Royal Mail plc

Full Year Results

Thursday, 19th May 2016

Moya Greene, Chief Executive Officer

Good morning everyone, thank you for attending our Full Year Results presentation.

500th year - we have come a long way since those Tudor times and the Royal Mail has certainly been through a lot of change, enormous change actually. Probably this year we've delivered more change than any other year since I and Matthew have been at the company.

As usual I'll take you through our progress against our strategies, and Matthew will take you through the numbers in detail.

We delivered very good results, determined and resilient in I think a pretty challenging market environment. Group revenue was up 1%. Group operating profit before transformation costs was up 5%. This is a result of our strategic approach to costs in the UK business in particular, and a stronger than expected performance in GLS.

In-year trading cash flow was £254m, reflecting increased investment. And in line with our progressive dividend policy the total dividend for the full year is up 5%, 22.1 pence.

Now turning to the UK Parcels Market. The trends are really much the same as before. The market, including Amazon, is still expected to grow around 4% in the medium-term, fuelled by e-retail. However, the addressable market growth will depend on the extent of Amazon's build-out of its own delivery network.

Through all of the measures that we have taken on the product side, on the services side, with technology, maintaining our tight control on costs, we remain the number one player in the UK parcel market, still accounting for over half the volume.

However, market capacity continues to grow, and that creates downward pricing pressure. E-retail parcel sizes are increasing due to the growth in clothing and footwear. Larger parcels are expected to be about 6% growth. The retail sector is driving an increase in returns traffic; that's outpacing the rest of the market, it's up 6%. We do very well, as you know, in that part of the business.

Consumers' expectations as well they're changing, they're becoming more demanding on speed, price. Convenience has led to more customer choice for delivery, for pick-up and returns.

And in the international space we are seeing the UK market dynamics basically replicated.

As always we keep an eye on everything that's happening in the market, including the disruptors in the market. And as a result of everything we've done we've maintained our pre-eminent position in the parcels business. We have addressed these trends. We've delivered, as I said, a huge amount of change.

For Account customers we are more flexible; we've extended our latest acceptance times to midnight for Tracked 48 and we've added more products to the weekend collections service. These initiatives have helped us win retail business and actually we've now replaced all of the lost Amazon volumes.

In the consumer/SME space we are focused on increasing convenience, with more Post Offices now open for longer hours and on Sundays, and our people can also drop off or collect parcels at our Enquiry Offices.

The international space is also very competitive, especially export where AURs are the higher of the two spaces, export and import. So the international area you will see in 2016-17 will be an area of focus for us. We want to solve, just as we have done in the domestic space, problems for online shippers, whether they be currency problems, Customs clearance, security or returns.

In a competitive market such as we have, and the UK is probably the most competitive market, quality, value and ease of doing business, these are the things that will drive customer loyalty, and so it has been for us at Royal Mail. We have improved our technology backbone. We have transformed our parcels operation. We are offering more customer-oriented propositions and at a greatly accelerated pace.

To drive quality almost half of our parcels now carry a barcode and a third can be tracked by customers. And just to put that in perspective for you, that's more parcels than our biggest competitor.

Next up will be outdoor doorstep scanning enabled by our new PDAs. It's probably the biggest rollout of PDAs in the UK. And we have added more functionality to that.

In terms of value, you need to keep a laser sharp eye on pricing in a market such as ours. And we have done that. Pricing is a now core competency for Royal Mail.

I mentioned that we are easier to do business with, and that is vital. We've seen our scores in this area go up by seven points in one year. Our returns portal is a real great addition for us here at Royal Mail, it's made returns much easier for customers. And we are extending our ability to accept returns now at our Enquiry Offices as well.

At 58% of our revenue letters are very important to us, so we continue to invest in the technology, in the service and the product enhancements that will promote the value of mail.

Our addressed letter volumes declined by 3%, which was better than expected, mainly due to the returns of direct delivery volumes. But not only that, in the first three quarters of the year we had very good economic growth and, as you know, that's probably the tightest correlation to letter volumes.

E-substitution, however, is still the driving force behind business mail declines. And we don't see the rate of e-substitution increasing in the medium-term. We are maintaining our guidance at 4% to 6% declines overall in that area.

Direct marketing mail is the fourth largest segment of advertising spend in the UK after the internet, TV, and total print media. It was up 1% in calendar 2015, but this is likely to weaken now going forward, as we saw in the first quarter of 2016 a softening of general economic conditions affect that sector.

We have a targeted approach to mail and in terms of how we promote the value of mail. Different letter market segments perform in different ways. As you know, we have invested £70m in Mailmark, and this has seen an increase in customer take-up. We launched a new digital stamp. I actually have little things that I can show you. This is an example of the new digital stamp [launched] in May, after a successful trial with 36 customers, including BT.

We have also expanded our Mailmen campaign. We now have 22 of the brightest leading lights in advertising advocating the value of direct mail.

For SME's we launched a new online tool – I also have an example of that for you to take a look at – MailshotMaker. This allows small and medium sized businesses to design online, start to finish and we'll deliver for them, their own direct marketing campaigns. It's a very good tool; I encourage you to have a look at it.

In the consumer space we continue to support the 'Keep me Posted' campaign, and we've just launched a really good new app called Swapshots. This is really a fantastic little tool. It will appeal to a younger audience, [and] to everybody. It allows you to take a picture anywhere, and we'll deliver that picture for you on the date that you tell us to in the online tool.

So, [in] these segments of mail, we're trying to introduce services and products that will continue to promote the value of mail.

Now, you know that at Royal Mail we have had to have, all the time that Matthew and I have been at the company, a very tight rein on costs. And that continues. And I think our strategic approach to costs is really paying off for us. For two years running our underlying UKPIL operating costs have been down by 1%. And our cost avoidance programme is on track. We avoided around £180m of costs this year and, as you know, by 2017-18 that will be £500m of costs.

We have worked very hard with our unions and with our people to drive efficiency across all aspects our operation; and we've done that at an absorbable rate of change in Royal Mail. For two years running we have come in within our targeted productivity improvement. We are at 2.4% productivity improvement this year. That's probably in the top quartile of UK businesses.

We are rolling out telemetry. Currently over 16,000 of our 45,000 vans have new technology in them. This improves driver behaviour and safety, but also gives us a new tool to reduce maintenance costs. We are starting to really restructure the network in a positive way. So you will have seen that last year we were able to take four air routes out of our network.

And in other areas of the business as well we will continue to chip away with initiatives like productivity improvements in Parcelforce depots, efficiency programmes across all of the central functions and throughout customer experience.

I think one of the things that has changed at Royal Mail is that we now have a much more respectful relationship with our unions and with our people. Our levels of engagement now with our people surpass large companies in the UK. That is a real improvement from some of the bad old days. We may not always agree on everything with our unions, but nothing is hidden at Royal Mail. Everything is discussed, everything is out in the open. And we remain determined to continue in this manner going forward.

I know you’re aware that this is a negotiations year for us. We have complex negotiations on pay; we have complex negotiations on pensions. And it’s true that when you’re into a negotiations year like that sometimes the temperature gets a little more heated. But I do value the whole spirit of collaboration that has taken hold in all aspects of our business and I think that will see us through this year just like it has in the past. We’re not going to negotiate in public but I just want you to know that those negotiations are well underway.

GLS: GLS is a great company. If you compare the performance of GLS over these past four, five, six years you will see that it’s performing better than its peers in Europe. In Europe we are now seeing the same trends developing as in the UK albeit at a different rate. It depends on the country, how online shopping is developing in that country, the degrees of internet penetration and how fast Amazon will roll out its own network in these countries.

Also if we look at the European market generally, as you know, the general economic conditions are pretty fragile. And this is the reason why we are particularly proud of GLS, it has performed very strongly; better than we expected with a 10% increase in volumes and 9% increase in revenue.

In GLS Germany, where there was a particular challenge brought forward by the new minimum wage legislation. As a result of very good and comprehensive planning, the fears that we had that there would have to be a compression in margins by 50 to 100 basis points, thankfully that hasn’t happened.

In Italy we continue to see very strong levels of growth. We are probably the strongest player in Italy right now. In fact we deliver Amazon Prime in Italy.

GLS France losses have been reduced but, as you know probably better than I, the general market conditions in France continue to be challenging, and so we are now expecting breakeven next year [2017-18].

As well as stepping up our investment in efficiency we are also investing to grow in new areas. We have moved further across the e-commerce value chain. I mentioned that we are looking to solve more problems for online retailers. That is what will keep those online retailers loyal to Royal Mail. So you have seen us in 2015 accelerate the speed of new offerings. We have solved problems, whether they’re problems in labelling, whether they’re problems in inventory management; we continue to look at what we can do to make it easier for online retailers, particularly the small and medium online retailer, grow their business.

We are also looking at ways to leverage existing assets in new ways. Our fleet is a good example. We have one of the biggest fleets for sure in the UK; almost 100 fleet workshops with substantial expertise in fleet maintenance. So we are trialling now third-party fleet servicing at seven different locations across the country.

As you know, over the past five years we've had to invest considerably in legacy technology. We've had to rebuild the technology backbone of the company to stabilise it, to ready us to be able to offer more customer-facing improvements on the technology side. That is now, that hard effort is now paying off for us. Not only have we resized our current network, our investment spend going forward you will see will be increasingly skewed towards projects and initiatives support our growth.

I'm now going to turn things over to Matthew. He'll take you through the numbers.

Matthew Lester, Chief Finance Officer

Good morning. So, starting with revenues of almost £9.3bn, representing an underlying 1% improvement year-on-year. On the next slide, we set out the arithmetic of the underlying calculation so I'll take you through that then.

Operating profit before transformation costs was £742m, on an adjusted basis. If you look at the reported number of £485m, the difference there is the difference between the cash and the IAS 19 P&L rate. That difference this year was £257m, hence the difference you can see.

Transformation costs were up at £191m, as we invested behind the cost reduction programme, and we talked about that at the interims; and as a result, margins declined slightly to 6.0%. Again, because of the investment that we are making both in terms of the capex that Moya was talking about, but also because of the cost reduction programme, in-year trading cash flow was £254m, a reduction on the previous year. But nevertheless, it more than covered the dividend that we declared, which was up 5% at 22.1p per share.

So in terms of the underlying movement, as I said the arithmetic is explained here. It's relatively simple this year, it's working days and foreign exchange. I'm going to focus on what we're expecting for the current fiscal year [2016-17]. We've got three extra working days in this fiscal year. That is expected to have an impact of £65m. In terms of foreign exchange, which predominantly impacts the GLS revenues, [costs] and profits, the rate that we recognised for the last fiscal year was 1.37. The year prior to that was 1.27, not dissimilar to current spot. There will be some underlying adjustments next year, in particular we have the £70m increase in National Insurance due to the introduction of the new 'single-tier' state pension scheme.

So first of all looking at the UK. Revenue of £7.7bn. That's down 1% on an underlying basis. But as Moya has said so too were the costs, down by 1%. Here you can see the impact of the transformation cost increase, in particular on UK margins, where we reported 5.4% adjusted margin. That's an underlying change of 30 basis points.

Moya has described the key initiatives and factors behind what's gone on here, so I will briefly touch on the revenues. In terms of parcels, revenues were up 1%. Volumes were up 3%. And here you can see the mix impact of the growth in import which are low average unit revenue, and a decline in export which are high average unit revenue, and that's the main driver behind the adverse mix impact you can see.

In terms of letters, they were down 2% in revenue terms. The volumes benefitted by 1 percentage point from the return of the direct delivery volumes. In terms of marketing mail, we think that a flat performance was very good for the year when you take that in the context of what goes on with other print related media. But as you can see, the second half was not as good a performance as the first half, very much reflecting the change in the underlying economic conditions.

Moving onto the costs here. We've set out how the underlying costs have moved. First of all, we would underline the fact that the cost programme is on track to deliver the £500m worth of benefit that we announced during the last fiscal year [2015-16]. Costs avoided just in the last fiscal year were £180m. You can see the cost pressures which we've described before. And in terms of the management reorganisation, that is getting the full year benefit of the management reorganisation which we undertook in 2014-15.

So in terms of a little bit more detail, if you look at the people costs, total core network hours were down 2%, which resulted in a 2.4% improvement in productivity. That's to say workload was actually up 0.4% year-on-year. It's an important feature that people do not realise about the time that Moya and I have been at the Royal Mail, workload has actually increased very slightly during that period as the amount of hours it takes to process parcels has slightly more than offset the reduction in the hours necessary to transfer [process] lower volumes of letters.

Importantly, there's also some volume driven increases in here. As Moya pointed out, a very strong performance in Parcelforce where volumes are up 12%. Clearly that comes with the greater variable costs that are associated with that business.

In terms of non-people costs another good performance here, down 3% year-on-year underlying. Distribution and conveyance was down 5%. This is partly due to lower terminal dues, but also due to lower fleet management costs and reduced use of UK air routes. Infrastructure is flat year-on-year. We have the impact of higher IT related costs which were offset by other cost reduction initiatives. Then the other is down 2%, and I think that just represents another year of challenging every pound that we spend and how we go about doing our business in Royal Mail.

Looking forward to 2016-17, just to bring a bit more light to what I've talked about before. In terms of the underlying adjustments, not only in the next year we're going to have the 'single-tier' impact that I referred, but going forward the year after that [2017-18] you're going to have things like the apprentice levy. It's a feature of employing large numbers of people as we do. You also then have the impact of the acquisitions which we will strip out of the underlying calculation. Then, as you can see in the balance of year we will have the impact of new initiatives which have variable costs, things like fleet, that will obviously put cost pressures on there. We'll also see an increased depreciation and amortisation charge of about £20m, reflecting the higher investments in IT that you have seen over the last couple of years.

In terms of transformation costs, we talked quite a lot about this at the half year, they came in at £191m, largely reflecting the accelerated voluntary redundancy programme that we were talking about associated with the cost reduction. I'm expecting to see around £160m worth of charge in the current fiscal year.

Moving onto GLS. We are pleased to report revenue of almost €2.2bn, an operating profit of €160m. Obviously on a sterling basis you don't see the year-on-year improvement that you see in the euro profits because of the weakening of sterling to which I referred.

Revenue. As Moya has already said we saw revenue growth across pretty much all markets. 4% in Germany, in all sectors but in particular in the export area.

Italy was a particularly strong performance where we saw revenues up 18%. That was another year of strong double digit growth. I don't think it would be reasonable of us to expect that to occur again this fiscal year [2016-17].

And as Moya has said, we saw revenue growth in France of 6%, and the losses have pretty much halved since we talked about it with you at the time of the IPO. But the challenging market means that we don't expect the turnaround to occur in the next fiscal year, it will take just a little longer than that [Breakeven now expected in 2017-18].

In terms of GLS costs, they're up 9% in line with revenues. Also, they reflect the increased costs associated with both how we addressed the German minimum wage legislation in terms of our own people costs, but also in terms of the higher sub-contractor costs which we incurred.

Moving down the P&L and moving into the finance costs, you can see that they have halved year-on-year, and that reflects the refinancing of the revolving credit facility late last year.

In terms of the tax charge, we're seeing 22% as the effective rate. That reflects both an improvement in the UK underlying rate which you are familiar with, but also changes to Italian tax with respects to allowable costs in that market.

On the next slide we've set out all the specific items, they're described here. I'm pleased to say there are no items which we haven't previously talked to you about. The only one that I'm going to refer to is the biggest one, which is the difference between the cash and the IAS 19 pension charge. As you know last year [2015-16] there was a £257m charge. We know now that for this fiscal year [2016-17] it will be £230m due to a slight strengthening in the AA bond rate at the end of the year.

So onto the really important thing, cash flow. EBITDA is flat at just over £1bn. We do see some absorption of working capital as we see a shift in our business from the more pre-paid to the more account based revenues, and also into the international area as we see more import and less export. So I'm expecting a similar level of working capital absorption in the current fiscal year [2016-17]. Total investment of £694m I'm going to spend a bit of time on, on the next slide.

In terms of income tax paid, we continue to benefit from the shelter from brought forward losses and capital allowances, and I'm expecting two more years of benefit from that shelter. And that resulted in-year trading cash flow of £254m, more than enough to cover the dividend.

The rest of this I would describe as more of a source and application of funds, and that's how we're going to cover this going forward, and also later in this presentation.

So looking at that investment. When you take off the sale of the operating properties, in this case it was the Croydon delivery office, you get to a net position of £656m. You can see that the big shift here is in terms of growth capex, and that reflects spends on parcel systems, parcels automations, purchase of PDAs, and further investment in GLS. I expect for this fiscal year to have a net cash investment back between the £550m-£600m, which we previously indicated.

In terms of the uses of cash and move change shows how it impacts net debt; we started with net debt of £275m, I've explained the in-year trading cash flow and the operational asset disposals. The acquisition of business interest was mainly NetDespatch and also some GLS Italian franchises.

In terms of the London property portfolio, we said that we were likely to spend the proceeds from Paddington on getting ready to sell both Nine Elms and Mount Pleasant, and last year we saw an outflow of £23m, but I expect to see most of that, about £100m, being spent in the current fiscal year [2016-17]. Then you can see the dividend of £213m, such that we closed with net debt of £224m.

In terms of pensions, on the left hand side we've set out the movement on an accounting basis, and I'm happy to discuss that with any of those with that persuasion afterwards. In terms of an actuarial basis, the one that we're currently talking to our Trustees about, we saw a broadly flat surplus of £1.8bn. That includes £550m of surplus relating to the pre-hedging of liabilities, which we've discussed previously. As Moya has said, we're well underway with negotiations and discussions with both the Trustees and the Union as to the nature and form of pensions that we will offer post-March 2018.

And finally in terms of property, we continue to prepare the sites and get ready for sale. We are marketing Nine Elms, but as you can imagine with Brexit and other issues overhanging us there's not a lot of active interest at the moment, though we remain in conversations with a few parties. And in terms of Mount Pleasant, this is a year where there's a lot of work to be done to get this ready to sell.

Moya Greene

It's really the success of our strategy that underpins our commitment to our progressive dividend policy. And just to remind you, our strategy is anchored on the following.

- We are going to stay number one in parcels in the UK.
- We are going to continue to prove out the value of mail.
- And we are going to grow carefully, prudently and properly in new areas.

I mentioned that we are solving more problems for online retailers, particularly small and medium sized, by doing things for them that are a little further up the e-commerce value chain, we are leveraging existing efforts in new ways. GLS has wide and deep experience, expanding successfully into new markets. It's now in 41 different markets, that's four more, in Europe, and we're going to see GLS take that very careful approach to these partnerships and careful geographic expansion in new ways. And we're going to look at expanding our place in niche B2B business. As you know, in the UK we're primarily a B2C player, 70% B2C, 30% B2B. Not so in GLS and it's primarily B2B and about 30% B2C.

So all of that is enabled, and the reason why I think we've been successful, we've certainly taken a very strategic approach to our costs, we've been successful at that. We have deepened our ability to move forward, stabilise the technology backbone, added new things, new customer service things, to our technology, so the innovation pace has picked up. And I think, very importantly going forward, maintaining a good relationship with our people and our unions.

Q&A session

Question 1

Mark McVicar, Barclays

The first question is really on GLS. A lot of your slide on GLS talked about it moving more and more into the B2C markets. What do you have to do with the product and the infrastructure and the systems to make that successful? Because you can't just take a dedicated B2B network and start running it past houses, it doesn't work. Could you explain a little bit more about how you're transitioning it or how you have transitioned it in some countries already?

Moya Greene

It does depend on new products and services. So, for example, you have seen GLS have the patent for, and now roll out, things like ParcelLock [GMBH]. You have seen GLS expand parcel shop opportunities to increase drop density in lots of new markets. And you're right, you have to be very careful how you do it.

For the most part, it is still a B2B company, but things are starting to meld with B2B and B2C and GLS has done that very well. It has a lot of experience in restructuring its routes and its route networks year-on-year. It is primarily a subcontractor driver model which makes things easier to do in that area. And as a result, they have fielded that change, I think, better than anybody else in the space. And as I mentioned, in places like Italy, they're the Prime Amazon provider right now.

Mark McVicar

And one other question is on the parcels, for a second. You talked about the parcels business in the UK in the three blocks: business/accounts, consumers/SME and international. I know you don't disclose it formally, but could you give us some idea of the different sizes of those businesses and the differing requirements that you have to deal with from them?

Matthew Lester

Accounts is about half and then SME and international make up the same, split the rest of the difference.

Moya Greene

And basically, the selling approach for the different segments of the market are quite different. With respect to accounts, you're really looking at making sure that you have a network that can handle big volumes in terms of pick-up and delivery. We do that brilliantly in the UK and elsewhere because of the way in which GLS has approached that segment of the business.

On the consumer side of the business, I think it is our very deep partnership with the Post Office that helps us. Consumers want convenience, whether it's in terms of dropping off their parcels or having your parcels delivered. 85% of people still want their parcels delivered to their home. Our delivery network in the UK is structured for exactly that.

We have done a lot in the network over the past five years to right-size it, and now with technology and automation enabling it, we're able to take larger parcel sizes through the Royal Mail core network. And obviously, as you know, we have the Parcelforce network as well, which has grown pretty significantly this year. It's primarily a B2C network and can take much heavier traffic, up to 30 kilos, and it is more in the express space and its technology enablement is also very strong.

So for all of those reasons you have to look at your parcel capacity in terms of what different segments of the market are looking for. Consumers are looking for convenience and maintaining control as much as possible over the delivery, having lots of options for where the delivery goes. Obviously they're very interested in price and you will know that we have taken a very laser-sharp approach to pricing, and that is particularly evident this year. In the UK, for example, we have reduced the cost of our medium-sized parcels by almost 40%.

For online customers, again you have to look at what online customers are expecting. We've got new labelling solutions in place, we've got better shipping tools in place for online customers, and on pricing we've tried to keep our pricing in the small and medium sized parcels constant, understanding that we're in a very different competitive market than we were, say, four or five years ago.

So in each of these segments you have to do different things. You have to sell in a different way, you have to be more alert to what people want; but you also have to be prudent. We are determined to offer changes that will make people loyal to us, and we've seen our numbers show that the changes we have introduced have done that, but we want to make sure that we are geared towards profitable growth.

Question 2

Angus Tweedie, Bank of America Merrill Lynch

Just a couple of questions. On GLS is it fair to say that you can't really expand margins, then, if you're going to keep investing, or should we expect some of the capex to be funding the investments moving into B2C going forwards?

On your natural attrition on your staff numbers, it seemed quite low compared to some of your peers. Can you remind us on the average age of your workforce and when would be the hump, once we can pass that?

And then finally, just on London property investments were up this year, and I think you said before it would be about £100m you'd need to spend. So shall we expect about another £70m/£80m next year, or how do you think about that? Thanks.

Moya Greene

On GLS margins, what I would say is that, if you remember, we guided that as a result of the German minimum wage, the margins in GLS would probably be compressed by 50 to 100 basis points, and that didn't happen. So we kept margins flat this year at 7.4%. And I don't want to be too dogmatic about that going forward because I look at the overall EU economy and there are certainly challenges there; but I also look at the performance of GLS over the last number of years and GLS is very geared towards profitable growth.

In terms of investment, the levels of investment in GLS over the past, let's say, three or four years, have been pretty constant, no big spikes there. But there's no question that if you look at our overall investment plan for the future, we are going to try to skew towards growth. We think that we've done a huge amount of heavy lifting in the past four years to move in terms of right-sizing the UK network and in terms of the stabilisation of the technology backbone. That was a huge problem for Royal Mail. I used to joke, half in earnest, sadly, that technology was state of the ark at Royal Mail. That isn't true anymore, and it isn't true because of all of the very grinding, heavy lifting that we have had to do with this big, huge legacy IT infrastructure that was Royal Mail.

I'm not saying that we don't have anything left to do on that front, we still do, but it is miles ahead of where we were when we started. So again, you will see a lot of the technology spend going forwards skewed towards things that the market expects us to provide.

Matthew Lester

Yes, I think the overall GLS margins, we're not expecting to see expansion in the short term because I think we've done a very good year of holding them where they were to this one.

In terms of the investment in property, yes is the answer, about £80m.

<u>Question 3</u>

Damian Brewer, RBC Capital Markets

Two questions please. First of all, can I just come back to the technology investment and the leap forward you made in the last year? It's initially, on the surface, surprising to see that the avoided cost change doesn't get any bigger in 2016-17. So could you talk a little bit more about the payback profile on that investment? Is it the case that some of that puts costs in in things like people time and scanning, before you then get the revenue and cost payback; could you talk a little bit more about that?

And then secondly, just on parcels, I remember the first presentation after the IPO, Moya, you were talking about two years of disruption after Amazon's insourcing in some of its delivery. I notice now that the Amazon mix of your revenue has gone from 6%, as I think it was then at the time in the IPO prospectus, to 5% today. And the Q4 parcel unit revenue at least looks a like bit more hopeful. Could you give us your latest prognosis on what you think is happening there with your account volume up 7%, are we beginning to see the worst of the shakeout go or are there new things you worry about?

Moya Greene

Let me deal with the Amazon question first and then, Mathew, why don't you deal with the payback on technology because of the different kinds of technology spend.

Amazon, anybody who prognosticates a return to some kind of equilibrium in a market such the UK is kind of brave, and I don't know if I should hazard down that territory! But what I would say is that because of the work that has been done by our COO, Sue Whalley, in the network, making the network more flexible, making it more adaptable, making it more responsive to what shippers need from our network. Because of the huge work that Catherine Doran and the technology team did to stabilise the backbone and put us in a position to start offering the customer-facing things that we need. We're now tracking, from a standing start, more parcels than any competitor behind us. So we've probably got 40% of our parcel volumes now tracked, and that will increase dramatically going forward.

All of that has mitigated considerably the Amazon impact. It took a while, but here we are now and we're able to compete successfully for big account retail traffic, and the wins, John Lewis, M&S, Waterstones, Boohoo, these are very important wins. And we still very much appreciate the Amazon traffic and nobody was more pleased than I was that when their network got into trouble, on Cyber Friday and Monday, that we actually had enough capacity to be able to help out, and we will continue to do that. But it does make a big difference when your networking, your technology and your pace of change can pick up so that you can go after sectors that were not there before.

In terms of Amazon spend in the UK, they're big in the UK now and they've got 7,000 drivers and 8,000 employees, ten fulfilment centres. That's a very big network here in the UK. And they have announced that they are going to build out networks in Germany and in other parts of Europe.

I suppose that a lot of the heavy lifting, in terms of building out that network in the UK, has already been done, and so they're probably going to concentrate on the expansion of the geographic footprint, but that won't change the dynamic. We still have 20% over capacity in the UK market, and retail as a sector, as you know, has had some pretty crushing blows to it in terms of margin over the past few years, so it's a difficult sector more generally.

So I think what you have to do is what we have done, you have to really stay tightly focused on your game, make sure you know what your customers in all segments are expecting of you to keep them loyal to you, move things through the system faster; and as I said at the outset, we've done that and as a result of doing that we have maintained that number one place by a country mile.

Matthew Lester

In terms of the cost reduction programme, it's payback and how does technology play with that: so first of all the technology spend as you can see was skewed more this year towards growth initiatives, towards the parcel items that I called out. That's not to under call the amount that's still necessary to go and spend in order to fix the backbone, and we're largely through that piece now but there will be more to spend on that in the future but more skewed as I said before to enable more things, but that's more top line orientated I would say.

In the last fiscal year, yes we did use technology to enable some of the cost reduction programmes, but it's not one of those ones where actually the cost reduction programme was predicated upon a very large technological enablement, it's much more about actually unpicking how we did things and then putting them back together. That's why you've seen the project costs actually increase year-on-year and that's what's going on there.

So overall it doesn't surprise me at all actually that this year's number is not dissimilar to last year's number; it wasn't as though we had not started things. It wasn't that we'd started the cost reduction programme on 1st April 2015, this was something that we were working up to and then we were ready to announce in October.

So in terms of the overall paybacks, they're fast paybacks because these are things that when you look at the nature of what we're doing often it's really about putting some people together in a room and looking about how to do things differently with a very clear objective, rather than any big sort of three year programme that ultimately results in a big difference. That's not what we're doing as part of that strategy.

Question 4

Penny Butcher, Morgan Stanley

Thanks. Two questions, the first one is regarding more I guess a view on timetable, I appreciate that you can't talk about sensitive exact labour negotiations, but what is your thinking on, you know, can you get the pay agreements and potentially sort of productivity done with the pensions or is this going to be a kind of staggered process at least out through 2018 when the pension component becomes more important? And mixed in with that, the view on Ofcom and how many more weeks do we need to wait for an update.

The second question is actually back on the property side, your comments seem to suggest that the intentions are still towards the possibilities around residential developments and the economy not helping the marketing of that. Have you actually considered as I understand from our real estate colleagues, one of the hot areas of London property right now is actually for logistics and industrial development because it's becoming quite scarce and companies need to move outside London more often. Could you remarket it and potentially become a landlord of sorts on that side and have a stream of income that way as opposed to thinking about development and selling the property?

Moya Greene

I'll leave the property to Matthew and I'll talk a little bit about where we are with our people and our unions. You know, one of the very big changes at Royal Mail is that we have a much more collaborative and open approach with our unions, and there's no question that even if you do you get into periods where formally you have to get to a particularly result. But I think the work that we have done with our people everywhere in the network, and if you look at our customer engagements scores, you know, they're better than UK large companies now and believe me they weren't anywhere near that five years ago.

I think the work that we have done and the openness with which we operate and the intelligence of the people who represent our people in our unions, there's just nothing hidden, they know what the inflationary environment looks like, they know what the pension situation is. So I'm not going to say to you that I think it's just going to be a smooth sail, I don't know, I hope it is, I hope that we've put enough into the relationship over these past few years that there will be no disruption anywhere for our customers.

And I look at the things that we have negotiated, Penny, over the past five years, we've negotiated some really, really difficult things and we just stayed at it and kept talking, kept the creative hat on and we've gotten there. And so the optimistic side of me thinks that this should be no different, we will get there and we will get there in a way that is affordable for the company and that doesn't damage relationships with our people, our unions or our customers.

In terms of regulation, really you should ask Ofcom, but all I can say is we responded in good time to a very, very comprehensive and significant amount of questioning, all throughout the summer. In fairness, it is a lot of material, in fairness, you have to give your regulator a chance to get through it, and I'd rather see them take the necessary time to really understand the market and the position of the universal service in the UK rather than do things quickly and miss something important.

Penny Butcher

I guess I was trying to connect the two - do you need to wait for the regulator in order to make progress on labour negotiations?

Moya Greene

Well I don't think so, no. Again, I would say our unions are very alert to the regulatory challenge and whether we get a signal of it tomorrow or three weeks from tomorrow or three months from tomorrow, our unions are very alert to that challenge and the view that our regulator takes to things that are important to our people.

Matthew Lester

On the property, the planning consents that we have are for residential, not for the other ones. If your property team know that people are paying more than £1,000 a square foot for sheds please could you send them my way straight away because I'd be more than happy to convert that planning permission in that regard.

I think the key thing here is that at the time, you know, if you go back to when we first talked about this people got very, very excited about this. We were always aware that these are large and complicated sites which is why we did not go and promote very great valuations against this area that we think are completely off the scale. We're going through what happens every now and then with London, that people get a bit of cold feet, we fortunately have a very strong balance sheet, we can take the long view, we've not predicated any of our other investments on the sales of these sites; so we have a great asset here and we will make sure we maximise the value and if we don't need to sell it in the next year that's fine by me, my balance sheet is in good shape.

<u>Question 5</u>

David Kerstens, Jefferies

Good morning everybody. A question on your operating expenses, with a similar amount of cost savings expected to come through this year and 2.8% wage inflation last year would you be confident to say that operating expenses will be again lower this year or is it still too uncertain?

And regarding the union negotiations would you expect a short-term view just focussing on the labour rates of pay deal for this year or are you trying to solve everything at once including the pension reform?

And finally, can you comment on the management changes that you announced last week? I think you made the GLS CEO responsible for all your global parcel operations now.

Moya Greene

Well let me deal with the last question first. You know, this is a big company, you're part of a big company, I don't want people to make a big deal out of this. We have about 500 people in our company that as a matter of good governance we look at succession plans for; and the top of the house is no different, that's no different than anything that we have done and that the Board has done in the six years I've been at the company.

It is true that as part of the development of your top team you look for ways to expose your top team to new areas of the company, and then you look for the experience and the expertise of individuals on your top team to be applied in new ways and it's good for them and it's good for us as a company. So I just would not want people, and I said this this morning when I was asked earlier, I would not want anybody to make a big deal out of this, this is business as usual as far as I'm concerned. Every single year that I have been at the company we've looked at ways in which we can develop people that are in the senior leadership group, and it goes pretty deep, so that's normal.

Matthew Lester

In terms of the expenses we're not going to comment more about what we may or may not do in terms of negotiations putting them together or separating them, I think Moya's covered that pretty well. In terms of the overall level, no we're not going to comment because it does depend ultimately on what pay deal you actually agree. I would point out there is a £70m headwind in addition which we didn't have last year, and also we're not going to have the £40m benefit year-on-year from the management reorganisation which obviously, as I showed in my slide, also impacted last fiscal year.

<u>Question 6</u>

Sylvia Foteva, Duetsche Bank

Hi good morning, it's Sylvia Foteva from Deutsche Bank. Two questions please on parcels in the UK. On the SME if we can kind of pick out the SME part of SME and Consumer, could you tell us a little bit about how that's kind of trending in terms of growth rates? Do you feel that obviously you have made some investments by acquisitions and organically, do you think that you have a unique selling point or are there more capabilities that you need to build out? And how do you think about market share in that SME market?

And then the second one, you've not mentioned the 1% to 2% growth in your addressable market, is that on purpose and what can we read into that? Thank you.

Moya Greene

In terms of the 1% to 2% I don't think that there's going to be much change going forward. The overall rate of growth I think will be as we posited three or four years ago, but Amazon is a very big retailer and when Amazon puts that kind of traffic through its own network that changes things.

In terms of the SME it's very important to keep in mind that we are the number one player in the UK and the SME customer is a crucially important customer for the Royal Mail. The thing that we have done to try to solve a broader array of problems that SME customers face, whether it's on the labelling side or it's just having the ability to connect our systems and to give them shipping tools that they can use to connect with us that don't take weeks to get connected but can be done now in a matter of a couple of days - all of those things count in terms of maintaining the loyalty of the SME group, the small online retailer, we want to be their partners in growing their business.

And so it's a combination of things. And in the UK if you look at the increase in scores that measure from one year to the next are you getting better or worse or staying the same in terms of are you simple to do business with? Our customers are telling us that we are much easier to do business with, we've gone up by about seven points in that score. We have an 82% customer satisfaction score overall, we are by far and away the biggest and most trusted delivery company for small and medium sized business.

I don't say that we get everything 100% right, and we certainly cannot afford like anybody in this business to be complacent. We have to keep adding, we have to keep listening; what is it that they need, what is it that we can help them with in terms of growing their business. But I look at what our parcels team has done, what our core network, what kind of change they've put in place in terms of later acceptance times, in terms of Sunday pick up, in terms of returns. We've probably done more in this year on the returns side to just make it very, very easy especially for the small and medium sized customer to get things back to them.

And that's just going to be the way it has to be because we're committed to being absolutely their partners for growth in the future.

Sylvia Foteva

If we think about your growth into this year and over the next couple of years then are you working on other big accounts, I'm sure you are, but should we expect anything on that side or are you working quite a lot on the SME side? And on the SME side do you think that the economy being slower has an impact or are you still kind of increasing your penetration?

Moya Greene

We're working across all fronts, I'll just leave it at that.

<u>Question 7</u>

Chris Combe, JP Morgan

I had a question about your market share slide. It looks like, compared to last year, you gave up about 1%. How do you account for Amazon in that calculation? Is that removed from the pie?

Matthew Lester

It is removed.

Chris Combe

It is, okay. And the second question, can you comment a bit on the rest of the UK competitive space? Do you feel they're keeping pace with innovation? You're leaping ahead.

And after that, any change of view with respect to GLS on potential opportunities from FedEx / TNT? I think your initial comments last year were that you didn't really see much opportunity; has that changed in any way?

And then lastly, what is the Amazon contribution to GLS in Europe? Thanks.

Moya Greene

On the TNT/FedEx deal, which I think I read in the newspaper today, congratulations to both companies. I think the deal has closed. I don't have anything to add from what we said. I don't think it's going to be a big impact. We are in Europe mostly a deferred parcel, surface parcel operation, so I don't think it's going to have anything new to say there.

In terms of where we are with the competition, we are watching everything that is going on in the UK market. It is an incredibly dynamic market. You can't get up any day and see that there hasn't been something changed. The biggest concern that I have is the one that I had last year, and that is the addition of capacity. We're about 20% over capacity in the UK today and you see that some of our competitors continue to add capacity. I think we'll have more capacity come on steam later this year, and certainly 2017, we've seen reports of more capacity coming on stream.

So actually even if you do, as we have done, continue to solve problems, particularly for small and medium sized business, and you continue to make your technology just more adaptable and easier, make you easier to do business with, I think you are going to see pricing pressure continue as a result of that constant over-capacity situation not showing any signs of alleviation.

But I'm very happy with what Royal Mail has done this year. We've gone from a standing start, not having barcodes on parcels to now having about 50% of what will be barcodable barcoded in one year. We've got 40% of our product now in our network, in our core network is being tracked. You look at the developments in the Parcelforce network their growth has been very significant this year. And I expect that their presence in the market will continue to show that sort of improvement.

So I'm not in any way unhappy with where we are. But you cannot be complacent and you have to keep your eye on the ball.

In terms of the market share numbers we have taken out now – it was really hard up until maybe 18 months ago to get a fix on how do you compare the international content in our competitors' numbers with our numbers. And these numbers are a year trailing anyway. So part of what you're seeing in that one-point differential is that not only is the Amazon traffic excluded, we're now able to make a better pass at taking out the international traffic, so you are comparing more on a like-for-like basis.

Matthew Lester

And in terms of Amazon in Europe I'd repeat just what we said in the release, no customer accounts for more than 2% of GLS revenues.

We'll take two more questions if we can, and then anything else we'll deal with afterwards.

<u>Question 8</u>

Sam Bland, Investec

You've spoken about the £550m to £600m of investment over the medium-term, and I think that's moving more towards capex and less opex. If you look at the longer term are there some projects possibly connected with One Wave that will drop out of that over time such that your longer-term need for investment is lower than that £550m to £600m number?

Then you've seen from some of the union communications with members that they've been slightly frustrated that you haven't yet made an open offer. I believe you made a closed offer on 18th April and haven't yet come back with an open offer. I just wonder what the hold-up is there. Are you waiting to see what Ofcom comes out with before going back and proposing something that can be discussed in public?

Moya Greene

I don't want to negotiate in public. That's just not right. Anything that we do should be really in front of our unions first; that's the respectful way to go.

But I wouldn't say that open or closed offers have very much to do with Ofcom – just to take that out of the equation.

Matthew Lester

I think the £550m to £600m, I wouldn't get too obsessed with one thing coming in or one thing going out. What we've tried to do is give an overall sense of how much cash needed to be reabsorbed out of that £1bn or so of EBITDA we've been producing for a while. And it will change over time in terms of where we're focusing the particular efforts. Obviously whilst it's been cost, you've got within the current number effectively two large amounts of voluntary redundancies that have gone through this fiscal year, together with a number of other things. But we will just tweak that over time. We treat that as that capital decision is the biggest decision that Moya and I make every year. We really, really are very concerned about where do we target that for the best returns. Sometimes it's going to be for cost reduction, sometimes it's going to be growth, sometimes hopefully we can get some things going in GLS.

So that £500m to £600m, while we think it is a good number going forward, it will change in mix, that's right.

<u>Question 9</u>

Matija Gergolet, Goldman Sachs

Three questions from me. The first one on parcels. You depicted very well how the quality of service ultimately has improved; but why are you therefore not a little bit more bullish on the potential parcel volume growth? It is accelerating. The guidance is still for now similar to this year.

Second question on the cost cutting. I appreciate you don't want to comment, say, on wages. But if I just do the numbers: you did £182m last year of avoided cost, another £180m roughly you are guiding for this year. This leaves us with £130m-£140m for the last year. So should we expect the best projects are already underway and therefore you're going to have a deceleration? Or actually that you could, given the current trend line, beat your £500m of avoided cost on a three-year basis.

And lastly just on the balance sheet. You have a strong balance sheet. In a one to two-year view we could have some real estate proceeds. How are you thinking about it? Is there are any M&A, for example, for you or for GLS on the horizon? Or is this maybe a topic we'll touch on in a year's time when we have the real estate perhaps a bit closer to completion?

Moya Greene

Well, let me deal with the parcel ambition. I think that we have a very strong ambition: we are going to stay number one and we are going to do everything that we have to do to retain profitable, sensible growth. But we already deliver one in two parcels in the UK. We are certainly reshaping our network and everything that Sue has done in the past couple of years, and everything that Catherine Doran and her team did over the past three on technology, positions us to make sure that that strategic objective remains very clear and uppermost in our mind.

But I just think that we have to be sensible. Amazon is a very big retailer, they've got a very big network already and there is too much capacity, the pricing pressure I think is going to continue. So we have tried, and you have known us since the IPO, we tried always to be very prudent in what we choose to do in the timing of it, in the staging of it, in what we go after, to make sure that the company remains in a good position.

So I just don't want you to walk away and think that the situation that I see now in the market is going to change in any significant way over the next year or so.

Matthew Lester

In terms of the cost programme, I think the truth is that yes, the nature of these cost programmes tends to be that you can get after the easier stuff earlier; no matter where you start from it's always the easier stuff you get earlier. So it doesn't surprise me the overall profile there. The people who report to me on the programme obviously get a rather different message to that. So we'll see where we come out.

In terms of yes, the balance sheet is strong. M&A clearly is something that could be used but at the moment with valuations that we see out there for anything that is strategic or valuable to us we have been passing. So it's not something which we see as the specific or targeted necessity at the moment. But if the right opportunities arose we would use them in the right way if they represented the right strategic decision.

With that I recognise that we have kept you here for more than an hour. Thank you very much and look forward to seeing you next time.

Moya Greene

Thank you.