Royal Mail plc
Full Year Results for the year ended 30 March 2014
Transcription of Results Presentation
22 May 2014

Moya Greene - CEO
Good morning, ladies and gentlemen. Welcome. I am delighted to be in front of you this morning with our first annual results post the privatisation of the Royal Mail. And, by way of overview, what I would say is that we have turned in a performance which is completely where we expected it to be. Our revenues are up. Our cash is up. We have, like every company, we've got a couple of headwinds that we are managing.

First on the parcel side, I think it's fair to say that it's a more intensely competitive field than it was a year ago, but we have very good plans in place already to manage that. And on the letters side of the business, of course the headwind is direct delivery. And there, unless we get early regulatory action, there is a concern that by 2017 [2017-18 financial year] we won't be able to meet that 5% to 10% commercial rate of return in the regulated business. But, again, we have very proactive strategies in place to address that.

So let's go to slide 3 and I'll go into a little bit of the detail. As I mentioned, it is a very good operational and financial performance. Revenues at the Group level are up by 2%. In UK parcels, our revenues are up by 7%. Parcels now account for 51% of the Group's revenue. That's up from 48% last year. Addressed letter volumes came in at the lower end of our forecast, in terms of rate of decline, came in at 4%. You recall that we guided 4% to 6% rates of structural decline in letters.

GLS again turned in a really good performance.

We have maintained our keen focus on costs. You will recall that just a couple of months ago we looked at the managerial complement and we saw that there was room for streamlining. We took it. If it had not been for the cost of that important action, our margins would be up by 100 basis points over where they were last year. EPS, we didn't have shares for the whole year, so it's a notional EPS, 26.3p, and, as we committed at the time of the IPO, we have announced a final dividend of 13.3p per share.

If we look at our strategy, we are delivering on our strategy, which is to become and to be recognised as the most successful parcel business in the UK. That's the growing part of our business. You will see that parcels are now 41% of UKPIL, which is up from 38% last year. We continue to expect overall parcel market growth, driven by e-retailing. The addressable market will be impacted a little by Amazon's move to become its own delivery agent. That has taken volumes out of the whole market. Thankfully, we are not reliant on Amazon. Amazon is only 6% of our [UK parcels] revenues.

Our focus has always been margin. When you met Matthew and me for the first time, you know that that's where we have tended to place our concentration and while others in the market have struggled with average unit rates, we have not. Our average unit rates are up by 8%. I am very pleased with the 7% [parcels] revenue growth and I will continue to be focused on profitable growth going forward.

On slide 5 we talk about the key elements of our strategy. And I'm very pleased to tell you that all of these elements taken together have worked very well for us. We are the market-leading player in the parcels business and we intend to stay the market-leading player. And, as you know, we are the leading player not by a little bit but a country mile and we've done that by getting the basics right. So we are optimising our networks. We have two networks in the UK. The core network, which probably carries more than 90% of our parcels, and, of course, the Parcelforce network, which is able to carry the heavier traffic and the express traffic. We have continued with our initiatives that optimise these two networks to make sure that the very bulky traffic is not in the core network, which is the foot-based network. We've increased first-time delivery with Delivery to Neighbour. We continue to roll out more and more convenient options for people on the delivery side. You will have heard yesterday that

we are trialling Sunday delivery and we are opening 100 of our busiest inquiry offices for parcel pickup and delivery. We'll be rolling that out.

On the technology side, that is an important part of what we have been able to improve in the past year. We've got 74,000 handheld devices in the hands of every postman and postwoman out there right now. Nearly 30% of our volumes are now tracked. We are adding convenience options in key product areas. Special delivery, for example, now has texting to let people understand when the special delivery will be arriving. We are also expanding our networks where it is prudent to do so. So Parcelforce has opened on time and on budget its Chorley hub [and] 11 new depots. We are progressing with the upgrading of all of our technology systems. It's much easier now to do business with Royal Mail than it was a year ago. It used to take months for high-volume shippers to connect their systems to ours. That's now done in a matter of weeks. We will continue to make improvements in that area. And, of course, we have really delved even more deeply into our study of the automation of the parcel side of the business. But we will be doing that in a very deliberate way.

Again, if you look at how we are delivering on our strategy, you will see that 'fast' has now become a watch word inside Royal Mail. It is a more intensely competitive environment. Amazon has put in place a delivery [network] that is about the size of Parcelforce and they've done that in a very short space of time. That's adding quite a lot of new capacity to the market. We have to be realistic. That's going to put pressure on people's ability to capture price going forward. So you have to have good plans and strategies in the tin to make sure that you're going to be able to address that and I think we do. If you look at the right-hand side of slide 6, you will see all of the initiatives that we have brought forward in the past year to make sure that we retain our leading position and, most recently, as I mentioned, piloting Sunday delivery.

GLS, a few words on GLS. Again, turned in a really good performance; revenues up 7%. In fact we saw revenue growth in all countries. Matthew's going to take you through the details, but just to highlight that we do continue to face the same kind of cost headwinds in Germany. I think the company has managed it pretty well. They have a number of initiatives to increase the density of delivery. They have also dealt with the fact that owner-operators are in short supply right now. The unemployment situation is a very tight labour market in Germany. That continues. But the France turnaround has gone better than expected. And Italy continues to turn in very high growth. The portfolio of businesses across Europe is really performing very strongly. This is an important strategic asset of the Royal Mail group of companies. It gives us geographic diversification. If we didn't have it, I suppose you would be asking us how we were going to get it.

On the letters side of the business, if I can turn to that now, we saw addressed letter volumes come in at about a 4% rate of structural decline. That was at the low end of our forecasted 4% to 6% was what we had called out. That's in the middle of the pack, if we compare across other universal service providers in Europe. It was the little bit of economic growth that helped us out on that side of our business. Marketing mail continues to perform well at GBP1.1 billion. We are investing in this part of our business. Mailmark has been rolled out. That's an important and innovative development for us. Putting a barcode on every envelope is the goal. We've just started the rollout of it. It's not only going to be an important revenue protection opportunity for us, but it's also going to be very valued added for our customers because they'll be able to know exactly how their delivery has gone, exactly what time the delivery was completed.

I want to say a few words now about direct delivery because, as I mentioned in the overview, that is a headwind that we have plans in place to manage. Just for those of you who do not know, in the UK, as the universal service provider, we have had a regulatory model for over a decade which mandated access for competitors to use our networks for delivery. We are very happy to take everybody's mail as long as we can get paid fair value for it. And right now, after the regulatory relaxation and the regulatory correction that we achieved, we do get paid fair value for it.

Now, though, the threat is direct delivery alongside access. That is unfair competition. It takes volumes in addition to the structural rate of decline that everybody has to manage, this takes volumes out of our network. But I want you to know there's no grass growing under our feet on this one. We are working very, very hard. We have a highly professional regulator. We are engaged with our regulator on this matter. In the coming weeks, we will be presenting a regulatory submission that will put all of our arguments forward to them, with the econometric support for those arguments for it. And

the argument is very, very powerful, that what we need now is timely intervention on the part of the regulator to put parameters around direct delivery. This regulator is highly professional and, like many regulators in the UK, they suffer from the legalistic processes that sometimes constrain them and constrain their ability to act quickly. (So we are working as well). Part of our plan is to work with Parliamentarians, not only to make sure that Parliamentarians understand the nature of the threat that direct delivery poses to a financially viable universal service; we are working with parliamentarians to suggest that a very, very minor adjustment to the Postal Services Act may be in order so that we can get the review of direct delivery done very quickly. In fact, we'd like it started now so that we can have parameters put around direct delivery in very short order. Direct delivery is one of those things where, if you look at what could happen (it won't happen right away) but it will happen, say, in 2017 [2017-18 financial year]. It's the kind of thing that if you don't put parameters around it now, no good complaining about what's happened in 2017. This is a situation where, if the horse bolts, there's no sense closing the door after the fact.

So the issue is to get timely intervention and to make sure all market participants know what the rules of the game are. And, as I said, we have a full-blown strategy and set of plans for helping people understand the importance of doing just that. As we said in our statement, we want to give you a little bit of an understanding of what it could mean. What direct delivery does is it cherry picks. It takes the high-density areas, the easy-to-serve areas, it takes the highest margin mail, the business mail, and it takes it out of our system so that we don't deliver it, and it delivers in those areas. TNT has said that they plan to cover 40% of the addresses in the UK by 2017. In order to do that, they only have to cover 8% of the geography. So you don't need to think long and hard about it to see how quickly that can undermine the economics of a universal service. Universal services depend upon cross subsidies, internal cross subsidies. Easy-to-serve mail cross subsidises hard-to-serve mail. High-density areas cross subsidise suburban and rural areas. And so no damage needs to be done. If you get timely regulatory intervention, you can head this off. And everybody will know, as I say, what the rules of the game are.

But if you wanted to put a number on it (if TNT does what it says it's going to do) it will take about GBP200 million off the revenue line [in 2017-18 financial year]. And it is high-margin traffic that we're talking about, so a lot of that would have dropped to the bottom line. It is one of those situations where, unless we put parameters around it now, you could get to a stage where you just won't be able to sustainably achieve the 5% to 10% EBIT margin on the regulated business. And just for those of you who are new to this, the regulated business in the UK is everything except Parcelforce and the surplus real estate.

I mentioned that we have had our eye very keenly on costs throughout the year. And Matthew will go through the numbers in some detail, but I will tell you, after four years now with Matthew Lester, it's hard to spend money at Royal Mail. And that is the reason why, on the cost side, we have been pretty successful. And on the productivity side, I mentioned that we continue to optimise our networks, putting the traffic in the right network. We continue to rationalise our network. We've gone from 69 mail processing facilities in 2008 to 40 today. We're now moving from rationalising the network to embedding standardisation all throughout our network, all throughout our operation. We've looked at overheads. We continue to look at overheads. I mentioned the program that was announced in March. That's going to have a payback for us over a mere two years. And I think the agreement that we have reached with the CWU just after Christmas is a ground-breaking agreement for the Royal Mail. We are doing things in a far more collaborative way. I will tell you that this time last year we would never have been able to have gotten, put together, start to finish, with our unions in a six-week period, the operational changes and the agreement on the operational changes to open our network, the 100 busiest offices, for Sundays. That was done in six weeks, in full collaboration with the CWU. I think that that is the way in which we're, hopefully, going to go forward as a result of the agreement that has been forged.

The hours out of the operation; very good at 2.9%. Sadly, because of the way in which traffic turned out, volumes were not where we forecasted them to be, mostly because of the changes on the Amazon side. So the productivity number was good, but it was a little shy of where we wanted it to be. It's at 1.7%. But certainly on the gross hours side, we were very pleased to see that number come in at 2.9%; almost 3% reduction in hours in the operations.
So I would say, to sum up, that we have made excellent progress. Our strategy remains unchanged. We are the leading player in the parcels side of our business. We have all of the plans and strategies

in place to make sure we continue to be the leading player. Our customers have rewarded us with more higher loyalty scores. And, as I said, as others in the market have struggled with AURs, we have not. We are focused on profitable growth and we're focused on, regularly innovating our service, making sure that we continue to provide the most convenient options for delivery in the UK. And, of course, we have very proactive plans in place to deal with the headwinds on the letters side, the direct delivery concern that we've called out today.

I'm going to turn things over to Matthew now at this point to take you through the numbers.

Matthew Lester - CFO
Morning. Thank you, Moya. This first slide is, hopefully, one with which most of you are familiar. It's the value drivers for Royal Mail. And, at the bottom of the slide, you can see that we have repeated basically what we put in the prospectus; that we will drive value over the long term by delivering low single-digit revenue growth, by containing cost growth within the growth of revenues and, as a result, we will see margins expand. The combination of revenue growth and expanding margins will drive good improvements in free cash flow over time.

As Moya has said, we've delivered on the first of those things with a 2% revenue growth. Because of the impact of the management reorganisation, total costs grew by 3% and we saw a small decline in the post-transformation margins of 20 basis points. Nevertheless, we saw strong growth in free cash flow to GBP398 million.

Moya's covered most of the items on this slide, but, before I get into the detail, it probably bears repeating them. Revenue for the Group now is just under GBP9.5 billion and we saw profit before transformation costs grow by GBP73 million and we saw a small increase in the margins at that profit level. Notwithstanding the impact of the management reorganisation, we saw growth in operating profit after transformation costs to GBP430 million. The management reorganisation, as I said, depressed the margin slightly. The impact of the management reorganisation depressed the margins by about 1 percentage point. Because of the improved operating performance and the impact of refinancing our debt, we saw strong growth in profit before tax. And notional earnings per share are now 26.3p.

As I said, free cash flow is just under GBP400 million this year and that has substantially reduced our net debt to GBP555 million. Moya said that we are actually confirming that we will be recommending a final dividend per share of 13.3p. And, on an annualised basis, that is equivalent to a full cash payment of GBP200 million.

I'm not going to spend any time on the next slide, it's really there for your reference, as I'm going to go through each of these numbers in detail on subsequent slides.

Before I get into that detail, I wanted to address a couple of distorting items, which we've talked about previously; the one-offs and the impact of changes to IAS 19 pension rates. Importantly, in terms of growth rates during the period, these effectively offset each other. But that will not be the case in the current fiscal year. Because there is no material change to the level of our VAT recovery rate, we're not expecting to see a further material credit in this fiscal year. Also, depreciation and amortisation is expected to increase year-on-year in the current fiscal year by about GBP20 million. The pension charge is expected to see a further increase of between GBP70 million and GBP80 million, again driven by increases to the IAS 19 rates, which we need to apply to pensionable salaries. But we are targeting a 50 basis points expansion in profit margin before transformation costs, excluding the impact of the VAT credit and the increased pension charge.

So turning to the UK business, revenue increased by 2%, but cost growth was contained to 1%. Transformation costs totalled GBP241 million, of which GBP104 million related to the transformation costs. And, as you can see, the impact of that transformation cost was to reduce margins post transformation by 40 basis points. But again, at this level, we saw an impact of around about 1 percentage point on those margins from that management reorganisation.

Moya has covered most of these drivers but, again, I want to repeat that we did see the sort of growth that we expected in parcels revenues, 7%. But, because of the impact primarily of size-based pricing, we did not see volume growth last year. Letters actually performed better than our expectations, with

letter volumes, the rate of decline, going to 4%, which is obviously better than we've previously reported, and a 2% decline in revenues.

As Moya has indicated, we fully understand that cost control is vital to improve margins. I'm going to cover people costs on the next slide, but, in terms of the areas where we've been particularly frugal this year, the non-people costs came in 3% lower in nominal terms year on year. That was despite a number of the items that we highlighted to you earlier in the process, namely the increased costs of export and our on-going higher level of investment in IT. This was mitigated by strong procurement and other demand management. There was also the benefit of the VAT, but that only accounted for 1 percentage point out of the 3%.

In terms of people costs, Moya has already covered the productivity and this partially offset the impacts of the pay deal, which we have agreed with our unions at the end of the last calendar year, and also the flow-through of the 2010 deal whereby, as we modernise the operation, we are now paying fulltime workers for a 39-hour week. Importantly, the change in the IAS 19 pension rate actually increased the pension charge and you can see that accounted for about a 1 percentage point increase in the total people cost. It's that material.

In terms of transformation costs, you can see that the year-on-year increase was mainly driven by the management reorganisation, which accounted for the vast majority of the voluntary redundancy charge you can see in the middle of that middle column. On-going, I'm expecting between GBP120 million and GBP140 million of P&L charge in terms of transformation costs, but that very much depends upon the level of voluntary redundancies which we recognise in a particular year.

Moving across to Europe and GLS. Euro revenues grew by 7%, as did costs, and there was a slight deterioration in the operating margin and I'm going to describe the drivers of that in the next slides.

First of all, in terms of revenue, you can see that that revenue increase was largely volume driven and I'm pleased to say that that was pretty much seen across all of our markets. Germany remains the largest market and we saw revenues grow by 3% in that country. In France we saw the turnaround continue in the second half and overall revenues are up 3%. We've seen lower volumes, but these have been more than compensated for by higher AURs. Revenue growth in Italy was 16%. Part of that growth can be explained by competitive disruption. We're not obviously going to expect to see that again this year, so whilst we expect to see continued strong growth in Italy, it's not going to be at the same rate as we saw in 2013/2014. But, very importantly, we saw revenue growth across all markets both in developed and developing Europe, showing the strength of our portfolio.

In terms of costs, the most important one is distribution and conveyance costs, which makes up two-thirds of GLS costs. Within this, the major factor behind that 7% increase is the increased rates that we pay subcontractors in Germany and we've seen ever-increasing rates that we are being required to pay, being driven by competitors putting on more and more capacity in that market. The other area where we've seen a material increase is other operating costs. As well as the one-off items we've also seen the impact of investments in IT. It's important to remember that one of GLS's key competitive strengths is it is preeminent in its IT and what it offers its customers. And we are going to continue to invest in that and this will probably offset, in total terms, the impact of the profit improvement coming through from France in 2014/2015.

Going into a bit more detail on the P&L, I'm going to cover the tax and specific items on subsequent slides. I'm just going to cover the net finance costs here, which came in at GBP67 million net for the full year. GBP52 million of that GBP67 million relates to the legacy Government borrowings. In terms of the specific items, these are pretty much what you saw at the half year. I'll just pull out two items. One is that the free share offer charge that we are required to recognise over a three-year period starting from whenever you actually give employees the shares is expected to be a charge of GBP170 million in the next fiscal year. I'm also expecting the pensions credit for interest to be GBP75 million in 2014/2015.

In terms of Group tax, the story is exactly what we said at the time of the IPO. Firstly, in terms of current tax in the UK, we will not see very much cash tax being paid here, obviously, in 2013/2014 because we get the benefit of being able to treat as a cost the full employee free share offer costs, despite the fact that it was a non-cash element. Also we benefit from brought-forward capital

allowances and some trading losses. If you cast your eyes over to the excluding specific items [column], you can see that GLS has got a high effective tax rate. Yes, of course, we see the impact of European tax rates being higher than the UK but, importantly, we are unable to offset the French losses against any other country's profits. The other big item on this chart you can see is the deferred tax under the UK on the reported basis. That predominantly relates to the pension reform credit in the P&L.

Moving on to the most important part, cash, you can see the operating performance improved EBITDA, as we've previously talked about. The cost of providing the pension in cash terms is less than we recognise in the P&L and that was a GBP58 million credit to the cash flow in this fiscal year. Obviously it will increase in the current fiscal year because we will see the impact of the IAS 19 coming through the P&L.

I'm going to talk about total investment in more detail on the next slide but we've again drawn out some of those one-off items that have increased free cash flow but we don't see as being underlying. Those totalled GBP140 million and they're set out in the little table to the right. We can see, though, that even when you strip out the benefit of those, you can see a very strong performance in terms of underlying free cash flow increasing to GBP257 million. It's important to note there will be one other item coming through in the current fiscal year, which will improve free cash flow on a non-underlying basis, and that's the fact that we will pay our monthly people just after the year end and the impact of that will be a positive GBP45 million in terms of cash flow in 2014/2015.

Looking at the investment, we did a net investment of GBP581 million in this fiscal year that we're reporting. That was made up of a total GBP617 million investment, offset by GBP36 million of property disposals of the operating properties that we've talked about in our press release. In terms of that GBP333 million non-transformational capex, that was principally GLS, Parcelforce and Mailmark. During the current year I'm expecting the cumulative cash investment over 2013/2014 and 2014/2015 to remain at the GBP1.2 billion that we put in the March press release, net of proceeds from operational asset disposals. In terms of outlook, I would expect there to be a step down in 2015/2016 of about GBP100 million from its 2012/2013 peak in terms of total investment.

I've pretty much covered (in terms of) the key message around the net debt. The free cash flow has substantially reduced our net debt, as expected, and, as a result, you can see on the top right-hand side we have strong credit metrics in relation to the S&P FFO-to-adjusted-net-debt metric, which we understand to be their key one.

And finally, pensions. First of all, on an accounting basis we started the year with a GBP0.8 billion surplus. The impact of pension reform, which we went through in detail previously, was to increase that surplus by GBP1.35 billion. Mainly due to changes in long-term assumptions for accounting purposes, we saw a GBP0.4 billion reduction in that surplus, meaning that we ended the year on an accounting basis with a surplus of GBP1.7 billion.

On probably what is a much more important basis, the actuarial one, i.e., the one we discuss with our trustees, we finished the year with an actuarial surplus of GBP1.4 billion. That surplus, as you know, was generated following the Pension Reform. And the key message to retain here is that the actuarial cost of providing another year's pension benefit is approximately GBP700 million. We're only paying in GBP400 million, so obviously we are expecting that surplus to come down over time and we've agreed that that was six years from 2012 was the period that we were actually going to keep the pension scheme open for. So we are well on track to be able to deliver against that commitment.

Moya Greene - CEO
Just a few words by way of outlook and a few words about the dividend.

The first thing that I would like to point out is that our key value drivers remain our objective for this fiscal year. But, as I mentioned in the overview, we have a few challenges on the competition side and, thankfully, we have plans and strategies that are proactive and are in place to deal with them. So we intend to stay very strongly in the lead on the parcels side of our business and we intend to do everything possible to protect a sustainable rate of return on the letters side of the business by dealing with the regulatory uncertainty around direct delivery.

As Matthew mentioned, we have a very tight focus on costs everywhere in the organisation, throughout the operation.

We have not changed our position on dividend. It's a progressive dividend policy. We will be in a position to provide more clarity on it once we see how the regulatory position with respect to direct delivery pans out. And we think that, going forward, we're in a very good position for this year. The worrisome year, as far as direct delivery is concerned, is really starting to bite in 2016 and 2017.

QUESTION AND ANSWER SESSION

Damian Brewer - RBC Capital Markets
Damian Brewer, RBC. A couple of question areas, please. First of all, just on Amazon, you said it's 6% of the revenue. I assume it's a higher proportion of parcel volume. Could you give us some feel for what that is?

And then delving into the parcel business, you've had volume flat in a market that seems to be rising. GDP in the UK is lifting. So it feels like you've lost share and now you're facing, potentially, a more competitive pricing environment. Could you give us an idea, first of all, as we lap, or have lapped, the April period of the size-based pricing, what the first few weeks of April have looked like, if you're able to share that with us? And then secondly, beyond what you detailed in that slide, could you give us a little bit more detail about how you do plan to either regain share or the pricing initiative or, indeed, readdress the cost base to focus on a parcel revenue base that may no longer, therefore, offset what's happening in the letter mail business?

And then just one financial one, if I can ask it. You ended the year with GBP9 million of deferred tax assets and about just over GBP60 million of unrecognised deferred tax assets. Effectively into 2014/2015 will then that finally absorb the remaining UK tax offsets and we'll start to see a higher cash tax rate beyond that? Thank you.

Moya Greene - CEO
Well, the first thing to keep in mind is we're not going to just chase traffic that is uneconomic for us or cannot be sensibly handled in our core network. But we are going to go after, vigorously, every bit of traffic that's out there that we can manage. And with the changes that we've made to our delivery network, we can manage more medium parcels. And so you've seen us reduce our pricing in the 2 kilogram parcel because we can handle more and more of that traffic.

We're going to go after sectors where we have not been prominent. Like, we're going after retail. We're working with retailers now to encourage them to change their packaging so that things don't need to be as bulky as many of the clothing retailers, for example, or the footwear retailers have been putting into everybody's network. That will make it more amenable for us. We have extended our hours in the operation, our cut-off times for delivering traffic to us. So we have very clear new services in place that are designed to keep us in the lead in what is, admittedly, Damian, you're right, a more intensely competitive market.

Unlike many people in the business, we are not reliant on Amazon traffic. Amazon is a great customer. But I've had Amazon as a customer for a long time now, in my business life, and I know that their strategies change. And even the volume commitments that they often give you sometimes do not materialise. So it's not a sensible policy for any parcel company, especially ours that is in the leadership, to just ignore that reality. And so we are going after other sources of traffic as Amazon continues to roll-out its network. I fully expect that Amazon will carry more and more and more of its own traffic. But there are other sectors where we are not yet prominent, and retail is one of them, that we are now finding success in because of the measures that I have just mentioned.

I think that when you carry 51% of the parcels in the UK, you are the market leader by a country mile, it's more important that we concentrate on what we have concentrated on, which is, what is sensible to put in our network? What's going to be economic for us? And, as I mentioned, I'm pretty proud of the fact, where others in the business have really struggled with average unit rates this year, we have not. Our average unit rates are up by 8%. And it's always been our focus since we've been at the Company, our focus has been on cash generation and profitable growth. And so that will always be

our focus. But that doesn't mean that we aren't very assiduously going after every bit of traffic that is out there that we think is amenable in our networks. And I'd also like to point out that the Parcelforce volumes, so this is where size-based pricing has really done exactly what we intended it to do, the Parcelforce volumes are up by 8%. So that's a very good performance. So as we were shifting things that were too bulky and cumbersome for us to handle in the core network, we captured a reasonably strong share of that inside the Parcelforce network. And Parcelforce has, in the past year, upgraded its automation, upgraded its capacity and is now well underway to upgrading its technology, which is already pretty good.

So I feel pretty confident that even with this, what I consider to be a, structural capacity change that has been introduced with Amazon that we will be by far and away the leading player and the player that is focused on the right thing, which is profitable growth.

And deferred taxes, I entirely turn that over to you, my esteemed colleague.

Matthew Lester - CFO
So you're right. Yes, you can make out your own calculations. We've given you the information you need in terms of how much capacity there is to absorb. You'll work out what profit you think the UK business makes but you're right, obviously. And, as we said in the prospectus, we're expecting very low cash tax rates for the year just gone, that's happened, this fiscal year and then it starts to normalise over another couple of years thereafter.

Dominic Edridge - UBS
Dominic Edridge, UBS. Just a couple of questions. Firstly, obviously you did change your pricing mechanism for the small sub-2 kilo parcels during the course of the year. Can you just say how that's going to affect things this year, because on the headline numbers it looks quite a dramatic price decline? So is that going to have an impact on the volume versus price mix for this year in terms of the revenue growth?

And then the second thing, in terms of the Sunday delivery that we had announced the other day, obviously the CWU came out and welcomed it. Obviously that was part of the labour deal. Could you just say is the cost of the Sunday delivery embedded in the current deal? Or are there any additional extras in terms of overtime payments or anything like that that we should be thinking about as it gets rolled out? Thanks very much.

Moya Greene - CEO
On Sunday delivery our unions know everything you know about the parcel market and how competitive it is and what you have to do and how price sensitive it is in some sectors of the parcel market. So I'm not expecting that our unions are going to be in any way, shape or form unreasonable about how Sunday services get paid for. But I do have to say that we haven't actually sat down and negotiated the fine points of that yet.

Matthew Lester - CFO
So in terms of that one, though, what we have said is that overall we are seeking to manage price on top of volume growth on average to impact around RPI. And that was certainly what our plans were leading towards. So we would absorb the impact of that price reduction, where other areas where we still find that we are more than competitive and, therefore, can raise our prices above RPI elsewhere to compensate the impact of that.

Dominic Edridge - UBS
Thanks very much.

Andy Chu - Deutsche Bank Research
Andy Chu, Deutsche Bank. I wondered if I could ask three questions, please. The first one is on direct delivery. I wonder if it's possible to give a sense of what the impact has been in the last financial year from TNT Post UK. I guess, in terms of a follow on direct delivery, the estimate that you've made out until 2017/2018 is based on TNT Post UK's projections. Do you think there's any further risk of existing operators who use your access to network, which I believe is another 50%, actually doing direct delivery or others coming into that marketplace?

And then the other two questions are on the parcels business. Is it possible to give us a flavour, please, in terms of the core network, what volume growth has been in April/May, having been flat for pretty much all of last year? And then just grabbing the Sunday delivery announcement yesterday, it feels as though that's following the strategy from some of your competitors, despite you being the market leader. Is it right to think of it as a natural conclusion that you'll have to do Sunday delivery? And is it possible then to get a flavour of what incremental costs you're thinking of, please, in terms of implementing a pretty large-scale Sunday delivery network? Thank you.

Moya Greene - CEO
Let me deal with Sunday delivery first. There are a few players that have announced small-scale Sunday delivery options. And the reason why they're pretty small scale at this point is that nobody really knows how much demand there's going to be for Sunday delivery. And if you talk to even your big online customers, they can't tell you how much demand they think there's going to be for Sunday delivery. My personal view is that it's going to go the way retail did. If we were talking 10 years ago about Sunday shopping, we probably would have said: The last thing that people want to do on Sunday is go shopping. Well, since I've been in the UK you can hardly get a parking space at any shopping centre on Sunday. So I think, over time, Sunday delivery is going to be something that people will use but right now none of us actually knows, which is the reason why we are going a little slowly on it. The core network, I don't have the volume numbers for the core network on a month-to-month basis and I don't think we disclose them, do we, Matthew?

Matthew Lester - CFO
We don't. What I would say is they're positive and I'm not going to go further than that because if they were 12% that could be something, and if they were 0% that wouldn't mean very much either for one month. They're positive.

Moya Greene - CEO
The other thing is that, like every aspect of traffic in our network, it differs even by day, never mind by week and by month. Direct delivery last year had virtually no impact at all because it really only just got moving last year and our calculations are based on only what TNT has said they're going to do. Is there further risk? Could other access players move their traffic into other people's delivery networks? I suppose they could. If they found that the price and the quality was what they were looking for, yes, that's possible. Certainly some of the modelling that we have done has looked at that, but I don't think that that's a first-order effect. The first-order effect I think is going to be for TNT to get as much of its own business mail into its own delivery network, because that's the easiest thing for them to do. They already have those customer relationships. They have roughly 3.5 billion items now. That will decline a bit over the next three years because of structural decline. But I'd say the first-order effect where they will get the really marginal improvement in their delivery options would be their own mail.

Matthew O'Keefe - Berenberg Bank
Matthew O'Keefe, Berenberg Bank. I guess a question for Matthew. On the 50 basis points of margin improvement that you flagged for the current year, should we assume that that's a steady state? Or should we assume more likely that in future years you might pick up the pace a little bit as some of the funny items that you mentioned drop out of the calculation? Just that.

Matthew Lester - CFO
We said, if you looked at the progression that we were aiming to achieve to get towards comparable margins, you'd need somewhere between 50 and 100 basis points of margin improvement over a period of time to get there. So, clearly, we will be targeting a much higher level and what we get will depend upon the degree of frugality that I am able to get in the network.

Hugo Turner - Credit Suisse
Hugo Turner, Credit Suisse. I've got one question, but I guess there are two parts to it, and it's touching on that 1.7% productivity improvement. Are you finding it slightly harder to restructure the business? And are you facing headwinds from unions in terms of working hours, which prevent you getting to that 2% to 3%? That's the first part. And the second part is, obviously Ofcom are quite keen to see you get to that 2% to 3% productivity improvement and you're below that. Is that going to influence your ability to raise prices in the future because Ofcom clearly want to see margin improvements coming from productivity rather than pricing? So maybe you can give us a bit of detail about the discussion you had with Ofcom on that. Thanks.

Moya Greene - CEO
Well, first off, Ofcom is pretty satisfied and pleased with the efficiency improvements and the progress that we are making along that track. Because if you look at what this Company has managed to do over a three-year period in terms of rationalising the mail processing network, taking so many facilities out of the network, in terms of rationalising the logistics of the Royal Mail, in terms of completely restructuring delivery and the introduction of new delivery methods, I have never heard Ofcom complain to me about efficiency.

In terms of is it harder? As you do those sorts of really big pieces of restructuring, obviously you have to look across the whole field and it's not going to come out for you in big bite sizes the way a mail processing facility is. It's going to come out by standardisation and literally screwing down every nut across a huge infrastructure. And that's where we are focusing our energies now, on that standardisation. It's harder for another reason. Productivity is a function of two things; how many hours you've loaded into the operation to handle the traffic that is on hand and how much traffic you actually end up with. And so the thing is, you start planning on how many hours you're going to load into the operation two, three, four months before the beginning of the year. Traffic forecasts can come off. Just like a move like Amazon, for example, will take your traffic forecast off. It took their own traffic forecast off. They were off their own Christmas traffic forecast this year. So you can't adjust to those sorts of traffic changes immediately in a huge big network like ours. It takes a while to get to the next cycle of loading hours in.

But I don't think it's so much anymore a union issue, as the union is on public record acknowledging, probably for the first time in its long history, that efficiency is key. That, never mind the whole question of how much regulatory support will you get, if you do not pay attention to efficiency that's an important consideration certainly. But efficiency is key just to stay in a leading position and make sure that you can continue to offer good high-quality jobs at Royal Mail. So our union is on public record now acknowledging that. It is a key part of the agreement, this ground-breaking agreement, that we have put in place.

And we have found, since we got through the hurdle of the threatened strike action just around the time of the IPO, we got through that and thankfully we didn't have a national strike, we've gotten through that and we've gotten the agreement, people are working much more collaboratively, even at the local level, to look to do things in a better way. So I don't think that it's going to be the union challenge that it probably was in the past. I wouldn't want to overstate that. Unions don't like to see procedures put in place that accelerates the decline in their membership, but I am seeing a very different change in attitude on all fronts, including that one.

Mark McVicar - Nomura
Mark McVicar, Nomura. First question is at the recent regulatory presentation, Ofcom said quite clearly, unless I misheard, that they've seen your projections, they have seen the TNT mail projections and they didn't see that there was any threat to the achievement of the 5% to 10% margin targets. If you're seeing your numbers and they're seeing your numbers, why is there a big gap in the interpretation?

Moya Greene - CEO
We do have a difference of view on that and what constitutes timely intervention. That's the first thing. And the second thing is this is the kind of problem that you can't fix. Once the proof is incontrovertible, it's too late. So this is the kind of thing where you have to intervene and you have to put set parameters around something, so that you know what the thresholds are and what the safe thresholds in terms of the universal service provider and the underlying economics of the universal service. So it is true that -- we respectfully have a difference of opinion on that.

In terms of why do they see things differently, one of the things is that they are focused too much on national market shares. National market shares are not relevant in the case of direct delivery. It's local market shares, because the reason why direct delivery undermines the economics of the universal service is that, locally, I can't fire that postman. I've still got to go. And so it is the local market share in a local market that is the relevant consideration to see; are the universal service economics under threat here? And they tend to look at things in terms of national market shares.

The other thing is that the configuration of urbanisation in the UK is different than it is in other European countries. We have higher levels of concentration in a few urban areas and greater areas of sparse population than other countries in Europe. And so that exacerbates this issue. And it makes it very clear that it is local market shares that is the relevant consideration when you come to consider what is a threshold, how much direct delivery can you have and where can you have it before you start to threaten the ability of the universal service to make a commercial rate of return.

So we think our regulatory submission, which is a very detailed document, goes through all of these arguments, supports them with a huge amount of professional econometric work that we have done. We are hopeful that the arguments that will be presented in that document will have powerful, persuasive value.

Mark McVicar - Nomura
But just to be clear, at the moment on the financials, you give them a set of financial forecasts based around your plan. And they are reinterpreting the margin outcome, effectively. So that they're saying it doesn't threaten USO and you're saying it does.

Matthew Lester - CFO
I think the difference is around peers and how far forward they are looking. And, as Moya has said, I think there is a piece here where our interpretation of the likely rational economic behaviour of participants may be slightly different, shall we say? So, in other words, they may look at a plan, but why would a plan look like that, would be where I would be particularly probing.

Moya Greene - CEO
The other thing that I have said on this issue is that Ofcom is highly professional and we have a really strong relationship, we think, with our regulator. But even highly professional regulators can sometimes get things wrong; even those that are diligent and try very hard. These are complex matters and you can sometimes get things wrong. And what I have said to Ed Richards is: If I'm wrong, Ed, if I'm wrong there's no problem. If I'm wrong and you're right, there's no problem. The only thing that happens if I do make a commercial rate of return, your duty is done, because your duty is not competition in relation to us, your duty is to secure, and that's the word, it's a very big word, secure a financially viable universal service in Britain. That's your duty. If I'm wrong, there's no problem. The worse that's happened is you've done a review early.

If you're wrong, not only have you not done your duty, the damage that's done is not fixable by you. At that point, you haven't got a bullet strong enough. So in terms of a balance of risk, what I'm saying is: What's lost here by hurrying up?

Mark McVicar - Nomura
Okay.

John Lawson - Investec Bank
John Lawson, Investec. Perhaps just following on Mark's theme, and I don't know whether you can comment a little bit. But in your presentation you talked about what you would like to see, or what is needed, is a very, very, minor change to the Postal Services Act. And I just wondered whether you could just elaborate on that a little bit.

The second question, quite different, is related to one of your appendices, where you talk about your Group property portfolio and you've given some data on vacant sites, etc., and talking about optimising value in the longer term. Again, if you could elaborate a little bit more on timing or your thinking around that.

Moya Greene - CEO
On the Postal Services Act, one of the problems that regulators have, even professional, highly diligent regulators like Ofcom, is that, over time, what has crept in is a highly legalistic approach to procedure. And, therefore, they're not usually able to act very quickly on anything. They've imposed upon themselves evidentiary burdens that are very high in terms of their threshold for action. So I think the only way to get around that quickly, that particular process problem that slows all regulators down, and certainly would slow this diligent regulator down. Right now the Postal Services Act gives Ofcom until 2015 to conduct their review of direct delivery. I think that should be changed. And I think

the Postal Services Act should say: Conduct a review of direct delivery now. Don't wait until 2015, because if you wait until 2015 whatever you do, even if you do nothing, you've got to start with a review. And if you wait until 2015 to do the review, by the time you get round to figuring out what you're going to do about it, you can probably add on another two years. That's too late.

Matthew Lester - CFO
Real-estate. I think we just made sure that people were not over interpreting the situation because there's been so much comment there. What we're flagging here is the sites are the ones that we've talked about in the prospectus. And what we are going to do is a site-by-site analysis of what is the right thing to go and do. There is a wide range of opportunity for us to go and develop those sites. We'll sell the land as is and we will be opportunistic in that way. And we have no fixed strategy which we have to adhere to. So just to say there's not any new news here, but we will maximise the value for shareholders over time.

Alex Paterson - Espirito Santo Investment Bank
Alex Paterson, Espirito Santo. You've touched on this in a number of the previous questions, but could I ask you to be a little bit more specific? In terms of Sunday trading, is the hourly labour cost that you'll be paying to your workers going to be the same as what they would earn Monday to Saturday? Or would it be higher? And if higher, please could you give a magnitude of change?

Moya Greene - CEO
Well, we already pay a slight premium for Sunday. We always have. There are people who work on Sunday. And so I don't want to get out ahead of our union. I have honestly not sat down and talked to Dave Ward about this matter yet. I will be doing it in the next couple of weeks. But, as I said, I think our people and the executive of the postal union, every conversation I've had with them on that has been a reasonable one.

Alex Paterson - Espirito Santo Investment Bank
Thank you.

Joel Spungin - BofA Merrill Lynch
Joel Spungin, Merrill Lynch. Just got two questions. The first one's just to understand on your expectations for mail pricing in the current year. Obviously, your price increases in access mail are currently on hold. How does that affect your overall pricing expectations whilst the issue is resolved with TNT Post?

And my second question is just to understand a little bit more about the 50 basis point margin improvement number that you mentioned. Just flicking through the presentation, you mention, obviously, there's a GBP28 million one-off that drops out. It's in the labour costs, I guess. And then you've also highlighted, obviously, GBP25 million of savings from the management reorganisation. That pretty much gets you to 50 basis points, even before we start to think about anything in terms of revenue growth and operating leverage through the network. So I'm just trying to get a sense of how conservative you're being, basically.

Moya Greene - CEO
Well, let me deal with the mail pricing and Matthew, you can deal with the guidance on the margin, if you wouldn't mind.

The general ordinary access pricing, that has gone into effect. What didn't go into effect and what really worries us, because we thought we did exactly what Ofcom told us to do last year when they put their regulatory approach into the public domain. March of last year, on direct delivery, what Ofcom said is: We expect Royal Mail to use the commercial freedoms that it has, as a first line of defence against the financial impacts of direct delivery. And, in particular, Ofcom said: We expect Royal Mail to look at its zonal pricing.

So and that's exactly what we did. Because if you give us a national mailing and you give us a forecast of how much mail we're going to get, we can manage our costs better than if you just show up one day and don't give us any indication of where you're going to inject the mail. So we put in place, if you recall, a small differential of 0.25p into the market to tilt the zonal pricing. Zonal pricing applies to urban, suburban, rural [and London] in set geographic configurations. And so we figured

that we would get a complaint. Because right now, everything we do, it's easy for any competitor to complain. Even if there's no substance to the complaint, if it ties us up in knots, it's a good regulatory strategy for somebody to follow. So we weren't surprised that we got a complaint.

What we were surprised at was that Ofcom said that it was going to review access pricing. And that was worrisome for us, because not only did it suspend the zonal pricing during the currency or the time duration that it's going to take to look at the complaint, but we actually don't know, for that period of time, what we can and cannot do, how much pricing freedom do we have. So we're hoping that they will get through that one relatively quickly.

I should say that, while zonal pricing was a bit of a help in terms of offsetting the financial impacts of direct delivery, it was never going to be enough. And I've always said to Ed: You are going to have to put some parameters around how much direct delivery can sensibly coexist, in a structurally declining market, how much of it can sensibly coexist with solid economics underneath the universal service provider, such that we are able to earn that commercial rate of return in the regulated business. But it was a help and it's a help that is now suspended. And that's what has been suspended.

Matthew Lester - CFO
But the rest of pricing has gone through so we are expecting to see an RPI-type increase above the volume.

In terms of the earnings pieces, just a couple of reminders from the prospectus. What we highlighted was that we're expecting a depreciation headwind in the current fiscal year of GBP20 million to GBP25 million year-on-year. And then there's also an increase in IT, again, of another GBP25 million year-on-year. So, if you like, the two items that you've highlighted net out against those. And, therefore, what we're pointing out is on an underlying basis we're back trying to get to that 50 basis point movement.

Chris Combe - JPMorgan
Chris Combe, JPMorgan. Just a follow up on the regulatory front. You've talked about a timely intervention as being preferable. Can you comment on what would be a best-case scenario in terms of remedies and which types of remedies you might see as less effective? And, tied into that, how do you expect that to inform the open consultation on access, which begins this summer.

And then lastly, if we look forward 12 months, what would hope to have achieved in terms of restructuring, in terms of parcel mechanisation and IT modernisation. Thanks.

Moya Greene - CEO
Well, let me deal with the last question first. We continue to make a lot of progress on improving the technology underpinnings of the Royal Mail. And, as I mentioned, we've put in place SMS texting on special delivery. We've got better ways to connect to high-volume shippers now than we had last year and we'll continue to improve on that. We've got about 30% of the parcels in our network now is subject to track and tracing. That's very good. That's an improvement over where we were. And we will continue to make gains. I expect that we will be at 50% of the traffic in our network subject to track and trace and other technology improvements over the course of the next 16 or so months.

On parcel automation, I'm being very careful on parcel automation because a lot of companies have really blown through and wasted capital on doing parcel automation wrong. But that doesn't mean that we're standing still. In fact, we are currently, in the market, we're going to test out a couple of different kinds of equipment, automated equipment, how it works for different shapes and sizes and configurations in our business. And we're starting that basically now. And so in two years' time we will have [in it] the sensible parts of our parcel business, not all of it, only where you have the volumes that make it sensible, in two years' time we will certainly know exactly how we're going to do the automation and where we're going to do the automation.

In terms of a best outcome on direct delivery, I don't want to speculate on what the available remedies are, because this is an area where there are going to be lots of creative minds applied to what would work here. But one thing that doesn't work is waiting to see the damage before you figure out what to do. So my immediate goal is to get that review of direct delivery underway right now and get the debate started on what's the shape and range of appropriate remedies for it. But, at the end of the

day, if you're in a declining market and you want to have sustainable economics in a universal service, there's only a certain amount of direct delivery in local urbanised areas that is compatible with that. And so by one device or another there are going to have to be limits placed on direct delivery in urban areas.

Matthew Lester - CFO
Time for one more question.

Susanna Invernizzi - Barclays
Susanna Invernizzi, Barclays. A couple of questions. First of all a follow up on what you've just mentioned on parcel automation. Am I right to read between the lines that maybe the expected capital expenditure that we talked about at the time of the IPO is slightly lower? I remember you had a buffer with regards to parcel automation, talking about, not the current fiscal year but next year, in next couple of years.

Moya Greene - CEO
No.

Susanna Invernizzi - Barclays
No, okay

Matthew Lester - CFO
What was the other question?

Susanna Invernizzi - Barclays
The second is that, leaving the UK and moving to GLS, I understand your point on the current fiscal-year operating margins being slightly diluted by IT costs. So if we can move beyond the current fiscal year and elaborate on margin prospects, possibly by country. Thank you.

Matthew Lester - CFO
So in terms of the capex, I think what Moya is alluding to is not so much that we're going to spend less but we are going to spend differently. The priority item has got to be the IT enablers, the customers, etc. So, if you like, what the study has been showing is that we've got to address that first of all and, frankly, putting in the kit can come in when it makes sense to do so (but the primary piece is). So no reduction in the level of expenditure but possibly a different focus of it.

And in terms of the GLS margin, no, we're not going to give margins by country. And what I'd be saying is, we will see how this one goes. The market is a competitive market out there. We are in a situation where, sure, we are always targeting, as Moya said, margin improvement in all our businesses but we will need to invest in them appropriately. So this year we've highlighted, no, we don't expect margin improvement in GLS and we'll see where we get to next year.

Thank you

Moya Greene - CEO
Thank you very much. Really appreciate you coming in.