Royal Mail plc

Royal Mail plc Interim Results for the half year ended 29 September 2013

Transcription of Results Presentation

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Presentation

Moya Greene - Royal Mail plc CEO

Good morning. Welcome to our first results presentation. We're absolutely delighted to see you all here, our first as a listed Company. I see some new faces; I particularly want to welcome you. The way we have ordered things today, I will run through some of the key elements of our strategy. Our Chief Financial Officer, Matthew Lester, will then take you through the numbers in detail, and we'll finish up with questions and answers after that. And Matthew will take all the hard questions.

I think the important message for today is that our underlying performance is completely in line with our expectations. There is a little bit of noise in our numbers; Matthew will go through that in greater detail. But fundamentally, we are delivering on our value drivers. You will see that our revenues are up 2% at Group level. We have, I think, done a reasonable job at containing costs. As a result, you have seen that our operating margins are improving; they're over 5% now.

Since Matthew and I have been at the Company, we have really focused on cash, and the cash-generating capability, particularly in the UK business, has been where historically I think this Company has had some very big problems. We are very pleased to see important improvement on the cash. When you take out some of the significant items that you will see that there is a £90 million improvement in underlying cash flow. You're going to have to understand some of the noise in the numbers from the half of last year as well, but can go through that in a minute.

We are delivering on our strategy, and our strategy is to be the most successful delivery Company in the UK, and with GLS, possibly Europe as well. A big part of the turnaround in the UK Company has been our success in the parcels business. We had to really change a lot of things in that area to be able to talk to you about where we are today. We've had three strategic priorities, the first obviously finding success in the parcels business, but also everybody in this sector has got to manage very carefully the decline in the -- the structural decline in the letters side of the business. And I think one of the very big changes at Royal Mail in the past three-and-a-half or four years has been the focus on the customer, what the customer expects and our ability to deliver for the customer.

We're very proud that today we are number one in the parcels business in the UK. Whether you look at it from the point of view of revenues or volumes, we deliver more than half of the total parcel volumes in the UK. There are a number of important trends, structural changes, if you like, that have helped fuel our position in the parcels business.

E-retailing is a very important one, and we see the boom in e-retailing in the UK continuing. The UK has the highest internet spend as a percentage of total retail spend of any European economy. It's at 9% now; it will move upwards to around 12% in the next couple of years and, as I mentioned, that rate of

growth does not show any signs of abating. We are likely to see 16% year-on-year growth in total online spend in the next 12 months. 18% of non-food expenditure in the UK right now is online, and it's an even higher percentage for particular items -- clothing, for example, 24% is online; footwear, 30% is online.

I think the reason why we have been able to be so successful is that the highest rate of growth is on the B2C side of the business for our core network that plays to our sweet spot. We go to all 29 million addresses every day and we deliver to some of the highest minimum service standards in the world. We're very pleased that we are being rewarded with votes of confidence, most recently *Which?*, you know the Consumer Advocacy Group, did a survey and found that 80% of consumers in the UK prefer Royal Mail as their number one parcel delivery Company. So, that has been very important to deliver on our strategy.

It is, however, a very competitive market out there. And every week, there's not a week goes by that there aren't changes where our competitors are introducing new products or services or ways to improve their offer, and we don't take our number one position for granted. You can't be complacent; you have to be on top of it every day, and I think we are.

We have responded, I think, pretty well to all of the market developments that we've seen in the past few months. We've seen things like Amazon now introducing its own delivery around its distribution centers and a Sunday service. But as you know, we were rewarded last Christmas partially because we did have a Sunday service for Christmas, and we will do that again this year.

We've got a very strong partnership with the large customers, particularly Amazon. I'm very proud that the Royal Mail delivers most of their traffic in the United Kingdom. And we continue to deepen that partnership. Our contracts are more on a long-term basis; we're being rewarded with better forecasts from online retailers of what their delivery requirements are going to be so that we're in a position to respond for them. We have adapted our offer to what the customer wants.

We are optimizing our networks. As you know, we have two networks in the UK -- the core network, which is primarily on foot, that delivers 90% of our parcels; but we also have the Parcelforce network, another great Company. It's better equipped, it's all mobilized, it's better equipped to deal with the heavier-weight traffic, so we have introduced size-based pricing to optimize the networks to make sure that we are increasingly putting the parcel in the network that can accommodate it the best -- the heavier-weights in Parcelforce; the lighter-weights in the core network.

As a result of size-based pricing, we've seen Parcelforce volumes improve by 9% and we have seen our revenues overall improve by 9% as well. And you will see that in almost every segment of traffic -- I think in every segment of traffic we've seen our average unit rates go up.

Click and Collect is a much talked about new development, structural development. Traditional retailers have to fight back and, importantly, they are creating their own very good online offers and arranging for people to very conveniently collect what they have ordered online. We have responded. We have launched what is going to be perhaps the largest Click and Collect offer in the United Kingdom with the Post Office. There are about 14,000 post offices in Britain; nobody's more than a mile away from a post office. Many of them now are offering longer hours, about 4,000 of them that are offering longer hours. And so over the course of the next year we will introduce our own Click and Collect offer to the market.

Strategy is important, having a good idea is important. But actually, it's way more important to be able to implement a good idea, and I think we have done that and we've shown that we can be adept. We don't get everything right; I like to think that we get most things right. But it's important that if you see that your customer are displeased with any aspect of what you've tried to do for them, as we did see a little bit of a wobble on some aspect of size-based pricing, it's very important that you respond correctly and immediately. We did.

We probably had the small parcel too small, and we were missing out on traffic that is important and very easily accommodated inside the core network. As a result, in October we've responded and we've basically increased the dimensions of what constitutes a small parcel so that now a shoe box-size parcel will be considered small. And as a result, we've been able to reduce the price for that traffic considerably.

Technology is very important, probably to every business, but it's critical in the parcel delivery business. We have completed now the biggest rollout of PDAs ever undertaken in the United Kingdom. We now have 74,000 PDAs in the hands of our people in the core network. We are now looking at our networks, particularly the Parcelforce network, which was capacity constrained. We've made very good progress on implementing a carefully constructed increase in capacity for Parcelforce. The Chorley hub is now open on time and on budget, so we're very pleased. And we have a dedicated team now inside Royal Mail that are working very hard on all aspects of parcel automation for the core network, so we've done a lot of work to advance on that very important objective as well.

Let me spend a few minutes now on GLS. As you know, GLS -- General Logistics Systems -- that's our parcel business in Europe. It is a great Company. It has always delivered better margins than its peer group and it's been a consistent performer, really going way back. It is a Company that has put together a network over 20 years that you probably couldn't put together today. It is very well positioned. It covers 37 different countries in Europe. It has some key strengths that I don't think are easily replicable. First is the footprint, but also common technology. That's very important. It has bedeviled many parcel companies, not being able to integrate technology.

The same technology runs across all aspects of their network. They have a very good business model. They have a high level of variable costs because they're an owner-operator-driver model. And they have a very diverse customer base. They're in every segment, every sector, small, medium and large. So, they're a pretty good Company.

Actually, they've had a very good half, better than expected. Volumes and prices are up. But some of the same problems that we addressed to you a few weeks ago persist. In Germany, for example, which is a very big market for GLS, they are still in a situation where historically low levels of unemployment have made even an owner-operator model more costly. So the cost pressures in Germany continue.

On France, this was the only area where they are not profitable. They have put in place a turnaround plan. I'm very pleased to tell you that they are slightly ahead of their own plan. They've done better in France than we expected to do, so I'm confident now that in the next 18 to 24 months we will get there. All other geographies are doing well. Let me call out Italy in particular. Italy is an incredibly strong growth area, even though the background GDP in that area is, as you know, it's negative. But Italy is now delivering a very significant proportion of the overall profits of GLS.

So it tells you something about the way in which they go at a market. There, they have been working just like they always have done with several franchisees. They work with these franchisees for years, get to know them, get the common technology platform in place, and then start buying them in when they know that there's not going to be any problem of integration. And that has seemed to work very, very well. So, they have expanded in some new areas. They're in Croatia now. And they're having, like everybody else, to invest in IT as well, and they've done pretty well with their expenditure plans in that domain.

I mentioned the importance for anyone in this sector to manage the decline in letters. It's just a fact of being in this business. But I do think that the Royal Mail is better placed to do so than any other company in this sector. First, I have been surprised and very pleased at just how accurate our econometrics team is at forecasting what the rates of decline are going to be. We had a higher rate of decline last year because of historic levels of price increase, but we have seen that that rate of decline is now moving back in, contracting toward where we said it would be. We're at 6%, and I think our guidance was 4% to 6% rate of decline going forward.

Secondly, we're better placed because we have such a high share of our revenues in a growing segment of traffic, parcels. Fully 51% of overall revenues at the Group level now are in the parcels business and we think that we are very well placed to continue to capture our share of that growth.

And finally, and this is very important, the regulatory changes that have been achieved here for Royal Mail have been very important for everything, not least of which our ability to manage the decline in letters. Unlike other regulators subject to the European directive, the regulator here, Ofcom, the primary duty is not competition, the primary duty is the sustainability of the universal service in the United Kingdom, and that's very important.

So, our regulator, through the legislation and through its own releases, is very clear, that we have to be able to make a commercial rate of return on our regulated business, which is not the entire business. It doesn't include things like Parcelforce, it doesn't include GLS, but most of the UK business, and has set that rate of return at a high range, between 5% and 10%. We have the regulatory freedom now to increase our prices. Obviously, we have to be sensible and we have to be mindful of what's going on in the market, but at least we don't have these regulatory caps that had really held the Company back several years ago.

So, what has all of that done for us? As I mentioned the volume decline has reverted to our expected range. Marketing mail is very important for us. It also distinguishes us from our peers in this sector, makes up about 12% of Royal Mail Group Revenues. That doesn't change the fact that there are still risks that we have to manage, and direct delivery is a very real risk. It's a key risk. We monitor it very closely.

You will have probably read that TNT is moving direct deliver into another urban area, Manchester. I think unchecked, direct delivery can very quickly undermine the economics of a universal service, because a universal service has necessarily a much higher fixed cost because it has to be positioned to go everywhere. Universal service also has minimum service delivery standards which other participants in the market do not have to achieve.

So, for all those reasons the cost structure of the universal service is going to be quite different. And if you cherry-pick high density routes, particularly in a segment of traffic that is in structural decline, it's

not difficult to see that you can undermine the economics of a universal service very quickly. So we are working very closely with our regulator, helping them understand how the dynamics of our market have radically changed in the past seven years.

It is an intensely competitive market. The sort of tests that are applied to Royal Mail are probably not fair given those changes in the market, and I think in some respect, although we've made great progress on regulation, there is still a differential in terms of the rules and how they apply that we would like to see lightened in the future. The structure of the market, even on the letters side of the business, is vastly different today than it was six or seven years ago, and so I think that calls for a new thinking on what is required to make sure that we do have a sustainable universal service in Britain.

We are continuing, though, to add value to all segments of traffic, including letters. Letters is still an important revenue and profit generator for the Company. So, for example, you will have seen that we are working to introduce Mailmark, which would put a bar code on every single envelope, at least the business side of envelopes, not [unaddressed] marketing mail, and full rollout of that is expected in 2016. We will do a trial with early adapters next year, but we will have that completed by 2016. And that will be a new way to add value to high-volume mailers. They will be able to track where each item is from every batch that they give to us to deliver.

A very important part of our strategy at Royal Mail has been to become much more customer-focused and customer-attuned. What do customers expect? What can they get? What other options do they have? And how do we structure our Company to remain the number one choice in the segments of traffic that are important to us?

We have, even in a time of unprecedented change -- there's been a huge modernisation program underway here at Royal Mail for the past three-and-a-half years. But even in a time of unprecedented change, we have now gotten our service levels back up to where they need to be, and these are, as you know, some of the highest minimum service standards in the world. So, we are very pleased to be able to say that our first class is above the 93% on-time delivery and our second class is well above the 98.5% on-time delivery.

And we're being rewarded with customer satisfaction and customer recommendations that are very important for our business going forward, even with huge change in our operation. In almost delivery office, we've been changing every aspect of how we do delivery. We're very happy that our customer satisfaction scores have remained stable. And actually, our net promoter score has gone up by six points.

In a recent study by - as I mentioned, by *Which?*, which in the past I don't think has ever been really laudatory about Royal Mail, they did acknowledge that we are the number one consumer choice for the delivery of parcels. So, that was really good.

I know you will want me to give you a bit of an update on industrial relations, and it probably feels like every week there's something in the press about industrial relations. But it's all good. We have managed to avert industrial action. We are working very hard to conclude an agreement. Everybody -- the executive of the CWU, our people, our industrial relations team, me personally -- we're working very hard to conclude an agreement. I'm very optimistic that we will get there soon and hopefully without any disruption to service in this very important time for us.

Transformation, that has been a big word at Royal Mail in the past three-and-a-half years, and I think what we've done has been very impressive, to be able to reduce the number of mail processing facilities by more than a third. But with this industrial relations backdrop, it has slowed a little bit. But even with the industrial relations backdrop, in this half year we've managed to close three additional mail processing facilities in Derby and Darlington and Bradford. And actually, just outside the half year cutoff point we've also closed our facility in Leicester. Productivity improvement is a little bit behind where we want it to be, but it's still pretty good at 1.7%, given all of the other challenges with which we've had to deal.

I think I will stop there and turn things over to Matthew, who can take you through the numbers.

Matthew Lester – Royal Mail plc CFO
Good morning. I think a number of you will probably be familiar with this slide; in as much as what it describes is how the Royal Mail strategy actually converts into the creation of shareholder value. I'm going to spend quite a lot of time on each of the lozenges that are actually on the slide in later slides, so I'm just going to start in terms of what the targets are.

The combination of the expected growth in the UK parcels and GLS revenues is sufficient to more than offset the expected decline in letters revenues; and as a result, we can target low single-digit revenue growth. Most of our costs are ones that are subject to RPI-type increases. However, through a combination of very high levels of productivity, procurement and other efficiencies, and also because we're past the peak of the transformation investment, we expect that we can actually target cost growth beneath the rate of revenue growth going forward.

That drives margin expansion, and we are targeting to have margins in line with our peers; we think that's round about between 7% and 8% over a three to five-year period. Because of the margin expansion, that actually drives growth in EBITDA. And again, because we're past the peak of the required investment in the transformation program, we can see an accelerated rate of free cash flow generation. So, that's the theory, and now I'm going to talk about how the first half has actually fitted within that.

In terms of the performance since the last quarter, which was obviously included in the prospectus, as we indicated then, we expected a slight slowdown in the rate of growth in UKPIL revenues, particularly impacted by the summer slowdown which Moya referred to. We've actually seen the fact that this summer we actually had one; and as a result, people did things other than online shopping in July. GLS continued the trends that we saw in the first quarter and, as Moya said, has actually performed slightly ahead of our expectations.

Both profit and cash are distorted by a number of items, and I am actually going to highlight where that occurs as I go through the presentation. In terms of margin improvement, we would say that the VAT credit and the depreciation, which I'm about to describe, probably increased margin improvement by about a percentage point.

I've laid out here just their impact in terms of the impact on pre-transformation profit. In terms of the VAT credit, in '12-'13 we had a very significant increase in the rate of VAT recoverable by the business due to the very large number of products which became VAT-able during that period. As a result, we need to agree with HMRC post year-end the exact rate that we are able to recover. A small percentage

change, i.e. a 1% change, actually has a big impact on us, £35 million, and that's what we saw when we finally agreed with the revenue what the rate of recovery was for '12-'13.

In terms of depreciation and amortization, we're expecting this year to be overall flat in the second half and actually see an increase in depreciation in subsequent years as the impact of the investment program comes through. Due to the timing of certain assets going out of useful life and actually when we've been making investments during the year, we actually saw a £10 million decline in depreciation year-on-year at the Group basis in the first half.

So, going to the biggest business unit, UKPIL, I think this slide really here is more for your reference, as I'm going to go through each of these items in more detail in subsequent slides. But what you can see here is that the UKPIL margin is doing what we expected it to, i.e., to trend towards the Group margin.

Looking at the revenue drivers, first of all, in the half we have just over £2.2 billion of letters revenues. As Moya said, the volume decline has been pretty much in line with what we expected and we were very pleased to see how quickly our volumes reverted within our forecast decline rate of between 4% and 6% from the previous year's rate, which was 8% down in volume terms for the year.

As we said, we now have the freedom to increase prices when we need to, and we offset that decline by two percentage points through price and mix benefits. In fact, if you actually strip out the impact of the Olympic stamp sales that were in the first half of the last fiscal year, the decline was 3% in revenue terms on a like-for-like basis, if you take and make that adjustment.

In terms of parcels, we had almost £1.5 billion worth of revenues in parcels in the first half of the year, 40% of UKPIL revenues. In terms of the volume and the price mix, this is where you see the impact of size-based pricing, i.e., low volume growth but a substantial increase in revenues as we optimized the networks through which the parcels actually go through. What we saw in terms of the mix here was that we saw a strong growth in the account and Parcelforce volumes; this offset the lower volumes in the consumer channels that Moya was describing.

Turning over to costs, first of all, please note that the VAT credit has to be applied to each of the lines in the correct proportion here. So, we've not shown the impact of that here, but you need to recognize it doesn't just impact one of the lines, it impacts all of them.

I'm going to talk about people costs on the next page. In terms of distribution and conveyance costs, if you actually stripped out the impact of that VAT credit, you would have seen that costs would have increased 5% in the first half. As we said in the prospectus, we expected the export payments that we make to other posts to distribute our products abroad, we call them terminal dues, the price of those have actually increased substantially and we'd expect that to feed through in the second half.

In terms of the other operating costs, I think we had a very, very good period in here. Yes, we did have benefit of the VAT credit there, but also this was particularly impacted by procurement and a very strong demand challenge, particularly in the operation. In addition, we had lower Post Office charges as we have seen the benefits of the contract coming through in terms of reduced costs we now will get through -- from post office year-on-year.

So, to people costs. 68% of the UK operating costs come from the people area. Productivity in the half was 1.7%; that's a little bit better than we reported at the quarter. It was impacted by the industrial

relations environment. We now need to see the volumes come through in terms of the Christmas volumes to further improve that in order to move towards our target of between 2% and 3% productivity improvement year-on-year. Overall, UK people costs are up 3%, but one percentage point of that comes from the non-cash IAS 19 charge, which has increased from 18.2% of pensionable salary to 20.3%.

In terms of transformation costs, as you will have seen from the press release, the main driver of the lower amount that we recognized in P&L terms half-year-on-half-year is the fact that last year we recognized a number of voluntary redundancy expenditures in relation to mail center closures which had been announced in the first half of last fiscal. This year, we did not have that feature. And also, because of what was going on in terms of industrial relations, the rate at which we were actually implementing the delivery office modernization program was slowed.

I expect a pick-up in the second half in the activity, particularly in the delivery office modernization, following the resolution of the industrial relations disputes and I would expect that we will see an overall cost of £160 million being charged for this fiscal year.

Moving on to GLS. As I said earlier, we have continued the trends we saw in the first half with revenues up 6%. What's important to note here is that we did actually see margin improvement despite this having a very different operating model with much more variable costs in this model than we have in the Royal Mail. And, as you can see, we're now seeing operating margins of 6.6%.

The revenue growth came very much from volume. The key upside, as Moya said, came in Italy, where the competition is somewhat disrupted in the first half and also German volumes were slightly better than our expectations.

In terms of costs, the two I will call out here would be the distribution and conveyance costs. As we highlighted when we spoke recently, in Germany we can see the costs per subcontractor have increased half-year-on-half-year because of the very low rates of unemployment in that country, means that the subcontractors are able to force higher costs on all industry participants and GLS.

In terms of other operating costs, you can see there's an increase there; that's driven by the investments that Moya was talking about. We do need to invest in our IT there, particularly as we attack the B2C market in GLS. And also, we've got turnaround costs related to France going through that line.

Moving to the second half of the P&L, we've said that there is quite a lot of noise in these numbers and so what we've done is we've introduced a specific items column that you will have seen in the press release. I'm going to talk about those specific items on the next slide. Here, I'm just going to highlight what's going on in terms of finance costs.

The interest payable of £52 million reflects the interest costs that we were paying on the government debt. That debt was refinanced effectively on the 15th of October, and from that date we're anticipating rates of around about 3.5% over the life of that debt, i.e., substantially lower than what you see here. In terms of the IAS 19 pension interest, in the second half, because of the increase in the value of the surplus, I'm expecting a £50 million non-cash pension interest credit to appear in this line.

So, in terms of the numbers that we will be focusing on and talking to you most of the time, we will be focusing on the before specific items numbers. So, in terms of EBIT, the £283 million; in terms of PBT, the £233 million; and in terms of earnings, the £169 million that you can see on this page.

So, as I've said, I've listed the specific items that we are putting in the middle column here. The two that I would mention in particular are, first of all, the pension reform credit. The fact that actually we've changed the value of the liability substantially by removing the assumption that wage costs for pension purposes would increase by 1% above RPI, it's now fixed at RPI, resulted in a very large credit coming through the P&L of almost £1.4 billion. That's a non-cash item.

The second one I would point to is in terms of the costs of the ESO, the employee share option -- sorry, employee share scheme. That is the gift by the government of 10% of the Company to our employees. We have to recognize the value of that gift through our P&L even though it didn't cost the Company anything. That's 10% of the market value at the time, which is £489 million, and it's spread over three years. In the second half, the charge will be £80 million, or £160 million on an annualized basis.

A little bit of time on tax. As we said at the time of the float, the impact of the employee free shares offer and the utilization of some brought-forward tax reliefs results in there being no current tax in the UK for the period. There is a very substantial deferred tax item, but that relates to the tax -- to the pension charge and, in itself, just like the pension, it's not an economic item as we see it.

In terms of GLS, you can see quite a high effective rate. The reason for that is not just the fact that European tax rates tend to be higher than the UK, but the fact that we make losses in France and we have no profits against which we can actually offset that because that sits only within the French jurisdiction. As you can see overall, we have a 28% effective tax rate before specific items. I expect that will decline over time both as the UK rate moves down and also as France stops losing money.

So, moving on to our favorite area, cash. You can see here that EBITDA has grown in line with the performance that we've been describing. The first item you can see there is the difference between the IAS 19 charges and what we need to pay into our pension schemes; that is a credit of £36 million in cash terms. What we've done here is also separated out some of the working capital noise that we talked about in the prospectus. In terms of the first half, because we've yet to agree the pay deal with our unions, we see that we've actually benefitted by £65 million for the deferment of that payment, which will now be paid in the second half of this year, i.e., it's the catch-up of the settlement.

In terms of the comparative period, all these items were actually in the prospectus, so you have the impact of the buy-forward of stamps, the impact of the VAT, whereby we actually collected more money on behalf of the government before we paid across, and the partial release of the pension prepayment of £190 million. It's important to note that the other part of that, the other £150 million, will come through in the second half of this fiscal year and obviously will be partially offset by the impact of the £65 million payment, which we will also need to make in the second half of the year.

In terms of property disposals, we've made the majority of the planned disposals that we intend to do for this fiscal year, and therefore I'm not expecting to see much more inflow from that.

So, in terms of the investment item, which was in the middle of that previous slide, the key message here is the shift that we highlighted when we were talking to investors pre the float is already occurring. You can see that actually we're investing less behind the modernization and more behind other areas, in

particular in the half and into the rest of this year behind Mailmark, which Moya has described, behind Parcelforce expansion, where we're increasing the capacity of that business by 30% over a two-year period, and into GLS. I'm expecting that the overall level of investment in this fiscal year will be slightly lower than the £665 million that we spent last fiscal year.

In terms of our indebtedness, I think the key message that we would have here is that we continue to target an investment grade profile. You can see, if you actually look at our ratios now, we're pretty much there in terms of what we need to be in terms of a Standard & Poor's free cash flow to net debt ratio. And I would also point out that, of course, in this fiscal year we will benefit from the fact that despite we've announced what we intend to pay as a dividend, i.e., £133 million, that cash outflow won't occur until the summer of 2014, i.e., after the year-end of this fiscal year. For your reference, I've put the facilities there that we now enjoy.

Before Moya and I go and talk about outlook, I just want to make a point here in terms of people actually trying to predict with great accuracy the level of our operating profit. As we said in the prospectus, if you change our -- have a 1% change in UKPIL revenues, that changes the revenues by £75 million. The sort of automatic marginality of cost is only £7 million. And therefore, a 1% change in revenues predictions would change the level of operating profit by about 17%. That is how sensitive the business is to very small changes in both revenue and cost assumptions, and it's important to note that as you think about predicting the business going forward.

In terms of sort of things that have changed in terms of since we last gave indications of this year, Moya has already referenced the fact that GLS is performing a little bit better than we thought. I would say that from where we sit today and having seen actually how customers have reacted to the industrial relations issues, some of them have actually switched volumes to other carriers in order to protect their business through this Christmas period.

However, the profit impact of that revenue loss is likely to offset the upside of the one-off items that I referred to in terms of the VAT and lower depreciation in the first half. It's important to note, though, we do expect to see continued growth in revenues despite the fact that volumes may well be flat in parcels in UKPIL in the first nine months.

As I've indicated, I expect the transformation costs now to be £35 million lower than they were in the previous fiscal year, and I expect the effective tax rate to be 28% on Group PBT, excluding specific items. In terms of Group cash, I would expect in terms of the investment, as I said before, to be slightly lower than the last fiscal year and, as I said, moving away from the mix from transformation into those other items. And I've already highlighted the working capital benefits.

So, with that I'll hand back to Moya for the rest of it.

Moya Greene
Thank you very much Matthew.

Moya Greene
Just by way of outlook, before we get to questions and answers, I think our key value drivers just remain unchanged, so we're seeing low single-digit revenue growth. We're still targeting 2% to 3% productivity improvements. I think, though, that in the next half we'll be at the low end of that range and then pick up pace subsequently. Margin expansion over the next three to five years, I think it will be in line with

our peers. As I mentioned earlier, we expect e-retailing to continue with very high rates of year-on-year growth and that will benefit our parcels business.

Letters decline, we are confirming our rate of decline at 4% to 6% going forward. I'm just delighted that we are resolving the IR situation and I'm confident that we will get through Christmas without too much, hopefully none, no disruption. But, as Matthew said, it has had a little bit of an impact that we can see, mostly in business that we have competitively won where customers are saying, "Well, let's just wait and we won't actually consign traffic to you in the pre-Christmas period, we'll wait until after Christmas." And a few customers have switched some volumes.

The most important message that I can leave you with in terms of outlook is this period, the next four weeks for us, are absolutely key for anybody in this business and definitely for us. And we are absolutely poised, we've got everything on board, we've got the pop-up parcel hubs, we've got all of our people in. We've been working on that since August, and we're absolutely poised to deliver another great Christmas for everybody in the UK.

And with that, I think we can end on an upbeat by letting you hear the wonderful Royal Mail choir. And all of our people who are in our ad, everybody that you see in that ad that is over the age of majority works for us. And so we're very proud and this is how we deliver Christmas. So, let's have a listen.

[Royal Mail Christmas advertisement runs]

Q & A session

Moya Greene
Can I just ask that in addition to telling us your name, tell us the institution that you represent as you put your questions forward? Mark?

Mark McVicar
Thank you. Good morning. Mark McVicar from Nomura. A couple of questions, really. Can we start with industrial relations? What remains to be done to get your over the line with the new deal?

Moya Greene
Drafting, and it's heavy-going. I think we're there in principle and, like any contract, once you start - I don't want to cast any aspersions on the legal community, but once you get the lawyers in the room and you start committing it to paper, blood pressure can go up because it sometimes doesn't exactly sound like what everybody had in mind. So, drafting. But I can tell you, Mark, everybody's working very hard and so we're optimistic.

Mark McVicar
And just to be clear, that deal would obviously be back-dated to the beginning of this financial year, hence the £65 million accrual, yes?

Matthew Lester
Correct.

Mark McVicar

That's the extra piece. Okay. The second question I had, could you just say a little bit more -- you mentioned it, Moya, at the start about your -- the Click and Collect parcel activity. How practically does that work? So, if my wife buys something from John Lewis and doesn't want to go and sit outside John Lewis, how does she get it out of your system or something like that?

Moya Greene
Well, we're just starting to launch it now, and we are -- it's a technology play, essentially. It's got to work for the person that's sending the parcel, for the company that's sending the parcel, and for the individual who can indicate online that they would rather have the parcel available at the post office, the nearest post office for collection.

Mark McVicar
Okay, got it. And my final question, just more broadly on parcels, are you happy that your sort of current lack of automation and, in some cases, lack of technology isn't actually costing you with customers who are becoming more and more demanding about track and trace and point of collection and returns and all this kind of stuff?

Moya Greene
That is a very good question. And no, we're not happy. We've got a lot of work to do on the technology side. I think we heralded that in the prospectus. It's one of my biggest worries, is can we stabilize this antiquated technology backbone and make it more flexible? Can we reduce our reliance on just a couple of suppliers?

We have a great technology team, I can tell you that, Mark, compared to where we were two years ago. We have recruited now 300 top technology professionals; basically, we've had to completely rebuild the technology capability inside the Company. It was a very poor outsourcing. We have gone through an extremely extensive RFP process to diversify our risk with suppliers so that it won't just be one or two key suppliers. We're bringing back in-house the areas of technology that are crucially important and that need to be under our control, things like application development, so that we can be more nimble and we can move faster. So, it's a great question. We have a long way to go.

That said, in the course of the past two years we have gotten ourselves stabilized. Two Christmases ago, we were in a very bad way, where our whole online business effort and initiative basically collapsed on us. That doesn't happen anymore. My heart is not up in my throat now every time we do a release, where I'm basically on the phone, are we there yet? I'm not as worried as I was two years ago.

And in terms of keeping up with the competition, we know we have to get there. In our core network, we've made great strides. Our emblem parcel product, for example, special delivery, now has a text messaging feature. And when we delivered the Olympic tickets -- now, mind you, that was only 1.6 million packets, it's not 1 billion, but we did have an SMS texting capability.

And so we've gone from having virtually no traffic in our core network -- track and traceable -- to now 20%, and we've got a project underway to, first, upgrade the shipping tools of Parcelforce -- they're pretty good, they do track and trace everything -- we're going to upgrade that and then run that upgrade across the whole core network so that we'll have a common technology platform.

So, we're working very hard to do that. But realistically, we won't be there for a couple of years.

Mark McVicar
And you still expect to make the decision on the parcel sorting automation next year sometime?

Moya Greene
Yes. We're still on track to do that. We have a very strong, dedicated team looking at every option, learning from the experience of others in the sector, and we're still on track to be there.

Mark McVicar
Okay, thank you.

Damian Brewer
Damian Brewer from Royal Bank of Canada. Three questions, please. First of all, as you've moved from the cube-sized box to the sort of shoe box-sized box, what's the initial reaction been? Has there been a change in customer perception yet? And, if so, how much has it been?

Moya Greene
Well, I'm not getting any hate mail, so I take that to be a good sign. It's too early to say because we only introduced it October 15th. We'll have a better sense, I think, as we get past Christmas, but I think we've got it more in the space of where people wanted us to be. Certainly, the anecdotal reaction has been positive.

Damian Brewer
Thank you. And then, on the direct access mail, obviously small at the moment --.

Moya Greene
Direct delivery, you mean.

Damian Brewer
Sorry, direct delivery.

Moya Greene
Direct access is huge.

Damian Brewer
EC postcodes, West London, and now Manchester.

Moya Greene
Yes.

Damian Brewer
Could you tell us a little bit more about the sort of kind of discussions you've having with the regulator there? Is there any discussion about going to tiered network access pricing to try and stop cherry-picking of the access mail? And are you making any discussions about sort of quality of delivery? I have to admit, my own experience with direct delivery mail is normally it's direct delivered and blows down your street and you have to pick it up.

Moya Greene

We are helping our regulator understand that it is probably, in the year 2013, unfair that only one participant in an intensely competitive market have very high minimal service standards and have to not only meet them but publish them and have them independently verified. So, we would like to have published and independently verified standards across the whole competitive landscape.

And as to what might we be able to under our access contracts, we're not there yet. But one of the regulatory freedoms that we did gain last year was the ability to change our access contracts. You recall that we had all of that kind of behavioral regulation applied to us, where we couldn't even terminate a contract. So, we've gotten rid of a lot of that and we will look to see what we can do to improve our situation.

But realistically, because of the rules that are on us, we have a margin squeeze test that's applied to us, not applied to anybody else, as if there was no competition in this market. And as you know, 80% of the upstream is with the competitors, is not with us.

So, I think what we are doing is right now we're starting to help the regulator understand, it's a new regulator, highly professional regulator. But, in fairness, they have not been in this sector for very long, so we're helping them understand that there have been huge changes in the structure of the market since this regulatory approach was put in place. And they have already said in their public pronouncements that they full understand that their primary duty here is different than it is for telecommunications, say. Their primary duty here is a financially sustainable universal service.

So, I think we're in the imparting of information phase with our regulator on that one.

Damian Brewer
And just one final one, just on the tax. Could you give us an update on the degree or size or relative position of the unutilized tax losses now, please?

Matthew Lester
Yes. Basically, it's not materially different to where it was before. It's around about £280 million.

Moya Greene
There was a question over here.

John Lawson
Good morning. John Lawson from Investec. I've got two questions. One, perhaps a bit of a follow-on from Mark's question and really revolves around the transformation costs sort of going forward, and obviously IT is a big factor. You've clearly given us some guidance this year, but I'm just trying to get a sense of where -- because the first half was a bit lower than we thought; therefore, does that mean there's going to be a bit more next year and the year after that we anticipated? Whether you could give us some guidance on the -- in particular the operating transformation costs. That's one question.

And I'll give you the second as well, which is about the letter -- addressed letter decline. We obviously talk about 4% to 6% as the range you -- obviously you just got in there, which is good, but can you just give us any degree of confidence going forwards as to whether substitution could get worse or not so or just elaborate on your thoughts there?

Matthew Lester

So, in terms of the transformation going forward, I think you're right if you just sort of stuck religiously to what we previously had modeled, the delay would naturally just push into the following year. However, part of the process that we're going through at the moment is actually assessing are there other things that we could do, can we do things more efficiently, can we actually do it without the need for so much operating expenditure?

I think the key message that we're giving to people is that if you recall we peaked around about £220 million worth of transformation and we said that we'd probably reduce that by -- at some point by about £100 million. I think that where we, on an ongoing basis, we still expect to be and the precise nature of what happens this year and next year is not -- it's too early to tell, but nothing changed in terms of that trend.

Moya Greene
So, letter decline. We're pretty confident that we are able to predict. I have seen the econometrics team do very precise work, even in the face of movements in price that might have been historically high. So, I'm very confident that the team is probably the best place -- certainly, a much better place than the team that I had in Canada, and I thought the Canadian team was excellent, but this team is very good. So, I'm feeling that they've got their arms around how the various puts and takes affect the rate of letter decline for different segments of letters, because they don't all react in the same way and they don't all play to the same dynamics.

On e-substitution, could it get worse? Well, my colleague, Jon Millidge, is famous inside Royal Mail for saying, "It can always be worse, Moya." But on the basis of the work that has been done, and we read everything assiduously, the PWC work, I think, was pretty good; it tried to break it down into every conceivable category. We think the easy part of e-substitution has been done and the next part is going to be difficult from a consumer behavior and it's going to be expensive. So, we think that we've got a reasonable run.

And PWC actually believes that for business mail it may taper off, it may become a slower rate of decline. I think they're thinking in the order of 3%. So, we don't see anything immediately on the horizon, immediately on the horizon that would change our views of how e-substitution is going to affect the volumes of letters in our system.

John Lawson
Thank you very much. Just a very quick follow-on. In the figures we've seen, is there anything the industrial dispute may have affected the -- i.e.it being at the upper end of that minus 4% to minus 6% range, or is it too small to notice?

Moya Greene
Yes, I'd say no, you wouldn't see it. You wouldn't see it. No. And just to be clear, John, we've had a dispute, but we didn't have a disruption. That's really important. It's the disruption that hurts and kills the business. When you have 150,000 people in a highly effective and engaged union, shall I say, you're always going to have disputes -- that's inevitable. The issue is, can you resolve them without causing your customer to lose confidence in you? And so far, so good.

Joel Spungin

Good morning. It's Joel Spungin here from Merrill Lynch. Just two questions. Matthew, first of all, for you, just on the £45 million one-off items that you highlighted, did they all fall into the second quarter? Because I thought that you mentioned them in the prospectus, if I remember correctly.

And my second question is with regards to property. I know it's something that you've been loath to talk too much about. But obviously, there is a lot of speculation, a lot of your shareholders care, particularly with regards to the London development portfolio. What, if anything, can you say about your strategy there and, in particular, if there's any indications you can give now in terms of how long it might take to crystallize value? That would be very helpful.

Matthew Lester
So, the first -- the answer to the first question is yes, they did happen in that one, so that's that answer. In terms of the property portfolio, I think the somewhat longer answer here -- it needs to be put in a bit of context to give us the opportunity to talk about it is -- what the speculation surrounds here is what is the gross development value of these sites? And there's a very leveraged impact on our value.

So, I'll give you an example. And I'm not saying these are right, but if you actually look at the London site you could easily see a situation today whereby a £1.5 billion gross development value, the land value of that would only be 10% of the total of that site. If you change the top by 10%, you double the land value. So, if anybody knows where property values in London are going to be in two to three years time, please, could they form an orderly queue and we can work out where we go from there. So I think there's a lot of people who very easily can make a relatively small change to that big top number and therefore impute a different value to the ones we've got here.

Our strategy going forward is going to be what it has always been. We are fortunate now that we actually have access to external debt facilities and therefore are no longer under a requirement by the government effectively to fund the business through property disposals or sale-and-leasebacks.

So, we're able to take a more strategic approach as and when a particular site is through a particular part of its development, we'd make an assessment, Moya and I are involved in this one, saying, "Do we materially see that holding on to this for a period of time, there is a good enough prospect that us doing our own work to get the next level of approvals that you need, " which, as you know, massively increases the value of a particular piece of land, "are we likely to have that versus the cash that's available today?" And we constantly test with Martin Gafsen and the team, "Okay, Martin, what are you going to get today? And what's the probability of you being able to go and take that next leap, which can often take a year or two years?"

So, we would see that there isn't -- as I've said, we don't expect any big disposals in this fiscal year, though that can change. If someone wants to come in and give us a knockout bid, we are not in any way predisposed just to hold onto certain properties, so we're very happy to accept any offers that you guys might have if they are good enough, but we would expect that over the next three to six years you'll start seeing some material disposals.

Moya Greene
The other thing that I'd like to say, and people seem to forget this, is that a lot of the properties that are in London, we need them, from an operating point of view. We have pared down and we've consolidated around Mount Pleasant, but we need those properties. And people are not dying to spend a million pounds to live on top of a mail processing facility. So there's a little bit of that in it, too.

Matthew Lester
It's changed that top-line a lot.

Moya Greene
It changes it a lot.

Joel Spungin
Thanks.

Matthew O'Keefe
Yes, thank you very much. It's Matthew O'Keeffe at Berenberg. You mentioned export payments as a driver of higher costs, so I just wanted to delve into that a little bit, if you could --.

Moya Greene
Terminal dues?

Matthew O'Keefe
Yes. Why the terminal dues are on the move and if perhaps there's any kind of offset in terms of what you can do on the import side and what you charge foreign post offices to deliver here.

Matthew Lester
The truth is it gets very concentrated, and the big pressure that has risen here is Australia. With a very strong Aussie dollar, we saw a very large amount of -- and it's across the world -- imports going into Australia. And there's a lag effect here. So the fact you might say, "But hold on, Aussie's now has come down, what, 30% against sterling over the last year?" The point is these are set well in advance. And what happened here was there was a massive amount of flow, and as a result, the Australian post is able to go and increase its charges to everybody very substantially.

These are negotiated, I believe it's annually or at least every two years, and I think what you'll find is that that then feeds through over the next two years. But because sterling has been weak and despite everything you read about our balance of payments we have seen a big impact in the amount of export volumes that we've got. So in terms of the question, can you do something on the other side, well, there's not the same demand and therefore our ability to be able to negotiate is not as strong.

Moya Greene
Is that clear?

Matthew O'Keefe
That's clear.

Moya Greene
There's a question down here in the second row.

Susanna Invernizzi
Thank you. Susanna Invernizzi from Barclays. Just a question, looking at your strong, robust operating figures for generation capacity, maybe if you can comment a little bit more on what is your use of cash flow and investment strategy going forward, maybe elaborating, if I may, first of all, on CapEx, including

comment on potential increase associated with parcel automation. Then, any acquisition at GLS, although I think probably are relatively small. And last, but not least, your optimal capital structure considering that -- if I am not wrong -- you are already generously above the covenants of the new facilities that you have just raised. Thank you.

Moya Greene
Why don't you take the CapEx; I'll do parcel automation and GLS. Yes.

Matthew Lester
Okay. So, I think we should sort of take in reverse, what's the overall theme here? The theme here is investment grade. Why? As the USO provider, and we know there's the piece here that we need to be financially stable. If we are going to go and argue for the regulator to go and act on our behalf, we have to be seen to be doing what we can on ours, so therefore actually having a strong balance sheet for showing financial stability is helpful in that grade. So, that's why investment grade.

As we said at the time of the prospectus, we actually do anticipate on average to see a step down of between £100 million and £120 million versus the peak level of investment of £665 million which we saw last year. That will happen over a period of time and yes, we'll come into quite lumpy bits because you can actually see some flows happening which may mean that the overall trend is masked in the short-term, but then the following year you'll see a bigger step down. So, we're talking about the flow here in terms of a step down in the overall level of investment.

In terms of the CapEx items within that bucket, Moya's going to about acquisition and CapEx, but within what we're talking about is that's the envelope that we have to spend, and Moya's going to talk about where we're going to spend it.

Moya Greene
I think we have, over the past two years, under Matthew's leadership and our team, we have an incredibly detailed capital project book that we monitor and watch and very, very closely because I have seen lots of companies in this sector really blow through capital in a highly unimpressive, shall we say, way. And hopefully, that will never happen to us. We're trying to make up for what was basically 20 years of chronic underinvestment, and only one area is technology.

And we still have a lot to do, but I wanted you to know that we have a very, very detailed capital project book and it includes doing highly diligent work, planning work, on big items like parcel automation, which we, as I mentioned, we have a dedicated team and we're looking at every single option and learning from the huge waste of capital that many companies have blown through as they've done automation in a questionable way. So, that's all on track.

GLS acquisitions, they are building out their network, but they're very, very diligent. This is not a Company that just sees another parcel company for sale and just marches in and buys it; that's just not the business model at all. It's very close -- it's not completely an organic growth model, but it's very close. It works with partners that then become franchisees. And then, only after a long period of time of working together where they can see that this is going to work for GLS as a multi-geography Company, do they buy it.

And so, for example, you saw them expand this half into Croatia. But that's not going to be a big amount of money, Susanna. That's quite manageable. I would say they will spend more on technology upgrades than they will on taking in, on a gradual basis, these franchisees.

In terms of acquisitions generally, we're pretty -- we're pretty nonplussed with some of the acquisitions that we have seen others make in our sector, so I would say we would be very cautious. But we don't want to be hidebound about anything. If something came up of the quality, for example, of GLS, hopefully we wouldn't be so hidebound that we'd miss it, because GLS has been a great Company for us. So, I wouldn't be putting a lot of acquisition money in your capital expenditure item.

Matthew Lester
Last question and we'll be done.

Moya Greene
Is that it? Wow. One more.

Matthew Lester
One in the front here. The last one.

Mark McVicar
Thank you. Hopefully, a very straightforward question. Could you just talk us through what happens to working days in the balance of the year? Because I think you had two more in Q1 --.

Moya Greene
Yes.

Mark McVicar
And I think we've just got the revenue impact from the half.

Matthew Lester
We had the same number in the second half of this fiscal year as we had in the second half of the last fiscal year.

Mark McVicar
Okay. Excluding the extra week, yes? So, 52 versus 52?

Matthew Lester
Excluding the extra week, yes.

Mark McVicar
It's flat.

Matthew Lester
One day we'll have a comparable comparable. One day, please.

Mark McVicar
Yes, it would be 2016, wouldn't it?

Matthew Lester
You're right. Yes, probably.

Moya Greene
Thank you very much.