

Financial review

The Group's results for 2008/09 have been strong once again, building on long term growth and strong cash flow generation.

Cash generated by our operations continue to fund capital expenditure, reduce the pension deficit and reward our shareholders by surplus capital returns and dividends.

The Operating review of the year in the Chief Executive's review provides commentary on the performance of the Group over the past year. The volatility in the financial markets impacted the economy as a whole and we are pleased that our results remained strong during this time. We have improved operating cash flows during the year and continue to have a strong balance sheet supported by long term financing.

Underlying earnings

Underlying earnings is a measure we use to assess normal underlying business performance and trends. The Group's earnings are adjusted to remove highly volatile or one-off costs. A reconciliation of underlying earnings is provided in note 1 of the Group financial statements.

Underlying earnings before tax increased by £73m to £636m, driven primarily by the strong like-for-like sales performance. The Chief Executive's review contains further information on turnover, customer numbers and retail space.

Savings from Phase 2 of the Optimisation Plan have helped to mitigate input price inflation pressures and energy cost increases.

Earnings per share (EPS)

Underlying earnings per share is the EPS measure we use to remove the potentially volatile impact of property gains and net pension interest income and consequently underlying EPS provides a better measure of the normal underlying business.

Basic underlying earnings per share increased from 14.38p to 16.67p.

The share buyback contributed 0.14p (6%) to the increase (see below) but the primary reason was the year-on-year underlying profit growth.

Summary cash flow

	2009 £m	2008 £m
Cash generated from operations*	1,064	856
Interest and tax	(145)	(127)
Capital expenditure	(678)	(402)
Disposal and divestment proceeds	22	94
Pension deficit funding	(100)	(100)
Share buyback and issues	(143)	17
Dividend	(131)	(108)
Long term cash on deposit movement	74	(74)
Financing	246	(269)
Net cash inflow/(outflow)	209	(113)
Net debt	642	543

* Before pension deficit funding.

Cash generated from operations

Cash from operating activities increased by £208m (24%) reflecting the strong profit generation of the Group from increased turnover and good profit conversion, combined with cost control throughout the business and improved working capital management.

Interest and tax

Interest received fell £21m from last year as the continuing fall in bank interest rates during the year adversely impacted our interest receivable on cash on deposit.

Interest paid remained at £70m for the year. The revolving credit facility was utilised for the first time in October 2008, resulting in a small increase in floating-rate bank interest payable. Interest paid to bondholders is at fixed rates, and this cost reduced by £8m this year following the maturity of a £250m bond in August 2007.

Corporation tax payable in the year was £104m. This cash outflow represented 50% of the tax bill for the year to 3 February 2008, and 50% of the tax for the year to 1 February 2009, as well as repayments received for prior years.

The effective rate of tax for the year was 30% which is 2% above the prevailing corporate tax rate of 28%. The higher rate is mainly a result of non-qualifying depreciation and expenses where the Group is unable to obtain tax deductions.

The principal objective of the in-house tax department continues to be to pay the appropriate level of tax at the right time. We actively engage with the UK tax authorities and aim to be transparent in all of our activities. The Group is predominantly UK-based, operates a simple business model, and does not engage in sophisticated tax planning structures.

Capital expenditure

Capital expenditure cash outflow was £678m, an increase from £402m last year, reflecting additional focus on growing the estate and supporting the Optimisation Plan as well as taking advantage of opportunities arising from the weakening of the commercial property market.

Normal planned capital expenditure

We opened nine new stores and extended a further 18 stores, as well as a number of projects strengthening the retail estate and the supply chain.

Optimisation Plan investment

The rebranding programme was completed throughout the estate, at an average cost per store of £0.5m. A new abattoir was developed and opened in the year, and a vegetable packhouse extended in order to increase capacity. A Group-wide programme to replace our IT systems entered the design phase and we began work on our new distribution centre in the South East of England. Total Optimisation Plan investment in the year was £182m.

Unplanned investments

During the year, we took advantage of the weakness of the commercial property market by acquiring the freehold of four stores that were previously leaseholds, as well as the freehold of our planned new distribution centre at Sittingbourne in Kent. The total cost of these investments in the year was £120m. As a result, the proportion of freehold to leasehold properties in the estate grew to 95%, and we regard this as a key strength of the Group's balance sheet.

Pension

Pension deficit bridge

	£m
Net pension deficit at 3 February 2008	(68)
Actual vs expected return on scheme assets	(425)
Higher discount factor	328
Funding above annual service cost	103
Other	13
Net pension deficit at 1 February 2009	(49)

The continuing volatility in the financial markets does not change our view that, on completion of the actions arising from the Pension Review announced last year, these schemes are adequately funded for the long term. The markets will have to be continually monitored for emerging trends to ensure this continues to be the case. The move from a final salary basis to one of Career Average Revalued Earnings (CARE) is the final action planned from the review, and is intended to make the schemes affordable for the future. If, following the consultation, the proposals are adopted, then it is anticipated that the valuation of the liability will decrease by c.£90m.

Scheme valuations for accounts purposes were inevitably impacted by the turmoil in the financial markets, which had an effect on both the asset values and the liabilities of the schemes. The return on scheme assets was £425m worse than actuarially expected, due mainly to falls in the equity markets. This was offset by the reduced long term value of scheme liabilities resulting from a rise in the long term real discount rate.

The injection, as planned, of £100m of additional funding in the year combined with the move to CARE for future benefit accrual will leave the schemes well funded for the long term and in a small surplus position on current actuarial assumptions.

Financing

The Group has a £1.1bn revolving credit facility which is not due to mature until September 2012. At the year end £250m had recently been drawn, allowing significant headroom for the Group's activities and investments.

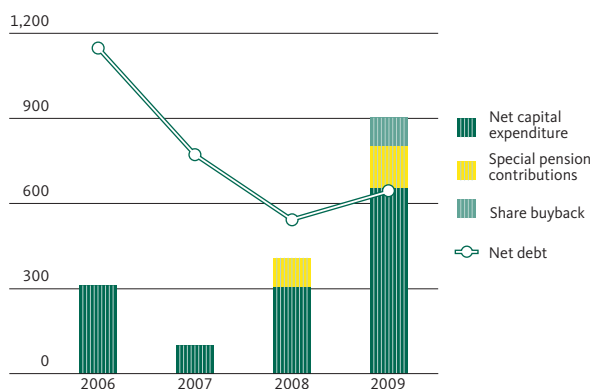
The Group's bonds, originally issued by Safeway plc, were retained in the acquisition of the Safeway Group in 2004. The next bond repayment is due April 2010 for €250m. Moody's rating of these bonds was upgraded to Baa1 in March 2008.

Financial review continued

Net debt

Net debt at the year end increased slightly from £543m to £642m. Increases in capital expenditure, additional pension funding, and the share buyback have required significant cash funds. Much of this was funded by cash generated from operations, demonstrating our solid underlying cash flow. Despite this high level of investment, we were pleased to have utilised only £250m of the revolving credit facilities at the year end.

Net debt £m



Net debt has only slightly increased despite increasing levels of investment.

Returns to shareholders

Returning surplus capital to our shareholders

In March 2008, we announced a two year share buyback programme to return £1bn of surplus capital to shareholders with a target of £500m in the first year. By the end of 2008, we had repurchased and cancelled 57.8 million shares costing £146m. In view of the acquisition of the Co-op stores, the purchase of a number of freeholds and the possibility that further attractive investment opportunities may arise in the medium term, the Board has 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.

Progressive dividend growth

The final dividend is proposed at 5.0 pence per share, making the total dividend for the year 5.8 pence per share, an increase of 21% on last year.

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. Funding for this enhanced return to shareholders will come from operating cash flow and committed facilities available to the Group.

Optimisation Plan

Our Optimisation Plan is to strongly improve operating margins, whilst shaping for growth.

The Optimisation Plan was announced in March 2006 as a medium term plan to bring profitability back in line with sector standards after the integration of Safeway. The objectives were simple – to apply the Morrisons philosophy to the new bigger business while adapting it where necessary. The plan identified

areas where savings could be made, or margins improved, as well as areas where investments were necessary to shape the business for growth.

Savings from Phase 1 were achieved in the prior year.

	Savings £m*	Phase 1 (06-08)	Phase 2 (07-10)	Total	Investment £m	Phase 2 (07-10)
Gross margin	Better buying, sales mix and wastage control	110	100	210	–	–
In-store	Realising efficiencies	90	50	140	Store refresh programme	180
Manufacturing	Managing capacity	–	15	15	New abattoir	70
Distribution	Rationalisation	30	25	55	New capacity in the South	90
Centre/IT	Elimination of dual running costs	30	10	40	New systems across the business	110
	Total savings	260	200	460	Total investment	450

* Contributions to EBITDA.

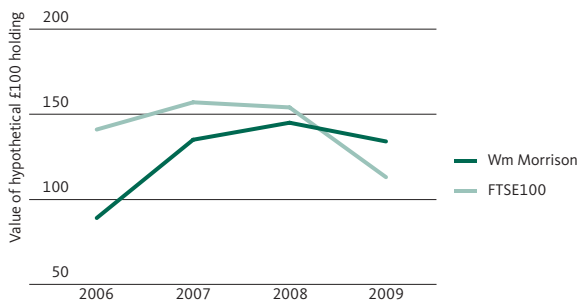
The investment of £450m is in addition to normal planned capital expenditure, including new space, of £400m annually.

Share price and total shareholder value

The Company's share price was 270.75p on 1 February 2009, a fall of 9% from the start of the year. This compares with a fall of 31% in the FTSE100 index and 14% in the Food and Drugs sector over the same period.

Over a three year period, the Company's share price has risen by 44% compared with a fall of 28% in the FTSE100 index and a rise of 19% in the Food and Drugs sector over the same period.

Total shareholder value*



The total shareholder return on Morrisons shares has increased over a three year period, whilst the FTSE100 has declined.

* Total shareholder value is the value of £100 invested in Morrisons shares on 2 February 2004 compared to FTSE100.

Key judgements and assumptions

Judgements and assumptions made in the financial statements are continually reviewed. Whilst some outcomes have been affected by the volatility in the financial markets, all judgements and assumptions in the accounting policies remain consistent with previous years. Consideration of impairment to the carrying values of assets has been made and we concluded that the individual carrying values of stores and other operating assets are supportable either by value in use or market values. The impact of the current economic conditions on the assessment of going concern has been considered in the general information section of the Directors' report and business review.

Provisions

The property provision of £112m (note 21) includes £75m for onerous leases relating to sublet properties to cover the shortfall between expected rent received and the rent payable, taking into account the vacant tenancy periods during the terms of the lease. The provision assumptions were reviewed in the last quarter in the light of worsening market conditions. This resulted in a charge of £5m to cover the additional anticipated risk over the life of the leases.

Store acquisitions

In December 2008, we agreed to purchase a number of stores from the Co-operative Group, subject to Office of Fair Trading (OFT) approval. The stores have an average retail square foot size of c.14,000 and will fit very well within our existing portfolio of around 150 smaller stores.

The acquisition was agreed at a price of £223m, of which a refundable deposit of £22m had been paid by the year end. Should the purchase obtain full OFT approval, the remaining £201m will be paid by instalments during 2009, and a store refurbishment programme costing a further £98m will commence in spring 2009.