

## THUS's business, objectives and strategy

THUS aims to be the leading alternative provider of telecommunication and Internet services for business customers in the UK.

We believe we can deliver this aim on the back of the large scale investment we have made in previous years. We built and developed our own advanced service capability, including 8,000km in total of network linking the major industrial and commercial centres throughout the UK. This allows us to control the quality of our services, to innovate more quickly with new and differentiated services, and to protect margins against competitive pressures. As more of our major corporate customers become directly connected, we become increasingly efficient by carrying a greater proportion of their traffic over our own network, minimising delivery costs and reducing payments to other operators.

This year has been another successful year in delivering our targets, set over a decade, as our Company grows to maturity from its flotation on The London Stock Exchange in November 1999.

The heavy investment made between 1999 and 2001, putting our UK-wide capability into place, depressed our headline profit and cash flow metrics. Since then, THUS has delivered sustainable positive EBITDA and, now, sustainable positive free cash flow<sup>1</sup>, with operating and pre-tax losses also narrowing significantly. Our continued progression will be tracked by three key financial measures – turnover, operating profit and cash flow.

With the delivery this year of positive free cash flow, it is now time to replace EBITDA, a primary measure which was strongly linked to our access to financing, with our next key milestone of operating profit.

We have set out a series of longer-term targets based on asset utilisation and profit margin to ensure we achieve our goal of delivering a return to shareholders above our weighted average cost of capital. To achieve this, we believe that our Company will have to approximately double its turnover by the end of the decade (2009). This will provide additional scale to expand operating margins, leveraging our low operating cost base and existing investments. Given our focus on customers, our strengths in a range of services and consistent quality, we believe that this is a realistic and achievable target which, representing less than 5% market share of the UK telecommunications market, leaves plenty of potential for longer-term growth.

### Overview of the year

THUS made good progress against its objectives during the year. We grew turnover by 14%, representing, we believe, more than double the market growth rate, leading to reduced operating losses of £21.2 million from £50.8 million last year. This puts us on track to go operating profit positive in the second half of the financial year ending 31 March 2005.

Cash flow was also positive in the second half of the year. We believe that we are the first infrastructure based altnet in the UK to have achieved this on a sustainable basis, realising a key validation point of our business model.

EBITDA margin expanded from 9% to 13% and capital expenditure fell from 15% to 12% of turnover, with approximately 55% of capital expenditure now driven by growth in turnover.

For an alternative carrier to sustain profitable growth, we believe the ratio of increase in turnover to capital expenditure must exceed 1:1 in order to deliver the scale required to provide a proper return on invested capital. During the year, we achieved this – we believe we are the first alternative carrier to do so. This represents another important validation point for our business model.

We have continued to grow business with existing customers and to win new customers. Millions of consumers in the UK now use our services daily, without knowing about THUS's key role. This is illustrated by the large and diverse customer bases of, for example:

- Sky Active through the "red button", and SkyTalk;
- Amstrad, via the Amstrad e-m@iler; and
- Tele2, through its residential voice resale services.

This approach of supporting the growth of our corporate customers, but not having to directly support or market to large consumer bases, remains one of four key legs in the delivery of our business model. It complements our direct sales to UK-centric corporates and SMEs, as well as our active reseller channel.

<sup>1</sup> Cash flow after returns on investments and servicing of finance and capital expenditure and financial investment.

## Operating and Financial Review

John Maguire,  
Chief Financial Officer



**Segmental analysis of turnover**  
**Data and telecoms, including facilities management**

Turnover in these services grew by 24% to £198.6 million, and was the main engine of growth for THUS.

The expansion of voice volumes was particularly robust, due to Carrier Pre-Select Services (CPS) which improve the capture of indirectly connected customer calls by automatically routing this traffic over THUS's network. Changes by the regulator have enabled THUS to move voice services from BT without requiring the customer to use special equipment or the inconvenience of access codes. We are also able to provision these services more effectively than before. While CPS was introduced in its current form in 2002, this year has seen more widespread adoption of the service.

CPS has also been used to support the retail telephony products of other operators, including Tele2's launch into the UK in the second half of the year. Tele2 is Europe's largest supplier of indirect voice telephony to consumers, and its choice of THUS to carry its UK services is a reflection of our scale and the class-leading quality of our facilities and services.

CPS will remain an important source of growth in the next year. Whilst, in the short-term, it may dilute our gross margin, the low level of incremental operating and capital costs required to support this scalable service makes it a strong contributor to operating profit progression.

In data services, wide area Ethernet services grew strongly. With over 2,000 circuits now provisioned, THUS has a strong first-mover advantage

in a technology that we believe has compelling advantages to corporate users of more traditional telecoms data services. New users in the year include Imperial College London, the Scottish Executive and TOTAL E&P UK, part of the TOTAL Global Energy Company.

We also continue to make advances with MPLS data services, including the provision of a managed network for GWR Group, enabling it to become the first radio broadcaster in the UK to multicast live commercial audio broadcasts over MPLS. This builds on THUS's success with Capital Radio and our expansion into data services for main national radio operators outside the BBC.

Facilities management represents an expanded area this year. Previously this has largely represented trading with our former parent company, ScottishPower. Contracts qualifying for inclusion in facilities management are typically of longer than average duration and involve a range of services requiring a dedicated THUS team for their implementation. Our recent contract win of Southern Water and our award of preferred bidder status with Glasgow City Council illustrate our scale and capability in this area. For example, the Glasgow City Council contract will run for a minimum of six years with an estimated value of £42 million.

**Internet**

Internet turnover grew by 10% to £99.1 million. During the year, the rapid market growth in the development of broadband Internet access via Asymmetric Digital Subscriber Line (ADSL) services continued. This strong growth was partly masked by continued churn in our narrowband

dial-up base but we have migration plans in place and expect the churn to greatly reduce next year.

UK broadband customers more than doubled year on year to 58,000, attracted by our wide and expanding range of product options, competitive pricing and targeted marketing promotions to business customers under the Demon brand.

For ADSL services we typically wholesale from BT but add enhanced features and functionality for our customers. ADSL is gross margin dilutive, but operating profit expansive due to low incremental operating and capital costs. We continue to review options to expand the margin profile of this growing customer base, including local loop unbundling, once the economic case justifies this investment.

Our UK broadband success was replicated in Demon Netherlands, which grew its ADSL customer base five-fold to 38,000, reflecting a higher consumer content. While THUS continues to focus on the UK, the Netherlands operation, at 4% of turnover, remains a growing and successful core adjunct to existing activities.

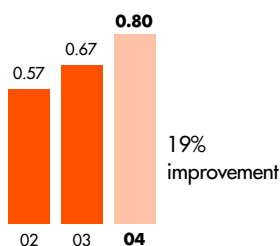
New innovations to our broadband product portfolio were implemented, including a range of high-speed, cost-effective, self-install options and the addition of private access DSL that allows customers to use broadband as a secure connection into private networks.

**Contact centre services**

Contact centre turnover for the full year fell to £21.7 million from £24.6 million. Although turnover in the first half fell below that in the previous year following the loss of the Microsoft account, the

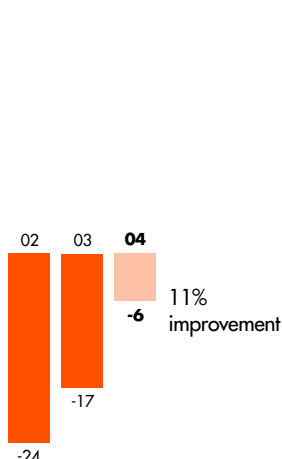
**Fixed asset turnover**

year ended 31 March  
times



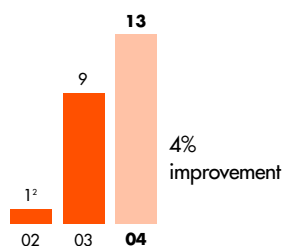
**Operating profit margin**

year ended 31 March  
%



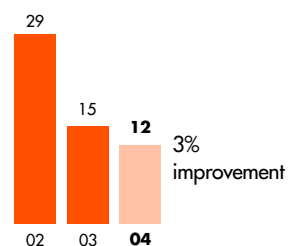
**EBITDA<sup>1</sup> margin**

year ended 31 March  
%



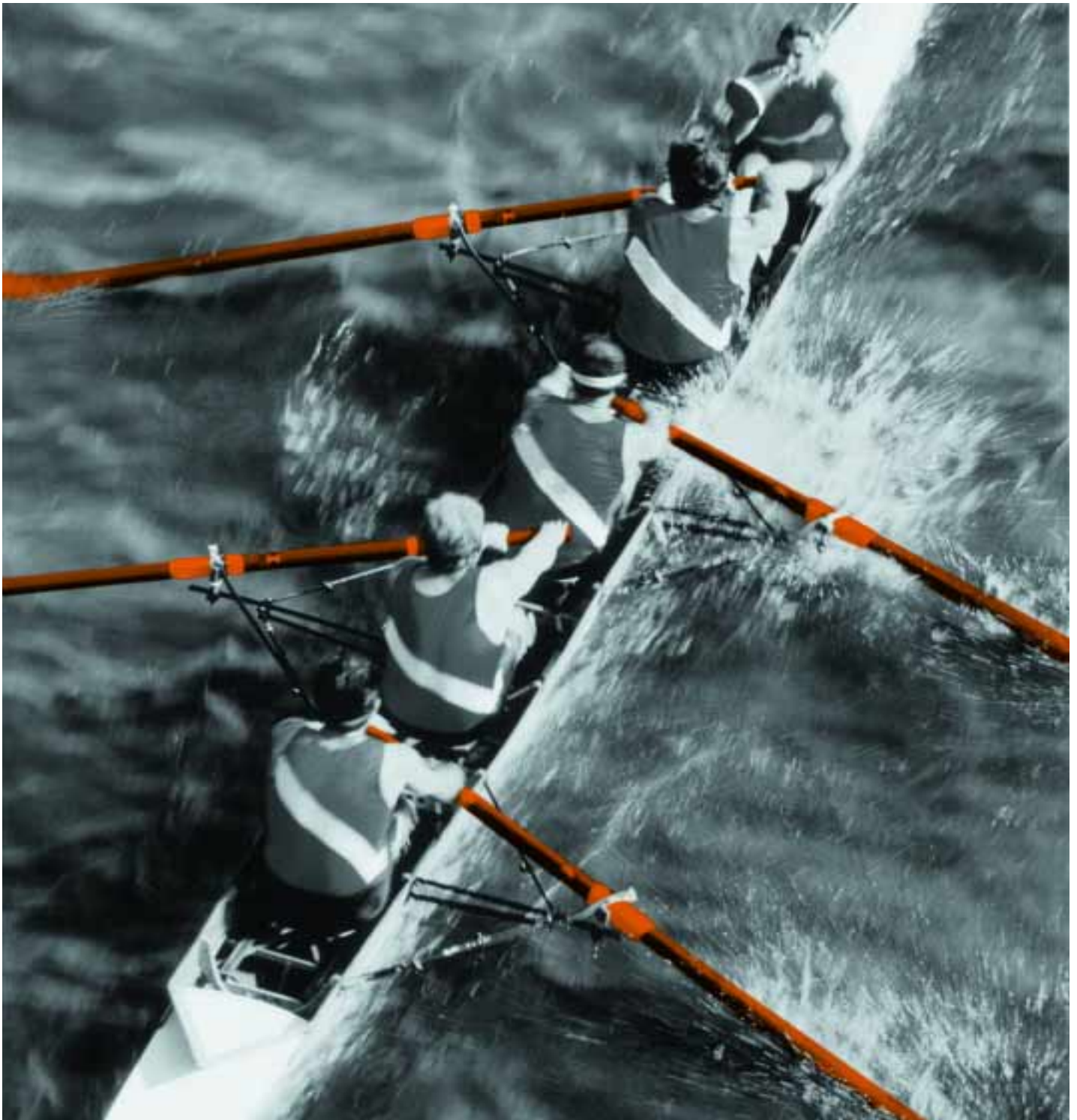
**Capital investment/turnover**

year ended 31 March  
%



<sup>1</sup> Earnings before interest, tax, depreciation and amortisation.

<sup>2</sup> Excludes £3.2 million restructuring costs.



## **Productivity**

**Day in, day out, we constantly strive to increase our effectiveness by utilising all of our resources, people, technology and knowledge to generate shareholder value.**



## **Profit**

**Our focus on generating value and quality services for our customers leads to profitable growth for our Company. This enables us to deliver on our promises and consistently achieve strong financial performance.**

division recovered ground in the second half, as indicated at the Interim results, principally through the expansion of existing accounts and the successful renewal of our major contract with Hewlett-Packard. Our focus remains on the top end of the market, providing support for customers who have complex needs and whose operations must be based in the UK.

#### Interactive

Turnover for the Interactive division, providing premium rate services and competition formats, declined by 18% to £13.0 million, reflecting a steep decline in turnover in the second half of the year, resulting from a marked increase in competition. Although turnover has fallen, this division contributes both operating profit and positive cash flow for the Group.

#### Margin expansion and progress to profit

With the achievement of positive cash flow in the second half of the year, our focus with respect to margin is now on operating profit. Operating losses more than halved to £21.2 million and we are on a solid trajectory to achieve operating profit in the second half of the next financial year ending 31 March 2005. The contributors to operating profit expansion are considered below.

Gross profit, excluding depreciation and amortisation, showed good absolute growth, up 8% to £116.7 million. Excluding the Contact Centre and Interactive divisions, underlying gross profit increased 13%, broadly in line with turnover growth.

Gross margins, excluding depreciation and amortisation, fell 2% to 35%, compared with 37% last year, and down

slightly to 21% after these items. Given our change in product mix with strong growth in CPS and broadband DSL, we do not expect any progression in gross margin during this financial year. Whilst, in the short-term, CPS and broadband DSL may dilute our gross margin, the low level of incremental operating and capital costs required to support these scalable services make them strong contributors to operating profit progression in line with our business model. We view this as an opportunity for growth and as part of the service transition that is currently taking place in the telecommunications market.

S,D&A (selling, distribution and administration) costs, excluding depreciation and amortisation but including other operating income, fell from 28% to 22% of turnover and by 10% in absolute terms to £73.1 million. The year saw the benefits of the full annual impact of actions taken in the prior period, as well as rationalisation of the back office billing platforms.

Combining turnover growth and cost efficiencies, EBITDA grew strongly to £43.6 million compared with £27.1 million in the year ended 31 March 2003 and £3.1 million<sup>1</sup> in the year ended 31 March 2002.

Depreciation and amortisation for the year at £64.8 million was £13.1 million lower than the previous year's charge. This mainly reflected lower impairment charges of £8.6 million year on year. There was an impairment of £4.8 million in the year, mainly reflecting accelerated depreciation on the 300km out of 6,100km of trunk network which was provisioned on overhead cable.

Statutory gross profit increased 8% to £69.5 million (after depreciation included within cost of sales), with a margin of 21%, and the operating loss reduced from £50.8 million to £21.2 million.

Net interest fell from £6.9 million to £5.3 million.

The loss before tax showed significant improvement, down 57% from £58.8 million last year to £25.0 million.

#### Earnings per share and dividends

The basic loss per ordinary share reduced by 57% from 4.44p per share to 1.90p. Given our Company's stage of development and the accumulated losses from the network deployment, the Board is not yet able to recommend a dividend.

#### Capital investment

Capital investment continued to be tightly managed and was £41.1 million compared with £44.9 million last year, falling to 12% of turnover from 15%. Approximately 55% of capital expenditure was tied to turnover growth either through customer connections, product development or platform capacity upgrades. Non turnover-growth capital expenditure includes billing platform replacements and other back office functions.

No individual project accounted for more than 10% of the total spend, reflecting the diverse and customer-linked nature of our investment programme during the year. Capitalised labour and overhead costs required to deliver this programme amounted to £8.7 million in the year.

<sup>1</sup> Excludes £3.2 million exceptional restructuring costs.

## Operating and Financial Review

## Tax

A small tax charge of £0.2 million arises from trading activities in the Netherlands. UK trading losses give rise to a deferred tax asset of £7.2 million with accelerated capital allowances and other timing differences of £37.8 million giving a total deferred tax asset not recognised of £45.0 million.

As disclosed in our Open Offer document to shareholders during our demerger process from ScottishPower in 2002, if our Company trades during the period from 19 March 2002 to 30 September 2005 on a material and non-commercial basis with members or former members of the ScottishPower Group, our former parent company, a tax liability of up to £570 million may be triggered arising from the original flotation of THUS in 1999. This payment would fall on THUS under Section 179 of the Taxation of Chargeable Gains Act 1992. Any trigger caused by events prior to 19 March 2002 is covered by an existing indemnity with ScottishPower. A strong control regime is in place to manage this remote risk.

## Cash flows

Net cash flow from continuing operating activities was positive at £37.4 million compared with £26.1 million last year. Underpinning this was EBITDA of £43.6 million. Cash flow before financing costs<sup>1</sup> was positive at £0.8 million for the first time in our Company's history, compared with an outflow in the prior year of £28.3 million. In addition, cash flow (after returns on investments and servicing

of finance and capital expenditure and financial investment) was positive in the second half of the financial year on a sustainable basis.

At the year end, net debt stood at £35.4 million compared with £32.7 million last year and gearing was 16%. Our drawdowns under our £60.0 million loan facility stood at £57.0 million, which converted to an amortising term loan on 1 April 2004. Repayments commence on 31 March 2005 and are complete on 31 March 2008, with a balloon repayment profile. The loan continues to be governed by standard covenants.

With a cash balance of £26.4 million, a positive cash flow operating business and stable financing, THUS has the capacity and financial resilience to meet the requirements of large new business opportunities or unforeseen external economic shocks to the sector or national economy.

## Statement of recognised gains and losses

The main movement in prior years, apart from trade losses, has related to gains from the sale of capacity under IRU (Indefeasible Rights of Use) agreements. The market for IRUs has contracted since 2002, and consequently there continues to be limited activity in this area.

## THUS's differentiating factors and operating environment

THUS is firmly focused on the UK market without the distraction of major international investments or foreign regulatory regimes and operating environments. We have completed

our UK-wide deployment of capability and are consequently deriving significant benefits of scale. Our quality and service innovation are class-leading and well respected. We are financially strong. We believe we are also the only alternative carrier to have a strong "ISP inside" with the Demon brand, merging the best of Internet and telecommunication cultures.

We believe these factors position us well to withstand the continued sector turmoil and enhance our ability to address concerns relating to growth and competitive intensity.

Our model implies that we need to approximately double in size to develop the scale to deliver an attractive return on capital. With a growing business telecoms market in the UK which we believe to be in excess of £10 billion per annum, this is a sufficiently sized opportunity for us to grow into. THUS has hit critical mass in key areas, allowing us to benefit from architecture decisions that support a full range of activities and enable a doubling of network capacity for just 5% of the original cost.

There is no doubt that the market remains extremely competitive, with a large number and variety of operators still active in the marketplace. However, with a strong service development capability, we are able to develop and launch higher value services in market segments in which few competitors operate. This also allows us to differentiate at the commodity end of services, where the capability to offer a migration path to higher value products

## Operating and Financial Review

is important. This gives customers such as Amserve the confidence to renew and grow services on major long-term contracts – in their case until 2009.

We also have to grow our margins. Leveraging increasing revenues on our scalable network and operating platforms provides a powerful driver for our new focus on operating profit.

Our Company's activities are affected by the rulings and actions of Ofcom, the industry's regulator. This year Ofcom has taken on the role of Oftel and initiated a review of the market. European regulation also plays an important role in promoting and defining the framework under which Ofcom operates and this is likely to increase. THUS continues to raise specific areas of concern with Ofcom.

## Policy issues

### Treasury

THUS's treasury policy aims mainly to manage financial risks arising from limited foreign currency exposure from our small Netherlands operation and limited supplier payments in US Dollars and Euros. Hedging in the form of a "cap" is in place to minimise interest rate exposure on our loan facility, where drawdowns are charged at LIBOR plus 3.5%.

Tight control exists over treasury activities, and any non-standard instruments require approval from the Chief Financial Officer or Board. THUS has no off balance sheet financing or special purpose vehicles, and maintains a simple and transparent corporate structure.

## Accounting Policies

The major event of the year relates to the introduction of International Financial Reporting Standards (IFRS) from 31 December 2005 year ends onwards, mandated by the European Union for all listed companies within the EU. At the moment, and for the year ending 31 March 2005, THUS reports under UK GAAP.

THUS intends to publish its first IFRS results at the half year ending 30 September 2005. This requires comparatives for the prior year including, therefore, a 31 March 2004 IFRS balance sheet. Consequently, during the year we have been reviewing our position with staff training and a diagnostic review to highlight key points of difference between IFRS and UK GAAP. We are currently quantifying these areas, and in March 2004 the Audit Committee met to consider our IFRS accounting policies.

New and revised versions of IFRS have been issued up to March 2004 as standards have evolved. In addition, a convergence project for revenue recognition between US GAAP and IFRS is under way and due to report in 2005. This has the potential to change the way all European companies account for certain aspects of revenue recognition. Consequently, as THUS looks at its key measures of turnover, operating profit and cash flow, detailed guidance on possible changes cannot be made at this point. The key primary measure of cash flow is unaffected by the adoption of IFRS.

Under UK GAAP, the Urgent Issues Task Force issued UITF 38 "Accounting for ESOP Trusts". This does not come into effect until June 2004 but, while early adoption is recommended, due to the unique nature of events during the telecoms "bubble" when most of these shares in THUS were purchased, early adoption is not appropriate for THUS.

Guidance notes were also issued on Financial Reporting Standards "Reporting the Substance of Transactions" (FRS 5) relating to revenue recognition, but these have not changed the interpretation of THUS's accounting policies in these areas.

## Outlook

The strategy we outlined at the time of our listing has enabled us to deliver our business model to date, scaling and flexing our business according to changing market conditions. Assuming the macro environment remains broadly unchanged, we remain comfortable with our short-term goal of becoming operating profit positive in the second half of the new financial year and our longer-term goal of at least returning our cost of capital.

<sup>1</sup> Representing cash outflow before financing of £(2.6) million (2003: £(36.7) million) and returns on investments and servicing of finance of £(3.4) million (2003: £(8.4) million).