

## 2 Operating and financial review

### Thread trading

Operating profit before reorganisation, impairment and exceptional costs: £62.9 million (2002 – £82.3 million) (see Note 2a). Earnings before reorganisation and exceptional costs, interest, tax, depreciation and amortisation (EBITDA): £98.3 million (2002 – £116.6 million).

Reported results in sterling were significantly affected by the impact of a weaker US dollar exchange rate on translation of local currency results. On a like-for-like basis, excluding the impact of exchange translation, acquisitions and disposals, sales increased by 1%. This reflected lower sales in North America and

generally weaker growth in other regions during H2 following 2% growth in H1 and an exceptionally strong H2 2002. Operating profit before reorganisation, impairment and exceptional costs (OP) on a like-for-like basis fell by 20% for the full year, principally as a result of lower operating margins in North and South America but also due to a number of beneficial corporate items in 2002 not recurring.

In the following comments on Thread regional performance, all comparisons with 2002 are on a like-for-like basis i.e. excluding the impact of exchange translation, acquisitions and disposals.

### Thread like-for-like sales and operating profit

	2002 restated £m	Exchange retranslation £m	Acquisitions/ disposals £m	2002 adjusted £m	2003 reported £m	Increase/ (decrease) %
<b>External sales</b>						
UK and Europe	321.6	18.9		340.5	349.3	2.6
North America	291.0	(23.2)		267.8	244.8	(8.6)
South America	87.6	(7.5)	4.7	84.8	86.0	1.4
Asia	222.4	(12.9)		209.5	232.1	10.8
<b>Total</b>	<b>922.6</b>	<b>(24.7)</b>	<b>4.7</b>	<b>902.6</b>	<b>912.2</b>	<b>1.1</b>
<b>Operating profit*</b>						
UK and Europe	14.8	(0.2)		14.6	13.7	(6.2)
North America	14.0	(1.1)		12.9	2.8	(78.3)
South America	11.5	(1.0)	1.1	11.6	7.8	(32.8)
Asia	35.6	(2.6)		33.0	37.5	13.6
Corporate	6.4			6.4	1.1	(82.8)
<b>Total</b>	<b>82.3</b>	<b>(4.9)</b>	<b>1.1</b>	<b>78.5</b>	<b>62.9</b>	<b>(19.9)</b>

\*Pre reorganisation, impairment and exceptional costs.

### UK and Europe

Sales +3%; OP -6%

Crafts sales grew strongly in both Western and Eastern Europe with particular success in Germany as a result of gains in market share from new product launches in handknittings. The market for industrial thread in Western Europe continued to decline as a result of customer migration to Eastern Europe and Asia. Our industrial sales were broadly flat with growth in zips and Eastern Europe apparel thread offsetting further decline in Western Europe apparel thread. Operating margins were affected by start-up costs of the new bulk production unit in Romania and losses in the industrial thread business in Western Europe. Our strategy of switching production capacity to Eastern Europe and Asia is designed to address these losses, but 2003 results were affected by the time lag in realising overhead savings in Western Europe in line with the migration in industrial sales.

### North America

Sales -9%; OP -78%

Crafts sales were down on the previous year as a result of de-stocking by certain major customers. Point of sales data indicates that underlying sales to final consumers continued to grow, albeit at a slower rate than previous years. Industrial sales in the US continued to decline as a result of migration of apparel production to Asia. Operating margins in both Crafts and Industrial were affected by lower sales volumes. There was substantial activity in the supply chain with the opening of a green field site at Orizaba in Mexico and closure of production at three sites in the USA. However operating profit was impacted by start-up costs in Mexico and production inefficiencies during the downsizing of US production.

**South America**

Sales +1%; OP -33%

Underlying demand for both crafts and industrial products was weak as consumer spending remained depressed throughout the region. The weak trading climate also led to reduced operating margins as price increases lagged inflation in operating costs.

**Asia**

Sales +11%; OP +14%

Industrial thread sales continued to grow strongly, more than offsetting the decline in North America and reflecting the benefit of our relationships with global retailers and brand owners. Operating margins improved slightly to just over 16% despite investment in new production capacity and sales and administration infrastructure to support future growth.

**Corporate**

The positive contribution to OP reduced from £6.4 million to £1.1 million principally as a result of a reduction in the release of negative goodwill and an increase in corporate provisions.

**Thread reorganisation, impairment and exceptional costs**

We made good progress during the year in continuing to downsize Western Thread capacity, whilst expanding in low cost locations, and reorganisation costs (including impairment of fixed assets) of £19.1 million (2002 – £15.2 million) were incurred. These costs are part of our reorganisation programme, which continues to deliver benefits in line with expectations.

Thread exceptional operating costs of £7.4 million (2002 – £nil) were incurred by the Company in the year, representing the costs associated with the offer for the Company by Coats Holdings plc.

**Non-Thread**

The refocusing of the Group on Thread is now virtually complete and sales and operating losses (before reorganisation, impairment and exceptional costs) from our other businesses, namely India Textiles, Bedwear and Fashion Retail, fell to £91.7 million (2002 – £233.0 million) and £5.2 million (2002 – £17.3 million) respectively.

Bedwear is now the only continuing non-thread business and following the sale of its manufacturing business in September has been reconfigured as a design, sales and marketing operation. In 2003 it made an operating loss (before reorganisation, impairment and exceptional costs) of £2.6 million (2002 – £1.1 million) partially as a result of the inevitable disruption associated with the exit from manufacturing. Increased flexibility in terms of product sourcing is expected to lead to a significant improvement in future performance.

Reorganisation, impairment and exceptional costs in the non-thread businesses amounted to £2.7 million (2002 – £3.9 million) and in 2003 related almost entirely to Bedwear.

**Operating profit**

Statutory operating profit at £28.5 million (2002 – £45.9 million) benefited from reduced losses in discontinued businesses but this was more than offset by the reduction in like-for-like Thread profits, higher reorganisation and exceptional costs, and the impact of exchange translation.

**Disposals**

The Group generated a net loss on the sale or termination of operations of £43.6 million (2002 – £6.2 million), largely in respect of the following disposals.

The UK Fashion Retail business was sold, as disclosed in our 2002 accounts, on 23 January 2003 and our US Fashion Retail business was closed during the year, resulting in a combined loss of £41.0 million. The operating results for these businesses have been included within discontinued operations. The results for the US business were shown as part of continuing operations in the 2002 accounts and therefore the 2002 figures presented in these accounts have been restated.

On 3 September 2003, the sale of Bedwear's manufacturing business to an investment consortium was completed resulting in a loss of £4.5 million. In addition, we completed our exit from the India Textiles business during the second half of 2003.

The sale of the Fashion Retail business was structured such that we retained the principal assets. During 2003 we generated approximately £23 million cash in respect of the sale of these assets, with additional proceeds expected in 2004. In total, profits on sales of property and other assets made surplus by the reorganisation and disposal programmes totalled £21.0 million (2002 – £8.7 million).

### Interest and tax

Net interest costs increased to £15.3 million (2002 – £13.0 million) reflecting an increase in net debt. Interest includes a non cash element of £4.0 million (2002 – £3.7 million) largely arising from the unwinding of the discount on future pension liabilities.

After gains and losses arising from the disposal of fixed assets and businesses, a loss before tax of £9.1 million (2002 – £36.3 million profit) was generated. However, on the ILMR basis (before goodwill, amounts written off investments and FRS3 exceptional items) profit before tax was £14.8 million (2002 – £32.2 million).

The tax charge was reduced to £3.8 million (2002 – £5.1 million). This charge is primarily made up of tax on profits of overseas subsidiaries net of a deferred tax credit of £6.6 million.

The basic loss per share was 2.9p (2002 – 3.6p basic earnings), but headline earnings per share were 0.5p (2002 – 2.7p).

### Accounting standards

The Group's accounting policies fully reflect all applicable standards issued by the Accounting Standards Board.

The Group was acquired by Coats Holdings plc (formerly Avenue Acquisition plc) on 7 April 2003. Coats Holdings plc's policy is to account for pensions in accordance with SSAP 24 – Accounting for Pension Costs. The Group's accounting policies have been brought in line with Coats Holdings plc and consequently SSAP 24 has been adopted in these accounts. Since 2001, FRS17 – Retirement Benefits had been fully adopted in preparing the Group's accounts, and therefore the 2002 results have been restated to a SSAP 24 basis. The full effect of adopting SSAP 24 is set out in Note 29.

### Pension arrangements

The Company operates a defined benefit plan in the UK and there are similar arrangements in North America. An actuarial review of the UK and USA schemes under SSAP 24 was conducted as at 7 April 2003 and indicates that these schemes are in surplus. Employer contributions continue to be suspended based on actuarial advice. The pension prepayments included in debtors in respect of these schemes total £38.3 million (2002 – £40.1 million).

There are various pension and leaving indemnity arrangements in other countries, primarily in Europe, where the Group operates, which in general are not funded. At 31 December 2003, the discounted liabilities arising amounted to £66.7 million (2002 – £68.2 million) gross of deferred tax and are included in provisions for liabilities and charges.

### Balance sheet and cash flow

The 2002 cash flow statement analysis has been restated to reflect the adoption of SSAP 24. 2002 included a £3.9 million refund from a discontinued pension scheme. This has now been recognised in the profit and loss account as part of the loss on sale or termination of operations and as part of the proceeds from the sale of subsidiary undertakings in the cash flow statement.

Net cash inflow from operating activities was £50.3 million (2002 – £96.8 million), reflecting a £10.3 million increase (2002 – £18.8 million reduction) in working capital as well as lower earnings. Stock increased marginally over 2002 levels, resulting in a £2.4 million cash outflow in 2003, whereas 2002 had benefited from a significant reduction in stock (£22.4 million) compared to 2001. In addition, creditors were £13.7 million lower at the 2003 year end (2002 – £5.8 million increase).

£15.3 million (2002 – £5.7 million) tax was paid, with 2002 having benefited from significant refunds of tax in both the UK and US.

The Group continues to make significant investments in its Thread business and capital expenditure was £57.9 million (2002 – £56.9 million). After adjusting for opening and closing year-end creditors, actual cash outflow was £66.0 million (2002 – £48.6 million).

The key projects were the expansion of capacity in low cost countries including Romania, Mexico and China. £9.4 million (2002 – £11.6 million) was spent on acquisitions, primarily the purchase in February 2003 of Vicunha, a Brazilian Thread business, and the purchase in November 2003 of the outstanding minority in our Indian Thread subsidiary Madura Coats.

The disposal of businesses and surplus assets generated £34.6 million (2002 – £22.1 million).

Net debt increased from £104.4 million at the start of the year to £131.5 million. Shareholders' funds fell from £463.2 million to £429.3 million, largely reflecting the £20.2 million (2002 – £3.1 million) retained loss for the year and a £14.0 million (2002 – £24.7 million) exchange loss charged to the statement of total recognised gains and losses. Gearing was 28.4% (2002 – 20.8%).

#### Treasury

The Group's policy is to minimise exposure to changing interest rates by ensuring an appropriate balance of fixed and floating rates. The exposure is managed through the use of interest rate swaps and forward rate agreements, the nominal principal of which does not exceed the underlying net debt.

The majority of the Group's profits, cash flows and assets relate to its overseas Thread operations and are denominated in a range of currencies. The principal exchange rates used in preparing the financial statements were as follows:

		2003	2002
Average	US\$	<b>1.64</b>	1.50
	Euro	<b>1.45</b>	1.59
Year end	US\$	<b>1.79</b>	1.61
	Euro	<b>1.42</b>	1.53

Borrowings are largely drawn in US dollars as a hedge against the impact of changes in the sterling/US dollar exchange rate on the translation of US dollar denominated assets. The Group's translation exposure in the profit and loss account is not hedged. Had 2002 overseas turnover and operating profit been translated at 2003 average rates, reported 2002 Group sales and operating profit would have been lower by £26.3 million and £4.7 million respectively.

The Group's committed banking facilities are provided mainly by a revolving credit facility agreement for £149.0 million. This agreement included a standard change of control clause which was triggered by the acquisition of the Group by Coats Holdings plc in April 2003. A temporary extension of the facility until 31 March 2004 has been agreed by our banks in order for a refinancing exercise to be completed.

During the year, the Group's convertible bonds of £60.4 million came due for redemption and were redeemed at their principal value on 9 August 2003. This funding was replaced by a new £60.0 million bridge facility, on the same terms as the temporary extension to the revolving credit facility.

At the year end the Group had total committed facilities of £212.0 million, of which £209.0 million was committed until 31 March 2004. At 31 December 2003 £146.4 million of debt was drawn against these facilities.

#### Going concern basis

Following the acquisition of the Group, negotiations have taken place with lenders with regard to refinancing the current facilities of Coats Ltd, in conjunction with Coats Holdings plc's refinancing of its acquisition finance.

The Directors believe that these negotiations will be successful and that the bank facilities will be refinanced.

After making enquiries and based on the above, the Directors have formed a judgement that at the time of approving the financial statements, there is a reasonable expectation that the Group has sufficient resources to continue in operational existence for the foreseeable future and therefore consider it appropriate for the financial statements to be prepared on a going concern basis. The financial statements do not include any adjustments that might result if the refinancing is not completed.