overall market value was marginally up after allowing for the temporary and promotional price cutting on some titles. As anticipated, the magazine market performed less strongly with reductions in volume and value across most market segments; overall the magazine market value was down 7.6%. Despite these declines, Smiths News performed well ahead of the market, driven by new contract gains.

Books

The total value of books sold to consumers in the UK was down by 1.3% in the first half of 2009 (The Group acquired Bertrams in March 2009). Bertrams' performance was ahead of this trend despite sales being adversely affected by the administration of the Woolworths Group and consequent impact on stock levels. Since its acquisition by the Group, Bertrams has performed well, regaining market share and having particularly strong sales in the Internet and International sectors.

Group Strategy and Objectives

The Group aims to be the market leader in newspaper, magazine and book distribution, and a major player in new markets that build on our skills and competencies, creating demonstrable value for shareholders.

We plan to deliver profit growth and cash generation to our shareholders by following clear focused strategies that benefit all stakeholders.



Kerrie Colford
- PR Manager, launching new corporate website

'The company has grown and developed enormously since demerger in 2006. This year's contract wins and the acquisition of Bertrams were transformational and we needed a website that reflected what's happening in the business. We set ourselves high standards for what we wanted the site to achieve. After researching what our stakeholders wanted, we added a lot of new tools, including a whole new interactive investor centre. Do take a look at www.smithsnews.co.uk'

Looking ahead, the prospects of the Group are stronger than ever.

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Progress against objectives during 2008 / 2009

In the 2008 Annual Report I outlined our priorities for the year ahead. We have made good progress in all areas.

Service excellence - *to maintain our position as the best service provider for publishers and retailers, developing a menu of services that can be tailored to customer needs.*

Service has continued to improve across Smiths News, with a greater consistency of performance as all depots reach the same high standards. In July 2009 all of our depots achieved 100% compliance to their key performance indicators. This relentless drive on service has been the foundation of our success in winning new contracts.

Independently conducted surveys, which are carried out on a monthly basis, continue to show our service as 'best in class', with retailers and publishers scoring Smiths News as the best service provider in 48 out of 61 service categories.

We invested £2.5m in upgrading our technology infrastructure; this will improve performance of our systems and increase their capacity in line with the requirements of the new business gains. We also continue to develop our market leading EPoS and Sales Based Replenishment solutions, which help customers respond quickly and efficiently to consumer demand.

Bertrams too has service at the heart of its customer proposition. We have increased the availability of titles in stock and feedback from customers confirms that service is improving after a difficult period during the administration of the Woolworths Group

Cost control and business efficiency - *to reduce the operating costs of the core business, targeting to offset the impact of inflation.*

Savings were achieved across Smiths News, with like-for-like costs reducing by £3.3m. These savings came from a variety of areas, including depot reorganisations, lower sales volumes, energy efficiency and a number of local cost reduction initiatives.

Network development and contract implementation - *to improve and expand our network without disruption to the core business, particularly focusing on those new areas of operation that will come into effect from July 2009 as a result of the additional business with News International.*

We have made outstanding progress. The network was expanded in readiness for the implementation of the News International contract gains, with new depots in seven locations. In August, our network increased by a further 20 depots that were previously operated by Dawson News. These depots were required to service the new territories resulting from our successful contract wins. Further details are included later in this report.

In addition to the new territories, we continued to review and develop our existing infrastructure. In December, a state-of-the-art depot was opened in Newport, combining operations across all of South Wales. We further consolidated operations in the East Midlands following the opening of a new depot in Nottingham in May 2008.

Contracts and new business gains - *to renew successfully those contracts that are reaching maturity and win additional business in areas that strengthen our profitability and strategic positioning.*

We renewed our contracts with all major publishers, increasing our market share of newspaper and magazine distribution to 55%. The contract wins confirm Smiths News as the clear market leader and will deliver an estimated £459m of incremental revenue, albeit at reduced margins.

	Estimated Additional Revenue* £m
News International	85
Telegraph	53
Trinity Mirror	47
Marketforce	44
Frontline Group	58
Seymour	26
Associated Newspapers	65
COMAG	35
Guardian	16
Express	30
Total	459

*based on current sales values

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We were sorry that we were unable to retain the contracts for Blackpool, Lancaster, Sheffield and Carmarthen. The loss of these territories was a consequence of publishers' network strategies and is no reflection on the service standards at these locations.

Regional Press publishers have also awarded us new contracts, with notable gains from Newsquest and Johnston Press. The total revenue of these contracts in 2010 is projected to be £10.5m. This is an area we are targeting for further growth.

Business development - *to identify and develop opportunities to use our skills and competencies in new market segments.*

We have made good progress despite the general economic conditions being less conducive to new business expansion. The acquisition of Bertrams creates opportunities to leverage our skills in the books market, and we are confident that over time, both Bertrams and Smiths News can benefit from working more closely together.

On a wider note, we have identified a number of markets in which we might expand our interest, with a clear understanding of where and how we can add value. But we will not be rushed or compromise delivery of our other priorities.

Talent management - *to invest in our people, ensuring we have and retain a pool of industry leading talent at all levels of the business.*

We have made good progress with our talent strategy, creating a Leadership Group as a focus for our most senior managers and supporting this with development pools at lower levels. We launched a graduate programme and an apprentice scheme and will be expanding these in 2010.

Earlier this year, Bertrams won the East Region Learn Direct Achievement Award for a Small/Medium sized company, recognising Bertrams' sustained commitment to learning and development.

Looking ahead, we are fully committed to developing the skills of our people, providing satisfying careers and extending the range of opportunities for employees to progress.

Objectives for 2009 / 2010

We have identified six priorities:

- **Business gains**
The full integration of the depots acquired in August 2009, including the implementation of our SAP information system at all locations. We plan to integrate without disruption, and quickly establish our market leading systems and processes.
- **Service excellence**
To raise the standards of service in our newly acquired depots towards those of our established locations, providing greater service consistency to customers throughout our network. We plan to deliver enhanced services that will improve profitability for all stakeholders, including an expansion of our Sales Based Replenishment service.
- **Cost control**
To maintain tight cost control across all business in the Group, achieving a like-for-like reduction in costs at least in line with inflation. We plan to introduce our efficient operating practices into the new territories operated by Smiths News and we will target savings in Bertrams through synergies and operational best practice.
- **Bertrams**
To increase the sales and profitability of Bertrams by applying the Group's expertise in service and efficiency. We plan to invest in Bertrams and to exploit the opportunities between its customer base and that of Smiths News.
- **New business development**
To research, prepare for and be alive to new business development opportunities that would enhance the Group.
- **People**
To increase our pool of market leading talent. We plan the implementation of new succession and leadership programmes, an extension of the graduate and apprentice schemes, and widening of opportunities for all staff.

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Key Performance indicators

Smiths News

The most important performance measures are those that our publishers and retailers identify as having the biggest impact on their businesses. We maintained our excellent performance in all of these areas during the year, operating well above targeted levels. Performance against these measures is listed below.

Measure	2009	2008
Newspaper pack accuracy	99.8%	99.8%
Magazine pack accuracy	99.7%	99.6%
On-time delivery	97.0%	96.3%
Newspaper returns collection on-time	99.8%	98.0%
Magazine returns processing accuracy	99.9%	99.9%

In addition to these and other measures we commission independently conducted customer surveys of our service to publishers and retailers. The results show that key customer groups consistently rate Smiths News as the market leader for service.

Bertrams

Measure	2009	2008
Availability of titles in core range	94.1%	92.7%
On-shelf stock integrity	99.8%	97.2%
Same day despatch	100%	100%
Delivered next day	98.2%	98.2%
Telephone calls answered in less than 20 seconds	93.3%	87.6%

This strong performance shows improvements year on year and reflects the concentrated focus on customer service following the Group's acquisition of Bertrams.

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Major Business Developments

News International implementation

In July 2009 Smiths News commenced delivery to the new territories awarded by News International. The new contracts expanded the network by an additional seven depots, serving 2,900 new customers; a further 3,300 of our existing customers were also affected by the contract changes as they had previously received their News International titles from an independent wholesaler.

Detailed planning was required to ensure a smooth transition and a seamless transfer from the previous wholesaler. Our preparation was such that we were able, at News International's request, to commence distribution to a number of territories, two weeks ahead of schedule.

Since July, the distribution to the new territories has progressed without any significant incidents, key performance targets are being met and retailers are pleased with the new service they are receiving.

Contract gains and network expansion

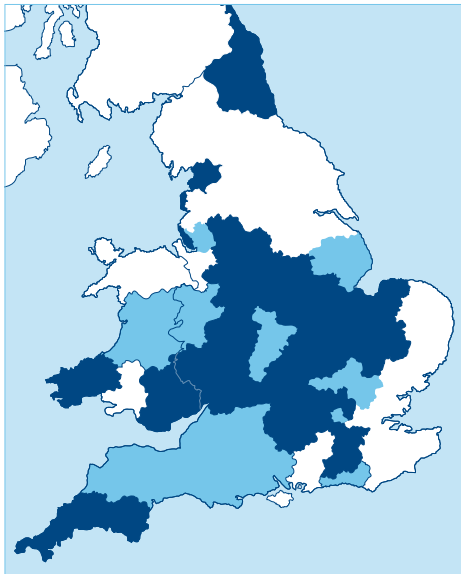
The new contracts, awarded by publishers early in 2009, have transformed the scale and reach of Smiths News.

The contracts were due to take effect by way of phased implementation over a two-year period. However, following the contract awards, Dawson News (which had lost most of its business) entered administration. In order to maintain continuity for customers Smiths News reached agreement with the administrator to assume responsibility for the leases of 20 depots, together with associated staff; parallel agreements were reached with publishers for distribution to the new contracts areas. The new distribution arrangements commenced on 2 August 2009.

Prior to the agreement an application for merger clearance was submitted to the Office of Fair Trading. The transaction was subsequently approved in August 2009.

The transfer of such a large number of territories inevitably required considerable one-off costs, and over the coming year further investment and one-off non recurring costs are anticipated. However, in the medium term, the early transfer of these territories means Smiths News will be well placed to exploit efficiencies and improve service for customers.

The map below shows the impact of these awards on our areas of operation.



New distribution areas gained in 2009 are in light blue. Dark blue shows pre-existing areas.

Note to map: Contracts were not successfully renewed in Carmarthen, Sheffield, Blackpool and Lancaster. For the time being these depots remain fully operational and we will assess their ongoing viability over the coming months, taking particular note of the impact on staff.

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Bertrams

In March the Group acquired the business and assets of Bertrams from the Administrator of the Woolworths Group. The opportunity matched our strategy of seeking to broaden our operational base with activities that complement the Group's core operation. We expect Bertrams to be earnings enhancing in its first full year of ownership and to generate returns well in excess of our cost of capital.

Bertrams is a highly respected book wholesaler, with a strong management team. It sells to independent and multiple retailers, services on-line orders and supplies to libraries on a contract basis. This profile is a close match to Smiths News and although Bertrams will operate as an independent unit, there is opportunity to share skills and experience across the Group.

Since March, Bertrams has performed well regaining market share and winning new contracts in the library sector. The major book publishers have been supportive in helping the business get back on track after the uncertainty caused by the Woolworths administration. Similarly, retail customers are pleased that Bertrams has joined a strong Group and they are benefiting from increased stock levels and improved service. We have also identified new efficiency improvements, drawing on the Group's expertise in service and logistics.

Over time we believe Bertrams will offer us significant opportunities. The book wholesale market has many similar characteristics to newspaper and magazine distribution and it is a logical diversification at this stage in the Group's development.



Michael Neil - Managing Director, Bertrams, glad to be part of Smiths News PLC.

'Being taken over by Smiths News was the perfect outcome for Bertrams. After a difficult few months we emerged happily from under the debris of Woolworths. The customers have been hugely supportive and have stuck with us. Our business has rallied quickly under the ownership of the Group - we've benefited from its financial stability and credibility with the book trade. This has given us the time to plan and deliver our two major trading opportunities effectively - back to university and Christmas. There are lots of opportunities for 2010 and we are looking forward to continuing to build the business.'

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Industry Regulation

In September 2009, after a lengthy review of the industry, the Office of Fair Trading (OFT) announced that it would not be referring the industry to the Competition Commission. In its review, the OFT identified a limited number of potential concerns, but concluded that it was not going to refer the industry to the Competition Commission for further investigation. Wholesalers, publishers and the major retailers have welcomed this decision. It will allow the industry to focus on developing the supply chain and responding to the regulatory changes brought about by earlier announcements from the OFT. Details of these are given below.

In October 2008, the OFT announced its findings in relation to the terms of newspaper and magazine contracts between publishers and wholesalers. The OFT gave its opinion on the award of distribution territories conferring 'absolute territorial protection' to the relevant wholesaler. The OFT concluded that in relation to newspapers such contracts were likely to meet the criteria for exemption under section 9 (1) of the Competition Act 1998; in relation to magazines the OFT concluded that the contracts would require amendment to remove the exclusivity provisions conferring absolute territorial protection for all but the most time-sensitive of titles. Smiths News has subsequently reviewed its publisher contracts to ensure compliance.

Newspaper Code of Practice

For many years the National Newspaper Code of Practice (the Code of Practice) governed the supply of newspapers to retailers who wished to receive supplies. In October 2008 the OFT made a provisional recommendation that wholesalers should be released from their undertakings under the Code of Practice. The Secretary of State for Business subsequently confirmed this recommendation in April 2009 and the Code of Practice has been formally withdrawn with effect from October 2009. Smiths News has subsequently reviewed its policies, removing the restrictions that were in place under the Code of Practice and making it easier for retailers to receive supplies of newspapers and magazines.

Further details of the OFT's announcements can be found on the OFT website http://www.offt.gov.uk/oft_at_work/markets/goods/newspapers-magazines/

Corporate Responsibility

The Group takes a proactive approach to corporate responsibility. We recognise that responsible business practices have benefits for all stakeholders. Our approach to corporate responsibility embraces our workplace, our marketplace, the environment and the communities we serve.

Further details of our corporate responsibility policy and our initiatives can be found on page 33 of this report and on our website www.smithsnews.co.uk

Smiths News will be well placed to exploit efficiencies and improve service for customers.

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Staff

The skill and determination of our staff is behind everything we do. We recognise that investing in people is key to making the Group a better and stronger company.

This year we've made further improvements to our succession planning, staff development and coaching programmes. We also launched a leadership skills framework to help us recruit and develop the right people for the right roles.

We believe in setting clear standards of performance and where applicable we link an element of remuneration to the achievement of personal goals. Performance is monitored on a regular basis and the process is supplemented by six-monthly reviews, which identify areas of development that will benefit the individual and the Group. Ultimately, our goal is to have a pool of market leading talent at all levels of the business.

A major component of our network expansion was the transfer of 1,800 employees from Dawson News. In the absence of the transaction the jobs of these staff were at serious risk given the financial situation of Dawson News. The integration of the new businesses will inevitably require a number of redundancies, but we will ensure these are managed professionally; we have established clear principles, ensuring every employee is treated fairly, and will be investing a significant amount of time in the consultation process.

As the Group expands we are determined to remain close to our staff, involving and engaging them in the future of the Company. Our recent employee survey was returned by over 70% of staff; the results showed we have a highly committed work force and gave us an in depth view of the issues that motivate and concern them. As a result we have identified a number of areas that we are targeting for improvement, including central communications and staff benefits.

Outlook

After a year of transformational change, the Group has clear priorities for the year ahead.

The implementation of the new contract gains has started well and we are pleased with the performance of Bertrams. We have clear plans to reduce costs in those depots we acquired in August and will maintain our relentless focus on service and efficiency throughout the Group.

Our markets remain challenging, but in recent months there has been a slight improvement in sales trends and we have made a good start to the year. We look forward to reporting another year of progress and believe Smiths News is well positioned for future growth.

Risks and Uncertainties

The Group operates in large and generally stable markets. Our revenues are relatively predictable and, with strong cost control, we can mitigate the risks to the achievement of targeted profits. We have robust internal procedures to monitor costs and revenues: the Risk Committee reviews the principal strategic and financial risks on a regular basis and the Audit Committee reviews the risk process - the findings are reviewed by the Board twice each year.

Our assessment of the principal risks is listed below.

- **Integration of new contract gains**

The integration of the new depots following the contract gains encompasses a wide range of operational and technical issues, in particular the installation of the SAP information system at all new locations. A failure to meet key deadlines could result in rectification costs, reduced efficiency and failure to achieve contractual KPIs.

Smiths News manages one of the UK's largest and well-established SAP installations with over 10 years experience of implementing the system within the business. The Board has identified the integration as the Group's top priority in the coming year and the necessary resources have been allocated to manage the project effectively - progress will be monitored on a continual basis.

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- **Impact of passive sales**

In line with guidance issued by the OFT, the new contracts awarded by magazine publishers make allowance for sales outside of the designated territories in response to request from retailers. Previous contracts were more restrictive, generally being granted on the basis of 'absolute territorial exclusivity'. The new arrangements could create an incentive for retailers to seek alternative suppliers, with a consequent impact on sales, margins and costs.

The combination of a leading service and most efficient operation means Smiths News is well placed to respond to any such requests.

- **Retail sales**

A reduction in retail sales would have an adverse effect on revenues and lower circulations could also undermine the business model of publishers leading to title closures.

National newspapers have a long-term trend of price increases offsetting the impact of volume declines. Magazine sales are more variable by sector and recent performance has seen a reduction in volume and value. The extent to which this decline is a temporary response to recent economic downturn, or is more 'structural' in nature, is at this stage uncertain.

In the medium term Smiths News is well placed to mitigate these risks. The contract wins have resulted in significant increases in market share and sales revenues; they also create opportunities for efficiency gains. The relative stability of the markets helps us to anticipate and plan for any worsening of conditions, enabling us to take appropriate action to protect profits.

- **Digital media**

The potential for consumers to move from traditional newspapers, magazines and books to digital media could have an adverse effect on sales and growth opportunities.

We recognise that the consumption of digital media will increase but believe there remains a strong future for traditional printed publications. Publishers increasingly see the channels as complementary and they continue to invest in print and production facilities. The vast majority of publishers do not make substantial profits from stand-alone digital alternatives so there are strong incentives for continued investment in traditional channels.

The Group will continue to closely monitor developments in the digital market.

- **Property and lease commitments**

Potential liabilities could crystallise in respect of previous assignments of leases where the liability could revert to the Group if the lessee defaulted. Pursuant to the terms of the Demerger Agreement, any such contingent liability, which becomes an actual liability, will be apportioned between Smiths News PLC and WH Smith PLC in the ratio 35:65 (provided that the actual liability of Smiths News PLC in any 12 month period does not exceed £5m). The company's share of these leases has an estimated future cumulative gross rental commitment at 31 August 2009 of £26.6m (2008: £34.4m).

Although the total liability is significant, many of the leases were assigned to retail companies that continue to trade well and are financially robust. Given the expiry of time, it is also likely that many of the leases included within the contingent liability have expired or been regeared.

For those leases that revert to the Group it is possible they can be re-assigned or sublet within a short time period

The cash impact resulting from the estimated future cumulative gross rental commitment would spread over more than 10 years.

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- **Continued difficult economic environment**

Continued difficult financial conditions could affect the ability of the Group's customers to pay on time.

The Group monitors payments carefully and has a strong track record of cash collection from its customer base. Payment for newspapers and magazines from smaller retailers is generally received on a weekly basis and their reliance on this product means that settlement of our invoice is generally prioritised.

Of our larger customers, the top five are major UK PLCs with good payment records and credit ratings. We also have credit insurance against a number of smaller multiple retail chains.

The failure of one or more of our key customers could result in exposure to a significant cash shortfall.

The Group's largest credit risk is to some of the UK's major retailers who have strong credit ratings. The average credit period taken on sale of goods is 21 days (2008: 21 days). We continue to manage our credit risk tightly to ensure our customers comply with payment terms.

Reduced liquidity could put at risk our ability to meet loan and other trading commitments.

The Group continues to generate strong free cash flow and is operating well within its existing banking covenants. The Company's bank facilities consist of a £40m term loan, a £50m revolving credit facility and an asset backed facility of up to £20m on the debtors of Bertrams; these are in place until June 2011, subject to a £5m term loan repayment in June 2010. We continually monitor any variance between forecast and actual cash flows in managing our liquidity risk.

The Group's treasury and risk management is set out in the Financial Review on page 30. The principal financial risks (capital, market, credit and liquidity) are detailed in Note 23 to the Financial Statements.



James Simmons - News International Project Manager, masterminding the addition of five new depots.

'It's certainly been a busy year! Winning the News International contract increased our footprint across the UK and helped us pick up other contracts that were being renewed. We've strengthened our reach, creating five new depots from scratch, capable of handling the demands of 2,800 new customers. Our distribution now encompasses an additional 170 routes, covering an extra 6,500 miles each day. We're certainly not taking a breather, instead we are focused on improving the network and growing the business.'