Appendix S

APPENDIX S — Privatization — Process and Financing Issues†

Privatization is one transformation strategy that the Postal Service could pursue. However, under the umbrella of privatization—a process whereby the Postal Service reduces its ties to the government and moves toward partial or complete private stock ownership—there are multiple scenarios that could take place. As a Private Corporation, the Postal Service would need to have sufficient financing flexibility to access a broad array of sources of capital for its business activities. This is a crucial ingredient for financial success.

Privatization Methodologies

In undertaking a transfer of its ownership to the private sector, the government would likely review the routes that private sector organizations typically follow when conducting a similar transaction. Broadly speaking, these routes consist of an Initial Public Offering (IPO) and a Merger & Acquisition sale (M&A). Although variations of these two basic processes exist, the applicability of these variations to the government's ownership position with respect to the Postal Service is difficult to predict. Consequently, the following descriptions of these methodologies provide a point of departure regarding the privatization process and could be refined over time.

Initial Public Offering

An IPO is the initial sale to public investors of all or a portion of the common stock of a company through a syndicate of securities underwriters, dealers, and brokers. It is a well-established privatization method, under which the owner's equity in an enterprise is publicly sold to equity investors. In the case of the Postal Service, an IPO would represent some of the government's entire share. Investors in the IPO market generally seek financial returns from capital appreciation of the purchased stock and/or dividends paid by the company. An IPO transaction is a formal and transparent process regulated by the Securities and Exchange Commission (SEC). An IPO requires that a company prepare and file a registration statement to register the company's securities with the SEC. A syndicate of underwriters then typically sells an IPO to a geographically diverse mix of institutional and individual investors. These investors carefully review the investment merits of the company and compare its potential with that of many alternative investments. Therefore, the price in an IPO, by its nature, represents a broadly based market valuation of the business.

An IPO process would result in a value for the Postal Service that represents the judgment of a wide range of potential investors, prevailing market conditions, and the projected business outlook for the Postal Service. The process results in a market value that is tied both to the value of the company and to market conditions existing at the time of the sale. The offering price can be positively or negatively affected by investor knowledge or perception of the company, general industry and market conditions, and other external factors. Accordingly, the investor community must be well informed about the company to ensure a successful IPO.

† This appendix was prepared for the United States Postal Service by JP Morgan.

The company and the underwriters work together to maximize investor participation. They develop and market the investment "story" and conduct informational tours to meet with brokers, dealers, and potential investors. In addition, the underwriters work with the company to gauge the market to ensure that the offering is brought to the market at the optimal time. It would be important, therefore, that the government have some flexibility as to the timing of its offering of Postal Service common stock. Additionally, it would be critical that a firm, timely decision-making process be set up in advance for government approval of the final terms of the sale to maximize the chances of a successful offering.

Assuming that there would be a transition stage leading up to full privatization, the Postal Service would have had the opportunity to develop a partial track record for new products and services under a public-commercialized structure. In determining whether it can more completely sever its ties to the government, the Postal Service would need to demonstrate to private providers of capital two things: 1) that its business strategies are viable, and 2) its business prospects are good and will provide the financial returns these investors demand. In short, investors would need to be convinced of the value proposition put forward by the Postal Service in any particular business—i.e., that the Postal Service can add equal or greater value than other competitors seeking to tap similar sources of capital.

A compelling story for potential equity investors in a commercialized Postal Service would be exchanging aspects of the monopoly for new abilities to restructure costs, manage pricing and products, enter new markets, and limit government liabilities. The combination would increase profitability and attract investor interest; such a de-monopolization strategy follows the example of a number of European postal operators. In certain European examples, e.g. Dutch postal operator TPG, value was enhanced by the ability to enter competitive businesses before the loss of the monopoly and transitionally to finance new businesses through monopoly profits.

A total or partial Postal Service valuation in advance of any equity offering would require reviewing a broad set of issues. The most important component of a Private Corporation is that such a Postal Service would be granted powers to earn profit margins higher than today and, after transition, approach the margins of other industrial leaders.

Valuation — In General

In a typical IPO, valuation considerations are extremely important and complex. In a privatization like the Postal Service's, where comparable companies may be harder to identify (depending on the structure and business lines of the privatized entity), proper valuation would be even more challenging. The goal in an IPO is to create a scarcity value for the company's shares. This results in great demand for shares and a sustainable market-clearing price acceptable to both the issuer and new investors.

An underwriter and the issuer will agree on a marketing price range prior to the IPO. This price range will reflect an analysis of a number of quantitative and qualitative factors, including perceived quality of management, long-term earnings growth outlook, market conditions, comparable company trading statistics, use of proceeds and the offering structure. Sponsorship of the issuer by its commercial partners and underwriters is also critical to investor perception of the company.

An underwriter will work closely with the issuer and research analysts to develop a set of projections that reflect its earnings growth potential during the next two to three years.

The first step that investors will use to determine a benchmark for valuation is to identify comparable public companies. In the case of the Postal Service, this will depend on the business profile of the entity being privatized. If there are no publicly traded comparables, the challenge is to make the case for an alternative industry sector most resembling the issuer. Investors will compare various historical and projected financial statistics of these companies to the issuer after adjusting for incomparabilities.

To determine valuation, investors will focus on multiples including price to earnings and firm value to Earnings Before Interest, Taxes, Depreciation and Amortization (EBITDA). Other metrics include long-term growth rate, market capitalization, dividend yield, and liquidity. In addition, investors will look at comparable company IPO valuations. Investors expect an immediate return compensating them for lack of track record as a public company, commonly referred to as an “IPO discount.”

Once the proper comparable group and IPO multiples have been determined, these multiples are applied to the analyst’s estimates for the issuer to come up with a target valuation. The public market will value the issuer on a pro forma basis, as if the IPO has taken place and the use of proceeds as outlined in the prospectus has been applied. The underwriter will also determine a target per share price range for the offering and recommend if a stock split of the issuer’s shares is necessary prior to the offering.

Postal Service Valuation

Valuing a commercialized Postal Service requires reviewing two broad sets of issues: 1) potential resolution of key commercialization factors including disposition of labor issues (such as current interest arbitration versus right to strike), retirement benefits liabilities, postal monopoly and privileges, pricing flexibility and competitive freedoms, universal service, ability to raise and invest capital, governance, and transition rules and time frames; and 2) translating the economic model from a break-even structure to a profit maximization one.

The most basic influences on valuation will be earnings and earnings growth rates, as well as the risks associated with the business. Decisions that enhance the ability for a commercialized Postal Service to increase profit margins and/or speed earnings growth will increase the valuation, and vice versa. The risks reflect issues such as electronic diversion and increased competition.

A successful commercialization of the Postal Service will require resolution of important economic issues that will each have a large influence on valuation. A best-case scenario for the Postal Service would include flexibility in labor management; a transition period to the loss of the legal letter monopoly in exchange for immediate competitive freedoms; control over pricing and product decisions; the ability to finance growth in the competitive businesses during the transition period; retention of certain privileges including tax and licensing fee exemptions; the ability to raise capital in financial markets as well as enter into all forms of strategic alliances, and the ability to have the U.S. government assume: 1) some liabilities, such as deferred retirement benefits and environmental problems; 2) responsibility for more narrowly defined and contractually based universal service obligations; and 3) the ability to raise capital markets as well as enter into all forms of strategic alliances:

- **Labor issues and retirement benefits.** Compensation and benefits comprise about 77 percent of total Postal Service expenses. Success in managing labor-related expenses will be necessary to improve margins. A one percent swing in expenses changes net income by close to $600 million. The disposition of deferred retirement liabilities related to the Civil Service Retirement System (CSRS) would also have a huge valuation impact. The future minimum payments to fund the CSRS benefits and retirees' cost-of-living adjustments are $30 billion. If the Postal Service had been allowed to manage its own retiree benefits, like corporations, that liability could have been dramatically lower. The Postal Service will need more flexibility in setting terms of employment to achieve cost reduction objectives. Postal Service employees now enjoy interest arbitration, which would need to be reviewed relative to the right to strike. Participation in a commercialized Postal Service stock offering, through an Employee Stock Ownership Program (ESOP) or other structures, would be a potential enhancement for employees. Conrail and transforming foreign postal operators provide examples of commercializing entities gaining labor management flexibility. The valuation would be highly sensitive to the Postal Service's ability to manage its labor issues appropriately.
- **Postal monopoly and privileges.** The Postal Service enjoys monopolies on distribution of certain letter mail, access to U.S. mailboxes, and access to its network. The value of the letter monopoly is high but falling over time as targeted competitors, particularly in the Internet arena, take market share. Retaining the mailbox monopoly and control over access to the Postal Service system would clearly help earnings and valuation. Phasing out the letter monopoly over three to five years could result in trade-offs for other benefits maintained by the Postal Service. The Postal Service's ability to bring its benefits in physical delivery to the Internet could boost the valuation.
- **Pricing flexibility and competitive freedoms.** The Postal Service is now constrained in its ability to set prices, to enter into new product markets and businesses, and to differentiate product/service offerings. It is also constrained in its flexibility in managing labor and in the number and location of post offices. Flexibility alone will not guarantee greater profitability, but it will provide the foundation to develop and execute a business plan that would keep the Postal Service competitive and in a position to provide the scope of services expected by customers. Achieving these freedoms would require a transition away from a tightly regulated environment, but it would also likely increase the valuation of this new commercialized entity.
- **Universal service.** The Postal Service provides universal service in terms of product coverage, delivery service, pricing, and retail access. Today's universal service requirement is a broad set of legal and regulatory mandates and constraints. If retained, the current universal service requirement would severely impair the Postal Service's ability to differentiate price and product/service offerings. The best alternative would be a contractual arrangement where the Postal Service would guarantee significant core elements of the universal service obligation. The economics of the alternatives would have a major influence on valuation.

- **Ability to raise and invest capital.** Currently the Postal Service has limits on raising and investing capital as well as on forming strategic alliances. Investors will apply a lower valuation to an organization that is constrained in its ability to invest and organize itself to most efficiently deliver services.
- **Governance.** The new structure and governance of the organization also will have an influence on valuation. Investors clearly want a board of directors who have the ability to act in the best interest of shareholders. Federal statutory limitations not applicable to private enterprises (such as government ethics restrictions, purchasing procedures, and lobbying) would need to be significantly modified or eliminated, depending on the structure chosen.
- **Transition rules and time frames.** The most important value issues related to transition are the timing of changes in the monopoly, the ability to start immediately with competitive freedoms, and the ability to invest earnings from the monopoly in competitive businesses. TNT Post Group (TPG) in The Netherlands and Deutsche Post World Net in Germany are operating within guidelines similar to these.

The key outcomes from an economic model will be expected profitability and growth rates. Answers to the issues raised above will be necessary to create valuation scenarios. Another way to ask the question about earnings, however, is whether the Postal Service can maintain its current margins or increase margins? If it increases margins, how far can the margins go? For the purposes of a valuation exercise, one needs to make assumptions about how much freedom a commercialized Postal Service would receive and how this newly granted regulatory freedom might allow the Postal Service to increase its margins to at least the best levels it has achieved in the past decade.

Equity Investor Questions

Potential investors will not assume the commercialized Postal Service can achieve and maintain margins without seeing a track record proving its performance. Investors, including Postal Service employees, would likely ask a number of questions in order to determine whether to invest in shares of a privatized Postal Service. There are some questions that would be asked specifically of the Postal Service, given its unique status, in addition to those that would likely be asked of any company involved in an IPO. The answers to these questions are important in that they indicate earnings potential. Investors will be most interested in the potential for earnings growth and the impact government policies would have on the company's performance.

Questions Specific to the Postal Service

- What are the U.S. government's intentions in selling shares in the Postal Service?
  – structure of the transaction;
  – monopoly impact; and,
  – residual government interest and impact on Postal Service activities.
- What is the Postal Service relationship to the U.S. government?
  – scope of monopoly;
  – pricing restrictions;
  – labor requirements;
  – public policy mandates;
  – employee benefit liabilities; and,
  – regulatory oversight.

Questions Investors Would Ask of Any Company

- What is the Postal Service?
  – company summary
- What will be the use of the proceeds?
- What are the company's goals and the business strategy to achieve them?
- What is the potential for earnings and free cash flow growth?
  – pricing power;
  – revenue growth;
  – expense management;
  – labor costs and labor relations; and,
  - capital expenditure requirements.
- What are the Postal Service's market characteristics?
  – by key businesses;
  – size, demographic, geographic, key customers;
  – competitors and competitive landscape; and,
  – regulation.
- What is the Postal Service position in its markets?
  – market share; and,
  – growth trends.
- What are new business initiatives?
  – within the organization; and,
  – Mergers & Acquisitions (M&A), joint venture, and other opportunities.
- What is the strength of the capital structure?
  – leverage; and,
  – dividend policy.
- What do the financials look like?
  – funds required and their use; and,
  – historical financial summary.
- What are the expected valuation parameters?
- What is the corporate governance structure and who sits on the board?
- What are the strengths of the management team?
  – incentive-based financial participation in Postal Service performance
- What are the key risk factors?

Merger & Acquisition Sale

An M&A transaction involves the sale of all or a portion of the assets or equity of a company to a single buyer or a group of buyers. Investors in the M&A market often seek financial returns through a strategic fit with their current business mix. The particular attributes of a transaction, including the size, nature of the business, transaction structure, and regulatory requirements, will influence the number of potential buyers.

The most likely M&A scenario would be the acquisition of some or all of the government's equity interest in the Postal Service by a strategic buyer. This strategic buyer could be a Postal Service competitor, (e.g., United Parcel Service), a current business partner (e.g., QuadGraphics), or a third party. An M&A transaction offers both the buyer and the seller flexibility to structure the transaction to meet their respective objectives. For example, appropriate restrictions regarding foreign ownership have precedent and could be structured to meet government concerns. The government's interest in maintaining a universal service requirement would need to be negotiated. Because an M&A buyer's objectives may be different from those of the investing public (IPO) generally, the anticipated proceeds from the two types of transactions may be different.

Again, although it is impossible to predict at this time an expected value for the government's ownership interest in the Postal Service, the process by which it would be done is fairly predictable. A potential purchaser's bid would reflect its own valuation, increased by cost savings opportunities it can take advantage of and decreased by its own perception of the industry's and the company's liabilities, risks, and ongoing government control and regulation. In developing its bid, a prospective purchaser will likely rely on a combination of three different analyses.

First, similar to the IPO process, a bidder will perform a comparable trading multiples analysis to estimate the Postal Service's value based on the public market multiples of similar investments.

Second, a bidder will perform a comparable transaction multiples analysis to estimate the Postal Service's value based on the price paid in the market for similar companies. The price paid will also be expressed as multiples of net income, revenues, and other financial measurements, both on a projected and historical basis, as in the case of a comparable trading multiples analysis. In both cases, if pure comparables do not exist (which is the case with the Postal Service) peer groups consisting of transportation and other companies would be used as a proxy.

The third analysis will be a discounted cash flow (DCF) analysis. A DCF analysis provides an estimate of the value of a company by forecasting the business's free cash flows (after-tax operating profit adjusted for noncash charges and investment requirements for fixed and working capital) and discounting those cash flows to the present at an appropriate discount rate or cost of capital. The discount rate is intended to reflect market interest rates, the time value of money, and the unique risks of the business.

In pursuing one of the above strategies, or a derivative of the IPO or M&A sale, the government can rely on a standard process. The government will likely need to hire an advisor such as an investment banker to provide an assessment of privatization alternatives and assist in executing the selected strategy. The advisor would be responsible for providing market analyses, conducting independent market valuations of the Postal Service as a private sector business, commenting on prospective investors or buyers, advising on the best strategy, and implementing that strategy. As such, a Privatization Schedule can be developed which has as its goals to best meet the objectives and criteria of the government for the privatization. Specifically, the advisor would:

- Determine what, if any, benefits accrue to the government and the Postal Service assuming implementation of a privatization strategy;
- Make several key assumptions about the Postal Service's operating performance, market conditions, and major uncertainties in performing a valuation analysis;
- Perform a net present value analysis comparing the economic return to the government from implementing the privatization with the economic return from maintaining its ownership;
- Clarify its understanding of and help define the Postal Service's future relationship with the government;
- Assist the Postal Service in developing its ultimate Privatization Plan for submission to the government;
- Assess the receptivity of potential privatization markets to various transaction structures; and/or,
- Participate in the consensus-building process with government, including executive and legislative branch entities.

Additionally, legislation would undoubtedly be required to set forth the Postal Service's transition to the private sector. This could be part of the legislation required for statutory changes. As in the case of other U.S. privatizations, like that of the United States Enrichment Corporation, discussed in Appendix T, *Overview of Selected Government Entities and Government Sponsored Enterprises,* authorizing legislation can stipulate at the outset that the government's equity interest in the company is to be privatized at an appropriate time, while also detailing the necessary legislation, to the extent necessary, in implementing the privatization.

Alternative Privatization Strategies

Most alternative privatization mechanisms are variations of the IPO or the M&A sale. The applicability of these alternatives will become evident at the time of privatization from an analysis of several factors, including the government's objectives, general statutory requirements described in the authorizing legislation, the receptiveness of prospective investors or purchasers, and the historical and projected success of the corporation. Additionally, the ownership interest and objectives of the strategic partners, if any, will be an important consideration in the evaluation of these less straightforward options. Several of these alternatives are described below.

Employee Ownership

In an employee ownership transaction, all or a portion of a company's equity is sold to its employees or managers. Many of the same issues that arise in an IPO process are relevant to an Employee Stock Ownership Program (ESOP) conversion and employees are likely to raise many of the same investor questions about earnings potential and business viability that are discussed above.

One hundred percent employee ownership requires the transaction to be structured as an M&A sale, in which the employees collectively finance the purchase of the company's stock, pledging the corporation's assets as security. Employee ownership has the benefit, in perception at least, of aligning employee interests with those of the overall success of the company. The applicability of this structure in the case of the Postal Service would be driven in part by the number of employees, the extent of their personal assets, the objectives of the government's strategic partner(s), and an analysis of acceptable leverage as part of the overall capital structure.

Although public equity investors are likely to welcome some level of employee ownership, strategic partners are less interested in purchasing or operating a corporation owned half by employees and half by the buyer, effectively limiting control by the partner. Corporations typically provide for a level of employee ownership through an ESOP, in place of a less-than-100 percent sale of the company to employees. Under an ESOP, employees are awarded equity in the company, either publicly traded or private, as part of their overall compensation package. This has the similar perceived effect of aligning interests while maintaining overall ownership in the hands of shareholders (in a publicly traded corporation) or a few senior officers (in a privately-held corporation).

An employee purchase of the government's interest would require a valuation process similar to that described in the M&A sale discussion.

ESOP Process

The ESOP structure is a product of complex federal legislation. The Postal Service would likely approach the establishment of an ESOP in a manner similar to a private company. There are, however, different rules and considerations that need to be made when dealing with the conversion of a federal government entity versus a private entity. The Postal Service has been examining many of these issues in the context of its plan to convert its Equal Employment Opportunity investigations unit to an ESOP. Many of these topics are addressed in detail in a 1995 National Performance Review discussion paper titled, "Federal Privatization Through ESOPs."

In general, a conversion to an ESOP requires three important steps first:

- A valuation of the organization must be completed by an independent party;
- The financial impact of the conversion on the existing owner's stake should be estimated. In the case of the Postal Service the existing holder would be the U.S. government and the considerations would be related to impact on the federal budget; and,
- The organization should create a plan to fund all stages of the ESOP. Since ESOP participants have a put option when they leave, the plan should project how it will meet the obligation to repurchase the stock of departing employees.

Typically, in the next stage, the firm and its advisers will prepare a formal plan document that lays down the specific terms and features of the ESOP. A valuation report will be prepared. The plan should address the ESOP's 1) use and operation, 2) eligibility requirements, 3) participation requirements, 4) company contributions, 5) account allocation formulas, 6) vesting and forfeitures, 7) voting rights and fiduciary responsibilities, 8) distribution rules and put options, 9) employee disclosures, and

10) provisions for plan amendments. The firm must also establish a trustee for the ESOP. The stock and any other assets held by the ESOP must be held in the name of the trustee.

Tax Benefits

ESOPs, both leveraged and nonleveraged, offer tax benefits. For a contribution to a nonleveraged ESOP, either stock or cash, the plan sponsor receives a tax deduction equal to its ESOP contribution expense. A leveraged ESOP allows the ESOP to borrow money from a bank or other qualified lender. Since ESOP contributions are tax deductible, a corporation that repays an ESOP loan is able to deduct both principal and interest from taxes. This can decrease the cost of financing to the firm considerably by reducing the number of pretax dollars needed to repay the principal by as much as 34 percent, depending on the company's tax bracket. Secondly, dividends paid on ESOP stock passed through to employees or used to repay the ESOP loan are tax deductible. This provision of federal tax law allows a firm to free up cash.

ESOP Precedents

There are currently about 14,000 ESOP companies operating in the United States, with approximately 18 million employees participating in ESOPs. While the federal government has created several smaller ESOPs, there has never been an ESOP conversion of a federal entity that is even close to the size, scope and importance of the Postal Service. There have been large private ESOP transactions, however.

The Office of Personnel Management

In 1996, the Office of Personnel Management (OPM) privatized its Office of Federal Investigations through the creation of an ESOP. The Office conducted background investigations on federal personnel and employed approximately 730 people at the time of privatization.

The new company, U.S. Investigations Service (USIS), became the first 100 percent employee-owned company to be created through a federal government privatization. The process grew out of an order from President Clinton in 1994 for all government agencies to look for programs and functions in the federal government that could be streamlined or eliminated. The OPM then devised a detailed conversion plan culminating in USIS's creation. All government employees who moved into the ESOP saw no reduction in pay, were granted a 401K savings plan, and received a health and life insurance package similar to that of the Federal government. To help guide the new organization through the ESOP process, OPM worked with a commercial bank, an investment bank, and a law firm with extensive ESOP experience.

United Airlines

In 1994, 54,000 of United Airline's 75,000 employees purchased 55 percent of United Airline's parent, UAL, for $4.9 billion. This ESOP, the largest in the United States, was a product of difficult negotiations between unions and United Airlines management. As a result of the ESOP, union representatives agreed to pay reductions for their members in exchange for ownership. The UAL ESOP was structured differently than most traditional ESOPs. In 1994, the ESOP borrowed money to buy United Airlines stock on behalf of the employees. During the next five years and nine months employees contributed money to the plan in order to repay the original loan. As the loan was repaid, employees were allocated shares in the ESOP.

Avis

In 1987, Avis established an ESOP for $1.75 billion, making its 11,000 employees owners. The transaction was partly financed by a $1 billion loan from a group of 30 banks led by Irving Trust Co. Avis offered its domestic fleet of 135,000 vehicles as collateral. Additional financing of $395 million was acquired from General Motors Acceptance Corp., Chrysler Credit Corp., and Pittsburgh National Bank. The Avis trust was given the responsibility of disbursing stock to employees as loans were repaid over 25 years. Employees were allocated stock according to their salary and position. Although employees were not allowed to sell stock, upon their death, retirement or departure from the company, Avis would repurchase their shares.

Customer Consortium Purchase

The purchase of the Postal Service's stock by a consortium of its customers is another type of M&A transaction. Companies which rely heavily on the Postal Service would pool their resources to structure a joint ownership of all or part of the corporation. A consortium purchase is similar to what is typically described as a joint venture (JV), in which differing parties with differing strengths and capabilities unite to operate an entity. Under a consortium purchase or JV, the purchasing entities have significant flexibility to structure ownership, voting control, management, and other factors in the operation of the corporation.

An M&A transaction of this type is highly complex when multiple buyers are involved. It would require negotiations among a number of parties, involving much more complexity than a standard M&A transaction. This is driven by the need for review by multiple regulatory bodies regarding antitrust concerns, the need to balance many differing objectives on the part of the prospective buyers, and the need to reconcile potentially divergent valuations.

Leveraged Buyout

A leveraged buyout (LBO) typically involves the acquisition of a company or group of assets by investors seeking to maximize their returns through attractive purchase prices and the use of significant financial leverage. LBO investors raise their funds by borrowing against the assets of the company they are acquiring. When managers of a company undertake an LBO, it is typically referred to as a management-led buyout and is similar to the employee ownership structure discussed earlier. Under such a scenario, a significant portion of earnings is required to meet debt service and repayment, usually at the cost of capital investment in the long-term success of the company. Other cost reduction measures are often undertaken, as well, during the period in which the LBO investors maintain ownership. Typically, these investors have a predetermined time frame for their ownership, after which they seek to either sell the company or, more likely, effect an IPO.

Alternative IPO Strategies

A master limited partnership (MLP) is a form of an IPO that involves an owner placing a subsidiary into partnership and selling limited partnership interests to public investors. Since the original owner retains the general partner interest itself, such a structure might not be ideal for the government, unless a follow-on sale of that interest were sold to a third party through an M&A transaction.

MLP's are essentially tax-driven vehicles because they eliminate the "double taxation" of corporate earnings. Taxes are paid only at the unit-holder level, based on the share of the MLP's earnings. As a result, they are largely attractive to investors seeking substantial cash payouts, which would be amplified by the tax advantages. Since the seller is the government, privatization proceeds based on tax advantages do not increase returns to the government as they would a third party purchaser. Since the Postal Service and the federal government pay no taxes, the benefits of an MLP would be lost in a government transaction and likely make it an unsuitable strategy.

A partial IPO is another potential strategy, allowing the government to divest its ownership through a series of partial offerings over an extended period of time. Such a path is designed to meet two main objectives:

- In the event that the seller is not comfortable with the IPO valuation overall, an initial partial offering will allow for the company to develop a trading history in the public markets, possibly positioning subsequent offerings to occur at more attractive levels. Subsequent offerings will be valued based on the then-current stock price of the company.
- Along the same lines, an initial partial offering allows time for a publicly-visible performance and track record to develop. This often has the effect of increasing interest in the stock and may alleviate concerns of a one-time offering which is large compared to market capacity.

Again, these examples of variations on the IPO or M&A sale process provide insights to the flexibility of potential privatization structures. The applicability of these would only become clear over time as the Postal Service approaches profit-sustaining capability and the government seeks to divest its ownership. The IPO and M&A sale processes described earlier in this section are points of departure from which an appropriate privatization strategy can be developed.

Financing a Privatized Postal Service

Prior to privatization, the Postal Service would have had the opportunity to develop a limited range of competitive products and services. By creating a private entity with significantly fewer, if any, ties to the government, a Private Corporation would enable the Postal Service with relatively unfettered ability to expand these initiatives and enter into other businesses of its choosing.

Regardless of the entity's exact legal structure, one key determinant of whether a privately owned Postal Service could successfully compete in new businesses on a wide open playing field would be whether the entity can access the capital necessary to support and finance its legacy businesses, as well as any new ventures.

Role of Debt/Access to Credit

The goal of a Private Corporation Postal Service would be to maximize the value of its equity for its shareholders while fulfilling any public mission obligation required of it. The development of financial policies that balance appropriate levels of equity and debt in the capital structure is a complex process subject to considerable judgment or "art," in addition to the more objective "science" of standard parameters set forth by markets or corporate finance theory. The relevant factors considered include: 1) the financial prospects for the company, 2) the expected ability to pay interest and repay debt, 3) the availability and cost of equity and debt, and 4) the risk tolerances of the shareholders and debt holders. The balance between debt and equity can be a key driver of stock market valuation.

Debt has the potential to magnify risks and returns to equity shareholders, while dividing the risks and returns of ownership between shareholders and lenders. When companies are profitable, interest expense, which is tax deductible, can provide a tax shield that enhances earnings. The availability and market cost of debt are critical components in determining appropriate debt levels. Market costs of debt rise as a company's risk of insolvency increases, and greater levels of debt increases the risk of insolvency. Provided that returns to the company exceed the principal and interest costs of debt, the addition of debt can magnify earnings available to shareholders. Conversely, debt can magnify losses and reduce shareholder earnings if company returns do not exceed the principal and interest costs of debt.

Rating a Private Corporation Postal Service

Credit rating agencies, such as S&P and Moody's, use basic forecasts as a tool to compare the abilities of companies to service their debt. The traditional letter ratings from each agency (i.e., AAA, BBB, etc.) imply probabilities of default and recovery. These ratings guide investors to appropriate debt pricing and availability. Companies often use credit ratings as key inputs in balancing debt levels with cost effective market access. When a company's actual performance falls short of expectations and issues arise about the ability to service debt, credit ratings fall, cost of debt rises, and sometimes access to debt ends.

Rating agencies and creditors (investors) would shift their attention from the ability to rely on the U.S. government as a source of financial strength to the earnings power and capital structure strength of the privatized Postal Service. Rating agencies are interested in the ability to repay debt and the reliability of those sources of repayment, which contrasts with equity investors' interest in earnings growth.

Under the current governmental structure the rating agencies would take considerable comfort from the Postal Service's relationship to government. They assume there is a reasonable probability that government would step in and repay debts if the Postal Service failed to do so. They would also take comfort in the availability of funding from the Treasury's Federal Financing Bank.

In the case of a Private Corporation Postal Service, the rating agencies would bias their analysis away from the relationship to the government and toward the fundamental ability of the organization to generate the cash needed to service its debt. They would also look at the reliability of external financing sources as well as other sources of liquidity inherent in the Postal Service balance sheet. Nevertheless, the rating agencies would probably continue to evaluate the Postal Service's public policy value and assume, to some degree, that the government could provide a source of repayment in the event of the Postal Service's inability to fulfill its public policy activities. Depending on the structure of the entity, this could be viewed as an "implicit" backing of the government, similar to the backing the rating agencies assume for the government-sponsored-enterprises, such as Fannie Mae and Freddie Mac.

In a Private Corporation, it is unlikely that the debt would receive any special status under the Securities Acts of 1933 and 1934, given the private status of this new entity. In that case, rating agencies and credit markets would look to the underlying strength of the organization and its actual or contractual relationship to the government, as well as the importance of its mission to the public.

As for any additional private company that might be established, it is likely that the company's debt would be treated as private debt, and analysts would give it a risk rating that reflects a further separation from the government. Consequently, the debt capacity and credit rating would depend on the expected cash flows to be generated by the business. Any limitations on access to capital would clearly be viewed negatively for purposes of determining debt capacity and credit rating.

The business model and business strategies of a Private Corporation Postal Service would have a significant impact on its ability to access private capital.

The Postal Service might also turn to more complex financing techniques to supplement its cash flow. These techniques might include asset sales and secured financing structures, such as leasing or securitization related to real estate, equipment and other assets. Depending on the circumstances, these transactions could prove more cost effective than other alternatives, provide more financing capacity than unsecured debt, and furnish access to financing when equity and debt markets are inaccessible.

Debt Capacity and Optimal Capital Structure

Companies use several methodologies to evaluate their overall debt capacity and their optimal debt levels. Key tools in these evaluations are forecasts that project financial performance based on prospective balance sheets, income statements, and cash flow statements. These forecasts take into account expected prices, volumes, expenses, investments, acquisitions, efficiencies, potential asset sales, competitive dynamics, macroeconomic conditions, the availability and cost of equity and debt, and other relevant information. Generally, multiple scenarios are forecasted to assess the potential for future results to vary from base case projections. Management judgement, however, is ultimately required to balance the risks and rewards of debt.

- Debt capacity measures how much debt a company can service (pay interest and repay principal). Forecasts are used to estimate the potential cash flow available to service debt, and therefore the maximum amount of debt that can be borne.

- Companies apply corporate finance theory to arrive at their optimal capital structure. These theories are built on balancing the market costs of equity and debt, the value of the tax shield, and the risk tolerances of shareholders, debt holders, and management to create the lowest cost capital structure for the company. In effect, companies balance the benefits of leverage and the tax shield against the cost of debt, the potential costs of bankruptcy, and the desire to retain access to additional financing at reasonable cost.

Corporate finance theory implies that companies with safe, tangible assets and taxable income to shield should have an optimal capital structure that relies more heavily on debt. Less profitable companies with risky, intangible assets should have an optimal capital structure that relies less heavily on debt financing.

Lessons from Foreign Posts

Numerous foreign postal administrations have been commercialized during the past decade. While the Postal Service is significantly larger than any of its foreign counterparts, it is instructive to look at the foreign experience implementing various deregulatory measures. Some recent work by McKinsey & Company for the Postal Service, focusing on Sweden, New Zealand, Germany, The Netherlands and Argentina, highlights a number of lessons learned on both the regulatory and business fronts. Successful foreign deregulatory initiatives have included the following key ingredients.

Regulatory Ingredients

- **Gaining agreement to place the issue of an appropriate transition period at the top of the agenda**. Foreign postal entities discovered that securing an appropriate transition period was their most important goal in the regulatory debate. The foreign experience indicates that a transition period can be both too long and too short. The immediate elimination of Deutsche Post's monopoly on parcels 20 years ago caused its market share to drop from 100 percent to 25 percent in a very short period. This resulted in significant damage to the organization, and its parcels business took almost 15 years to recover. Deutsche Post's experience with the lifting of its letter monopoly is also a good example of how an excessively long transition period can reduce an organization's incentive to change. Uncertainty about whether the 2003 date for elimination of the letter monopoly would be extended resulted in the waning of pressure within Deutsche Post to reduce costs and prepare for competition. At the same time, competitors in the liberalized ad mail market gained time to start up new businesses, learn the trade, gain scale, and consolidate.
- **Providing immediate competitive freedoms but phasing out the monopoly over time.** The eventual success of a foreign post in a commercialized environment appears closely tied to how reforms are phased in during the transition period referred to above. Deutsche Post and TPG in The Netherlands gained broad competitive freedoms early in their transition periods. With certain regulatory restrictions and oversight, they could invest in new capabilities and enter new businesses prior to phasing out the monopoly. As a result, the two have been able to prepare for competition by acquiring and consolidating various parcel and express providers, investing heavily in logistic management and e-commerce capabilities, and fundamentally restructuring their retail networks.

- **A full embrace of the need for deregulation by postal administrations and affiliated government ministries.** By embracing rather than fighting deregulation, Deutsche Post in Germany and TPG in The Netherlands gained significant credibility and leverage in the regulatory debate. This allowed them to win important concessions, most notably broad competitive freedoms prior to losing their respective monopolies.
- **The successful completion by foreign posts of early "symbolic actions" which demonstrated a solid commitment to deregulation**. In Germany, Deutsche Post immediately relinquished its monopoly over advertising mail. In The Netherlands, TPG agreed to a major reduction in the price/weight limit that defined their letter monopoly. As a result, both posts were able to win competitive flexibility before a phase out of the monopoly.
- **A strong partnership between postal services and their employees to develop joint positions and build a common understanding of the forces driving deregulation and the advantages of embracing rather than resisting change.** While the unions in Germany, The Netherlands, Sweden, and New Zealand were concerned about job losses resulting from deregulation, a common understanding of electronic diversion, the clear political trend towards deregulation, and impending deregulation abroad convinced employees that the status quo was neither sustainable nor desirable. The Netherlands provides the best example of this dynamic.

Business Ingredients

- **Reducing labor cost.** Prior to deregulation, most foreign postal operators paid wages higher than those paid by the private sector. During and after deregulation, foreign posts cut their labor forces to become competitive. Deutsche Post reduced its workforce by 18 percent in three years. The New Zealand Post reduced its employment base by 40 percent over a ten-year period. Sweden Post reduced its overall cost base by 20 percent in two years. In addition to working closely with their employees and unions to develop a shared outlook and agenda (as described above), foreign posts have made provisions to project job security and wages for existing employees. The Swedish, German, and Dutch posts relied on early retirement, severance packages, and natural attrition to avoid job cuts. In addition, Deutsche Post and TPG grandfathered existing employees under the old wage system and put new employees on a new pay scale.
- **Introduction of a differentiated pricing structure.** Foreign posts have found that the uniform pricing structures left over from a regulated environment have exposed them to underpricing by new competitors with lower scale economies, particularly in low-cost market segments. While differentiated pricing has helped posts gain and/or retain market share, regulators have typically argued that some uniformity in pricing has to be retained. In addition, foreign posts have had difficulty administering differing price structures in different market segments. Avoiding price "spill-overs" from lower-priced to higher-priced markets has been particularly challenging.
- **Improving marketing and sales capabilities and stronger performance ethic.** Deutsche Post, TPG, and Sweden Post realized they needed to better meet the individual needs of each customer segment. They understood that a monopoly

environment with captive customers and uniform prices had not forced them to develop the skills and knowledge to perform high-quality market analysis. As a result, they made it a top priority to build better marketing, sales, and product development capabilities. All invested heavily in these areas and usually recruited outside talent to lead the efforts.

- **Reevaluating operations functions.** Despite having operations-focused cultures, foreign postal operators undergoing deregulation found that their operations functions were not well suited to a commercialized environment. As a result, foreign postal operators have performed initial rounds of cost-cutting coinciding with the start of the deregulatory process. More comprehensive reviews and restructurings have followed these steps.
- **Position for growth in new market.** Motivated by the slowing growth of letter mail volume, commercialized foreign postal operators have quickly entered new businesses to secure “first mover advantage” as soon as they have obtained new competitive freedoms. In general, these posts have focused on parcels, express, logistics, and e-commerce. The best examples are Deutsche Post and TPG. While still maintaining a letter mail monopoly, they have used the freedom to invest earnings, enter new businesses, and set up strategic alliances to buy various logistics, parcels and express mail providers in Europe with a goal of building European-wide networks and to position themselves as “complete logistics solutions providers.” Recently, Consignia in the United Kingdom was granted the ability to retain some of its earnings to invest in other businesses. They have used this authority aggressively to complete acquisitions and joint ventures, while, at the same time, commencing other new business initiatives.