

Royal Mail Holdings plc



Trading update for the half year ended 28 September 2008

- **Operating profit* doubles despite fall in letter volumes**
- **Continued downward drive on costs cuts overheads**
- **Quality of service targets now being achieved**
- **Post Office Limited in profit helped by growth in new product sales and cost savings**
- **Government Post Office closure programme nearing completion**
- **Transformation in Letters business underway**
- **Huge challenges to be overcome to secure the future of the Universal Service**
- **Structural market decline accelerating as more customers switch to electronic communications**
- **Post Office awaits critical decision on the future of the Card Account**

* as set out in the table on page 3

Royal Mail Group's operating profit more than doubled from £86 million to £177 million in the first half of the 2008-09 financial year compared to the same period the previous year despite a further fall in mail volumes.

The strong financial performance came alongside a rise in customer quality of service with the most recent figures showing the vast bulk of mail hitting or exceeding its targets.

Operating profit grew by £91 million in the first half of the year compared to the same period last year. The company's continued focus on reducing overheads as competitive and economic pressures mount played a significant role in the financial uplift with reductions in IT and other costs in the Post Office network and efficiency gains in the Royal Mail Letters business.

These are good results that demonstrate that real progress has been made in what are clearly difficult economic circumstances. This strong performance has been delivered against a backdrop of falling mail volumes, increased competition, an unsatisfactory regulatory regime and the challenge of meeting the heavy demands of our pension scheme. Everyone at Royal Mail understands the importance of the one-price-goes-anywhere Universal Service and these results demonstrate our determination to protect and strengthen it.

The increase in our profitability that we are reporting today underlines the huge effort that has been made across the company to drive up quality of service, to cut our costs and to improve our current financial performance. However we are also facing huge pressures with the Universal Postal Service still loss-making, competition intensifying still further both from electronic communications and rival operators – and the increasingly heavy costs of servicing the historic pension deficit. The scale of these challenges means there is an urgent need to step up the pace of modernisation and to ensure that everyone in the company is playing their part in transforming our operations and delivering a world class postal service.

The challenges facing the company are:

- The one-price-goes-anywhere **Universal Service** – used by social customers and by businesses big and small to communicate with their customers and each other, and which underpins the economic and social fabric of the country – continues to be loss-making and its future is under threat.
- **Increasing competition** in the overall communications market in which we operate has seen an acceleration in the switch by businesses and individuals away from mail to electronic media, including internet and email. At the same time, rival mail operators in the open letters market are increasing their share of volumes with competitors currently handling almost one letter in every three posted.
- The rate of **structural volume decline** in UK postal market – as in the rest of the postal world – has accelerated, leading to a 4% fall in Royal Mail's volumes in the first half of 2008-09. Royal Mail is now handling an average daily postbag of around 79 million letters – some five million fewer on average each day compared to just two years ago when mail volumes peaked.
- On top of the structural decline in the mail market, Royal Mail faces additional risk from the squeeze in the UK economy, as mail volumes and revenues track GDP, and from the drive by both businesses and individuals to cut their costs as the economy tightens. Royal Mail is particularly vulnerable to a downturn in the advertising market, which is a key element in overall mailings.
- Royal Mail Group remains **heavily cash-constrained** and, in contrast to its rivals, currently has no ability to raise money in the financial markets while Government funding, even at commercial interest rates, is subject to scrutiny by the European Commission.
- Earlier this year the company reformed the pension scheme to reduce the risk going forward. Despite this, however, the **pension deficit** in accounting terms has increased by more than £1 billion to £4 billion – up from the £2.9 billion deficit at March earlier this year – as a result of the heavy falls in the stock markets. Of particular concern is the actuarial deficit, which is due to be revalued as at 31 March 2009 and it is likely to have increased substantially from the previous level of £3.4 billion in March 2006. The urgent need to tackle this major challenge is underlined by the continuing burden of the heavy cash contributions the company is required to pay towards the deficit and servicing the pension plan.

- Following the wide-ranging national agreement last autumn with the Communication Workers Union on flexible working practices, the essential drive to modernise the Royal Mail Letters business – to ensure it can compete effectively in a market that is both declining and gets ever more competitive – is now underway. Although many offices are working hard to introduce new working arrangements and get efficiency gains from the new technology being installed there has also been **resistance on the ground** at local level that's damaging the pace of change.
- **Swifter transformation** means we must continue to bring in people, across the business, with the skills and experience in operational change which Royal Mail needs for the next stage of our transformation, which in turn will enable us to compete effectively in the competitive market.
- The **regulatory regime** constrains Royal Mail's ability to compete fairly and respond with price flexibility, new products and services in the business mail market – the only sector of the market where competition is well developed. As the independent review of the postal services sector said in its initial report in May this year, the way in which the sector is regulated will "need to change."

The industry as a whole faces a number of challenges and that's why the Government set up an independent review of the sector, which is due to report shortly. Irrespective of the outcome of that review, we know that central to any industry solution is the need for Royal Mail to accelerate its transformation, and we have a robust plan in place to do so. Most importantly we need clarity over the future of the industry and Royal Mail's status in an increasingly competitive communications marketplace.

POST OFFICE BACK IN PROFIT

A strong push to cut overheads, especially the cost of running the IT systems crucial to the operation of every branch, along with growth in new products and services, particularly the Post Office's HomePhone and broadband services, helped reverse a lengthy period of losses in Post Office Limited.

The business made an operating profit of £28 million in the first half of the year compared to a £7 million loss 12 months earlier, after taking account of the Government's annual £150 million Social Network Payment which is helping keep open thousands of loss-making Post Office branches.

The business's turnover was up 2.7% on the 2007 half year performance with income from new products and services exceeding falls in traditional Government business. This is another positive sign for the future of the business as the Network Change programme to reduce the size of the branch network, in line with the available Government funding, nears completion.

However, despite all the efforts of the Post Office team to turn the business around, of critical importance going forward is the decision on the Card Account contract to replace the current Post Office Card Accounts in April 2010. This crucial decision is clearly central to the future of the branch network and Post Office Limited has submitted a very competitive bid.

PARCELFORCE WORLDWIDE PROFITS UP

Parcelforce Worldwide's operating profit doubled to £4 million over the period of the two half years and its revenues grew by an impressive 5.7% in an exceptionally tough market. The business's quality of service remains among the strongest in the field.

GLS – STRONG PERFORMANCE

GLS, the Group's European parcels business which operates in 36 European states, again improved its performance with a half year operating profit of £59 million. On a like-for-like basis, including when the impact of a favourable exchange rate in favour of the Euro against Sterling is taken out, the company has recorded underlying sales growth of 4.5% and profit growth of 6%.

UNIVERSAL SERVICE REMAINS KEY

Royal Mail has always firmly believed that the Universal Service to the UK's 28 million addresses is a crucial part of the economic and social fabric of the country – and we remain determined to transform our operations and build on the progress we have made to protect the one-price-goes-anywhere postal service for every customer. However, the Universal Service is undoubtedly in danger unless we have fairer regulation, the ability to access cash going forward to keep investing in the business, and a long-term solution to the pension funding burden that currently consumes so much of the revenues we generate.

Allan Leighton
Chairman
23 October 2008

Adam Crozier
Chief Executive
23 October 2008

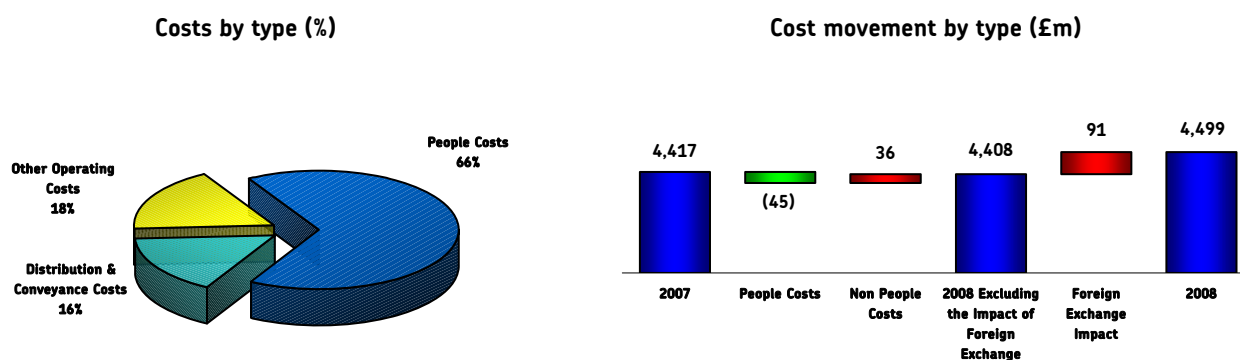
Financial Highlights

- Group external revenue has increased year on year by £173m (3.9%).
- Group operating profit before exceptionals has increased by £91m to £177m.
- Royal Mail has delivered a significant improvement in operating profit despite volume decline. People costs have decreased as a result of reduced pension costs and management of headcount, which have absorbed the impact of the pay deal agreed.
- Increasing revenue from new products and continuing transformation have contributed to Post Office Limited generating a profit in the first half of 2008-09 compared to a loss in the prior year.
- GLS and Parcelforce Worldwide continue to show profitable growth whilst operating in very competitive markets.

Business Unit	External revenue		Operating profit/(loss)*	
	2008 £m	2007 £m	2008 £m	2007 £m
Royal Mail	3,265	3,269	46	5
General Logistics Systems	715	565	59	45
Parcelforce Worldwide	184	174	4	2
Post Office Limited	461	449	28	(7)
Other businesses	23	18	40	41
Group	4,648	4,475	177	86

* All references to operating profit / (loss) are before exceptional items. To aid comparability, 2007-08 operating profit for Royal Mail has been restated to annualise the impact of the pay deal agreed in October 2007.

Due to the timing of Easter bank holidays, 2008-09 has approximately two additional working days compared to the same half year period in 2007-08.



Royal Mail

External revenue fell by £4m (0.1%) to £3,265m, despite a tariff increase and the impact of additional working days in 2008-09. Market volumes have continued to decline, with Addressed Inland volumes falling by over 4%, compared with a decline of around 3% last year.

Volumes have fallen across all product streams and only increased for Downstream Access (DSA), diluting margins, as customers continue to switch to competitors. DSA volumes of 2.5bn items compares with 1.8bn items last year, an increase of 38.9%. Revenues have further reduced over the period as customers continue to optimise their use of Royal Mail's wider product range.

Operating profit in Royal Mail has increased by £41m to £46m driven by people cost savings that reflect reduced pensions costs, management of headcount, and a move from full time to part time workers. These savings have absorbed the impact of the pay deal agreed last year. Non-people costs have increased and include higher fuel and utility costs, together with higher depreciation and transformation spend as Royal Mail continues to invest in modernising its operations.

GLS

External revenue has increased by £150m (26.5%) to £715m in 2008 and operating profit increased by £14m. Performance in the current year has been enhanced by the strengthening of the euro.

On a like for like basis, including adjusting for the impact of foreign exchange, underlying revenue increased by 4.5% driven by strong parcel volume growth, particularly in international traffic, and underlying profits have improved by c.6%.

Parcelforce Worldwide

External revenue increased from £174m to £184m, an increase of £10m (5.7%). UK contract income has reduced, partly due to the current economic climate. This has been more than offset by increases in Retail, Export and Import revenues. The revenue result has been underpinned by the continued focus on customer service and quality of service.

Operating profit is £2m higher than last year. The revenue increase has been partially offset by inflationary pressures, including the impact of higher fuel costs.

Post Office Limited

External revenue increased by £12m (2.7%) to £461m. Increased income from Financial Services, HomePhone and Broadband products exceeded the impact of the continued decline in Government Services and Retail income.

Revenue growth, together with savings in both people and non-people areas of spend has resulted in an improvement in operating result from a loss of £7m in the first half of 2007-08 to a profit of £28m in the first half of 2008-09. Savings have been achieved by exercising tight cost control, including contract renegotiations with key suppliers.

Other businesses

The increase in external revenue from other businesses is driven by iRed, the Group's end-to-end document management operation, which commenced trading in the second half of 2007-08, generating external revenue of £5m.

Operating profit from other businesses principally arises from Royal Mail Estates Limited, which leases a portfolio of property interests to Royal Mail Group Ltd. The year on year movement in operating profit is driven by iRed's start up losses.

Pensions

Pension Deficit £m (28 September & 30 March)	2008 Sept	2008 March
Pension deficit (balance sheet)	4,035	2,923

The balance sheet pension deficit has increased during the half year from £2,923m in March 2008 to £4,035m. The increase in the deficit of £1,112m mainly relates to an actuarial loss of £1,085m, driven by lower than expected asset values due to changes in market conditions.

Pension Payments: Group Contributions	2008 £m	2007 £m
Regular pension contributions	279	268
Funding of pension deficit	2	9
Payments relating to redundancy	19	21
Prepayment in 2007-08 of 2008-09 regular pension contributions	(50)	-
Net cash payments	250	298

Regular pension contributions increased by £11m (4.1%) year on year, mainly as a result of increased pay costs. The rate of employer contributions to the Royal Mail Pension Plan has remained at 20.0% and the regular rate of employee contributions remained unchanged at 6.0%.

Payments to fund the deficit throughout the year 2007-08 amounted to £284m and they will continue at an average of over £260m per annum for the 15 years from 31 March 2008. There have been no employee deficit contributions.

Cash Flow

	2008 £m	2007 £m
Net cash outflow before specific financing and investing activities:	(520)	(84)
Exceptional government grant	152	313
Social Network Payment	150	150
Net new borrowings	81	101
Finance lease agreements	19	-
Net movement in financial asset investments	(31)	(146)
Total net cash (outflow)/inflow	(149)	334

During the period the Group's cash and cash equivalents decreased by £149m (2007 £334m increase). However, this was after £152m (2007 £313m) was received from Government to compensate Post Office Limited for providing 'services of general economic interest' and receipt of the Social Network Payment (SNP) for the full 2008-09 year of £150m (2007 £150m), half of which has been recognised in operating profit.

Before these items, the Group's cash flow was an outflow of £520m (2007 £84m), mainly driven by cash outflows in modernising our operations through capital expenditure £218m (2007 £114m) and voluntary redundancy £149m (2007 £90m), and ColleagueShare stakeholder dividend payments to all qualifying employees £156m (2007 £nil). These outflows, and larger working capital and other outflows compared with last year £189m (2007 £23m), have more than outweighed the inflow from operating profit before interest, tax, depreciation, amortisation and SNP of £192m (2007 £143m).

Basis of preparation

The Group comprises Royal Mail Holdings plc (the Company) - which is wholly owned by HM Government - and its subsidiaries. The information shown in this publication is unaudited and does not constitute statutory financial statements. The Group prepares its consolidated statutory financial statements on the basis of International Reporting Standards (IFRSs) as adopted by the European Union.

In determining its approach to interim reporting, the Group has considered interim reporting requirements and guidelines, and the requirements of its stakeholders. The Group believes that a Trading Statement addresses the needs of its stakeholders in communicating the interim results of the Group. This approach will be reviewed on an annual basis.

The financial information presented herein has been prepared on a going concern basis and in accordance with the accounting policies expected to be used in preparing the consolidated statutory financial statements for 2008-09. Except to the extent otherwise stated, these do not differ significantly from the accounting policies used in the consolidated statutory financial statements for 2007-08 (part of the 2007-08 Report & Accounts) which have been filed with the Registrar of Companies. 2007-08 comparatives have been restated to annualise the impact of the pay deal for comparability. The report of the auditors on those consolidated financial statements was unqualified and did not contain a statement under section 237(2) or section 237(3) of the Companies Act 1985.

Except where otherwise indicated, financial information presented herein is stated in sterling to the nearest million. This publication should be read in conjunction with the financial and non-financial information contained in the 2007-08 Report & Accounts, copies of which can be found at the corporate website (see below) or are available upon request from the Company Secretary at the registered office (see below).

Cautionary statement

Where this trading update contains forward looking statements, these are made by the Directors in good faith based on the information available to them at the time of their approval of this report. These statements should be treated with appropriate caution due to the inherent uncertainties underlying any such forward looking information.

Registered Office & Corporate Website

Royal Mail Holdings plc, 148 Old Street, London, EC1V 9HQ. Registered No: 4074919

www.royalmailgroup.com