# Financial review

## Reported results

Reported results are prepared in accordance with IFRS. Reported Group revenue reduced to £9,251 million (2014-15 £9,328 million). Operating costs before transformation costs increased to £8,766 million (2014-15 £8,717 million). Group operating profit before transformation costs reduced to £485 million (2014-15 £611 million) and operating profit after transformation costs decreased to £294 million (2014-15 £466 million). The reduction was mainly driven by the year-on-year increase in the IAS 19 pension service charge, which is treated as a specific item. The total charge for other operating specific items reduced to £156 million (2014-15 £248 million) mainly due to lower legacy costs. As a result, Group operating profit after operating specific items was £138 million (2014-15 £218 million). Profit before tax reduced to £267 million (2014-15 £400 million) as the prior year benefited from the profit on disposal of the Paddington site. Earnings per share for continuing operations reduced from 32.5 pence to 21.5 pence.

## Presentation of results

The remaining commentary in this financial review, unless otherwise indicated, focuses on the adjusted results (continuing operations). The adjusted basis reflects the cash cost of providing pensions, which Management believes is a more meaningful basis upon which to analyse business performance. Movements in revenue, costs, profits and margins are on an underlying basis. This is consistent with the way that financial performance is measured by Management and reported to the Board. Again, this assists in providing a meaningful analysis of the trading results of the Group. The analysis of underlying movements in adjusted results is set out at the end of this section.

## Group revenue

| (£m) | Adjusted 52 weeks ended 27 March 2016 | Adjusted 52 weeks ended 29 March 2015 | Underlying change |
|---|---|---|---|
| UKPIL | **7,666** | 7,757 | (1%) |
| GLS | **1,580** | 1,557 | 9% |
| Other[1] | **5** | 14 | |
| **Total revenue** | **9,251** | 9,328 | 1% |

The main factors impacting revenue in the year are described in the sections entitled 'UK Parcels, International & Letters (UKPIL)' and 'General Logistics Systems (GLS)'. 'Other' revenue reduced due to the expiration of a contract to provide facilities management services to Post Office Limited.

## Group operating costs

| (£m) | Adjusted 52 weeks ended 27 March 2016 | Adjusted 52 weeks ended 29 March 2015 | Underlying change |
|---|---|---|---|
| People costs | **(5,199)** | (5,230) | Flat |
| Non-people costs | **(3,310)** | (3,358) | 1% |
| Distribution and conveyance costs | **(1,736)** | (1,764) | 2% |
| Infrastructure costs | **(995)** | (1,019) | (2%) |
| Other operating costs | **(579)** | (575) | 1% |
| **Total operating costs** | **(8,509)** | (8,588) | Flat |

Group operating costs were flat on an underlying basis as lower UKPIL costs were offset by increases in GLS. The main factors impacting operating costs in the year are described in the sections entitled 'UK Parcels, International & Letters (UKPIL)' and 'General Logistics Systems (GLS)'.

## Group operating profit after transformation costs

| (£m) | Adjusted 52 weeks ended 27 March 2016 | Adjusted 52 weeks ended 29 March 2015 |
|---|---|---|
| UKPIL | **417** | 470 |
| GLS | **117** | 115 |
| Other | **17** | 10 |
| **Group operating profit after transformation costs** | **551** | 595 |
| *Margin* | ***6.0%*** | *6.4%* |

[1] 'Other' revenue excludes inter-segment revenue of £141 million (2014-15 £152 million)

Group operating profit before transformation costs grew by five per cent. The increase in operating profit from the Other segment relates largely to improved trading performance in Romec Limited. Group operating profit after transformation costs declined by two per cent as a result of higher transformation costs. Operating profit margin after transformation costs decreased by 10 basis points on an underlying basis to 6.0 per cent.

## Specific items

Operating specific items in the period related mainly to the 'pension charge to cash difference' of £257 million (2014-15 £129 million) and the Employee Free Shares charge of £158 million (2014-15 £169 million). The difference between the pension charge and cash cost represents the difference between the income statement pension charge rate of 29.8 per cent and the actual cash payments into the schemes. Year-on-year, the increase in the difference has been driven by a decrease in AA corporate bond yields, which increases the income statement charge but not the cash payments. The IAS 19 pension service charge rate for 2016-17 is 28.8 per cent which means that the pension charge to cash difference is expected to reduce to around £230 million. The charge for the Employee Free Shares will reduce over time reflecting the phasing of the charge over the vesting period. For 2016-17 the Employee Free Shares charge is expected to be around £110 million, taking into account the further one per cent of Free Shares to be allocated in due course and an estimate of the level and mix of leavers.

Non-operating specific items include a profit on disposal of property, plant and equipment of £29 million (2014-15 £133 million) mainly arising from the sale of the Croydon Delivery Office. The net pension interest credit was £113 million (2014-15 £75 million). This is higher than the prior year due to the increase in the accounting surplus at 29 March 2015 and the impact of the change in pension accounting policy (see Note 1 to the financial statements). For 2016-17 the pension interest credit is expected to be around £120 million due to the increase in the accounting surplus at 27 March 2016. Profit on disposal of discontinued operations of £31 million (2014-15 £nil) relates to the sale of DPD SL, a subsidiary of GLS Germany.

## Net finance costs

| | Rate | Facility (£m) | Drawn (£m) | Facility end date |
|---|---|---|---|---|
| €500 million bond | 2.5% | 392 | 392 | 2024 |
| Revolving credit facility | LIBOR+0.55% | 1,050 | – | 2020-21 |
| **Total** | | **1,442** | **392** | |

Net finance costs were £13 million compared with £26 million in the prior year. The reduction was mainly due to improved terms on our borrowing facilities and leases and lower outstanding balances of gross debt following the amendment of the syndicated bank facilities in the prior year.

The blended interest rate on gross debt (including finance leases) for 2016-17 is expected to be approximately three per cent.

## Tax

| **(£m)** | **Adjusted 52 weeks ended 27 March 2016** | Adjusted 52 weeks ended 29 March 2015 |
|---|---|---|
| UK tax charge | **(84)** | (102) |
| Foreign tax charge | **(34)** | (36) |
| **Total tax charge** | **(118)** | (138) |
| Effective tax rate | **22%** | 24% |

The Group effective tax rate on adjusted profit before tax was 22 per cent. The UK effective tax rate of 20 per cent is broadly in line with the UK Corporation Tax rate. GLS effective tax rate of 29 per cent (2014-15 31 per cent) has reduced mainly due to changes in tax rules in certain territories, particularly Italy.

## Earnings per share (EPS)

Basic adjusted EPS for continuing operations was 41.3 pence compared with 42.8 pence in the prior year, reflecting the increase in transformation costs.

## Cash flow

| (£m) | 52 weeks 2016 | 52 weeks 2015[2] |
|---|---|---|
| EBITDA before transformation costs | **756** | 889 |
| Pension charge to cash difference | **257** | 129 |
| Adjusted EBITDA before transformation costs | **1,013** | 1,018 |
| Trading working capital movements | **(26)** | (5) |
| Share-based awards (SAYE and LTIP) charge to cash difference | **13** | 5 |
| Dividends received from associate | **1** | – |
| Total investment | **(694)** | (648) |
| Income tax paid | **(40)** | (37) |
| Net finance costs paid | **(13)** | (18) |
| **In-year trading cash flow** | **254** | 315 |
| Other working capital movements | **6** | 17 |
| Cash cost of operating specific items | **(6)** | (8) |
| Proceeds from disposal of property (excluding London property portfolio), plant and equipment | **38** | 39 |
| Proceeds from disposal of discontinued operations | **41** | – |
| Acquisition of business interests | **(18)** | (10) |
| Cash flows relating to London property portfolio | **(23)** | 100 |
| **Free cash flow** | **292** | 453 |

Adjusted EBITDA before transformation costs was broadly flat at £1,013 million.

Trading working capital movements were an outflow of £26 million largely as a result of the change in international sales mix, a trend which is expected to continue.

In-year trading cash flow was an inflow of £254 million, £61 million lower than the prior year mainly driven by an increase in investment.

### Investment

| (£m) | 52 weeks 2016 | 52 weeks 2015 |
|---|---|---|
| Growth capital expenditure | **(253)** | (168) |
| Replacement capital expenditure | **(208)** | (252) |
| Transformation operating expenditure | **(233)** | (228) |
| Voluntary redundancy – ongoing | **(159)** | (62) |
| Voluntary redundancy – management reorganisation | **–** | (96) |
| Project costs | **(72)** | (61) |
| Business transformation payments | **(2)** | (9) |
| Total investment | **(694)** | (648) |
| Proceeds from disposal of property (excluding London property portfolio), plant and equipment | **38** | 39 |
| **Net investment** | **(656)** | (609) |

Total gross investment increased to £694 million, mainly due to an increase in expenditure on projects and initiatives to support growth. Growth capital expenditure increased by £85 million with the principal investments being in relation to parcel IT systems, parcels automation, the purchase of new PDAs and investment in GLS. Replacement capital expenditure decreased by £44 million. The main investment in the period related to IT, in particular IT transformation, with reduced spend on vehicles. Transformation spend increased by £5 million to £233 million, mainly as a result of increased spend in relation to project costs largely due to the cost avoidance programme. Total spend in relation to voluntary redundancy was in line with the prior year. Proceeds from the disposal of property, plant and equipment (excluding London property portfolio), mainly relating to the sale of the Croydon Delivery Office, were £38 million, giving a total net investment of £656 million. This was slightly higher than expected due to timing of certain projects.

Tax payments of £40 million largely relate to amounts paid in Europe. In the UK, we continue to be able to offset the majority of taxable profits with capital allowances and brought forward losses. This is now expected to normalise in 2018-19, mainly due to relief available from additional Employee Free Shares allocations.

[2] 52 weeks 2015 has been restated to move change in GLS client cash of £6 million from 'Trading working capital movements' to 'Other working capital movements' and to extract £10 million in respect of 'Acquisition of business interests' from 'Growth capital expenditure' within 'Total investment'

Cash cost of operating specific items related to legacy and legal costs. Going forward, the Company is liable to pay National Insurance contributions on any Free Shares that are sold by employees prior to the end of each of the Share Incentive Plans' five year terms. The amounts and timing of any such cash payments are uncertain but will be treated as operating specific items.

As previously reported, on 31 March 2015 GLS Germany sold its entire holding in its subsidiary DPD SL resulting in proceeds from sale of discontinued operations of £41 million.

Acquisition of business interests cash flows of £18 million relate to amounts paid in respect of investments made in the year, mainly NetDespatch Ltd, Mallzee Ltd, Intersoft Systems & Programming Limited and acquisitions in GLS, including deferred consideration paid in relation to acquisitions made in prior periods.

Cash flows relating to the London property portfolio of £23 million largely relate to remediation work, reprovisioning costs and professional fees at the Nine Elms and Mount Pleasant sites.

## Net debt

| (£m) | Balance sheet category | 52 weeks 2016 | 52 weeks 2015 |
|---|---|---|---|
| Obligations under finance leases | Current liabilities | **(84)** | (93) |
| Interest-bearing loans and borrowings | Non-current liabilities | **(392)** | (366) |
| Obligations under finance leases | Non-current liabilities | **(136)** | (179) |
| Total gross debt | | **(612)** | (638) |
| Cash and cash equivalents | | **368** | 287 |
| Cash at bank and in hand | Current assets | **185** | 127 |
| Client cash | Current assets | **13** | 20 |
| Cash equivalent investments | Current assets | **170** | 140 |
| Financial assets – short-term deposits | Current assets | **–** | 56 |
| Pension escrow investments (RMSEPP) | Non-current assets | **20** | 20 |
| **Total net debt** | | **(224)** | (275) |

Net debt was £224 million at 27 March 2016, £51 million lower than at 29 March 2015. The decrease in net debt was driven by the in-year trading cash flow and proceeds from the disposal of assets, partially offset by dividend payments to equity holders of the parent Company.

We continue to target investment grade credit metrics, that is, no lower than BBB- under Standard & Poor's methodology.

A reconciliation of net debt is shown below.

| (£m) | 52 weeks 2016 | 52 weeks 2015 |
|---|---|---|
| Net debt brought forward | **(275)** | (555) |
| In-year trading cash flow | **254** | 315 |
| Other working capital movements | **6** | 17 |
| Cash cost of operating specific items | **(6)** | (8) |
| Proceeds from disposal of property (excluding London property portfolio), plant and equipment | **38** | 39 |
| Proceeds from disposal of discontinued operations | **41** | – |
| Acquisition of business interests | **(18)** | (10) |
| Cash flows relating to London property portfolio | **(23)** | 100 |
| Dividends paid to equity holders of the parent Company | **(213)** | (200) |
| Dividends paid to non-controlling interests | **(7)** | (1) |
| Decrease in finance lease obligations (non-cash) | **–** | 8 |
| Foreign currency exchange impact | **(21)** | 20 |
| **Net debt carried forward** | **(224)** | (275) |

## Pensions

The IAS 19 pension position at 27 March 2016 was a surplus of £3,430 million, compared with a surplus of £3,049 million at 27 September 2015 and £3,367 million (restated – see Note 1 to the financial statements) at 29 March 2015. The IAS 19 accounting position and key assumptions for the valuation are provided in Note 10.

The process for the triennial valuation of the Royal Mail Pension Plan (RMPP) at 31 March 2015 has commenced and the outcome will be announced in due course. The Royal Mail Senior Executives Pension Plan (RMSEPP) triennial valuation at 31 March 2015 has been completed, based on the assumptions agreed as part of the Funding Agreement made between the Company and the Trustee in 2013. If the assumptions used for the 2012 triennial valuation of the RMPP and the 2015 triennial valuation of the RMSEPP are rolled forward to 31 March 2016, the combined actuarial surplus would be £1,777 million, compared with £1,525 million at 30 September 2015 and £1,793 million at 31 March 2015. It is this basis that the Pension Trustee and the Company use to assess the ongoing funding needs of these schemes. To support the Company's commitment that, subject to certain conditions, the RMPP will remain open to defined benefit accrual until at least March 2018, the Trustee has hedged a large proportion of the interest and inflation exposure on this expected future service benefit accrual. The Trustee increased this hedging further during 2015-16, and on an actuarial basis the amount of the surplus at March 2016 relating to the liabilities hedged in advance of those accrued to the same date, was approximately £550 million. This element of the surplus will unwind over time.

Under the 2012 triennial valuation of the RMPP, the Company agreed to pay ongoing cash contributions of 17.1 per cent of pensionable pay until 2018. At that time, this amounted to around £400 million per annum. This was made possible by the creation of an actuarial surplus of £1.6 billion as a result of the Pensions Reform in 2013. Without this surplus, the Company contributions required would have been around £700 million per annum, or 30 per cent of pensionable pay. Accordingly, the surplus was expected to decline over time.

Although market conditions for defined benefit schemes have been very volatile over the past 12 months, the funding position of the RMPP at the end of the 2015-16 financial year is broadly in line with that at the end of 2014-15, largely due to increases in the market value of gilts and derivative assets held to hedge interest rate and inflation risks. We continue to expect that the RMPP actuarial surplus will reduce over time, although the pace of this reduction will only be confirmed once the 2015 triennial valuation process has been concluded.

As part of the March 2012 actuarial valuation, the Company agreed to pay additional contributions of up to £50 million a year from April 2016 onwards if the Trustee considers these necessary to maintain the Plan's projected funding position in March 2019. Until the Trustee has carried out its assessment of liabilities at 31 March 2016, we will not know if any payment will become due for 2016-17.

## Dividends

The final dividend of 14.3 pence per share in respect of the 2014-15 financial year was paid on 31 July 2015, following shareholder approval.

The Board is recommending a final dividend of 15.1 pence per ordinary share, payable on 29 July 2016 to shareholders on the register at the close of business on 1 July 2016, subject to shareholder approval at the AGM on 21 July 2016. This gives a total dividend for the year of 22.1 pence, an increase of five per cent.

As previously stated, given the seasonality of the Group's business, the Board would expect to pay an interim dividend each year equal to approximately one-third of the prior year's total dividend and to set the final dividend for each year in light of the full year performance of the Group.

## Property

We continue to adopt a flexible approach in relation to our large London development sites at Nine Elms and Mount Pleasant and continue to explore options to realise value from them. Proceeds from the sale of the Paddington site will be reinvested into these larger sites to enable development.

## Financial risks and related hedging

The Group is exposed to commodity and currency price risk. The Group operates hedging policies which are described in the Notes to the financial statements.

The forecast diesel and jet commodity exposures in UKPIL are set out below together with the sensitivity of 2016-17 operating profit to changes in commodity prices and fuel duty.

| 2016-17 Exposure | Forecast total cost £m | Fuel duty (incl irrecoverable VAT) – not hedged £m | Underlying commodity exposure (incl irrecoverable VAT) £m | Underlying commodity volume hedged % | Residual unhedged underlying commodity exposure (incl irrecoverable VAT) £m | Impact on 2016-17 operating profit of a further 10% increase in commodity price £m | Impact on 2016-17 operating profit of a further 10% increase in fuel duty £m |
|---|---|---|---|---|---|---|---|
| Diesel | 148 | 94 | 54 | 90 | 3 | – | (9) |
| Jet | 8 | – | 8 | 77 | 2 | – | n/a |
| Total | 156 | 94 | 62 | 88 | 5 | – | (9) |

As a result of hedging it is anticipated that the diesel commodity cost for 2016-17 will reduce by £12 million. Without hedging the cost reduction would have been £31 million (based upon closing fuel prices at 27 March 2016). Due to the policy of hedging in advance, the current oil prices will result in anticipated lower effective diesel commodity cost in the future.

The UKPIL and Other business units' functional currency is Sterling, while GLS' functional currency is the Euro. Therefore the translational exposure to the Group's operating profit relates to GLS' profits.

In 2015-16, the average exchange rate between Sterling and the Euro was £1/€1.37 representing an eight per cent strengthening in Sterling compared with £1/€1.27 in 2014-15, which resulted in a £8 million reduction in GLS' reported operating profits.

The Group manages its interest rate risk through a combination of fixed rates loans and leasing, floating rate loans/facilities and floating rate financial investments. At 27 March 2016, all of the gross debt of £612 million was at fixed rate to maturity.

Counterparty risk is managed by limiting aggregate exposure to any individual counterparty based on their financial strength.

## Events after the reporting year

**Romec Limited (Romec) – acquisition of 49 per cent shareholding**

On 31 March 2016, Royal Mail Group Limited (RMG), the main operating subsidiary of Royal Mail plc, acquired the 49 per cent of shares in Romec that it did not already own, from ENGIE (formerly Cofely Workplace Limited), making RMG the sole shareholder of Romec. The financial terms of the acquisition are not considered by Management to be material in the context of the Group as a whole.

**Settlement of French Competition Authority fine**

Following the results of an investigation by the French Competition Authority (Autorité de la Concurrence) in respect of alleged breaches of antitrust laws by one of its subsidiaries, GLS France, a settlement amount of €55 million was paid by the Group on 15 April 2016. This amount is fully provided for in the Group financial statements at 27 March 2016 and at 29 March 2015.

## Auditor

Following the audit tender process explained on page 50 of the Annual Report and Financial Statements 2014-15, the proposal to appoint KPMG LLP as external auditor was approved by shareholders at the 2015 AGM.

## Underlying change

Movements in revenue, costs, profits and margins are shown on an underlying basis. Underlying movements take into account differences in working days in UKPIL (2015-16 303; 2014-15 304) and movements in foreign exchange in GLS (2015-16 £1/€ 1.37; 2014-15 £1/€ 1.27). In addition, adjustments are made for non-recurring or distorting items, which by their nature may be unpredictable. For volumes, underlying movements are adjusted for working days in UKPIL, and exclude elections in letter volumes. For 2016-17, the estimated impact of working days in UKPIL is around £65 million (2016-17 305.6 days).

| (£m) | Adjusted 2015-16 | Adjusted 2014-15 | Working days (UKPIL) | Foreign exchange (GLS) | Underlying 2014-15 | Underlying change |
|---|---|---|---|---|---|---|
| **Revenue** | | | | | | |
| UKPIL | 7,666 | 7,757 | (26) | – | 7,731 | (1%) |
| GLS | 1,580 | 1,557 | – | (109) | 1,448 | 9% |
| Other | 5 | 14 | – | – | 14 | n/m |
| Group | 9,251 | 9,328 | (26) | (109) | 9,193 | 1% |
| **Costs** | | | | | | |
| **Group** | | | | | | |
| People | (5,199) | (5,230) | – | 25 | (5,205) | Flat |
| Non-people costs | (3,310) | (3,358) | – | 76 | (3,282) | 1% |
| Distribution and conveyance costs | (1,736) | (1,764) | – | 66 | (1,698) | 2% |
| Infrastructure costs | (995) | (1,019) | – | 7 | (1,012) | (2%) |
| Other operating costs | (579) | (575) | – | 3 | (572) | 1% |
| Operating costs before transformation costs | (8,509) | (8,588) | – | 101 | (8,487) | Flat |
| **UKPIL** | | | | | | |
| People | (4,764) | (4,789) | – | – | (4,789) | (1%) |
| Non-people costs | (2,294) | (2,353) | – | – | (2,353) | (3%) |
| Distribution and conveyance costs | (776) | (821) | – | – | (821) | (5%) |
| Infrastructure costs | (890) | (919) | – | – | (919) | (3%) |
| Other operating costs | (628) | (613) | – | – | (613) | 2% |
| Operating costs before transformation costs | (7,058) | (7,142) | – | – | (7,142) | (1%) |
| **GLS** | | | | | | |
| Operating costs | (1,463) | (1,442) | – | 101 | (1,341) | 9% |
| **Profit, margins and EPS** | | | | | | |
| **Group** | | | | | | |
| Operating profit before transformation costs | 742 | 740 | (26) | (8) | 706 | 5% |
| Margin | 8.0% | 7.9% | | | 7.7% | 30bps |
| Transformation costs | (191) | (145) | – | – | (145) | |
| Operating profit after transformation costs | 551 | 595 | (26) | (8) | 561 | (2%) |
| Margin | 6.0% | 6.4% | | | 6.1% | (10bps) |
| Profit before tax | 538 | 569 | (26) | (8) | 535 | – |
| Tax | (118) | (138) | | | (130) | – |
| Profit for the period | 420 | 431 | | | 405 | – |
| Profit attributable to the Group | 413 | 428 | | | 402 | – |
| Group earnings per share (pence) | 41.3 | 42.8 | | | 40.2 | – |
| **UKPIL** | | | | | | |
| Operating profit before transformation costs | 608 | 615 | (26) | – | 589 | 3% |
| Margin | 7.9% | 7.9% | – | – | 7.6% | 30bps |
| Transformation costs | (191) | (145) | – | – | (145) | |
| Operating profit after transformation costs | 417 | 470 | (26) | – | 444 | (6%) |
| Margin | 5.4% | 6.1% | | | 5.7% | (30 bps) |
| **GLS** | | | | | | |
| Operating profit before transformation costs | 117 | 115 | – | (8) | 107 | 9% |
| Margin | 7.4% | 7.4% | | | 7.4% | Flat |