National Audit Office

Report
by the Comptroller
and Auditor General

Department for Business, Innovation & Skills

The Privatisation of Royal Mail

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National Audit Office

Department for Business, Innovation & Skills

The Privatisation of Royal Mail

Report by the Comptroller and Auditor General

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Comptroller and Auditor General
National Audit Office

27 March 2014

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This report examines whether the Department achieved its sale objectives, while protecting the taxpayers' interests.

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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.

Part One

The context for the sale

1.1 This part explains the historical context for the sale of Royal Mail, the company's role in delivering the universal postal service and the government's objectives for the sale.

Delivering the universal postal service

1.2 Under European law,[5] the government must ensure that there is a universal postal service five-days-a-week at affordable prices. The Postal Services Act 2011 strengthened this obligation and set out the UK's requirement to provide a six-day-a-week, one-price-goes-anywhere universal service for letters (five-days-a-week for parcels). The UK letters market was fully liberalised in 2006 to introduce competition and Royal Mail's competitors now handle around 45 per cent of all letters and around 75 per cent of bulk mail.

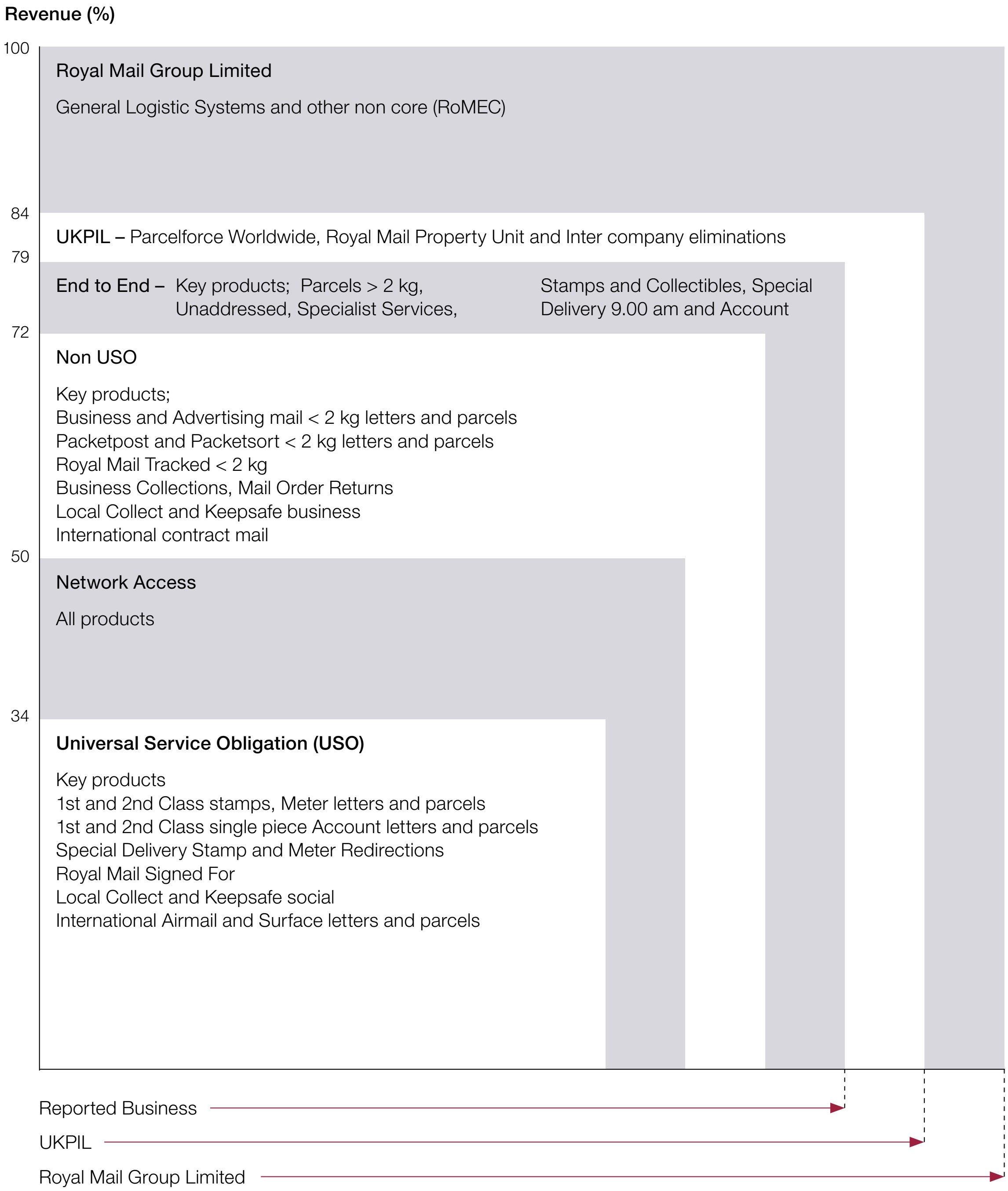
1.3 Royal Mail Group Limited (RMG) is the designated universal service provider in the UK and the only company currently capable of providing the universal service. It does this through its 'Reported Business', which is a subset of its UK Parcels, International and Letters (UKPIL) business.[6] In 2012-13, UKPIL employed 150,000 staff who processed and delivered more than 1 billion parcels and 14 billion addressed letters across the country. Royal Mail plc (Royal Mail), also, has a number of different businesses above and beyond delivering the universal service including General Logistics Systems (GLS), its European Parcel business (**Figure 1**).

1.4 The increase in electronic communication has led to a long-term decline in addressed letter volumes which fell by 8 per cent on a like-for-like basis between 2011-12 and 2012-13.[7] However, the increased use of online shopping has resulted in a rise in the volume of parcels, which grew by 4 per cent on a like-for-like basis in 2012-13 and contributed nearly half (48 per cent) of Royal Mail's revenues for the year. Royal Mail's competitors in the parcels sector include DHL, My Hermes, Amazon Logistics and TNT. The parcels market experienced a temporary slowdown in the growth of e-retailing during the summer of 2013. In the nine months ended 29 December 2013, group revenues grew 2 per cent on a like-for-like basis. Parcels revenue increased 8 per cent and volumes were flat.

5 European Union Postal Legislation – Directive 97/67/EC as amended by Directive 2002/39/EC and Directive 2008/6/EC.
6 UKPIL includes the Royal Mail core network and Parcelforce Worldwide.
7 Richard Hooper CBE, *Modernise or decline: policies to maintain the universal postal service in the United Kingdom*, Cm 7529, 16 December 2008, p.41.

Figure 1

Royal Mail's businesses and services



Notes

1 ROMEC is a joint venture between RMG and Balfour Beatty Workplace Limited, 51 per cent of which is held by RMG. ROMEC largely provides facilities management services to RMG.

2 End to end delivery involves the collection, transporting, sorting and delivery of letters by a single postal operator.

3 Network access allows other postal operators to collect, transport and sort letters before handing them over to Royal Mail Core Network for final delivery to end recipients.

Source: Royal Mail Group Limited, Regulatory Financial Statements 2012-13, p 4

Hooper Review of the universal service

1.5 In the light of the long-term decline in the letters business and the associated threat to the sustainability of the universal service the government asked Richard Hooper CBE to chair an independent review of the postal sector. His 2008 review considered policies to maintain the universal postal service in the UK and he updated it in September 2010. Hooper concluded that the universal service was under threat from an unprecedented decline in volume of letters and that Royal Mail was less efficient than many of its European counterparts.

1.6 The 2008 review recommended that Royal Mail needed access to private capital and greater commercial confidence and expertise through the introduction of a strategic partner or partners. The 2010 review said that the appointment of a new management team since 2008 meant that the requirement for corporate experience was less pressing and an introduction of equity capital could come from an initial public offering (IPO).

1.7 The reviews also recommended a number of other actions to protect the universal service which "were to be taken together as a package" and, as a result, the government introduced legislation that became the Postal Services Act 2011 and took the following actions:

- **The assets and liabilities of the Royal Mail Pension Plan (RMPP), which was in deficit, were transferred to the government.**

- **Post Office Limited was legally separated from Royal Mail and remained with the government.** Post Office Limited and Royal Mail entered into the Mails Distribution Agreement, a long-term commercial agreement so that stamps and other Royal Mail products can continue to be bought from Post Offices across the country. In 2012-13, Royal Mail paid £371 million under this agreement. The government continues to fund Post Office Limited.

- **Ofcom introduced a new regulatory framework in relation to postal services which gave Royal Mail greater commercial flexibility but confirmed its obligations to provide the universal postal service.**

The objectives of selling Royal Mail

1.8 The sale of the majority of the government's shares in Royal Mail by the Department was the sole remaining step in implementing the Hooper recommendations. The government published its sale objectives in April 2013. These 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.

1.9 Furthermore, the Department had a policy of allocating the government's shares in a manner that it considered would establish a long-term, stable and supportive shareholder base. It considered that this was necessary to give Royal Mail future access to private capital and investor support in the longer-term.

1.10 Royal Mail did not need to raise any new equity capital through the sale. However, the government considered that applying private sector capital and disciplines to Royal Mail's business decisions and removing the need to compete with other demands for capital from the public sector would be the best way of sustaining the universal postal service and providing access to capital on a timely basis.

1.11 The privatisation follows on from stock market listings of many of Royal Mail's European peers such as Deutsche Post, Austrian Post, Post NL and, most recently, the sale of shares in bpost, the Belgian postal operator, by a private equity fund on 13 June 2013.

Our report

1.12 This report examines whether the Department achieved value for money for the taxpayer in the way that it sold Royal Mail. It does so by assessing:

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

Part Two

Restructuring Royal Mail's business in readiness for sale

2.1 This section examines the work of Royal Mail and the Department to transform Royal Mail's performance ahead of the sale and the effects on the government balance sheet.

Repairing Royal Mail's balance sheet

Pension

2.2 The Hooper Review recommended that Royal Mail's historic pension deficit should be removed. This pension deficit had been larger than the net assets of the company, meaning that the company was technically insolvent and so could not be privatised. Royal Mail's historic pension liabilities were transferred to the government in April 2012 (£37.4 billion of liabilities and £28.8 billion of assets, representing a deficit of £8.6 billion)[8] following approval from the EU Commission under State Aid rules. On 1 April 2012, Royal Mail had no pension deficit on a funding (actuarial) basis. The transfer of the historical liabilities removed the obligation for Royal Mail to make additional cash payments of around £300 million every year to address the pension deficit. The final stage of Royal Mail's pension reform was completed in September 2013 to ensure that the future pension accrual for current members was funded from regular contributions.

Property portfolio and surplus assets

2.3 In 2011, Royal Mail identified three large sites in London which were expected to become surplus (see paragraph 2.5). Royal Mail also occupies 2,000 sites which are used for its operations. Most of these properties were integrated into the business and some were vacant.[9] Since April 2007, Royal Mail has released around £500 million of cash from the sale, and sale and leaseback, of parts of its estate.

8 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.
9 Royal Mail plc, *Prospectus*, 2013, p.109.

2.4 The National Audit Office has recommended that surplus assets should be removed from public companies prior to privatisation where possible, on the grounds that it is unlikely that the selling department will recover full value for the surplus property. An alternative is to include arrangements to clawback a share of sale proceeds if assets cannot be satisfactorily removed; clawback can also be applied to operational sites which might become surplus in future. In this case the Department and its advisers concluded that it could not separate out the surplus properties. The proceeds from the sale of surplus property was part of Royal Mail's own contribution to the cost of its restructuring (set out in its restructuring plan), and was an important element in the European Commission's decision to clear the State Aid in early 2012. The Department considered that the level of aid approved by the Commission at the time was necessary to ensure Royal Mail's survival. Any failure to implement the restructuring plan could have resulted in the Commission opening an investigation for misuse of aid, which could in turn have led to a reduction in the approved amount. This process could have put the sale timetable at risk. The Department separately concluded that the use of clawback would have had a disproportionately negative effect on overall value. Although the Department took steps through presentations to the syndicate's analysts and disclosure in the prospectus to draw the existence of the London surplus sites to investors' attention, we consider that the basis on which Royal Mail was sold did not fully recover the value of these sites.

2.5 The 13.8-acre Nine Elms site in Vauxhall is close to Battersea Power Station where substantial development is under way and planned. The government has recently agreed a £750 million financial support package to support the construction of two new underground stations nearby. There is currently still an operational delivery office on the site. The 12-acre Mount Pleasant site in Islington is close to the Farringdon interchange, eight-acres of which is expected to be developed as a mixed-use site, retaining the existing sorting office and incorporating a new visitor centre for the Postal Museum & Archive and its mothballed postal railway. The one-acre site in Paddington may have alternative uses subject to planning consent. A property valuation in June 2013 prepared for Royal Mail estimated the market value of these three surplus sites at £200 million (equivalent to 20 pence per share). The market valuation was derived by discounting a gross development value by development costs and other risk adjustments that were uncertain at the date they were prepared.

Improvements in Royal Mail's financial performance

2.6 Royal Mail's financial performance improved over the five years from 2008-09 to 2012-13. **Figure 2** provides some key financial indicators that show Royal Mail's margin on earnings before interest and tax – a key measure of profitability – growing from 0.9 per cent to 4 per cent.

2.7 The UK Parcels, International and Letters (UKPIL) division, which most closely matches the business needed to deliver the universal postal service obligation (USO), has started to generate profits meaning that it is able to fund investment requirements and contribute to the company's ability to pay dividends. **Figure 3** shows that Royal Mail group is also now generating rather than consuming cash.

2.8 The improvements in Royal Mail's performance were driven by the impact of removing the pension deficit, and by the following operational factors.

Price increases under the new regulatory regime

2.9 In October 2011, postal services regulation moved from Postcomm to Ofcom. In March 2012, Ofcom introduced a new regulatory framework designed to ensure the continued provision of the universal postal service. Ofcom has granted Royal Mail considerable commercial flexibility, for example by removing nearly all direct price controls. From 2012-13 direct price controls only apply to about 5 per cent of Royal Mail's revenue, compared to around 60 per cent previously.[10] The company increased the price of first and second class stamps by 30 per cent and 39 per cent respectively in 2012-13 (**Figure 4** on page 20). Royal Mail also reported a profit for the first time from the charges paid by other postal operators to access part of Royal Mail's network. Under the new regulatory regime Royal Mail is allowed to make a commercial return of between 5 and 10 per cent on its provision of the universal postal service. Ofcom monitors Royal Mail's performance in relation to universal standards, quality and affordability.

Growth in Royal Mail's parcels business

2.10 Growth in online shopping has had a positive impact on Royal Mail's parcel business. Between 2010-11 and 2012-13, parcel volumes in the UKPIL business increased from 973 million items to 1,064 million items (an annualised growth rate of 4.6 per cent) and the respective revenues rose from £2,348 million to £2,933 million (an annualised growth rate of 11.8 per cent). The euro revenues of Royal Mail's European parcel business, General Logistics Systems (GLS) also grew on average at a rate of 3.1 per cent in each of the three years to 2012-13, to reach £1.5 billion. Parcels now make up approximately half of Royal Mail's turnover.

10 Although approximately 50 per cent of the group's revenue, including revenue subject to direct price control, is subject to Ofcom oversight of the universal service obligation and network access.

Figure 2
Extracts from Royal Mail's five-year summary income statement

	2008-09	2009-10	2010-11	2011-12	2012-13
Revenue (£m)	8,695	8,547	8,415	8,764	9,279
Revenue growth compared to prior year (%)		-1.7%	-1.5%	4.1%	5.9%
EBITDA before transformation costs (£m)	523	595	493	681	915
EBITDA margin (%)	6.0%	7.0%	5.9%	7.8%	9.9%
EBIT (£m)	78	153	74	277	367
EBIT margin (%)	0.9%	1.8%	0.9%	3.2%	4.0%

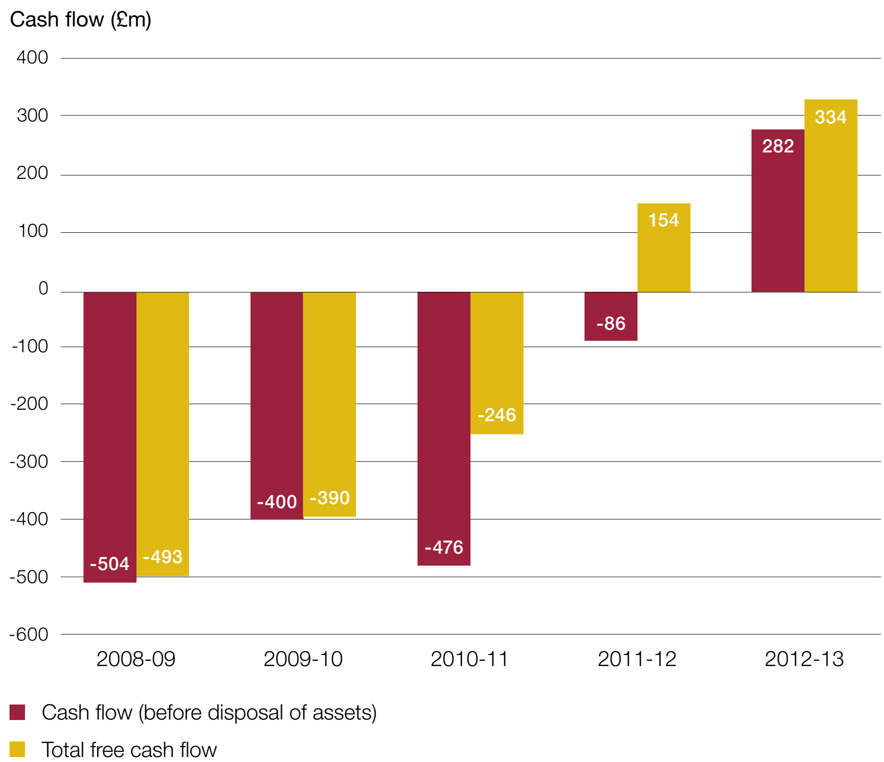
Notes

1 Revenue in 2012-13 is for a 53-week year due to a lengthening of the reporting period. The figure adjusted for a 52-week year is £9,146 million.

2 EBITDA is earnings before interest, tax, depreciation and amortisation. EBIT is earnings before interest and tax.

Source: National Audit Office Analysis; Royal Mail Annual Report 2012-13, Group five-year summary (unaudited)

Figure 3
Royal Mail started to generate cash in 2011



Source: Royal Mail Annual Report 2012-13, Group five-year summary (unaudited), p 124

Figure 4
Stamp prices

Note

1 On 31 March 2014, the price of a first class stamp and second class stamp increased to 62 pence and 53 pence respectively.

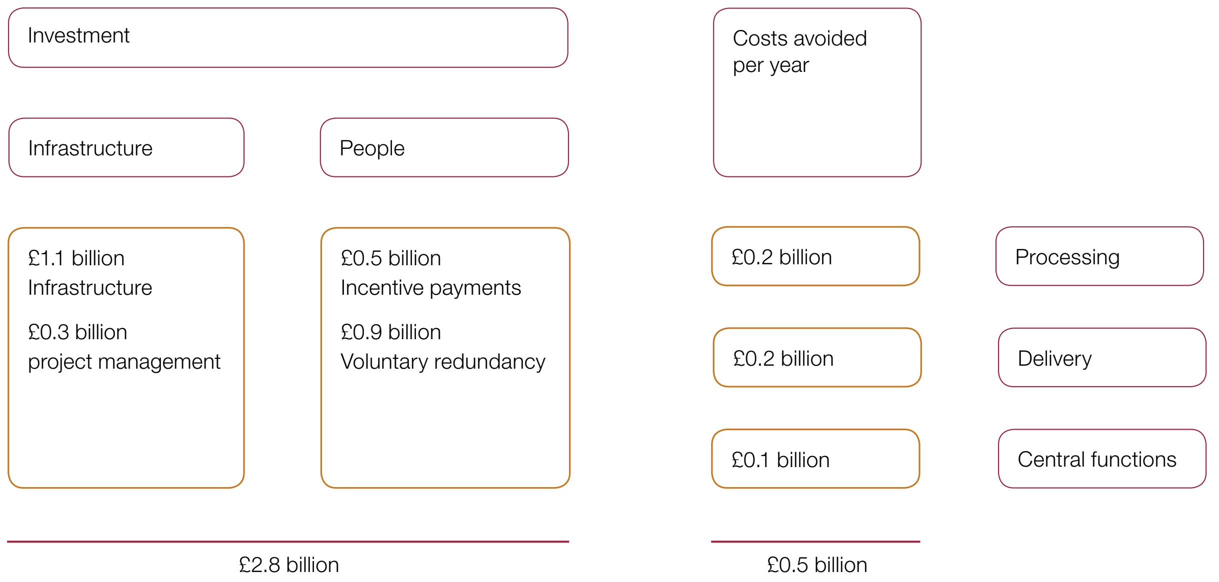
Source: Royal Mail

Royal Mail's transformation programme

2.11 Royal Mail has made a number of attempts to transform the business in recent years. In 2007, it launched a long-term transformation programme to modernise the core network and improve financial performance. The programme consists of a number of successive agreements with the Communication Workers' Union (the union) and cost £2.8 billion in total (**Figure 5**). The key investment period ran between 2010 and 2013. Royal Mail continues to evaluate options for the introduction of automation in its parcels business. Royal Mail management has estimated that the recurring benefit derived from the programme is £0.5 billion per year.

2.12 A small change in Royal Mail's revenue can have a large impact on profit because it has a high proportion of fixed costs. Royal Mail employs a large workforce totalling 167,000 of which 150,000 provide mail and parcel collection and delivery services throughout the UK. Royal Mail has made substantial progress in automating the letters business but still needs significant operational improvements to bring its performance into line with its peers.

Figure 5
Royal Mail has invested over £2 billion in its transformation to March 2013



Source: Royal Mail plc, *Prospectus*, 2013, pp. 71 and 136

2.13 Despite the improvements in Royal Mail's finances the company still had unresolved industrial relations issues at the time of the IPO. Approximately 80 per cent of Royal Mail's operational and administrative employees belong to the union, which strongly opposed the privatisation. A number of elements of a collective agreement between Royal Mail and the union reached in 2010, including a three-year pay deal, were due for renegotiation in April 2013. Until summer 2013, Royal Mail believed that a new deal would be negotiated before the sale, but in July 2013 it told the Department this was now unlikely. The associated threat of industrial action created considerable uncertainty as it was almost unprecedented for an IPO to take place in such circumstances.

2.14 On 4 September 2013, and following member consultation in June, the union announced that a ballot for national industrial action would run from 20 September to 3 October, later revised to 27 September to 16 October. The union's reasons for possible industrial action concerned the pay deal, pension reforms and the impact of privatisation on job security and terms and conditions. The earliest possible date for a strike under the revised timetable was 23 October.

Establishing Royal Mail's initial capital structure

2.15 The Department wanted Royal Mail to have access to private sector debt and an initial capital structure consistent with an investment grade credit rating. This was an appropriate objective which sought to secure the company's financial standing for the future and to sustain the universal service.

2.16 While in public ownership, Royal Mail had borrowed money from the government on commercial terms to cover cash shortfalls and to modernise its operations. In June 2013, the company had nearly £1 billion in outstanding government debt, at an average interest rate of 8.8 per cent (**Figure 6**). In total, the Department and its advisers projected Royal Mail to have net debt of £848 million[11] just ahead of a sale, representing about 1.1 times its gross earnings.

2.17 The Department considered five options for Royal Mail's future debt levels, including maintaining current levels, borrowing more or borrowing less (**Figure 7**). The range of options would have been consistent with providing the company with an investment grade rating, even in a scenario where trading performance decreased.

2.18 The Department decided that option three, leaving the debt levels unchanged, provided an appropriate balance between maximising proceeds for the taxpayer and, although cautious, would ensure that Royal Mail achieved a sustainable investment grade rating and put it in line with industry peers. It believed that this option would withstand the risk of potential adverse financial performance. It was on the basis of this debt figure that the Department agreed the notional dividend of £200 million with Royal Mail's board.

2.19 In September 2013, Royal Mail signed an agreement for £1.4 billion of new bank debt and borrowing facilities which were available upon listing in October. The competitive interest rates that it achieved in this process indicate that the new lenders had confidence in Royal Mail's risk profile. Royal Mail used existing cash and its new debt to repay government borrowing. The new borrowing delivered significant savings for the company, estimated at £79 million a year. The terms of the shareholder loan only required Royal Mail to repay the capital with accrued interest at the time of the sale, nearly three years ahead of the loan's maturity in 2016, thereby saving the company further interest charges of £150 million.[12] In addition, the National Loans Fund was obliged to recover £500 million of principal from Royal Mail and £107 million of early repayment charges from the Department at the time of the sale.

2.20 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, in future, provide significant flexibility for the company and be seen as a key benefit by its shareholders.

11 The total borrowing from the government and under existing finance leases of £1,354 million, less cash of £506 million.

12 The company was then able to obtain a lower interest rate since the risk profile of Royal Mail in 2013 was significantly lower than in 2007 when the 12 per cent cumulative interest rate was agreed on that tranche of the company's lending.

Figure 6
Royal Mail owed the government nearly £1 billion before the sale

	Amounts outstanding (£m)	Interest rate (%)	Maturity dates
General Logistics System funding loan (through National Loans Fund)	500	5.8	2021–2025
Shareholder loan	473	12.0	2016
Total	**973**	**8.8**	

Note

1 The shareholder loan was subordinated to the claims of other creditors and carried a higher rate of interest (payable on maturity or early repayment) to reflect this risk.

Source: Royal Mail plc, *Prospectus*, 2013

Figure 7
Options for Royal Mail's debt levels after the sale

	Net debt (£m)	Ratio of net debt to earnings	Indicative credit rating	National Audit Office comment on outcome for the taxpayer and Royal Mail
Option 1	448	0.6x	BBB+ (stable)	£400 million of outstanding government debt written off. Royal Mail's net debt reduced, leading to a higher equity value at a specified enterprise value
Option 2	648	0.8x	BBB (positive)	£200 million of outstanding government debt written off. Royal Mail's net debt reduced, leading to a higher equity value at a specified enterprise value
Option 3	848	1.1x	BBB (stable)	All outstanding government debt repaid. Royal Mail's net debt unchanged
Option 4	1,048	1.4x	BBB (stable)	£200 million upfront proceeds for the taxpayer. Royal Mail's net debt increased, leading to a lower equity value at a specified enterprise value
Option 5	1,248	1.6x	BBB- (positive)	£400 million upfront proceeds for the taxpayer. Royal Mail's net debt increased, leading to a lower equity value at a specified enterprise value

Source: Shareholder Executive, June 2013 presentation, and National Audit Office analysis

Effects on the government balance sheet

2.21 The sale of shares generated cash proceeds of £1,980 million and the remaining 30 per cent stake is valued at £1,704 million.[13] Royal Mail has also repaid the debt provided by the government. The government has retained the cost in relation to historical pension liabilities.

2.22 The government also retains the ultimate risk of delivering the universal service but following the privatisation it is given more protection in the form of an equity buffer. The Postal Services Act 2011 provides for a special administration regime should Royal Mail fail altogether. The Department assessed the residual risks following a sale, but did not quantify the financial implications of corporate failure.

13 Value based on share price on 13 March 2014.

Part Three

Advisers, transaction alternatives and valuation

3.1 This section examines the Department's appointment of financial advisers, the selection of the initial public offering (IPO) process and the valuations of Royal Mail.

Using advisers

3.2 The Department assembled a team with the professional experience required to navigate a complex restructuring and complete a landmark transaction. It also appointed a multidisciplinary team of professional advisers, which was appropriate given the scale and complexity of this transaction (**Figure 8** overleaf).

Investment banking syndicate

3.3 The Department and its independent corporate finance adviser interviewed a large number of banks to select the members of the investment banking syndicate who would be responsible for marketing and selling the shares. The investment banking syndicate comprised seven investment banks including: Barclays, Bank of America Merrill Lynch (Merrill Lynch), Goldman Sachs International (Goldman Sachs), Investec, Nomura, RBC Capital Markets and UBS Investment Bank. UBS and Goldman Sachs were appointed as the joint global coordinators. All syndicate members were paid a fee split into a base fee of 0.9 per cent and a discretionary bonus of 0.3 per cent of the gross proceeds of the offering, which incentivised them to maximise the value and number of shares sold.[14] This fee is low compared to the market average and government precedents.

3.4 UBS had worked with the company and the Department as the Department's independent corporate finance adviser from 2010 to 2013 before becoming a global coordinator. Goldman Sachs and Merrill Lynch were introduced by Royal Mail in November 2012 (although not formally engaged) to assist in preliminary investor marketing before the Department appointed Goldman Sachs as a global coordinator and Merrill Lynch as a syndicate member in 2013. Barclays was Royal Mail's financial adviser on the IPO and has subsequently become Royal Mail's corporate broker. The other syndicate members, Nomura, Investec and Royal Bank of Canada were appointed to assist with the marketing and distribution of shares.

14 At the time of writing, no decision has been taken on whether to pay the discretionary element.

Figure 8
Adviser fees

Role	Adviser	Previous role	Fee (£m)
Independent Corporate Finance Adviser (from 2013)	Lazard & Co., Limited (Lazard & Co)	None	1.5
Independent Corporate Finance Adviser (until 2013)	UBS	None	0.3
Financial accounting	Deloitte	Financial	0.7
Investment banking syndicate			12.7
• Global coordinators and book runners	Goldman Sachs and UBS	Goldman Sachs and Merrill Lynch had worked for Royal Mail since 2012. UBS was the government's adviser on the transaction until 2013 (see above) and had worked with Royal Mail on pre-sale strategy in 2012	
• Book runners	Barclays and Merrill Lynch	Barclays had advised Royal Mail since 2010, and is now its corporate broker	
• Co-lead managers	Investec, Nomura and Royal Bank of Canada (RBC)	None	
Retail offer	Solid Solutions	None	0.5
Legal	Freshfields	Legal adviser to the Department since 2009	1.8
Communications	Citigate Dewe Rogerson	None	0.5
Total			18
		Recovered from or offset by Royal Mail	(5.3)
		Net cost to the exchequer	**12.7**

Notes

1 Does not show Royal Mail's advisers who provided legal advice, due diligence and property valuations.

2 Lazard & Co and Solid Solution's contracts were with Research Council UK.

3 Lazard & Co is a separate legal entity from Lazard Asset Management (LAM). The ultimate parent company of Lazard & Co and LAM is Lazard Ltd, a NYSE listed company.

4 Syndicate fee comprises a base fee (0.9 per cent of proceeds from institutional investors), plus incentive fee (0.3 per cent). No decision has been taken on the syndicate's incentive fee.

5 The Department has recovered all advisory fees from Royal Mail after the sale except for the fees paid to the syndicate (although the fee for Barclays work as sponsor was recovered), Lazard & Co's fees, and £211,000 paid to Freshfields for the part of the retail offer specific to the UK Armed Forces.

Source: National Audit Office analysis

Independent corporate finance adviser

3.5 In April 2013, the Department appointed Lazard & Co as its exclusive independent corporate finance adviser to provide advice before the sale and to oversee the sale process.

3.6 The Department delegated a comprehensive range of responsibilities to Lazard & Co, including: a review of strategic options; arranging the selection process for the syndicate; capital structure advice; an independent valuation of the Royal Mail business; and advice on pricing and oversight of the syndicate's allocation of shares. Lazard & Co's fee structure incentivised successfully completing a transaction, and paid a fee that was not dependent on the valuation or transaction type.

3.7 The decision to appoint an independent adviser is consistent with recommendations from the Committee of Public Accounts following the flotation of Railtrack in 1996 in which we commented on the potential conflicts of interest that could arise when the roles of syndicate and financial adviser are combined. However we consider that departments should examine ways to reduce reliance on professional advisers for judgements affecting taxpayer value. When they are appointed departments should ensure that advisers' responsibilities do not create tensions with the need to obtain value for the taxpayer. In this instance, the Department delegated a wide range of responsibilities to its independent corporate finance adviser and aligned its incentives with the policy objective of achieving a sale. The taxpayer interest was not clearly prioritised within the structure of the independent adviser's role. We consider that the specification of the responsibilities and duties and contractual performance standards for advisory services of this nature could be reviewed.

Managing advisers' conflicts of interest

3.8 All regulated firms, including financial advisers, are subject to regulations and principles overseen by the Financial Conduct Authority and Prudential Regulation Authority. These place an overarching duty on regulated firms to pay due regard to the interests of their customers and treat them fairly, and to manage conflicts of interest fairly. Notwithstanding this protection, an Office of Fair Trading market study published in 2011[15] identified the potential for conflicting interests in some circumstances between the provision of equity underwriting services and the sales/distribution services. The OFT found a number of features of the equity underwriting market which provided reasonable ground for suspecting that competition for equity underwriting services is prevented, restricted or distorted in the United Kingdom, however, it decided that it was not appropriate to exercise its discretion to make a market investigation reference to the Competition Commission.

15 Office of Fair Trading, *Equity underwriting and associated services*, January 2011. OFT1303.

3.9 Syndicate members often also have asset management arms and information barriers, legal and physical separation and regulatory and contractual protections are in place to manage potential conflicts between the asset manager and the investment bank. For example, of the seven investment banks in the syndicate, we have identified that at least five were allocated shares on behalf of their asset management arms for distribution to their clients. No individual employee working on the transaction, nor investment banking division, was allocated shares. A total of 13 million shares were allocated to clients represented by the syndicate members and the independent corporate finance adviser. This activity is in the ordinary course of business for an investment bank marketing an IPO.

3.10 The independent corporate finance adviser, Lazard & Co., is part of a global independent financial advisory and asset management firm within which asset management activities are undertaken, separate from financial advisory services through Lazard Asset Management (LAM). The Department took the view that excluding advisers linked to asset managers from the competition for the role of independent financial adviser would have constrained the choice of advisers available to it. The Department's contract with Lazard & Co. specified correctly that the information barrier between Lazard & Co. and LAM must be complied with in order to prevent the LAM team obtaining confidential information, and considered that it could rely on the general regulatory and legal provisions to protect its interests. Lazard & Co. took additional precautions to manage potential conflicts of interest by ensuring that it did not participate in solicitation of investor feedback from LAM or provide LAM with any non-public information about Royal Mail.

Valuing Royal Mail

3.11 The Department needed to understand the value to the taxpayer of both keeping and selling Royal Mail in order to achieve maximum value. However, in common with all IPOs valuing the company was difficult as its shares were not traded and there was no observable share price. This contrasts with an equity placement for a company that is already listed (for example, see our report on the first placement of shares in Lloyds Banking group).[16] The Department was dependent on the professional judgement of its advisers with respect to valuation.

16 Comptroller and Auditor General, *The first sale of shares in Lloyds Banking Group*, Session 2013-14, HC 883, National Audit Office, December 2013.

3.12 We found that the valuations presented to the Department by its independent corporate finance adviser and the global co-ordinators varied over the course of the transaction. Given the variety of specific assumptions contained within the valuation ranges it is very difficult to make a like-for-like comparison between the ranges, but we have presented the ranges without further adjustment on a single chart (**Figure 9** overleaf). The valuation methodologies focused principally on the short-term dividend yield, although a range of other methods, including earnings multiples and discounted cash flow, were used alongside this. The reason for the focus on dividend yield was due to a lack of confidence in being able to forecast medium-term cash flows. For example, due to the recent unexpected profit falls in the parcels market and the market backdrop of uncertain mail decline. A number of the valuations also made adjustments for an 'IPO discount'. We do not think that the dividend and earnings based valuations made explicit adjustments for the potential valuation of surplus London property, broader asset backing or potential capital structure changes following the sale. We also think that advisers placed little weight on discounted cash flow analysis which would have focussed on Royal Mail's much improving cash flow and longer-term growth potential. The Belgian postal operator, bpost, which was listed in June 2013, became an important valuation benchmark, despite the substantial differences in the characteristics of Royal Mail and bpost, such as financial performance, relative size, business mix and ownership.

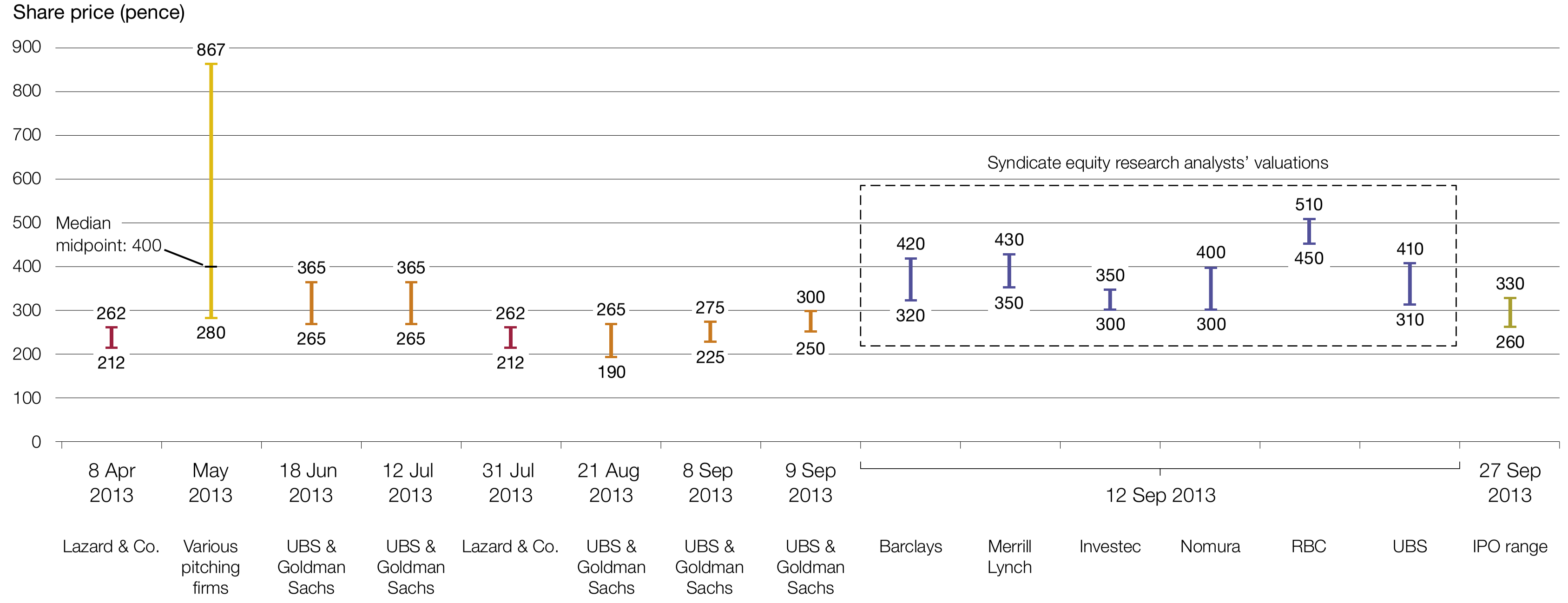
The independent corporate finance adviser's valuation

3.13 The independent corporate finance adviser had access to the company's business plans and spent time with its management to learn about its activities. In its first valuation report on 8 April 2013 it valued Royal Mail at between 212 and 262 pence per share, after adjustment for a typical IPO discount of ten per cent, and this range was reconfirmed on 31 July 2013.[17] The approach was based on a number of different methodologies including in particular a dividend yield approach and earnings multiples. A central assumption was that Royal Mail needed to pay an annual cash dividend equivalent to between 6 to 8 per cent of the share price. This was significantly higher than the FTSE100 market average (3 per cent yield) and higher than Deutsche Post and Austria Post and lower than bpost. It was also equivalent to a 30 per cent discount on an earnings-based valuation of Deutsche Post's valuation; the rationale for such a discount based on information and perceived risks at the time was Deutsche Post's long-term public markets track record (including long-term track record of profitability in contrast with Royal Mail), significantly lower industrial relations issues and significantly different business mix including a more established express parcels business and emerging markets operations (Figure 9).

17 This valuation equates to an enterprise value of £3 billion to £3.5 billion. Enterprise value includes both equity and debt.

Figure 9

Equity valuation ranges prepared by the independent corporate finance adviser, pitching firms, global coordinators and syndicate equity research analysts



Notes

1 The equity valuations have been derived using a variety of different methods and assumptions (see Appendix One, Figure 22).

2 Equity valuations for 100 per cent of Royal Mail's shares have been converted into a price per share by dividing by 1 billion shares. For example, an equity value of £3.3 billion equates to a share price of 330 pence.

3 The equity valuation ranges presented by the independent corporate finance adviser are stated after a 10 per cent indicative IPO discount, the ranges presented by the global co-ordinators are stated after a 5-10 per cent IPO discount and no discount has been applied to the equity valuation ranges presented by the syndicate equity research analysts.

4 The prospectus price range (260 to 330 pence) is equivalent to a dividend yield of 6.1 to 7.7 per cent, an EV/EBITDA multiple of 4.2 to 5.0 and a price to earnings ratio of 8 to 10 (based on estimated results for 2014).

5 No valuation range was published by the Goldman Sachs equity research analyst.

Source: National Audit Office analysis of valuations by various parties

The syndicate's valuations

3.14 There was strong interest from the investment banking community to secure a role in the syndicate. The majority of banks pitching to be part of the banking syndicate had little or no prior information on which to base a valuation and made assumptions based upon information already in the public domain. It is understandable that a very wide range of valuation estimates ranging from 280 to 867 pence per share were presented and the Department correctly placed little reliance on this information.

3.15 After the syndicate had been appointed, these banks were given access to the company's business plan, and in the summer of 2013 the global coordinators presented valuations ranging from 265 to 365 pence per share (Figure 9). The bottom end of the range was based on an equity research sum of the parts valuation for Deutsche Post's DHL Mail business, as well as the bpost earnings multiple and dividend yield. The top end of the range was a 15 per cent discount EV/EBITDA[18] multiple of the Deutsche Post DHL Group. The global coordinators presented alternative valuations in August reflecting their view of the possible impact of significant industrial action and recent trading performance in the parcels division. This valuation range (190 to 265 pence) represented a discount of around 30 per cent to the previous range.

3.16 On 12 September 2013, shortly before the Department announced the price range and commenced book-building, the syndicate research analysts (who are employed by the syndicate banks but operate autonomously from the advisory team and are supervised by internal compliance teams) published valuations of Royal Mail based on information from the company's management. These equity valuations ranged from £3 billion to £5.1 billion (300 to 510 pence per share).[19] These valuations were key data points in establishing the pricing range as they incorporated the latest view on dividends, capital structure and property and were informed by the lengthy interaction with Royal Mail's management on the highlights of the company's equity story. Most of the valuations prepared by syndicate analysts referred to Royal Mail's property portfolio. Equity research carried out by UBS described it as 'hidden value' worth £330 million to £830 million. The Department explained that the upper end of the range is far above the market value of the properties.

18 EV is enterprise value. EBITDA is earnings before interest, tax, depreciation and amortisation.
19 The range does not include Golman Sach's valuation, as no valuation was included in its published research report. The range excluding RBC is £3 billion to £4 billion.

The Department's valuation of retaining Royal Mail

3.17 The Department estimated the value of retaining Royal Mail in public ownership as a cash inflow for the tax payer of £0.3 billion to £1 billion. The high end of the retention value range, £1 billion (equivalent to £1 per share), assumed Royal Mail's profits would decline relative to recent performance, based on historical underperformance and industrial relations issues under public ownership. The Department forecast that earnings before interest and tax would fall by approximately a quarter compared to performance in 2012-13 under continued public ownership, but would increase significantly if sold. The differences in the forecasts also reflected the risk that key management executives might have resigned if the IPO did not proceed. The Department regarded the retention value of £1 billion as a counterfactual for the sale but in preparing such estimates there will always be a high degree of uncertainty about the assumptions that have to be made about future performance. Our examination of these assumptions indicates that the Department took a cautious approach but that retaining Royal Mail in public ownership was still likely to result in lower cash inflows for the taxpayer than a sale.

Determining the structure of a sale

3.18 The Department's primary sale objective was to deliver a sale of shares in this Parliament. It therefore had to ensure that the shares would be sold, even considering the uncertain backdrop created by factors such as Royal Mail's lack of profit history and the unresolved industrial relations issue. The Department explored various options for selling Royal Mail but decided to proceed with an Initial Public Offering (IPO) as this was most likely to maximise sale proceeds.

3.19 The Department adopted a process known as book-building, which has been the main way of conducting IPOs over the past 20 years (**Figure 10**). It was introduced to UK privatisations in the 1990s to reduce underwriting discounts during IPOs and continues to be used because banks are reluctant to accept significant risks in connection with new share issues.[20]

3.20 An Office of Fair Trading market study on rights issues in 2011 demonstrated that banks are also reluctant to accept underwriting risks for listed companies that seek to raise additional equity (rights issues).[21] The OFT estimated that between 2003 and 2008 the typical rights issue discount was 30 per cent. In 2009, when a number of financial institutions made large rights issues during the financial crisis, the average discount increased to 40 per cent. Although Royal Mail was an IPO and not a rights issue, the OFT study may provide an indication of the likely cost of lengthy and extensive underwriting risk.

20 During an IPO banks only commit to underwriting the shares at the end of the book-building period, when they judge there are sufficient orders and have agreed the final price. Banks only take risk during the two or three day settlement period between pricing and settlement. In effect, their risk is limited to any investor that fails to pay for allocated shares.

21 During rights issues, underwriters generally agree a fixed price, at a substantial discount to the market, for the new shares being offered in a rights issue and underwrite the shares over a period of at least two weeks while shareholders decide whether to purchase the new shares being issued. This discount does not adversely affect investors who buy their new shares, as they retain their proportionate interest in the company. Underwriters may reduce risk by reaching agreement with investors prepared to act as sub-underwriter. Office of Fair Trading, *Equity underwriting and associated services*, January 2011. OFT1303.

Figure 10

Description of book-building

Book-building is similar to an auction process for determining a price for shares that are being sold. For IPOs, the seller makes a single non-binding offer at the start of the process, setting out the number of shares it wishes to sell (the offer size) and a range of prices at which it is willing to sell, and potential buyers then bid for the maximum number of shares they would buy at prices within this range. Bidders may improve their bid at any point. The auction is run on behalf of the seller by investment banks known as 'book-runners' who work together as a 'syndicate' and attempt to encourage potential investors to improve their bids. If the seller believes it can sell the shares at a price above the initial price range, it can increase the sale price, but must give investors 48 hours to decide whether to withdraw their bids.

At the end of the process a final price is determined and shares are 'allocated' (sold) to some of the institutions that bid at that price. The price and number of shares to sell is generally set to deliver an orderly after-market, and the seller has complete discretion in how much of each of those bids it fulfils. This can incentivise bidders to ask for more shares than they actually want in the auction stage as they expect that they will not receive the full amount.

Notes

1 The number of shares eventually sold may be increased by 15 per cent by an 'over-allotment option' or 'greenshoe' (see paragraph 4.10), so the total number of shares in the Royal Mail offer was 41 per cent to 52 per cent of the company, rising to 49 per cent to 60 per cent including over-allotment.

2 Investors may choose to submit bids 'at strike' meaning they specify a maximum amount of money to be invested, and the number of shares will be determined by the final price. Where individuals ('retail investors') are allowed to participate as bidders they can only bid at strike.

Source: National Audit Office

3.21 Book-building has many of the characteristics of an auction, but it requires significant judgements about the valuation and price range, allocation and number of shares to be offered, to establish an orderly market in the shares following the sale. It is customary to seek excess demand for the shares (typically twice the number of shares available); to incorporate an IPO discount (typically estimated at 10–15 per cent); and allocate the shares to institutional investors with the overall objective of achieving a stable aftermarket and a successful transaction.

Allocating the shares and offer size

3.22 Recent research by John Kay in 2012[22] found that markets do not always work well for IPOs for public companies raising new equity share capital and highlighted concerns about the short-term view that the markets take.

3.23 The Department devised an allocation policy that was intended to introduce a core, stable base of long-term investors who would be supportive of the business over the longer term. It aimed to sell up to 60 per cent (600 million shares) of Royal Mail and allocate these shares on a 70:30 ratio between companies ('institutional investors') and individuals ('retail investors').

22 John Kay, *The Kay review of UK equity markets and long-term decision-making Final report*, July 2012.

3.24 There was no ministerial directive towards retail participation in the offering (for example, widening or deepening of share ownership), but ministers considered that it was appropriate to make the share issue available to the public. There were no incentives, discounts or staged payments for retail investors and only a limited advertising campaign.

3.25 In addition there was a free share offer of 10 per cent of the company (100 million shares) for employees. The take-up was close to 100 per cent. At the offer price of 330 pence per share, this represented over £2,000 per eligible employee. The shares will be awarded over two tax years to comply with HMRC rules on employee share incentive schemes and Royal Mail benefited from a corporation tax deduction for the cost of the scheme, as disclosed in the prospectus.

Pricing the shares

3.26 To make book-building work successfully, the Department had to generate sufficient demand for the shares, both to ensure that they could all be sold, and to obtain as high a price as possible. This was challenging as the IPO was one of the largest transactions of its kind in the UK in recent years (**Figure 11**), and was set against the uncertainties created by the unresolved industrial relations issues.

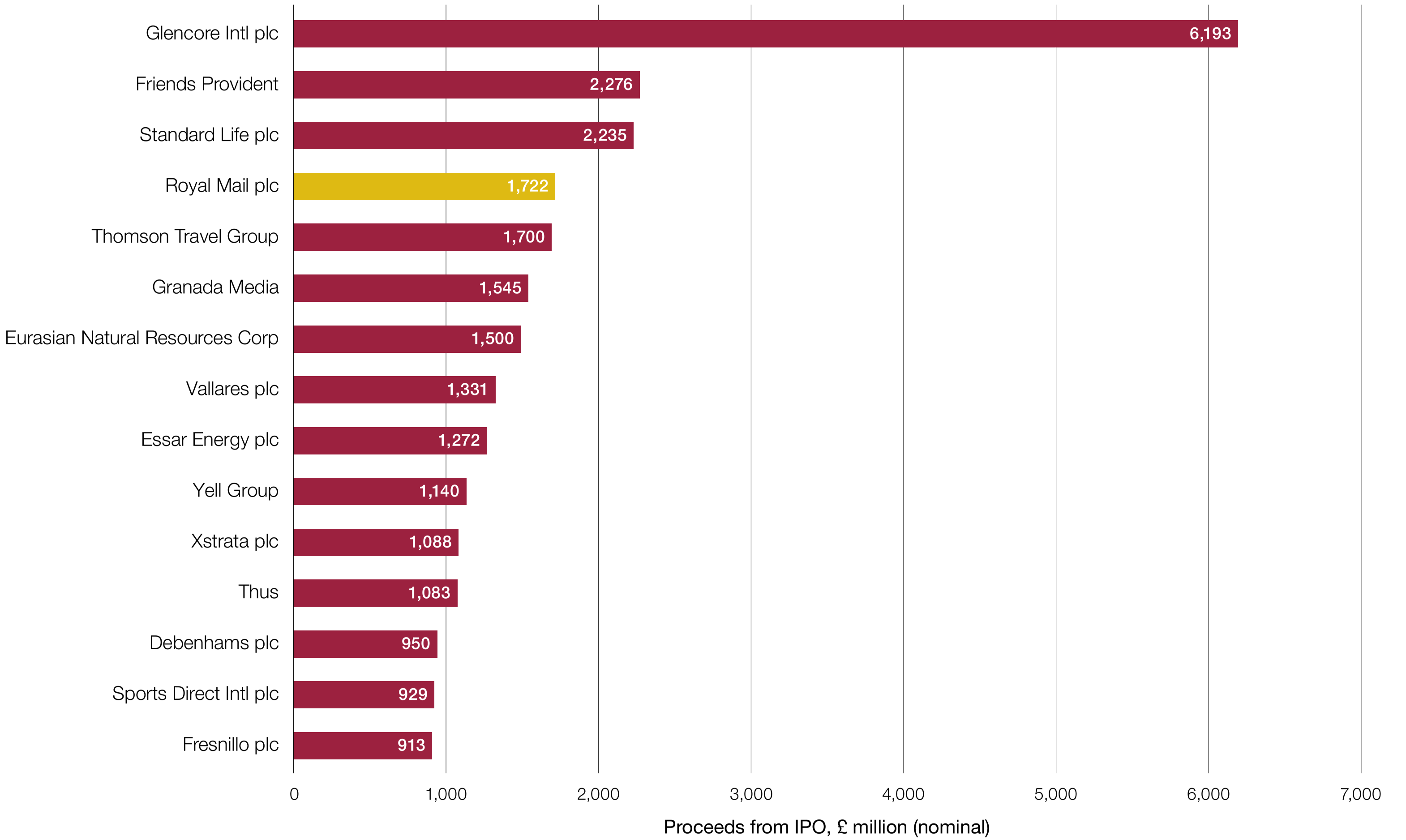
3.27 To create demand for the shares the banking syndicate ran one of the largest ever global marketing exercises, including four initiatives between November 2012 and September 2013. **Figure 12** on page 36 describes the purpose of the different phases of marketing and the number of potential investors met.

3.28 The marketing phases described in Figure 12 elicit only indications of possible demand at certain price levels and investors are not expected to make binding commitments. Despite the huge marketing effort, the Department did not have any certainty that the price indications would translate into firm orders at the given prices. This was problematic when set in the context of the uncertainty created by unresolved industrial relations issues on both pricing, due to the difficulty of projecting the impact on profitability, and investor interest.

Figure 11

The Royal Mail transaction was large compared to historical precedents

The 15 largest IPOs on the main London Stock Exchange since June 1995



Note

1 Excludes proceeds from over-allotment (paragraph 4.10).

Source: National Audit Office analysis of London Stock Exchange data

Figure 12

The banking syndicate ran one of the largest marketing exercises ever for an IPO with the purpose of securing demand

	Early soundings	Refining the sales message	Pilot fishing	Investor education	Book-building
Timing	Nov 2012 – Mar 2013	May – Aug 2013	2 – 6 Sep 2013	8 – 27 Sep 2013	27 Sep – 8 Oct 2013
Purpose	Identify potential priority investors and gain feedback on potential deal	Receive feedback about potential deal and messages around industrial relations	Secure indications of demand and price to give comfort about deal execution	Educate as wide a range of investors as possible about deal	Receive valuation feedback and encourage deal momentum
Lead	Barclays Goldman Sachs Merrill Lynch	UBS Goldman Sachs Lazard & Co.			
Number of potential priority investors	65	35	21		17
Other potential investors met				548	39

Source: Adapted from UBS and Goldman Sachs advice to the Department

3.29 In the face of uncertain demand, to maximise the chances of successfully placing all the shares the Department therefore decided to focus on 21 'priority investors' who it considered fulfilled the allocation criteria of long-term supportive investors.[23] The Department considered the possibility of seeking binding agreements from a group of 'cornerstone' investors but rejected this because it would have reduced the sale price of the shares. Instead it focused on building a shadow book of demand for shares prior to the publication of the prospectus. This standard process of 'pilot fishing' attempted to secure commitments from the priority investors to buy shares at certain levels once the book-building opened, even in the worst case scenario of unresolved industrial relations issues, but it conceded price tension to the priority investors. The Department also secured a commitment from Royal Mail's board that it would announce an intention to pay a £133 million dividend consistent with a full-year notional distribution of £200 million in its first year, even in the face of a potential strike, so that investors had an additional measure that they could use to value the company.

23 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.

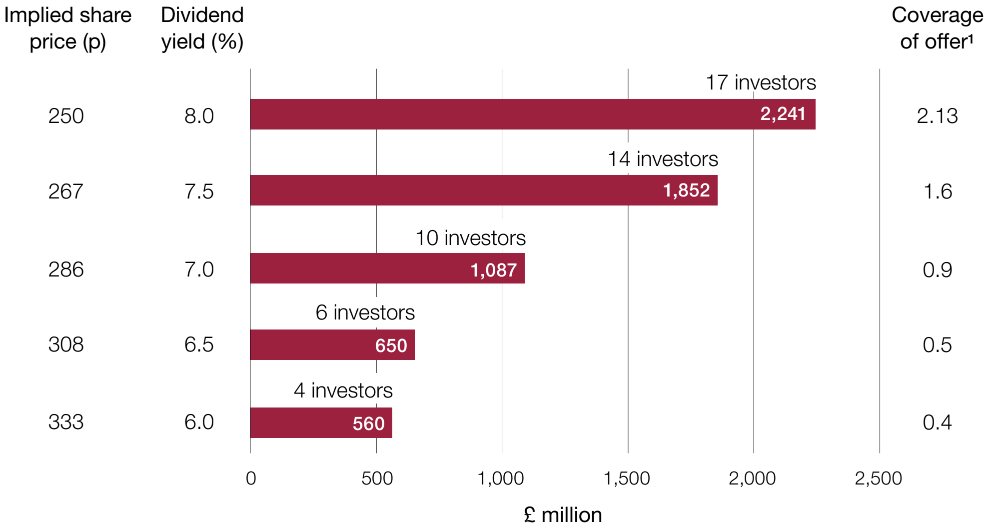
3.30 In early September, 17 of the priority investors provided firm, but non-binding, expressions of demand at various price levels. **Figure 13** shows that all 17 investors indicated they would purchase shares at 250 pence. On this basis, as well as feedback from a number of other institutions, the Department set the bottom of the price range for the IPO at 260 pence. This range was set on the basis that it represented the likely price at which it could place all the shares in the worst case scenario where strike action took place before pricing was finalised, in order to avoid the risk of having to postpone or cancel the transaction. It was also consistent with a 7.7 per cent dividend yield (Royal Mail had announced a notional £200 million dividend), which was broadly in line with the recently listed bpost.

Alternatives to an IPO

3.31 Although an IPO was the preferred route, the Department wanted to maintain flexibility for other sale strategies, including a trade sale and a minority equity investment. In order to maintain flexibility in the method of share sale, the Department instructed its independent corporate finance adviser to hold confidential meetings with a small number of potential investors, including private equity and sovereign wealth funds. These 'Plan B' discussions took place between April and July 2013. Royal Mail's management was not involved. No firm expressions of interest were received during this process but it was regarded as a potential, though less attractive, alternative to an IPO. Three of the targeted investors became priority investors in the IPO and were allocated shares.

Figure 13

Seventeen priority investors indicated demand for dividend yields implying a share price between 250p and 333p



Note

1 Coverage of the offer expresses the amount offered as a multiple of the number of shares expected to be sold to institutional investors, i.e. at a price of 250p, there were more than enough indications to buy the shares on offer to institutions twice over.

Source: Adapted from UBS and Goldman Sachs advice to the Department

Part Four

Book-building, final demand and pricing

4.1 This section examines how demand increased during the book-building process and how the share price and ownership of Royal Mail changed after the sale.

Book-building

4.2 The book-building took place over eight business days from 27 September to 8 October 2013 within a price range of 260 to 330 pence per share. There were two separate offers. The banking syndicate made an offer to institutional investors (‘institutional offer’) and the Department itself and retail intermediaries made a separate offer to the general public (‘retail offer’).

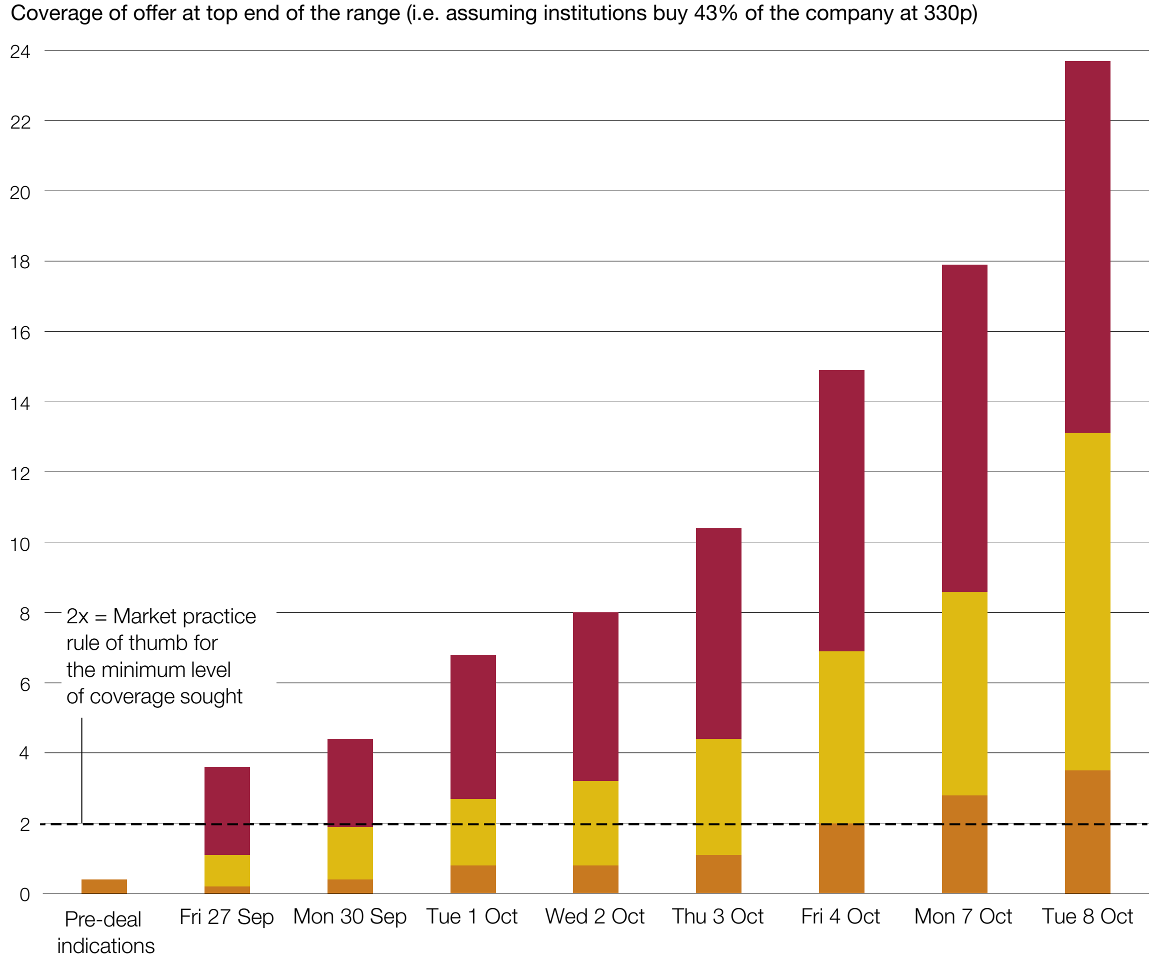
4.3 The Department decided to run the institutional and retail offers in parallel with the same end date. The Department used the retail offer to create additional demand for shares but did not actively use it to create additional price tension.

The build-up of institutional demand

4.4 Institutional shareholder interest accelerated rapidly. By the end of the first day of book-building the total demand from all institutional shareholders was 3.6 times the number of shares available for institutions at the top of the price range, increasing to 24 times at the final price by the end of the process (**Figure 14**). The syndicate banks met a very large number of investors including the 21 institutions met during pilot fishing, and eventually secured bids at the maximum price of 330 pence from 19 of these, including 16 of the priority investors. Orders from the ‘pilot fishing’ accounts were sufficient to cover fully the book by 3 October. When an offer becomes oversubscribed investors can expect to have their allocations scaled back and are incentivised to bid for more shares than they wish to purchase. Book-building is not therefore fully effective in revealing the actual level of demand.

Figure 14
Institutional demand

Institutional demand rapidly built up during the book-building exercise to 24 times the shares on offer to institutions (at 330 pence)



	Pre-deal indications	Fri 27 Sep	Mon 30 Sep	Tue 1 Oct	Wed 2 Oct	Thu 3 Oct	Fri 4 Oct	Mon 7 Oct	Tue 8 Oct
Hedge funds	—	2.50	2.50	4.10	4.80	6.00	8.00	9.30	10.60
Long only	—	0.90	1.50	1.90	2.40	3.30	4.90	5.80	9.60
Pilot fishing	0.40	0.20	0.40	0.80	0.80	1.10	2.00	2.80	3.50
		Announced to market that books covered				Decided not to extend range	Price range narrowed to 300–330 pence		Price guided to 330 pence

Notes

1 During book-building, institutions bid for shares within the range of 260–330 pence. The graph shows the number of shares requested at 330p as a multiple of the number of shares the Department was proposing to sell to institutions.

2 ‘Pilot fishing’ is 21 investors met during pilot fishing, including 16 of the 17 priority investors (the last did not bid for any shares at 330p, although they did bid at lower prices.

3 ‘Long only’ represents investors that were considered likely to hold shares for a longer period than ‘hedge funds’ who were considered likely to sell quickly.

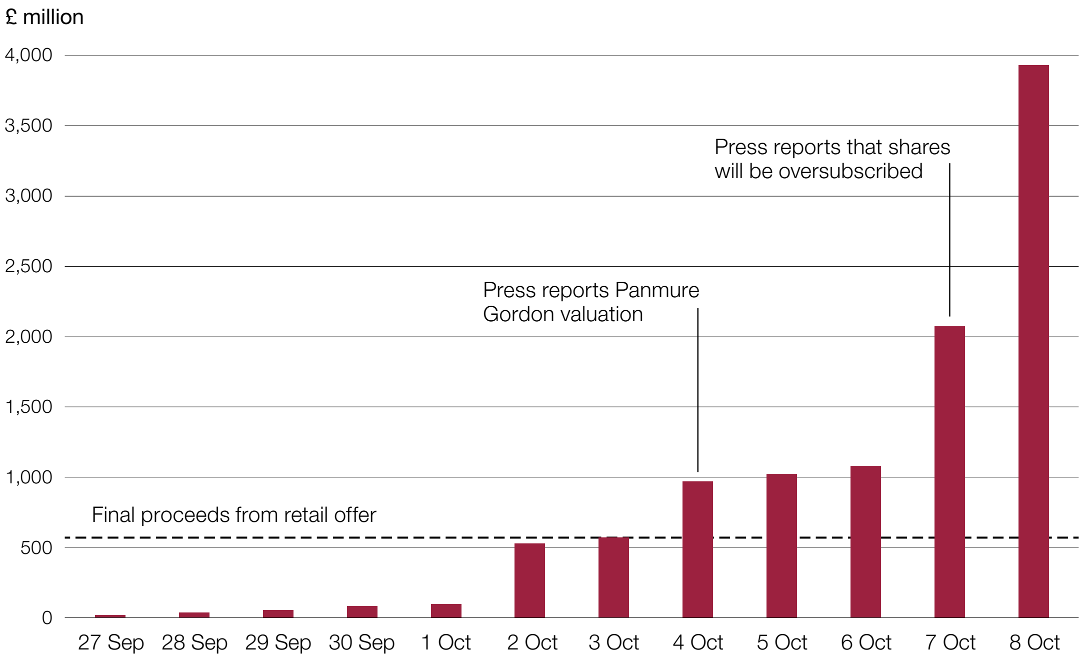
Source: Adapted from UBS and Goldman Sachs advice to the Department

The build-up of retail demand

4.5 Retail demand grew slowly for the first five days of the book-building period but rapidly during the final two days, possibly as a result of being able to apply online. By the end of the book-building period on 8 October, the value of retail demand was seven times the number of shares available for individuals, and was sufficient to have purchased the entire 60 per cent being sold at 330 pence per share (**Figure 15**). The demand from retail was not used to put upwards price pressure on the institutional investors as had often been the case in the privatisations of the 1990s.

Figure 15
Retail demand

Retail demand rapidly built up during the final two days of the book-building exercise to seven times the shares on offer at 330 pence



	27 Sep	28 Sep	29 Sep	30 Sep	1 Oct	2 Oct	3 Oct	4 Oct	5 Oct	6 Oct	7 Oct	8 Oct
■ Retail demand (£m)	11	34	54	77	97	527	564	970	1,023	1,076	2,075	3,933

– – Retail proceeds (£568 million)

Notes

1 Retail investors do not bid at different prices, but specify the maximum amount of money they want to invest. The price of the shares is determined only by the institutional offer.

2 Demand shown is cumulative. However, bids through intermediaries were only collected on 2, 4, 7 and 8 October. This accounts for some of the jump in demand at those points.

3 These figures include employees applying under the Employee Priority Offer.

Source: National Audit Office analysis of the Department's data

The decision not to increase the price before closing the book

4.6 Given the strong demand during book-building, the Department had the option to move its price range up. In our 1996 report on the flotation of Railtrack we recommended that departments retain the flexibility to change the price range. In such circumstances investors must now be offered a 48-hour withdrawal period. This creates more substantial logistical issues for offers which include, as with Royal Mail, a retail component, but the Department had contingency plans to do so for both offers. In practical terms the price could not be increased later than 4 October without the withdrawal period spanning the announcement of the result of the strike ballot and potential fixing of strike dates. The broader macroeconomic uncertainty of whether the United States would breach its borrowing authority also represented an additional element of risk.

4.7 On 3 October, the Department asked the syndicate banks whether it was possible to increase the price range. The global coordinators advised that, given the orders in the book, the maximum price increase could not be more than 20 pence per share to 350 pence (potentially generating additional proceeds of £120 million), although there was no certainty that the final price would exceed 330 pence per share. The syndicate and the independent corporate finance adviser recommended against a higher price, highlighting a risk that the offer might not ultimately price at the top of a new range with the consequent risk of the loss of momentum that had built up during book-building, and potentially a lower share price as well as noting there had been only one such change of the price range in the last decade.

4.8 In an IPO, the seller sets a range of prices at which it will sell the shares, and competitive tension is limited to within this range. The seller sets the range based on its understanding of the value of the asset being sold, and the demand in the market. When the seller sets the range there is no competition between potential buyers so it is difficult for the seller to accurately gauge the full level of demand in the market. Once book-building starts, bidders are competing to buy shares and at this point may have incentives to reveal higher levels of demand. But by announcing that it is willing to sell within the price range, the seller has effectively capped the price at the top of the range: there is no mechanism and only a limited incentive for bidders to reveal anything about demand at higher prices.

The decision to sell the maximum number of shares available

4.9 If the Department had expected the share price to increase significantly following the IPO then it might have considered that the government would have benefited from selling fewer shares and retaining a larger stake which may have had a higher value.

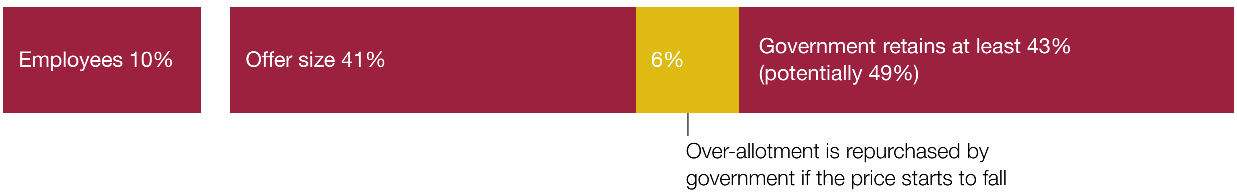
4.10 The Department had limited flexibility to sell fewer shares while simultaneously achieving the objective of selling a majority of the company due to technical factors associated with share price stabilisation (known as over-allotment) which means that the Department would retain a larger number of shares if the share price falls than if the price increases. The Department could have sold only 47 per cent rather than 60 per cent of the company, while meeting its objective of selling a majority of the shares (**Figure 16**). It decided to sell 60 per cent on the basis of advisers' 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. Moreover, 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.

Figure 16

The over-allotment arrangement reduced flexibility given government's desire to guarantee that a majority holding be sold

The Department decided to sell 60 per cent of the shares under the offer

With a 47 per cent offer size, the over-allotment (set at 15 per cent of the offer size) would fall to 6 per cent, still enough to guarantee a majority be sold



Notes

1 The over-allotment of shares helps to stop the share price falling in the first 30 days. If the share price starts to drop then the bank underwriter (UBS) can buy back the over-allotment (set at 15 per cent of the offer size) from the market on behalf of the government. With a 47 per cent offer size, the government would still have reduced its holding to at most 49 per cent but, because the decision to repurchase the shares is at the discretion of the underwriter, a smaller offer size would have meant the government could not guarantee that over 50 per cent was sold. Government would have retained any profit on repurchase of the over-allotment shares.

2 The Department could have retained 110 million more shares, worth £363 million at the offer price by reducing the offer size from 52 per cent to 41 per cent.

Source: National Audit Office

Final demand and allocation of shares among bidding investors

4.11 The government allocated 60 per cent of Royal Mail to institutional and retail investors in accordance with the principles established at the outset of the process (**Figure 17** overleaf):

- Over one fifth of Royal Mail (22 per cent) was sold to the 16 priority investors who had bid for shares at 330 pence.
- Seventeen per cent was sold to 94 investors who had been targeted in the pre-deal marketing (three institutions that were part of pilot fishing but had not given pre-deal indications were allocated 3 per cent).
- A further 3 per cent was sold to a further 180 investors that were considered high quality. Nothing was allocated to a large majority, 506 institutions, that applied.
- Approximately 16 per cent of the company was sold to 690,000 individual investors (not including employees). Retail investors that asked for less than £10,000 were sold 227 shares each (£749.10 at 330 pence a share), and those that applied for more than £10,000 (5 per cent of the total applying) received nothing.[24]

Share price performance

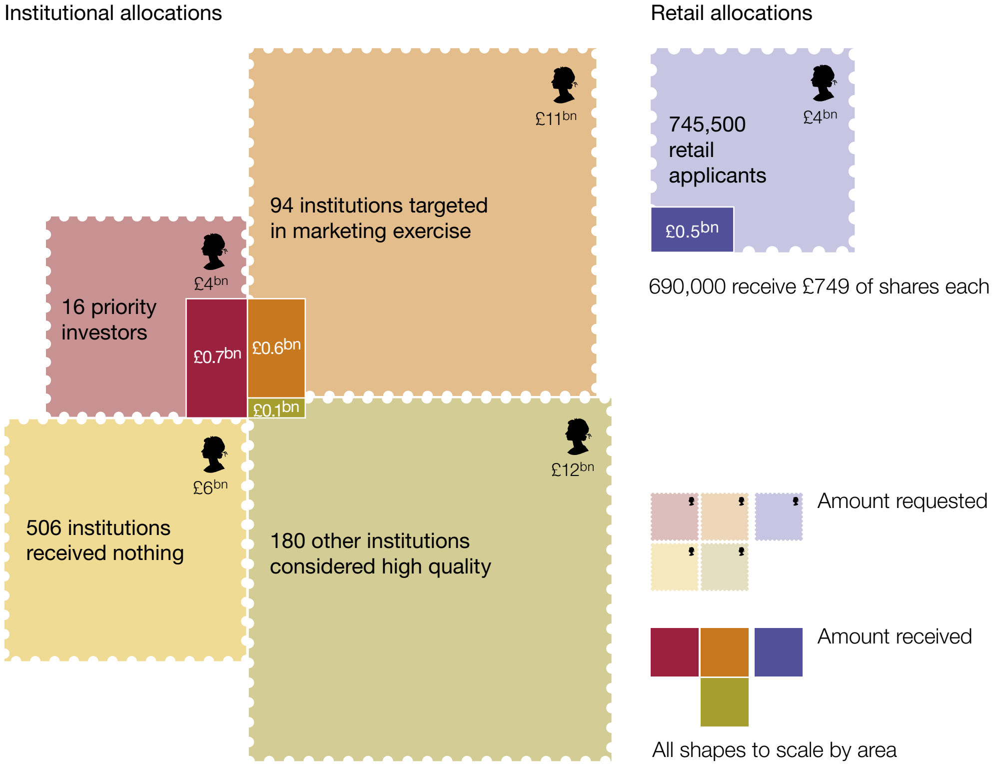
4.12 On the first day of trading, 11 October 2013, the shares opened at 448 pence: 36 per cent above the IPO price. At the close of trading, Royal Mail's share price closed at 455 pence, up 38 per cent. The Department participated in the increase by retaining a 30 per cent stake, but the benefit of the price rise on the 60 per cent stake sold (a first day increase of £750 million) flowed to the new shareholders.

4.13 On the first day of trading, 253 million shares – representing 42 per cent of the shares available for trading – changed hands on the London Stock Exchange.[25] The cumulative total trading volume for the first ten trading days was 475 million shares. On average 2.6 million Royal Mail shares are traded every day on the London Stock Exchange.[26] This is much smaller than the number sold at IPO, but is comparable with the trading activity of other FTSE 100 index companies with a similar market capitalisation.[27] Looking on a five-day average trading volume basis Royal Mail is now much more closely in line with the FTSE 100 average, with 0.93 per cent of available shares traded on average (ranked 43) compared to the FTSE average of 0.91 per cent.

24 Royal Mail employees that applied through a special offer open only to employees (the Employee Priority Offer) were allocated the full amount requested, subject to a cap of £10,000 but with any further amount treated as a separate request under the general retail offer.
25 Excludes the 300 million shares retained by government and the 100 million shares given to employees.
26 The median of all days between 11 October and 13 March 2014.
27 Market capitalisation is the total value of the used shares of a publicly traded company.

Figure 17
Share allocations

The allocation of shares favoured 16 priority institutions who gave firm offers in the pilot fishing exercise



Institutional investors demand and allocation

	Number of institutions	Shares sought (£m)	Shares allocated (£m)	Average allocation (£m)
Priority investors	16	3,952	728	46
Institutions targetted during marketing exercise	94	11,441	570	6
Other high-quality institutions	180	12,251	114	0.6
Institutions receiving nothing	506	5,684	–	–
Total	**796**	**33,328**	**1,412**	

Retail investors demand and allocation

	Number of retail investors	Shares sought (£m)	Shares allocated (£m)	Average allocation (£m)
Number receiving shares (excluding employees)	690,000	2,430	517	749
Number receiving nothing	55,500	1,450	–	–
Non-employee total	**745,500**	**3,880**	**517**	
Employee Priority Offer	15,000	54	51	3,400
Total	**760,500**	**3,933**	**568**	

Notes

1 Totals may not sum due to rounding.

2 The number of investors may be overstated as some institutions requested shares through more than one fund.

3 As well as receiving a free share allocation Royal Mail employees were eligible to buy shares through a special offer open only to employees (the Employee Priority Offer).

Source: National Audit Office analysis of share allocation register

4.14 In the first five months, Royal Mail's share price has traded in the range of 455 to 615 pence. **Figure 18** overleaf shows that its share price had increased more than that of the peer group companies and the FTSE 100 index.

Comparison with other recent IPOs

4.15 Royal Mail's 38 per cent share price increase on its first day is greater than that of recent IPOs on the main UK market (**Figure 19** on page 47). Based on data for recent UK IPOs, Royal Mail performed much more strongly on the first day than the IPOs that preceded it. Among the strongest of these are three property-related companies (Foxtons, Crest Nicholson and Countrywide, each of which was listed in 2013). Since the IPO there have been a number of other share issues in 2014 that have performed strongly including an electrical appliances distributor (AO) and a retailer (Poundland).

Changes in share ownership

4.16 On 18 October 2013, a hedge fund, Children's Investment Fund Management UK (TCI), reported that, by 16 October, it had acquired 58.2 million Royal Mail shares (5.8 per cent of the company), making it the largest institutional shareholder. On 16 January 2014, TCI reported that its stake had reduced to 45.8 million shares (4.6 per cent of the company). On 23 October 2013, GIC (Government of Singapore Investment Corporation) reported that its holding had gone above 4 per cent.

4.17 Two months after trading began (by 12 December 2013), the cumulative number of shares traded exceeded the 600 million shares sold in the IPO. One week later, on the day that Royal Mail entered the FTSE 100 index, 50 million shares traded.

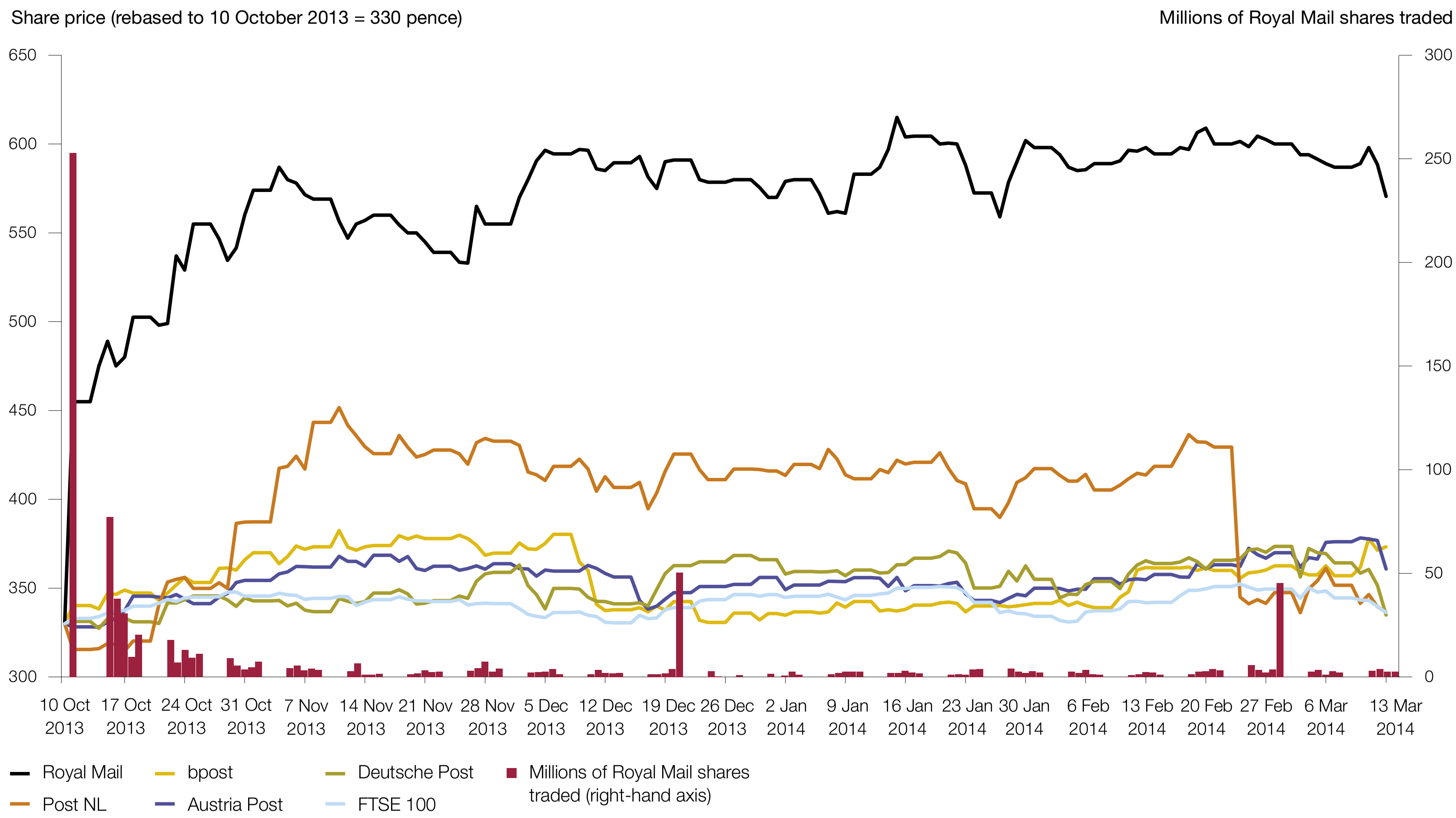
4.18 The Department reviewed the change in share ownership between October and November 2013 (**Figure 20** on page 48). Of the 20 largest shareholders at the date of the IPO:

- four had increased their stake, of which two had doubled their stake;
- seven had sold all of their allocated shares; and
- four had reduced their stake by over half.

4.19 By the end of January 2014, six priority investors remained among the largest shareholders. In aggregate, these shareholders held 12 per cent of the shares outstanding, just over half the 22 per cent allocated to the 16 priority investors at IPO (**Figure 21** on page 49).

Figure 18

Change in share price of Royal Mail and listed European postal companies for five months since the flotation of Royal Mail



Note

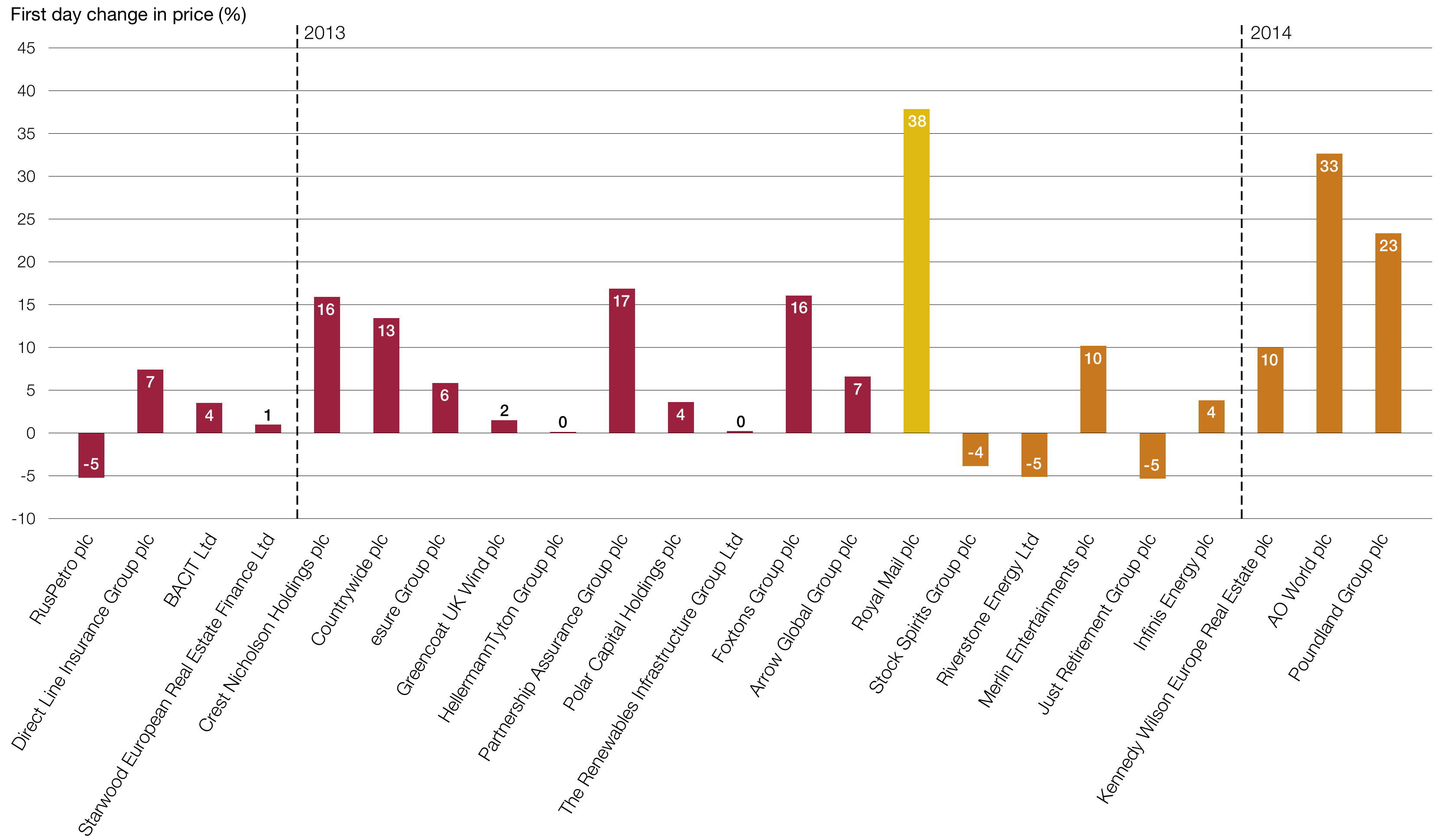
1 Share prices and FTSE 100 index rebased to 330 pence as at 10 October 2013.

Source: National Audit Office analysis of Bloomberg data

Figure 19

Day one share price increases of large recent IPOs

Royal Mail had the largest first-day increase of large UK IPOs since 2012



Notes

1 Shows UK IPOs on the main London Stock Exchange since 2012 where the proceeds (excluding any from over-allotment) exceeded £150 million.

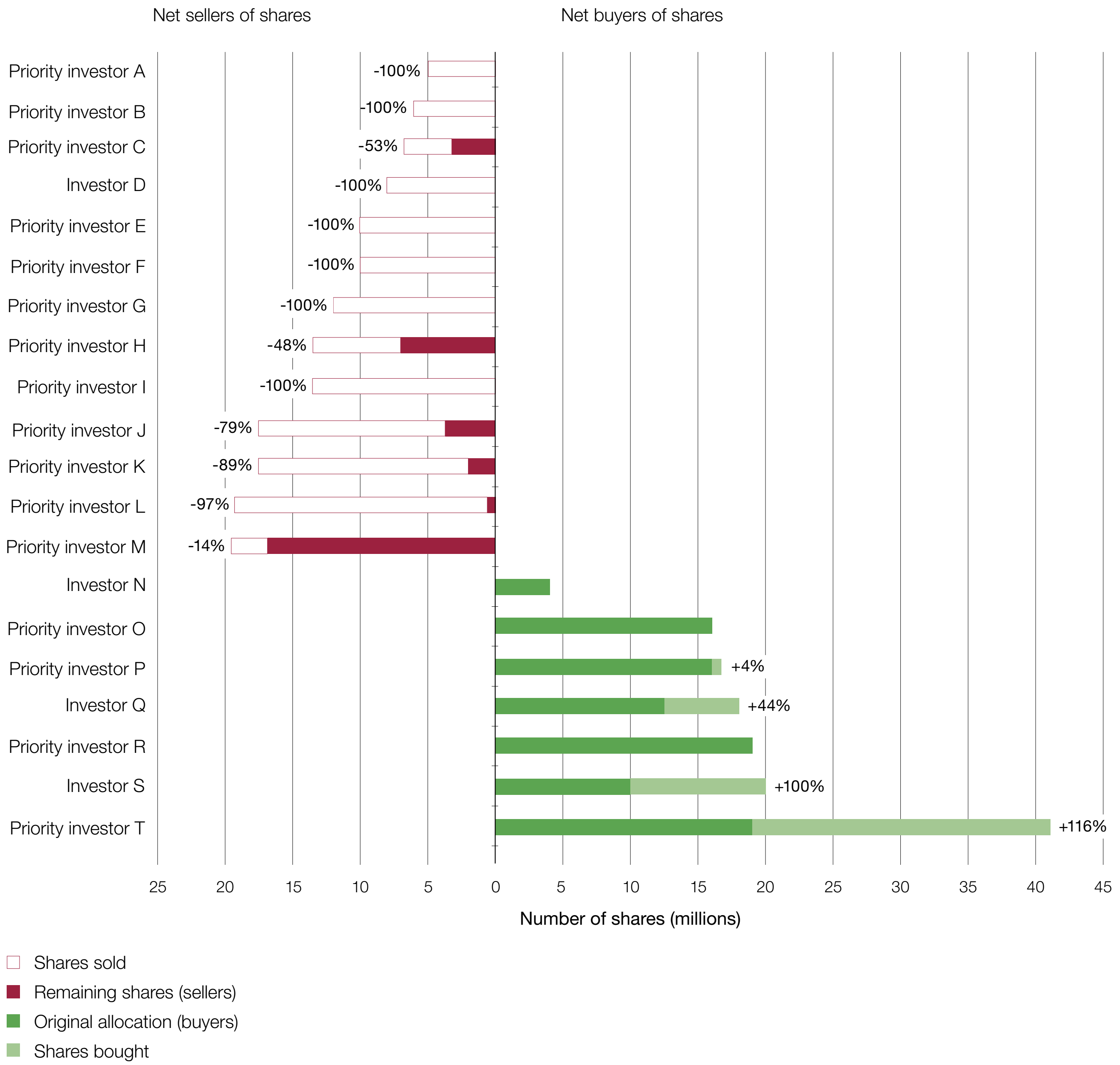
2 IPOs shown in chronological order.

Source: National Audit Office analysis of Bloomberg and London Stock Exchange data

Figure 20

Change in shareholdings of the 20 largest institutional shareholders at IPO

Many of the priority investors sold their holdings within the first few weeks of trading but some increased their holdings



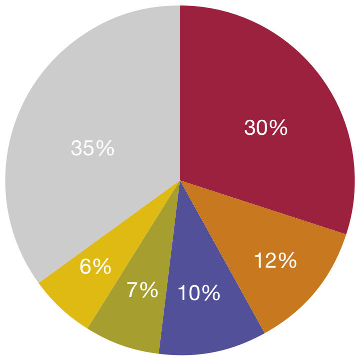
Notes

1 Shows the changes to the holdings of the 20 institutions with the highest allocations at pricing. At IPO there were four institutions tied in position 20, but only one was included in the analysis.

2 The analysis may understate holdings where institutions hold shares through multiple funds.

Source: National Audit Office analysis of the Department's data

Figure 21
Royal Mail shareholders as at 28 January 2014



- Government retains a 30% stake
- Six of the 16 priority investors remained in the top 20. Collectively they held 12% of the company
- Shares held in trust for employees represents 10% of the company
- Five investors who were classed as non-priority long-only funds at pricing held 7% of the company
- Four investors classed as hedge funds at pricing held 6%. (This included TCI who were the second largest individual shareholder after government)
- Other investors held 35% of the company

Notes

1 Based on an analysis of the top 20 shareholders provided by Royal Mail.

2 The analysis may understate holdings where institutions held shares through multiple funds.

Source: National Audit Office analysis of Royal Mail data

Appendix One

Valuation methods

Figure 22

The main metrics and benchmarks used by the adviser, banking syndicate and equity analyst to value Royal Mail

Metric	What it means	How it is used to do a valuation	Main valuation assumptions
Dividend yield (Expected dividend/share price)	Expresses the dividend income that investors would expect to receive from owning shares as a percentage rate. Higher yields imply lower growth of earnings and higher risk.	Peer benchmarks used to estimate the dividend yield. Dividend yield is applied to the forecast dividend to get the share price.	Expected full year dividend of £200 million in 2014 published in the prospectus. Most valuations set a yield as a premium to bpost and a discount to Deutsche Post.
Earnings multiples (Enterprise value/Earnings before interest, tax, dividends and amortisation)	Expresses the value of the business as a multiple of its forecast next year's earnings. Higher multiples imply higher growth of earnings and lower risk.	Peer benchmarks used to estimate the multiple. Multiplied by EBITDA to derive enterprise value. Net debt is deducted to estimate the share price.	Valued Royal Mail based on forecast 2014 EBITDA. Most valuations set a yield as a premium to bpost and a discount to Deutsche Post.
Sum of the parts	Allows for different valuations of separate parts of the business.	Separate calculations of dividend yield and earnings multiples for the letters and parcels business.	GLS (global parcel delivery) is worth higher earning multiples than the core letter business.
Discounted cash flow analysis	The present value of the future cashflow generated by the company.	Uses forecast free cash flows (cash generated before interest and dividends). Discounted by the estimated weighted cost of capital for the company. Net debt is deducted to estimate the share price.	The adviser used the company's business plans for 2013–2016. The analysts used their own forecasts of cash flows. Higher ranges were produced by those that discounted post-transformational cash flows.
Leveraged buy-out	The value of the business to a private investor.	Discounted cash flows after deducting interest payments for increased levels of debt.	Only undertaken as part of valuing the company for a sale to a private investor. Various assumptions of debt.
Market value of property	The estimate of proceeds from selling a property at a given date.	Gross development value is adjusted by a number of assumptions to derive a market value estimate.	Details not available.

Appendix Two

Our audit approach

1 This study examined 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. It covers:

- the context for the sale and the government's overall objectives and achievements to date;
- restructuring Royal Mail's business in readiness for sale;
- advisers, transaction alternatives and valuation; and
- book-building, final demand and pricing.

2 Our audit approach is summarised in **Figure 23** (overleaf). Our evidence base is described in Appendix Three.

Figure 23
Our audit approach

The Department's primary objective

To sustain the universal service for the benefit of all users by introducing private sector capital and commercial disciplines.

How this will be achieved

To be achieved through:

- 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.

Our study

The study examined whether the Department achieved its sale objectives, while protecting the taxpayers' interests.

Our evaluative criteria

Was Royal Mail's business restructured effectively to meet the sale objectives?

Did the Department's preparations maximise the chances of a good sale outcome?

Did the Department execute the sale successfully?

Our evidence

We interviewed key figures in the Department, its advisers, Royal Mail and HM Treasury.

We reviewed literature and key documents detailing the corporate restructure.

We analysed and reviewed key data.

We reviewed literature and key documents concerning the sale preparation.

We interviewed key figures in the Department, its advisers and Royal Mail.

We analysed and reviewed key data.

We reviewed literature and key documents.

We interviewed key figures in the Department, its advisers and Royal Mail.

We analysed and reviewed key data.

Our conclusions

We conclude on value for money on page ten.

Appendix Three

Our evidence base

1 Our conclusion on whether the Department achieved its sale objective, while protecting the taxpayers' interests was reached following an analysis of evidence collected between January and February 2014. Our audit approach is outlined in Appendix Two.

2 We reviewed key documents including:

- submissions to ministers and other analysis prepared by the Department;
- valuations and strategy papers prepared by the Department's advisers ahead of the sale;
- reports prepared for Royal Mail management concerning the sale including property valuation reports;
- the prospectus;
- records of the progress of book-building and allocations of shares; and
- contracts between the Department and the syndicate banks and the independent corporate finance advisers for the IPO.

3 We interviewed key figures in the Department and their advisers to determine their views on a range of issues such as:

- the restructuring of Royal Mail in preparation for the sale;
- the information and assumptions used to price the shares;
- the book-build and share allocation process; and
- the share price following the IPO.

4 We interviewed key figures in HM Treasury and the Communication Workers' Union, as well as some large investors, to understand their views on the sale.

5 We reviewed and analysed information which included:

- Royal Mail's financial results and forecasts;
- the Department's valuation of Royal Mail in public ownership and under different sale scenarios;
- the key valuations provided by advisers, pitching firms, global coordinators and syndicate research analysts;
- the fees paid to advisers;
- the performance of Royal Mail's shares after the IPO;
- the allocation of shares to investors and their behaviour in the aftermarket; and
- data on other IPO's and the share prices of other postal operators.

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