19 November 2014

Royal Mail plc Half Year 2014-15 Results

Management presentation and Q&A transcript
[Amended in places to improve readability only]

Moya Greene – Chief Executive Officer

Good morning, ladies and gentlemen. Welcome. Very pleased to see you all here again. Very pleased to report our results for the half year. We have delivered 2% revenue growth and margin expansion, as we expected.

As you know, we are the pre-eminent player in the UK parcels market and as a result of the number of initiatives that we've accelerated and brought forward, we are still the pre-eminent player and we plan to remain there. Our volumes are up by 2%.

Letters actually did better than we expected. We're not changing our guidance. We think the structural decline in letters is still in the range of 4% to 6%, but that came in a bit better at 3% volume decline.

GLS has performed strongly, better than expected; 7% increase on revenues, 7% increase on volumes and this is in a Eurozone where, as you know, it's a pretty flat backdrop economy.

Our operating costs are flat. We think that's a very good performance and they will be flat as well at the year end. And that has mitigated pressures on the top line and so we have really concentrated our energies on making sure that we protect our profit.

Now, if you look at slide 4, I'm going to talk a little bit now about what is, let's face it, a more challenging market.

Cont…

Last time we met, I mentioned that Amazon would be delivering its own parcels in the UK. What that has meant - I don't think it changes the rate of growth in the parcels market; it's still around 4% to 5%. But what it does is it changes the addressable market for all parcel players in the UK for the next couple of years or so until it washes itself through.

As a result of the capacity that Amazon has added to the market, and other players as well have added new capacity to the UK market, just in time to see the number of parcels available for the industry come off a bit, that has put some pressure on average unit rates.

We are maintaining our discipline in the market. You will see, as I mentioned, that our volumes are up 2%, I'll come on to this in a minute. We've introduced a number of new initiatives that make sure that our offering remains a very strong offer in the parcels business.

It requires innovation to keep a pre-eminent place and that is exactly what we have done.

So what you will see is that, as a result of the increasing competition in the parcels market, we have brought on stream and accelerated a number of initiatives. We are targeting sectors of the online business that we had not been strong in.

We're certainly making all of our services better. We've got Local Collect in place now for 20,000 small and medium-sized customers.

We've changed the size of our small parcels. While I mentioned that we're maintaining discipline on price, there are areas where we can be even a stronger value product offering in the market. We've done that. You saw that we reduced the price of the parcels between 1 and 2 kilograms and we've got a seasonal price promotion on for Christmas.

We've got a better tracked return product in the market now.

We're able now to harvest some of the technology improvements that we have had to make over the past two or three years.

Cont…

You'll see that, within a six-week period, we have offered a range of Sunday services so that delivery is more convenient. If you are not home you can now pick up your parcel at any one of the 100 busiest enquiry offices. Actually, Sunday delivery is already our third busiest day. We're delivering on a trial basis inside the M25 area.

Our whole network now is open later on the weekend so people can induct their parcels with us at a later period of time and still have them delivered the next day.

We've got a good partnership with Post Office, so we've got literally 10,000 click-and-collect opportunities, collect [collection] opportunities with the Post Office.

So I think all of these initiatives, certainly on the technology side, if you go on to our website now it's a lot easier if you are a parcel shipper to connect to Royal Mail today than it was even six months ago and the opportunities that you have on our website used to be pretty clunky. It's now pretty slick. Used to take weeks to connect your shipping system to ours, now takes a matter of days.

And if you are a parcel shipper today, if you go on to our site, in three easy clicks you can get to the send button. You can pay on our site with PayPal if your account is with PayPal. You can pay on our site if your account is with us, with a Royal Mail account or with your eBay account.

So we have accelerated all of these initiatives to make sure that we maintain our place as the pre-eminent player in the UK parcels business.

I mentioned that we had to do work on the technology side. The technology backbone of Royal Mail needed upgrading. As a result of two years of investment on the technology side we're able to harvest that.

You will have heard, for example, that over the next few years we will be spending another £130 million to roll out the next generation of PDAs for postmen and women.

Cont…

We're going to have bar codes on more and more parcels; by this time next year about 80% of our parcels. And remember, that's not a small feat. We are a big player. We've got a billion parcels. Some of our competitors they've got about 100 million or 150 million parcels. So we'll have about 80% of our parcels will have a bar code on them. We're making good strides on parcel automation. We've got a very good tracked returns offer now with eBay and I already mentioned the Click and Drop.

So all of these things taken together have helped us retain a very strong position; the strongest position in the UK market.

So if you just look at the numbers.

As I mentioned in the opening, looking at performance in the first half, Matthew's going to take you through the detail, but volumes are up by 2%. We're still experiencing account growth and we're winning new contracts. That's helping to offset volumes lost to Amazon.

As you know, even though Amazon's a brilliant and a large online player, we were never dependent on Amazon traffic. Of course, I'm happy to take Amazon traffic but we were in a position that we were not dependent on Amazon's traffic and we were moving into other sectors so that it will be less of an issue for us, their decision to develop their own delivery network in the UK.

Our international import parcel volumes were higher than we expected. Export is affected by the some of the same factors that we see in the UK. So, as a result, revenue was down but that's really a change in mix; we've got more lower AUR parcels and not as many high AUR parcels.

GLS, as I mentioned, turned in a stronger performance than we expected. Revenues up 7% and margins at close to 7%. That is, they are ahead of plan in terms of the restructuring of France. They have managed the continuing cost pressure that we called out the last time we met in Germany pretty well. And in Italy that is a very strong performer for the whole GLS network.

Cont…

GLS is focusing on improving both its B2C but also, as you know, the core business in GLS is B2B, but on the B2C side it has introduced FlexDelivery, which allows recipients to change delivery details in flight. That is being rolled out in other countries and so we're very, very pleased with a better than plan expected from GLS, performance from GLS.

The letters side of the business, as I mentioned, came in better than we thought. And this, again, is - well, I think the rate of decline at 3% is partly attributable to the economy. But it's also attributable to things like the investments that we've made in the past couple of years in the letters business.

You will have heard about the Mailmark innovation. This allows addressed business mailers to know where their envelopes, each and every envelope, is the minute it hits our system. That is delivering value for business mailers.

We've also now got a really good partnership going with 70 leading UK charities and consumer organisations and businesses to help them understand the value of mail. And that's coming together very well.

I think it's a real pleasure for me to see, after two years of investment, how we're doing on the marketing mail side. The market reach initiative now is showing gain and you'll see that our marketing mail is up by 5%.

I think the story today that I'm really proud to put some emphasis on is the cost story. I mentioned that costs are flat compared to the half year last year. I have to congratulate our Chief Operating Officer [Chief Finance Officer]. He's made it very hard, he's always made it very hard, but he's made it particularly hard to spend any money at Royal Mail. And, as a result, you will see 60% of our costs are people, 40% of our costs are non-people, our non-people costs are down by 4%.

And we've had a slight uptick in the people side of the business but even there Sue Whalley, our Chief Operating Officer, has done a great job.

The productivity performance is strong at 2.1%. That has partially offset the wage increase.

Cont…

So that productivity performance, if I read the newspapers correctly, that puts us probably in the lead in UK companies. Productivity is not, from what I read in the newspapers, not doing that well for UK companies. We're very proud.
Again, all the people in our operation have worked very, very, hard to make sure we handle the traffic with fewer and fewer hours. And we've also handled the traffic very well. You will see that our delivery performance is some of the best delivery performance that we've turned in.

So I think what you're seeing on the cost side is a really good story, that culture of frugality that Matthew has brought to the business ever since he came to the business is now starting to bed in everywhere. And that will continue. I think, as I mentioned, costs will be flat at the year end and I think at least flat for next year.

A number of actions have been taken on the cost side. I'll just mention a few because I think it's really important to understand that we still believe that it's very important for us, if you've got pressure on the top line, it's very important to protect the profit picture by keeping a very tight rein on costs. And that's what we have done and that's what we intend to do. And we believe that these opportunities will continue to be harvested going forward.

Any company is going to have changes that they have to cope with and I am very proud of the amount of change that we have brought to Royal Mail. But we haven't compromised in any way our customers. And our customers' perceptions of us keep getting better. You will see that our net promotion score from our customers has gone up significantly compared to the half last year. Our customer satisfaction scores are also up.

And, as I mentioned, it's a lot of things. It's being innovative. It's responding to what your customers need, that's for sure; making it easy for your customers to do business with you, that's for sure. But, at the end of the day, we're a delivery company, and the high-quality delivery and some of the best delivery numbers that we've had in a number of years, that has also helped. And, at the end of the day, if you do that, you will always do well in terms of delivering your overall strategy.

Cont…

So I would say the initiatives are now in place to protect our pre-eminent position in the parcels market and we intend to bring forward more and more of them. As I said, the technology backbone has become more stable. We're able to add more technology to the parcels business.

We are promoting the value of letters to businesses and to people who want to market goods and services in the UK.

I mentioned, the last time we met, that the universal service in Britain is a precious thing and we still need regulatory reform to make sure that it is not cherry picked and the economics of the universal service are not deliberately undermined. So we're continuing to advocate for that.

The tight cost control is a very important feature of daily life at Royal Mail. Matthew's going to talk more in detail about that.

And I remember when I first stood up in front of you, some of you asked was GLS core to the business? GLS is core to the business. The performance of GLS, turning in that kind of a performance in a weak economy, has given us the sort of diversification that we will always want to have.

So, at that, I'm going to turn things over to Matthew to take you through the numbers. Thanks very much.

Matthew Lester – Chief Finance Officer

Thanks, Moya. Good morning, everybody. So starting by running down the Group P&L.

For the half year we reported revenues of just over £4.5 billion and an operating profit before transformation costs of £279 million. And that means that we delivered margins of 6.2% on a reported basis.

Cont…

We've highlighted in the release the issues that we had to address in terms of underlying adjustments, and I'm going to cover those in detail on the next slide, but, importantly, you can see the difference that these make to the underlying margin whereby before transformation costs the Group actually delivered a 20 basis point improvement in the period. And after transformation costs that increased to a 70 basis point improvement, resulting in operating profit margin after transformation costs of 5.1%.

Earnings per share excluding specific items are 16.3p. And we've declared our first interim dividend of 6.7p per share. That's one-third of the annual dividend, in accordance with our policy, which we announced at the time of the IPO.

So to the underlying adjustments.

All of these have previously been highlighted to you, some of them as much as one year ago, the first of which is the VAT credit, where we adjust for the year-on-year difference between the exceptionally large credit we got last year and the one we received this year. That adjustment is worth £30 million.

The period-on-period difference in the non-cash IAS 19 pension cost is £34 million in the period and will be £70 million in the full year, working day impact on profit was £20 million and there's a small net FX adjustment of £3 million, meaning that the underlying operating profit for the comparable period was £266 million compared to the £279 million which we reported for this period; an improvement of £13 million.

The next slide's really there for your reference as I'm going to talk about all of the remaining issues in detail subsequently.

So, starting with the UK business, revenue of just over £3.7 billion.

You can see that on an underlying basis revenue and operating costs were both flat. We again have made the relevant adjustments in the table on the right-hand side of this slide to show how you reconcile the reported and underlying margins, but, before transformation costs, margins again increased by 20 basis points to 5.9%.

Cont…

Transformation costs of £47 million in the period, slightly lower than they were this time last year. And, importantly, for the full year we're not expecting any major management reorganisation to need to be accrued for and, therefore, there will not be that £100 million or so in the second half of this fiscal year compared to last.

As a result, we see in the first half of the year operating margin after transformation costs of 4.6%.

So starting with the revenue drivers. Moya has covered the commercial issues behind this, so I'll just touch on how they come through numerically.

As Moya said, parcel volumes are up 2%, but there is a negative price and mix impact and that's mainly mix, i.e., selling more items which are lower average unit revenue, which offsets this by about 3 percentage points, producing an overall 1% decline in UKPIL parcel revenues.

Letters, on the other hand, produced a 1% improvement in revenues. You can see that what we've got here is a strong economy and that often produces very good results in the marketing mail, enhanced by our investment that Moya described, and we have the benefit of elections also increasing the year-on-year revenues.

In terms of costs, I'm going to go into the detail behind this on two subsequent slides, so the key message here is what Moya's already called out. That is that on an underlying basis they were flat in the period and we expect them to be flat for the full year and we're targeting them flat for the year after that as well.

Starting with people costs.

The two underlying movements are the productivity improvement of 2.1%. We're particularly pleased with this, given that actually the management who are charged with driving this improvement were actually going through their own reorganisation in the first half. So to get back within the range in that I think is a particularly strong performance by Sue and the team.

Cont…

And then you have the other items that we've previously been highlighting. We had the impact of the wage agreement that we agreed this time last year. And then, on top of that, we are rebuilding our IT team. So we've now got almost 400 people in our IT department that we actually pay ourselves; they're not the outsourced part of it. And we've been investing in Parcelforce to deliver the volume growth that you've seen in this morning's release.

In terms of non-people costs, you can see here the element of the VAT credit difference that relates to non-people costs, which we strip out on an underlying basis, and I'm going to just cover a couple of items here.

In particular in distribution and conveyance, improved fleet management has delivered a very strong performance and that's a greater year-on-year impact than even the reduction in the terminal dues or the export costs that we have incurred.

We've actually reorganised the property management under one coordinated management team and they have delivered significant improvements this year.

We also benefit from lower costs in relation to Post Office. However, if you look at other costs, where we used to recognise a credit, where we used to recharge them for those costs, obviously that is no longer there since we have now demerged and the agreement between us has come to an end in terms of property management.

But what you've got going on there as well is this culture that we have introduced over very much a four-year period of really being very tight on everything we spend, so we look forward to contribution to your coffee at the end of this.

Transformation costs.

We've put the main drivers and movements on the right-hand side of the slide so I won't go into detail there. But, as I said earlier, they are lower than they were this time last year. However, for the full year I am expecting that £120 million to £140 million charge that we have said is going to be a consistent feature of our P&L.

Cont…

What we would say, though, is that the actual amount will very much depend upon when we announce, or actually make, any specific changes vis-a-vis the timing of our actual year end.

Moving on to GLS. I think Moya's already summarised this very well; good revenue, good profit. As a result we can see the profit margin moving to 6.9%.

First of all in terms of revenues, you can see here that FX does have a material impact on the reported sterling figures.

However, when you look on a Euro basis you can see that this is very much a volume-driven performance and that has occurred in all of our major markets and across the rest of the portfolio as well. So a very strong performance, given the economic backdrop there.

In terms of costs, it's worthwhile just giving a bit of explanation on a couple of items.

People costs up 8%. That's driven predominantly about the fact that we do need to put some more people costs into our own operations when we have higher volumes and the fact that GLS, like Royal Mail, is investing extensively in building its IT capability in order that it can have a pre-eminent position when it comes to technologically-driven solutions for our customers.

Distribution and conveyance costs up 7%. Yes, that's up in line with volume but recall we were calling out that there was continued pressure coming from the costs of the rates charged by German subcontractors. Across the rest of the Group that impact has been mitigated, so we're very pleased with that performance.

Key thing to note, though, is that in Germany we do have the impact of minimum wage legislation, which will come in at the beginning of the next calendar year, really have a material impact on the next year. We are unable yet, though, to give an assessment of precisely how the market will react to those changes.

Moving to the slightly more technical parts of the P&L, I'm going to discuss a couple of items on this slide.

Cont…

First of all, the net finance costs down substantially to £14 million. That simply reflects the fact that we're no longer paying the Government rates of interest that we were prior to privatisation.

In terms of taxation, excluding specific items, that is an effective tax rate of 25% for this period compared to 27% for the prior period. Those drivers of that are exactly what we called out this time last year; namely, changes to UK corporation rate and the impact of lower French losses on the taxable position of GLS.

In terms of specific items, there's nothing here that we have not previously highlighted.

Within the business-related costs is the provision in relation to the French competition investigation.

And, in terms of profit on disposal of property, that does not yet include the benefits of the profit on the disposing of Paddington because that is yet to close. That will be reflected in the full year.

Probably the most important slide for me, cash flow.

First thing I'll talk about is the trading working capital movement. As you can see, it's almost exactly the same as the movement we saw in the same period last year.

For the full year as a whole I'm expecting the trading working capital to be flat, i.e., that it would require an inflow in the second half of the year, but we expect, as I said, overall flat for the full year.

I'm going to talk about investments on the next page and as usual we've actually excluded the distorting items separately from the in-year trading cash flow. However, this year, on a net basis they're actually about the same total amount as the prior period.

Cont…

So if you look at the free cash flow and adjust for the VAT credit and the management reorganisation you get free cash flow in line on a year-on-year basis.In terms of that investment, again we've put some detail in the slide here. I think I'd call out a couple of things. First of all, you can see, as we said at the time of the IPO, we were going to be increasing our investment in non-transformation CapEx. In the period I would highlight that we've invested substantially in GLS and in IT-related projects. We will expect to see a further cash outflow in relation to the management reorganisation program of about £60 million in the second half of this fiscal year.

But cumulatively, I still believe that we will spend round about £1.2 billion in terms of the total investment over the last fiscal year and the current fiscal year. And, going forward, I'm anticipating spending between £550 million and £600 million on the items covered on this page annually, of which between £250 million and £300 million is in the form of maintenance or replacement CapEx.

In terms of net debt, not really a lot to say. The free cash flow pretty much offsets the dividend. We have refinanced a number of the term loans, or parts of the term loans, through the issuance of €500 million bonds.

In terms of pension, on an accounting basis you can see that the surplus has increased to £2.1 billion.

Probably more importantly, on an actuarial basis the surplus has increased to £1.6 billion and this has been driven by the asset performance that you can see in this chart. But it's important to note that actually a lot of this asset performance is timing in nature and we still expect to see that the surplus, on an actuarial basis, will actually be eliminated by March 2018; the time at which we have given our commitment to keep the defined benefit plan open to accrual.

Lastly from me, a word on property. As I've indicated, we continue to expect to receive the proceeds of selling Paddington in the second half of this year of just over £100 million. As you are aware, Nine Elms is currently being marketed. And in terms of Mount Pleasant, we're very pleased to see that the Mayor supported our position and we are in the final stages of agreeing the financial contributions that we make to local authorities. The next step is to complete the design work and to separate the operation from the redevelopment scheme.

Cont…

Thank you very much.

Moya Greene – Chief Executive Officer

Now just a few words on the outlook.

Our performance for the full year will be in line with our expectations, despite a challenging market, a more challenging market, on the parcel side. We're pulling out all the stops to make sure that we stay the number one player.

Very importantly, we will continue to hold the reins on costs very tightly so that we will deliver flat underlying costs for the UK business at the year end and we expect to be at least there as well in 2015/2016.

We're really like many retailers in one respect. Christmas is a really important season for us. I can tell you that we are ready to deliver again another great Christmas. Just as we did last year, we start planning for Christmas early and that always pays off, but performance depends on how people spend over the Christmas season.

So I'm going to stop there now and we can get to your questions.

Matthew Lester – Chief Finance Officer

Perhaps we'll do the usual; mic and people could say name and company before asking. That would be helpful to know where you live.

Matthew O'Keeffe - Berenberg

Just three questions from me please. Back in May you alarmed some of us with your talk of competitive headwinds and a £200 million hole in the top line, which I think, if I remember, was based upon your assessment of the published plans as made clear by your main competitor here. Since then, obviously, Whistl has frozen investment in the UK.

So my first question is how you see that hole now. Is it smaller? Is it more distant? Are you still as worried about it as you were?

Cont…

Two other questions. I wondered just, with respect to the working capital movements, etc., where you see net debt at the end of the year.

And then just finally on the property question, I noticed one of your options for Nine Elms is development in partnership with someone else. And my question here really is don't you think that you have enough challenges ahead of the Group without trying your luck as a property developer as well? That's it from me, just those three.

Moya Greene – Chief Executive Officer

I'll deal with the direct delivery issue and I'm going to ask Matthew to deal with the working capital, net debt and the property issue.

In answer to your question, I would invite you to draw a distinction between what is here and now and what will happen.

I am just as worried. Whether it happens in 2017 or it happens in 2019, what I can tell you is, if you undermine the economics of this precious universal service and this kind of cherry picking in a world where there is structural decline in the revenue pool that is available to pay for the universal service, a cherished service in the UK, if you allow somebody to just extract from that revenue pool, it's so steepens and deepens the decline in what is available to pay for the universal service that it is the kind of problem actually that just does not age very well.

And it is the kind of problem where you have to get ahead of the curve and you have to lay out the ground rules. This is very unfair competition to allow a party to do that, to cherry pick the profitable easy-to-serve areas of the country and to dump into our network, in a supervised pricing environment, which is a legacy of the regulatory approaches of the past, dump into our network what they don't want to deliver and what is very high cost to deliver.

So I am just as worried and we have, as a result, continued to garner support for our position. It's not a difficult position to understand and I do believe that Ofcom should start looking at this as soon as possible because it will be complex to come up with a solution for it.

On the working capital and net debt and property?

Cont…

Matthew Lester – Chief Finance Officer

I just think one thing, Moya. When Moya and I talk about this and we game it, if you were in Whistl's position ask yourself, you've just made that proposition to Ofcom that this is an existential issue for you, do you go and roll out tactically? I think there's a lot to be thought through in that way, how you actually play this for the long term.

In terms of the working capital and net debt position, I think what we're saying here is that, overall, we would expect to see a reduction in net debt. The absolute amount will depend upon the time - it would be very materially affected actually by the property disposals and what we choose to go and do.

So, as I said, I don't actually have a particular target that we share here. You can work it through in terms of whatever you've projected for our numbers this year and the guidance we've given in terms of reinvestment.

In terms of that question you had here in terms of Nine Elms - I think we've given enough numbers. In terms of Nine Elms, the proposition here is a very simple one. We are not about to go and establish our own building unit and suddenly have Royal Mail Construction established here, but there is, and you've seen people like National Grid, for instance, announce it recently, there is a piece here where our shareholders are telling us; please don't just give great property development profits to somebody else. We would like to participate in those, if it's the right thing to do. But it is far too early for us to call that.

If we get some fantastic offers where the risk return of participating in those profits is not the right thing to do, then Moya and I will very happily accept a very large cheque, thank you very much.

But what we're saying here is that we have seen, probably, and certainly if you wind back the clock a year, there was a lot of question were we doing the right thing just selling these assets, it appears that there is a good amount of profit to be made from them as well. But we will only find out when we get the bids in.

Cont…

Matija Gergolet – Goldman Sachs

Three questions, one on cost, efficiency and one more on real estate. Firstly on the - actually starting with efficiency, can you give us an update of what is your current level of automation in parcels? You mentioned that you want to get to 80%. What's the current level? What kind of cost savings should we be expecting from that increase in the automation? Secondly on the costs, more on the numbers, could you help me understand why do you say have a flat cost structure when actually I see it's more like a 2% growth in the UKPIL if I just look at the numbers, but you call it flat? And just one more on real estate. We keep seeing that now every quarter - well, every six months you report £20-£30 million of other smaller real estate disposals. So if you start summing them up, they actually start becoming quite material. How many more, say, semesters should we expect to have some nice £20-£30 million items from real estate? Thank you.

Moya Greene – Chief Executive Officer

Let me start with the parcel automation question and Matthew will take you through our really, I think, strong performance on cost and where we're going on disposals.

We see a lot of people waste a lot of capital on parcel automation poorly planned. So we've taken a decision that we are going to learn from everybody's mistakes and we're going to go at parcel automation the way that we go at everything, in a pretty deliberate way.

But we've started. We've got an RFP in the market now for equipment, and we're trialing the equipment. And we have a good plan put together now that will see us automate the sortation of parcels, particularly in the larger site. And in terms of modeling, the cost of that is all in our capital planning budget going forward.

Cont…

How much cost will it take out? Well, it remains to be seen. In terms of the numbers of people, obviously it will have a positive impact. And we have not quantified that yet. We want to see what we're going to do, how we're going to do it and how fast we're going to bring it on stream. But there will be savings attributable to moving from a manual sortation process to an automated one. In terms of bar coding and being able to track more and more parcels through our system, as I mentioned, we've made a lot of investment over the past three years in the legacy backbone of the technology estate in Royal Mail, which, I think is fair to say, had suffered from chronic underinvestment.

So we've now stabilised that and we are able to now start adding on to it the sorts of services that our customers want. Our customers want to be able to connect with us easier. I think that part has come on very strongly in the half-year.

They also want to be able to track more and more of our product and we have a very big parcel estate and a lot of parcel product that needs to be tracked; much, much more, much bigger scale than anybody else in the UK market.

We will have barcodes on 80% of our parcels by this time next year. We have doubled the ability to track our parcels through the system in the past year and we will continue to do that and offer more and more services. More dynamic information flow to the end recipient, for example, we will start to be able to do.

So all of that, I think, is very beneficial to our customers and helps us retain our pre-eminent position. There is a cost upside to parcel automation that we haven't quantified yet, but it's real.

Matthew Lester – Chief Finance Officer

I'm glad to see you've got the same question as my audit committee had. So if you go to slide 18 you can see that there are two adjustments that are relevant to costs. That is the VAT credit, which was a benefit to last year's costs, which we did not get this year in the same extent. And there's the year-on-year IAS pension charge difference.

Cont…

Those two add up to £64 million. If you add the £64 million to the operating costs of £3,417 billion you get to £3,481 billion and you compare that to operating costs of £3,484 billion, I admit that is a £3 million adjustment onto £3 billion. And if you've got any more on that, Mike's in front of you, so he can add to that.

In terms of the small disposals, this is what we said at the full year. We were going to differentiate between what we would describe as developmental opportunities and the ones which are actually part of business as usual, where we said, and Catherine has, I know, been talking to a number of analysts about this.

What's going on there is that we will sell those properties and we will reinvest the proceeds of that back into the business, either because we've actually got to re-provide within the same location, which is literally just moving office, if you were, or, alternatively, if we are able to do any consolidation, it won't be a large amount to this, there is a big program you've seen, it's actually in the deck here, of just upgrading the experience that both our staff have in terms of what they get to work in - let's be honest, it's not great in many places; we're having to upgrade that - but, as importantly, and probably more importantly, the experience when you guys go to pick up a parcel from a delivery office, that needs enhancing and 45 delivery offices, I think, Stuart, are under renovation, just in this period.

Damian Brewer – RBC Capital Markets

Three questions, given it's the fashion today. First of all, on costs. Flat is, in real terms, a decline. As you look beyond even 2015/2016, is what happens after that dependent on parcel automation? Or is there more in terms of efficiency on the other parts of the cost base still to go for in the business, as you begin to pick through the still-existing legacy issues?

Secondly, in the very short term some of your parcel competitors are looking increasingly financially wobbly. If one of them doesn't make it through Christmas, how much contingency do you have in the system to pick that up? Or will you simply look at doing what you've got already and pricing up on that?

Cont…

And then very finally, looking into next year you've obviously got two less working days, a little bit more charge on the pension. As you've thought about the dividend policy for the interim this year, how do you think of dividend potentially bridging next year and how do you handle that? Thank you.

Moya Greene – Chief Executive Officer

I'm going to ask Matthew to handle the working days issue and the dividend issue. I'm going to deal with the parcel capacity issue at Christmas first.
We start planning for Christmas earlier and earlier, and this year we started planning for Christmas in April. It's a very important time for us. We delivered an absolutely outstanding Christmas last year and some of our competitors weren't as fortunate. I attribute that outstanding performance to really good planning and early planning for Christmas and we've done the same this year. So we're prepared to deliver another great Christmas.

Because we plan and we prepare in advance, we try to take a fix on how much traffic we are going to have to deal with. So we do that in a number of ways; obviously very tight connections to our customers, but also a very careful view of what's going on in the market. And we say to our customers: Look, don't just come to us in the month of December and expect us to deal with your capacity issues. It's better that we plan.

But obviously we have some capacity, like everybody else, and we plan for that. So I'm thinking in terms of all the work that we have done to try to assess how much volume is going to be there and the lead time planning that we've done, we're good. If a little bit extra comes our way, we can always handle it. Our people at Christmas time pull out all the stops.

Yes, it is true that this business sometimes goes through periods like this one, where there's a bit of, what I call, ill-discipline in the market. People have brought on capacity in advance of need. There's been a change in the addressable market for everyone, because of what Amazon has done. And so there were fewer parcels for everybody to vie for in the UK.

And that is going to put pressure on average unit rates when you have capacity that, basically, is more overall than the market needs at a period of time. I've seen this before, I've been in the business a long time, it takes a couple of years for that to wash itself through.

Cont…

In terms of the financial position of some of the players in the market, it's amazing, though, how long they can lose money. I'm here almost five years now. Some of these players have been losing money for the whole period of time I've been in the UK. And for various reasons, either because they've got big banks behind them or big investors behind them, they continue to lose money.

Whether or not that's going to somehow consolidate immediately after Christmas, I don't know. I've been predicting in my own head consolidation in the parcels market for five years. Haven't seen any.

Matthew Lester – Chief Finance Officer

I think you asked about costs beyond 2015-16. I don't think we've got much to add to what we had in the prospectus.

We have set long-term structural targets here, which is very much around delivering this year-on-year productivity improvement, which is at the core of the way we work with our union. There is not something out there that we suddenly see: Ah great, now here's a major shift.

And, indeed, when we talk about the parcels, being again consistent with what we said, that is a way for us creating opportunity, which we will harvest over time. And that's why Moya was saying as we invest carefully, we will build in opportunity. We will then harvest that as it comes through.

And, I would call out two things that are big there. One, the next renegotiation of the union's rates and things like that that's to come; and, as you rightly say, there's the parcel investment that we will be making.

In terms of working days, I think year-on-year there is two less in 2015-16. So it's less working days, which is not good.

Cont…

And, in terms of dividend, nothing really more to say other than that which we've said previously. We are absolutely genuine when we come back to this point about the regulatory impact on this business. It is very, very significant. And until such time as we have greater clarity on what that actually means, it's not right for us to update the capital return policy for the business.

Chris Combe – JP Morgan

Also three questions. Just to pick up on the regulatory front, do you expect an explicit reply from Ofcom in response to the document you submitted back in June? That's the first one.

With respect to the Amazon guidance you provide today, the impact on the market, what do you expect in terms of your own wallet, or share of wallet with Amazon, which, I believe, is about £200 million of revenue?

And lastly, given all the non-cash movements impacting EBIT, could we see you move towards a cash EBIT basis that's been adopted by one of your peers? Thanks.

Moya Greene – Chief Executive Officer

I'm going to ask Matthew to deal with the EBIT question.

I do expect a reply from Ofcom. We put a huge amount of work into our submission. We had the benefit of a great contribution from highly credible professional econometricians and lawyers in the preparation of that document. And we have worked with people who have worked on the regulatory side for a long time in the preparation of that document.

So we think that we put together a compelling and reasoned set of arguments to accelerate the review, which they have to do anyway. They have to start it by the end of 2015.

And also, as you know, TNT [Whistl] has complained about our zonal access pricing that we tried to introduce. And we thought we were acting completely in line with, and we still continue to believe that those prices are completely in line with the guidance that we were given in 2012. So that needs to get resolved one way or the other and the sooner the better on that as well.

Cont…

And Ofcom has announced itself that it wants to do a review of access pricing and, again, we're ready and willing to participate in all of that and that eventually has to give clarity as to what we can do.

There's no question that there is a piece of regulatory legacy, if I can put it that way, that sees the Royal Mail in a completely different light from how the Royal Mail is today. The Royal Mail 10 years ago probably could have been considered dominant in the letters market. It's a really open question whether any of those definitions are sensible in a world where the new duty is to secure this precious thing called a universal service.

So yes, we do expect answers on all of those fronts and the sooner the better. I cannot tell you when we will get them. They're a highly professional group of people in Ofcom. We've had lots of discussions with them. Because they are professional they are very deliberate about everything they do, which is good. But I think, like many regulators, the deliberation and the legal process that they must follow sometimes means that they can't be as fast as you and I would like them to be.

On the Amazon wallet, we don't give out numbers of how much one customer actually has with us at any given time. But I can tell you that it is certainly less than 6% of our revenues [UKPIL parcels revenue] and we are not dependent on Amazon. I have huge regard for Amazon. They're a brilliant company and obviously I'm very happy to deliver their traffic for them if they want me to, but I think they've made a decision in another direction; that they've chosen to deliver their own traffic.

So we're not dependent. We're putting in place all of the necessary things to make our offer even more compelling than it is today; technology support, more convenience, more partnerships, new ways for parcel customers to connect with us. All of that is what, at the end of the day, is going to make sure that we retain our place.

Cont…

Matthew Lester – Chief Finance Officer

In terms of a cash EBIT number, yes, effectively that's what we will get to. What we will do is that we will make the adjustment that you can see in the cash flow statement between the difference of the cash cost of the pension and the IAS cost of the pension [IAS 19 non-cash pension charge] and we will disclose that impact on our key profit and earnings numbers.

Andrew Hollingworth – Holland Advisors

Just following up from two, I think, points that are most relevant.

On the Amazon expansion, could you just give us your understanding of what their - or guess at what their long-term plans might be in terms of are they planning to deliver some traffic, all of their traffic, other people's traffic, because obviously they've got different business models in other areas that have expanded outside of initial phases?
And then, in terms of the Ofcom discussion, I understand that obviously it's ongoing but one thing that comes out of this is you've got a limited power of appeal - a limited power of pushback if you don't like what Ofcom ultimately come up with. And how are your thoughts evolving on that? And can that situation change in terms of power of appeal or pushback on USO.

Moya Greene – Chief Executive Officer

Let me deal with the last question first and then I'll go back to Amazon. I'm not even thinking about appeals at this point. I think we've made a very compelling argument to our regulator. Our regulator, as I mentioned, is very professional.

Its primary duty is quite different today than the regulator's duty even four or five years ago. The primary duty of the regulator is not competition in the UK. The primary duty of the regulator is to secure a financially viable universal service and a universal service everywhere.

Cont…

And certainly here in the UK, where it's a really high-quality universal service, it is a precious thing, because everywhere the profit pool that is available to support the universal service is under pressure because of the structural decline that I mentioned earlier. So if you steepen the rate of that decline by allowing this kind of arbitrage of the universal service you're going to not secure the financial viability.

So I'm not thinking about appeal. I'm thinking about giving Ofcom the space and the arguments that I think are sufficiently compelling to allow them to come forward with a framework that will be beneficial for all participants in the market.

With respect to Amazon and its plans, I'm a great admirer of Amazon. I've just finished reading that wonderful Brad Stone book, The Everything Store. This is the history of Amazon. The one thing that comes through in that book is that this is a company which is brilliant in many, many respects and it is constantly changing its strategy. So I'm not privy to those strategic decisions.

For me and the Royal Mail and all of our team at the Royal Mail, I've always said to our teams: Do not count on any customer, including Amazon, being your customer forever. You have to make sure that you have an offer that is compelling, that's price right, with a product suite that has got the right service dimensions to it, very, very high-quality delivery and go after with a vengeance all the traffic that is out there. And that's what we're doing.

And we think if you look at this business everywhere in the developed world, at least, if you look at this business it goes through periods like this when you have to wash through the capacity configuration of the industry. And I think that's what we're going to have to do, as far as I can see, which is only out about a couple of years.

And whether they will start to deliver for other people, I don't know. But I would say to you and everybody, including Amazon, Royal Mail's a very, very high-quality delivery company.

Cont…

Dominic Edridge – UBS

Dominic Edridge, UBS. Just I'll stick with two questions. Firstly, just in terms of the parcel products, could you just maybe talk about what solutions or what products you'll be offering to your customers in 12 months' time that you don't today? In other words, if I was a customer, what am I actually going to see?

And secondly, could you just say how that compares with maybe some of your big competitors in the market, i.e., and I suppose my concern is I'd look at you and say you're catching up to maybe where your competitors are today. Is there a chance you can actually jump ahead and add some more bells and whistles on or more products on over time to get ahead of the curve?

And then, aligned with that, obviously you've given an update on your view of what the market growth is going to be in parcel, the 1% to 2%. Obviously that's very different, maybe, from what the expectations have been in the past.

I know that in the past the suggestion has maybe been that you're looking to grow underlying margins by 1 percentage point per year. This year it's 0.5 percentage points. Does that mean that the 1 percentage point, because of the lower growth rate in parcel, isn't going to be achievable into the medium term or at least the next couple of years?

Moya Greene – Chief Executive Officer

You do the margin and I'll talk about bells and whistles without compromising our competitive position in the market.

On the bells and whistles, you have seen our commercial team, and we have the leading members of our commercial team here, Mike Newnham and Nick Landon, and actually on the letters side, Stephen Agar, you have seen them in the past year add a lot of bells and whistles to our offer.

Cont…

We were one of the first to offer the Sunday services. The shipping tool already is probably one of the best shipping tools - in fact, some of the biggest parcel companies themselves are saying: Oh wow, we didn't expect it to get that good that fast. And they have difficulty adapting their own shipping systems. So we're getting better and better.

When we get the next generation of handheld - the PDAs out there, they're going to have a lot more functionality than they do today. We have added a lot of track and trace. And for us to add a track and trace to 40% of our business, that's two times our competitors in terms of scale.

So for us to say that we're going to have a barcode on 80% of our parcels by this time next year, that is a big step up in terms of your ability now to not just understand where every single item is in your system, but to have a lot more information about the item too as to where it can go.

So dynamic delivery, things like that. Special delivery enhanced you will see, for example, in the next year. And I think I'll just stop there because we really like surprising and delighting the market.

And I think when we got the Sunday services, and this is a real credit to our unions and to our operating colleagues, Sue Whalley and Stuart Simpson are here with us today, real credit to them. They got those Sunday services up and running in the operation from the time that we conceived of them until the time that we actually put them in the market in six weeks.

We have done Click and Drop from the time that we designed it - we designed it, tested it, launched it in 10 weeks.

So that tells you that the technology backbone that really, really was a big drag on our business because it weighted us because of chronic underinvestment - we've still got a way to go, but, as Matthew, said we've got a great team now. We had no team four years ago. We've got a great team, we've got a new set of technology partners and so we're able to do a lot more today than we could even have thought about three years ago.

Cont…

Matthew Lester – Chief Finance Officer

I think in terms of the margin progression, I think it is, I'm afraid, somewhat granny and eggs here. If the top line is not growing as fast as it was before, the ability to expand margins as rapidly as people may have projected is clearly going to be not as easy.

So I think in the short term you're right, Dominic. We continue to project margin improvement of the order that you were talking about for this fiscal year. But I think after that it is definitely going to be the case it will take us longer to get to the margins that we had indicated we were targeting, which was competitor margins, than people had thought we might.

I think people were talking this time last year that we're very much on the close end of the three- to five-year timeframe that we gave. We would say this reinforces our view that five years is more likely.

Hugo Turner – Credit Suisse

Hugo Turner, Credit Suisse. I've got four questions. The first is I think there have been some quite senior changes at Ofcom. I think Ed Richards is stepping down at the end of the year and there's another senior move that's leaving. Is that going to influence the decision-making process and potentially delay it, in your view? Or is that really quite insignificant? That's the first question.

The second question goes back to parcels automation. If you did accelerate that process, I think the question is would you be able to take out headcount under the current labor agreement with the Communication Workers Union? And if you could just remind us when that ends would be useful as well.

The third question is could you give a bit more detail around the £25 million in incremental cost savings that are coming through in the second half. I think that comes from the management reorganisation. Just a bit more detail would be useful.

Cont…

And then the last one really goes on the surplus property portfolio. So the cash that you get from those disposals, over the medium term is the plan to return it to shareholders? Or is it going to be cash that's going to be reinvested in further transformation costs in the future to try and drive that underlying EBIT growth?

Moya Greene – Chief Executive Officer

I'm going to leave the property question to Matthew.

Let me just say, senior changes at Ofcom, I don't know. Ofcom has a lot of bench strength. It's a really highly professional organisation. But there's no question that we have really, really enjoyed our relationship with Ed Richards. He is a first-class professional. He's a very practical man, as well as being technically very strong.

So my honest answer is I don't know and I do want to call out that they got a lot of strength over there. But he's a really key person, there's no doubt about it, and this is a big issue for Ofcom. And so I expect, if it were me, if I were the Chairman over there, I would want to give the new CEO an opportunity to get his or her arms around it. But I don't know that.
On parcels automation, we think we're going at it the right way. We've got a good plan and we think we're going at it at the right pace. And I really try to be very, very collaborative with our union. Our people put their heart and their soul into building this Company and delivering for it day to day.

And so the labor agreement is not going to be an agreement that, in any way, impedes us or deters us from going forward. In fact, I think the labor agreement, as it has engendered a much higher degree of collaboration with our unions, is a facilitator of these sorts of changes.

Our operating colleagues are now in discussions with our trade union on everything we are doing. And I can tell you that at the top of the CWU, the national executive level of the CWU and probably all throughout the CWU, there is a real understanding of this business and the need for change.

Cont…

In terms of when it expires [the agreement], it expires at the end of 2015, it's a three-year agreement - I don't think it's the labor agreement that's going to impede us. I think we've got a good process going now for discussions with our union and I just want to elaborate and expand on those.

Matthew Lester – Chief Finance Officer

In terms of the £25 million, that comes from the management reorganisation program, which we announced in March. And what we've called out in this period is that we expect for the next fiscal year to actually achieve annualised savings of £70 million and we're expecting to achieve £25 million at least in the second half of the current fiscal year. So that's the management reorganisation that's driving that.

In terms of surplus property, again, as I said before, the capital returns policy is something which is dependent upon the regulatory environment and so anything I say regarding this has to be couched in the context of we are genuinely waiting for that.

As we said before, we think that there is around about the need to invest £550-£600 million into the organisation in any year in order to effect the sort of changes that Moya has been talking about.

Just throwing more cash at it actually doesn't help. Why? Because there's only a certain amount of change that any organisation in a particular state can absorb and we think the £550 million to £600 million is around what you can actually get out in terms of a sensible investment and expecting a sensible return.

David Kerstens – Jefferies

I have two questions; one on letters and one on pensions. Regarding your letter volume, the 3% underlying decline, can you quantify what the impact has been from competition on this number? I understand in some areas that some of your managers have said they lost 10% of their mailbag to the competition. Is that effect also visible on your overall number?

Cont…

And secondly, related to this, what do you expect the impact on your volume in letters will be from your customer campaign? And then would that keep you at the better end of your 4% to 6% guidance range next year?

And then secondly on pensions, I think you were guiding for a slightly lower pension operating cost for this year of £70 million, while rates have further decreased. How does this effect exactly work? And do you have any guidance already which we can use for next year? Thanks very much.

Moya Greene – Chief Executive Officer

On letters. In the areas where TNT Whistl is delivering, in those postcode areas, yes, you do see already an impact on the mailbag. They can get to 14% market share in some of those postcodes in a 4-6 month period. We have seen that.

I don't know if we have disclosed the number and so I'm going to leave it to - if we have disclosed it, Catherine will tell you what the impact has been this year. I just don't want to trip up. I don't think we have. I do know the number but I don't think we have disclosed it.

In terms of our guidance, we're sticking with the 4% to 6% range. We think that's a safe range from all of the variables that go into letters. There are a whole lot of things; the underlying economy, whether there are elections, how big the marketing spend is, what share of overall marketing spend in the UK do we garner in the mail medium. So there are a lot of things that go into it. And, of course, direct delivery.

So I think that it would be imprudent of me to be any more precise for you on what I think the letters volumes is going to be next year. So if it's on the 4% side, we're good. If it's on the 6% side, we're not so good.

Cont…

Matthew Lester – Chief Finance Officer

I think I'm answering your question, so if not, please come and see me afterwards. The £70 million figure that we called out in May was the year-on-year impact of the increase in the IAS service rate [IAS 19 non-cash pension service charge]. That is set at the beginning of the year and any changes that then happen subsequently are not recorded through the operating P&L. They come through another part they call the statement of something differences.
So what will happen is that then next year you reset the rate again and, as we've called out, the impact, if nothing was to change, on a non-cash IAS charge would be a further increase of almost £45 million, which is why, to one of your colleague's questions earlier, we feel it necessary to start moving towards a more cash-based recording because the delta is just getting too big for us to just continue to explain. We need to put that in numerically.

Doug Hayes – Morgan Stanley

Doug Hayes, Morgan Stanley. Three questions, please. First, just going back on the guidance for the full year, did I understand you correctly that you still think you can achieve the 50 basis point increase that you had originally mentioned at the full-year results?

Matthew Lester – Chief Finance Officer

Yes.

Doug Hayes – Morgan Stanley

Okay, thank you. Secondly, on the cash flow side of things you mentioned that the trade working capital was flat year over year in the first half. But if you look at some of the other working capital movements those were actually down year over year or a cash outflow. Can you give us some more insight into that and how you expect that to develop for the rest of the year?

Matthew Lester – Chief Finance Officer

These are the ones that we strip out from the non-in-year element. Is that the one you're referring to?

Cont…

Doug Hayes – Morgan Stanley

Yes. So you've got the trade working capital and then the other working capital on your slides.

Matthew Lester – Chief Finance Officer

Basically, the only thing I would call out, as we've already put that there, if we look at the year as a whole compared to the previous year as a whole the big thing that will be in there that I can call out now is that you have the impact that we will actually pay our managers two days after the period end. And that, again, has a £45 million year-on-year benefit.

Apart from that a lot depends upon things like whether or not we do a stamp price increase and things like that, which we have not made any decisions on yet.

Doug Hayes – Morgan Stanley

Great, thank you. And finally, just on the revenue mix in parcels, you mentioned that the negative mix was due to selling lower priced goods rather than a price war or something like that. Is this because customers are actively trading down into these lower priced goods? Or is Royal Mail actively trying to sell some of the lower priced goods?

Matthew Lester – Chief Finance Officer

No, the best example I can give of this is if you look within the international portfolio, actually we've sold and we've increased our revenue year on year within international. However, that has resulted from a significant increase in the amount of imports that we actually distribute in this country. The AURs of those imports are roughly one-third of the exports and so that's the sort of switch you're getting.

So it's not so much people trading down. It's actually different economic activity occurring, which then is reflected in a different mix of what we actually sell.

Cont…

Joel Spungin – Bank of America Merrill Lynch

Joel Spungin, Merrill Lynch. Just got a couple of questions. First of all, just - if we just start with the general election coming up in the UK next year, based on your previous experience do you have a sense of what the impact on volumes from a general election is? Obviously we saw an election this year but a general election is obviously a much bigger event. That's my first question.

Secondly, if I can just come back on Amazon. Given what you're saying about Amazon's plans and what it's going to do to the B2C market, given we have seen significant capacity added in the B2C space in the last couple of years, is it a fair assumption that pricing is going to remain under significant pressure for the next two years? Your shares are trading down 9% so the market clearly thinks it does. So anything you can say there is obviously helpful.

And my final question is just regards there was some stuff in the press around the planned hiring for temporary workers into the Christmas period and I think I saw a remark somewhere that the number of people you're hiring this year is less than it had been in previous years. So I'm just curious to understand why that might be.

Moya Greene – Chief Executive Officer

Well, let's talk about - I'm not going to say too much on elections, because we do know quite specifically what it means and I don't think it is a material difference.

Amazon capacity. Adding that kind of capacity, and when you look at the other players in the market, capacity has been added by others as well, not just Amazon, when you add that kind of capacity to the market it is usually the case that it increases pressure on price. I think that's clear.

The 19,000 that we have taken on is just slightly lower than what we took on last year. And I think that we learn every year how to get ready for Christmas and we just learned that we probably didn't need as many as we had taken on last year. And so by planning earlier and by really trying to anticipate the fall to earth of the traffic more precisely, we feel that we can be more effective at that number.

Cont…

Matthew Lester – Chief Finance Officer

But it's a small difference. You're not talking big numbers here, to be honest.

Great. Thank you very much, indeed. We look forward to seeing you next time. If you have got a couple, anyone else got any more detailed questions, we will be hanging around for five minutes or so afterwards.

Forward-Looking Statements

This presentation contains various statements and graphic representations (together, “forward-looking statements”) that reflect management's current views and projections with respect to future events and financial and operational performance. The words “target”, “objective”, "growing", "scope", "platform", "future", “forecasts”, "expected", "estimated", "accelerating", "expanding", "continuing", "potential" and "sustainable" and similar expressions or variations on such expressions identify certain of these forward-looking statements. Others can be identified from the context in which the statements or graphic representations are made. These forward-looking statements, as well as those included in any other material discussed as part of this presentation involve known and unknown risks, uncertainties, assumptions, estimates and other factors, which may be beyond Royal Mail's control and which may cause actual results or performance to differ materially from those expressed or implied from such forward-looking statements. All statements (including forward-looking statements) contained herein are made as of the date of this presentation and Royal Mail disclaims any obligation to update any forward-looking statements, whether as a result of new information, future events or results or otherwise. There can be no assurance that forward-looking statements will prove to be accurate, as actual results and future events could differ materially from those anticipated in such statements. Accordingly, readers should not place undue reliance on forward-looking statements due to the inherent uncertainty therein.