



Post Office Ltd

Annual Review

November 2011

RESTRICTED – POLICY & COMMERCIAL

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Executive summary

POL faces declining traditional revenues and highly competitive new markets, while its current branch models are unsustainable

These challenges must be faced as POL undertakes a complex separation from its parent

Successful outcomes may permit a subsequent potential mutualisation of Post Office Ltd

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Market risks

- Cost levels impact capacity to win key new contracts, especially Government services
- Mail volume decline affects business over the Post Office network
- Low interest rates hit financial services

Focus on developing pipeline of new products

- Digital exception channel for HMG work (face-to-face services for those without computers)
- Identity verification role e.g. passports and licensing
- New financial services products

Developing the network

- New fully variable cost models
- Longer opening hours
- Smaller footprint in store

Separation from Royal Mail

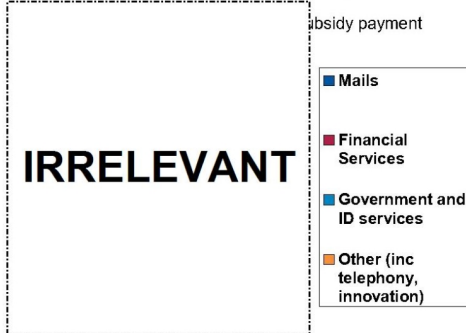
- Need to negotiate contractual terms with RM over distribution of RM products and shared services
- Bolstered Board required to challenge and support executives in separation process and beyond
- Suitable governance arrangements need to be introduced as the companies separate
- Aspiration of a mutual Post Office Ltd once separation and the business transformation envisaged in the current business plan are complete

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Business overview

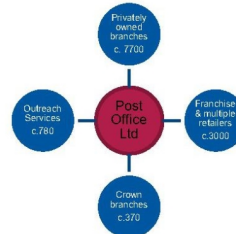
- Post Office Ltd provides mails services, financial services, government services and telephony services across a network of around 11,800 branches.
- There are currently 373 Crown Offices (large, mainly urban, centrally-run post offices) and around 11,500 sub post offices (privately owned by sub-postmasters and franchises). POL directly employs 8,500 staff. POL also runs a cash logistics business.
- POL has four main areas of income – mails, government services, financial services and telephony.

Breakdown of net revenue in 2011 (£m)

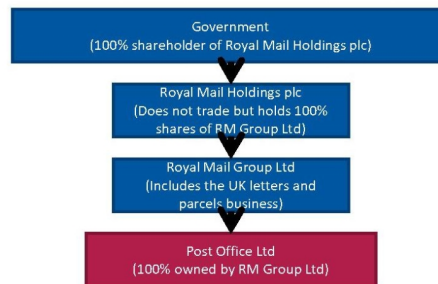


Shareholder
Executive
HM Government

Network of branches operated by Post Office Ltd



Existing Ownership Structure



Business overview

- Post Office is a unique provider of mails, financial and government services across a nationwide network. It has a national network larger than that of all the UK banks put together, with 93% of the total UK population (and 99% of those living in towns and cities) living within one mile of a post office.
- Post Offices provide a range of services to customers across the socio-economic spectrum, carry out a critical economic function for many small firms, and often play a significant social role in communities. Over 170 different services are available over Post Office counters and all but one is subject to at least a degree of competition.
- In return for the ~~IRRELEVANT~~ funding from Government for 2011-2015 announced in October 2010, the Government requires Post Office Ltd to ensure that there is a minimum of 11,500 post offices across the country, and that this network conforms to the strict access criteria (established in 2007 following a national consultation) which ensure reasonable access to Post Office services regardless of where people live.
- This network requirement hampers the business's ability to operate on a commercial basis and largely explains the areas in the traffic lights review where the business's performance is sub-optimal: amber for strategy and financial performance; red for balance sheet risk (also impacted by POL's share of RM's current pension deficit).
- Dependence on access to post office services is particularly acute in rural areas where the post office branch is in many cases the only local retail outlet, but branches are also of real importance in deprived urban communities.
- Post Office Ltd is facing increasing competition, especially in the bill payments market, by competitors such as PayPoint. Post Office Ltd also has to compete openly for Government work.

Business overview: market breakdown

Market breakdown

Mails Services

- POL is facing the challenge of declining mail volumes, and separation from Royal Mail. It will be imperative for POL and RM to successfully negotiate a suitable length IBA before separation. Negotiations are at an advanced stage.
- POL's product mix in the market will change. As the volume of letters declines they will seek to grow the volume of packages they distribute.
- To improve the customer experience, POL aims to reduce queue times, extend opening hours, and improve the in-branch experience of customers, focussing on developing 'Post&Go' self service kiosks, solutions for small businesses, online mail support and pre-paid mails.

Government Services

- POL plans to become the physical channel alternative to Government's own direct channels for those customers who cannot interact online and for those services which require a physical touch point, e.g. ID services.
- POL faces increasing competition from others in this market, and must openly compete to win Government services.

Financial Services

- POL aims to deliver a proposition which reflects customer needs and preferred channel choices. For example, they are currently considering a pre-paid debit card and working with DWP on a transactional account providing working credit.
- This is a highly competitive market in which POL has had some success due to public perception of it as a trusted brand. POL have been particularly successful in foreign exchange services where it is the market leader.

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Business overview: market share

| PILLAR | MARKET | POL MARKET SHARE (%) | LARGEST COMPETITOR | COMPETITOR'S SHARE (%) |
|--------------------|-------------------------|----------------------|-------------------------------|------------------------|
| Mails | Fulfilment | ~90 | Royal Mail Accounts | ~4 |
| Mails | Collections and Returns | ~15 | Retailers "Click and Collect" | ~40 |
| Financial Services | Travel Money | 24 | M&S Money | 8 |
| Financial Services | Travel Insurance | 4 | Insure&Go | - |
| Financial Services | Insurance | 1 | Direct Line | ~8 |
| Financial Services | Lending | 1 | High Street Banks | - |
| Financial Services | Savings | 1.5 | Lloyds Banking Group | ~25 |
| Financial Services | Bill Payments | ~35 | PayPoint | ~18 |
| Government | Government Services | ~1 | - | - |
| Telephony | Broadband | 1 | BT | 28 |
| Telephony | Homephone | 2 | BT | 37 |

Long term strategy

Commercial objectives

- Strengthen POL's Board, in particular through appointment of a new Chair and Non Executive Directors to give increased levels of oversight and challenge.
- Separation of Post Office Ltd and Royal Mail to ensure operational autonomy as soon as possible.
- Roll-out of new models – 2,000 Post Office Locals and 4,000 Main Post Offices – over the Spending Review Period.
- Eradicate the losses made by the 373 Crown Offices.
- Achieve significant growth in government services income, through providing the face-to-face services that will still be required to support a 'digital by default' approach to service delivery on behalf of Government.
- Maximise profitable revenues from other areas, especially financial services.

Policy objectives

Key elements of Government policy for the post office network are:

- To ensure no network closure programme and a minimum network of 11,500 branches
- To ensure the network access criteria are met
- To ensure key services are available across the network
- To reduce government subsidy for the network over the long term

Key elements of Government policy for Post Office Ltd are:

- To support delivery of POL's commercial strategy
- To develop options for mutualisation of POL

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Long term strategy: ownership

Mutualisation

- The Postal Services Bill allows for POL to either remain in state ownership, or be transferred to a mutual.
- A report commissioned by Government on options for mutualisation of Post Office Ltd was published by Co-operatives UK in May. The report focuses on how best to transfer Post Office Ltd from Government ownership into a mutual run for the public benefit.
- We launched a public consultation in September, to obtain greater detail regarding a suitable model for mutualisation.

The consultation document addresses the following key issues:

- The current structure of Post Office Ltd and its business strategy.
- Why Government thinks mutualisation could be a good idea for Post Office Ltd.
- Our belief that the members of the mutual should comprise an equal mix of 'producers' (such as employees and subpostmasters) and 'consumers', with no one constituency having an overall majority.
- Why we believe that a Post Office mutual could work best without a Government ownership stake, to provide a clear cultural break from the past, with Government able to continue its relationship with the mutual on a contractual basis.
- Our proposal that a possible structure for a Post Office mutual could be a three tier structure, comprising of the membership, a representative body, and Board of Directors.
- Other considerations which we need to take into account before a move to a mutual would be possible, the most important of which is Post Office Ltd's financial stability.
- Government will be issuing its response to the consultation document in Spring 2012.

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Operating Performance: Overview of 2010-11

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Operating performance: restructuring & organisational changes

- Work is underway to move POL from its current position as a subsidiary of RMG to become a sister company of RMG under a common parent company, Royal Mail Holdings plc (RMH).
- This is proposed to coincide with the implementation of the pension solution on 1 April 2012, subject to state aid clearance.
- At that point, the new Inter-Business Agreement will have been agreed, POL staff will become formal POL employees and new group governance arrangements will be put in place.
- We are developing proposals with the companies for the role and constitution of the RMH Board once RMG and POL have moved to sister companies under the RMH holding company at March 2012.
- We envisage that the businesses will remain in the same corporate and tax group, but operationally separate, until the earlier of an RMG transaction or a POL mutualisation.
- A new Chair and senior non-executive director have recently been appointed in order to bolster POL's negotiations in separation discussions. The Board will be further strengthened by appointment of new NEDs.
- The company is also deploying a People Engagement plan aimed to ensure that the whole organisation (including agents) is aligned behind the strategic plan.

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Operating performance: opportunities

- The major opportunity is network modernisation, converting over half of all post offices into new 'local' and 'main' models with fully variable pay based on the volume of transactions. POL intend to offer a ~ 40% increase in opening hours and reduce queue times so that 90% customers are served within 5 minutes.
- Beyond this, Post Office Ltd will develop a much greater focus on innovation, setting aside funds to develop new propositions. In particular they will investigate:
 - Development of proposition to support universal credit.
 - Online mails services aimed at supporting growth in mails.
 - Payments solutions which will support the phasing out of cheques (such as pre-paid debit cards).
 - Further self-service solutions.
 - Development of relationship with Credit Unions to increase financial inclusion.
 - Commencement of RBS contract, and possible progress with HSBC and Santander.
- Of these, the major one is developing its universal credit proposition, which could be aligned with a transactional account offering potential significant revenue growth.

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Operating performance: risks

| RISK | | MITIGATION |
|---|------------|---|
| Terms of separation from RMG jeopardises mail revenues or impose significant new costs. | | Appointment of new chair and bolstered board intend to strengthen POL's voice during negotiation and remove possibilities of conflict. |
| New Government services and innovation revenues fail to feed through sufficiently during the life of the next strategic plan (to 2014/15) leading to greater POL demand for Government subsidy. | IRRELEVANT | POL has recruited a specialist HMG services team. ShEx is working closely with OGDs to communicate post office policy and encourage strategic engagement with POL as a potential delivery partner on a without-prejudice basis. |
| State aid application for payments for 2012/15 and ongoing operation of working capital facility is unsuccessful. | | Co-operation and close working with the European Commission. Approval process is on track. |

- Transferring POL to mutual ownership will be contingent on the successful mitigation of these risks.
- ShEx POL team will continue to monitor these risks through weekly internal meetings and monthly financial and strategy meetings with POL.

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Illustrative Valuation

Key assumptions

- We expect that, upon separation, Post Office shares will be held at zero value in BIS accounts.
- Valuation of the Post Office is not something the team undertakes for deliberate reasons; this is an illustrative valuation constructed for this Investment Review purpose only. It is highly confidential and not for onward circulation.
- We have set out some illustrative outputs based on DCF valuation only. (There are no suitable comparable companies or transactions from which we could produce alternative valuation methodologies.)
- Central case: 8% WACC, 1% terminal growth rate, based on the current business plan.
- Very indicative figures below.

| | |
|--|------------|
| Including government subsidy and funding for network modernisation | IRRELEVANT |
| Including subsidy but excluding funding for network modernisation | |
| Including funding for network modernisation but excluding subsidy | |
| Excluding government subsidy and funding for network modernisation | |

- These figures come from POL's most recent business plan of October 2010.

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Balance Sheet of Post Office Ltd: Company in March 2011

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Board and management

- Quality of management team and board and shareholder relationship are Green in traffic lights.
- Significant changes to the top team in recent years. Three MDs during the past two years.
- Current MD is Paula Vennells (formerly Network Director since 2007).
- A new Financial Director, Chris Day (former Group Financial Controller, BBC) and new Financial Services Director, Nick Kennett (former MD, epay) have recently started.
- Separation from Royal Mail requires an independent voice for POL within the Royal Mail group governance structure:
 - A New Chair of POL, Alice Perkins, has been appointed with a strong public sector background. She is undertaking a board review.
 - A new Non-Executive Director, Neil McCausland, has been appointed with a strong retail background that will complement the chair's public sector background.
 - We are in the process of recruiting a further NED to POL.
 - These appointees do not sit on the Royal Mail board and are independent of Royal Mail in any discussions about separation.
- Corporate governance
 - Chairman's proposals would assist in making POL combined code compliant on separation.
- Remuneration and incentives
 - POL MD remuneration set through RM Board remuneration process. HMG also has an approval right over POL executive incentive arrangements to deliver the strategy agreed in October 2010. When the business separates, new articles of association will give HMG fuller rights to approve POL Board remuneration directly. Upon separation from Royal Mail, ShEx will join the POL board.
 - Bonus worthy metrics are split between financial performance (focus product sales, all product contribution, operating profit, total operational costs, free cashflow), customer (call centre performance, mystery shopper) and people (staff engagement index, serious accidents).

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Government stakeholders

| Stakeholder | Stakeholder interest | Assessment of relationship | Key current issues | Strategy to obtain support/ overcome barriers |
|--------------------------------|--|---|--|---|
| HMT | <ul style="list-style-type: none"> HMG shareholding HMG lending to business Accounting and budget impact of business performance Long term risk of subsidy | <ul style="list-style-type: none"> Strong ShEx working relationship with key HMT team | <ul style="list-style-type: none"> Discussions ongoing re mutualisation and will need to work closely with HMT on progression of proposals | <ul style="list-style-type: none"> Maintained close dialogue and sharing of strategy |
| Cabinet Office | <ul style="list-style-type: none"> POL procurement strategy and role in providing transactions to support online services. | <ul style="list-style-type: none"> Good working relations – merit in expanding and renewing post CO reorganisations. | <ul style="list-style-type: none"> POL's position in providing face-to-face transactions in light of digital delivery and OPS White paper. | <ul style="list-style-type: none"> Continue to identify and target key contacts, coordinating with POL where required. |
| DWP | <ul style="list-style-type: none"> Contracts with POL for payment of benefits | <ul style="list-style-type: none"> Good working relations | <ul style="list-style-type: none"> POL's role in delivering Universal Credit, the impact of UC on POCA. | <ul style="list-style-type: none"> Maintain close dialogue and coordinate with POL where required. |
| DTT (DVLA) | <ul style="list-style-type: none"> Contracts with POL for provision of services | <ul style="list-style-type: none"> Strong working relationships | <ul style="list-style-type: none"> DVLA plans to procure a wider range of face-to-face services shortly – crucial to POL's GS strategy. | <ul style="list-style-type: none"> Maintain close dialogue and appropriate procedures during procurement process. |
| Home Office (IPS, UKBA) | <ul style="list-style-type: none"> Contracts with POL for provision of 'check and send' passport applications | <ul style="list-style-type: none"> Some relationships in place – could be strengthened | <ul style="list-style-type: none"> UKBA procurement outstanding. Direction on data collection for online passports unclear - key projected revenues for POL. | <ul style="list-style-type: none"> Attempt to expand contacts with key senior officials, coordinating with POL where required. |

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Shareholder Executive role

- 1 x Director – Susannah Storey provides overview as head of RMPS Team
- 1 x Executive Director – Will Gibson (90%) is currently covering this post, pending recruitment this winter
- [3] x Assistant Directors - Mike Whitehead and Jane Hoy (100%), [Will Gibson (90%)]
- 1 x HEO – Peter Batten (100%)
- 1 x Fast Streamer – Katie Wake (50%)
- Besides pure shareholder issues, ShEx plays a supportive role for POL's directors, providing a voice within Government (a major customer) and guidance on political issues.
- Generally good relationships with the business and the management team at all levels.
- Excellent relationship with HMT team (Polly Payne/Ruth Hannant/James Perry)
- Advisers
 - UBS will assist in RM/POL separation advice
 - Freshfield will assist in separation issues and state aid process
 - Deloitte has assisted with due diligence of the commercial strategy
 - POL are receiving advice on separation issues from Linklaters (separately from RM)

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Traffic light analysis

| | | |
|--|-------|---|
| 1. Shareholder Relationship | Green | |
| 2. Implementation of Shareholder Model | Amber | Chair's letter not yet issued. Policy and shareholder management roles are combined within ShEx. |
| 3. Quality of Management Team & Board | Green | |
| 4. Strategy | Amber | Strategic plan may not create shareholder value in the short term, pending modernisation. |
| 5. Financial Performance | Amber | The company doesn't produce positive economic profit as network access criteria exceeds a commercial network. |
| 6. Balance Sheet & Risk | Red | Balance sheet is insolvent. |

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Appendices

- Traffic light analysis
- Chair letter [Draft shortly to be circulated to Chair]