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Restricted policy and commercial
ShEx Board 5th May 2011

Update on Royal Mail and Post Office Limited

Introduction

This note provides an update to the Board on the Royal Mail process including Post Office Limited. It covers progress since the last Board meeting, including the outlook for Royal Mail, funding and broader strategic issues.

The Board will appreciate that the contents of this note are highly confidential.

Progress since the last Board meeting

Since the Board last met, there has been a broad range of developments on the Royal Mail process, including the following key areas:

- **Business plan:** The company has agreed a number of significant overlays to the (heavily downgraded) January business plan, adding c.£1bn of profit (and cash) over the next five years.
- **Sale timetable/ achievability:** Whilst these overlays will not impact sufficiently early to support a transaction on our original timetable (2012), our advisors have indicated that these changes, if delivered, should support a transaction by 2013/14. The company is keen to keep the momentum for an earlier deal (Spring 2013) and we will seek to support them in this
- **Pensions:** We have made significant progress with Treasury on securing a 2012 pensions solution, ahead of any sale and therefore loosening the policy link between the two. This is a difficult but fundamental decision, underpinning the short and long term viability of the business. We anticipate final approval to be dependent on a number of specific conditions designed to place further pressure on the business to drive towards a deal (including tighter governance and sharpened remuneration incentives). Critically, we have now been clear with RM that this is the last chance – if the base case is not delivered and specific milestones are not achieved, the Government would move to Plan B (i.e. no sale solution as described below).
- **Short term financing:** As a result of poor current trading and reduced forecasts, the Company's cash position continues to be tight. However, we have addressed two key vulnerabilities: the pensions solution will avoid the primary cashflow concern of the March 2012 pension deficit payment (£280m); and we successfully agreed a short term covenants reset on commercial terms in March.
- **Long term Balance Sheet:** Our (and Royal Mail's) advisors are clear that the current level of debt is too great to facilitate a sale, and that virtually all the debt should be paid down / written off as part of a sale. As any restructuring will require Brussels approval we are working with Treasury to make a decision on size and timing of restructuring that can be submitted as part of our final Aid package in May.
- **Legislation:** The Postal Services Bill continues to progress well through Parliament. It completed Committee Stage in the House of Lords on 6 April and will start its Report Stage on 4 May. We are still on track for Royal Assent before Summer Recess and hopefully by mid/end June.
- **Regulation:** We have made further progress on regulation, securing amendments to the legislation (including that the business needs to earn a "reasonable commercial" return) and a letter to Ofcom from SoS to underpin the need for Royal Mail to be given appropriate regulatory freedom. Management have said that they are pleased with these developments and are confident these will help secure the upwardly revised revenue forecasts in latest agreed plan.

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- **State Aid:** We have visited the Commission three times to discuss the case and provide background briefings. Commission interest is high and we are aiming to submit a notification in some form by the end of May, but this remains an ambitious target.
- **Industrial Relations:** IR at Royal Mail remains fragile. Recent announcements by the company (in particular on the closure of two London Mail Centres) have raised the temperature, and the CWU have given the company until the end of April to meet their demands. It is not clear if their threat of industrial action is real.
- **POL:** Work on separating POL from the RM Group continues, as does the search for a new Chair for POL. No suitable candidate has yet been identified. We are working with HMT developing options to enable NS&I to reverse its decision to terminate its sales contract with POL. State aid approval for POL's FY11/12 funding was secured on suitable terms shortly before the 31 March deadline.

The cumulative effect of the above developments is that we remain broadly on track with "Plan A", but with an unavoidable separation of sale and pension solution.

At the same time, we continue to assess the performance of the company against the plan and retain more radical alternative options for the company while it is in public sector ownership ("Plan B", which could include the sale of GLS). We have formally communicated this position to the business.

1. Business plan

The company's January plan presented a substantial reduction in both profitability and cash flow. Following extensive engagement with the business and a SoS meeting with Donald Brydon on 16 March, the business has revised the Plan to reflect the new regulatory regime, the ability to limit future wage growth and some tax issues. This will result in approximately a c.£1bn cumulative increase in PBIT between 2012 and 2017. We still do not believe the plan is as aggressive as it could be, but we do not believe that management will drive it any faster at this stage, given its inherent risks.

Table 1: Latest RMG business plan projections (with pension solution, overlays)

£m	2011	2012	2013	2014	2015
Revenue	8,418	8,602	8,778	8,785	8,894
EBITDA (pre exceptionals)	462	575	704	859	1022
FCF (pre interest, tax, exceptionals)	36	87	206	459	666
FCF (pre interest, tax post exceptionals)	-232	52	-22	292	523

2. Pensions solution

The Government's stated policy envisaged a clear link between the pension solution and the ability to carry out a transaction at the same time. However, the Company's cash shortfall at March 2012 and the perceived inability to complete a sale in the original planned timeframe have required alternative options to be pursued. In a complex and fragile situation, SoS and Treasury have reached a broad consensus that the balance of advantage lies in taking on the pension deficit at March 2012.

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However, HMT still find the pension decision difficult and have required as a condition to this agreement:

- an unambiguous message to the business that this is their last chance and that Government will pursue other options if a sale no longer looks likely;
- tighter Governance. The chairman will be asked to support stronger engagement with NEDs and an early independent Board review;
- that the LTIP will be primarily linked to our objective of a successful sale. The Chairman will be asked to work with the Shareholder Executive to develop a revised framework for BIS and HMT ministers to consider.

Overall we are comfortable with these conditions, on the basis that these are applied and handled carefully. However, we have been clear that we must balance the useful focus provided by these levers against their potential to destabilise management in delivering our ultimate objective of a sale. We are working on the exactly how and when this slight change in the policy position will be made public by Government.

3. Short-term viability

We have addressed two key short term balance sheet vulnerabilities for the business:

- the pensions solution will avoid the primary cash-flow concern of the March 2012 pension deficit payment (£280m); and
- we successfully re-set debt covenants on commercial terms in March, providing a conditional waiver of the covenants that the business was forecast to breach in the period March 2011-March 2012. The terms of the waiver have been confirmed as commercial for State Aid purposes by UBS.

The company now has sufficient cash without debt restructuring or recourse to additional equity to trade through to 2014 if it delivers its current plan. We are validating latest projections which now show tight headroom in mid 2012 (the seasonal cash low is September). Whilst this has always been the case, the company has stated this as a concern, with a possible need for a new short term facility. We are exploring with HMT options for such a facility on an intra year basis.

4. Deal strategy and Balance sheet

The business has provided us with a strategy for achieving an early deal, aimed at a transaction in early 2013, preferably, for them, through an IPO. In order to achieve this objective the company is pushing for an early balance sheet restructuring, through both writing of large parts of the existing debt and making new capital commitments (potentially through access to the £1.1bn Government escrow). They are focused on securing an investment grade credit rating in 2012/13 and keeping momentum to an early deal to maximise the prospect of its delivery.

Our (and Royal Mail's) advisors agree that the current level of debt is too great to facilitate a sale or create a viable business:

- Royal Mail has been under capitalised for some time and to secure private sector investment it will need a more robust balance sheet. Both our advisers (UBS) and the Company's advisers (Barcap) are clear that much of the debt burden needs to be removed by the time of a deal;

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- To secure approval from Brussels for the aid, we will need to restructure the balance sheet to convince them that the business is restored to viability through the Government's proposed measures, including the ability to withstand reasonable downside scenarios.

A key element of the overall strategy therefore relates to the timing and size of the balance sheet restructuring. Given the importance of this to the Brussels package we are currently working with Treasury to find an optimal position.

We have not accepted RM's "ask" for full early write off and access to escrow given the financial risk and budget impacts this would incur to Government. Instead, we are currently working to secure SoS and HMT approval for a balance sheet solution in which:

- Government explicitly commits to debt restructuring at the point of or immediately prior to a sale (paying down facilities with proceeds or, if insufficient, writing-off an appropriate level of outstanding debt);
- In the meantime Government also commits to rollover existing debt in 2014 to avoid any going concern issues if a sale were not completed by then;
- Once the pension solution is implemented, the £1.1bn Government escrow will automatically be released to the Government Escrow Reserve. Under the existing legal arrangements, the escrow will be effectively ring-fenced and Royal Mail will not be able access or spend it without Government's consent. HMG would be clear to Royal Mail that access to those monies would be tightly restricted to a material downside scenario. This balances the downside protection essential to both the Board and Brussels with maintained pressure on the business (i.e. no new financial headroom). At the point of sale the escrow could be either removed to Government (with existing powers) or left in the company as considered appropriate;
- If the business were demonstrably off-track to deliver a sale on the agreed timetable, which would be evidenced by any request by Royal Mail to access the RMH Escrow Reserve, Government would restructure the balance sheet and move to Plan B (consistent with the conditions outlined in the correspondence relating to the pension agreement). We are being clear with management that access to the escrow and the ability to deliver a deal are mutually exclusive. Options would include rolling over or writing off some of the existing debt; selling GLS; and, in a worst case, considering a different level of USO and, if necessary, providing SGEI funding (i.e. subsidising the USO if RM was not able to cover its costs on a commercial basis).

5. Regulatory issues

Royal Mail remain concerned that the Postal Services Bill - even after the modifications that were made in drafting to tip the balance more in favour of protection of Royal Mail - provides too much room for regulatory interpretation and therefore would not be viewed as positively by investors, or be as helpful for universal service stability, as required. We have therefore put forward three new groups of amendments to the Bill: first, to ensure that the regulator takes into account the need for Royal Mail to make a "reasonable commercial" rate of return while on a path towards efficiency; second, to give the regulator greater oversight on the risk of

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"cherry-picking" by competitors, and; third, to give Royal Mail greater certainty that they would remain the sole universal postal service for the foreseeable future. Donald Brydon wrote to the Secretary of State in late March to set out the concerns of the Board on regulatory certainty and what will need to be done to address these (including amendments to the Bill and a public statement/letter to Ofcom). We have addressed these points and therefore expect that the Board will feel sufficiently confident to ensure the benefits of the regulatory overlays are built into the plan. The Company are broadly happy with the position, although it recognises there is a significant amount to do with Ofcom to get the best outcome in March 2012.

6. State Aid

State Aid approval is required by March 2012 to be able to undertake the pension reform before the next deficit repayment falls due. This will be sought under the Restructuring Aid guidelines, which necessitates the submission of a comprehensive Restructuring Plan setting out how the business will become "viable" and self sufficient in the long term. The development of the Restructuring plan is therefore on the critical path to State Aid approval and will be our focus over April and May. Whilst Royal Mail has done a significant degree of work in this area it cannot be finalised until the balance sheet support measures are known, so we are working with them on the basis of the outcome we expect, which can then be confirmed in early May. UBS are also engaging on the work on viability which has to be proved on the basis of the base and reasonable downside cases.

In addition to the Restructuring plan, we must also submit a notification document setting out all aspects of the case, and a market survey which helps the Commission to define the markets in which Royal Mail operates, and decide the extent to which the aid distorts those markets. Significant progress has been made already on both documents but they will have to undergo further revision in the next few weeks.

Aside from timing of the notification (which is ambitious), key risks revolve around "compensatory measures" and "own contribution". The former relates to actions that Royal Mail will be required to mitigate the effects of any market distortion caused by the aid, the latter relates to contributions that Royal Mail makes to its restructuring out of its own resources. In both cases this could include the divestment of key assets such as GLS and Parcelforce. Our recent trips to the Commission have highlighted their interest in these areas. What is clear is that the Restructuring plan submitted initially may be significantly different to the plan at the end of the process.

7. Industrial Relations

The background to the IR situation at RM is the company's growing frustration at the union's stalling on implementation of the Modernisation Agreement - probably resulting from the fact that the implications of the agreement (i.e. closures) are beginning to bite. The company recently announced the closure of two mail centres in London as part of its modernisation programmed at the same time as an announcement that employees' ColleagueShares (i.e. their shares in the company's quasi-share scheme) currently have no value as a result of the poor performance of the company and the consequent revision of the Business Plan. The Union have seized on this as the company "fixing" ColleagueShare so that their members were deprived of the benefits. They have given the company until the end of April to address these concerns, as well

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as the phasing of mail centre closures, and long-standing concerns about the shift from uprating pension benefits by RPI to CPI (as a result of central Government decisions). Given the ongoing threat of industrial action, we have stepped up our monitoring activities and have set up regular meetings with Royal Mail to consider handling / contingency / longer term strategy / and implications for Business Plan and the future of the company.

8. Relationship with Board and Management

Relations continue to be show signs of strain at times with the Chairman and CEO, largely a function of uncertainty over the likelihood of achieving a successful transaction, linked to the debate on the business plan and balance sheet. Progress on the pensions solution, completion of the covenant re-set and support on regulation represent significant support to the business and will go some way to improving the situation.

The conditions being imposed on RM as part of HMG agreeing to the March 2012 pensions solution will enhance interaction with the RM board. They are also expected to push management harder through a direct link between the LTIP and the achievement of the business plan. While these conditions will be unattractive to the Chairman and CEO they should set a clear framework to work together towards a deal.

Ed Davey attended the RM Board on 27th April in an attempt to continue our work to be more open with the Company. This meeting generally went well with an open discussion of issues.

9. Post Office Limited (POL)

Work continues to develop the terms of an "operational separation" of POL from Royal Mail by September 2011, particularly on the terms of POL's sale of RM products and shared data and services. No binding commercial agreements will be agreed between the two companies before consideration by a suitably robust and independent POL Board, to be constituted following the appointment of a new POL Chair. Following one shortlisting process, no suitable candidate for the Chair position has been identified and the recruitment consultants, Egon Zehnder, are now considering alternative sources of candidates.

POL's major commercial challenge continues to be delivering on ambitious plans for growth of its government services revenue. Interviews are now underway to appoint a new Government Services Director to lead on this. We are working with HMT to develop options which will enable to sales relationship between POL and NS&I to continue.

State aid approval for POL's FY11/12 funding was obtained shortly before the 31 March deadline and the payment of £180m subsidy went ahead as planned. The next objective is to obtain clearance for the remainder of the SR funding package to FY14/15 as smoothly and quickly as possible. This is complicated by the congruent Royal Mail pensions aid process (POL would benefit from a pensions solution), and a consequent Commission desire to understand fully the commercial relationship between the two businesses.

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