Nestved LLC

Article Series

FORMULATING STRATEGIES FOR GLOBAL SUCCESS

Global Postal & Parcel Industry News

ArticleID: 2590 [hellmail.co.uk]
01 December 2010
by *Timothy D. Nestved*

Royal Mail Calendar Year 2010 Review of Financials *(REVISED)*

Another six months has transpired, and it is time for a final review[1] of Royal Mail's calendar year-end financials(local copy). Royal Mail Group (RMG) stated operating profit, which is actually RMG's pre-operating profit (the "POP"), for the period declined £132m due to further declines in mail volume.

Expenses:

Let us begin with an analysis of the expenses. Royal Mail normally has reported three expense categories: People Costs, Distribution and Conveyance and Other Operating Costs. A new expense category, Depreciation & Amortisation, was introduced by Chairman Donald Brydon in the "*Annual Report and Financial Statements for the Year ending 28 March 2010*." The new expense category made it more difficult to perform comparable financial analysis for the prior reporting period.

Let us look at People Costs first. People Costs are not reported. Neither are Distribution and Conveyance costs. Other Operating Costs are not reported either. Surely the expenses are reported, after all, it is a financial statement and expenses are half the profit equation *(and I presume the Chairman and CEO are aware of this fact)*. It is confirmed; no expenses are reported. I can honestly say, in almost four decades, I have never encountered a business that reported its financials and failed to report its expenses. It is equivalent to your bank providing you with a bank statement showing credit transactions (deposits only), collecting fees without reporting any of them, and not listing any of the debit transactions (withdraws), but the statement shows you have significantly less money! The act should have provoked many questions and inquiries[, but aside from my own, nobody else seems to care]. The fact that expenses were excluded is a huge red flag[, or at least it should be].

In fact, one of the normal financial and statistical forensic analysis processes is reviewing a financial statement is to see what is removed or added, for executives use the financial statements as another form of corporate PR. The objective is to project the image they wish to express, and for the most part, it works. Since expenses are not provided, the focus shall turn to mail volume, for it is the reported claim for the fall in POP.

Mail Volumes:

Beginning with the average Items Handled per day (or Average Daily Postbag containing letters, packets and parcels), a decline is reported again. According to CEO Ms. Moya Greene, the Items Handled per day now "*contains 68m, a reduction of 16m from the peak of 84m in 2005, or a fall of 24% in just five years*." First off, by my calculations, the percentage is actually a fall of 19%, not 24% (Ms. Greene's error is 5.5m letters, packets and parcels per day, which is too significant to call a minor error). Second, comparing the current volume of 68m to the volume of five years ago instead of the more appropriate prior or year-ago period looks to be a statistical distraction, for the section is entitled: "*Key commentary on the six months ending 26 Sept 2010*." What does the more recent data indicate?

Merits of Extraordinary Expenses:
The average Items Handled per day (approximate numbers because actual volumes are generally not provided), percent of change from the prior period and actual change from the prior period for 2005 through 2010 are as follows:

Letters Volume, Royal Mail				
Period	**Average Items/Day Actual/(rounded)**	**Percent Change**	**Volume Change via**	
			Actual	**Rounded (m)**
2005-2006	84.9m (~84m)	-	-	-
2006-2007	82.9m (<83m)	-2.3%	-2.0m	83-84=-1
2007-2008	80.3m (>80m)	-3.2%	-2.7m	80-83=-3
2008-2009	75.9m (>75m)	-5.5%	-4.4m	**75-80=-5**
2009-2010	70.4m (~71m)	**-7.3%**	**-5.5m**	71-75=-4
2010-2011 [2]	69.5m	-1.2%	-0.9m	69.5-71=-1.5
1st Half 2010	68.0m*	-5.0%*	*	*
*half-year only data				

The 2009-10 Year-End financial statement (Mar2010) indicated the declining mail volume rate in the latter months, on a month-to-month basis (not for the period overall), was approaching -10%. That is, the higher volume declines were in the later months of the 2009-2010 period because the full-year ended with a lower overall average rate of -7.3%. If the percentage rates for the annual periods were placed on a graph, the results would look like a hockey stick or a check mark (in reverse), that is, a decline that goes from -2.3% to -7.3% at which point it bottoms out, and then, moves upward to -1.2%. What does this mean?

The declining mail volumes reached their maximum decline (peaked out) in the prior period (likely just three-quarters of the way through the period) and although the mail volumes are still declining, the rate of decline is slowing—not increasing as before. Using the rounded reported volume numbers themselves, one can see the peak decline between Annual Reporting periods occurred in 2008-09 period (i.e., subtract the total decline between periods: in millions, 84-83, 83-80, 80-75, 75-71, and the results are -1, -3, -5, and -4, respectively). Using more exact volume numbers (of which Royal Mail does not publically report), the peak is more accurately shown to occur in the 2009-10 full-year reporting period. Regardless, the data indicates the rate of decline for UK letters volume is slowing.

Think of "peak" or "peaked-out" as a river experiencing a flood rise that reached its peak and is going down. The river is still flooded but it is no longer rising. Achieving peak is always a newsworthy event and what you want to see. I did not see an explanation, conclusion or realisation that the all-important mail volume rate of decline "peaked-out" in 2009-10 (or 2008-09 on a rounded volume change basis) in the Chairman's Statement (Mr. Donald Brydon), nor in the Chief Executive's Statement (Ms. Moya Greene), which begs the question: Is this new information to them and the remaining Royal Mail executives?

Competitor Mail Volumes:
Let us move to mail volumes from competitors, or what Royal Mail calls Downstream Access. Prior to the 2004-2005 fiscal calendar year, Royal Mail sold postage, picked up all items

(letters, parcels and packages), sorted and delivered them. Post 2004, competitors picked up items, sorted and introduced these items into Royal Mail's system "downstream" (after pickup/sorting) for delivery. The business model for the competitors is simple: provide their service at a reduced cost to that which Royal Mail charges. The result is mail volumes remain the same (i.e., there is no volume decline due to competitors), but revenue streams are modified. That is, revenue is lost by Royal Mail and gained by the competitor offering the service. In short, when each Royal Mail competitor offering "downstream access" reports growth, Royal Mail is generating less revenue (noting some growth may be from other competitors, but Royal Mail is still the ultimate looser in the transaction). Now, let's look at the competitor volume numbers.

The average Items Handled per day by Competitors, percent of change from the prior period and actual change from the prior period for 2004 through 2010 are as follows:

Letters Volume, Royal Mail Competitors			
Period	**Average Items/Day**	**Percent Change**	**Volume Change**
2004-2005	87m	-	-
2005-2006	1,157m	+1,230%	+1,070m
2006-2007	2,442m	+111%	+1,285m
2007-2008	4,091m	+67%	**+1,649m**
2008-2009	5,311m	+30%	+1,220m
2009-2010	6,370m	+20%	+1,059m
1st Half 2010	7,198m*	+13%*	*
*half-year only data			

Graphing the numbers shows that competitors continue to gain, although the percentages have declined over time, which is as expected (as competitors' growth slows as market equilibrium approaches). The peak in volume change by competitors on a year-over-year basis indicates when mail volume attributed to competitors reached its peak, and the data shows that occurred back in the 2007-08 period.

Because competitors rely on Royal Mail to deliver their letters, Royal Mail's average items per day data includes competitors' letter volumes. That is, letters volume due to competitors will rise as they take more business from Royal Mail, while Royal Mail's letter volumes will decline because society is sending fewer letters, and not because of changes in competitor volumes. In fact, competitor letter volume will never be negative (whereas negative percent change relative to competitor letters volume indicates competitors are handling less produce). Any decline in average items per day by competitors means one or more competitors closed or went bankrupt, and the majority of their former customers reverted back to Royal Mail. As long as the net result for all competitors is growth (no matter how small), the percentage will be positive. What does this mean relative to the financial statement? A quick look at revenues is required first.

Revenues:
Fortunately, Royal Mail is still reporting revenues in their mid-year financial statement, so the appropriate category to review is Royal Mail Letters revenue, current and past.

Royal Mail Letters experiences a seasonal jump in volume during the holiday season; therefore, the required solution is to compare a year's prior second-half revenue against the subsequent first-half period for several years.

Letters Revenue (£m) & Volume, Royal Mail						
2nd Half Period		1st Half Period		Percent Change	Volume	
Period	Revenue	Period	Revenue		Full Year	% Change
Oct'06-Mar'07	£3,510	Apr-Sep 2007	£3,269	-6.9%	82.9m	-
Oct'07-Mar'08	£3,561	Apr-Sep 2008	£3,265	-8.3%	80.3m	-3.2%
Oct'08-Mar'09	£3,442	Apr-Sep 2009	£3,210	-6.7%	75.9m	-5.5%
Oct'09-Mar'10	£3,354	Apr-Sep 2010	£3,074	-8.3%	70.4m	-7.3%

The data shows the percentage change relative to revenues for half-year periods has repeated over the last four years from October 2006 through September 2010 (i.e., -6.9% for 2006-07 and -6.7% for 2008-09; and -8.3% for 2007-08 and 2009-10), although the percentage change in mail volume has steadily declined each year.

Continuing, as previously shown, mail volume for the period April 2010 to September 2010 actually improved (i.e., actual numbers according to Royal Mail indicate improvement of near -10% in April versus only -5% near September), which means revenues for the period must be better because volumes did not fall as much as the prior period. Think of it in terms of taxes: if you were taxed on gross income at 7.3% last year and this year you are taxed at 5% instead, you would experience an improvement, which means you will have more net income due to the smaller imposed tax.

To be complete, let us continue by comparing the revenue for year-ago 1st half periods (and since these periods all exclude the holiday season, the comparison is valid). For the current year, percentage change in revenue fell more than double the prior period's percentage, but mail volume declines improved (although they still declined overall).

1st Half-Year Letters Revenue, Royal Mail				
Period	Revenue	Percent Change	Volume	
			Full Year	Change
Apr-Sep 2007	£3,269m	-	<83m	-
Apr-Sep 2008	£3,265m	-0.1%	>80m	-3.0m
Apr-Sep 2009	£3,210m	-1.7%	>75m	**-5.0m**
Apr-Sep 2010	£3,074m	-4.2%	~71m	-4.0m

What explains it?

Revenue Decline Explained:
If you recall the data on competitors, their gains equate to declines for Royal Mail Letters revenue. This explains the revenue decline, and it is worth noting this also is not explained very well in the financial statements. It begs the question of whether or not the Royal Mail executives and its Chairman realise the connection or not? Do they simply know revenue figures are declining, while competitors' figures are gaining, without understanding the core workings and interconnects? If they understand the link, then what are they doing to counter it? The financials do not say anything to this regard (noting automation does not and will not address this issue), and unfortunately—new owners or not, new sources of capital or not—revenues will not magically increase without understanding the entire problem set, accompanied by providing real solutions in all the affected areas.

Price Increases:
Raising postage prices, which is slated for early next year, will increase revenue, but it will also

reduce demand, causing a repetitive cycle (as seen by other postal services such as USPS), meaning further declines in revenues offset by higher prices (and reductions in services along the way) without presenting solutions to solve the problem and break the cycle. Those that engage in price hicks and other "*buggy-whip remedies*" merely highlight their lack of knowledge of the distressed business cycle and the turnaround efforts required for distressed market participants like Royal Mail.

Pre-Operating Profit Decline Claim:
On the issue of mail volume declines as the cause of the Royal Mail's operating profit loss, or POP loss, it is unlikely. Competitor volumes are increasing at greater rates then the mail volume decline. That is, the change in mail volumes (-5%) was reported to go from around 71m to 68m, or roughly 3m total in the first half period of 2010. The change in volume for competitors (+20%) was 6,370m items up to 7,198m items, or 828m total. According to my calculations, 828m is significantly greater than 3m. A mail volume decline means the item never enters Royal Mail's system, while any competitor volume gain means the competitor took the pickup-side of the business away from Royal Mail, but Royal Mail still must deliver the item.

Both declines impact Royal Mail's revenues; however, any competitor volume increase impacts Royal Mail's expense side (i.e., POP) as well. That is, mail volume declines means those items are not handled and not delivered, but when a competitor's volume increases, all those items are still introduced into Royal Mail's system "downstream" taking resources to move, transport and deliver, all of which impose a greater demand on Royal Mail resources, thus increasing their expenses (noting they did not earn any revenue from the pickup-side of the transaction).

In summary, competitor volume increases, which are over 250 times larger at the moment and growing, have a significantly greater impact on both Royal Mail's revenues and expenses as compared to overall market mail volume declines. Furthermore, the greater impact to expenses means a greater impact to POP. In conclusion, Royal Mail's claim that the POP is attributed to mail volume declines is inaccurate and incorrect. It begs the question: do the executives and the Chairman at Royal Mail understand the specialised business requirements required to turn around a distressed business that includes Universal Service?

To explain, consider a general contractor that builds homes. Before becoming a general contractor, the person learned the trade by being a framer. Building a home is mostly framing, but it also requires plumbing, electrical and masonry expertise. As a framer, the person is able to run electrical wire and install the empty electrical boxes, but actually wiring the electrical switches and outlets requires expertise knowledge, thus making the general contract an inappropriate person for specialised needs. Royal Mail is in a distressed industry, worse than being just a distress business, which requires a completely different set of skills, talents and knowhow. The focus of modernisation at Royal Mail for the past seven years has been on automation, which can only reduce costs (and possible improve response times for sorting and such). The greater threat to Royal Mail is on the growth and revenue side of the business and the market overall. Anyone can cut costs; not everyone has the ability and knowledge to innovate on the revenue side.

Unjustified Claim:
Any claim of obtaining the expertise in a sale is absurd, as no postal operator or private equity firm (or management consultant I am aware of other than myself) has demonstrated the skill set required. That is, automation anyone can do, and the results will be reduced expenses/costs. A distressed business, and especially a distressed industry (like postal services) does not become distressed simply because its costs were out of control.

USO Mail Volumes and Loses:
Something else not reported in the Financial Statements is the impact of the Universal Service

Obligation (USO).

Period	USO Volume	Operating Loss	Percent Change	
			USO Volume	Operating Loss
2005-2006	9,894m	£-15m	-	-
2006-2007	9,341m	£-66m	-5.6%	+340%
2007-2008	8,699m	£-349m	-6.9%	+428%
2008-2009	7,385m	£-191m	-15.1%	-45%
2009-2010	6,310m	£-8m	-14.6%	-96%

First, the USO volumes are declining, while the Operating Loss is nearly £0. Notice the Operating loss has gone from £-349m in 2007-08 to £-8m last year.

OP and POP Analysis:
As for analysis of the Pre-Operating Profit and Operating Profit, without any expenses listed, it is really a futile effort, which clearly was the intent. Every financial statement, including the one being analyzed, has stated that modernisation is working because expenses are decreasing. Making such a claim is invalid now, for £-66m in Royal Mail Letters POP means expenses increased dramatically. Without adequate reporting, it is impossible to confirm where the money went, but I am confident I know (and will state it was not an expense related to property, plant or equipment, operating expenses (as in payment for services from an external provider), distribution or conveyance, nor normal people costs.

Continuing, 86% of the total £132m decline in POP was attributed to Royal Mail Letters. The majority of Royal Mail's expenses are people costs (roughly two-thirds), and the financial statement said the number of UK employees was reduced "*by 2,800 in the first six months, the large majority in the Letters business*." As such, expenses in the Letters group should have improved, not worsened. Quoting a line from the movie Jerry McGuire, "*Show Me The Money*."

Closing:
Like most other avoidable disasters, it will take an actual failure before the matter receives serious consideration, at which point a mirror is the only item needed to identify the cause of the failure, and about £5bn more (and counting) in the case of Royal Mail. Hiding expenses is just another trick and one that demonstrates attempting to help is a complete waste of time. You get what you pay for, and short cuts generally require doing it over correctly (which ultimately costs more and takes longer), facts never cease to exist, and the difference between *think-I-know* and *know* generally is the difference between failure and success.

Turning around Royal Mail's distressed business requires much more than is currently being presented, employed or considered. The outcome is predictable: continued price increases, declining demand, and competitor gains in the most profitable segments, as well as continued service reductions and a futile effort of scaling back universal service to cut costs. In the end, a final decision will be to return postal services to the government (at a minimum £5bn additional price tag) or accept higher priced, non-universal postal services. As predicted, 2010 is exactly like 2009, and still no solution (not even one that is in the presentation stage). Make no mistake, any proposal of a sale, partial or in whole, is merely a measure to transfer the problem to the new owners, while generating cash. It will not solve the postal issues at Royal Mail, and there exist many examples that attest to this fact.

About the Author: Timothy Nestved is founder and president of Nestved LLC, as well as a principal consultant, with expertise in turning around firms in the delivery services industry, including distressed firms facing similar challenges to those of national postal service providers like the Royal Mail and USPS. Inquiries for Timothy may be submitted through the Contact Us page at Nestved, LLC.

About Us: Nestved LLC is a management consulting firm specializing in strategy formulation and disruptive technology ideation and innovation across a multitude of industries, with unique turnaround and distressed industry/market expertise. Our strategy formulation is centered in the areas of strategic, turnaround and crisis management. We deliver inventive solutions for unprecedented to seemingly perplexing problems, including sui generis and catastrophic events. Established in 1995, our clients range from recognized global leaders to innovative startups, as well as governments. When faced with a business or market crisis, unprecedented challenge or "events" others failed to properly identify and solve, the astute call on us. Nestved LLC — *"Formulating Strategies for Global Success"* Visit us at http://www.nestvedllc.com/

1. Our efforts to provide our expertise relative to Royal Mail's reform and moderisation efforts to ensure continued operation of Universal Service, as well as setting Royal Mail on a realistic path of financial self-sustainability have proven to be futile, so we are stepping aside to permit the major participants to learn for themselves that the path they have selected will not achieve the goals they have defined for the project, noting the wasted cost for such self-education will likely exceed £5bn.
2. At the time of publication, full-year results were not available, so only half-year values were printed and used in the analysis.

