# Australian Postal Corporation

Assessment of WACC for Australia Post's Reserved Letters Business

1 August 2022

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Linda Watts
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Australian Postal Corporation
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AUSTRALIA

1 August 2022

Dear Linda

**Re: Assessment of WACC for Australia Post's Reserved Letters Business**

Australia Postal Corporation (Aus Post or the Group) has engaged Deloitte Financial Advisory Pty Ltd (Deloitte) to provide an assessment of the weighted average cost of capital (WACC) for its Reserved Letters Business (the Letters Business) to assist in the upcoming pricing notification to be lodged with the Australian Competition and Consumer Commission (ACCC) for the regulatory periods FY2023 and FY2024.

This report, which has been prepared under the terms of our engagement letter dated 7 April 2022, sets out our assessment of the WACC to be used in relation to the upcoming price notification and the associated information and analysis on which our opinion is based.

Please refer to Appendix 1 of this report, which summarises the context to this valuation including the basis of preparation and any limitations.

We appreciate this opportunity to be of service.

Yours faithfully

**Stephen Adams**

Partner

Deloitte Financial Advisory Pty Ltd

# Glossary

| Reference | Definition |
|---|---|
| AASB | Australian Accounting Standards Board |
| Aus Post or the Group | Australian Postal Corporation |
| CAPM | Capital Asset Pricing Model |
| CGU | Cash generating units |
| Deloitte | Deloitte Financial Advisory Pty Ltd |
| EMRP | Equity Market Risk Premium |
| FY | Financial year |
| IFRS | International Financial Reporting Standards |
| IFRS 16 | IFRS 16 - Leases |
| $K_e$ | Cost of equity |
| $K_d$ | Cost of debt |
| Letters Business, the | Reserved Letters Business |
| Management | Management of Aus Post |
| $R_f$ | Risk-free rate of return |
| $R_m$ | Expected return on the market portfolio |
| Report, the | This report, setting out our opinion of the appropriate discount rates for the Letters Business |
| WACC | Weighted average cost of capital |
| α | Specific company risk premium |
| β | Beta |

# Contents

# 1 Conclusion

The following table provides our assessment of the WACC to be used in relation to the upcoming price notification by Aus Post.

We have not reviewed the underlying cash flow projections to which the WACCs will be applied, the underlying Regulated Asset Base (RAB), or otherwise considered the likelihood of these cash flows being achieved. Furthermore, we note the ultimate responsibility for the determination of the appropriate discount rates and build-up of the post-tax revenue model rests with Aus Post.

Table 1: Summary of post-tax nominal discount rates for the Letters Business

| | Low | High | Mid |
|---|---|---|---|
| Risk free rate ($R_f$)[1] | 3.73% | 3.73% | 3.73% |
| Equity market risk premium (EMRP) | 5.75% | 5.75% | 5.75% |
| Beta (ungeared β) | 0.95 | 1.05 | 1.00 |
| Beta (geared β) | 0.95 | 1.13 | 1.04 |
| **Calculated $K_e$** | **9.19%** | **10.24%** | **9.69%** |
| | | | |
| Net debt / enterprise value | 0.00% | 10.00% | 5.00% |
| Tax rate | 30.00% | 30.00% | 30.00% |
| $K_d$ (pre-tax) | 6.89% | 6.89% | 6.89% |
| **$K_d$ (post-tax)** | **4.82%** | **4.82%** | **4.82%** |
| | | | |
| **WACC (post-tax)** | **9.19%** | **9.70%** | **9.45%** |
| **Selected WACC (post-tax)** | **9.25%** | **9.75%** | **9.50%** |
| **Vanilla WACC[2]** | **9.19%** | **9.90%** | **9.55%** |
| **Selected Vanilla WACC** | **9.25%** | **10.00%** | **9.63%** |

*Source: Deloitte analysis*

*Notes:*

1. *Risk-free rate as at 30 June 2022*
2. *The nominal, vanilla WACC is the weighted average cost of capital using a pre-tax cost of debt and a post-tax cost of equity*

As set out in the table above, Deloitte has assessed the nominal post-tax WACC for the Letters Business to be in the range of 9.25% to 9.75%. If we were asked to determine a most likely WACC for the Letters Business, we would consider it reasonable to use the mid point of our assessed range, being 9.50%, as there is no evidence that the most likely value is towards the high or low end of the range.

Please refer to the following sections of this Report for discussion on each of the key inputs set out above.

# 2 Deloitte approach and inputs

### 2.1 Overview of approach

Aus Post have requested our assistance in assessing a reasonable discount rate for the Letters Business, to assist Management in the upcoming pricing notification for the ACCC. We understand the ACCC assesses the maximum allowable revenue (MAR) using a post-tax revenue model (PTRM). The cost components of the PTRM are:

- Operating costs
- Return of capital, representing the depreciation of fixed assets
- Return on capital, representing the required rate of return on the asset base
- Tax allowances.

The sum of these components represents the MAR. As the PTRM treats the corporate tax allowance as a separate cost block, the required rate of return is the return required after tax has been paid.

On this basis, we have assessed the discount rate on a post-tax nominal basis. Further, we have presented the nominal vanilla WACC, as this was adopted by the ACCC in their most recent determination on Aus Post's pricing notification relating to the Letters Business. We note the ultimate responsibility for the determination of the appropriate discount rates, the RAB and build-up of the post-tax revenue model rests with the management of Aus Post (Management).

We understand the pricing notification relates only to the Letters Business, which is the business unit within Aus Post relating to the delivery of all letters weighing less than 250 grams.

The Letters Business forms the majority of the Groups regulated business in accordance with *Australia Post's Community Service Obligations* as detailed in s.27 of the *Australian Postal Corporation Act (the APC Act).* We note the APC Act sets out the performance standards relating to the frequency, speed and accuracy of mail delivery. Further, we note these performance standards apply to some letter services, they do not necessarily apply to all letters services. The key function of the Letters Business is the 'last-mile' delivery, relating to the delivery of letters to their final destination. We note the 'last-mile' service is a labour intensive, asset-light business model. We note service business, such as the Letters Business, typically run at higher levels of operating leverage, and are predominantly funded by equity.

We note the Letters Business has experienced declining revenues in recent years, this decline is expected to continue as electronic mailing and distribution continues to increase. Notwithstanding this, we have assessed the discount rate on a going concern basis, such that the business is assumed to be funded by long-term equity and debt capital.

The discount rate used to equate the future cash flows to their present value reflects the risk adjusted rate of return demanded by a hypothetical investor for the asset or business being valued.

Selecting an appropriate discount rate is a matter of judgement having regard to relevant available market pricing data and the risks and circumstances specific to the asset or business being valued. For ungeared cash flows, discount rates are determined based on the cost of an entity's equity and debt weighted by the proportion of equity and debt used. This is commonly referred to as the WACC.

The WACC can be derived using the following formula:

$$\textbf{WACC} = \left(\frac{E}{V} \times K_e\right) + \left(\frac{D}{V} \times K_d \times (1 - t_c)\right)$$

The components of the formula are:

| | | |
|---|---|---|
| $K_e$ | = | cost of equity capital |
| $K_d$ | = | cost of debt |
| $t_c$ | = | corporate tax rate |
| E/V | = | proportion of enterprise funded by equity |
| D/V | = | proportion of enterprise funded by debt |

The adjustment of $K_d$ by (1- $t_c$) reflects the tax deductibility of interest payments on debt funding.

Our calculations in respect of $K_e$ and $K_d$, and our conclusions on the nominal post-tax WACC for the Letters Business are set out in the following sections.

## 2.2 Cost of equity capital ($K_e$)

The cost of equity, $K_e$, is the rate of return that investors require to make an equity investment in a firm.

**Selected $K_e$ approach**

Whilst the discount rate can be estimated based on a fundamental ground up analysis using one of the available models for estimating the cost of equity capital (such as the aforementioned models), market participants often use less precise methods for determining the cost of equity. These may include hurdle rates or target internal rates of return and often do not distinguish between investment type or region, nor do they vary over economic cycles. For the purpose of our analysis, we have estimated the cost of equity based on the CAPM approach.

**Capital asset pricing model (CAPM)**

The cost of equity capital under CAPM is determined using the following formula:

$$K_e = R_f + \beta\,(R_m - R_f)$$

CAPM calculates the minimum rate of return the company must earn on the equity-financed portion of its capital to leave the market price of its shares unchanged. The CAPM is the most widely accepted and used methodology for determining the cost of equity capital.

The components of the formula are:

| | | |
|---|---|---|
| $K_e$ | = | required return on equity |
| $R_f$ | = | the risk-free rate of return |
| $R_m$ | = | the expected return on the market portfolio |
| $\beta$ | = | beta, the systematic risk of a stock |

We note the CAPM is the most common approach and considered best practice in estimating an assets cost of equity due to the simplicity and limited number of inputs.

The components in the above CAPM equation are discussed below.

## 2.3 Risk-free rate ($R_f$)

The risk-free rate compensates the investor for the time value of money and the expected inflation rate over the investment period. The frequently adopted proxy for the risk-free rate is the long-term Government bond rate.

In determining the risk-free rate, we have calculated the five-day average zero coupon yield on the 10-year Australian Government Bond, being 3.73% as at 30 June 2022. This rate represents a nominal rate and therefore includes inflation.

## 2.4 Equity market risk premium (EMRP)

The EMRP ($R_m$ – $R_f$) represents the risk associated with holding a market portfolio of investments, that is, the excess return a shareholder can expect to receive for the uncertainty of investing in equities as opposed to investing in a risk free alternative. The size of the EMRP is dictated by the risk aversion of investors – the lower (higher) an investor's risk aversion, the smaller (larger) the equity risk premium.

The EMRP is not readily observable in the market and therefore represents an estimate based on available data. There are generally two main approaches used to estimate the EMRP, the historical approach and the prospective approach, neither of which is theoretically more correct nor without limitations.

The former approach relies on historical share market returns relative to the returns on a risk free security; the latter is a forward looking approach which derives an estimated EMRP based on current share market values and assumptions regarding future dividends and growth.

In evaluating the EMRP, we have considered both the historically observed and prospective estimates of EMRP.

**Historical approach**

The historical approach is applied by comparing the historical share market returns relative to the returns on risk free assets such as Government bonds, or in some cases Treasury bills. The historical EMRP has the benefit of being capable of estimation from reliable data; however, it is possible that historical returns achieved on stocks were different from those that were expected by investors when making investment decisions in the past and thus the use of historical market returns to estimate the EMRP would be inappropriate.

It is also likely the EMRP is not constant over time as investors' perceptions of the relative riskiness of investing in equities change. Investor perceptions will be influenced by several factors such as current economic conditions, inflation, interest rates and market trends. The historical risk premium assumes the EMRP is unaffected by any variation in these factors in the short to medium term.

Historical estimates are sensitive to the following:

- the time period chosen for measuring the average
- the use of arithmetic or geometric averaging for historical data
- selection of an appropriate benchmark risk free rate
- the impact of franking tax credits
- exclusion or inclusion of extreme observations.

The EMRP is highly sensitive to the different choices associated with the measurement period, risk free rate and averaging approach used and as a result, estimates of the EMRP can vary substantially.

We have considered studies undertaken by the Securities Industry Research Centre of Asia-Pacific Limited, Morningstar, Inc., Credit Suisse/London Business School and Aswath Damodaran. These studies generally calculate the EMRP using historical approaches to be in the range of 5.0% to 8.0%.

**Prospective approach**

The prospective approach is a forward looking approach that is current, market driven and does not rely on historical information. It attempts to estimate a forward looking premium based on either surveys or an implied premium approach.

The survey approach is based on investors, managers and academics providing their long term expectations of equity returns. Survey evidence suggests that the EMRP is generally expected to be in the range of 6.0% to 8.0%.

The implied approach is based on either expected future cash flows or observed bond default spreads and therefore changes over time as share prices, earnings, inflation and interest rates change. The implied premium may be calculated from the market's total capitalisation and the level of expected future earnings and growth, with regard also given to the value attributed to franking credits.

**Selected EMRP**

We are of the view that since the unveiling of the global financial crisis in mid-2007 and the subsequent periods of increased volatility in equity and debt instruments, the relevance of historical observations and long-term average measures for the estimate of the EMRP has substantially weakened.

As a result, Deloitte has increasingly placed more weight on current and prospective approaches to assess the EMRP. In particular, we estimate the EMRP based on current share market values and assumptions regarding future dividends and growth. This analysis involves the setting of several variables and can only be considered indicative. As a result, we therefore also use other market indicators to support our estimate of the prospective EMRP, which include the spreads observed on domestic and foreign corporate bonds and equity market volatility.

Based on our prospective analysis, we have selected an EMRP of 5.75% at 30 June 2022, we note this is broadly in line with historical observations.

### 2.5 Comparable company analysis

In arriving at our selection of key inputs, we have had reference to a set of broadly comparable companies that operate in similar industries to the Letters Business. From a set of 21 potentially comparable companies that operate postal services and parcel services we identified a subset of selected companies that we consider similar to the Letters Business and the broader Aus Post business. This analysis is summarised in the table below.

Table 2: Comparable company analysis

| Company | Revenue composition | Commentary | Letters Business | Aus Post |
|---|---|---|---|---|
| **Postal Organisations** | | | | |
| Poste Italiane S.p.A. | - 49.3% Letters and parcels<br>- 32.6% Financial services<br>- 11.0% Insurance services<br>- 7.1% Payments and mobile | Poste Italiane S.p.A. provides postal, logistics, and financial and insurance products and services in Italy. We note, Poste Italiane does not separate revenues by letter and package. Further, as Poste Italiane S.p.A provide banking and financial services, we note this impacts the treatment of debt capital in the company's capital structure. On this basis, we do not consider the observed leverage and implied unlevered beta, on the basis of its operations and business mix, comparable to Aus Post or the Letters Business. | ✗ | ✗ |
| Deutsche Post AG | - 29.0% Express delivery<br>- 26.4% Global forwarding<br>- 20.7% Post and parcel<br>- 16.8% Supply chain<br>- 7.1% eCommerce solutions | Deutsche Post AG operates as a mail and logistics company in Germany and broader Europe, the Americas, Asia Pacific, the Middle East, and Africa. We note, the post and parcel business unit comprises of Post Germany (47.1%), Parcel Germany (40.0%), International (12.1%) and other (0.9%). | ✗ | ✓ |
| Royal Mail plc | - 72.2% Parcels<br>- 24.6% Letters<br>- 3.2% Advertising mail | Royal Mail plc, together with its subsidiaries, operates as a universal postal service provider in various geographies. We note Royal Mail plc has a significantly larger geographical footprint than Aus Post and the Letters Business. | ✗ | ✓ |
| Österreichische Post AG | - 45.5% Parcels and logistics<br>- 44.8% Letters/Mail<br>- 9.5% Retail and banking<br>- 0.1% Corporate | Österreichische Post AG, together with its subsidiaries, provides postal and parcel services in Austria, Turkey, Germany, and internationally. It operates in three divisions: Letters/Mail, Parcel and Logistics, and Retail and Banking.<br>The Mail division engages in the collection, sorting, and delivery of letters and document shipments. The Parcel and Logistics division offers solutions for parcel and express mail items; and value-added services, including food delivery, warehousing and order picking. The Retail and Banking division is involved in the provision of telecommunication products and merchandise.<br>We note, although Österreichische Post AG offers a more diverse range of services, c. 44.8% of revenues relate to the Mail division and is comparable in its operations to the Letters Business. | ✓ | ✓ |
| PostNL N.V. | - 55.6% Letters and parcels<br>- 39.7% Fulfilment services<br>- 4.7% Other postal and logistics | PostNL N.V. provides postal and logistics services to businesses and consumers in the Netherlands, rest of Europe, and internationally. PostNL N.V. collects, sorts, transports, and delivers letters and parcels; and offers data and document management, direct marketing, and fulfillment services, as well as cross-border mail solutions. | ✓ | ✓ |
| bpost NV/SA | - 40.2% Mail and retail solutions<br>- 51.2% Parcels and fulfilment logistics<br>- 8.6% Other | bpost NV/SA, together with its subsidiaries, provides mail and parcel services to consumers, businesses, and the government in Belgium, rest of Europe, the United States, and Internationally. We consider bpostNV/SA to be broadly comparable to the Letters Business. | ✓ | ✓ |
| Singapore Post Limited | - 47.1% Logistics<br>- 44.9% Post and parcel<br>- 8.0% Property | Singapore Post Limited, together with its subsidiaries, engages in post and parcel, eCommerce logistics, and property businesses in Singapore, Japan, Europe, New Zealand, Hong Kong, Australia, and internationally. The Post and parcel segment offers services for collecting, sorting, transporting, and distributing domestic and international mail | ✓ | ✓ |
| Pos Malaysia Berhad | - 69.3% Letters and packages<br>- 15.8% Logistics<br>- 9.8% Aviation<br>- 5.1% Other | Pos Malaysia Berhad provides postal and related services in Malaysia and internationally. We note Letters and packages revenues are skewed to parcels (47.6%) and letters (33.9%) | ✓ | ✓ |
| CTT - Correios De Portugal, S.A. | - 52.4% Letters<br>- 30.2% Express mail and orders<br>- 11.7% Payment services<br>- 5.8% Financial services | CTT - Correios De Portugal, S.A., together with its subsidiaries, provides postal and financial services worldwide. We note CTT's revenues are predominantly driven by its Letters segment. | ✓ | ✓ |

| Company | Revenue composition | Commentary | Letters Business | Aus Post |
|---|---|---|---|---|
| **Parcel Providers/Integrators** | | | | |
| United Parcel Service, Inc. | - 62.2% Domestic letters and small packages<br>- 20.1% International letters and small packages<br>- 17.7% Supply chain solutions | United Parcel Service, Inc. provides letter and package delivery, transportation, logistics, and related services. | ✓ | ✓ |
| FedEx Corporation | - 49.2% Express delivery<br>- 35.9% Small package delivery<br>- 9.8% Freight services<br>- 5.1% Other | FedEx Corporation provides transportation, e-commerce, and business services in the United States and internationally. | × | ✓ |
| XPO Logistics, Inc. | - 68.4% Last-mile logistics<br>- 31.6% Less-than-truckload delivery services | XPO Logistics, Inc. provides freight transportation services in the United States, rest of North America, France, the United Kingdom, rest of Europe and internationally. | ✓ | ✓ |
| Mainfreight Limited | - 46.3% Air and ocean forwarding<br>- 41.8% Domestic transport<br>- 11.9% Warehousing | Mainfreight Limited provides supply chain logistics solutions in New Zealand, Australia, the Americas, Europe and Asia. We have considered Mainfreight Limited as a comparable company as its operations are predominantly in similar geographies to Aus Post and the Letters Business | ✓ | ✓ |
| Yamato Holdings Co., Ltd. | - 79.9% Delivery business<br>- 8.7% Logistic services<br>- 4.3% E-business services<br>- 2.9% Fuel services<br>- 2.2% Financial services<br>- 2.0% Moving and household delivery | Yamato Holdings Co., Ltd. provides delivery, logistics, home convenience, e-business, financial, auto works, and other related services in Japan and Internationally. We note Yamato has significantly more diverse operations than Aus Post. | × | ✓ |
| Forward Air Corporation | - 81.8% Expedited freight<br>- 18.2% Intermodal | Forward Air Corporation, together with its subsidiaries, operates as an asset-light freight and logistics company in the United States and Canada. Forward Air Corporation provides pick-up, delivery and other services including final mile, truckload, warehousing and other handling services. | ✓ | ✓ |
| Blue Dart Express Limited | - n/a | Blue Dart Express Limited provides courier and express services. We note Blue Dart Express Limited operates an asset-heavy business model and provide freight and shipping services for large products. | × | × |
| Freightways Limited | - 78.8% Express package and business mail<br>- 21.2% Information management | Freightways Limited, together with its subsidiaries, provides express package and business mail services in New Zealand, Australia, and Internationally. We note Freightways operate in similar geographies to Aus Post and the Letters Business. | ✓ | ✓ |
| Aramex PJSC | - 68.3% Small package delivery<br>- 21.8% Freight forwarding<br>- 7.2% Logistics services<br>- 2.7% Other | Aramex PJSC, together with its subsidiaries, operates in the freight, express, logistics, and supply chain management businesses in the United Arab Emirates, the Middle East and Africa, Europe, North America, Asia, and Internationally. | × | × |
| Speedy AD | - n/a | Speedy AD provides courier services in Bulgaria and the International market. Speedy AD offer express, standard, parcel and tire courier services. We note Speedy AD do not report revenue by segments. | × | × |
| DX (Group) plc | - 58.4% Freight delivery<br>- 41.6% Express delivery | DX (Group) plc, through its subsidiaries, provides parcel freight, secure, courier, and logistics services in the United Kingdom and Ireland. The Freight division collects and delivers larger and heavier products, including those with irregular dimensions and weight to business and residential addresses nationwide. The Express division offers collection and express delivery of time sensitive, mission critical, and high value items for B2B and B2C customers. | × | × |
| GDEX Berhad | - 91.0% Express delivery<br>- 9.0% Logistics services | GDEX Berhad, an investment holding company, provides express delivery and logistics services in Malaysia, Vietnam, Indonesia and Singapore. | × | × |

| Company | Revenue composition | Commentary | Letters Business | Aus Post |
|---|---|---|---|---|
| Xpediator Plc | - 79.0% Freight forwarding<br>- 18.9% Logistics and warehousing<br>- 2.1% Transport solutions | Xpediator Plc, together with its subsidiaries, provides freight management services in the United Kingdom and the rest of Europe. | × | × |
| CTI Logistics Limited | - 61.7% Transport<br>- 34.4% Logistics<br>- 3.8% Other | CTI Logistics Limited provides transport and logistics services in Australia. It operates through three segments: Transport, Logistics, and Property. We note the Transport business segment pertains to courier, parcel distribution, taxi truck, fleet management, heavy haulage, line haul, container handling, and freight forwarding services. | × | ✓ |

*Source: Deloitte analysis, S&P Capital IQ*
*Notes: Numbers subject to rounding errors*

### 2.6 Beta estimate (β)

**Description**

The beta coefficient measures the systematic risk or non-diversifiable risk of a company in comparison to the market as a whole. Systematic risk, as separate from specific risk as discussed below, measures the extent to which the return on the business or investment is correlated to market returns. A beta of 1.0 indicates an equity investor can expect to earn the market return (i.e. the risk free rate plus the EMRP) from this investment (assuming no specific risks). A beta of greater than one indicates greater market related risk than average (and therefore higher required returns), while a beta of less than one indicates less risk than average (and therefore lower required returns).

Betas will primarily be affected by three factors which include:

- the degree of operating leverage employed by the firm, in that companies with a relatively high fixed cost base will be more exposed to economic cycles and therefore have higher systematic risk compared to those with a more variable cost base
- the degree of financial leverage employed by a firm, in that as additional debt is employed by a firm, equity investors will demand a higher return to compensate for the increased systematic risk associated with higher levels of debt
- correlation of revenues and cash flows to economic cycles, in that companies more exposed to economic cycles (such as retailers or energy and resources companies), will generally have higher levels of systematic risk (i.e. higher betas) relative to companies less exposed to economic cycles (such as regulated utilities).

They can also be influenced by the index against which they have been calculated, the time period over which they were calculated and the level of trading in the share of the relevant company. As such, in a market like Australia, immense care must be taken in the assessment of the appropriate beta.

The geared or equity beta can be estimated by regressing the returns of the business or investment against the returns of an index representing the market portfolio, over a reasonable time period. However, there are a number of issues that arise in measuring historical betas that can result in differences, sometimes significant, in the betas observed depending on the time period utilised, the benchmark index and the source of the beta estimate. For unlisted companies, it is often preferable to have regard to sector averages or a pool of comparable companies rather than any single company's beta estimate due to the above measurement difficulties.

**Market evidence**

In estimating an appropriate beta for the Letters Business, we have considered the betas of listed comparable companies operating in the postal and logistics industries. These betas, which are presented in Appendix 2, have been calculated based on weekly and monthly returns, over a two- and four-year period, compared to the relevant domestic index.

The observed beta is a function of the underlying risk of the cash flows of the company, together with the capital structure and tax position of that company. This is described as the levered beta.

The capital structure and tax position of the comparable companies may not be the same as that of the Letters Business. The levered beta is often adjusted for the effect of the capital structure and tax position. This adjusted beta is referred to as the unlevered beta. The unlevered beta is a reflection of the underlying risk of the pre-financing cash flows of the entity.

**Blume Adjustment**

In estimating an appropriate beta for the Letters Business, we have 'Blume adjusted' the observed levered beta of the selected comparable companies. Studies have found that there is a consistent tendency with either an extremely low or high estimated beta to have a less extreme beta in the next period, hence beta's exhibit a tendency to regress towards 1[1]. The Blume adjustment can be applied to either the beta of the comparable companies or the selected subject company beta. In theory the application of either method should result in a similar outcome, as such we have applied the below Blume adjustment formula to the observed levered betas of the comparable companies:

$$\beta_{Adjusted} = 0.635 \times \beta_{Unadjusted} + 0.371$$

As we are considering historical observations to estimate a forward-looking beta, we are of the opinion it is reasonable to adjust the observed historical betas using the Blume equation to allow for the mean reversion tendency.

### 2.7 Selected β

The table below summarises our findings in relation to comparable publicly traded companies. We note the Deloitte selected comparable companies refers to the companies with operations identified as most similar to the Letters Business, as set out in the table above. Refer to Appendix 2 for the full analysis.

Table 3: Letters Business - Observed comparable company beta

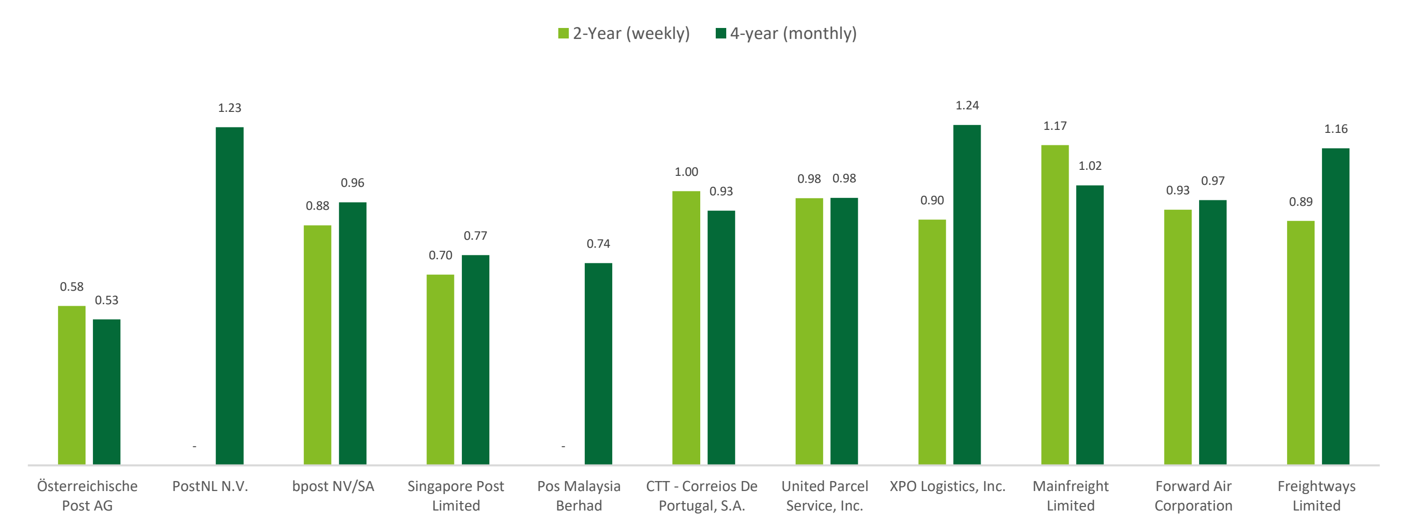
| | 2-year weekly beta | | 4-year monthly beta | |
|---|---|---|---|---|
| | Levered | Unlevered | Levered | Unlevered |
| Deloitte selected Letters Business comparables (average) | **0.98** | **0.89** | **1.13** | **0.96** |
| Deloitte selected Letters Business comparables (median) | **1.01** | **0.90** | **1.09** | **0.97** |

*Source: Deloitte analysis*
*Notes:*
*Figures as at 30 June 2022*

In selecting an unlevered beta for the Letters Business, we have considered the blume adjusted, observed historical betas of our selected comparable companies as set out in the figure below.

[1] *Blume, 'Betas and their regression tendencies', 1975*

**Figure 1: Observed unlevered betas for companies comparable to the Letters Business**




Source: Deloitte analysis, S&P CapitalIQ
Notes: Observed betas have been Blume adjusted, as set out in section 2.6

With respect to the above, we note the following:

- the unlevered beta based on weekly returns over a two-year period for the companies comparable to the Letters Business range from 0.58 to 1.17, with an average and median of 0.89 and 0.90, respectively
- the unlevered beta based on monthly returns over a four-year period for the companies comparable to the Letters Business range from 0.53 to 1.24, with an average and median of 0.96 and 0.97, respectively

With respect to the above, we have placed greater reliance on businesses providing 'last mile' services. We note service businesses typically maintain lower levels of external debt and operate with higher levels of operating leverage. As mentioned above, we anticipate businesses with higher operating leverage would be more susceptible to economic cycles, implying a higher level of systematic risk, and a higher beta.

On this basis, we have selected an unlevered beta in the range of 0.95 to 1.05 for the Letters Business.

### 2.8 Deloitte calculated $K_e$

Based on the above inputs, we arrive at a cost of equity, $K_{e,}$ as follows:

Table 4: Selected cost of equity capital

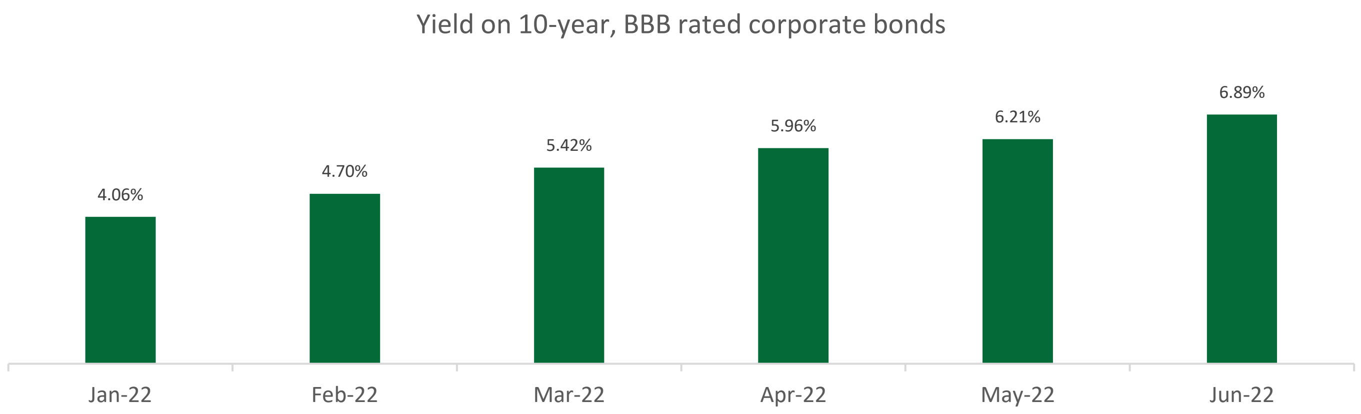
| | Low | High | Mid |
|---|---|---|---|
| Risk free rate ($R_f$) | 3.73% | 3.73% | 3.73% |
| Equity market risk premium (EMRP) | 5.75% | 5.75% | 5.75% |
| Beta (ungeared β) | 0.95 | 1.05 | 1.00 |
| Beta (geared β) | 0.95 | 1.13 | 1.04 |
| **Calculated $K_e$** | **9.19%** | **10.24%** | **9.69%** |

*Source: Deloitte analysis*
*Notes:*
*1. Risk-free rate as at 30 June 2022*

### 2.9 Cost of debt capital ($K_d$)

The cost of debt is a reflection of the interest rate demanded by debt capital providers. In selecting a cost of debt we have considered the current interest rate of the Group and the observed yields on non-financial corporate bonds for BBB-rated entities. The figure below illustrates the recent movement in 10-year corporate bonds for BBB-rated entities.

**Figure 3: Observed yield on 10-year BBB rated corporate bonds**




Source: RBA, Deloitte analysis

In addition to the above, we have considered the current cost of debt for the Group. Management have advised the Group's current weighted average cost of debt is c. 3.84%. The current outstanding debt includes two tranches of fixed rate debt, set out below, with a portion of it recently being swapped to a floating rate.

Table 5: Summary of outstanding fixed rate debt held by Aus Post

| Counterparty | Type | Facility amount ($'m) | Base reference rate | Base rate (%) | Margin (%) | All-in rate (%) |
|---|---|---|---|---|---|---|
| 2023 MTN (issued Nov 13) | Fixed medium term note | 175.0 | 10-year swap | 4.35% | 1.15% | 5.50% |
| 2026 MTN (issued Dec 16) | Fixed medium term note | 180.0 | 10-year swap | 3.00% | 1.00% | 4.00% |

*Source: Management*

We note the above fixed rate debt implies a weighted average interest rate of c. 4.74%.

In selecting a cost of debt for the Letters Business, we have considered the borrowing capacity of the business on a standalone basis. As an operating unit within Aus Post, we note the Aus Post cost of debt could be extended. Notwithstanding this, we note the Letters Business should be assessed on a standalone basis, to reflect the fair market cost of capital. To reflect the borrowing margin of businesses of similar size and operations, we have considered the yield on 10 year non-financial BBB-rated corporate bonds as at 30 June 2022. We consider the 10 year maturity of the observed corporate bonds appropriate notwithstanding the shorter duration of the Regulatory Period, on the basis that a commercial enterprise would not seek to refinance its entire debt portfolio every two years, rather would rationally seek to refinance a portion of its debt every year. On this basis, we have estimated the cost of debt for the Letters Business to be 6.89%.

### 2.10 Capital structure analysis

In selecting an appropriate level of gearing for the Letters Business, we have considered the following:

- the gearing of the companies comparable to the Letters Business, on a pre-IFRS 16 basis, are observed to have an average and median of 15.1% and 9.5%, respectively
- the gearing of the companies comparable to the broader Aus Post group, on a pre-IFRS 16 basis, are observed to have an average and median of 16.2% and 9.8%, respectively
- the operations of the comparable companies, and more specifically, the level of operating leverage
- the capital structure of Aus Post, which as at 30 June 2021, was in a net cash position
- in a report prepared by the Auditor General in 2017, it was found that on a stand-alone, benchmark basis, it seemed unlikely that the Letters Business would be able to sustain any debt in its capital structure, absent of government subsidies[2]. We understand this observation was made with reference to the secular decline in the volume of letter delivery services, as well as the service nature of the business, whose asset base predominantly comprises of assets of an intangible nature and net working capital.

[2] *G. Hehir, "Australia Post's Efficiency in Delivering Reserved Letters Services", ANAO report No. 11, September 2017*

On this basis, we have selected a gearing ratio in the range of 0.0% to 10.0% for the Letters Business, being at the lower end of the observed leverage of the selected comparable companies. We are of the opinion this is not unreasonable due to the difficulty for the Letters Business to be able to raise debt on a stand-alone basis with reference to the nature of its operations and underlying assets.

### 2.11 Nominal vanilla WACC

We note, for the purpose of pricing notification, Aus Post are required to apply a nominal vanilla WACC.

The nominal, vanilla WACC is the weighted average cost of capital using a pre-tax cost of debt and a post-tax cost of equity. Represented In other words, it excludes all tax-related inputs from the WACC calculation. A provision for the cost of taxation is made separately from the WACC, in the form of an estimate of the company tax that would be payable each year by the regulated entity.

The nominal vanilla WACC can be derived using the following formula:

$$\textbf{Nominal vanilla WACC} = \left(\frac{E}{V} \times K_e\right) + \left(\frac{D}{V} \times K_d\right)$$

The components of the formula are:

$K_e$ = cost of equity capital

$K_d$ = cost of debt

E/V = proportion of enterprise funded by equity

D/V = proportion of enterprise funded by debt

### 2.12 Calculation of WACC

Table 6: WACC calculations for the Letters Business

| | Letters Business | | |
|---|---|---|---|
| | Low | High | Mid |
| Risk free rate ($R_f$) | 3.73% | 3.73% | 3.73% |
| Equity market risk premium (EMRP) | 5.75% | 5.75% | 5.75% |
| Beta (ungeared β) | 0.95 | 1.05 | 1.00 |
| Beta (geared β) | 0.95 | 1.13 | 1.04 |
| **Calculated $K_e$** | **9.19%** | **10.24%** | **9.69%** |
| | | | |
| Net debt / enterprise value | 0.00% | 10.00% | 5.00% |
| Tax rate | 30.00% | 30.00% | 30.00% |
| $K_d$ (pre-tax) | 6.89% | 6.89% | 6.89% |
| **$K_d$ (post-tax)** | **4.82%** | **4.82%** | **4.82%** |
| | | | |
| **WACC (post-tax)** | **9.19%** | **9.70%** | **9.45%** |
| **Selected WACC (post-tax)** | **9.25%** | **9.75%** | **9.50%** |
| **Vanilla WACC** | **9.19%** | **9.90%** | **9.55%** |
| **Selected Vanilla WACC** | **9.25%** | **10.00%** | **9.63%** |

*Source: Deloitte analysis*

# Appendix 1: Context to the Report

Deloitte was appointed to prepare a Report expressing our opinion as to a reasonable WACC for the Letters Business in relation to the upcoming pricing notification. This has been prepared in accordance with our signed engagement letter dated 7 April 2022.

**Purpose of the report**

Aus Post has engaged Deloitte to provide an assessment of the weighted average cost of capital (WACC) for the Letters Business to assist in pricing notification for the regulatory periods FY2023 and FY2024.

We are not responsible to you, or anyone else, whether for our negligence or otherwise, if the Report is used by any other person or for any other purpose.

**Access by the ACCC**

We understand a copy of the Report may be provided to the ACCC in connection with the upcoming pricing notification. The ACCC may have access to the Report in connection with the pricing notification and not for any other purpose. The ACCC may only use the Report for the Purpose set out in this Report. We do not warrant or represent that the Report or our work will be sufficient for the needs of the ACCC or appropriate for any other purpose.

**Limitations, qualifications, declarations and consents**

The Report represents solely the expression by Deloitte of its opinion as to the discount rates or WACC of Aus Post's Letters Business to assist Aus Post in complying with its ACCC pricing notification. The opinion of Deloitte is based on economic, market and other conditions prevailing at the date of this Report. Such conditions can change significantly over relatively short periods of time.

We have not been provided with nor reviewed the cash flow projections pertaining to the Letters Business to which the discount rates apply, and therefore not considered the likelihood of these cash flows being achieved. As such, our advice assumes risks are included in the relevant cash flow projections prepared by Management. We note the ultimate responsibility for the determination of appropriate discount rates for the Letters Business, in relation to the upcoming pricing notification, rests with Aus Post.

Statements and opinions contained in this Report are given in good faith but, in the preparation of this Report, Deloitte has relied upon the completeness of the information provided by Aus Post and its officers, employees, agents or advisors (as set out below in 'Sources of Information'). Deloitte does not imply, nor should it be construed, that it has carried out any form of audit or verification on the information and records supplied to us. Drafts of our Report were issued to Management for confirmation of factual accuracy.

The Partner responsible for the preparation of this Report is Stephen Adams, Partner, B. Ec, M App. Fin., F. Fin.

Deloitte will receive a fee for preparing this Report. This fee is not contingent on the conclusion, content or future use of our Report.

**Sources of information**

In preparing this Report, we have had access to the following principal sources of information:

- publicly available information on comparable companies and market transactions published by Capital IQ, ASIC, Thomson Research, Thomson Reuters Financial markets, SDC Platinum and Merger market
- other publicly available information and media releases from Aus Post and comparable companies operating in comparable sectors
- "Australia Post's Efficiency in Delivering Reserved Letters Services", ANAO report No. 11, September 2017
- "Betas and their regression tendencies", Blume, 1975
- discussions with management and key personnel of Aus Post including, but not limited to;
  - Linda Watts, Group Financial Controller
  - Jason Kwan, Head of Enterprise Planning & Performance
  - Mark Pollock, General Manager for Mail Services & Decipha
  - Simon Cammell, General Manager for Group Finance
- Summary terms of current fixed rate debt facilities

# Appendix 2: Comparable companies

Table 7: Comparable companies for the Letters Business

| Company Name | Market cap (AUD million) | Enterprise value (AUD million) | Net debt/EV (%) | 2-year weekly beta | | 4-year monthly beta | | Considered comparable | |
|---|---|---|---|---|---|---|---|---|---|
| | | | | Levered beta | Unlevered beta | Levered beta | Unlevered beta | Letters Business | Aus Post |
| **Postal Organisations** | | | | | | | | | |
| Poste Italiane S.p.A. | 17,580 | 104,645 | 83.2% | 1.05 | 0.22 | 1.02 | 0.22 | ✗ | ✗ |
| Deutsche Post AG | 65,961 | 70,852 | 5.7% | 0.98 | 0.94 | 1.01 | 0.96 | ✗ | ✓ |
| Royal Mail plc | 4,500 | 6,316 | 28.7% | 1.44 | 1.09 | 1.63 | 1.23 | ✗ | ✓ |
| Österreichische Post AG | 2,788 | 2,748 | - | 0.58 | 0.58 | 0.53 | 0.53 | ✓ | ✓ |
| PostNL N.V. | 2,254 | 2,478 | 8.9% | n/m | n/a | 1.33 | 1.23 | ✓ | ✓ |
| bpost NV/SA | 1,710 | 2,127 | 19.6% | 1.03 | 0.88 | 1.13 | 0.96 | ✓ | ✓ |
| Singapore Post Limited | 1,526 | 1,583 | 13.9% | 0.79 | 0.70 | 0.87 | 0.77 | ✓ | ✓ |
| Pos Malaysia Berhad | 142 | 340 | 58.3% | n/m | n/a | 1.52 | 0.74 | ✓ | ✓ |
| CTT - Correios De Portugal, S.A. | 703 | 198 | - | 1.00 | 1.00 | 0.93 | 0.93 | ✓ | ✓ |
| | | | | | | | | | |
| **Parcel Providers/Integrators** | | | | | | | | | |
| United Parcel Service, Inc. | 231,494 | 248,984 | 7.0% | 1.03 | 0.98 | 1.04 | 0.98 | ✓ | ✓ |
| FedEx Corporation | 85,282 | 125,272 | 31.9% | 0.87 | 0.64 | 1.16 | 0.85 | ✗ | ✓ |
| XPO Logistics, Inc. | 8,040 | 11,557 | 30.4% | 1.21 | 0.90 | 1.67 | 1.24 | ✓ | ✓ |
| Mainfreight Limited | 6,358 | 6,947 | 8.5% | 1.25 | 1.17 | 1.09 | 1.02 | ✓ | ✓ |
| Yamato Holdings Co., Ltd. | 8,396 | 6,712 | - | n/m | n/m | 0.66 | 0.66 | ✗ | ✓ |
| Forward Air Corporation | 3,585 | 3,983 | 10.0% | 1.01 | 0.93 | 1.05 | 0.97 | ✓ | ✓ |
| Blue Dart Express Limited | 3,400 | 3,524 | 3.5% | 0.99 | 0.97 | 0.87 | 0.85 | ✗ | ✗ |
| Freightways Limited | 1,370 | 1,515 | 9.5% | 0.96 | 0.89 | 1.25 | 1.16 | ✓ | ✓ |
| Aramex PJSC | 2,198 | 2,060 | - | n/m | n/m | 1.02 | 1.02 | ✗ | ✗ |
| Speedy AD | 451 | 429 | - | n/m | n/m | 0.65 | 0.65 | ✗ | ✗ |
| DX (Group) plc | 304 | 458 | 33.7% | n/m | n/a | 1.48 | 1.05 | ✗ | ✗ |
| GDEX Berhad | 312 | 260 | - | 1.04 | 1.04 | 1.60 | 1.60 | ✗ | ✗ |
| Xpediator Plc | 83 | 96 | 9.6% | 1.01 | 0.93 | 1.53 | 1.41 | ✗ | ✗ |
| CTI Logistics Limited | 78 | 106 | 26.7% | n/m | n/a | 0.94 | 0.75 | ✗ | ✗ |
| | | | | | | | | | |
| **Selected Letters comparables (average)** | | | **15.1%** | **0.98** | **0.89** | **1.13** | **0.96** | | |
| **Selected Letters comparables (median)** | | | **9.5%** | **1.01** | **0.90** | **1.09** | **0.97** | | |
| **Selected Aus Post comparables (average)** | | | **16.2%** | **1.01** | **0.89** | **1.11** | **0.94** | | |
| **Selected Aus Post comparables (median)** | | | **9.8%** | **1.01** | **0.91** | **1.07** | **0.96** | | |

*Source: Deloitte analysis, Capital IQ.*
*Notes:*
*1. Figures as at 30 June 2022*
*2. Net debt is on a pre-IFRS 16 basis, excluding lease liabilities*
*3. Observed levered betas have been blume adjusted, as set out in section 2.6*