Government Response to the Business, Innovation and Skills Select Committee First Report of Session 2014-15:

Royal Mail Privatisation

Presented to Parliament by the Secretary of State for Business, Innovation and Skills by Command of Her Majesty

October 2014

Cm 8953

This publication is available at www.gov.uk/government/publications

Any enquiries regarding this publication should be sent to us at
shareholder.executive@bis.gsi.gov.uk

Print ISBN 9781474110631

Web ISBN 9781474110648

Printed in the UK by the Williams Lea Group on behalf of the Controller of Her Majesty's Stationery Office

ID 29081401 43616 10/14

Printed on paper containing 75% recycled fibre content minimum

Contents

1. Introduction

1. The Business, Innovation and Skills Select Committee (“the Committee”) published its Report on the Royal Mail Privatisation on 11 July 2014 (HC 539 – 1).

2. The privatisation of Royal Mail in October 2013 completed the Government’s reforms of the postal sector and Royal Mail as enabled by the provisions in the Postal Services Act 2011. The overall objective of the Government’s reforms has been to secure the universal postal service – the one-price-goes-anywhere, six-days-a-week service that is vital to the UK economy for both businesses and social users. Royal Mail is now a FTSE 100 company with the access to the private sector capital that it needs to invest and to grow the business in an increasingly competitive communications market.

3. The Committee prepared its report after conducting several oral evidence sessions and receiving written evidence.

4. The Government has considered the Report and this paper sets out the Government’s response.

2. Government response to the Select Committee's conclusions and recommendations

Objectives of the Sale

1. It is clear that the Government met its objectives in terms of delivering a privatised Royal Mail with an employee share scheme. However, it is not clear whether value for money was achieved and whether Ministers obtained the appropriate return to the taxpayer. We agree with the National Audit Office that the Government met its primary objective. On the basis of the performance of the share price to date, it appears that the taxpayer has missed out on significant value.

We welcome the Committee's conclusion that the Government met its primary objective for the sale.

When assessing value for money it is important to look not only at the proceeds achieved through the Initial Public Offering (IPO) but also at the wider value for money aspects of the sale. The IPO raised proceeds of nearly £2bn for the tax payer. Royal Mail no longer has to rely on public funds. It operates on a fully commercial basis and now has access to private sector capital to invest and grow its business, as evidenced by the raising of £1.8bn in bank facilities and debt capital markets since the IPO. The IPO has also reduced the risk to the tax payer that it would have to provide support for the universal postal service. By retaining a 30% stake in the business, the Government will benefit from future dividends (£39.9m for 2013/14) as well as the capital value of the shares.

A failed IPO would have been a poor outcome for the taxpayer, as the National Audit Office (NAO) recognised in its report. If the IPO had not gone ahead, the value of Royal Mail if it were retained in public ownership would be less than £1bn.

The share price opened at 450p on its first day of trading. But this price was in the context of only a small number of shares being traded (in contrast to the 600 million shares that the Government sold at the IPO). We are clear that we could not have sold 600 million shares for 450p each. The Offer Price of 330p was the highest price that we and our advisers felt we could be confident of achieving and there was no evidence at the time - and the Committee has not found any evidence during its investigations - to suggest otherwise.

Since the IPO the share price has been volatile and in the last eight months has fallen from 618p to 388p.

If the Government had sought to achieve a higher price at the IPO - without either a guarantee or evidence to back this - we would have introduced significant risk to the process. It would have been wrong to risk the success of the IPO in such circumstances.

Offer Price

2. Ministers placed great emphasis on the negative aspects of the industrial relations between Royal Mail and the Communications Workers Union, and in particular on the threat of strike action. While this was a significant factor for investors, we believe that the Government over-emphasised the risk. The share price before, during and after the Union's acceptance of a pay deal demonstrates that industrial relations were less of an issue for the market than they were for Government.

It was clear from the engagement with potential investors that the unstable and widely publicised industrial relations situation was a significant concern for them. Government, therefore, needed to make an appropriate assessment of the impact of such concerns in the context of the IPO.

We disagree with the Committee that we placed too much emphasis on the strike threat. There was an open ballot for strike action at the time of the IPO and the Communication Workers Union (CWU) had been clear about their intention to oppose privatisation. Previous national strike action in 2007 and 2009 had caused significant disruption to the postal service. These strikes accounted for 60% of the total working days lost to industrial action across the whole economy in those years, amounting to 627,000, and 269,000 days lost in 2007 and 2009 respectively. As well as the impact from lost revenues, the strikes impacted on Royal Mail's reputation as a reliable provider of postal services. Royal Mail reported in its 2008/9 accounts that "the strikes called by the CWU in the summer and autumn of 2009 damaged customers’ confidence in the Letters business and had an adverse effect on the Group as a whole". Further strikes would have been damaging to Royal Mail’s reputation as a reliable service provider in an increasingly competitive postal market.

Royal Mail management and our advisers spent over a year engaging with investors to educate them about the business’ potential for growth and to stimulate demand for shares. Industrial Relations was one element of the story but it was a significant risk that could not be ignored. It became clear in the run up to the IPO that that the industrial dispute would only be resolved after the sale of shares as, in our view, much of it was aimed at preventing the sale.

As we have said in evidence to the Committee, the other significant risk factor in the run up to the IPO was that the global markets were facing considerable uncertainty due the US Government being in partial shut-down and the imminent approach of its debt ceiling.

Demand for Shares

3*. The level of the upper limit set for the potential price of shares gave investors a price above which they had no incentive to declare an interest. The Government's advisers must have been aware of this but failed to gauge*

demand at higher price levels. The fact that many long-term investors bought shares later at a far higher price is evidence to us that there was demand for Royal Mail shares at a higher price. We therefore do not accept the Ministers' assertion that the demand for shares would have disappeared at an offer price above 330p. The fact that both Ministers and officials have refused to acknowledge any level of demand for a higher price is, to say the least, disappointing.

The Government based its decisions on the IPO Offer Price on the evidence that we had at the time. The price range was set following engagement with over 500 institutions in one of the largest institutional engagement processes for a UK IPO. The price range reflected not just investor demand but also comparison with key listed European peers and advice from our banking advisers. Based on the evidence from this comprehensive process, we were advised that there was no certainty that we could achieve a higher price. The NAO acknowledged this lack of certainty in their report.

We have consistently acknowledged that there has been some demand above 330p – clearly some investors have bought shares at higher prices once the shares began trading. However, the share price has remained volatile since the IPO - ranging from a high of 618p in January to a low of 388p in September.

The Committee’s views on the share price are based on hindsight and ignore the fact that we were selling 600 million shares. The Committee has not found any evidence to suggest that that the Government or its advisers missed vital information prior to the sale. The price achievable when selling this volume of shares cannot be compared to the price paid by a small number of investors on daily trading volumes of a few million shares per day in the after-market.

A more aggressive approach could have resulted in a failed transaction, leaving the taxpayer at risk of supporting the universal service and leaving the company unable to access the private capital it needs to invest and grow.

"Froth"

4. The Secretary of State noted that the valuation of shares reflected the information that is available at the time. He also argued that "froth" had, in some way artificially inflated the share price. Unfortunately, he was unable to provide us with a meaningful explanation of its impact on the share price in terms of time and value. The Secretary of State's initial use of the term referred to the "immediate aftermath" of the flotation. This was subsequently extended to months and then possibly years. As a result we do not find the argument of "froth" as a credible response to the significant increase in the share price.

The point the Secretary of State was making during the oral evidence sessions was that share prices after an IPO can be volatile and take time to settle. The evidence from trading in Royal Mail shares over the past year has demonstrated that volatility.

The share price reached a high of 618p in January this year but since then the shares have been trading significantly below that peak – the price fell to 388p in September, 18% above the offer price. Market analysts have still not reached a consensus on the target price for Royal Mail with current price targets (typically expectations for the price in 12 months' time) between 360p and 700p.

The Secretary of State said that the 'froth' could dissipate over a period of 3 months to 1 year. Twelve months after the IPO, the price had fallen by over a third from the peak which is 'froth' at any common sense definition.

There is no market norm or exact science in determining how long it takes for a company's share price to reach its stable market value after an IPO. The Association of British Insurers (ABI) has said that that the earliest an IPO can be judged is after the first set of company results (in Royal Mail's case this would have been 7 months after the IPO). Since Royal Mail published its result for 2013/14 in May, the share price has ranged between 555p and 388p. Towards the end of July, the price fell below the price reached on the opening day of trading.

Level of Discount

5. It is accepted that all IPOs will be floated at a discount, with the share price expected to rise when shares are traded. This is important because a fall in the share price on flotation would inhibit the company from raising further investment. However, the rise in Royal Mail shares in the immediate aftermath was significantly higher than the normal percentage increases described by the banks.

6. We conclude that the Department underestimated the market value of Royal Mail and that the sustained increase in the performance of Royal Mail shares points to a pricing decision that was too influenced by perceived risks and fear of failure rather than maximising value for money for the taxpayer.

The Government welcomes the Committee's acknowledgement that a fall in share price would have been a poor outcome for Royal Mail and that the expectation was that the share price would rise after the IPO.

Our pricing decisions were driven by the evidence we had at the time: feedback from 500 investors; comparable valuations of similar companies; analyst valuations; and our valuations undertaken in conjunction with our advisers. Throughout this process we were seeking to secure the best price possible without risking the sale itself. The syndicate of banks was incentivised to secure the optimal share price as their remuneration was a percentage of the sale value.

Our primary objective was to secure a sale in order to safeguard the universal postal service and de-risk the taxpayer. Our focus was on delivering the sale but value for money was central to our decision making which was regularly tested throughout the process through the rigorous scrutiny procedures that apply to all major Government projects. We sold at the highest price supported by the evidence we had.

As mentioned above, the Committee has reached this view with the benefit of hindsight. We had no evidence that we could achieve a successful IPO selling 600m shares at a price higher than 330p. The Committee did not find any evidence that was available in advance of the sale to show that a higher price could be achieved. The NAO has recommended that the Government should consider whether alternative methods of accessing equity markets to that used for the Royal Mail IPO could achieve better value for money. The Government will consider this in order to assess alternatives to bookbuilding for future asset sales.

Priority Investors

7. We agree that it is sensible to identify, in advance, companies which are committed to investing in an IPO. However, we fail to see the benefit to the taxpayer of embarking on a policy of identifying long-term investors without either a criterion on which to judge them or any undertaking given by investors to support Royal Mail in the medium or long-term. The current ownership of Royal Mail by long-term investors has little to do with Secretary of State's actions. Unlike those preferred investors who bought cheaply and sold quickly at a profit, if the current investors are long-term, many of them may have bought at a price far higher than the one set by the Government.

8. We welcome publication of the list of priority investors. However, we are disappointed with the handling of this by the Secretary of State. Twenty-four hours before publication, the Secretary of State told us that such action would result in legal action against his department. We find the speed of this U-turn surprising.

9. The Government's publication of the names and allocations of the preferred investors only provides one part of the picture. We recommend that the Government update that list to include information on which investors sold their shareholding, when they sold and the share price of Royal Mail at that time.

We welcome the Committee's agreement that it was appropriate for Government to identify investors who would be committed to buying shares. Our intention was to ensure that Royal Mail started out with a core of long-term, stable investors who understood the business, along with a small hedge fund participation needed to ensure liquidity in the aftermarket. We achieved that. The investors who were chosen for pilot fishing were typical of those that can be found in a FTSE 100 company and were those who had shown commitment.

The Government did not expect the shareholder register to remain static. Institutional investors have a duty to act in the best interests of their clients so when the share price increased above their assessment of the fair value for the company based on their own research and analysis, some of these investors sold some or all of their shares. This does not detract from their track record of long term support for FTSE and UK listed stocks. Other investors have bought shares up to the peak of 618p – which underlines the wide range of views on the value of this company. Since the IPO, the Law Commission has looked at the fiduciary duties of institutional investors for the Government and has published welcome guidance which makes clear that pension scheme trustees, and those managing assets on their behalf, should consider long-term factors which are, or may be, financially material to the performance of an investment.

We did not seek an agreement with any investors as to how long they should or would hold their shares. Such a commitment would have reduced the achievable price and, therefore, reduced value for the taxpayer.

In relation to the release of the names of the pilot fishing investors, there were legal considerations to take into account before deciding to disclose this information. This involved balancing the interests of the investors and the public interest in release of the information. In these specific circumstances, the Secretary of State took the decision that the balance of public interest lay in disclosing the names. This was in light of the strong interest in who the investors were and some erroneous speculation in the media which the Secretary of State considered should be corrected.

The Government is unable to provide information on which investors sold their shares and at what price. We do not hold such information and there is no mechanism for Government or anyone other than the investors themselves to hold this information. Royal Mail is responsible for maintaining and updating the company's share register and market information research firms prepare information on shareholdings in companies. However this does not include information about specific values for any share sales/purchases. The Government has no role in collecting or collating such information.

Royal Mail Assets

10. We note the conclusion of the NAO that the Government has not extracted the full value of the surplus assets owned by Royal Mail. What is more disturbing is that the Government ignored established NAO recommendations either to remove such assets from the privatisation process or to insert claw-back provisions on the future sale of the properties. The absence of claw-back provisions means that the taxpayer will not reap any benefit should the Department's valuation be proved to be wrong.

The Government did not ignore National Audit Office recommendations about the treatment of surplus property. Each Government asset sale must be looked at on its merits and in the specific circumstances of Royal Mail we concluded that the disadvantages of claw-back or removal from the company outweighed any potential merits.

We confirmed that our financial advisers felt that potential upside from the three major London sites, which were publically disclosed as surplus, could be reflected in the valuation of Royal Mail through the IPO process. Therefore, we made the decision to capture value from future property sales through disclosure in the Prospectus and through analysts' briefings.

We considered that this approach was preferable to the uncertainty of a claw-back arrangement which could have reduced upfront value and returned nothing to the taxpayer in the longer term. We have not found evidence that clawback in relation to real estate has achieved meaningful value for the taxpayer when it has been used in other privatisations.

Removing the surplus property prior to the IPO would also have risked reopening the state aid approval as it would have reduced Royal Mail's ability to make the required company contribution to its restructuring plans.

Government Advisers

11. It should be of concern to Ministers that the NAO concluded that they were too dependent on the professional judgement of its advisers, and that such a reliance on external advisers should be reduced. We do not believe that Ministers were well-served by their Departmental officials, the independent adviser or by the Shareholder Executive. Their blanket refusal to acknowledge a single mistake in spite of a critical auditor's report does little to inspire confidence in their organisations.

12. We recommend that the Shareholder Executive should be required to undertake a detailed valuation of any proposed sale so that the Shareholder Executive, Government and select committees have a baseline against which to subsequently judge valuations made by independent advisers.

The Shareholder Executive team had significant experience of financial transactions in both the private and public sectors. This was augmented by specialist advisers, who the NAO acknowledges were appropriate for a transaction of this scale and complexity. The Shareholder Executive carried out the public procurement exercise for choosing the advisers according to Government procurement rules.

The banking syndicate was fully incentivised to maximise value and the independent adviser was aligned with Government's objective to secure a transaction in this Parliament.

The process was completed successfully and the Government's objectives were met, as acknowledged by the Committee and the NAO. No evidence has been presented or identified to indicate that the process itself or the advice to Ministers was flawed or not backed by the evidence derived from extensive investor engagement and analysis.

The Government would like to clarify the position on valuations which we accept may not have been presented sufficiently clearly to the Committee. The Shareholder Executive does conduct valuations of assets as part of a disposal process.

Our valuations of Royal Mail were conducted with the assistance of financial advisers, but the assumptions and inputs were agreed with Shareholder Executive officials in advance. These were the Government's valuations and formed part of our business case as it developed from the preparatory stages of choosing the sale route through to the IPO. These valuations were a key evidence point in determining pricing, together with other key valuation methodologies such as comparison with similar companies (the multiples method), analyst valuations and investor feedback.

<u>Lazard and Value for Money</u>

13. The NAO is clear in its recommendation that "the taxpayer interest was not clearly prioritised within the structure of the independent adviser's role". We do not believe that this refers solely to an incentive payment structure. Prioritising value for money should not be motivated by financial incentives, it should be a central aim of all of those involved in the sale of public assets. That value for money was not a clear priority in Lazard's contract is unacceptable.

All our advisers were fully aware of the Government's published objectives for the sale of Royal Mail shares which included securing value for money for the tax payer.

We specifically incentivised the syndicate banks to maximise the value of the IPO by structuring their fees as a percentage of proceeds. In the case of Lazard, they were aligned with our primary objective of securing a sale of shares in this Parliament in order to protect the universal service and de-risk the taxpayer in the long-term. It was critical that they were not incentivised to pursue a particular size or type of deal so that we received independent, unbiased advice.

This combination of syndicate and independent adviser fees created the right balance to protect taxpayer value.

<u>Perceptions of Conflicts of Interest</u>

14. While we have no evidence of inappropriate behaviour by those companies employed by the Government, it is clear to us that any perception of financial advantage must be removed from the privatisation process. Therefore we recommend that the Department give serious consideration to excluding any company involved in the selection of preferred investors, as a preferred investor, even if the appropriate "Chinese walls" remain intact.

The Government welcomes the Committee's acknowledgement that there is no evidence of any wrong-doing in the respect of the Royal Mail IPO. We also recognise that there may be a perception issue around the division between banks' advisory and asset management arms.

In line with standard market practice, and as recognised by the NAO, the asset management arms of the banks involved in the IPO were separate from their advisory arms in line with the Financial Conduct Authority's (FCA) rules on conflict of interest. The FCA has both civil and criminal prosecution powers to enforce these rules.

The asset management arms of our advisers received 13 million shares in total (only c.3% of the shares available to institutions) which were held on behalf of their clients. As such the banks did not directly benefit from increases in the share price (although they do benefit from handling and client fees). At the Public Accounts Committee hearing on 30 April, Lazard Asset Management (LAM) explained that, while their clients (including local authority and corporate pension funds, unit trusts and others) did make profits as a result of the rise in the Royal Mail share price, LAM itself only generated income of some £40,000 on an annualised basis from the IPO.

With regard to future sales, we believe that this issue should be looked at in the context of the specific circumstances of each transaction. Rather than an across-the-board exclusion, the Government considers that the issue of "perception" could be addressed in future by ensuring that there is full transparency in such situations and that there is a wider understanding amongst potential critics of the existing rules including the penalties that banks face if those rules are broken. Moreover, excluding firms could be counter-productive and potentially reduce the field of banks that would be prepared to work for Government as advisers on future asset sales if we were to prevent banks' asset management arms from bidding for shares for their clients even though they were fully compliant with FCA rules.

General Correction

The Report contains several references to William Rucker being a member of the Shareholder Executive. This is not correct. William Rucker is the CEO of Lazard in London.

ISBN 978-1-4741-1063-1

9 781474 110631