Report
by the Comptroller
and Auditor General

HM Treasury and United Kingdom Financial Investments Limited

The first sale of shares in Lloyds Banking Group

HC 883 SESSION 2013-14 18 DECEMBER 2013

Key facts

£3.2bn	3%	33%
proceeds from the sale	discount to the market price at which the shares were sold	of Lloyds Banking Group remaining in public ownership

77.4p was the market price of the shares ahead of the sale

2.8 times more demand than shares on offer

75p was the price at which the shares were sold

4.3 billion was the number of shares sold

74p was the price of the shares at the end of the first week of trading

Summary

1 To maintain financial stability at the height of the financial crisis in late 2008, the government provided public support to the banking sector, including the purchase of £20 billion of shares in Lloyds Banking Group (Lloyds). In September 2013, the government sold just over 15 per cent of the taxpayers' shares in Lloyds to institutional investors for £3.2 billion. Following the sale, the government continues to be the largest single shareholder, with just under 33 per cent of Lloyds' ordinary share capital. A further sale of shares is likely in 2014.

2 This first sale was arranged by United Kingdom Financial Investments Limited (UKFI), a stand-alone company established in 2008 by the Treasury to manage the government's stakes in Lloyds and Royal Bank of Scotland. While UKFI devised and executed the strategy for selling the shares, the decision on the final form and timing of the sale rested with the Chancellor of the Exchequer.

3 We have stated in the past that we would return to the subject of banking interventions when the government disposes of the assets acquired, and did so for the first time in March last year with a published report on the sale of Northern Rock plc.[1,2] This report examines the value for money of the Lloyds share sale, particularly whether:

- the most appropriate sale method was chosen;
- the sale was timed and structured appropriately;
- the price obtained was reasonable; and
- whether there was a gain or shortfall for the taxpayer.

1 National Audit Office Strategy 2011-12 to 2013-14 (National Audit Office, November 2010), paragraphs 3.8 and 3.9.

2 Comptroller and Auditor General, *HM Treasury: The creation and sale of Northern Rock plc,* Session 2012-13, HC 20, National Audit Office, May 2012.

Key findings

Was the most appropriate method of sale chosen?

4 When planning to sell public assets, we expect departments to conduct a thorough review of all available sale options. In this case, there was a choice between: a private sale to another bank or large financial investor; or a wider offering of shares to institutional and retail investors.

5 UKFI did not receive any expressions of interest from other banks. In any case, a bilateral deal negotiated with another bank or large financial investor would have been difficult to justify unless the shares could be sold at, or at a premium to, the then prevailing market price. In such circumstances, UKFI correctly decided to explore options for a sale to a wider range of investors (paragraphs 1.6 and 1.7).

6 Selling all the shares in one go would not have been good value. At a market value of around £20 billion, the shareholding was too large for a single sale at a competitive price. A series of sales over a period of time was likely to produce better value (paragraph 1.9 and Figure 1).

7 A sale to both institutional and retail investors would have been too high-risk. A sale involving retail investors would have required up to six months of preparation, publication of a prospectus and an announcement of the date of the sale. This would have constrained UKFI's flexibility to conduct the sale when market conditions offered the best prospect of selling the shares at a fair price (paragraph 1.12).

8 To minimise risk, UKFI correctly decided to sell the shares over a 12 to 48 hour period. In the summer of 2013, economic conditions remained uncertain and there was also uncertainty on how central banks might begin to roll back monetary stimulus measures, such as quantitative easing, in an orderly way. Given such uncertainty, a sale of part of the shareholding, using a more flexible and timely process, offered the best defence against the risk that the financial markets might fall (paragraphs 1.11, 1.16 and 2.7).

Was the sale timed and structured appropriately?

9 Having chosen an appropriate sale method, we also expect departments to consider carefully whether market conditions are right for such a sale and, if so, how many shares could be sold.

10 UKFI commissioned an extensive analysis of the value of Lloyds. UKFI asked JP Morgan to analyse whether the market price of Lloyds shares reflected a fair valuation of the business. JP Morgan used three valuation approaches to construct a fair value range of 41p to 89p a share and this was reviewed by Lazard & Co acting as UKFI's capital markets adviser (paragraphs 2.3, 2.4 and Appendix One).

11 UKFI's judgement that a sale from August 2013 onwards offered good value was based on sound evidence. In the summer of 2013, Lloyds shares were trading at 73p to 77p, close to a 12-month high and at the upper end of the range of values implied by JP Morgan's analysis, reflecting a significant improvement in investor confidence following the Eurozone crisis and encouraging data on the UK economy (paragraphs 2.5 and 2.6, Figures 2 and 3).

12 The number of shares that could be sold was, however, limited. Although a sale over a 12 to 48 hour period would minimise exposure to market risk, the size of the sale was constrained by the short sale period, which favoured large institutional investors able to react quickly (paragraphs 1.11, 2.12 and 2.13).

Was the price obtained reasonable?

13 Where shares are already trading on the Stock Exchange, we expect departments to protect value by: maintaining confidentiality ahead of any sale; maximising competitive tension among potential purchasers; and setting a price which reflects demand and ensures a stable price for the shares in trading after the sale. It is also important to minimise the costs of arranging the sale.

14 The share price was unaffected by the prospect of an imminent sale. Although speculation around a sale appeared regularly in the media, share price movements in the two weeks ahead of the sale showed no unusual downward movement, suggesting that UKFI's plans had not become known to market participants (paragraph 3.2 and Figure 4).

15 Demand in the sale was high but depended on orders from investors who were not seen as longer-term holders of the shares. Demand for the shares at a price of 75p exceeded the number of shares on offer by some 2.8 times and compared well with similar sales. However, over three-quarters of this demand came from institutions that were seen as shorter-term investors. UKFI and its advisers received feedback from longer-term investors that demand had been subdued. Given the growth in the share price during 2013, further near-term price rises were expected to be limited (paragraphs 3.3 to 3.5, Figures 5 and 6).

16 The dependence on shorter-term investors limited the price at which the shares could be sold. UKFI's key objective in this first sale was to maximise price while ensuring a positive but stable aftermarket. Pricing the shares at 75.5p or 76p would have required allocating more than 60 per cent of the shares to institutions that were seen as shorter-term investors. If these investors sold their shares soon after the sale, there was risk of a weak aftermarket and negative perceptions affecting future sales. For this reason, UKFI priced the sale at 75p a share (paragraphs 3.6, 3.7 and Figure 7).

17 Nevertheless, the sale was at a smaller discount to the market price than seen in similar sales. As Lloyds shares were already traded on the Stock Exchange, their market price immediately before the sale provides a benchmark against which the price obtained can be measured. At 75p a share, the price represented a 3 per cent discount to the closing market price of just over 77p ahead of the sale. This discount compares well with the average discount of just over 4 per cent seen in the ten largest similar sales since 2008 (paragraphs 3.8, 3.9 and Figure 8).

18 Following the sale, the market price of the shares has held steady, lending support to UKFI's decisions on timing and pricing of the shares. At the end of the first week of trading the market price of the shares fell slightly from 77p to 74p. In the four weeks following the sale the shares traded at between 73p and 77p, mirroring changes in the FTSE 100 index (paragraph 3.10 and Figure 9).

19 UKFI does not hold detailed information on who sold and who bought shares in the aftermarket. Over 2.5 billion shares were traded in the four days after the sale but we have not been able to establish who was buying and who was selling in the aftermarket and whether allocations of shares to investors were a reasonable reflection of their actual behaviour after the sale (paragraphs 3.11 and 3.12).

20 Costs were lower than in similar sales. It is standard practice for investment banks, acting as book-runners to market a sale, to charge the seller of shares a fee, expressed as a percentage of the proceeds raised. However, following a competitive procurement exercise and negotiations, UKFI secured agreements with the book-runners that it would not be charged a fee (paragraphs 3.13 to 3.15).

Was there a gain or shortfall for the taxpayer?

21 There was a shortfall for the taxpayer of at least £230 million. A simple comparison of the price at which the shares were bought with the sale price produces a gain for the taxpayer of just under £120 million. However, taking account of the cost of borrowing the money to buy the shares produces a shortfall of £230 million. In 2009, the first report on maintaining financial stability published by the National Audit Office concluded that the scale of the economic and social costs from the collapse of one or more major UK banks was difficult to envision and that the interventions to support the banks were justified. (paragraphs 3.16 to 3.20 and Figure 10).

Conclusion on value for money

22 This first sale represented value for money. UKFI conducted a thorough review of its options, choosing a sale process that maintained flexibility on timing and allowed the transaction to be completed quickly once a decision to sell had been made. The sale took place when the shares were trading close to a 12-month high and at the upper end of estimates for the fair value of Lloyds' business. Furthermore, the shares were sold at a relatively low discount to the market price compared with discounts seen in similar sales, and the after-market in the shares has remained steady. The shortfall of at least £230 million should be seen as part of the cost of securing the benefits of financial stability during the financial crisis, rather than any reflection on the sale process, which UKFI managed very effectively.

Recommendations

23 Ahead of the next sale, **UKFI should analyse in detail who bought and who sold shares in the aftermarket and whether such behaviour was anticipated correctly in the pricing and allocation of shares.** Such information will help UKFI to deepen its understanding of the likely behaviour of individual institutional investors and of the types of institutions to which it would prefer to sell Lloyds shares.

24 When seeking authority to launch future sales and recommending the price at which shares should be sold, **the Treasury should take account of the cost to the taxpayer, particularly the cost of finance, when analysing the opportunity cost of retaining the shares as opposed to selling them.** Such an analysis would also provide the basis for more informed public reporting of outcomes immediately after future sales.

25 **Where departments are required to undertake longer-term projects requiring specialist skills, they should consider hiring experts directly and retaining them in-house.** Such a strategy may provide better value for money than buying in expertise for short periods on consultancy-type contracts. UKFI had a clear mandate to design and manage this sale and has provided the Treasury with greater expertise, along with a more independent focus and discipline regarding taxpayer value.