

Chairman's statement

Eric Nicoli

Business achievements 2002/03

HMV UK

21 new stores opened, including 150th "milestone" store at Truro

HMV.co.uk launches online digital music downloads in partnership with OD2.

Music Week Retailer of the Year award for the fifth successive year.

Waterstone's

Refurbishment of nine stores, representing 10% of sales.

£10 million stock renewal programme successfully completed.

Growth in DVD

Video category, helped by DVD, delivers 41% of UK sales, Christmas 2002.

British Video Association Retail Success of the year 2002 - specialist retail category.

Strong maiden interim results

Group operating profits increased 32.8% to £17.3 million. Maiden Interim dividend of 1.1p per share

Record Christmas trading

8.5% Group sales growth, including 4.6% LFL growth. 5.6% LFL growth in both Waterstone's and HMV Europe.

North America

Increased Canadian market share to 24.4%.

Canadian Music Industry Awards Retail Chain of the Year 2002 for the 15th successive year.

Asia Pacific

Four new store openings in Japan.

Market share growth in Japan: Music 0.3% to 6.9%, DVD 1.2% to 5.1%.



A year of achiev

Our first year as a listed company on the London Stock Exchange has seen HMV Group make appreciable progress, both in meeting the strategic objectives for growth laid out at the Initial Public Offering and delivering an excellent set of financial results. The Group financial performance was strong during the period. Sales were up 3.2% to £1,707.7 million, operating profit increased by 12.1% to £118.4 million and our net debt was reduced by £241.8 million (£95.0 million on a pro forma basis).

All HMV and Waterstone's people are to be congratulated for this excellent business performance, which was set against the backdrop of an ever more competitive retail environment, a decline in the worldwide music market and macro-economic conditions which, as the year unfolded, weakened consumer confidence.

We have much more to do, however, before the full potential of the Group is realised. At the IPO we stated as two main priorities for strategic growth the execution of a new store opening programme for HMV in the UK and the turnaround of the Waterstone's business, a programme which will continue over several years. I am pleased to report excellent progress on both of these fronts.

At HMV, 21 new UK stores were opened, taking the total number at the year end to 158. The outstanding performance of the new stores, and the extraordinary growth of our DVD sales, means that the Group can look forward with confidence to highly consistent and rapid returns from the further expansion of HMV UK during the new financial year.

At Waterstone's, the refurbishment of nine of our largest stores was completed to schedule in readiness for the crucial academic and Christmas selling periods, whilst application of the best-in-class retail standards established in HMV helped our books chain to improve financial ratios in a market which was ostensibly flat.

Our HMV businesses in North America and Asia Pacific have responded resolutely to the weakness seen in their regional music markets. These businesses have in several areas strongly outperformed their local market and leveraged their competitive positions to advance supply chain relationships and increase market share of DVD. This gives us confidence for our prospects for growth in our chosen international markets.

The Group possesses outstanding operational capabilities and has a capital structure apposite for realising the considerable potential for further expansion. Sales and profit growth remain our strong focus as we aim to maximise on behalf of our shareholders the opportunities to progress further. Our balance sheet, which shows strong free cash flow generation and net debt falling ahead of expectations, gives the Board confidence to reinforce the progressive dividend policy laid out at the IPO.



Eric Nicoli Chairman
30 June 2003

ement

Chief Executive's statement
Alan Giles

Fast forward

2002/03 was another year of excellent progress for HMV Group. The Group delivered excellent profit growth and achieved a £95 million reduction in net borrowings. This was achieved in a year when the UK, our largest market by sales and profit, experienced a softening in music sales and a general downturn in consumer confidence, which was exacerbated in the final quarter by the build-up to and eventual war in Iraq.

At the time of our IPO in May 2002 the Group identified several objectives that would enable us to pursue our ambition to be the most successful international retailer of music, books and video. I am pleased to report that, by successfully following a very focused strategy for ongoing growth, we continue to deliver against these objectives and advance nearer to our ambition.

The seven key points of our strategy as outlined in last year's annual report:

01 Apply the HMV blueprint across the Group

To transfer best practice from the highly successful business model developed by HMV in the UK.

02 Secure leadership in chosen markets

To operate in attractive markets where the Group can maintain or obtain market leadership.

03 Deliver unrivalled authority

To deliver leading market share through superior range, customer service and product knowledge in each catchment area.

04 Achieve superior financial performance

To generate superior financial performance by achieving "best in class" operational standards.

05 Exploit new product opportunities

To build on the Group's strong track record of the early adoption of new formats, such as DVD, thereby securing competitive advantage and market share growth.

06 Embrace alternative distribution channels and technologies

To ensure that the Group is well positioned to take advantage of viable alternative distribution channels and technologies that present viable strategic opportunities for its business.

07 Optimise store portfolio

To ensure that the Group has a suitably positioned, sized and configured store portfolio tailored to local markets designed to maximise long-term returns.



Growth strategy

HMV UK store openings

HMV Europe, operating through 166 stores primarily in the UK, has yet again proved itself to be the high-performing engine of the Group, delivering record sales, profit and cash flow. Total sales grew to £867.4 million – a 10.6% increase on the previous year, inclusive of a 3.7% like for like improvement.

Whilst highly successful, HMV's national coverage is under-represented compared to its retailing peers and there exist outstanding opportunities to increase our store numbers. HMV stores are sited in each of the top 50 UK markets ranked by Experian, but are not in over 50% of the next 150 markets. In these towns HMV has high brand awareness and a valuable consumer franchise but no distribution to, effectively, some 20% of UK shoppers. This group of catchments has become the focus of our expansion, and during the year we opened a record 21 new stores, including Carlisle, Colchester, Grimsby, Putney, Winchester and Truro, where our landmark 150th store opened in December.

We also added to our edge-of-town portfolio, with new store openings at Edinburgh's Fort Kinnaird and Ocean Terminal, Manchester West One and Liverpool Speke Park. For the first time, HMV now has a presence on railway concourses following the opening of new stores at London's Victoria and Manchester's Piccadilly stations.

As a focus for capital investment, shareholders can be assured of both the scale and consistency of returns from these new openings, with the 50 new stores opened in the past five years generating an average cash payback of just 16 months. We are highly selective in where we invest and, because of the strength of the HMV brand we are able to secure advantageous property terms which lead to these superior returns. This gives us great confidence that the 15 new stores planned for the new financial year will also be significantly value enhancing to the Group.

DVD market leadership

In HMV Europe, total DVD sales grew by 83% year on year, although with some cannibalisation of VHS, total video sales increased 32.4% for the full year. In the UK we have established a leading, 25.8% share of the DVD market, an outstanding feat given that HMV was not the market leader in VHS.

The explosive growth in DVD in the UK, HMV's largest market, has been achieved from a still emerging but rapidly growing base of approximately 30% household penetration for DVD players. Overall in 2002/03, the UK installed base for DVD hardware grew by 87%, according to the British Video Association, and the market is still matching the development of the US, but some 16 months later.

VHS was predominantly a new release driven format and back catalogue sales and collecting had not developed to the same extent as music. The superior quality of DVD and the additional content which suppliers now feature has, however, led to the development of a strong catalogue business.

The proven consumer appetite for DVD software plays directly to HMV's strengths as a range authority retailer and its expertise in continuously stimulating consumer interest in catalogue titles through pre-planned sales campaigns. With only 11,000 titles available on DVD so far, compared to 23,000 for VHS, there exists ample scope through continuing range expansion to support consumers' desire to collect DVD.

The challenge for HMV in DVD is to make consumers aware of the huge breadth of new product releasing to DVD, and to this end HMV continues to develop new initiatives. During the year HMV launched the ScreenXtra preview DVD, which is a very effective tool for raising awareness of release dates and HMV offers to our core DVD customers. HMV also introduced into stores the New to DVD sections, which highlight non-chart catalogue re-issues and this too is driving strong market shares for HMV.

Why have music sales been declining?

A combination of illegal Internet downloading and CD burning have taken some of the edge off of growth in global music sales, but does not sufficiently explain why some music markets continued to see positive growth. France has all the ingredients for music downloading – mature PC penetration and a rapidly growing broadband Internet market – but saw growth in its music market of 4% in 2002. In our view, this divergence is largely a function of how successful the local record labels and retailers have been in developing and promoting the market. We also believe that the high growth DVD product format is competing with music for a share of consumer expenditure, and is evidence that consumers' desire to own and collect product in physical format is undiminished.

Is DVD growth sustainable?

DVD has enjoyed phenomenal growth in the previous two years. We believe there is much more to come, stimulated by increasing household penetration of hardware, including recordable DVD, and an expansion in the number of software titles. Although we do not expect a repeat of the UK's 100%+ growth, DVD will lead our video category to high double-digit growth this year. Looking forward, we expect HMV's ability to maximise catalogue sales through promotions to help us maintain market leadership even when the growth in hardware begins to plateau.

Chief Executive's statement continued

The growth in DVD meant that video contributed over 40% of sales in HMV UK at Christmas, compared to 45% for music. Our businesses in North America and Asia Pacific, where HMV had not been as successful with VHS, are also making significant progress in introducing DVD to their product mix.

Expansion in Japan

Progress is also being made on our medium-term strategic growth plans for Japan, where we ended the year with 37 stores located in many of the key catchments. Japan did not escape the downturn seen in other world music markets during the period, declining by 9%. However, it remains the world's second largest market for music, with a strong indigenous J-Pop business, which represents three quarters of the market, and widespread interest in international artists.

Our estimated 7% market share in Japan's highly fragmented market means there is an opportunity for us to become the leading player through expanding our store portfolio. Our share of the market belies the strength of the HMV brand, which is one of the best known in Japan. Approximately 10% of our Japanese sales are now made online, reflecting our high brand awareness and the success of our e-commerce operation, but also the relative under-representation of our stores.

The HMV business in Japan is currently sub-scale, and the infrastructure we have in place is capable of supporting a considerably larger chain. Our 2002/03 new stores, at Oita, Machida, Hakata and Sapporo, have all performed well. Our expansion plan has targeted eight new store openings during the new financial year, a programme prudently aligned to the development of store managers required to meet HMV's high operational standards.

Lease lengths in Japan are typically shorter than in other major HMV territories, which means a low-risk investment profile for new store openings. The Group remains confident of achieving rapid returns as scale economies unfold and as we more deeply engrain into the HMV business in Japan the world class operating standards evident in HMV UK.

Waterstone's turnaround

Good progress was made during the first 12 months of our three-year recovery programme for Waterstone's. During the period Waterstone's tackled head-on some of the biggest challenges that had been set for the turnaround of the business, including the replacement of £10 million of slow-moving stock with fresher and more saleable titles, and the refurbishment of nine of our larger stores representing approximately 10% of Waterstone's turnover.

Most of this activity was carried out in the first half, prior to the peak academic and Christmas trading periods. The benefit was seen in Waterstone's like for like sales performance at Christmas, which was up 5.6% against a strong performance in the prior year. This in part reflected the successful application of promotional tactics similar to those developed in HMV UK. These included the launch, in close co-ordination with suppliers, of a highly marketable "Book of the Week" campaign for each of the six weeks prior to Christmas.

The refurbished Waterstone's stores provide a contemporary and commercial environment. A new children's concept was introduced and further coffee concessions were opened. All of these improvements have been made without compromising on the unrivalled range authority for which Waterstone's is renowned.

Looking forward, Waterstone's continues to rigorously apply the HMV Blueprint. This process has provided appreciable results that have been translated to sales and profit growth and balance sheet improvement, although not all ideas have translated successfully. As Waterstone's gradually improves profitability and restores operating margins to more acceptable levels the Group remains determined that its shareholders will benefit from the incremental value created.

New channels and formats

With a longer term horizon in mind, the Group continues to experiment with new technologies and distribution formats in the event that these should become viable and widespread channels to deliver the products we sell to consumers.

Can HMV compete with supermarkets for CDs, games, DVDs and books?

The supermarkets have been aggressively pursuing their expansion of non-food ranges in recent years, and are an established feature of the competitive environment. Although supermarket competition has brought some deflationary pressures and they have gained market share, their potential to replicate the range, service and environment found in HMV or Waterstone's is constrained by space and their focus on family-oriented, best-selling titles. Our stores typically have a lower share of these types of products than titles deeper into the range.

Are improvements at Waterstone's being made at the expense of its literary traditions?

The Group is proud of Waterstone's reputation for literary authority, which owes everything to the passion and dedication of its booksellers. It is true that the books market became more competitive since price controls were abandoned in 1995. The aim of our Waterstone's recovery programme is to improve the chain's retailing capabilities so that it is better equipped to meet the requirements of today's vastly more commercial books market. Our focus is on strengthening Waterstone's core brand value as the most authoritative range bookseller and on applying HMV's world-class retailing standards to Waterstone's.

The recent decline in the world music market has been widely attributed to CD burning and the illegal free sharing of music between users of peer-to-peer Internet sites. Currently, consumer research exists to support the seemingly opposite views that music downloading is to some degree both stimulating and substituting sales of physical product. Precise trends at this stage are difficult to decipher, but it is clear that downloading is emerging as a part of the distribution landscape. Whether this will move beyond piracy to a viable commercial model remains to be seen, however.

So that the Group can better understand the dynamics of legitimately selling music for download via the Internet, HMV Europe entered into a strategic partnership with the UK online music service provider OD2. This allows subscribers to the secure service to stream, download or permanently burn tracks to CD for a monthly fee of £4.99. As might be expected, given the free availability of pirated music from peer-to-peer Internet websites, sales from this channel so far have been modest. However, it has given us considerable insight to consumer preferences and behaviour and positions the Group to take advantage of downloading as and when it evolves into a legitimate and viable channel to market.

As a channel to market, the Internet has settled down so that sales of physical product online as a share of the overall market are 5%–6% for books and music. We continue to make improvements to our online offer to drive sales and profitability. During the period, we eliminated the losses from running the HMV.com website in Canada by entering into a strategic alliance with amazon.ca whilst preserving our branding, and each of the Group's five transactional websites now trades profitably.

In July HMV UK will link with leading mobile phone operator Vodafone Live to offer a range of CDs, DVDs and games to mobile Internet customers. The offer has potential for purchases of physical product and downloads being charged directly to a customer's telephone bill and closely resembles the HMV mobile Internet offer, which represented 18% of total online sales in Japan.

In HMV's store at 360 Oxford Street, London, new flat-screen listening posts are being introduced, enabling customers to access and play clips from 250,000 music, DVD and games titles either via an online search or by scanning the barcode of specific titles. The kiosks are scheduled to be rolled out to all HMV UK stores over the next three years.

We are determined that we can maintain our proven track record in providing appropriate levels of support to the right distribution technologies and formats as and when they arrive, and continue to invest in innovative experiments as a way of assessing the strategic viability of new channels and technologies for our businesses.

Outlook

As we continue the execution of our growth strategy, the Group is able to look forward with confidence to the year ahead.

HMV UK is producing consistently world-class retailing standards and strong financial ratios, and as we anticipate our store expansion programme for the UK and the continuing growth in DVD we remain confident that this business can build on its outstanding levels of performance.

HMV UK's proven retailing skills are the benchmark for our international businesses in Asia Pacific and North America. As we continue to apply these techniques, build out our DVD business and, in Japan, pursue the opportunity to expand our store portfolio, we are confident of realising the potential that our market positions in these territories provide.

In Waterstone's, further operational improvements will be made as we continue with the three-year turnaround plan. We take great encouragement from the learning and progress that has so far been achieved and, through the application of the HMV model and a disciplined focus on managing the capital tied up in the business, we remain determined to restore Waterstone's to a more profitable level of return for our shareholders.



Alan Giles Chief Executive Officer
30 June 2003