Report
by the Comptroller
and Auditor General

Department for Business, Innovation & Skills

The Privatisation of Royal Mail

HC 1182 SESSION 2013-14 1 APRIL 2014

Key facts

£1,980m	£1,704m	38%
cash proceeds for government's 60 per cent stake sale	value of government's remaining 30 per cent stake[1]	increase in Royal Mail share price on the first day of trading

24	number of times by which the share offer was oversubscribed by institutions
£334 million	free cash flow generated by Royal Mail in 2012-13
167,000	Royal Mail's employees who were given 10 per cent of the shares
690,000	retail investors bought shares
72 per cent	increase in Royal Mail share price over the first five months of trading[1]
60 pence	cost of a first class stamp at the date of the sale, an increase of 30 per cent in 2012-13

1 Value as at 13 March 2014.

Summary

1 In October 2013, the Shareholder Executive (the Department) part of the Department for Business, Innovation & Skills sold 60 per cent of the government's shares in Royal Mail plc to private investors for 330 pence each, generating proceeds of £1,980 million. Following this transaction Royal Mail shares have been admitted to the main London Stock Exchange index (FTSE 100) and the company has joined a peer group of national postal operators that have been privatised by other European member states in recent years, including those of Austria, Belgium, Germany and the Netherlands. On the first day of conditional trading Royal Mail's shares closed at 455 pence (38 per cent higher than the sale price) and in the following five months have traded in the range of 455 pence to 615 pence.

2 The privatisation implemented the final recommendation of two government reviews by Richard Hooper CBE (2008 and 2010) on securing an affordable, sustainable universal postal service. The Hooper reviews had concluded that Royal Mail was less efficient than many postal companies elsewhere in Europe that had undergone modernisation, and that it urgently needed commercial confidence, capital and corporate experience to modernise quickly and effectively. To achieve this Hooper recommended:

- transferring responsibility for Royal Mail's historic pension liabilities to the government;
- reform of the regulatory regime and removal of price controls; and
- introducing private capital to Royal Mail.

3 The government has already implemented the first two recommendations. The sale of Royal Mail aimed to achieve the third. The government published its objectives for the sale in April 2013, which were to sustain the universal service for the benefit of all users by introducing private sector capital and commercial disciplines, to be achieved by:

- delivering a sale of shares within this Parliament;
- creating an employee share scheme that would lead to at least 10 per cent of the company in employee ownership; and
- delivering a financial outcome for the taxpayer, which, when considered in the context of the overarching policy objective, represented value for money.

The Department also aimed to allocate shares to investors in a way that optimised price while establishing a long-term, stable and supportive shareholder base.

Scope of the report

4 This report examines whether the Department achieved its sale objectives, while protecting the taxpayers' interests. We have not examined the wider issues of regulating the postal sector, the level of protection afforded by the regulator for the universal service, or the implementation of Hooper's other recommendations such as removal of the historic pension deficit from Royal Mail. It covers:

- the context for the sale (Part One);
- restructuring Royal Mail's business in readiness for sale (Part Two);
- advisers, transaction alternatives and valuation (Part Three); and
- book-building, final demand and pricing (Part Four).

Key findings

Preparing and restructuring Royal Mail

5 **Royal Mail is now a profitable business with much improved cash flow, following substantial intervention by the government.** In 2007, Royal Mail started a long-term transformation programme to improve efficiency. In 2012, it was separated from the Post Office business, with the latter remaining in public ownership. The government took over Royal Mail's historic pension liabilities, which was valued as a deficit of £8.6 billion.[2] There were wide ranging regulatory reforms including the removal of most of the price controls. The combination of these factors contributed to a turnaround in the company's cash flow. It generated £334 million cash in 2012-13, reversing negative cash flow of £493 million in 2008-09. Hooper recommended that the government should go further to allow Royal Mail access to private capital and commercial disciplines (paragraphs 1.7, 2.2, 2.6 to 2.11 and Figures 3, 4 and 5).

6 **The Department took a cautious approach to Royal Mail's initial capital structure.** The Department replaced Royal Mail's government borrowing with commercial debt at a level consistent with an investment grade rating. Market expectations are for Royal Mail to generate significant cash flows in the next few years, which would provide the ability to substantially repay its new debt. This could provide significant flexibility for the company and be seen as a key benefit by its shareholders. The Department also decided that Royal Mail should retain its property portfolio which included three properties in London with a market value of more than £200 million which had been recognised as surplus assets. Although the value of the estate, the status of these assets and the necessary separation activities were disclosed in the prospectus and reflected in analyst reports which informed investor decisions, we do not believe that the basis on which Royal Mail was sold recovered all of this value (paragraphs 2.3 to 2.5, 2.15 to 2.20, 3.13, 3.17 and Figures 6 to 7).

2 Royal Mail plc, *Update on pensions, Royal Mail plc Half Year Results 2013-14 presentation slides*, 27 November 2013. Figures stated on an actuarial basis.

7 **Privatisation has reduced taxpayer risk to support the universal postal service, but the government retains the ultimate responsibility.** The government is responsible for ensuring continuation of the universal postal service. The UK population enjoys a more extensive universal postal service than is required under European Union law, including Saturday collection and delivery. Royal Mail has responsibility for delivering the universal service and is the only company with a national network and scale to provide this. Private capital has created an equity buffer to protect the taxpayer, and Ofcom could intervene if it assessed that the universal service was under threat or the company fails to meet service standards. A special administration regime would be triggered if Royal Mail should collapse, although the government has not quantified the financial implications for the taxpayer if this occurred (paragraphs 1.2 to 1.3, and 2.22).

Advisers, valuation and initial public offering (IPO) process

8 **The Department placed significant reliance on financial advisers to prioritise completing a sale.** The Department assembled a team with the professional experience required to navigate a complex restructuring and complete a landmark transaction. It also appointed an independent corporate finance adviser and delegated a wide range of tasks including independent advice covering valuation, selecting, supervising, and overseeing the allocation of shares by the banking syndicate, and exploring other sale options. In addition, the Department appointed a syndicate of banks to market the shares to potential investors and allocate shares. It aligned the independent corporate finance adviser's incentives with the principal objective of achieving a sale in the current parliament and the syndicate was incentivised to maximise proceeds (paragraphs 3.2 to 3.11 and Figure 8).

9 **The sale was designed to ensure the government would become a minority shareholder.** The Department targeted a majority sale to achieve its policy objectives. Having explored the only viable alternative of a private sale, an IPO was the Department's preferred method of introducing private capital. Investors expressed a strong preference for the government to sell a majority of its shares. The Department agreed to limit the government's voting rights to a maximum 30 per cent even if the privatisation resulted in a residual stake of between 30 and 50 per cent (paragraphs 3.31, 4.10 and Figure 16).

10 **The Department estimated that the value of retaining Royal Mail in public ownership was less than £1 billion (£1 per share).** The calculation assumed that if the IPO did not proceed, Royal Mail's profits would decline relative to recent performance, based on factors such as historical underperformance and the Department's view of industrial relations issues under public ownership. It also reflected the risk that key management executives might have resigned if the IPO did not proceed (paragraph 3.17).

11 **The timing of the sale was relatively inflexible and took place under conditions of considerable uncertainty.** The government announced its intention to sell Royal Mail within the current Parliament. This gave limited time for Royal Mail to demonstrate a profitable track record. The Department kept timing options open, but there was little flexibility. The timing of the strike ballot and the possibility of the United States breaching its debt ceiling affected the latter stages of the IPO timetable and price (paragraphs 1.8, 2.12 to 2.14, 3.27 to 3.29 and 4.6).

12 **The Department conducted an extensive marketing campaign to attract interest in Royal Mail's shares and prioritised those investors most willing to underpin demand for shares.** To attract investor interest in Royal Mail's shares the banking syndicate started a global search for investors almost a year before the IPO. The syndicate conducted hundreds of discussions with potential investors and this filtering process identified 17 'priority' investors that were willing to place non-binding orders for shares at a price of 250 pence even in the worst case scenario of industrial action.[3] This gave the Department confidence there was sufficient demand for shares for the IPO to proceed but price-competition at this stage was limited (paragraphs 3.28 to 3.31 and Figures 12 and 13).

13 **The Department set the low end of the price range at a cautious 260 pence per share to prioritise certainty.** It was concerned about meeting its objective of allowing Royal Mail access to private capital and the ability to achieve a sale, reflecting the uncertainties created by industrial relations and prevailing market conditions. The Department secured a commitment from Royal Mail's board to announce an intention to pay a £133 million dividend in its first year so that the shares could be priced on a dividend yield basis, which is a very short-term measure.[4] The Department set the lower end of the price range based on the indications it had received from the priority investors and reflecting the views of over 500 potential investors contacted during the marketing exercise. It set this price to ensure that there was sufficient demand for a sale, and intended to use an auction process, known as book building, to capture demand at higher prices. The full-year dividend used to set the price was equivalent to a dividend yield of close to 8 per cent per year and was based on comparisons with the Belgian postal operator (bpost) but a much higher yield than that of the UK stock market (paragraphs 3.27 to 3.31 and Figures 12 and 13).

3 Priority investors is a term defined by the National Audit Office used throughout this report to denote a group of around 20 investors who were involved in the early "pilot fishing" stage of the process, were deemed by the Department to have shown early leadership in the sale, and were given preferential treatment by the Department when shares were allocated.

4 Approximately two-thirds of the notional full-year dividend of £200 million that the directors of Royal Mail believed they would have proposed if Royal Mail had been listed throughout the year.

Pricing and allocating the government's shares

14 **The shortcomings of a standard book-building process and legal requirements made it very difficult for the Department to sell above 330 pence per share once the range had been announced.** Increasing a price range can also increase the risk of securing a transaction. The Department published a prospectus containing a relatively wide price range compared with historical precedents. The high end of the price range (330 pence per share) was 27 per cent above the low end. The banking syndicate generated sufficient demand through book-building to increase the price from 260 to 330 pence per share. A book-building process provides very little information about demand for shares at prices above the upper limit of the price range. The syndicate and the independent corporate finance adviser advised that book-building had not revealed sufficient demand at meaningfully higher prices and given the external timing factors it was, on balance, too risky and impractical to increase the price despite the high demand within the existing range. At least two investors involved in book-building subsequently increased their shareholdings at much higher prices, while a number of others sold shares (paragraphs 4.16 to 4.18 and Figure 20).

15 **The Department decided to sell the full 60 per cent of shares on the advice of the syndicate and its adviser.** The Department could have retained 110 million more shares, worth £363 million at the offer price, while still achieving the policy objective of reducing the government's ownership below 50 per cent. Retaining more shares might have allowed the Department to further benefit from any future increase above the sale price but it decided to sell 60 per cent on the basis of the syndicate's and its independent corporate finance adviser's views that this would take advantage of positive momentum around the IPO, ensure investors were allocated sufficient shares and reduce taxpayer exposure to a potentially volatile share price (paragraphs 4.9 and 4.10 and Figure 16).

16 **Royal Mail's share price increased substantially after the sale and a number of priority investors have sold their shares at a much higher price.** Royal Mail's share price rose to 455 pence (+38 per cent) on the first day of trading. The Department participated in the increase by retaining a 30 per cent stake, but the benefit of the price rise on the 60 per cent stake sold (a first day increase of £750 million) flowed to the new shareholders. The shares are actively traded and in the first five months have traded in a range between 455 and 615 pence. Sixteen of the 17 priority investors bought shares, and were allocated larger proportions of their orders than other investors reflecting the Department's expectation that they would form part of a stable long-term and supportive shareholder base, but almost half of the shares allocated to them had been sold within a few weeks of the IPO (paragraphs 4.11 to 4.19 and Figures 17 to 21).

Conclusion on value for money

17 By floating Royal Mail on the Stock Exchange the Department achieved its key objectives of introducing private capital and commercial disciplines. Given Royal Mail's prospects and prudent initial capital structure it is now less likely that the taxpayer will have to provide public support for the universal postal service. We consider that in order to achieve its main objective, the Department took a cautious approach to a number of issues which, taken together, resulted in the shares being priced at a level which was substantially below that at which they started trading. The Department conceded price tension for certainty that the transaction would be completed by setting a low end of the price range (260 pence) to reflect short-term market uncertainty, a risk of industrial action and the views of a small group of priority investors whose participation was seen as vital, alongside indications derived from a broader community of over 500 potential investors. When the Department approached the wider market through a 'book-building' exercise to test demand further, it encountered the inherent limitations of a standard process that is not effective at revealing demand for shares at prices above the high end of the range it set (330 pence) and lacks flexibility for a price increase when demand exceeds expectations.

18 The strong share price increase of 38 per cent on the first day of trading and the trading range throughout the first five months indicates that Royal Mail's shares are worth much more than this process was able to extract. Industrial relations have settled down and there have been generally positive developments on the stock market and in the broader economy. The company has headroom to borrow more money, sell surplus assets and pay additional dividends to its shareholders in future. Several of the priority investors have made a substantial profit by selling their shares shortly after the IPO, while others have increased their stakes at higher prices. The government has participated in the price increase via a 30 per cent residual stake. We have concluded that although the Department achieved its primary objective of delivering a sale of shares within this Parliament it could have achieved better value for the taxpayer.

Recommendations

a **The government should consider whether alternative methods of accessing equity markets would achieve better value than the process used to privatise Royal Mail.** The government may return to the equity markets in due course and has significant holdings in bank shares. The sale process used by the Department did not identify the market price of the shares and this is not an isolated example. Recent initial public offerings have exhibited wide variations in first-day trading share price performance, ranging between a fall of 5 per cent and an increase of 38 per cent.

b **We expect good practice to be demonstrated when the government disposes of its remaining holding,** for example as seen in the first sale of shares in Lloyds Banking Group by United Kingdom Financial Investments and HM Treasury. The Department has retained a 30 per cent stake in Royal Mail, which is currently worth around of £1.7 billion.

c **Government should consider ways to reduce reliance on professional advisers, and ensure that where it does use advisers it seeks to optimise overall value for the taxpayer.** In this instance, the Department delegated a range of responsibilities. It incentivised the syndicate to complete a transaction and maximise proceeds. The independent corporate finance adviser was incentivised solely to complete a transaction, consistent with the primary policy objective.

d **To help departments, we have gathered together and published our, and the Committee of Public Accounts', recommendations on these past sales on our website.** This was the first initial public offering in many years but the issues faced by the Department were not new. The National Audit Office conducted value-for-money examinations of the majority of the privatisations undertaken in the 1980s and 1990s and the lessons learned should not be forgotten.