National Audit Office

The privatisation of QinetiQ

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SUMMARY

1 This report examines whether the privatisation of the defence technology business QinetiQ was a good deal for the taxpayer. The privatisation was carried out in two stages – the sale of 37.5 per cent of the business in February 2003 (33.8 per cent to the Carlyle Group and 3.7 per cent to management and employees). The aim of this was to help develop the business ahead of a flotation on the London Stock Exchange, which took place in February 2006. The privatisation has generated net proceeds of £576 million and the Ministry of Defence (the Department) still holds a 19 per cent stake in the business worth £235 million as at 31 October 2007. A complete timeline for the process is shown in **Figure 1 on pages 6 and 7**.

2 QinetiQ has a vital role in carrying out research and advising the Department on the development and procurement of equipment as well as managing the testing and evaluation of this equipment. It also engages in wider commercial activity and since the privatisation has expanded into the US. It was created out of the Defence Evaluation and Research Agency (DERA) in 2001 specifically to allow the majority of DERA's activities to be privatised. To protect defence interests the most sensitive aspects of DERA's business were kept in the public sector and a system – the Compliance Regime – was put in place to protect the independence of QinetiQ's advice to the Department once it had become a commercial supplier.

3 The decision to split DERA followed wide consultation on the form of the privatisation. Implementing the split was challenging and carried out to a tight timetable. The Department handled this process well. Although the Department did more than was legally required and there have been no legal challenges to date, there were complaints from some elements of the defence industry about the handling of their intellectual property.

4 The decision to sell a minority stake in the business to a strategic partner, rather than float the business on the Stock Exchange soon after incorporation, was taken in early 2002 in the light of poor market conditions and the absence of a commercial track record. Nevertheless, the competition for a strategic partner began in March 2002 even though the market was poor and the commercial terms of the important Long Term Partnering Agreement (the LTPA) had not yet been agreed.[1] The Department considered that a delay to the privatisation process could have had an adverse impact on long term value by undermining staff morale, damaging customer relationships and restricting QinetiQ's commercial freedom at a key stage in its development. In recognition that QinetiQ was hard to value and that the timing of the sale would have an effect on proceeds, the Department decided to sell only a minority of shares, in line with relevant recommendations from the Public Accounts Committee and National Audit Office.

5 Achieving a good price in a sale relies on there being strong competition. Twelve investors were selected to participate in the competition and four were shortlisted. The difficult timing and complexity of QinetiQ's business increased the market's perception of risk and contributed to there being only two compliant bids, in July 2002, both from private equity firms. The Carlyle Group were appointed 'preferred bidder' in September 2002, before the detailed terms of the LTPA had been agreed. The sale to Carlyle was signed in December 2002 and completed in February 2003, when the LTPA was signed.

6 After Carlyle were appointed preferred bidder they negotiated a reduction in the value of the business of £55 million, £25 million relating to the pension fund deficit (see paragraph 2.29) and £30 million relating to the value of the LTPA (see paragraph 2.27). Our analysis shows estimated cash proceeds in the final bid falling by £32 million to £155 million in the final deal. This was a result of a number of changes including the sale of 2.5 per cent more of the shares than initially agreed (see paragraph 2.32). Decisions on restructuring and funding of the services included in the LTPA had been going on since 1998. Due to the uncertainties stemming from the lack of agreed terms for the LTPA, we consider that the sale to Carlyle may have yielded less money than the Department could have received if the LTPA had been signed prior to the sale. The Department told us it was concerned that delaying the sale would have an adverse impact on the value received from the privatisation. To help reduce uncertainty in the bidding process the Department included draft terms for the contract within the sale documentation.

7 As is normal for private equity firms, Carlyle used share incentives to align management's interests with their own, that is, to realise the maximum possible increase in the value of the equity in the short to medium term. The Department considered that its interests in terms of incentivising management to increase the value of the business were aligned with Carlyle's. Although it did not want management to make very large returns purely as a result of the privatisation it accepted that management could make significant amounts of money if this was linked to the growth in the value of the business. The Department did not, therefore, seek to influence the structure of the share incentive scheme. Carlyle amended their proposed management incentive structure before being appointed preferred bidder to reflect advice from QinetiQ management. The Department subsequently approved the scheme after Carlyle were selected as preferred bidder. Its approval was based on a review of a limited range of potential outcomes, which it believed were realistic at the time (see paragraph 2.17). Up to 20 per cent of the equity was made available to management and employees, subject to performance targets being met (see Appendix 4). Unusually for such deals, but in line with the Department's objectives, share incentives were made available to all QinetiQ staff, including a small allocation of free shares. Not all staff took the opportunity to invest their own money in the business.

8 The structure of the deal resulted in QinetiQ having a relatively low equity value of £125 million and high levels of debt. The equity value increased to £1.3 billion[2] between the 2003 sale and the 2006 stock market flotation. This was strongly influenced by the improved business performance achieved by QinetiQ management following expansion into the US defence market and into the civil market in the UK and elsewhere. This contributed to a 36 per cent increase in revenue and a 261 per cent increase in operating profit between 2003 and 2006.[3] The increase in the equity value was also influenced by an upturn in the value of defence and technology stocks.

1 The Long Term Partnering Agreement is a 25 year contract to operate and maintain the test and evaluation ranges.
2 Including £150 million of new money raised by the company.
3 International Reporting Standards were introduced in 2005 which affected the presentation of financial results. The impact of this is shown in Figure 13.

1 Timeline of the privatisation of QinetiQ

Key

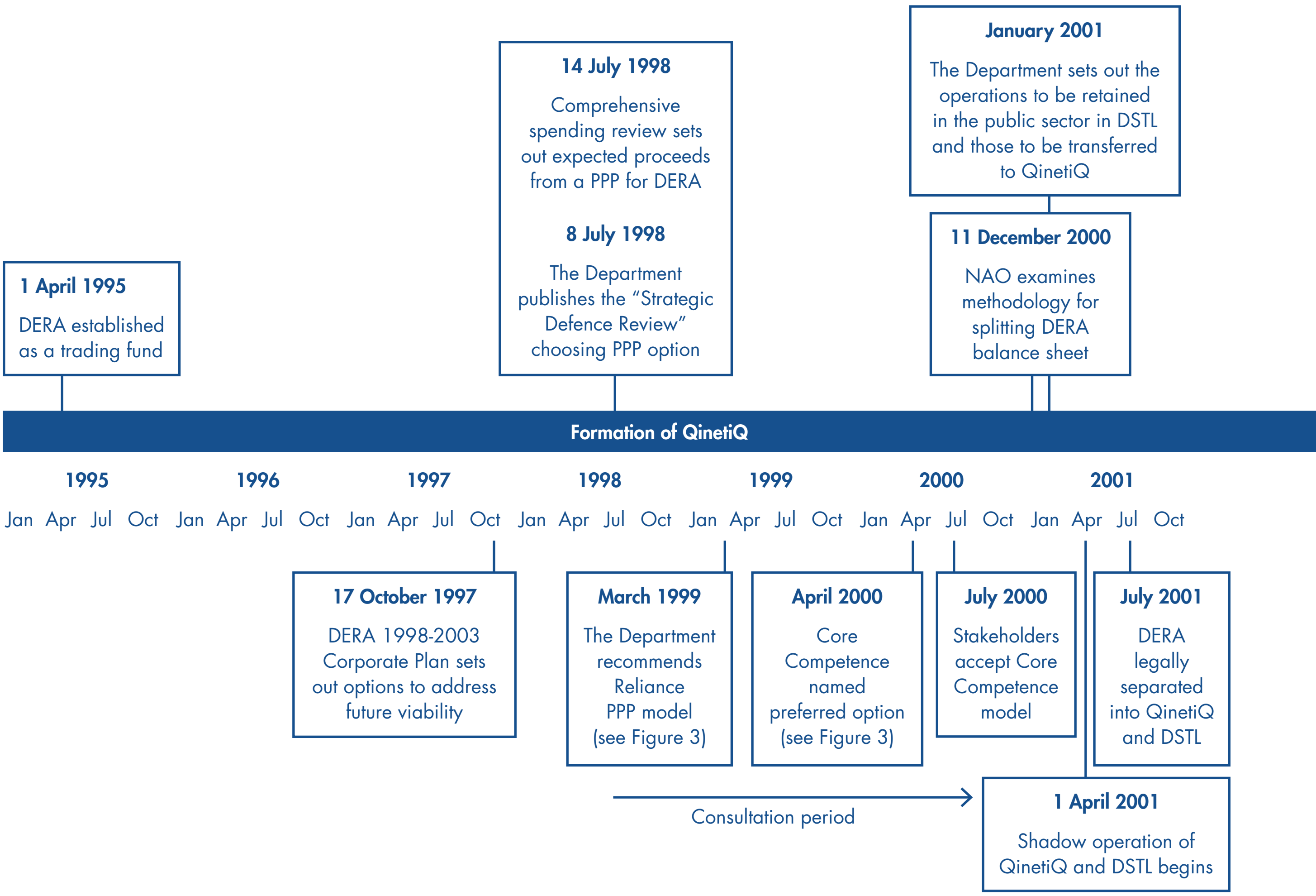
DERA – Defence Evaluation and Research Agency

PPP – Public Private Partnership

HCDC – House of Commons Defence Select Committee

DSTL – Defence Science and Technology Laboratory

LTPA – Long Term Partnering Agreement



Source: National Audit Office analysis

The process of appointing a strategic partner

8 March 2002

Strategic Investor advertisement

23 April 2002

Information Memorandum issued

22 May 2002

Seven indicative bids received valuing QinetiQ in the range £450 million – £600 million, all bidders requested 51 per cent of QinetiQ

28 May 2002

Bidders shortlisted to four

8 July 2002

Bidders requested to bid for 51 per cent and 35 per cent of QinetiQ

15 July 2002

Two final bids submitted in range £325 million – £350 million

16 August 2002

Revised final offers received

4 September 2002

Carlyle announced as preferred bidder with offer of £374 million

4 September 2002 – 28 February 2003

Carlyle negotiate as preferred bidder

3 December 2002

Share Purchase Agreement signed

QinetiQ's Acquisitions up to the flotation

Date	Acquisition	Price
March 2002	Motionbase (UK)	£0.8 million
August 2004	HVR Consulting Services (UK)	£10.9 million consideration
September 2004	Foster Miller Inc. (US)	£96.9 million consideration
September 2004	Westar Aerospace & Defense Group Inc. (US)	£73.0 million
August 2005	Planning Systems Inc. (US)	£23.1 million consideration
August 2005	Apogen Technologies Inc. (US)	£160.1 million consideration
September 2005	90% of Verhaert Design and Development NV (Belgium)	£6.0 million
October 2005	Broad Reach Networks Ltd. (UK)	£0.3 million

Consideration includes acquisition costs and is net of cash acquired on purchase and deferred consideration

January 2002

Potential investor market testing

28 January 2002

Early flotation abandoned

Sale to strategic partner | **Route to Flotation**

2002: Jan Apr Jul Oct | 2003: Jan Apr Jul Oct | 2004: Jan Apr Jul Oct | 2005: Jan Apr Jul Oct | 2006: Jan Apr Jul Oct

28 February 2003

Financial close – 37.5 per cent of QinetiQ sold (including 3.7 per cent to employees)

QinetiQ equity established at £125 million

QinetiQ sign LTPA

Flotation

25 January 2006

Flotation prospectus issued

10 February 2006

Flotation valuing equity in QinetiQ at £1,300 million, £2 per share (including £150 million new money)

9 The value of the shares of the top 10 managers was £107 million at the time of the flotation, from an initial investment of £537,250. The Department considers that the management incentive scheme met the objective of maximising value. The returns achieved by management reflected a greater increase in the value of the business than it had expected, which also generated higher than expected returns for the taxpayer. Although we accept that limiting returns to management can diminish the attraction of such deals to potential investors, we consider that the returns in this case exceeded what was necessary to incentivise management to deliver this growth in the value of the business.

10 The 2006 flotation was well executed and benefited from favourable market conditions, with the Department realising £300 million of additional proceeds, net of costs. The decision to sell only a minority of shares to Carlyle enabled the Department to benefit from the majority of the growth in value. The absence of a dedicated offer to the public, which had been present in most previous privatisations, had an adverse effect on the media perception of the privatisation. This decision was taken because the shares were only considered suitable for sophisticated investors and the costs of marketing the issue to the public would not have been outweighed by the benefit of extra demand because of the limited size of the offer. The public were able to buy limited shares through brokers.

Value for money assessment

11 The Department considers that privatisation has delivered excellent value for money on the basis that it has generated approximately £800 million for the taxpayer, net of costs (£576 million in cash proceeds to date and a 19 per cent stake in QinetiQ worth £235 million as at 31 October 2007). The equity value of QinetiQ increased from £125 million to £1.3 billion as a result of the introduction of a strategic partner in 2003, despite difficult market conditions and the complexity of QinetiQ's business. The Department also considers that the process has established QinetiQ as a successful new British company and that it has provided a sustainable future for key defence capabilities and the employment of 13,500 staff.

12 Our assessment of the outcome in terms of value for money is mixed. The privatisation achieved a key objective of improving the viability of a business of national strategic importance by allowing QinetiQ to expand its business into the US and other civil markets. The measures put in place to protect defence interests at present appear to be working as intended. It is, however, too early to tell if all the Department's objectives in privatising DERA will be met.

13 We consider that more money might have been raised from the 2003 sale to Carlyle, which generated total proceeds of £155 million. The resulting business strategy, however, was instrumental in increasing the value of QinetiQ and the 2006 flotation maximised proceeds. In the long term, the value for money of the privatisation to the taxpayer will depend on a range of factors, such as the value for money of the Long Term Partnering Agreement and the continued availability of independent advice, as well as the proceeds received.

14 We have calculated that as at 31 October 2007 the Department made a notional internal rate of return[4] of 14 per cent from the privatisation. This calculation uses the book value of QinetiQ on incorporation as an estimate of the Department's past investment in the business and takes account of the costs the Department has incurred throughout the privatisation and the value of the Department's remaining stake in QinetiQ; it does not attempt to quantify non financial benefits. The Department does not accept that the book value of QinetiQ at incorporation is a robust measure of the value of the business at that time and considers that it is not possible to derive an accurate estimate of the return it has achieved over the whole privatisation.

15 Carlyle made an internal rate of return of 112 per cent[5] on their investment in QinetiQ. The internal rate of return achieved by the Department over the same period was 99 per cent.[6] The Department's internal rate of return was similar to Carlyle's because both parties invested on the same terms at that stage. The Department, however, incurred significant costs during the 2003 sale.

4 The internal rate of return (IRR) is the discount rate at which the present value of all cash flows will be zero; it is used to rank investment opportunities, the higher the IRR the more profitable the investment. For our analysis we have included the value of the retained shares of the Department as at 31 October 2007.

5 This is based on the price paid by Carlyle for their stake in 2003 and the subsequent proceeds received from the sale of this stake.

6 This ignores the receipts from the sale to Carlyle, assumes that the Department's initial investment in QinetiQ was equal to £78 million, the value of its shares in QinetiQ at that time, and includes the value of the retained shares of the Department as at 9 February 2007, the date Carlyle sold their remaining stake in the business; the Department's eventual return will depend on the value of these shares when sold.

Recommendations

The Department's ongoing relationship with QinetiQ

The Department must actively manage the risks that privatising QinetiQ has created if the transaction is to realise value for money.

1 Although the Long Term Partnering Agreement (LTPA) has brought benefits to the management of test and evaluation services, the Defence Procurement Agency and its successor need to act as an 'intelligent customer' to ensure the savings envisaged in the contract are realised. We welcome the fact that in February 2007 the Department has decided to review some of the services conducted by QinetiQ and to build appropriate cost benchmarks. In the absence of other comparable service providers, cost benchmarks should be based on QinetiQ's past performance and should have regard to the cost of providing test and evaluation services by other bodies abroad. The Department should ensure these are developed in advance of the first price review period in March 2008.

2 The Compliance Regime appears to be working as intended but, as QinetiQ continues to expand its customer base and is able to bid for defence manufacturing work beyond April 2008, maintaining the effectiveness of the regime will become more difficult. We welcome the Department's September 2006 decision to audit the robustness of the Compliance Regime. The Department intends that the initiative to award an increasing proportion of research contracts through competition will reduce its dependency on QinetiQ, provide access to new sources of innovation and improve value for money. It should revisit its aspirations for this initiative and ensure that they are realistic in light of the market capacity for this work.

Lessons from the privatisation of QinetiQ

The decision to sell a minority stake to a strategic partner ensured the Department shared in the growth in value at the flotation. There are, however, lessons that can be applied to benefit future deals.

Achieving best value from a sale

3 When marketing a sale to potential strategic partners, it is important to gauge market interest by approaching as many potential investors as is feasible to assess their understanding of the business and their ability to participate in the process within the proposed timetable. In cases where the market is difficult and the business is unique or complex and lacking a commercial track record, as in the case of QinetiQ, the public sector should educate potential investors about the opportunity. This would include providing written information on the business and the transaction timetable to a wide range of potential investors.

4 If marketing activity demonstrates that there is limited interest in the opportunity, the public sector should reconsider the timing and structure of the proposed deal. In the public sector the impetus is often to press ahead in difficult circumstances rather than to attempt to maximise proceeds. It is not unusual for private sector deals to be postponed if the market is less favourable than anticipated.

5 It is undesirable to negotiate a significant contract with the company to be privatised in parallel with the privatisation, as was the case with the Long Term Partnering Agreement (LTPA), and the public sector should avoid this. If, nevertheless, the public sector finds itself in this position it will have additional risks to manage.

a Bidders need certainty over the terms of key contracts in order to value the business. If there is any uncertainty it is likely this will lead to a lower price or discourage bidders from submitting binding, unconditional offers. The public sector should not appoint a preferred bidder until the terms and price of the contract have been substantially agreed.

b To achieve the maximum value the public sector needs to have a full understanding of the value of the business and of the interactions in value for money. There is a trade-off between the value received from a contract as a customer and the level of proceeds achieved from the sale. In the case of QinetiQ the Department relied on a financial model developed for customers and had not substantively valued the contract (see Appendix 5). It was therefore not in a position to understand the true value of the contract to QinetiQ and whether the fall in proceeds was balanced by a benefit to the Department as a customer. Departments should achieve this by ensuring there are robust independent valuations of all the key aspects of the business and that these are updated where contractual terms change.

Managing differing interests

6 When private equity firms are involved in a privatisation process they typically offer incentives to management to maximise the value of the business in the short to medium term. This may create the scope for a successful management team to make returns that are far in excess of the rewards available in the public sector. The interests of the public sector may not be fully aligned with those of the private equity bidders, especially in respect of the potential scale of returns for management. If Departments wish to limit the scope for such returns then they should consider mechanisms such as capping arrangements, taking appropriate professional advice if required. Such mechanisms may diminish the attraction of the deal to potential investors.

7 Departments should protect their interests by not allowing management to discuss incentive schemes with potential partners until the main principles have been agreed and a preferred bidder chosen.

8 Non-executive directors have an important role to play in safeguarding shareholder interests. Their participation in employee share schemes could lead to a perception of a conflict of interest. We recognise, in the case of QinetiQ, that the timing of the offer was after the deal had been substantially agreed. Following the QinetiQ privatisation, however, non-executive directors may anticipate the possibility of making significant financial gains. Any such expectation has the potential to create conflicts of interest. There is no specific guidance to prevent non-executive directors from participating in share ownership schemes put in place as part of a privatisation. To avoid any perception of a conflict of interest, the Government should ensure that they are not offered an opportunity to participate.

Managing the separation of intellectual property

9 The Records Audit and Segregation Process, carried out as part of the separation of QinetiQ from DERA, involved auditing all intellectual property held by DERA so that QinetiQ was not unlawfully in possession of any intellectual property belonging to third parties. This exercise went beyond what was legally required. Elements of the defence industry, however, had significant concerns over the transparency of the process and the time allowed for them to confirm the correct treatment of intellectual property they had given to DERA before its successor was to become a competitor. The Department should ensure that in future privatisations, the defence industry is given adequate time to satisfy itself that all intellectual property has been treated appropriately prior to the business becoming a corporate entity. This can be achieved by engaging with industry during the process and reflecting the need to agree the treatment of intellectual property within the timetable for the transaction. This would be consistent with the Department's aspirations to promote 'closer working, greater trust [and] increased partnerships' with the defence industry as set out in the Defence Industrial Strategy.[7]

7 Section A8.1, *Defence Industrial Strategy*, Defence White Paper, published December 2005.