

Dear Fellow Shareholders:

What do growing companies do in slumping markets? They work harder to meet customer needs, increase market share and expand their competitive advantage. They manage costs, while continuing to invest in their business and their people for the future. They respond effectively to short-term challenges without deviating from their long-term plans. Borders Group distinguished itself in all these ways in 2002.



◀ **Gregory P. Josefowicz**

Chairman, President and Chief Executive Officer

Despite a struggling economy and lackluster retail environment, Borders Group modestly increased sales, we improved our earnings, and continued to expand our domestic and international presence. While the holiday season and fourth quarter fell short of our goals, we ended fiscal 2002 in a fundamentally strong position:

- ▶ Consolidated sales rose 2.9% to a record \$3.5 billion. For the year, sales for our Borders and International segments increased 3.8% and 25.1%, respectively, while sales at Waldenbooks declined 5.5%.
- ▶ Consolidated earnings per share increased 28.3% to \$1.36 per share.
- ▶ We maintained our strong financial position by ending 2002 with cash, net of debt, of \$106.4 million, equal to our position one year ago.

Disappointingly, our sales growth was not as strong as in past years. This contributed to a decline in the value of Borders Group stock of approximately 19% during calendar year 2002, compared to a drop of just over 24% in the S&P 500 for the same period. Leveraging our strong cash position, we returned approximately \$75 million to shareholders in the form of stock repurchases, and we intend to use stock repurchases as a core strategy for increasing shareholder value.

STRONG MOVES FOR A SOFT MARKET

On a relative basis, Borders Group continued to outpace the industry in 2002, increasing our average monthly share of U.S. retail book and music sales. In typical growing markets, those share gains would have translated into sales increases. But book and music industry sales declined in 2002 and our performance suffered as a result. Comparable store sales for our

Borders segment declined 1.2% for the year. Waldenbooks' comparable store sales fell 3.2%.

It's not that our customers are spending less when they shop. In fact, the average per-visit purchase at our Borders stores increased nearly 2% in 2002. But total store visits were down during the year, due in part to fewer blockbuster book titles to help drive traffic. While these popularity cycles impact our business, there's a lot we've learned about how to manage them.

To help counteract last year's soft market conditions, we continued to rein in costs, reducing our expense ratio for the eighth consecutive quarter. We improved inventory management for the second straight year, keeping our investment in inventory essentially flat, while increasing our total square footage by 6.7%. We ended 2002 in a net-cash position, and favorably restructured our outstanding loan agreements during the year.

As a result, our financial position remains solid, and we continue to make strategic investments to improve our sales and earnings, staying

focused on the four-point business plan that we initiated two years ago:

1. BUILDING OUR CORE BUSINESS

Investing in stores remains an important part of building our core business. During 2002, we opened 41 new domestic Borders locations, from Wilton, Connecticut, to San Diego, California, bringing our total at fiscal year-end to 404.

Our expansion included 10 new "small market" stores, designed primarily for communities that aren't large enough to support our full-size superstore format. These new stores—which average about 17,000 square feet compared to approximately 23,000 square feet for a typical Borders superstore opened in 2002—exceeded our initial sales expectations, and we will continue to explore opportunities for this format.

New-store growth enabled us to increase sales in 2002. Domestically, Borders stores generated \$2.3 billion in sales in 2002, up 3.8% over 2001. While we launched several new initiatives during the third and fourth quarters

to increase sales and further differentiate our business—including the launch of a new Express In-Store Pick Up service with Amazon.com—these programs did not have much time in 2002 to develop or make significant contributions to growth, yet we look forward to their potential for further contributions.

Category Management is primary among these initiatives. A successful concept in retail management for many years, Category Management is:

- ▶ a proven business philosophy with the consumer as the focus;
- ▶ a collaborative business process with our suppliers; and
- ▶ a dynamic business strategy that impacts organizational design and culture.

Applying Category Management techniques to our business, individual categories of our stores are now managed as distinct profit centers, each with its own goals and business plans. In 2002, we completed implementation of

Category Management plans in six categories, increasing sales, percentage of in-store sales and market share. By the fourth quarter of 2003, about 70% of the categories in Borders stores will have category plans implemented to improve performance. We are committed to accelerating this highly effective initiative.

While books continue to represent the majority of our sales, we are also working hard to expand other complementary categories. These efforts helped to drive double-digit comp sales gains in movies and continued strong growth in gifts and stationery during the fourth quarter. We also improved the performance of our cafes, and continue to seek attractive third-party alliances that we believe can help boost both food and beverage profits and incremental sales throughout our stores.

During the year, we intensified our efforts to measure and monitor customer satisfaction, which we continue to drive to higher levels. According to our research, customers rate product availability and personal service among our greatest strengths, and two of the attributes that contribute most to customer loyalty.

We introduced a number of new training programs in 2002 to constantly improve customer service and satisfaction. These programs are also aimed at enhancing the skills and career advancement of our employees, and helping us strengthen our reputation as a great place to work.

2. DRIVING INTERNATIONAL GROWTH

Borders Group remains the only U.S. retailer to own and operate a significant number of book and music superstores internationally. During 2002, we expanded our presence by opening eight new overseas Borders locations, ending the year with 30 Borders stores throughout Australia, England, New Zealand, Puerto Rico, Scotland and Singapore, and 37 Books etc. locations in the U.K. We also opened a new distribution center in the U.K., doubling our usable square footage.

Our success internationally is based in large part on building on and leveraging our company's core competencies. We work to perpetuate the initiatives that have made

Borders successful in the U.S., while recognizing and making adaptations for cultural differences. For the year, International segment sales increased 25.1% to \$315 million. While its net loss increased during 2002, International generated net income during the fourth quarter, and we aim to achieve breakeven performance by year-end 2003.

Among International's operating initiatives in 2002, we improved our store model in Australia, and vastly improved our organization and infrastructure in the Pacific Rim region. We also streamlined inventory management and stocking in the U.K., contributing to increased turn and well merchandised, more productive stores.

3. LEVERAGING ALLIANCES AND TECHNOLOGY

Our successful alliance with Amazon.com, launched in April 2001, continues to grow stronger, giving us more ways to sell more books to more customers more often. Launched in October, the new Express

In-Store Pick Up service gives Amazon.com and Borders.com shoppers the option of ordering books, music and movies online for later purchase and pick up at a nearby Borders store. Customers who have used the new service love it, saying it expands access to our products and provides nearly “instant gratification” when they shop.

Online purchases made through Borders.com continued to grow at an accelerated rate in 2002. Customers can also visit Bordersstores.com to find the closest Borders location, browse up-to-date event information and reserve titles online for in-store purchase and pick up. In November, we teamed with Amazon.com to launch Waldenbooks.com, providing 24/7 buying and other services to loyal Waldenbooks customers.

During the fall, we also launched a new alliance with Alibris, giving our customers access to more than 15 million used, out-of-print and hard-to-find books worldwide. Customers can now search for and order these titles to be shipped to their neighborhood

Borders store using one of our in-store Title Sleuth computer stations or they can have one of our associates place the order for them at an information desk. This new service gives us yet another way to efficiently find and deliver the exact book that a customer is looking for, and creates a new growth opportunity for us in the hard-to-find book category.

We're also applying technology to improve our operational efficiency. A good example is our Common Systems program. Common Systems is a long-term project that will enable Borders and Waldenbooks businesses to operate on one common technology platform with the goal of improving business processes and reducing our costs over the next several years. In 2002, the focus of our Common Systems initiative included the development and testing of new Product Flow-Receiving systems and procedures to streamline backroom processes and increase inventory accuracy. We also introduced a new PeopleSoft software system to improve the processing and management of human resources information, payroll processes and benefits administration.

4. MAXIMIZING CASH FLOW AT WALDENBOOKS

As the largest mall-based bookseller in the United States, Waldenbooks was hurt by declining consumer mall traffic in 2002. For the year, the segment generated \$852 million in sales, a 5.5% decline compared to the previous year.

Despite this decline, Waldenbooks continues to contribute a significant portion of our consolidated profits and free cash flow, and we are working hard to both rationalize and enhance its business. During 2002, this included closing 53 under-performing stores, giving us a total of 778 Waldenbooks locations at fiscal year-end.

During 2002, we performed an intensive analysis of all our Waldenbooks stores, studying why some stores perform better than others, and looking for ways to improve sales and productivity nationwide. As a result of this Peer-Based-Improvement program, we have separated the stores into groups that share similar locations, formats, mall productivity

and competitive environments. By applying the “best practices” of the most successful stores within each peer group, we expect to boost their performance, and provide objective benchmarks for store managers to monitor and evaluate their progress.

In addition, Waldenbooks expanded membership in its long-running Preferred Reader® loyalty program in 2002, also increasing sales to those customers. Waldenbooks' seasonal businesses also performed well, including the operation of 725 Day by Day Calendar kiosks which helped to bolster holiday sales.

STAYING FOCUSED IN 2003

The business environment is likely to remain challenging in 2003. But we strongly believe in our business and product categories, and we further believe the initiatives we have put in place will help us to distinguish our performance, in weak and strong cycles alike. During 2003, we will stay focused on implementing our four-point business plan, including:

- ▶ Opening approximately 40 new Borders stores domestically, which will generally reflect a trend toward smaller square footage and be located in markets where there is less impact on existing stores. In addition, we plan to open six to eight new international locations in markets where we already have a presence, such as the U.K. and Australia.
- ▶ Continuing to roll out Category Management within our stores, and maximizing the returns from each individual category.
- ▶ Enhancing the design and productivity of our stores and increasing our emphasis on strategic non-book and non-music categories, such as gifts and stationery.
- ▶ Expanding our alliances and technology—including adding new features to Title Sleuth—to differentiate our brands and improve our service to customers.
- ▶ Strengthening Waldenbooks through initiatives like our Peer-Based-Improvement program.

Additionally, we will continue to expand and improve our training initiatives for employees across all of our businesses. Their exceptional knowledge and outstanding service are the qualities that distinguish us most in the minds of many customers, and we are committed to helping our employees continuously develop their skills as “customer advocates” and build successful careers.

While market conditions may continue to work against us in the coming year, I believe we have the people, the passion and the “character” to meet the challenge. I look forward to reporting our progress to you in the year ahead.

Sincerely,



Gregory P. Josefowicz
Chairman, President and Chief Executive Officer