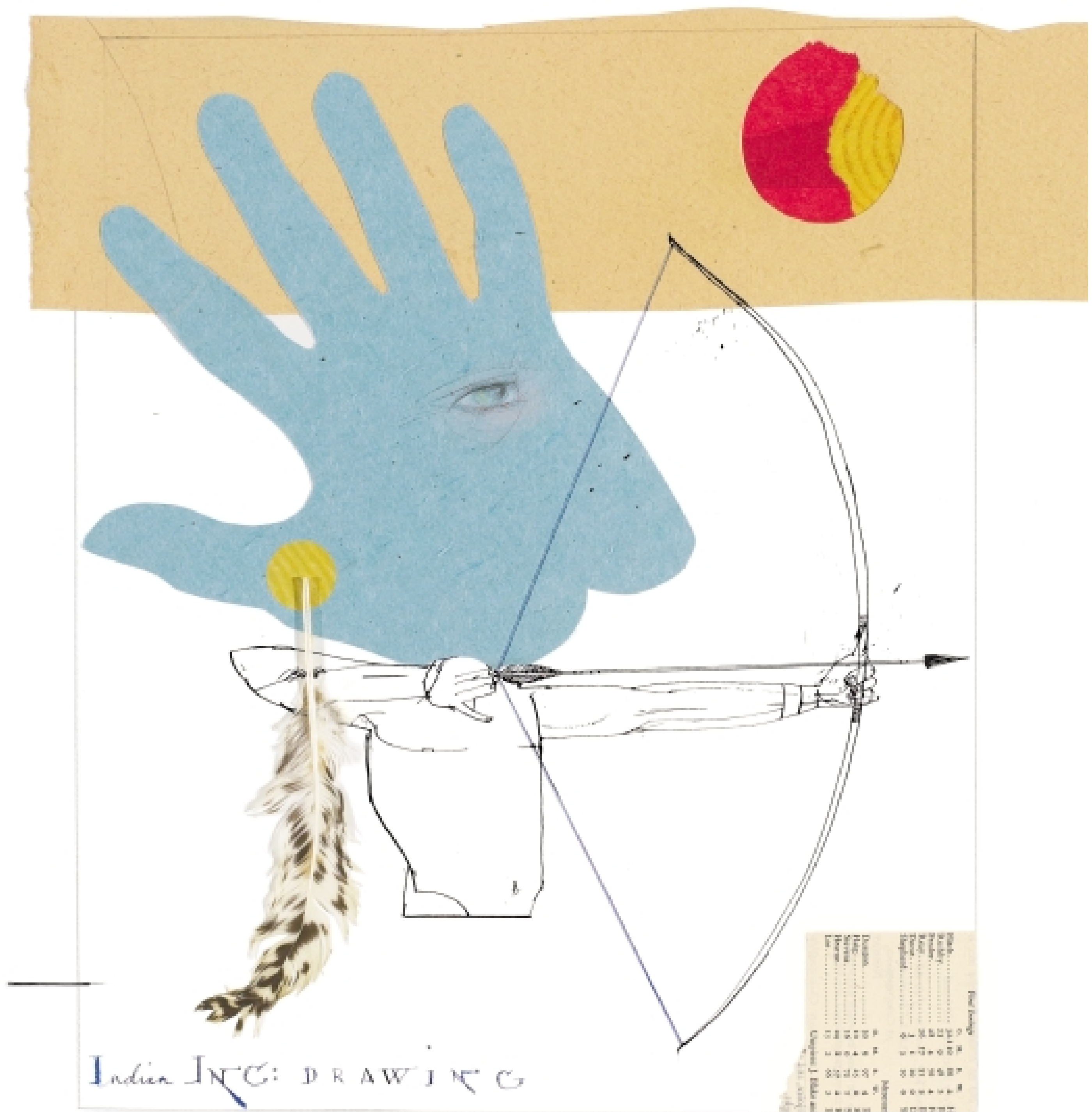
Operating & financial review



Competitive performance

Despite very difficult trading conditions throughout the world, our 2002 results reflect the achievement of balancing market pressure on revenues against reducing costs.

Public relations and public affairs continued to be most affected by the recession. Branding & identity, Healthcare and Specialist communications was somewhat affected, with healthcare and direct, a part of specialist communications, being more resilient. Advertising and Media investment management has been less affected than anticipated and Information, insight & consultancy has continued to see some limited growth, although it has been increasingly affected by the recession.

Despite these circumstances, there is no reason to believe that the Group cannot achieve the revised objective set in 2002 of improving margins by up to another one margin point in 2003 with the potential for a further half of one margin point improvement in 2004.

Your Board does not believe that there is any functional, geographic, account concentration or structural reasons that should prevent the Group achieving operating margins of up to 13.8% by 2004. After all, the best listed performer in the industry is or has been at 15-16% and that is where we would want to be. Neither is there any reason why operating margins could not be improved beyond this level by continued focus on revenue growth and careful husbandry of costs.

Our ultimate objective continues to be to achieve 20% margins over a period of time and improving the return on capital employed.

Revenue[2] per head
$000

	Year	
WPP	02[1]	116.7
	01[1]	115.7
O&M/JWT/Y&R/MindShare/Mediaedge:cia	02[1]	107.2
	01[1]	106.9
Omnicom[1]	02	131.5
	01	121.9
IPG[1]	02	118.3
	01	132.8

[1] Constant currency. See definition on page 134

PBIT[3] margins
%

	Year	
WPP	02	12.3
	01	14.0
O&M/JWT/Y&R/MindShare/Mediaedge:cia	02[1]	15.1
	01[1]	16.4
Omnicom[1]	02	15.2
	01	15.9
IPG[1,4]	02	8.9
	01	13.0

[1] Constant currency. See definition on page 134

Notes

[1] The figures above for Omnicom and IPG (The Interpublic Group) have been derived from their respective 10-K filings with the SEC in respect of the year ended 31 December 2002. As both these companies report under US GAAP, the above figures should be read as indicative of their financial performance as they are not directly comparable with WPP's UK GAAP reporting.

[2] Revenue per head has been calculated as reported revenue divided by the average number of employees in the relevant year. For Omnicom and IPG, who do not report average headcount in their 10-K filings, it has been estimated as the average of opening and closing headcount for the year.

[3] PBIT: Profit on ordinary activities before interest, taxation, goodwill amortisation and impairment, fixed asset gains and write-downs. The calculation of PBIT is set out in note 28 of the financial statements.

[4] Interpublic PBIT margin for 2001 as presented above excludes restructuring and merger-related costs of $645.6m.

Geographic performance

The worldwide advertising and marketing services industries shrank by approximately 5% in 2001 as a result of the worldwide recession which started in the fourth quarter of 2000, and was further impacted by September 11.

This sharp downturn affected the US most significantly, but also impacted Europe, Asia Pacific and Latin America.

In 2002 North America and the UK have been most affected by the recession, with Continental Europe and Asia Pacific, Latin America, Africa and the Middle East least affected.

In the fourth quarter of 2002, North America exhibited revenue growth for the first time in almost two years.

Constant currency[†] revenue growth

%

North America	02	–2.4
	01	32.8
UK	02	–1.3
	01	17.7
Continental Europe	02	5.3
	01	46.7
Asia Pacific, Latin America, Africa & Middle East	02	4.7
	01	33.9

[†]See definition on page 134

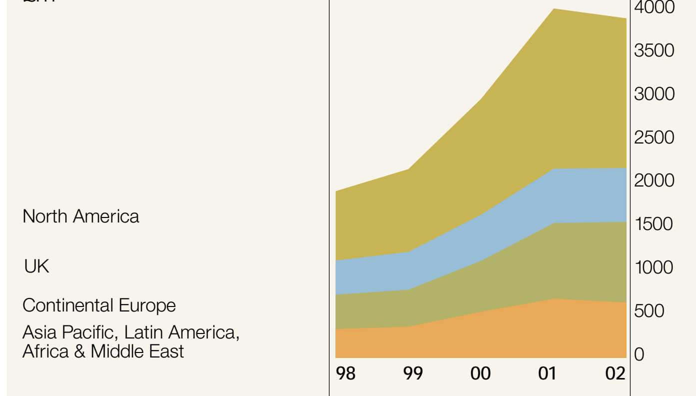
PBIT[1] margins by geography

%

North America	02	14.1
	01	14.5
UK	02	10.9
	01	11.8
Continental Europe	02	10.7
	01	13.7
Asia Pacific, Latin America, Africa & Middle East	02	10.9
	01	14.8

Revenue by geography

£m



Notes

[1] PBIT: Profit on ordinary activities before interest, taxation, goodwill amortisation and impairment, fixed asset gains and write-downs. The calculation of PBIT is set out in note 28 of the financial statements.

Sector performance

Advertising and Media investment management

In constant currencies, this sector's revenue grew by 2.5% last year. The combined operating margin (including income from associates) of this group of companies (Ogilvy & Mather Worldwide, J. Walter Thompson Company, Y&R Advertising, Red Cell, MindShare and Mediaedge:cia) was over 15%.

In 2002, Ogilvy & Mather Worldwide generated estimated net new billings of £147 million ($221 million), J. Walter Thompson Company £534 million ($802 million), Y&R Advertising £212 million ($319 million). Red Cell, which has been strengthened significantly by the addition of new talent, the acquisition of Berlin Cameron and Partners in the US and the increase in the shareholding in the Batey Group in Asia Pacific, generated estimated net wins of £52 million ($78 million) excluding the recent assignment of Coca-Cola Classic in the US.

Also in 2002, MindShare and Mediaedge:cia generated estimated net new billings of £1,007 million ($1,512 million). Plans to form a worldwide 'WPP Media' parent company are currently being implemented.

Information, insight & consultancy

Although the recession has increasingly impacted the Group's Information, insight & consultancy businesses, on a constant currency basis revenues grew 4% in 2002, partly driven by acquisition. Like-for-like revenues were still down less than 1%. Despite this overall top line performance, revenues, operating profit and operating margins came under pressure, particularly at Center Partners and Research International.

However, strong performances were recorded by Millward Brown at Greenfield Consulting in the US and the UK; IMS in Ireland; MFR and Millward Brown in France, Spain, China and Brazil; and by Research International in Australia, Japan, Singapore, Taiwan, Thailand and South Africa.

Public relations & public affairs

In constant currencies, the Group's public relations and public affairs revenue continued to be most affected by the recession, particularly in technology, media and telecommunications, declining by 8%. Burson-Marsteller, Ogilvy Public Relations Worldwide, Robinson Lerer & Montgomery in the US, and Finsbury and Buchanan in the UK performed well.

Following the like-for-like decline in revenues in 2001, and 2002, the public relations and public affairs businesses reduced their costs significantly and as a result operating margins before associates improved by over one margin point in 2002.

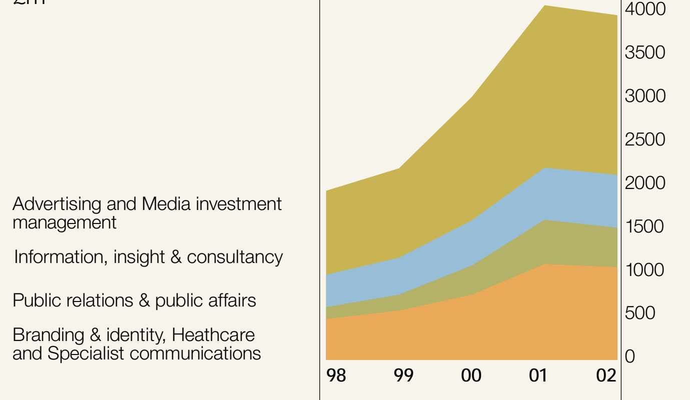
Constant currency† revenue growth
%

Sector	Year	%
Advertising and Media investment management	02	2.5
	01	30.8
Information, insight & consultancy	02	4.0
	01	14.4
Public relations & public affairs	02	–8.0
	01	49.3
Branding & identity, Healthcare and Specialist communications	02	–0.2
	01	43.1

†See definition on page 134

PBIT[1] margins by sector
%

Sector	Year	%
Advertising and Media investment management	02	15.2
	01	17.3
Information, insight & consultancy	02	7.1
	01	9.8
Public relations & public affairs	02	10.4
	01	9.6
Branding & identity, Healthcare and Specialist communications	02	11.1
	01	12.5



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(continued overleaf)

Review of operations

As a result of the worldwide recession, which started in the US in the fourth quarter of 2000 and the impact of the tragedy of September 11, the worldwide advertising industry shrank by approximately 5% in 2001, with marketing services also down a similar amount.

The recession continued into 2002, when advertising and marketing services expenditure was probably down again in the low single digits and the downturn has now continued for over two years. The tragic events of September 11 had a material negative impact on the second half of 2001 and many people (ourselves included) felt that the second half of 2002 might see a relative improvement, particularly given easier comparative figures. However, further stock market nervousness in the third quarter of 2002 raised additional concerns about corporate profitability, consumer confidence and a possible economic 'double-dip', producing a 'dead-cat' bounce.

While the Group has seen a reduction in the rate of decline in each quarter of 2002, with the US exhibiting revenue growth in the fourth quarter of 2002 for the first time in almost two years, uncertainty remains. As a result, 2003 is likely to be another difficult year, with hopes for a more significant recovery being pinned on 2004 and the positive impact of quadrennial factors such as the US Presidential election, political advertising in the US pushing up media rates, the Athens Olympics and the European football championships.

Network television price inflation and declining audiences, fragmentation of traditional media and rapid development of new technologies continued to drive experimentation by our clients in new media and non-traditional alternatives. 1998 was really the first year when WPP's marketing services activities represented over 50% of Group revenue. In 2002 these activities represented over 53% of Group revenue, a little less than 2001, as Advertising and Media investment management revenues were more robust than anticipated. In addition, in 2002, our narrowly defined internet-related revenue was over $300 million or over 2% of our worldwide reported revenue. This compares with approximately 5% for online media's share of total advertising spend in the US and approximately 3% share worldwide. The new media continue to build their share of client spending.

Group financial performance

Reportable revenue was down almost 3% to £3.908 billion. Revenues including associates are estimated to total £4.644 billion.

Profit pre-goodwill amortisation and impairment, interest, tax, fixed asset gains and write-downs was

down 14.4% to £480.2 million from £561.1 million and down almost 12% in constant currencies.

Net interest payable and similar charges (including a charge for the early adoption of FRS 17) increased to £86.4 million from £71.3 million, reflecting lower cash generated from operations, the full-year impact of the increased level of acquisition activity in 2001 and share repurchases and cancellations in the current year. Headline interest cover remains at the relatively conservative level of almost six times and at six times, excluding the FRS 17 charge.

Profit before interest, tax, fixed asset gains and write-downs fell by over 44% to £302.5 million from £546.3 million.

The Group's tax rate on headline profits was 26%, down from 27% in the previous year, reflecting the impact of further improvements in tax planning.

Diluted headline earnings per share were down over 19% at 24.9p. In constant currency, earnings per share on the same basis were down under 16%.

All severance and restructuring costs have been included in operating profits. Following the collapse in technology equity valuations in 2001, it was considered prudent to write down the net balance sheet value of the Group's investments in this area by £70.8 million. 2002 has seen further declines in these technology investments, many of which are in private companies. An additional write-down of £19.9 million has been taken in 2002, mitigated by gains on asset disposals of £9.2 million. The carrying value of these investments is now written down to £19.3 million.

In addition, a further £145.7 million was taken as an impairment charge primarily reflecting accelerated amortisation of goodwill on first generation businesses which have suffered in the recession. This additional charge represents 3.2% of the goodwill shown in the balance sheet at the start of 2002.

As a result, profit before tax fell 50% to £205.4 million and diluted earnings per share by almost 68% to 7.7p.

The Board recommends an increase of 20% in the final dividend to 3.67p per share, making a total of 5.40p per share for 2002, a 20% increase over 2001. The record date for this dividend is 6 June 2003, payable on 7 July 2003. The dividend for 2002 is four and a half times covered by headline earnings.

Operating margins

Pre-goodwill amortisation and impairment, reported operating margins (including income from associates) fell to 12.3% from 14.0%. Excluding income from associates, reported operating margins fell less, by 1.4% from 12.9% to 11.5%. Post-goodwill amortisation and impairment, reported profit before interest, tax, investment gains and write-downs was down 44% to £302.5 million from £546.3 million. Before incentive payments totalling £90.1 million or over 16% (under 14% in 2001) of operating profit before bonuses, taxes and income from associates, operating margins fell to 13.8% from 14.9%, reflecting stronger performance of some operating units against last year and increased provision for the LEAP senior management incentive program, due to stronger than anticipated WPP total shareholder return against the peer group. Reported operating costs including direct costs fell by almost 1%, but rose by almost 3% in constant currency.

On a reported basis the Group's staff cost to gross margin ratio, excluding severance and incentives, increased slightly to 56.9% from 56.6%.

Variable staff costs as a proportion of total staff costs have increased over recent years, reaching 12.1% in 2000. The impact of the recession in both 2001 and 2002 has reduced this ratio to 9.2% and variable staff costs as a proportion of revenue to 5.3%. This highlights the benefits of the increased flexibility in the cost structure.

With the recession, the task of eliminating under-utilised property costs continue to be a priority. At the beginning of 2002 the Group occupied approximately 14 million square feet worldwide. By the end of the year, occupancy had fallen to 13.5 million square feet or a 4% reduction. In addition, a further 1.1 million square feet or an additional 8% will be jettisoned by the end of 2003.

Like-for-like performance

On a constant currency basis, revenue was up 0.7% and gross profit up 0.9%. Like-for-like revenues, excluding the impact of acquisitions and on a constant currency basis, were down 5.9%. Over the four quarters of 2002, like-for-like revenues have fallen by decreasing amounts – more than –9% in quarter one, –8% in quarter two, more than –3% in quarter three and less than –3% in quarter four. In quarter four, North America showed revenue growth for the first time for seven quarters
of almost 2%.

Like-for-like total operating and direct costs were down 4.6% on the previous year. Staff costs excluding incentives were flat, as were total salaries. Non-staff costs rose as a proportion of revenues, primarily reflecting the 'lumpiness' of property costs as capacity is reduced.

On a constant currency basis, pre-tax profits were down almost 43% reflecting the strengthening of sterling against the dollar, counterbalanced to some extent by its weakness against the euro. If sterling had stayed at the same average levels as 2001, profits on this basis would have been £315.2 million.

Headcount

Actual people numbers averaged 50,417 against 50,487 in 2001, down marginally. On a like-for-like basis, average headcount was down to 50,417 from 55,109, a decrease of over 8%. At the end of 2002 staff numbers were 49,439 compared with 52,670 at the end of 2001 on a pro-forma basis, a reduction of over 6%. Headcount numbers have been falling by approximately half of 1% per month.

Acquisitions and start-ups

In 2002 the Group increased its equity interests, at a combined initial cost of £105 million in cash, in Advertising and Media investment management in the UK, France, Germany, Spain, The Netherlands, Switzerland, Sweden, Finland, the Czech Republic, Slovakia, Australia, New Zealand, China, India, Taiwan, Brazil and the Middle East; in Information, insight & consultancy in the US, Ireland, France, Poland and Thailand; in Public relations & public affairs in the US, Norway, China, Australia, Japan and Taiwan; in direct and promotion in the US; and in sports marketing in Germany.

Parent company initiatives

Increasingly, WPP is concentrating on its mission of the "management of the imagination", and ensuring it is a big company with the heart and mind of a small one. To aid the achievement of this objective and to develop the benefits of membership of the Group for both clients and our people, the parent company continues to develop its activities in the areas of human resources, property, procurement, information technology and practice development. Ten practice areas which span all our brands have been developed initially in media investment management, healthcare, privatisation, new technologies, new faster-growing markets, internal communications, retailing, entertainment and media, financial services and hi-tech and telecommunications.

Executive options

WPP intends to expense the cost of executive options in its income statement. Under UK GAAP, there is no definitive guidance on how this is to be implemented. However, page 132 details the impact of expensing executive options using a Black-Scholes valuation model and applying US transitional guidelines contained in FAS 148. On this basis, only executive options issued in 2002 would be expensed in that year. As options granted are weighted towards the second half of the year, the resulting reduction in headline earnings per share would have been only 0.4p. Fully expensing all executive options granted over the last three years on a consistent basis would reduce headline earnings per share by approximately 7%.

Treasury activities

Treasury activity is managed centrally, from the parent company's London, New York and Hong Kong offices, and is principally concerned with the monitoring of working capital, managing external and internal funding requirements and the monitoring and management of financial market risks, in particular interest rate and foreign exchange exposures.

The treasury operation is not a profit centre and its activities are carried out in accordance with policies approved by the Board of Directors and subject to regular review and audit.

The Group's interest rate management policy recognises that fixing rates on all its debt eliminates the possibility of benefiting from rate reductions and similarly, having all its debt at floating rates unduly exposes the Group to increases in rates.

Its principal borrowing currencies are US dollars, pounds sterling and euro. Borrowings in these currencies, including amounts drawn under the working capital facility, represented 97% of the Group's gross indebtedness at 31 December 2002 (at $1,248 million, £155 million and €1,005 million) and 98% of the Group's average gross debt during the course of 2002 (at $1,407 million, £171 million and €1,043 million). 62% of the year-end dollar debt is at fixed rates averaging 5.23% for an average period of 26 months. 100% of the GBP debt is at a fixed rate of 3% (including the effect of the redemption premium on the £450 million 2% convertible bonds) for an average period of 52 months. 55% of the euro debt is at fixed rates averaging 5.45% for an average period of 36 months.

In April 2002 the Group issued £450 million of convertible bonds carrying a coupon of 2%. The bonds are convertible into 41.9 million WPP ordinary shares. Proceeds from the issue were used to repay drawings under the £360 million bank facility arranged to acquire Tempus Group plc in 2001 and for general corporate purposes. The bonds are redeemable in April 2007 at a premium of 5.35% over par which, together with the 2% annual coupon, has the effect of providing bondholders with an all-in return of 3% over the five-year life of the bonds. The additional 1% per annum associated with the redemption premium is accrued and charged as interest in the profit and loss account. £295 million of the £440 million of proceeds net of expenses were converted into US dollars, Euro and Japanese Yen through cross-currency swap agreements with the Group's bankers. These cross-currency swaps are shown in the tables in note 5 on page 112.

Other than fixed rate debt, the Group's other fixed rates are achieved principally through interest rate swaps with the Group's bankers. The Group also uses forward rate agreements and interest rate caps to manage exposure to interest rate changes. At 31 December 2002, no forward

2002 cash flow £m

46 Other
117 Depreciation
177 Goodwill amortisation and impairment
273 Operating profit
Free cash flow[1] £349m
78 Net interest
101 Capital expenditure
85 Tax
Cash in
Cash out

2001 cash flow £m

115 Other
110 Depreciation
506 Operating profit
Free cash flow £494m
15 Goodwill amortisation and impairment
56 Net interest
118 Capital expenditure
78 Tax
Cash in
Cash out

2000 cash flow £m

93 Other
64 Depreciation
379 Operating profit
Free cash flow £292m
15 Goodwill amortisation and impairment
66 Net interest
112 Capital expenditure
81 Tax
Cash in
Cash out

Notes
[1] See definition on page 134.

rate agreements or interest rate caps were outstanding.

These interest rate derivatives are used only to hedge exposures to interest rate movements arising from the Group's borrowing and surplus cash balances arising from its commercial activities and are not traded independently. Payments made under these instruments are accounted for on an accruals basis.

An analysis of the debt and fixed rate maturities is shown in note 9 on page 113.

The Group manages liquidity risk by ensuring continuity and flexibility of funding even in difficult market conditions. Undrawn committed borrowing facilities are maintained in excess of average gross borrowing levels and debt maturities are closely monitored.

Targets for average net debt are set on an annual basis and, to assist in meeting this, working capital targets are set for all the Group's major operations.

The Group's significant international operations give rise to an exposure to changes in foreign exchange rates. The Group seeks to mitigate the effect of these structural currency exposures by borrowing in the same currencies as the operating (or 'functional') currencies of its main operating units. The majority of the Group's debt is therefore denominated in US dollars and euros, as these are the predominant currencies of revenues.

The Group's operations conduct the majority of their activities in their own local currency and consequently the Group has no significant transactional foreign exchange exposures. Any significant cross-border trading exposures are hedged by the use of forward foreign exchange contracts. There were no such material contracts in place at 31 December 2002. No speculative foreign exchange trading is undertaken.

Cash flow

As at 31 December 2002, the Group's net debt fell to £723 million compared with £885 million at 31 December 2001 (2001: £893 million on the basis of 2002 year-end exchange rates), following net cash expenditure of £281 million on acquisitions (including £94 million of loan note redemptions) and £76 million on share repurchases and cancellations.

Net debt averaged £1,343 million in 2002, up £509 million against £834 million in 2001 (up £521 million at 2002 exchange rates), primarily reflecting the full-year impact of acquisitions made in 2001. These net debt figures compare with a current equity market capitalisation of approximately £5.3 billion, giving a total enterprise value of approximately £6.6 billion.

Cash flow strengthened as a result of improved working capital management and cash flow from operations.

In 2002, operating profit before goodwill amortisation and impairment was £450 million, capital expenditure £101 million, depreciation £117 million, tax paid £85 million, interest and similar charges paid £78 million and other net cash inflows of £46 million. Free cash flow available for debt repayment, acquisitions, share buy-backs and dividends was therefore £349 million. This free cash flow was absorbed by acquisition payments and investments of £281 million, share repurchases and cancellations of £76 million and dividends of £56 million. The Company almost fulfilled its recently set objective of covering acquisition payments and share repurchases and cancellations from free cash flow.

Your Board continues to examine ways of deploying its substantial cash flow of over £400 million per annum to enhance share owner value. As necessary capital expenditure is expected to remain equal to or less than the depreciation charge, the Company has concentrated on examining acquisitions or returning excess capital to share owners in the form of dividends or share buy-backs.

As noted above, your Board has decided to increase the final dividend by 20% to 3.67p per share, taking the full-year dividend to 5.40p per share which is four and a half times covered, at the headline earnings level. In addition, as current opportunities for cash acquisitions may be limited particularly in the US, the Company will continue to commit to repurchasing up to 2% of its share base in the open market, when market conditions are appropriate. Such annual rolling share repurchases are perceived to have a more significant impact in improving share owner value than sporadic buy-backs.

Pensions funding

In light of recent stock market declines and consequent poor equity investment returns, the Company has reduced its forecasted weighted average return on US pension assets from 9.1% to 7.2% and on UK pension assets from 5.8% to 5.4%. Our advisors indicate that further average cash contributions of approximately £12-£13 million per annum would be necessary to fully fund all funded pension schemes over their remaining lives, unless stock markets recover.

Net balance sheet assets

No hedging is undertaken in relation to the accounting translation of overseas balance sheets. In 2002 this resulted in an increase of £82 million (2001: decrease of £81 million) in the sterling value of share owners' funds due to movements in exchange rates. In 2002, net assets of £3,714 million compared with £3,641 million in 2001.

2003 prospects

Given the current state of the world economy, your Group has performed reasonably well. In essence, operating costs, including severance and restructuring

costs, have been reduced following the significant fall in like-for-like revenues. As the Group forecasted the general decline in economic conditions relatively early, the consequent focus on matching staff costs to revenues has resulted in a fall in average headcount by over 8% and point-to-point headcount by over 6%. This has been achieved, in part, by a slow-down in recruitment and the impact of the normal attrition rate.

As usual, and given conditions in 2002, our budgets for 2003 have been prepared on a conservative basis, largely excluding new business particularly in Advertising and Media investment management. They predict broadly flat like-for-like revenues in comparison with 2002 and a stronger second half of the year relative to the first.

They also indicate Advertising and Media investment management revenues up by 1%, counterbalanced by flat marketing services revenues. This compares with budgeted growth of 10% and achieving 15% in 2000, budgeted growth of 7% and a decline of 3% in 2001 and flat budgeted revenues and a decline of 6% in 2002.

In the first quarter of 2003, constant currency revenues were up over 1% and on a like-for-like basis, excluding acquisitions and currency fluctuations, were flat.

Estimated net new business billings of £410 million ($660 million) were won during the first quarter of 2003.

Net debt at 31 March 2003 was £1,335 million, compared with £1,505 million at 31 March 2002. Average net debt in the first quarter of 2003 was £1,252 million compared to £1,227 million in 2002, at 2003 exchange rates. In the 12 months to 31 March 2003, the Group's free cash flow was £442 million. Over the same period, the Group's expenditure on capital, acquisitions, share re-purchases and cancellations was £489 million.

Worldwide economic conditions are likely to remain difficult in 2003 particularly given the uncertainty created by the war in Iraq and the Sars epidemic. Should conditions improve, the Group is well positioned to respond to any recovery, given its geographical and functional spread and strengths, its flexible cost structure and strong cash flow. Incentive plans for 2003 will again focus more on operating profit growth than historically to stimulate top-line growth, although objectives will continue to include operating margin improvement, improvement in staff costs to revenue ratios and qualitative Group objectives, including co-ordination, talent management and succession planning.

In the short term, growth in advertising and marketing services expenditure will likely remain fairly flat or low, particularly given procurement pressures and the dampening effect of the increasing proportion of fee remuneration on the impact of cyclical upturns

In connection with the provisions of the Private Securities Litigation Reform Act of 1995 (the 'Reform Act'), the Company may include forward-looking statements (as defined in the Reform Act) in oral or written public statements issued by or on behalf of the Company. These forward-looking statements may include, among other things, plans, objectives, projections, anticipated future economic performance and assumptions and the like that are subject to risks and uncertainties. As such, actual results or outcomes may differ materially from those discussed in the forward-looking statements. Important factors which may cause actual results to differ include but are not limited to: the unanticipated loss of a material client or key personnel, delays or reductions in client advertising budgets, shifts in industry rates of compensation, government compliance costs or litigation, unanticipated natural disasters, the Company's exposure to changes in the values of other major currencies (because a substantial portion of its revenues are derived and costs incurred outside of the UK) and the overall level of economic activity in the Company's major markets (which varies depending on, among other things, regional, national and international political and economic conditions and government regulations in the world's advertising markets). In light of these and other uncertainties, the forward-looking statements included in this document should not be regarded as a representation by the Company that the Company's plans and objectives will be achieved.

Paul Richardson
Group finance director