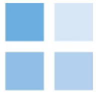


OFCOM

FINANCEABILITY OF THE UNIVERSAL SERVICE

October 2011

Final Report

REDACTED NON-CONFIDENTIAL VERSION

Submitted by:

Cambridge Economic Policy Associates Ltd

EXECUTIVE SUMMARY

Ofcom (after the transfer of regulatory responsibility from Postcomm) is currently considering how to regulate prices for Royal Mail beyond 2012. This is in the context of a rapidly changing postal services market, with continuing volume declines and a pressing need for acceleration of business restructuring. In addition, the Postal Services Act 2011 provides for the transfer of Royal Mail to the private sector, and should this occur private investors will be relying on the framework that is now being developed.

In support of the price control review process, CEPA was appointed by Postcomm in March 2011 to advise on issues associated with ensuring financeability of the Universal Service Obligation (USO). This included:

- an initial phase up to March 2011 focussing on approaches to measuring financeability and the handling of specific issues; and
- a second phase up to August 2011 covering a financial assessment of market comparators and market consultations.

Our work has involved: an analysis of the financial statistics for comparator companies; an assessment of evidence on the cost of capital for Royal Mail; and a targeted consultation with financial market participants, including rating agencies, analysts, and investors.

We have four main conclusions:

- A "traditional" utility approach to setting an allowed return for Royal Mail suggests a financial profile for Royal Mail over 2012-17 that we believe makes Royal Mail unfinanceable and insufficiently robust to credible downside risks.[1]
- Alternative approaches to setting returns, using a broader range of evidence, would allow a higher level of profit and so a better chance that Royal Mail is financeable, and would exhibit greater robustness to market and operating risks.[2]
- Using a Regulated Asset Base (RAB) as the primary metric to set revenues gives an incentive to invest in tangible assets. In a business facing structural decline, this incentive may not be compatible with minimising costs to customers (both in the short- and long-term).
- Severe downside business and operating scenarios are seen as credible by financial participants. Clarity about the regulatory response should such scenarios materialise would support, and may be essential to ensuring financeability from the private sector.

[1] While we do not believe that credit ratings are necessarily appropriate in the Royal Mail case, this approach would not be consistent with an investment grade rating.

[2] This approach should be consistent with Royal Mail having the potential to support an investment grade credit rating.

Inadequacy of traditional approach

Using recent market evidence and regulatory precedent, a pre-tax allowed return on a RAB in the range 6.2%-8.3% could be justified if Royal Mail is seen as similar to regulated infrastructure companies. This is unlikely to allow Royal Mail to be financeable and consequently the company would not be awarded an investment grade credit rating in the period 2012-17.

In forming their rating judgements, rating agencies make an assessment of perceived business risks in combination with an examination of specific financial ratios and the likelihood that they can be sustained at or better than specified levels. Two of the key credit metrics are Net Debt / EBITDA (one measure of financial gearing) and EBIT margin.

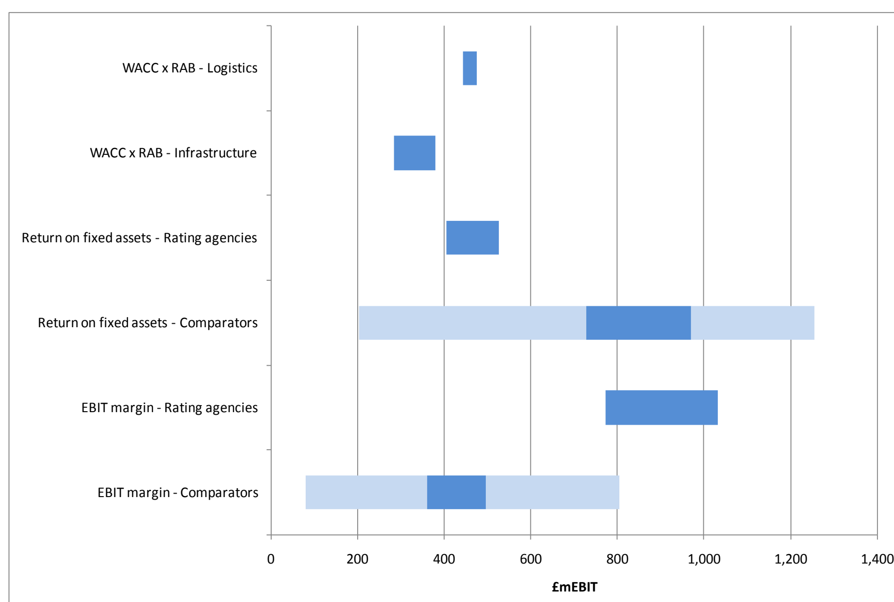
Financial projections indicate that measures of net debt and earnings would remain inconsistent with an investment grade rating even were Royal Mail to be seen to be a relatively low risk business. Moreover, there is a significant adverse decline in these metrics in the event of credible downside scenarios, suggesting risks may be seen as unacceptable by both debt and equity markets.

Alternative approaches

A higher allowed return for Royal Mail could be warranted if the estimated WACC is calculated using logistic company beta and gearing evidence. On this basis, a pre-tax WACC of 9.7-10.4% could be justified, which would deliver a higher level of profit to Royal Mail. Indeed, Royal Mail's comparators have a very high return on assets (inter-quartile range of 18-24%).

An alternative remuneration approach, used in the Netherlands for example, is to set an allowed return on sales. Postal firms have a return of sales in the range of 5-10% (EBIT to revenue), and rate set by the Dutch government for Post NL is towards the upper bound of this range.

Figure 1: Levels of EBIT under different assumptions applied to a modelled notional revenue



Robustness to severe downside risks

Although most market participants accept continued decline in letters volumes, a faster decline is credible. Furthermore, projected efficiency gains may not materialise (for example, Postcomm considered an annual efficiency gain of three percent could be achieved in 2006). These and other risks will be considered by the financial markets should private sector investment in Royal Mail be sought. Indeed, our discussions with investors suggest that they are likely to take a pessimistic outlook as their base case in considering their prospective returns, given the poor track record of the business to date.

But more significantly, debt and equity markets would examine what is likely to happen in the event that severe financial difficulty ensues for whatever reason. They would also consider scenarios to be realistic that involve risks occurring in combination. Financeability may therefore require visibility of how the regulatory regime might protect investors under such scenarios. In particular, the Postal Services Act 2011 contains provisions to provide financial support in the event that it is needed, but the way in which such provisions might be used is not at all clear. Clarity on how Ofcom would approach such a situation may be needed to ensure that Ofcom can fulfil its statutory duty to ensure that the USO is financeable.

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Disclaimer

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1. INTRODUCTION

1.1. Scope of work

In March 2011, Postcomm appointed CEPA as an advisor on the financeability of the universal service, provided by Royal Mail, as part of the proposed regulatory framework for 2012 onwards which includes proposed privatisation. Specific areas highlighted in our initial Terms of Reference (TORs) include financeability, cost of capital/capital structure, and mechanisms to reduce risk.

The work has been undertaken in two phases:

- In Phase 1 up to April 2011, we provided initial views on the consultation documents and high-level thoughts on Royal Mail's investment profile in light of a possible privatisation.
- In Phase 2, we have provided wider advice on financeability and financial issues in any regulatory framework, including:
  - an opinion on different approaches to setting the allowed return;
  - collection and analysis of financial data on comparable companies; and
  - consultation with market participants to determine views on financeability.

As a culmination of Phase 2, we have agreed to develop a Report that will inform Ofcom's 2011 consultation documents. This document represents a final version of this report for publication.

1.2. Background

As noted above, there are several developments in the postal market and its institutional and policy environment that form the background to this work:

- **Market decline**. The structural decline in demand for Royal Mail's services which are covered by the Universal Service Obligation (USO). This decline is apparent not just in the UK, but in Europe and other developed countries including the USA. The global financial crisis and the associated deep recession, and subsequent slow growth, have exacerbated the underlying structural decline.
- **Operational problems**. A continued modernisation programme within Royal Mail has, in combination with the reductions in demand identified above, so far failed to return the company to profitability. This modernisation programme involves new capital expenditures and reductions in operational expenditure, which itself has contributed towards workforce and Union tensions.
- **Financial problems**. Market decline and fixed operating costs have contributed towards financial problems for Royal Mail, including negative free cash-flow. In addition, the company has an inappropriate financial structure, including a significant pension deficit. Pension promises to retained staff also imply a high level of ongoing pension service costs.

- **Postal Services Act**. Government policy and recent legislation includes plans to raise private capital for Royal Mail through part-privatisation. This itself has led to direct confrontation of some of the issues above including financial structuring, and, as a result, requires European "State Aid" clearance.

This is a very different background from that faced by other regulated companies in the UK. For those companies, investors can make a reasonable expectation that the businesses would continue in their current form into the long term. For the USO elements of the Royal Mail service, investors cannot be certain of the stability of the business.

- Although this does not mean that the USO is not financeable (although sources of finance are more restricted) it does mean that the structure of regulation to make it financeable may need to be different from utility/ infrastructure businesses.
- The business plan needs to clearly reflect and accept the prospect of a declining market, both in the decisions on cost cutting and investment.

Consequently, the regulator may need to adopt an amended regulatory approach, for example a return on sales approach may also be sufficiently transparent and easily understood by financial markets; provide a basis for returning Royal Mail to profitability more quickly, facilitating a sale of the business; provide Royal Mail with incentives to optimise capex spend, and in particular not to spend on capex on which it cannot credibly earn a return; potentially slow the necessary reductions in staff numbers; and make transparent to all stakeholders the contribution that structural decline contributes to the ongoing problems of Royal Mail, facilitating decisions.

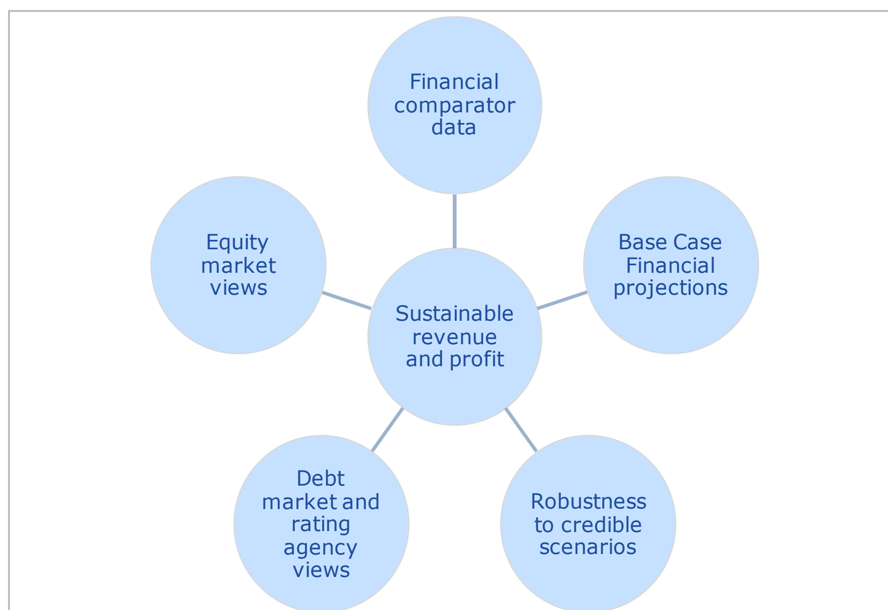
1.3. Our approach

In this paper, we examine a range of evidence on what an appropriate level of profitability for Royal Mail could be. In particular, and as summarised in Figure 1.1, we undertook the following:

- **Examination of evidence on comparator companies**. We look at postal companies, as well as other companies where the economics or other features make it appropriate to make comparisons. We examine profitability measures, as well as valuation and debt capacity metrics.
- **Credit ratings agencies' approach**. We have assessed the way that credit rating agencies assess postal companies, and the implications for the levels of metrics necessary for Royal Mail to secure an investment grade rating.
- **Consultation with others in the financial markets**. These discussions are used to inform judgements about their required level of particular financial metrics.
- **Cost of capital approach**. We have examined recent regulatory precedent and market evidence on the range for a WACC that might be used in setting an allowed return.

In the final chapter of this report, we draw together these elements to construct an indicative range for the profitablity of Royal Mail.

Figure 1.1: Our approach to establishing the right level of profitability



1.4. Structure of document

The aim of this document is to provide evidence and analysis on the suitable allowed profit for Royal Mail in the next regulatory regime beyond 2012 commensurate with a financeable universal service. The remainder of this draft final report is structured as follows:

- Section 2 provides extensive market evidence, including financial analysis of comparator companies and feedback from financial market participants.
- Section 3 provides estimates of potential rates of return under different approaches.

A draft of this report was submitted to Postcomm and Ofcom which included a theoretical review of approaches to setting the allowed return, a review of Royal Mail's business plan, assessment of business risks and details of our financial modelling. It also included a concluding section combining financial forecasts with our comparator analysis.

These sections were removed due to duplication with Postcomm and Ofcom's own analysis and for commercial confidentiality reasons.

2. MARKET EVIDENCE

This section presents our analysis of market evidence, in terms of financial data on comparable companies and feedback from the market.

2.1. Comparator companies

2.1.1. Comparators and Data sources

Royal Mail is in the mail delivery business and also undertakes related logistics and delivery activities. Its natural comparator companies are therefore the listed postal companies, in particular those based in Europe. The largest of these are the German integrated operator Deutsche Post, and the Dutch company Post NL. The latter was formed on 26 May 2011 when TNT separated into two companies: the core letters delivery business in the Netherlands, and the faster growing logistics business TNT express. The other smaller comparator in the mail business is Österreichische Post. We have also included companies that are active in related businesses such as logistics and freight forwarding.

Other types of business may also have the same investment characteristics as Royal Mail. Relevant characteristics include:

- "Asset light" companies that offer **services over networks**, but do not own the underlying infrastructure assets. Such companies need to build integrated activities that form their network, including the brand and other intangible assets. Companies in this category include transport businesses.
- **Companies operating in a declining market**, in particular where there is structural change resulting from technical development. We have included companies where the internet is allowing disintermediation, in particular in the provision of package holidays (customers no longer need an agent to provide the holiday package but can readily construct it themselves). Possibly more relevant are directories companies. In the past they supplied information delivered to homes and businesses, taking revenue from advertising. A number of these companies were listed over the last decade, some with attractive valuation metrics. The internet has now replaced this source of information. Box 2.1 provides a summary of financial issues facing a UK directories company. Equity analysts also use "legacy" telecoms businesses as comparators, and we have included these.
- **Companies with problematic labour relations**. Airline companies, in particular the "flag carriers" rather than the low-cost airlines, have a history of union issues, and these also have network features that have similarities with those of a postal service. We have also included Serco, a company which has a track record of managing workforces transferring from the private sector.

A summary of the comparator companies we have included is set out in Table 2.1.

Table 2.1: Comparator companies

Concept	Sector	UK	Rest of Europe	ROW
Same or related business	Mail delivery	UK Mail	Deutsche Post Post NL Oesterreich Post	Singapore Post
	Logistics		TNT Express Panalpina	UPS, Fedex Yamato Holdings
	Freight forwarding		Bollore K&S Corp	Toll Holdings Mainfreight
Services over a network	Transport groups	National Express First Group		
Facing structural change	Directories	Yell Group	Pages Jaunes Groupe Seat Pagine, Eniro	
	Travel groups	Tui Travel	Kuoni	
	Legacy telecoms		Belgacom, KPN	
Restructuring/ unionised workforce	Airlines		IAG, SAS, Lufthansa	
	Outsourcing	Serco		

Source: CEPA analysis

Our analysis is mainly based on data from Bloomberg. Where we have used forward looking forecasts, these are consensus data published by Bloomberg, representing the average of forecasts published by sell-side equity analysts covering the company

Box 2.1: Lessons from a firm with a declining market – Yell

Historic aggressive expansion: acquisition of TPI, Spanish directories business as recently as 2007 for £2.3bn, large goodwill write-off for Spain in year end March 2009 accounts.

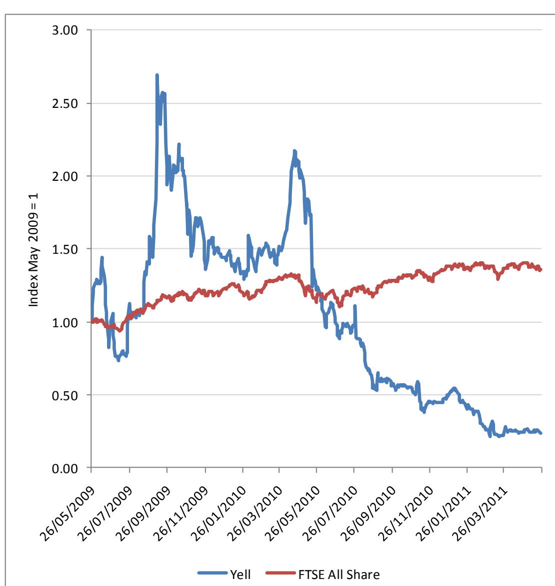
Hard hit from 2007 on, partly by recession, partly by structural decline in demand for directories, exacerbated by high cost of accessing additional cash in the bond markets.

Rapid decline in profitability 2006-08

No substantial change to valuation metrics – around 6x EV/EBITDA, but on a substantially lower base EBITDA

Capital increase to sustain business in 2009-10 successfully raised

Following share price decline, appears to be stable. BUT significant debt maturing in 2013-14 and 2014-15.



2.1.2. Financial performance measures

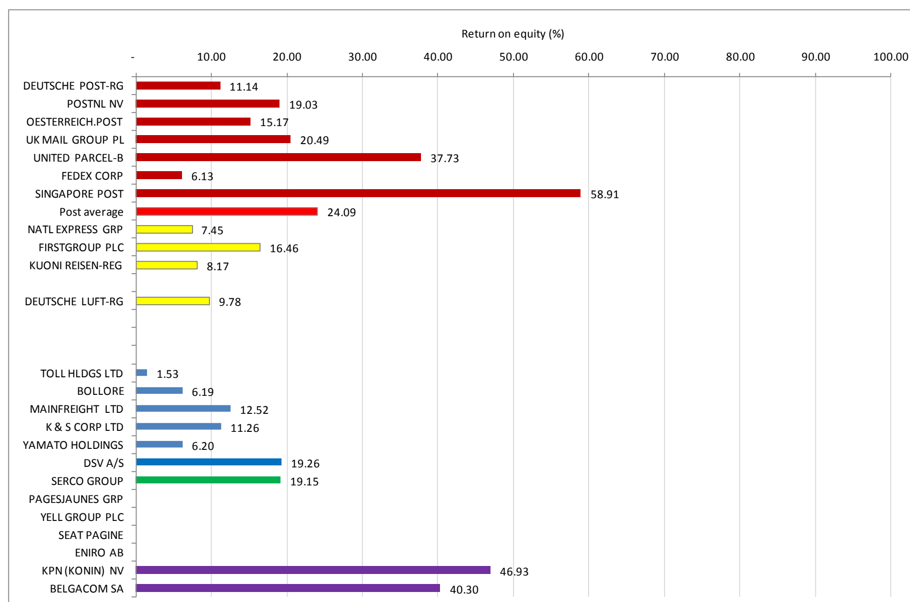
Figures 2.1-2.3 and Tables 2.2-2.3 show data on three measures of financial performance:

- Return on equity, post-tax profit divided by equity capital.
- Return on capital employed, post tax earnings divided by total capital.
- EBIT margin, operating profit after depreciation divided by sales, or a "return on sales".

The following observations can be made from this data:

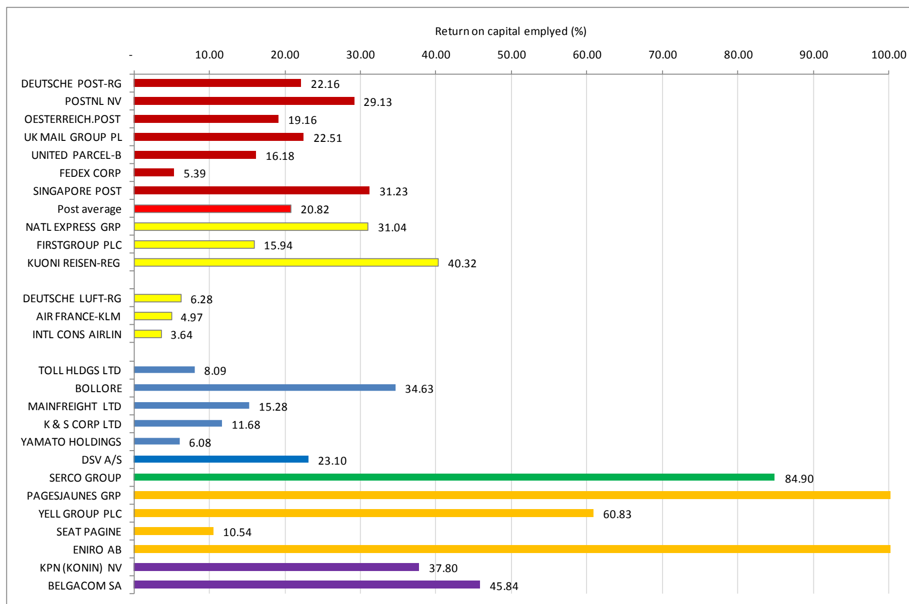
- Throughout this period, the airlines have shown low and volatile returns on equity. Returns on capital have been positive, and more stable, showing the effect of gearing.
- The logistics and freight forwarding businesses show very high returns on capital employed and on equity. This reflects the economics of the business, with the "asset" being intangible, or constructed through operating costs rather than capital investment.
- The directories businesses also show large returns on capital employed. This is likely to be a consequence of the write down of assets rather than strong performance.
- The nominal returns on capital employed from the postal businesses have typically been well above the type of cost of capital numbers that are used to value the business by investors. Typically they are in the range 10-25% but have been higher. They are also fairly volatile.
- Except for the directories business, EBIT margins for other sectors have been in the range 5-10%.

Figure 2.1: Return on equity (%), 2007-11



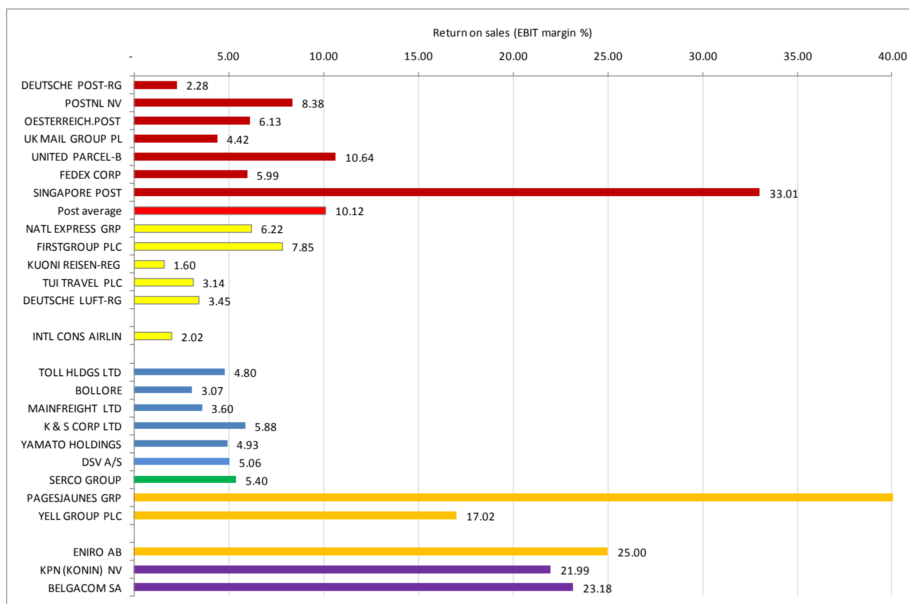
Source: Bloomberg. *2008-10 historic, 2011 forecast

*Figure 2.2: Return on capital employed (%) 2008-11**



Source: Bloomberg. *2008-10 historic, 2011 forecast.

*Figure 2.3: EBIT margin, 2008-11**



Source: Bloomberg. *2008-10 historic, 2011 forecast

Table 2.2: Breakdown of selected comparator RoS

	Return on sales (EBIT to operating revenue)				
	Average 2007	**Average 2008**	**Average 2009**	**Average 2010**	**Average 2011**
DIRECTORIES					
Yell	25.91	25.94	25.41	20.20	#DIV/0!
Pages Jaunes	40.84	42.60	43.48	41.75	42.82
Seat Pagine	30.65	26.72	18.18	17.19	- 21.71
Eniro	28.88	16.37	8.84	24.91	85.99
AIRLINES					
Lufthansa	6.14	6.23	2.65	1.14	4.67
Air France	5.70	3.94	- 4.24	- 2.90	0.52
BA	8.35	7.80	- 1.67	1.51	3.67
SAS	3.16	0.24	- 4.02	- 5.74	- 3.27
POSTAL					
Post NL	12.50	9.75	6.94	6.54	6.54
Deutsche Post	5.46	3.17	- 1.25	2.91	4.29
Oesterreich Post	7.67	7.25	6.67	5.95	5.97
UK Mail	3.50	4.03	4.67	4.68	4.09
UPS	10.40	3.32	8.37	10.38	12.42
Fedex	9.17	7.71	5.23	5.85	6.14
OTHER					
Serco	5.33	5.10	5.16	5.47	5.64

Table 2.3: Breakdown of selected comparator ROCE

	Return on capital employed				
	Average 2007	**Average 2008**	**Average 2009**	**Average 2010**	**Average 2011**
DIRECTORIES					
Yell	98.83	81.29	74.07	50.71	
Pages Jaunes					
Seat Pagine	38.34	32.21	13.86	10.73	24.19
Eniro					
AIRLINES					
Lufthansa	21.42	12.08	4.35	5.10	6.36
Air France	10.52	5.56	4.97	4.97	4.97
BA	6.97	7.63	3.64	3.64	3.64
SAS	31.44	- 3.14	- 3.14	- 3.14	- 3.14
POSTAL					
Post NL	40.10	47.03	49.51	44.21	39.35
Deutsche Post	80.34	62.06	45.72	41.36	38.97
Oesterreich Post	17.33	16.25	16.42	14.66	8.78
UK Mail	17.70	14.93	12.54	9.47	7.56
UPS	28.71	51.10	60.08	55.88	59.42
Fedex	16.18	11.95	14.34	11.94	10.17
OTHER					
Serco	62.33	68.85	69.33	71.20	84.05

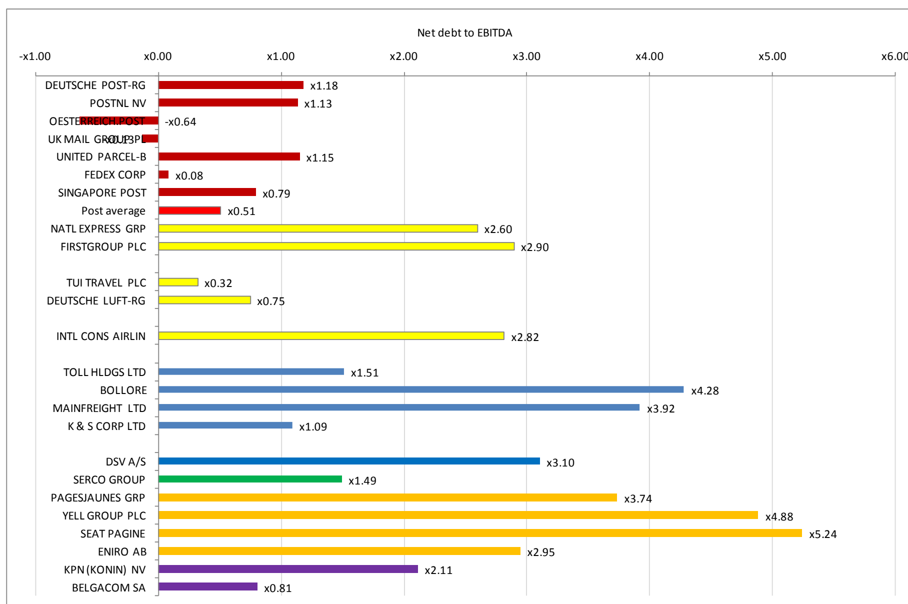
Data provided where available; data irregularities removed

Source: Bloomberg, CEPA analysis

2.1.3. Debt capacity

Data on debt is summarised in Figures 2.4 and 2.5, showing two ratios related to leverage that are commonly used in financial markets, Net Debt / EBITDA and interest cover. The bulk of companies in the set of comparators appear to have chosen relatively low levels of debt. Net debt / EBITDA ratios for a range of companies are around 1.0x. There are a range of companies, though, for which Net debt/EBITDA figures are much higher. These companies, however, are companies that have experienced severe structural decline or the effects of the recession, most notably the flagship airline companies and the directories.

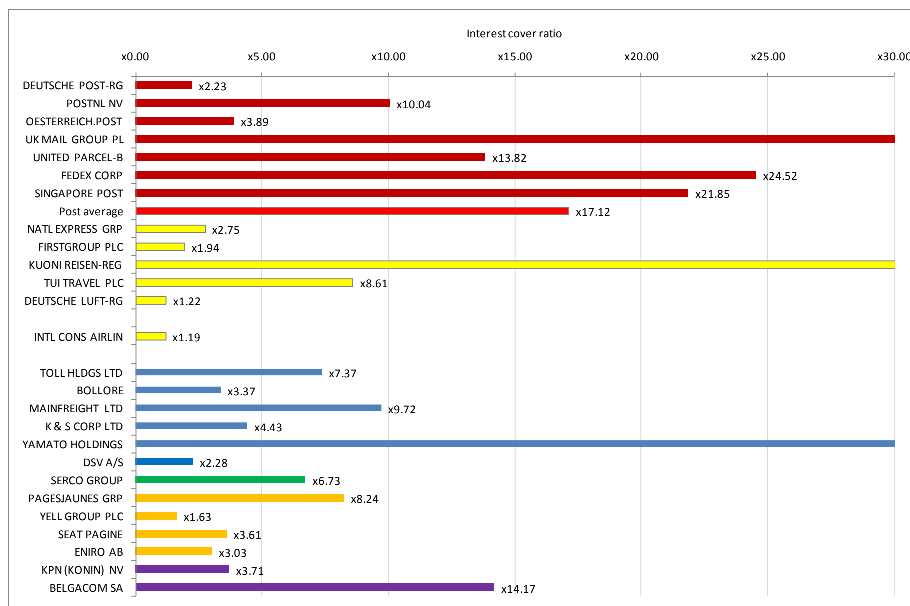
Figure 2.4: Net debt / EBITDA



Source: Bloomberg

Similar observations can be made about the interest cover chart. This indicates that the risk of decline is perceived to be real, and that management and investors see that a conservative financial structure is appropriate.

Figure 2.5: Interest cover (EBIT / net interest)



Source: Bloomberg

2.1.4. Valuation measures

Figures 2.6-2.8 show three of the main valuation measures used in equity markets to assess the value of companies for the comparator companies, plotted against a relevant growth measure:

- the price earnings ratio (**P/E**); this is the simplest measure, representing the ratio of the value of the share divided by the earnings attributable to each share (i.e. after tax and interest, the return to debt capital). We have plotted this against expected growth in earnings per share. Other things being equal a higher expected growth rate would be associated with a higher P/E. It suffers from well known flaws, in particular distortions from accounts, although analysts aim to correct for extraordinary items and non-standard accounting treatments. It remains very widely used as a valuation tool, in particular for less asset-intensive businesses.

- **yield** (or dividend per share / share price). Other things being equal, a higher yield would be associated with a lower growth and vice versa as low growth companies can normally afford to pay out a higher proportion of earnings as dividends, faster growing companies have a higher reinvestment rate; and

- the **EV/EBITDA** (enterprise value, which is the market value of the whole firm, i.e. debt plus equity / earnings before interest, tax, depreciation and amortisation). This measure is not distorted by financial structure. Higher growth in EBITDA is normally associated with higher EV/EBITDA.

Although we have plotted the valuation measure against a growth measure, it is important to note that other factors will also affect the valuation ratio that is appropriate for a business, including perceptions of risk and the duration of assets.

The P/E vs. EPS growth chart shows the following:

- A core group of companies with average growth and P/E ratios (growth of 5-15% pa, P/E of 8.0x – 12.0x);
- A cluster of companies with higher expected growth trading at higher than average multiples, representing the logistics and freight forwarding businesses (growth exceeding 17%, P/E exceeding 12.0x);
- Companies with very low P/E, with an uncertain future (two of the directories businesses, with low single digit P/E);
- A few companies with negative growth, and a low P/E. Most notably these are Post NL (directly comparable to Royal Mail) and Pages Jaunes, a shrinking directories business.

The yield chart shows three main groups:

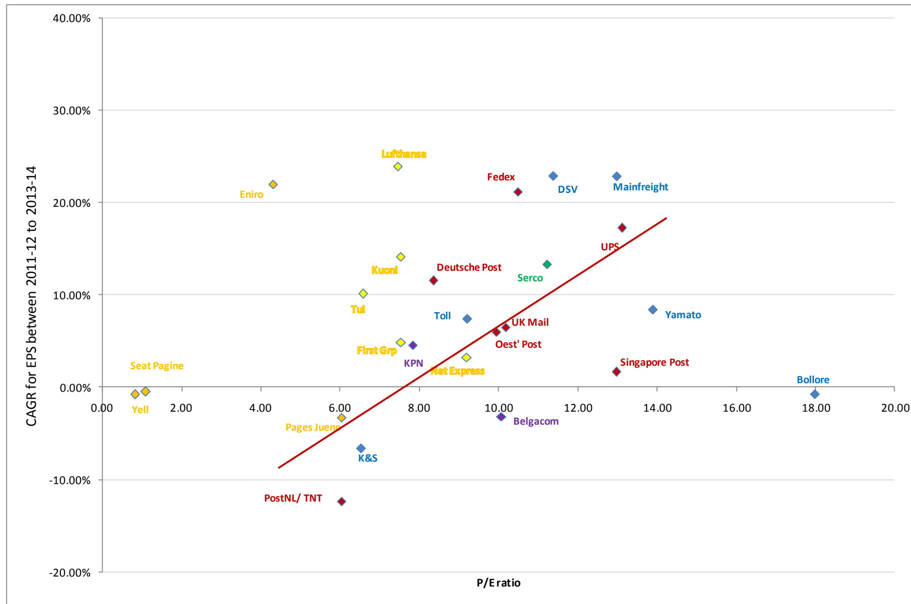
- Companies which have passed on the dividend (we have adjusted the data for these to show them on the vertical axis);
- Companies with lower yields, but offering faster growth. As with the P/E chart these are mainly the freight forwarding and logistics companies. In addition, the group includes Serco, the outsourcing group.
- Companies with higher yields, offering slower growth. This includes the postal groups in the sample and other network businesses.

The chart of EV/EBITDA ratios vs EBITDA growth shows similar relationships:

- It is interesting to note that the airline groups trade at low multiples. This suggests the market perceives high risk associated with the earnings of these companies;
- Most postal companies trade at low multiples of 4.0-6.0x.
- Higher multiples in the comparator group are associated with much faster growth exhibited by the logistics focused companies.
- The measure for Post NL is higher than the other postal groups, which may be distorted by misstatement of consensus data, a problem which is common around demergers.

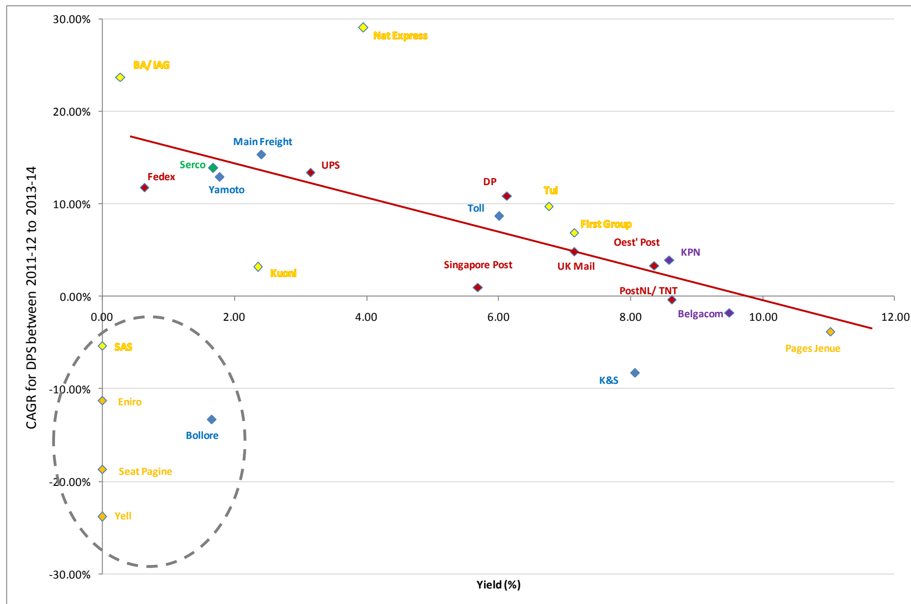
It is also important to note that infrastructure and utility businesses typically trade on much higher EV/EBITDA multiples of 8.0-10.0x or more, where longer term earnings are secure and volatility of earnings is low. Higher multiples (above 10.0x, and as high as 20.0x) are considered appropriate for long duration toll roads, with remaining concession lengths of decades. Lower multiples are considered appropriate for infrastructure companies where concession lengths may be shorter (e.g. Veolia Environnement). The data suggests that even if Royal Mail's business can deliver profits, the low growth and risk associated with the market will be associated with an EV/EBITDA valuation that is in the range 4.0-6.0x.

Figure 2.6: Prospective 2011 P/E vs 2011-13 EPS growth



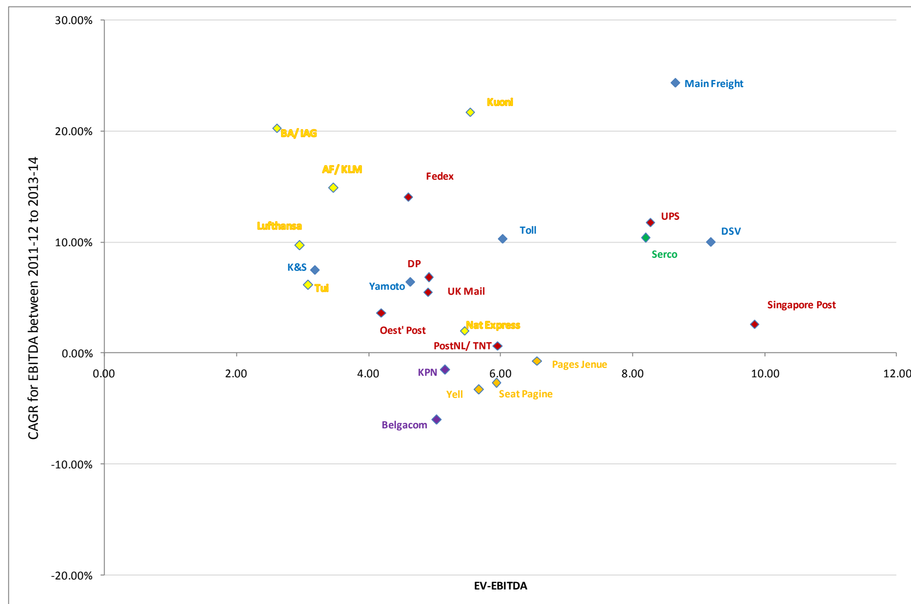
Source: CEPA analysis of Bloomberg data

Figure 2.7: Prospective 2011 yield vs 2011-13 dividend growth



Source: CEPA analysis of Bloomberg data

Figure 2.8: Prospective 2011 EV/EBITDA vs EBITDA growth

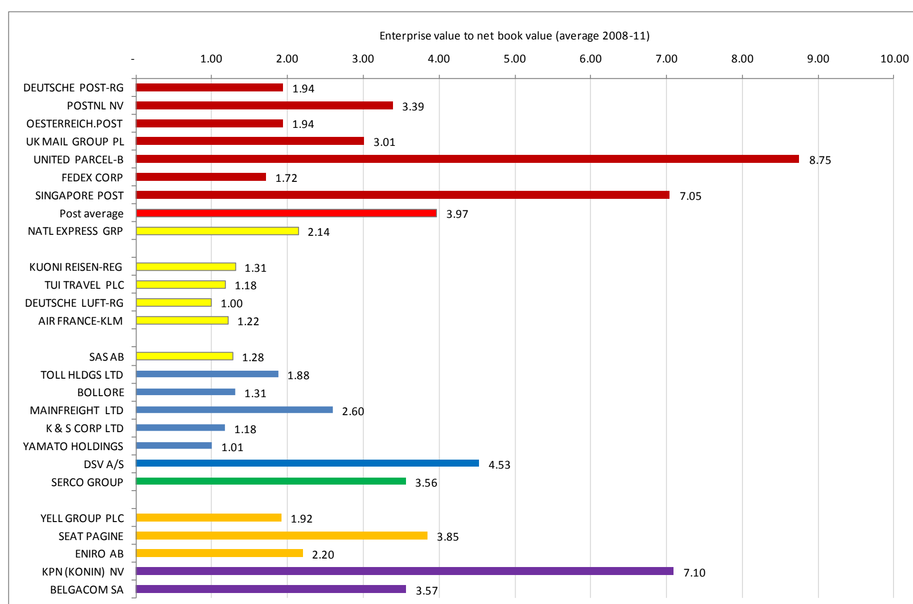


Source: CEPA analysis of Bloomberg data

Another measure that is used to assess company value is the market to asset ratio. This is a measure the value premium to the historic investment in assets. As is well known, market to asset ratios for non-regulated companies (i.e. with no RAB and with diverse approaches to measuring assets, e.g. intangibles) must be treated with caution. Nonetheless, Figure 2.9 indicates the following:

- Historic directory companies have traded at a large premium to NBV, but with sharp declines in share prices these now trade at a discount.
- Some large premia to NBV for the logistics companies, or other companies where the investment in the business is in operations. This is the case, for example with UPS. Serco also has an "asset-light" strategy, putting in place a set of skills that allow it to earn margin on contracts (some of which are of long duration) but without investment in assets to secure these.
- Low ratios of EV/NBV for the airlines businesses. Although these businesses have valuable recognisable brands, the market only values these when they can be monetised. This has not been the case in the recent past with falling yields and prices during the recession, and at the same time these companies have borne continued fixed costs associated with their extensive route networks.
- Post businesses appear to be trading in a large range of 1.0-2.0x. There is clearly a large differential in the way that these companies are able to exploit their capital equipment – and indeed some may have chosen different mixes of capital and operating costs to achieve similar objectives, which would affect the ratios. Post NL has a higher multiple, which may again be due to distortions around the demerger.

*Figure 2.9: Market to asset ratio (Enterprise value / Net Book Value of tangible assets), 2008-11**



Source: CEPA analysis of Bloomberg data. 2008-10 historic, 2011 forecast.

2.2. Feedback from market

As part of the workstream to generate market evidence on financeability, we have undertaken a range of detailed discussions with financial market participants. These three categories include:

- debt rating agencies;
- investment analysts; and
- representatives of investors.

In the current context, we have not conducted a large capital markets survey, but have rather had a more limited number of focused conversations with individuals where we expected valuable insights. Our questioning focused on ascertaining views on:

- the outlook for the mail services market;
- appropriate comparators;
- the metrics which would be used for credit ratings;
- the approach to regulation, and in particular how the approach to regulation might affect; and
- Royal Mail as an equity investment, and in particular what would need to change to make it saleable, how it would be valued, and the appropriate cost of capital for the business.

2.2.1. Outlook for mail services market

There was consensus about the long-term structural decline in the letters market served by universal service porducts. The precise assumptions about the pace of decline varied. Typically those surveyed considered declines of 5-7% pa are to be expected, but there were some

expecting lower declines (of 2-3%) in letters. In line with statements made by companies, prospects in other segments of the business were seen to be better, with some modest growth in parcels typically expected.

In terms of competitive pressures, in the long term it was thought that there was room for only two or three substantial players in the market. With a shrinking business, it was thought unlikely that more players would be able to support the necessary scale of operations. However, competition is seen as very important, in particular it was suggested that the prospect of competition should be used by Royal Mail to force radical restructuring in its own business – without real threats radical change won't occur.

2.2.2. Appropriate comparators

All the financial market participants needed to compare Royal Mail to the European Postal operators. For those analysing debt, this is Deutsche Post, Post NL, and in addition Post Italienne. For equity, it is Deutsche Post, Post NL, and Österreich Post.

Although other companies operate in markets that have similar characteristics, they were not all considered to be sufficiently similar to warrant comparison. However, equity analysts are beginning to consider fixed line telecoms companies as comparators, since they offer services in a changing market over a relatively asset-light network.

Interestingly, debt analysts were very concerned about the significant differences between the companies. This did not concern equity analysts. They believed that while the businesses are distinctive, they were sufficiently similar to make these comparators helpful as a guide to what investors should do.

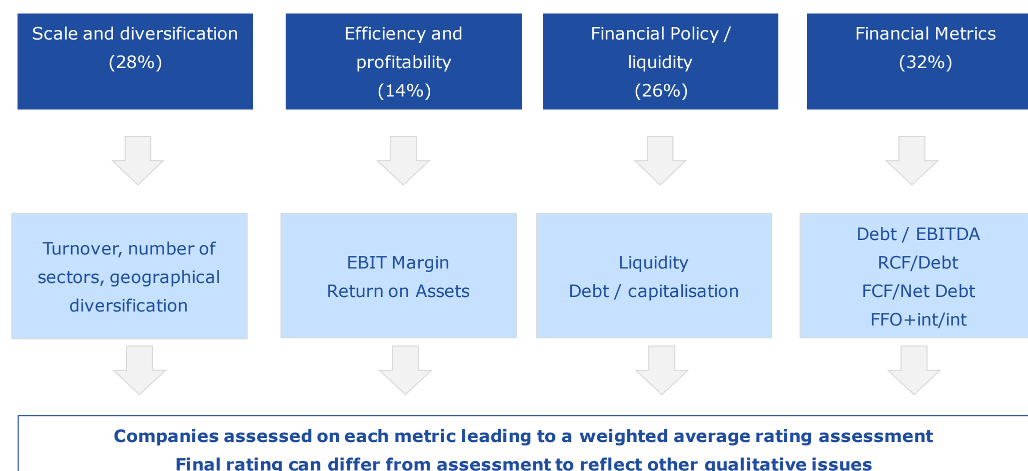
2.2.3. Metrics for credit ratings

The market participants other than the rating agencies relied on the rating agencies for views on the credit metrics. In this sub-section, therefore we will focus on the views of the two rating agencies which cover postal services, S&P and Moody's. Others commented that the debt investors appeared to do more detailed financial analysis than the agencies, and considered robustness against a broader range of scenarios, but the metrics that they tested were very similar, or exactly the same.

Moody's has a clear framework that it uses for assessing companies in the sector.[3] Companies are assessed on a range of criteria, and a rating awarded to each (on the same scale as the rating methodology). These factors include the standard type of credit metrics based on financial analysis. In addition, some qualitative factors reflecting the scope, and riskiness of the business are also included. This is summarised in Figure 2.10.

[3] Moody's (2008). Rating Methodology: postal and express delivery companies. December 2008.

Figure 2.10: Moody's rating methodology



Source: CEPA analysis of Moody's

Some points are worth highlighting as being important for the rating:

- **Scale** is considered important, with larger businesses expected better to be able to be robust to changing market conditions, maintaining market share, and investing in new technology when needed.
- **Stability** of the business is assessed by a qualitative analysis of entry barriers, and exposure of the different businesses of the company to cyclical trends. Diversification also seen as valuable, with reliance on one major revenue stream considered negatively. This is assessed through the number of different types of activity accounting for at least 10% of turnover (activities include postal, express delivery and banking).
- **Geographic diversification** – and the risks associated with certain markets – also reflected in the rating.
- **Sustained** high measures of **profitability** (EBIT margin and return on assets) are seen as important. Where there isn't a track record of sustainable profitability, it would likely lead to a lower rating than would otherwise be warranted. Analysis of management performance and response to developments are a part of this rating assessment.
- The remaining measures reflect standard credit rating assessments, summarised in Figure 2.10. These reflect liquidity and ability of cash flows to meet interest payments.

The scores for each of these factors are aggregated, through a weighting process. It is possible for the agency to move away from the indicated ratings based on judgement, usually such deviations are no more than one notch.

The detail of S&P's approach is different although the broad principles are the same. Essentially the risks for all companies in different sectors are assessed on a similar framework to ensure consistency of ratings across sectors. Risks are divided into two broad categories:

- Business risk, reflecting the country/ countries in which the company does business; the risks facing the industry and the company's competitive positioning within it; and how profitability stacks up against the competition.

- Financial risk. These reflect choice such as gearing, governance, adequacy of cash flows to meet interest payments.

These factors are rated separately, and combined to form an overall rating using Figure 2.11.

Figure 2.11: S&P stylised methodology

Business And Financial Risk Profile Matrix

Business Risk Profile	Financial Risk Profile					
	Minimal	Modest	Intermediate	Significant	Aggressive	Highly Leveraged
Excellent	AAA	AA	A	A-	BBB	--
Strong	AA	A	A-	BBB	BB	BB-
Satisfactory	A-	BBB+	BBB	BB+	BB-	B+
Fair	--	BBB-	BB+	BB	BB-	B
Weak	--	--	BB	BB-	B+	B-
Vulnerable	--	--	--	B+	B	CCC+

These rating outcomes are shown for guidance purposes only. Actual rating should be within one notch of indicated rating outcomes.

The values of the metrics used to determine ratings are highlighted in Figure 2.12. A few points are worth highlighting:

- Businesses perceived as higher risk do need much tighter values for the credit metrics to be able to sustain an investment grade rating. Margins need to be around 50% larger, as does return on assets. Leverage metrics suggest that debt needs to be around 50% lower.

- The level of the metrics is also quite distinct from those of typical "infrastructure" businesses which are more typical of industries subject to price regulation.

Figure 2.12: Credit metrics and investment grade

	Values consistent with investment grade	Values consistent with investment grade for higher business risk	Network utilities	
Moody's				
EBIT margin	8-12%	12-16%		
Return on Assets	6-10%	10-13%		EBITA/average assets
Debt / EBITDA	2.5-3.5x	1.5-2.5x	Not credit metric, but >5.0x frequently observed	
RCF/Debt	12-20%	20-30%		RCF is after dividends
FCF/Net debt	5-10%	10-15%		
(FFO + interest)/ interest	4-6x	6-8x	2.5-4.5x	
Net Debt / RAV	n/a	n/a	55-70% or higher with credit protection	
S&P				
FFO/Debt	30-45%	45-60%	10-15%	
Debt / EBITDA	2-3x	1.5-2x		

Source: collated from S&P and Moody's

Lenders and ratings agencies will tend to evaluate creditworthiness on the basis of the group cash-flows, to the extent that they see security in the subsidiary cash-flows. Royal Mail's earnings from GLS can thus contribute towards financeability.

Some other important feedback from the rating agencies included the following:

- **Regulation**. This was not a focus of the analysis, and an explicit recognition of RAB for the UK was unlikely as other countries do not use this methodology.

- **History**. It is much harder to get an investment grade rating without a track record of sustained profitability.

- **Comparable risk**. Royal Mail is seen as much riskier than the other comparator companies. This is a combination of the scale, lower diversification, as well as the poor track record of achieving cost cuts. The scale and competitiveness of Deutsche Post seem to offer it considerable safety.

2.2.4. Approach to regulation

There was a strong – but not universal – sentiment that the form of regulation is unlikely to have a major impact on appropriate metrics and/ or valuation. For example, rating agencies didn't necessarily discuss regulation with companies prior to issuing a rating or rating change, but rather focused on the credibility of the sustainability of companies achieving the metrics.

Most of those surveyed considered that the form of regulation has less impact on valuation than market dynamics following deregulation of postal services and the prospect of volume declines. Valuation would depend on cash generation, and the use of a RAB rather than other metrics would not be a key determinant of that. One analyst expressed a view strongly that regulation of any form was unnecessary.

A few respondents, though, said that it was possible that a RAB could make a difference to the confidence that they would place in the long term sustainability of the business, and thus positively affect their investment decision. For it to do this, though, it was important that there was absolute clarity about how the RAB would be recovered, in particular in the event of extreme downside scenarios. If this were not clearly set out, there would be little value in the RAB approach. So the use of the RAB would be beneficial if this can be demonstrated to increase confidence in future returns.

Other comments on regulation included the following:

- One respondent said that the fast pace of change in postal markets meant that the regulator needed to be able to respond very quickly, in stark contrast to the five yearly price controls seen in other sectors.
- It needs to be clear that investors must be able to benefit from the upside in the event that all goes well (i.e. earn supernormal returns).
- The USO needs to be properly defined and Royal Mail rewarded for delivering it in a clear and transparent way.

2.2.5. Royal Mail as an equity investment

In our draft report we presented investors' views and our own analysis of the investment opportunity Royal Mail presented. This analysis has been largely redacted to avoid interfering with financial market views and processes relating to possible privatisation. In general, postal services and logistics companies, are not likely to be viewed as conventional infrastructure companies by many of the traditional holders of those assets.

2.3. Summary

We have constructed a dataset of financial information from companies facing similar issues to Royal Mail, for example:

- those on similar or related business, such as postal services companies and logistics firms;
- those who run services over an "asset-light" network other than the above;
- those facing structural change in relation to e-substitution and market decline; and
- those with a unionised workforce or requiring cost restructuring.

Our assessment focuses on measures of financial performance, debt capacity/ sustainability and approaches to valuation. We are able to infer the following:

- Companies most directly comparable to Royal Mail, i.e. those in post, logistics and outsourcing, tend to have high returns relative to equity and total capital. These return ratios are much higher than the cost of capital for a regulated utility, which are much more asset-heavy and capital intensive
- At the same time, postal firms have a return of sales in the range of 5-10% (EBIT to revenue), larger than the range of 3-6% for logistics or outsourcing firms. All three sets of firms are asset-light, but sales margins are high in post most likely because of the considerable market and structural risks they face (or perhaps the fact that competition is less intense).
- Postal services companies do not have high levels of gearing, indeed, lower than those of logistics and travel services firms. This again points towards the market risks they face, including high income elasticity and competition.
- Those companies paying less dividend today are likely to have stronger growth prospects compared with our other comparators. For example, the logistics, outsourcing and US postal firms are relatively "low dividend, high growth". The European postal companies have higher expected 2011 yields of 6-9%, but growth of less than 10% (as do travel and legacy telecoms). This suggests that an equity investor will require a high yield in light of expected market decline.
- Postal firms tend to be valued at x4-6 times EBITDA (higher in some cases), which is less than infrastructure companies (x8-10) but similar to many logistics firms and the 'legacy' telecoms firms. This tells us that Royal Mail is likely to be viewed by an acquirer more like these peers than a regulated utility.
- A higher price to earnings (P/E) ratio is associated with stronger earnings growth forecasts for most firms. Limited earnings growth and a low market multiple is a feature, for example of Post NL. Firms with an uncertain future have a lower market multiple. Postal firms tend to have a market multiple of x8-10, lower than previous years.
- In terms of enterprise value to net book value of tangible assets, i.e. similar to market asset ratios (MAR) examined by regulators, postal companies tend to be high at x2-4,

relative to logistics (x1.3) and transport companies (x1-2). This may reflect a lighter asset base or higher growth prospects.

Overall, our market analysis provides us with a set of market comparators by which we can judge reasonable returns for a notional investor in Royal Mail, considering its projected performance. This is particularly useful when comparing these companies to infrastructure sectors.

Table 2.4: Summary of financial comparators (2011 except debt metrics which are 2010)

	Return on equity		**ROCE**		**EBIT margin**		**Net debt to EBITDA**		**Interest coverage**	
Post average	26.6%		19.6%		10.1%		x0.33		x19.71	
Serco	20.4%		57.1%		5.6%		x0.80		x8.28	
	Q1	**Q3**	**Q1**	**Q3**	**Q1**	**Q3**	**Q1**	**Q3**	**Q1**	**Q3**
Postal companies	16.4%	35.9%	18.8%	23.1%	5.0%	11.7%	-x0.16	x0.86	x4.83	x18.82
Travel companies	1.6%	8.0%	31.7%	65.5%	2.8%	7.4%	-x0.65	x2.15	x2.86	x13.80
Airlines	-2.4%	11.5%			-1.0%	1.4%	x1.66	x10.20	x0.54	x1.81
Logistics companies	7.8%	10.4%	9.7%	28.6%	4.7%	5.2%	x1.09	x1.99	x3.44	x10.03
Directories companies	-96.8%	-46.6%	38.4%	38.4%	-4.8%	24.4%	x2.95	x5.08	x2.57	x4.95
Telecoms companies	46.0%	47.9%	39.3%	44.3%	24.4%	24.5%	x1.02	x1.77	x5.43	x5.72

	EV-NBV		**EV-EBITDA**		**P/E Ratio**		**Yield**	
Post average	x2.97		x5.83		x9.76		6.1%	
Serco	x2.50		x8.18		x11.47		1.7%	
	Q1	**Q3**	**Q1**	**Q3**	**Q1**	**Q3**	**Q1**	**Q3**
Postal companies	x1.34	x3.89	x4.59	x6.71	x8.66	x11.54	4.6%	7.2%
Travel companies	x1.10	x1.32	x4.05	x5.70	x7.29	x8.13	3.5%	7.1%
Airlines	x0.30	x0.65	x2.68	x3.82	x7.08	x11.33	0.0%	1.7%
Logistics companies	x0.95	x2.28	x4.97	x8.10	x10.07	x13.96	1.6%	5.0%
Directories companies	x0.08	x0.27	x5.79	x6.06	x1.04	x4.56	0.0%	3.1%
Telecoms companies	x2.91	x3.94	x4.96	x4.97	x8.11	x9.32	9.1%	9.5%

3. ESTIMATING A RATE OF RETURN

Given the market evidence of appropriate comparator companies, statistics on measures of returns and financeability, and the views of market participants, in this section we summarise potential estimates of an appropriate return for Royal Mail. We take three approaches to this:

- Estimated Weighted Average Cost of Capital (WACC) based on the Capital Asset Pricing Model (CAPM) model and using market evidence and regulatory precedent as if Royal Mail were in a similar asset class to other infrastructure companies. As an infrastructure type investment, the market might perceive a high level of security on future revenues (e.g. by assuming that the market would have great confidence that the company would be able to recover its investment in RAB with a reasonable return with high confidence).
- As above, but with a broader consideration of the asset class to include logistics companies facing greater cyclicality of revenues, and higher risk from competition.
- A more market-driven approach that uses a suite of financeability measures including returns on sales as well as credit metrics.

This section sets out the context to setting a return for Royal Mail, before providing draft estimates in these three areas.

3.1. Context to setting the return

An assessment of the cost of capital for Royal Mail needs to be made subject to a number of important caveats:

- There is currently no private finance, either debt or equity, and thus there is no traded security on which to draw evidence.
- Our market consultations suggest that the degree of risk associated with Royal Mail, or parts of it, would be perceived by the market to be higher risk than other comparator postal service companies.
- The form of regulation to apply in future has not yet been settled, and the cost of capital will clearly depend on the perceived risks associated with this.

These factors make a full assessment of the appropriate rate of return for Royal Mail different to the usual regulatory process.

In addition, Royal Mail provided a view on its appropriate cost of capital in 2008. In terms of supporting a conventional approach, we feel that this provides a sensible approach and starting point. We comment on estimation of specific parameters below.

3.2. Conventional approach – "infrastructure" WACC

At this early stage, it is helpful to consider the approaches to the cost of capital, and to suggest how this might be interpreted. A 'conventional approach for doing so will use the CAPM as a framework for determining the cost of capital; examining recent regulatory precedent and market evidence to inform the judgements of values to be used in the CAPM formula.

Regulatory precedent

Table 3.1 sets out the key ranges for the values used in the CAPM for several recent decisions by a range of regulators. We provide comments on specific CAPM parameters below.

Table 3.1: Regulatory precedent on the cost of capital

CAPM	**Postcomm**		**Ofcom**		**Competition Commission**		**Ofgem**	
	Price control review 3 (2006)		**Openreach consultation (2011)**		**Stanstead decision (2011)**		**EDPCR5 (2009)**	
	low	***high***	***low***	***high***	***low***	***high***	***low***	***high***
Risk-free rate	2.50%	2.50%	1.50%	1.50%	2.00%	2.00%	2.00%	
Debt risk premium	0.50%	0.50%	2.00%	2.50%			1.50%	
Equity risk premium	3.50%	5.00%	5.00%	5.00%			3.00%	5.00%
Asset beta	0.65	0.75	0.40	0.50			0.24	0.34
Equity beta			0.68%	0.98%	1.00%	1.24%		
Gearing	20.00%	20.00%	50.00%	50.00%	50.00%	50.00%	65.00%	
Tax	28.00%	28.00%	25.00%	25.00%	28.00%	28.00%		
Cost of equity (pre-tax)					5.00%	8.20%	6.70%	6.70%
Cost of debt					3.40%	3.70%	3.60%	3.60%

Risk-free rate

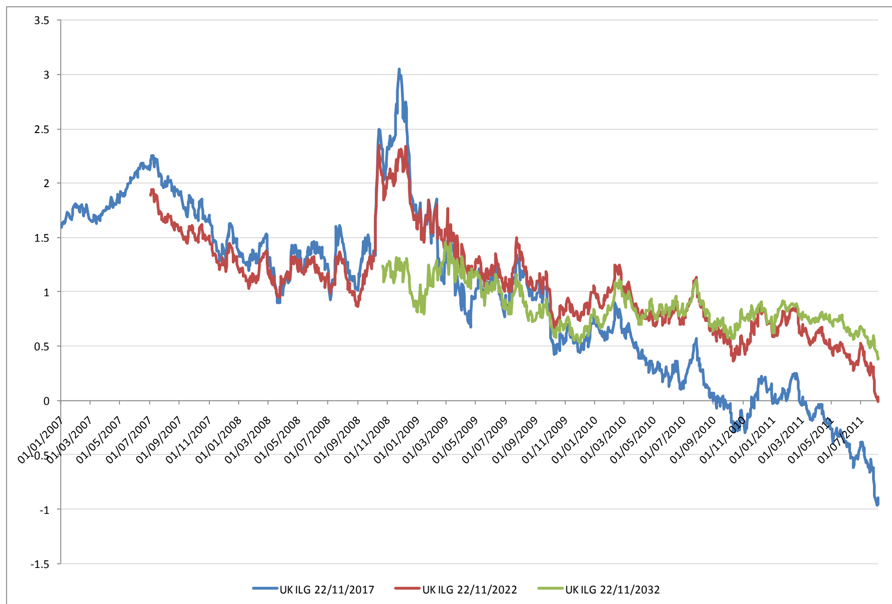
Firstly, there seems to be regulatory consensus on a lower risk-free rate than the previous Royal Mail price control, with recent decisions settling around 2.0%. This is supported by market evidence, from which we can see declines in real yields to maturity on UK Index-linked gilts with five, 10 and 20 year maturities, particularly since 2009. Table 3.2 summarises average yields for these maturities, while Figure 3.1 shows these movements over time.

Table 3.2: Summary of average yields on UK ILGs

Feature		**UK Index-linked gilts**		
Maturity		22/11/2017	22/11/2022	22/11/2032
Issue		08/02/2006	11/07/2007	29/10/2008
Amount		11,984,000,000	14,754,720,000	12,978,452,000
Moody's		Aaa	Aaa	Aaa
S&Ps		NR	NR	NR
Currency of issue		GBP	GBP	GBP
Av. Yield to Maturity	2007	1.799	#N/A	#N/A
	2008	1.527	1.368	#N/A
	2009	1.001	1.182	0.939
	2010	0.260	0.788	0.816
	2011	-0.235	0.525	0.719

Source: Bloomberg

Figure 3.1: Yields to maturity over time



Source: Bloomberg

On balance, there is some evidence that real risk-free rates might be below those featuring in recent regulatory decisions, although many of these market effects may be temporary. Therefore a reasonable range could be between 1% and 2% (in line with the Competition Commission's suggested range in its Bristol Water decision).

Debt premium and gearing

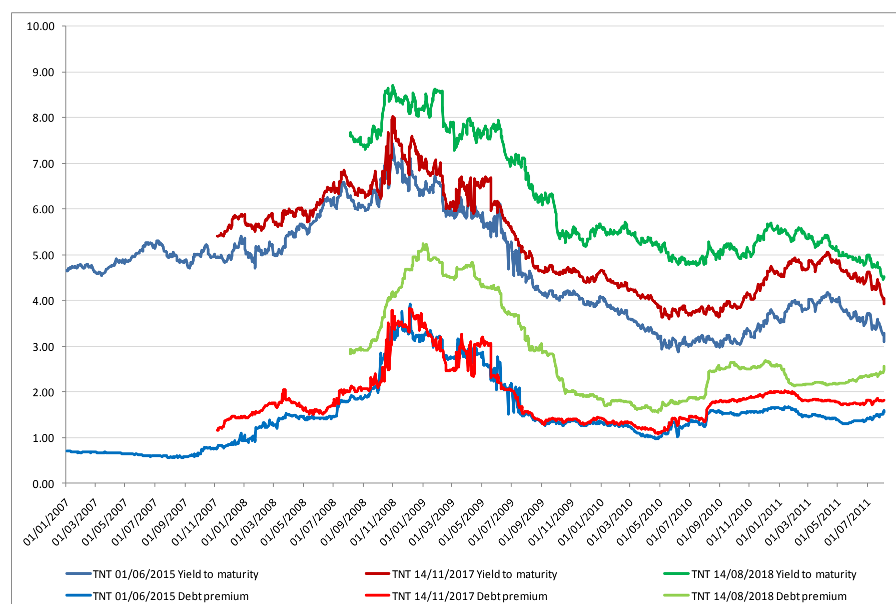
Greater consideration of postal market factors since PCR3 would provide a case to move toward higher lending margins and lower gearing. This is similar to the upper bound of a recent Ofcom consultation ("Openreach"), which would be a reasonable reflection of Royal Mail's default risk. However, in its 2009 electricity market decision, Ofgem use a lower spot estimate for the debt premium. Table 3.3 and Figure 3.2 also suggest that debt premia since the 2008-09 financial crisis have fallen (to around 2.0%) for comparable postal services companies. However, it is reasonable to assume that Royal Mail would remain at the higher end of any industry range. Therefore, we use a debt premium of 2.5%.

Table 3.3: Yields and spreads for postal company bonds

Feature		Post NL - Outstanding bonds		Deutsche Post(1) - Outstanding bonds		UPS(2) - Outstanding bonds		Fedex(3) - Outstanding bonds
Maturity		01/06/2015	14/11/2017	04/10/2012	30/01/2014	15/01/2021	12/02/2031	15/01/2019
Issue		01/06/2005	14/11/2007	04/10/2002	30/10/2003	12/11/2010	12/02/2001	16/01/2009
Amount		400,000,000	650,000,000	750,000,000	1,000,000,000	1,500,000,000	500,000,000	750,000,000
Moody's		N/A	Baa1	Baa1	Baa1	Aa3	Aa3	Baa2
S&Ps		BBB	BBB	BBB+	BBB+	AA-	AA-	BBB
Currency of issue		EUR	EUR	EUR	EUR	USD	GBP	USD
Av. Yield to Maturity	2007	4.928	#N/A	4.613	4.758	#N/A	5.239	#N/A
	2008	5.943	6.355	4.810	5.110	#N/A	5.953	#N/A
	2009	5.080	5.552	3.310	3.949	#N/A	5.971	#N/A
	2010	3.338	4.052	2.012	2.551	#N/A	5.065	4.377
	2011	3.779	4.659	2.157	2.766	3.778	4.964	4.158
Av. Debt premium	2007	0.683	#N/A	0.457	0.575	#N/A	#N/A	#N/A
	2008	1.919	2.151	1.110	1.376	#N/A	1.299	#N/A
	2009	2.073	2.095	1.257	1.615	#N/A	1.699	#N/A
	2010	1.351	1.532	1.001	1.205	#N/A	0.823	1.248
	2011	1.461	1.821	0.727	1.046	0.645	0.754	1.187

Source: Bloomberg; (1) DP Finance; (2) United Parcel Service; (3) Fedex Corporation

Figure 3.2: Post NL bond yields and spreads over time



Source: Bloomberg

In PCR3, notional gearing is assumed to be 20%. This is clearly much less than other sectors. For example, Ofgem (December 2009) and Ofwat (November 2009) both raised their gearing assumptions by 2.5% compared to their previous determinations to 65% and 57.5% respectively. More recently, the Competition Commission ('CC') used an assumption of 60% gearing in the Bristol Water reference. Treating Royal Mail as an infrastructure company as per the previous determination, we see no reason to deviate from 20% total debt to total capital.

Cost of equity

Across different sectors regulatory determinations appear to be reaching a consensus on the equity risk premium of 5.0%. We see no reason to deviate from 5.0%.

Similarly, treating Royal Mail as an infrastructure asset, a range for the asset beta of 0.7-0.9, higher than that of the electricity distribution companies and BT Openreach, seems reasonable.

While corporation tax rates are due to fall to 24%, hence the rate used by Ofcom in their recent decision, we remain conservative with a rate of 28%.

Therefore a range for the pre-tax cost of equity is 6.7% to 9.2%. While this is higher than Ofgem (2009) and the Competition Commission's recent determination for Stanstead Airport, it is comparable to Potcomm's estimate in PCR3 of 6.6% to 8.7%.

Recent postal market evidence is described below in terms of an alternative approach.

WACC estimate

Treating Royal Mail as an infrastructure asset (albeit one facing somewhat greater market risks than a utility and a low level of gearing) and using a conventional CAPM approach based on regulatory precedent, we generate a range for the "vanilla" pre-tax WACC of 6.2% to 8.6%. This is similar, but with a higher upper range, to that estimated by Postcomm in PCR3.

3.3. Amended approach – "logistics" approach

Our judgement is that the key differences from the usual infrastructure assessment set out above will be in terms of (i) notional gearing; and (ii) the cost of equity (specifically the asset beta).

Notional gearing

As can be seen in Table 3.4, gearing levels in other European postal companies are low and falling. Both Post NL and Deutsche Post have gearing (total debt as a percentage of total capital) of less than 40%, while it is less than 10% for Oesterreich Post and UK Mail. Given this, we regard any level of gearing as being an aggressive assumption within CAPM, and so would assume zero debt in the capital structure.

Table 3.4: Gearing levels for postal companies

Postal operators	Gearing (total debt to total capital)				
	Average 2007	Average 2008	Average 2009	Average 2010	Average 2011
Post NL	40%	47%	50%	44%	39%
Deutsche Post	80%	62%	46%	41%	39%
Oesterreich Post	17%	16%	16%	15%	9%
UK Mail	18%	15%	13%	9%	8%
UPS	29%	51%	60%	56%	59%
Fedex	16%	12%	14%	12%	10%

Source: Bloomberg

This indicates that gearing should be the lowest of the comparators, and thus zero, or lower. Previous analysis (e.g. by other consultants) suggesting that 20% might be an appropriate level of gearing was undertaken prior to continued and accelerated declines in relevant segments of the postal services market and volatile financial market conditions.

Cost of equity

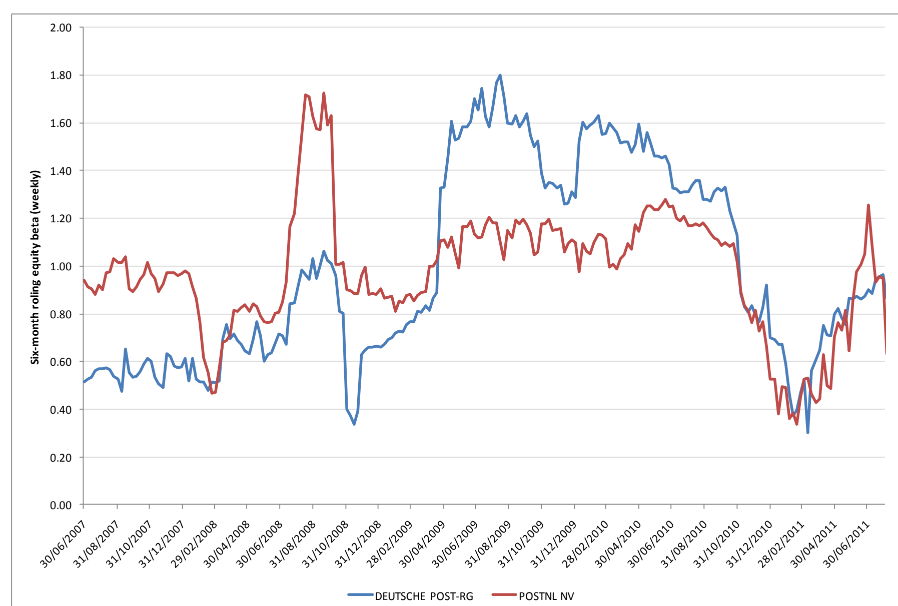
Market evidence on a range of companies is shown in Table 3.5, and the six month rolling average equity betas for Post NL and Deutsche Post are shown in Figure 3.3.

Table 3.5: 6-month rolling equity betas for postal companies

Postal operators	Rolling six month equity betas				
	Average 2007	Average 2008	Average 2009	Average 2010	Average 2011
Post NL	0.56	0.70	1.29	1.34	0.71
Deutsche Post	0.95	0.98	1.06	1.08	0.67
Oesterreich Post	0.72	0.60	0.03	0.49	0.53
UK Mail	- 0.09	0.13	0.27	0.24	- 0.29
UPS	0.56	0.94	1.03	1.01	1.08
Fedex	0.92	1.03	1.24	1.09	1.32

Source: Bloomberg

Figure 3.3: Rolling equity betas for Post NL and Deutsche Post



Source: Bloomberg

The data indicate that the equity beta for the sector is not stable. For the main comparators Deutsche Post and Post NL, the equity betas have ranged between around 0.4 and 1.8 over the last four years, and lower figures for other comparators (e.g. the beta for UK Mail averaged 0.09 in 2007). However, it should be noted that betas for infrastructure companies are also not stable, and this is particularly the case at times of market turmoil when "normal" equity beta relationships are disturbed.

Overall, we judge that an asset beta (or equity beta since we assume no gearing) of 1.0-1.2 (with an average of 1.1) would be a realistic reflection of the risks facing logistics companies. The market evidence shows that, while the equity beta is not stable for the comparator companies, it

is higher than that exhibited by infrastructure companies. Furthermore, Royal Mail's financial performance has continued to be volatile, and evidence suggests that this may continue.

Comparison

These additional considerations give rise to an estimate for the pre-tax WACC for a logistics company, and Royal Mail in particular, of 9.7% to 10.4%. This is clearly higher than implied by a conventional analysis that regards the company as an infrastructure company.

Figure 3.4: WACC calculation under different approaches

CAPM parameter	General assumptions		Infrastructure Company		Logistics Company	
	Low	*High*	*Low*	*High*	*Low*	*High*
Real risk-free rate	1.5%	2.0%	1.5%	2.0%	1.5%	2.0%
Debt premium	2.5%	2.5%	2.5%	2.5%	2.5%	2.5%
Cost of debt			**4.0%**	**4.5%**	**4.0%**	**4.5%**
Equity risk premium	5.0%	5.0%	5.0%	5.0%	5.0%	5.0%
Beta			0.68	0.93	1.10	1.10
Real post-tax cost of equity			**4.9%**	**6.7%**	**7.0%**	**7.5%**
Tax rate	28%	28%	28.0%	28.0%	28.0%	28.0%
Pre-tax cost of equity			**6.8%**	**9.2%**	**9.7%**	**10.4%**
Gearing			20%	20%	0%	0%
Pre-tax WACC			**6.2%**	**8.3%**	**9.7%**	**10.4%**
Vanilla WACC			**4.7%**	**6.2%**	**7.0%**	**7.5%**
Post-tax WACC			**4.5%**	**6.0%**	**7.0%**	**7.5%**

3.4. Estimating an appropriate return on sales

There is less consensus on the appropriate approach to setting a return on sales in a regulatory setting, even if, as might be the case for Royal Mail, investors are more likely to pay significant attention to this as a measure of performance than returns on assets or capital. Various sources of information can be considered, for example:

- other postal companies such as Post NL, which is allowed a margin of 10% as set by the relevant ministry and monitored by the regulator;
- other asset-light comparators such as those discussed above in Section 2 of this report (a range of 5-10% for the margin on sales is found from this dataset); and
- other regulated sectors.

The last of these is likely to be the least useful since traditional utilities are more capital intensive (with the capital reflecting both the stock and flow). However, capital intensive sectors can provide a reality check with respect to return on sales. Consider the example of the water industry compared to the existing Royal Mail situation in Table 3.6.

Table 3.6: Comparison of Water and Royal Mail metrics

Sample	Water	Royal Mail	Comment
Turnover	£10 billion	£6 billion	
Capex	£675 million	£400 million	
RAB	£48.5 billion	£2.5 billion	
Profits (forecast)	£3.5 billion	£200 million	
Capex/turnover (%)	6.7	6.7	
RAB/Turnover (%)	485	42	Most significant driver of differences
Profits/turnover (%)	35.0	3.3	

Note: Royal Mail data in table to be verified and refers to 2009/10.

While the precise numbers are subject to verification, the orders of magnitude are instructive. This shows the margin on sales as being 35% for water, a multiple of 10 times the post figure with the vast majority of this driven by the different scales of the RABs.

Clearly a margin of 35% of sales is not appropriate for post, but neither is 3.3%. The Dutch postal operator has been allowed a margin of 10%. Our other comparators suggest a range of between 5% and 10%.

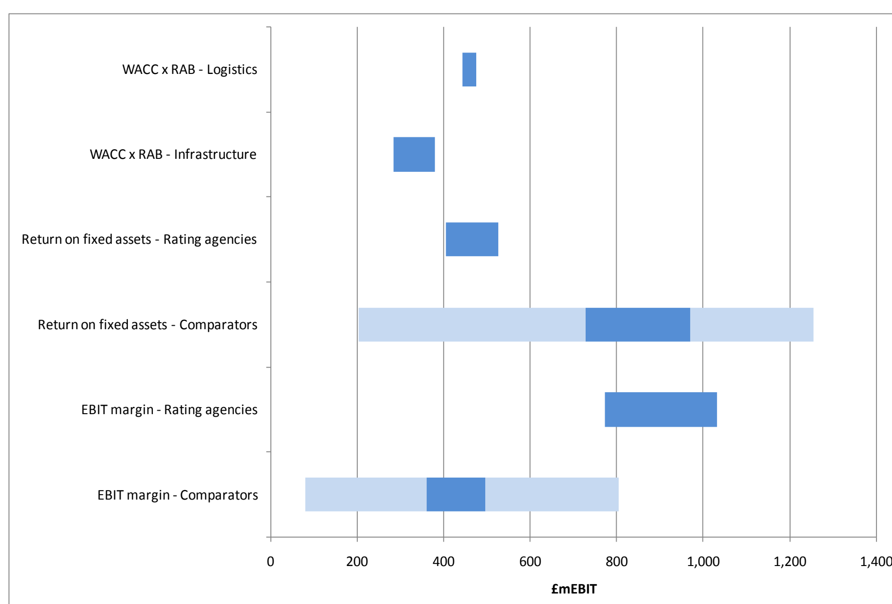
It is too early to provide a precise estimate of the appropriate margin but we believe that the available evidence suggests a value above 5% and possibly higher than 10%.

3.5. Implications of market evidence

Figure 3.5 summarises what different approaches might suggest about the required EBIT.

- For the "WACCxRAB", the range is given by the ranges of estimates calculated above assuming that Royal Mail is considered either to be like other infrastructure companies, or like a logistics company.
- The rating agency range is based on the range of values to obtain an investment grade rating for businesses facing higher risks. We have used the operational measures, rather than the financial measures as the capital structure is yet to be determined. Note that we use a range of 12-16% for the EBIT margin required by ratings agencies for investment grade status since this refers to entities facing greater business risks.
- For the comparators, the pale blue extends to the full range of the data for the measure, with the dark blue range being the inter-quartile range.

Figure 3.5: Indicated EBIT constructed by different measures applied to a modelled notional revenue (1)



Source: CEPA analysis compiled from various sources

(1) Note that modelled notional revenue, fixed assets and RAB are modelled based on starting value, Capex and depreciation assumptions made.

The chart allows us to make several important observations:

- The EBIT generated by a WACCxRAB treating Royal Mail as an infrastructure company is less than £400m in the range we have above. This is towards the lower end of the range for comparator companies' EBIT margins.

- The EBIT generated by a "WACCxRAB" treating Royal Mail as a logistics company is more than £400m. This is within the inter-quartile range of comparator companies' EBIT margins.

- The range of EBIT levels required by ratings agencies to achieve an investment grade rating relative to assets is consistent with the logistics WACC and comparator companies' EBIT margins.

- Comparator companies are making a return on fixed assets greater than we would expect given the related metrics. This might be because they have better capital efficiency, older or more depreciated assets, or account for a lower level of tangible assets as they are not remunerated on the basis of a RAB.