

Chief Executive's business review

Marc Bolland

Our performance over the year confirms our broadening customer appeal, successfully delivered in a wide range of stores from 11,000 to 40,000+ square feet. We have identified significant potential to attract new customers and will focus on space growth in order to take us from a national to a nationwide company.

Strategy update

Our three year strategy, as laid out in our 2007 Annual report, is to position the business as the UK's 'food specialist for everyone'. This builds on our historic strengths of value and fresh food quality, now applied to a national, bigger business following the Safeway acquisition in 2004. As a food specialist, we are clearly differentiated from our larger competitors, all of whom are seeking to expand their non-food credentials. We also emphasise our deep understanding of food: through being closer to source than other retailers, through our unique manufacturing and packing facilities, through the amount of food preparation undertaken in our stores and through the employment of more specialist butchers, fishmongers and bakers than our competitors. We stress that our offer is for everyone, because our great food is also always great value.

Our strategy builds on our strengths, and is in tune with our customers' need for excellent value and their increasing focus on the health, provenance, quality and freshness of the food they buy. In order to deliver our strategy, we have previously outlined the building blocks that need to be put in place, and our plans to do this by 2010. These include freshening up our stores and improving and developing the infrastructure of the business in the key areas of manufacturing, distribution and operating systems. The operating review of the year, set out on pages 6 to 8, highlights our progress towards these goals.

Store estate development

From our position as the fourth largest grocery retailer in the UK, we see significant opportunities to expand our store estate. As the food specialist for everyone, it is our conviction that we offer a real difference in grocery retailing that is highly attractive to a broad range of customers. However, there are many parts of the country where we remain under-represented. We estimate there to be over eight million households in the UK which are not located within a 15 minute drive of a current Morrisons store. This represents a higher target customer base than any of our three larger competitors. Our offer works well in a wide range of store sizes, from 11,000 to over 40,000 square feet, giving us flexibility in site selection. A key part of our strategy, therefore, has been to grow the number of Morrisons stores, and in 2007 we published a target of adding 1.0m square feet of new space by January 2010. Our acquisition of Co-operative/Somerfield stores, completing in the coming year, will see that target exceeded by 0.5m square feet, and we are confident that we will open a further 0.5m square feet of retail space in the year to January 2011.

We believe that delivery of our strategy of expansion and further optimisation of the operation of the business has resulted in strongly improved profit margins for our shareholders, whilst also positioning the Group for long term growth.



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Our focus on fresh food and value appeals to shoppers everywhere and provides a strong platform to take Morrisons from national to nationwide.”

Chief Executive's business review continued

Solid shareholder investment and returns

The Group is securely financed and has a strong balance sheet. We are confident that our planned investment requirements can be met from existing facilities. We will continue to pursue a prudent approach to financial management which is based on a number of principles:

- we wish to maintain a strong investment grade balance sheet;
- operational control of our retail stores is fundamental to us;
- we are a prudent organisation and we structure our finances accordingly; and
- our defined benefit pension schemes' assets and liabilities are effectively part of our balance sheet, and should be managed as such.

The Board concluded in March 2008 that surplus capital of £1bn should be returned to shareholders during 2008 and 2009, with £500m of that to be delivered in the first 12 months of the programme. Whilst £146m was returned in 2008 through share buybacks, the Board also identified new investment opportunities for the Group, over and above our original plans. These were the acquisition of stores from the Co-operative Group, the purchase of the freehold interest in our planned distribution centre at Sittingbourne and the acquisition of the freehold interest of four existing stores which, combined, account for unplanned investments of £460m. The Board believes these growth opportunities represent a more attractive deployment of capital than the planned share buyback. The Board also believes that further investment opportunities may arise in the medium term and has therefore decided that the capital originally earmarked for share buybacks in the 2009/10 financial year should be retained within the business to give Morrisons maximum financial flexibility.

We have targeted progressive dividend growth in 2008 and 2009, over and above earnings growth, in order to bring dividend cover to a level in line with the average for our sector, which is around 2.5 times, by January 2010. Funding for this enhanced return to shareholders will come from operating cash flow and committed facilities available to the Group.

Operating review of the year

2008/09 was another good year for Morrisons – we made sure that we offered our customers great value every day, in a rapidly deteriorating economy, whilst still investing for the long term future of the business.

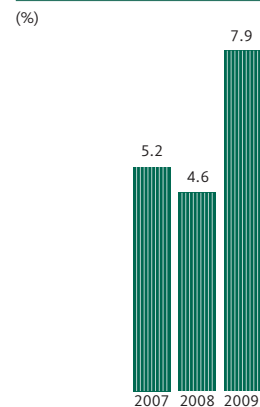
New retail space

We opened nine new stores in the year, at Giffnock, Gorleston, Whitefield, Kidderminster, Granton, Northallerton, Blandford Forum, Clifton (Nottingham) and Holyhead. Two of these (Giffnock and Kidderminster) were replacements of existing stores and two (Blandford and Northallerton) were former Safeways, which had been closed since the acquisition due to their small size. Our decision to reopen them reflects our growing confidence in the operation of, and return from, smaller stores, and we have been pleased with their performance. A further two of the stores (Gorleston and Clifton) were previous Co-op/Somerfield stores that we acquired and converted to Morrisons. In both cases we saw very significant uplifts in sales compared to those achieved under their former ownerships, and as a result we were pleased, later in the year, to agree the acquisition of a further tranche of stores from the Co-op/Somerfield that we will open in 2009/10.

Key Performance Indicators

Like-for-like sales (ex-fuel)

+7.9%



Like-for-like sales is the measure of growth in existing stores.

Source: internal

We continued our programme of store extensions, with 90,000 square feet added in the year, and ended the year with 382 stores and a total of 11.1m square feet of retail space, growth of 2.7% on the start of the year.

Turnover growth

Turnover grew by £1.5bn to £14.5bn, a 12% increase. Part of this increase (c.3%) was due to the very high prices of fuel seen in our forecourts business in the year caused by a worldwide spike in oil prices, and this will unwind again in the coming year as pump prices have come back down. We were pleased with our stores sales growth, which was industry leading and broad based. Like-for-like sales, the measure of growth in existing stores, increased by 7.9% with customer numbers up 4.2% and average basket spend up 3.6%.

Market share growth

Based on TNS market research data, we believe our grocery market share grew from 12.1% to 12.3% in the year.

	Like-for-like stores	Other	2008/09 Total	2007/08 Total
Sales of goods (£m)	11,877	317	12,194	11,238
Fuel (£m)	3,523	74	3,597	2,871
Total sales inc VAT (£m)	15,400	391	15,791	14,109
Turnover exc VAT (£m)	14,171	357	14,528	12,969
Sales per square foot (£)	21.65	13.46	21.41	20.18
Customer numbers (m)	500	11	511	482
Customer spend (£)	23.92	21.14	23.86	23.10

Geographically, we grew in all regions, with the South particularly strong as the Morrisons brand continued to become better known. Across our store estate, we grew in all sizes of stores, with smaller stores below 25,000 square feet leading the way. Our market research shows that we won customers from all major competitors in the year. In-store, our Market Street ranges did well, responding to our strong emphasis on fresh food preparation. Our own-label ranges all showed growth, albeit the strong trends of the previous two years towards premium products slowed, with Eat Smart up 13%, the Best up 5% and Organics up 10%. By contrast, the Value range – relaunched in the year – saw 50% growth.

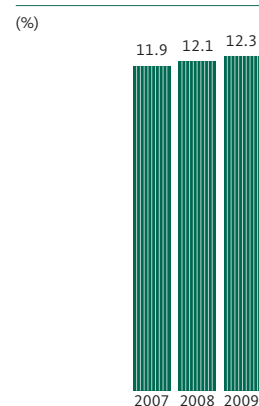
Industry leading offers

The growth of the Value range reflected the very difficult economic environment experienced by consumers throughout the year. Commodity price inflation, which began in 2007 but fed through strongly into products during 2008, meant that customers were paying more for their weekly shopping basket for the first time in some years. At the same time, disposable incomes were decreasing due to the impact of high energy prices, reduced availability of mortgage credit, a rising tax burden and increasing unemployment. We were quick to respond to the challenges being faced by our customers. Whilst we maintained our focus on the quality, healthiness and provenance of our food, we also delivered a year of innovative value offers to our customers. We launched over 21,000 price cuts throughout the year, and designed our promotions to help customers save money while eating well. Our £4 meal deals proved very popular, and we switched more of our promotions into 'half price' rather than 'buy one, get one free' in response to customers' need to spend less each week. We helped customers to treat themselves too, with great value deals such as 2 for 1 offers on party foods, the Mamma Mia DVD for £7 and a range of games for Nintendo Wii at £10. In the run-up to Christmas, we rewarded our most loyal customers with a £20 shopping voucher through the Collector Card scheme.

Key Performance Indicators

UK Grocery market share

12.3%



We have increased our 52 week UK grocery market share with good performance across the whole country and particularly strong growth in the South.

Source: TNS

Chief Executive's business review continued

In addition to value messages, we continued to profile our unique food production capabilities, in our factories and in Market Street, and our understanding of food provenance. Our broad appeal and community involvement was well illustrated by our new schools initiative, 'Let's Grow', which is designed to help schools teach children how to grow food. Over 18,000 schools registered for the scheme, well beyond our expectations, and in February 2009 we began to dispatch free planting and gardening equipment including over 30,000 tools, 29,000 pairs of gardening gloves, 13,000 bags of compost and over 10,000 growing kits.

Operating results

Our forecourts business grew strongly in the year. As fuel prices moved above £1 per litre, consumers became highly price conscious and shopped around for value. We made sure that our pricing was always highly competitive, and indeed led the market back down below the key £1 price point when oil prices again began to fall. Average unleaded pump prices were 103.5p in the year, compared with 94.9p the previous year. Litreage grew by 11%, in a declining market.

Summary income statement	2009 £m	2008 £m	Change %
Turnover	14,528	12,969	12
Gross profit	913	818	12
Other operating income	37	30	23
Administrative expenses	(281)	(268)	(5)
Property transactions	2	32	(94)
Operating profit	671	612	10
Finance income and cost	(16)	-	(100)
Taxation	(195)	(58)	(236)
Profit for the period	460	554	(17)

Gross profit grew in line with the level of turnover growth. The gross profit margin of 6.3% was level with the previous year, although lower than it would have been due to the dilutive effect of high fuel sales, which have a very low margin. The impact of this, we estimate, was a 20bps reduction in margin. Offsetting this was the release of a provision first taken in 2005/06 relating to the rationalisation of our distribution infrastructure. The original provision was £75m, and after taking all final costs associated with this restructuring we were left with a balance to release of £8m, which is included in gross profit. The details of this can be found on page 71 of the accounts. Adjusting for these two effects, our gross profit increased by 0.1% despite the headwind effect of high energy costs in our stores and supply chain. We successfully mitigated these costs through continued delivery of our Optimisation Plan.

The Group's two biggest costs, after cost of goods sold, are store wages and distribution costs. After a number of years of strong improvement in store labour productivity, the year under review saw us investing in customer service to support our sales growth. Despite this, labour costs as a proportion of sales improved by 0.5%. The cost to deliver each case through our distribution network continued to fall, despite higher fuel costs, with a further reduction of 2.5% year-on-year. We gained good benefits from new systems that improved the efficiency of our delivery schedules.

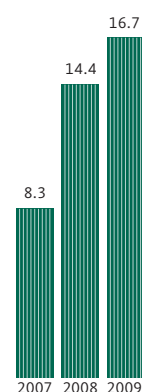
Our administrative expenses were up by 5%, below the rate of the turnover increase, reflecting tight control of our overheads. Marketing costs, which account for over one-third of administrative expenses, increased in line with turnover, as we continued to seek, with success, to articulate the Morrisons story to a wider audience.

Key Performance Indicators

Underlying earnings per share

16.7p

(pence)



Basic underlying earnings per share has increased 16%.

Optimisation Plan progress

Our aim is to become the 'Food Specialist for Everyone', and that means:

Food specialist

We really understand food:

- we know where it comes from
- we pack it and make it in our factories
- we make it in our stores
- we employ craft skills in every store

For everyone

Great food which is also:

- great value
- for every day, not just special days.

Our Optimisation Plan, originally communicated in 2007, set out a number of programmes designed to deliver by our financial year ending January 2010, and we remain well on track. Key elements of the Plan included:

- refreshed and rebranded stores;
- range extension and product innovation;
- investment in further manufacturing capacity;
- an increase in distribution capacity in the South;
- in-store efficiency initiatives;
- replacement of our systems; and
- Corporate Social Responsibility initiatives.

Progress in each of these areas is outlined below.

Refreshed and rebranded stores

Customers visiting Morrisons today experience a modern and unique food specialist, following the successful completion of the programme to freshen-up our stores and brand. The programme covered the exterior and interior signage of the stores, our Market Street counters, our trucks and our filling stations. All work was completed, on time, at an average cost per store of £0.5m – a very cost effective new design scheme when compared to similar programmes elsewhere. Alongside the physical work, all staff were fitted with uniforms carrying the new brand and over 3,000 own-brand Morrison products received new packaging.

Range extension and product innovation

Our product ranges, too, have been extensively reinvigorated. Range development has been particularly strong in 'Value' lines but value and freshness are not incompatible, as seen in the launch of our innovative 'Fresh Ideas' ready-to-cook fresh meals, which offer a great value alternative to dining out.

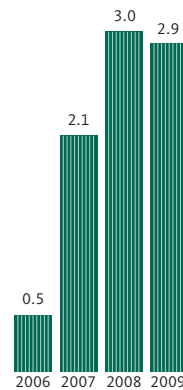
Our control of the fresh food supply chain, through our bakeries, fruit and vegetable packing facilities, meat and cheese processing plant and abattoirs gives us great flexibility to respond to changing customer needs and priorities. The value conscious behaviour that came to the fore in 2008 provided us with the opportunity to use this flexibility to great effect. We led the industry with great value deals on fresh foods, such as our £4 family meal deals which comprised eight fresh food items for 50 pence each. Such deals, when advertised, create great demand, and it was only our close control of the supply chain that allowed us to cope with the volumes generated

Key Performance Indicators

Dividend cover

2.9 times

(times)



We have targeted progressive dividend growth in 2008 and 2009, over and above earnings growth, in order to bring dividend cover in line with the average for our sector, which is around 2.5 times, by January 2010.

Chief Executive's business review continued

without disappointing customers looking for a bargain. Similarly, our abattoir and butchery operations are designed to use the whole animal, with minimal food waste. We have long sold lower priced cuts of meat such as brisket and neck fillet, which make delicious meals at bargain prices. These cuts are once again popular, and Morrisons is best placed to provide such variety and value. Equally, by being close to the source of supply, by being in the livestock markets every day and by only offering fresh fish on our counters, our fresh meat and fish quality cannot be matched even by much more expensive competitors.

Our advertising campaigns built on the previous year's success, with a continuation of the 'Fresh Choice for You' message placing emphasis on freshness, in-store production, in-season food and our food provenance knowledge. We continued to use down-to-earth, approachable personalities including Helen Baxendale and Richard Hammond – the campaign produced the highest consumer recall in 2008¹. Our research has confirmed that the campaign has significantly increased consumer awareness of Morrisons and what we stand for. To balance the 'Fresh' message, we launched a high impact 'Price Crunch' campaign in April, which ran through the rest of the year and was used to highlight our great value offers and everyday prices. This too, struck a chord with our customers.

Distribution network investment

We continued to invest in our infrastructure as part of our Optimisation Plan. The new distribution centre at Sittingbourne, in Kent, is well under way. It will manage the growing volumes of our business in London and the South East and will open by the end of 2009. We took the opportunity to acquire the freehold of the site during the year, at a cost of £80m, in order to ensure maximum flexibility for the future. We were pleased to open our new abattoir at Spalding during the summer of 2008, and it is already producing at high volumes and very good levels of efficiency. This extra capacity has been key to ensuring that we can offer fresh pork, beef and lamb that is all UK sourced and all processed by us – something unique in British supermarket retailing.

In-store efficiency initiatives

We continue to invest in ways to improve customer service whilst also becoming more efficient in our stores. Following a successful trial, self-scan checkouts are now rolling-out to over half our stores. Queue management software, which predicts very accurately the number of tills required to be open to serve the customers in store, is also at an advanced stage of roll-out.

Replacement of our systems

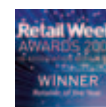
The Group's major programme of systems renewal continued to make good progress during the year, with detailed planning completed and Wipro, one of the world's premier computer services companies, selected as our implementation partner. As previously announced, the implementation programme began in late 2008 with the pilot phase of our new human resources and payroll system, which will go fully live during 2009. The coming year will see the implementation of financial systems, depot systems and the start of the roll-out of the new point of sale systems into stores. In 2010 we will begin to replace systems in our manufacturing facilities, throughout the supply chain and the product masterfile.

We were proud to win all three major industry titles in the same year.

Retailer of the Year 2008 & 2009

Retail Week

We are the only retailer to have won this prestigious award for two consecutive years, being commended for the use of imaginative and extensive marketing to highlight our traditional strengths in fresh produce and our competitive stance on price.



Supermarket of the Year 2008

Retail Industry Awards

The judges commented that we won the award because we came back stronger following a challenging period; they also noted the efforts we had made in refreshing our product ranges.



Grocer of the Year 2008

The Grocer Gold Awards

The Grocer judges praised Morrisons for the success of its stores' refresh programme and our focus on the fresh food offering of Market Street.



¹ (source: Marketing Magazine – Adwatch)



Corporate Social Responsibility initiatives

Much of our investment, whilst improving the business, has also improved our carbon emissions. In the past two years we have invested £66m in new, efficient refrigeration capacity in our stores and £18m in new trucks and trailers. These measures have improved our chill chain, and also significantly reduced our emissions. A similar programme to replace all our petrol pumps with new, low emission technology, is well advanced, with 220 out of 287 filling stations having been re-pumped at the year end. As a result of these and other initiatives, our target to reduce our carbon footprint by 36% from 2005 levels has been achieved one year early. We are delighted to be the only grocery retailer to have been awarded the new Carbon Trust Standard for carbon reduction.

Long term growth

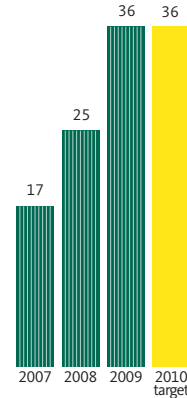
The overall investment requirements for the Optimisation Plan, outlined last year, are £450m over and above the normal run-rate of capital investment, and the programme will run to January 2010. In 2008, £182m of this was invested, bringing the cumulative total to £250m.

Alongside the Optimisation Plan, our new space programme laid out a target of opening an additional 1.0m square feet of retail space in the three years to January 2010. We are well on course to achieve that through our normal pipeline of new stores and store extensions, but over and above this target, the acquisition, announced in November, of smaller Co-op and Somerfield stores, which will complete in 2009, will add around a further 500,000 square feet to our estate to bring the total at 31 January 2010 to approximately 12m square feet.

Key Performance Indicators

Carbon footprint*

(% cumulative reduction)



We have met our target of 36% reduction of CO₂ emissions one year early from a base set in 2005.

* Source: externally validated using Defra's Environmental Reporting Guidelines.