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**The published Hellmail version required removal of tables, so the article's content had to be rewritten accordingly [here, the original tables were added].*

Royal Mail Mid-2010 Review of Financials and Modernisation – Part 2 *(REVISED)*

Part I reviewed major events impacting Royal Mail during the prior half-year reporting period (Oct-Mar). Part II, delayed to in an effort to resolve Hellmail data table publishing support issues, focuses on analysis of the financial results for the second half-year October 2009 to March 2010 period and full-year April 2009 to March 2010 period (Royal Mail Annual Report 2009-2010[*removed*] Fiscal Year and Half-year Financial Report[*removed*] [originally reported copies: Annual Report and Half-year Report]).

Revenues:

Moving on to the financials themselves, revenues are down (i.e., -2.2% overall from a year ago and -2.8% overall from the year ago second half-year period). Royal Mail Letters' revenue for the second half-year was down 2.6% as compared to the year ago period, which is not bad considering postal strikes occurred in the period. In fact, statistical review of Royal Mail's revenues showed small but otherwise consistent changes in revenues over time and between periods, indicating postal strikes did not have a major impact on revenue declines. Revenues for GLS and Parcelforce were also down in the second half-year period as compared to the year ago period, at -1.4% and -3.3%, respectively. Excluding the non-core Other Businesses group, revenue for the core business groups was down 2.3% from the year ago period.

Bottom line, overall revenues are down for 2010, and postal strikes were not responsible for the decline. When one considers the prior year's period—of which current performance is compared against—includes the period of global economic downturn (i.e., the global recession), then *lower revenues for this reporting period as compared to a prior depressed period is not at all impressive and quite troubling to say the least.*

Defining POP:

Clarification of the term Operating Profit* is required to eliminate ambiguity and unintended misrepresentation. The use of the asterisk '*' following the standardised accounting term Operating Profit (the "OP") by Royal Mail in, and throughout, its financial statements modifies, or otherwise changes, the original term's standard definition from actual Operating Profit to Pre-Operating Profit (the "POP"), noting Royal Mail had decided not to use the standard term Pre-Operating Profit. The asterisk is used because Royal Mail excludes certain Operating Expenses (E), referred to as Exceptional Items—or Exceptional Expenses (x) to be precise—from its calculations of Operating Profit, resulting in a modified Operating Profit* signified by the asterisk. Given, R=Revenues, then OP=R−E and e=E−x, where 'e' equals operating expenses less exceptional expenses. Thus, POP=R−e, which becomes (through substitution) POP=R−(E−x), which is POP=R−E+x, which is POP=OP+x. As can be seen, Operating Profit does not equal Pre-Operating Profit (i.e., POP≠OP) and the difference is the amount of so-called exceptional expenses (i.e., x) Royal Mail conveniently excludes from their modified operating profit* figure, more commonly defined as Pre-Operating Profit or POP.

Merits of Extraordinary Expenses:
Presenting OP less extraordinary expenses, as well as OP, in financials is an acceptable and desirable practice, for it can provide a more accurate view of the financial performance of the firm in specific reporting periods when extraordinary events occur, in addition to aiding in performing comparable financial analysis (e.g., competitor to competitor and competitors to overall market analysis). However, the practice of modifying standard definitions can lead to abuse or improper use. For example, consider a firm's financials being quoted by other sources or verbally by management without inclusion of the special modified references (e.g., newspapers and analysts commonly report the operating profit, but the reader has no idea the definition of operating profit has been modified and true operating profit may differ significantly from what was reported because the reports and analysts, for whatever reason, fail to note the significant change).

Therefore, it is a far better practice (i.e., best practices) to use a non-standard term instead of modifying a standardised term. Eliminating any possibility of unintended misrepresentation or ambiguity are both highly desirable outcomes relative to financial reporting and the dissemination of financial data.

From here on, I shall refer to Royal Mail's modified operating profit* as Pre-Operating Profit or POP, as it should be, and hopefully Royal Mail, its auditor and everyone else will do the same.

Pre-Operating Profit (POP):
Since Royal Mail wishes to present financial details using modified *"operating profit*"* (i.e., POP), I will oblige by doing the same here. The table below presents POP data for 2009 and 2010, to include the percentage change for POP as compared to its year ago period. At first glance, one might see increasing POP year over year, as well as increasing POP half-year over half-year for all of 2010, but what should draw your attention is the 4.0% in the first half-year reporting period of 2010. *Why is that period's POP so low as compared to the other periods?*

POP, Royal Mail						
	2009			2010		
	1st Half	2nd Half	Full-Year	1st Half	2nd Half	Full-Year
POP (£m)	177	144	**321**	184	220	**404**
POP Percent Change*	105.8%	89.5%	98.1%	**4.0%**	52.8%	25.9%
*(from year ago period)						

The next table (below) shows the actual Expense differences (i.e., deltas or Δ) for each expense category from the year ago period, with negative numbers indicating expenses decreased by the value shown, and positive numbers indicating expenses increased by the value shown.

ΔExpense (£m)	**Year 2010**		
	1st Half	**2nd Half**	**Full Year**
People Costs	-143	-123	**-266**
Distribution/Conveyance Costs	31	-29	**2**
Other Operating Costs	29	-65	**-36**
Totals	**-83**	**-217**	**-300**

Two items from the table's data stand out. First, of the £300m overall reduction in expenses, the majority (88.7%) was attributed to People Costs (£-266m). Second, the data shows non-People Costs expenses were increasing in the first half-year, then declining in the second half-year period. Note, the second half-year is the busier half-year period due to the holidays, while revenues for the second half-year showed consistency to prior periods, so the postal strikes are likely not the cause for major changes in expense for 2010.

Using the formula OP=R–E (or POP=R–e), any change in OP is the result of a change in either revenues or expenses. Furthermore, there is an inverse relationship between operating profit and revenues/expenses; therefore, lower OP means higher expenses if revenues remain constant. An analysis of Royal Mail's revenues shows no substantive variations in revenues, meaning the change must be the result of a change in expenses.

Workforce Reductions:
Regarding workforce reductions, they were greater during 2010, as the table below shows, with an overall reduction in workers of 4.2% (-4.2%) from the year ago period, and the greatest reduction in four (4) years. Statements in Royal Mail's 2010 financial report confirm this: relative to Royal Mail Letters group and people costs, "*...decrease in costs is mainly due to a significant reduction in people costs...*" and relative to the Chairman's Statement, "*Group's headcount reduced by almost 8,000 in 2010...*", with the actual number being 8,051 fewer.

Headcount Reductions	2007	2008	2009	2010
Percent Change (from yr ago period)	-3.5%	-1.4%	-2.6%	-4.2%

Expense Strategy:
Bottom line, *automation will displace workers, resulting in workforce reductions presuming the pre-cost-benefit analysis stage was performed correctly, so reductions in People Costs expenses are expected!* Therefore, workforce reductions during 2010 explain the declining People Costs expenses (e.g., payroll expenses, et cetera) for both 2010 half-year periods. Moreover, the large decrease in People Costs expenses in the first half-year indicates a greater portion of the workforce reduction occurred in or near the beginning of that period, and well in advance of any mention of holiday season national industrial action (strikes), noting People Costs will not fluctuate unless the workers were rehired (which is not occurring).

As a result, excluding the £-143m in people costs in the first half-year (due to workforce reductions) shows the non-People Costs expenses for the same period increased £60m (31+29). Therefore, the aforementioned question "Why is POP so low?" actually becomes, "Why are operating expenses for non-People Costs expenses so high in the first half-year period of 2010?" Or, more precisely, "*Why are there so many Distribution/Conveyance and Other Operating Costs (expenses) in the first half-year period, and such a decline in the busier, second half-year period?*"

Did somebody conceive a poor, and ill-advised, strategy to front-load expenses for the first half-year period so that the difference between POP for 2009 and 2010 for select Royal Mail business groups—those with operations in the UK for example—could be positive but approaching zero, with the notion that threats of pending or imminent strikes in the immediate start of the second half-year period by postal union's members could possibly be lessened or avoided by showing perceived fragility of Royal Mail in the marketplace from a financial perspective just prior to the start of the busiest and more profitable time period of the year?

Such a strategy would be ill-advised because the union has no bargaining power to force Royal Mail into any real negotiations except strikes, and the limited and localised strikes *failed to produce results for the union, so the threat of strikes cannot be avoided or lessened by mere financial results. As for Royal Mail, financial results present no real strategic strength in any bargaining strategy, to include employee compensation negotiations, but presuming so would constitute a poor strategy to say the least, and one indicating a complete lack of understanding of the dynamics overall. In addition, front-loading expenses means the next period will have lower expenses, and therefore, a higher POP (unless expenses are front-loaded yet again), thus falsely giving some, including the union, the opportunity to claim increasing POP means Royal Mail is "on the mend."*

Front-loading/Deferring:
For those unfamiliar with front-loading expenses or deferring expenses in accounting terms, an example may best describe the impact, whereas their meaning are likely clear. I will use an example of pre-paying an expense to describe front-loading, and use an actual example of pension payments from Royal Mail's end-of-year financial reports (that is, the 2009 report, page 16, £50m prepayment entry in table labeled "Pensions cash funding..." or 2008 page 16; and 2010 page 16).

In 2008, Royal Mail prepaid £50m of 2009's pension obligation. Pension payments—actual net cash payments—were £920m, £823m and £867m for 2008, 2009 and 2010, respectively. The actual expense differs from the amounts paid because accrual accounting is used. The actual year's pension expense for each year was £870m, £873m and £867m for 2008, 2009 and 2010, respectively. Based on cash payments, the fluctuations in the totals between the years are £-97m (823-920) and £+44m (867-823), respectively. Based on actual year's expense, the fluctuations in the totals between the years are £+3m (873-870) and £-6m (867-873), respectively.

Pension Payment Fluctuations Due to Front-Loading			
	2008	**2009**	**2010**
PE, Pre-paid Expense (m)	£50	£0	£0
AE, Actual Expense (m)	£870	£873	£867
EP, Excess Payment from prior yr (m)	£0	£-50	£0
TP, Total Payments [PE+AE+EP] (m)	£920	£823	£867
Front-Loading Impact [TPx - TPx-1] (m)	-	£-97	£44
Real or Actual Fluctuation [AEx - AEx-1] (m)	-	£3	£-6
Reported Front-Loading Distortion (m)	-	£-94	£38

As can be seen, the 2008 prepayment directly impacted the financials for 2008 and 2009, but it also indirectly impacts 2010 as well. That is, in the year-end financial report for 2010, paragraph six (6), page 16, notice the following statement, "*Net cash payments to fund pensions have risen by £44m, from £823m to £867m.*" The statement is correct in accounting terms, but misleading relative to cash payments versus actual year's expense per year. That is, the amount attributed to pension expenses in 2010 actually decreased by £6m (£-6m), from £873m in 2009 down to £867m for 2010. Also, since £50m was prepaid in 2008, 2009 receives the cash payment benefit on paper, which differs from the actual year's expense, and impacts the numbers for 2010 as well. *There is a significant difference between £+44m and £-6m. And, while both numbers are correct in their own respects, the prepayment of the pension expense may have caused many to unfortunately gloss over the 2010 statement and falsely believe the 2010 allocation of pension expense was £44m greater than in 2009, when in fact, it is £6m less.*

Deferring expenses is essentially the inverse of front-loading, noting there are instances when prepaying or deferring expenses is desirable, or possibly required (e.g., when specific tax or liquidity issues exist). Front-loading, on the other hand, is an accounting trick. Since standard terminology for terms like credit, debit, expense, et cetera differ between the accounting field and everyday usage of the same terms, my descriptions had to adhere to standard accounting terminology to remain valid, which may have caused some to wonder why the wording appeared technically cryptic—my apologies.

Expenses:
A prior Royal Mail financial analysis pointed out the financial statements lacked detail regarding expenses, with only three main expense categories and no breakdown of specific expenses within the categories or by business groups. The three expense categories are too broad, encompassing too many sub-expenses. For example, fuel expenses; what are they and what are their rates of change per period? Or, temporary labour costs during the holiday seasons; how much of the margin gains for the holiday reporting periods are attributed to lower labour costs due to temporary workers?

Continuing, revenues are reported by business groups, but expenses (by main expense categories) are not. Likewise, POP is reported in the financial statements by business group, but OP is not provided for business groups, and the expense data that is provided makes it impossible to calculate OP for the business groups. Lastly, financial performance values, like Return on Sales (ROS), use OP, and since OP for the business groups is lacking, actual ROS values for the business groups are also impossible to calculate, although Royal Mail provides modified POP ROS values. *Hopefully future financial reports shall contain better expense reporting*. *[In actuality, in subsequent financial reports, Royal Mail Directors and Management opted to report less information, thus making external financial analysis more difficult to perform.]*

Another expense, regular pension contributions, is down 4.5% (-4.5%) from the year ago period, while the accounting pension deficit has increased 17.7% for the same period (i.e., £6.8bn in 2009 to £8.0bn in 2010). Of course, the non-accounting figure is widely expected to be closer to £10.0bn (and my estimation has always been in the range of £12bn to £15bn).

Loans and Financing:
Net drawdown of borrowings and financing (loans) continues to increase, from £33m in 2008, to £310m in 2009 to £500m in 2010, or 839.4% change from 2008 to 2009 and 61.3% from 2009 to 2010, improving net cash outflow totals. In 2009, £310m in loans improved net cash outflow from £-683m to £-373m, while in 2010, £500m in loans improved net cash outflow from £-625m to £-125m.

Loans and Financing			
	2008	**2009**	**2010**
Net Drawdown	£33m	£310m	£500m
Year-to-Year Change	-	839.4%	61.3%
Net Cash Outflow (pre-drawdown)	-	£−683m	£-625m
Net Cash Outflow (after to loans/fin)	-	£−373m	£-125m

Financial Data:
The table below provides POP and OP data for Royal Mail for the years 2006 through 2010. From the table, true or actual OP is not as impressive as the POP figures Royal Mail prefers to use. OP declined for 2010, although Royal Mail again prefers to emphasise POP, and its deceptive increase. Although POP increased 25.9% (+25.9%) from the year ago period, actual OP declined 34.3% (-34.3%) from the year ago period, and at the current rate of decline, actual OP will be negative by the end of the first half-year period of 2012. *As a reminder, the difference between POP and actual OP figures are nothing but expenses, actual expenses!*

(£m)	2006	2007	2008	2009	2010
POP	355	233	162	321	404
Actual OP	145	-10	-279	173	**113**

As the Return on Sales (ROS) table below shows, the actual or true ROS figures are not as impressive as the figures Royal Mail presents in their financial reports using the modified POP data. *There is a significant difference between the real ROS of 1.2% and Royal Mail's augmented ROS of 4.3%!*

Return on Sales (ROS) (%)	2006	2007	2008	2009	2010
ROS % (using POP)	3.8%	2.5%	1.7%	3.4%	4.3%
Actual ROS %	1.6%	-0.1%	-3.0%	1.8%	**1.2%**

Select GLS/Parcelforce Data:
As for GLS and Parcelforce, GLS has had the same number of customers for four years straight, and financial performance seems counter to its market competitor's results. Parcelforce has had declines in holiday volumes for each of the past two years. *This data is disturbing considering these should both be growth businesses. In addition, the Hooper Report refers to these businesses as the future growth areas for Royal Mail.*

Summary:
In summary, revenues are declining, the growth businesses are not experiencing growth, and Royal Mail Letters business continues to experience faster declining volumes year over year. Regular pension contributions are less, while the pension deficit obligation grew substantially. Increased borrowings have improved cash flow data, while also increasing interest expense. OP is significantly lower than the POP Royal Mail prefers to focus on, with both actual OP and ROS down for the year. If you would like the financial summary of Royal Mail sugarcoated, then by all means, only preview POP, and POP is increasing.

As further evidence of Royal Mail's declining financial performance, I refer the reader to page 95 of Royal Mail's "*Annual Report and Financial Statements, Year ending 28 March 2010,*" specifically the "*Group five-year summary"* data, with select data presented in the table below.

Select Five Year RM Data (£m)	2006	2007	2008	2009	2010
(Loss)/Profit after tax	395	286	135	**(229)**	**(320)**
Non-current liabilities	(6,181)	(5,558)	(3,676)	(7,872)	(9,494)
Net liabilities	(3,339)	(2,264)	(241)	(4,656)	(6,281)

By definition, a distressed business is one with multiple years of declining financial performance, and Royal Mail certainly is experiencing multiple years of declines, to include 2010!

No doubt, Royal Mail management will "adamantly" disagree with what is presented thus far, but that does not change the facts. Part III reviews the modernisation effort.

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

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