National Audit Office

Report
by the Comptroller
and Auditor General

HM Treasury

The sale of Eurostar

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HM Treasury

The sale of Eurostar

Report by the Comptroller and Auditor General

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Sir Amyas Morse KCB
Comptroller and Auditor General
National Audit Office

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This study examines whether the government achieved its sale objective of maximising proceeds from the sale of its stake in Eurostar and the redemption of the preference share.

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The National Audit Office study team consisted of:
Richard Draper, Daniel Fairhead, Algirdas Glemza, Richard Lewis and Simon Reason, under the direction of Matthew Rees.

This report can be found on the National Audit Office website at www.nao.org.uk

For further information about the National Audit Office please contact:

National Audit Office
Press Office
157–197 Buckingham Palace Road
Victoria
London
SW1W 9SP

Tel: 020 7798 7400

Enquiries: www.nao.org.uk/contact-us

Website: www.nao.org.uk

Twitter: @NAOorguk

Key facts

£585.1m	£172m	22
sale price for 40% stake in Eurostar	price paid by Eurostar to redeem preference share	expressions of interest for Eurostar shares

3	bids in the final round of bidding
6 months	duration of the formal sale process, October 2014 to March 2015
almost double	the sale price (£585.1 million) was 192% of the government's valuation of £305 million
1.1%	transaction fees as a proportion of total proceeds (the 40% stake and preference share)
£3 billion	estimate for total taxpayer investment in the Eurostar train service, one part of the High Speed 1 project, which cost taxpayers more than £8 billion

Summary

1 Following a successful sale process the government agreed to sell its 40% stake in Eurostar International Limited (Eurostar) for £585.1 million in March 2015. The winning bidder was Patina Rail LLP, a consortium made up of Caisse de dépôt et placement du Québec (CDPQ), a Canadian investment fund, and Hermes Infrastructure (Hermes), a UK-based fund. Eurostar also agreed, in a separate transaction, to redeem the government's preference share, providing a further £172 million for the taxpayer.

2 Eurostar is the sole operator of passenger rail services between London and continental Europe via the Channel Tunnel. The train service opened in 1994 as a joint venture between the UK, French and Belgian governments. In 1996 the UK arm of Eurostar was transferred to London & Continental Railways (LCR), a private sector consortium, which planned to finance the building and operation of a new high-speed rail link between St Pancras and the Channel Tunnel. However, as the number of passengers using Eurostar was significantly lower than expected, LCR could not raise the private finance needed to build the link (now called High Speed 1 (HS1)). To keep the project alive taxpayer support was provided to LCR and the company was eventually nationalised in 2008. In public ownership, LCR was restructured and split into 3 parts that could be sold: Eurostar UK (the passenger train service), HS1 Ltd (the track/infrastructure) and a property portfolio.

3 In 2010 the entire Eurostar business was incorporated as a UK company jointly owned by the UK government (40% stake) and the national rail operators of France, SNCF (55% stake) and Belgium, SNCB (5% stake). A preference share was also issued by the company to the UK government at this time. Eurostar carried forward significant UK tax losses which could be offset against future taxable profits and thus reduce future UK corporation tax (as standard tax rules allow). The preference share would pay a dividend to the UK government as the tax losses were utilised over time (see Part Five).

Scope of this report

4 This report considers whether the government achieved its policy objective of maximising the proceeds from the sale of its stake in Eurostar and the redemption of the preference share. The report is structured as follows:

- Part One covers the background and context for the sale;
- Parts Two and Three describe the sale preparation and process;
- Part Four considers the valuation of the Eurostar shares; and
- Part Five provides further detail on the redemption of the preference share.

5 We have published three previous reports on the HS1 project, of which the UK stake in the Eurostar train service is one part.[1] The aggregate proceeds from the sale of Eurostar, the previous sale of the HS1 track infrastructure and forthcoming sale of property assets will be significantly less than the taxpayer's investment in the entire HS1 project. We have previously concluded that the benefits to transport users did not outweigh the costs of the HS1 project. The sale of Eurostar does not alter that assessment. Appendix Three gives more information on the historical context.

Key findings

Context and sale decision

6 Eurostar has performed well since its incorporation in 2010 under its current management team. Prior to restructuring, the UK arm of Eurostar made losses amounting to around £1.8 billion. Since its incorporation, Eurostar has been profitable – passenger numbers, revenue and profit have all increased. A major contributor to this improved financial performance was a reduction in the track access charges as a result of a new charging regime which started at the end of 2009 (paragraphs 1.6 and 1.7, Appendix Three).

7 The total taxpayer investment in Eurostar, prior to its incorporation, is significantly greater than the proceeds generated from this sale. Taxpayer spending on the HS1 project, of which the Eurostar cross-Channel train service is one part, was more than £8 billion. We estimate that UK taxpayers' financial investment in Eurostar and its predecessors (including the write-off of losses incurred) amounts to approximately £3 billion. The Department for Transport (DfT) told the Committee of Public Accounts it would complete and publish an evaluation of the costs and benefits of the whole HS1 project by summer 2013. This document was published in October 2015 but was not available during our fieldwork so we have not commented on it in this report (Appendix Three, Figure 23).

1 Comptroller and Auditor General, *The Channel Tunnel Rail Link*, Session 2000-01, HC 302, National Audit Office, March 2001; Comptroller and Auditor General, *Progress on the Channel Tunnel Rail Link*, Session 2005-06, HC 77, National Audit Office, July 2005; Comptroller and Auditor General, *The completion and sale of High Speed 1*, Session 2010–2012, HC 1834, National Audit Office, March 2012.

8 **The government had held its minority shareholding in Eurostar as a financial investment**. The trading performance of the company is not expected to be altered by the change of ownership. Some asset sales are justified by government on the basis that the sale will result in improved efficiency for the business but this was not the case with Eurostar. Eurostar has its own management team and benefits from the rail expertise of its majority shareholder (SNCF). The sale business case concluded that the hold and sell values would be theoretically similar. The government justified the sale on the basis that the proceeds could be used to reduce national debt. The sale was consistent with government policy to sell assets which it has no policy reason to hold (paragraphs 1.8–1.12).

Sale preparation and process

9 **Eurostar's profits are forecast to increase from 2016 once it has introduced new trains**. The business is currently undergoing a major investment cycle. New higher-capacity trains, the first of which should be rolled out at the end of 2015, are expected to increase profits. This is due to a combination of increased revenues and improved cost efficiency. The government considered waiting to sell after the new trains were introduced as it thought higher profits could feed through into a higher price. However, it concluded that any delay would come with uncertainty and risks, so decided to sell in early 2015 rather than wait (paragraphs 2.4–2.7, Figures 5–7).

10 **The government reached an agreement with the other shareholders to run a competitive sale process following extensive negotiations**. The transaction protocol ensured that the other shareholders (SNCF and SNCB) did not have a veto on any potential buyers. This maximised the pool of investors able to bid for the asset (paragraphs 2.10–2.12).

11 **Preparatory work, by the government and its advisers, made the business more marketable to potential investors**. Changes to the shareholder agreement were effective in encouraging investors' interest and appetite for the shares. In particular, the new agreement provided an improved dividend policy, sell-on rights and protections for the new shareholder (paragraphs 2.10–2.12, Figure 8).

12 **Once the sale was launched in October 2014 the timetable was tight with little room for contingency because of the intention to agree a deal before the General Election**. The preparation for the sale was complicated by the need to transfer the shares away from DfT to avoid a potential conflict of interest as Eurostar was part of a consortium bidding for a rail franchise which DfT would be awarding. Negotiations with the other shareholders also took longer than anticipated. The formal sale process began in October 2014 and an agreement needed to be reached by March 2015 before the election period began. Bidders told us that the timetable was tight yet sufficient (paragraphs 2.8, 2.9, 2.12, 3.13–3.15, Figure 10).

13 **The government and its advisers ran the sale process well and there was competitive tension between the bidders**. The vendor due diligence reports combined with the meetings with management and SNCF had the desired effect, enabling bidders to gain confidence in the prospects of the business and encouraging higher bids. The 3 final round bids were around one-third higher than these bidders' first round bids. One of the final round bidders, a UK local authority pension fund, became aware of the sale much later than the other bidders but the process was flexible enough to allow it to participate (paragraphs 3.8–3.15, Figures 12 and 13).

14 **Transaction costs were approximately 1% of the sale proceeds**. Total adviser fees and other costs related to the transaction amounted to £8.2 million, 1.1% of the proceeds of the 40% stake in Eurostar and the preference share. The financial adviser had good knowledge of the business from its past involvement in the HS1 project. The legal adviser was paid on a billed time basis rather than a fixed fee. The legal cost for an internal transfer of shares, from DfT to HM Treasury, was £0.5 million. HM Treasury was concerned about the cost of the legal work and considered re-procuring the legal adviser during the sale process but it decided that a change of legal team midway through the process would have been inefficient and problematic due to the time-critical nature of the work. The government also agreed an incentive package with Eurostar management and key employees of up to £0.3 million in total upon successful completion of the sale (paragraphs 2.13–2.17, Figure 9).

Valuation and proceeds

15 **The 3 valuations, which formed part of the advice to ministers on whether to go ahead with the sale, were prepared using conventional techniques**. As with other government asset sales, the valuations were used to form a judgement about whether the offers received were fair and exceeded the value of retaining the shares. Additional assurance from an independent expert was used alongside the valuations prepared by the government and its financial adviser. The ministerial submissions provided valuation ranges and underlying assumptions. A detailed valuation annex to the final business case provided sensitivity analysis to explore the likely effects of alternative assumptions on potential bid levels. The project team noted that they would be unlikely to recommend that a sale below the independent adviser's valuation of £315 million (range of £265 million to £370 million) would represent value for money, but that an offer just above this level would not have been recommended automatically (paragraphs 4.2–4.4, Figure 14 and 15).

16 The valuation of Eurostar is particularly sensitive to the likelihood of a competing rail service emerging. The valuations assumed that a competitor would commence rail services in the next 10 years. The valuations prepared by the government and its advisers assumed that a competitor would commence rail services before 2025, significantly reducing Eurostar's profits. Sensitivities were run by the government and its advisers which showed that their valuations were around one-third lower than scenarios in which a competitor did not emerge. It would take several years for a new entrant to begin operations and there are currently no public statements by any potential competitor of a firm date to run a competing train service. Other important factors affecting the valuation include Eurostar's future business performance, the discount rate applied to its future cash flows to compensate for risk, and any discount that a holder of the shares would require as a minority shareholder in an unlisted company (paragraphs 4.6–4.8, 4.20).

17 The sale price of £585.1 million for the 40% stake in Eurostar was more than 90% above the mid-point valuations of £305 million prepared by the government and its financial adviser. Given that the proceeds were much higher than the valuations, a hindsight review provides an opportunity to examine this gap. To a large extent, the gap demonstrates the successful sale, which attracted competitive bids and took place during benign market conditions. However, without questioning the integrity of the 3 valuations, we consider that credible valuations above £500 million could have been supported without changing the assumptions about the business plan or emergence of competition. Instead, we applied lower discount rate and minority shareholder discount assumptions (paragraphs 4.3–4.20, Figure 14 and 17).

Preference share

18 Eurostar redeemed the preference share for £172 million, giving the government a clean break from the company. Standard tax rules allow Eurostar to carry forward its historical trading losses to offset against future taxable profits, thereby reducing UK corporation tax payments. A preference share was created when Eurostar was incorporated in 2010, which would pay a dividend to the UK government as these tax losses were utilised over time. The company was due to start paying preference share dividends to the government in 2015 and, subject to its trading performance and absorption of the historical losses, it would have continued to pay these dividends had the preference share not been redeemed. The redemption of the preference share means that the government receives cash upfront rather than receiving dividends in the future. At redemption date, the forecast dividends discounted on a simple risk-free basis could have repaid £216 million of government debt (including interest accrued), however, this assumes that there is no risk to the receipt of these dividends. In reality, there is a greater risk associated with them than with government borrowing. The £172 million price was agreed in negotiations and was more than the government's hold valuation of £158 million, which was based on a discount rate of 12.2% (paragraphs 1.4 and 1.5, 5.4–5.7, Figures 18 and 19).

Conclusion on value for money

19 The government made a policy decision as part of the 2013 Spending Round to sell the 40% stake in Eurostar before 2020. We believe that the timing of the sale, agreed in 2014, was primarily driven by the desire to sell prior to the 2015 General Election. This transaction took place during a period of benign market conditions and low interest rates. There were a number of risks to value for money associated with this deal that the deal team managed successfully, including: the tight timetable, the need to attract high-quality bids at a time that Eurostar was embarking on investment in new and unproven trains, and the corresponding uncertainty about the increase in future profits.

20 Once the decision was made to sell, the government and its advisers prepared well. Changes to the shareholder agreement made the investment attractive to a wide range of investors, such as pension funds. The process was well run, and sufficiently flexible to convert competitive tension into a price significantly above the initial valuation. Given that the redemption of the preference share by Eurostar affects the cash flows to the new owners of the 40% stake (via dividends) it is appropriate to conclude on the combined outcome of the 2 transactions. We consider that the sale process of the UK government's entire financial interest in Eurostar, which yielded £757.1 million, resulted in the government achieving its objective of maximising proceeds and represented value for money for the taxpayer.

Recommendations

The government is undertaking a significant asset sales programme forecast to exceed £62 billion over the current Parliament. The recommendations below are general principles prompted by our review of the Eurostar sale, not a commentary on this sale. We recommend that HM Treasury should take the lead in ensuring that all departments selling assets should:

Sale preparation

a consider how they can encourage the widest possible number of credible bidders for all assets they are selling;

b give due prominence, in business cases for asset sales, to the relationship between the timing of the sale and the marketability to investors (including a consideration of the track record and future prospects);

Sale process

c use sale processes that exhibit the right balance of rigour and discipline, but sufficient flexibility;

d ensure deal teams contain the right balance of internal staff and external advisers. Where external advisers are appointed, continue to place downward pressure on all costs, while acknowledging that the lowest price will not always provide best value;

Valuation

e apply a range of valuation methods, and use market-based assumptions, as a rigorous cross-check alongside the Green Book methodology to ensure that 'hold' valuations are informed by the prices that may be achieved in competitive and negotiated deals in the prevailing market conditions; and

f consider whether the additional assurance on valuation that may be provided by an independent valuation expert would be strengthened if this expert had no prior knowledge of existing valuations.

Part One

Introduction

1.1 This part provides information about the past and present interest of the taxpayer in the Eurostar cross-Channel train service.

UK government involvement in Eurostar

1.2 Eurostar International Limited (Eurostar) is the sole operator of high-speed passenger rail services between London and continental Europe via the Channel Tunnel.[2] The ownership structure of the Eurostar service has undergone a number of significant changes since it first started running in 1994.

1.3 Between 1996 and 2008 the UK arm of Eurostar was one part of a business run by a private consortium, London & Continental Railways (LCR). The company got into financial difficulties and received taxpayer guarantees in 1998. It was eventually nationalised in 2008 (**Figure 1**). We have published 3 previous reports about the whole project (of which Eurostar is one part). Information about these and the historical context is in Appendix Three.

UK government's 40% stake and preference share in Eurostar

1.4 As part of the restructuring of LCR, the Eurostar business became an incorporated company in the UK. In September 2010, the UK government and the national rail operators of France (SNCF) and Belgium (SNCB) merged their interests in Eurostar into a single corporate entity, Eurostar International Limited (**Figure 2**).[3] Following the incorporation, the UK government owned:

a **a 40% stake in the ordinary shares of Eurostar**: the majority of the shares (55%) were owned by SNCF with the remainder (5%) owned by SNCB; and

b **a preference share**: this was due to pay dividends to the UK government based on future utilisation of UK corporation tax losses.

2 Eurostar should not be confused with Eurotunnel, the company that owns the Channel Tunnel infrastructure and operates vehicle shuttle services between the UK and France.

3 Prior to incorporation the UK arm of the Eurostar train service was known as Eurostar UK.

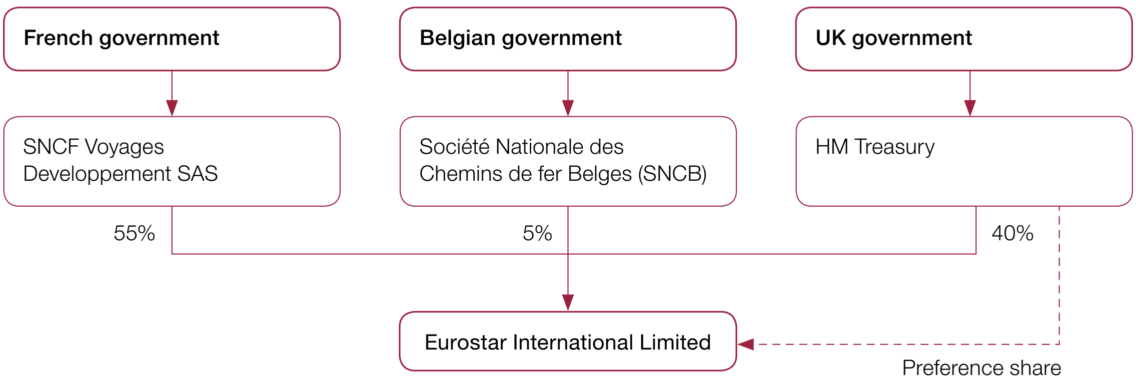
Figure 1
Eurostar – key events

Year	Event
1994	Eurostar international train services begin running through the newly opened Channel Tunnel in a joint venture between the UK, French and Belgian governments.
1996	The Department for Transport (DfT) awards London & Continental Railways (LCR) a contract to build and operate a high-speed rail link from London to the Channel Tunnel (High Speed 1 (HS1)) and run the UK arm of the Eurostar service. LCR intends to partly fund construction through raising finance on the back of Eurostar UK's revenues.
1998	Eurostar UK's revenues are significantly lower than expected. The government provides debt guarantees to allow LCR to raise finance to fund construction of HS1.
2003	First section of HS1 opens.
2007	St Pancras International station and final section of HS1 complete.
2008	Revenues still below revised 1998 forecast. LCR brought into public ownership and split into 3 distinct parts: HS1 track, Eurostar passenger train service and a property portfolio.
2010	Eurostar incorporated as a business. UK government owns 40% stake and a preference share.
Focus of this study	
2013	Eurostar shares earmarked for sale in the Spending Round 2013.
October 2014	Sale of Eurostar formally launched.
March to May 2015	Sale of Eurostar shares and redemption of preference share by company completed.

Source: National Audit Office analysis

Figure 2
Ownership structure of Eurostar prior to the sale

Following incorporation in 2010 the UK government owned 40% of Eurostar and an additional preference share



Note

1 Prior to the transfer to HM Treasury the 40% stake and preference share was owned by LCR, which is 100% owned by DfT.

Source: National Audit Office analysis

1.5 UK tax law allows companies to carry forward tax losses against future profits therefore reducing profit subject to corporation tax. Eurostar's UK tax losses amounted to around £1.8 billion prior to the 2010 incorporation. These losses were valuable to the company because future taxable profits can be offset against them. The losses could have been valued as part of the UK contribution on incorporation; however, they were difficult to value and would have resulted in the UK having a majority stake – which none of the shareholders wanted. Instead, a preference share was created which would pay the UK government a dividend amounting to 70% of tax losses utilised once a threshold had been reached.

1.6 Eurostar has been a profitable, cash-generative and growing company since it was restructured and incorporated in 2010. Eurostar has a large market share (75% to 80%) on its core routes compared with airlines with a 20% to 25% share (see **Figure 3**). The European Commission has described its position in these markets as dominant.[4]

1.7 The company has a healthy balance sheet – it holds cash and its assets are significantly greater than its liabilities – and it is embarking on a significant investment in new trains.[5] Since 2012 it has distributed around 25% of profit after tax as dividends. The total dividends paid following the financial results of 2012, 2013 and 2014 amounted to £41.1 million, of which the UK government received a 40% share of £16.44 million (**Figure 4** on page 16).

Sale decision and rationale

1.8 The government's policy is to sell assets where there is no policy or strategic rationale to retain them. As part of the Spending Round 2013, all departments were asked to set out asset disposal plans for the 5-year period 2015-16 to 2019-20. The 40% stake in Eurostar was identified as a potential candidate for disposal in the Department for Transport's (DfT's) submission.

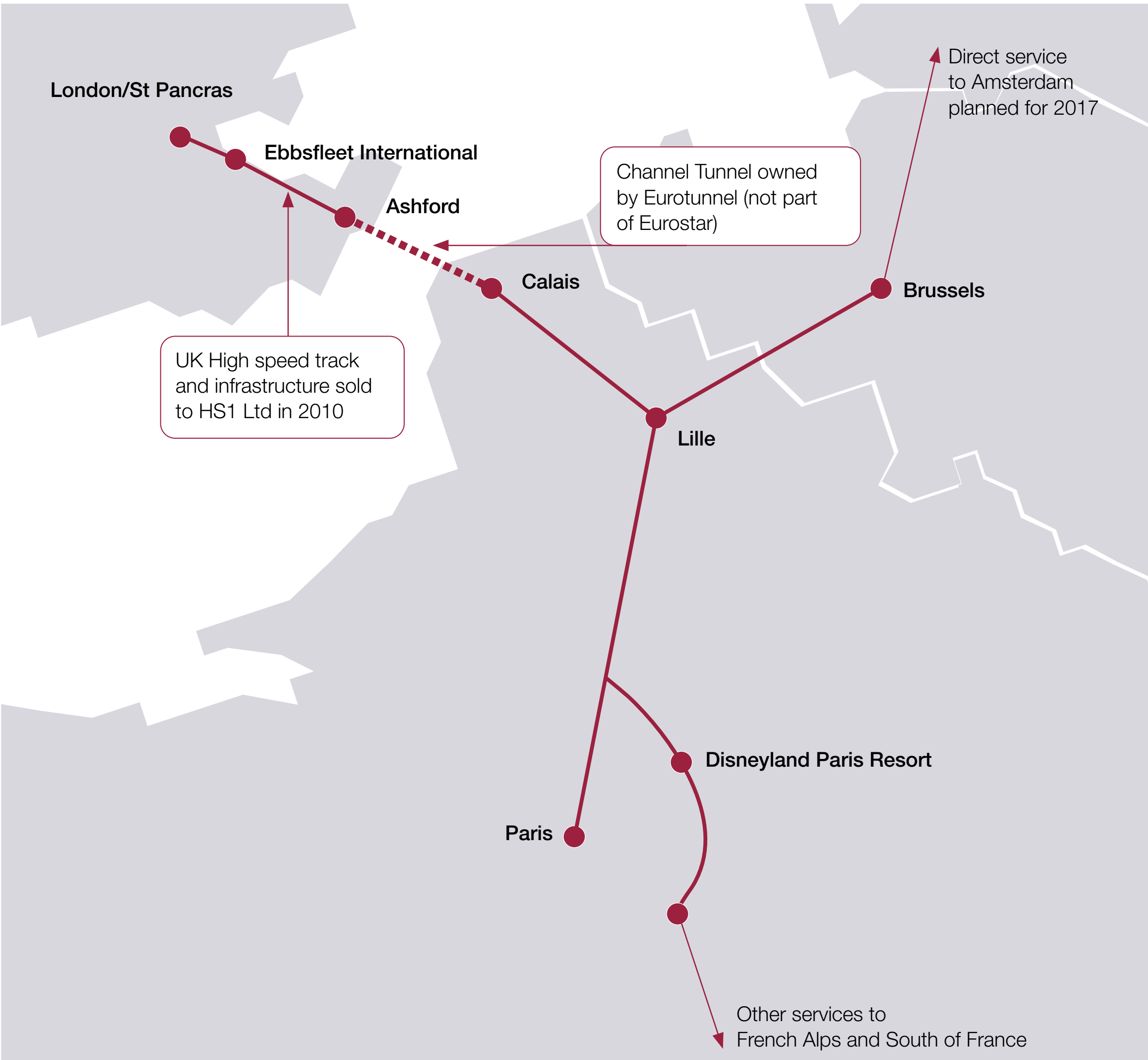
1.9 The DfT's strategic outline business case of June 2013 said there was no strong policy rationale for holding the 40% stake. However, it did acknowledge that the UK holding had historically had policy interest. As examples, it cited the renovation of St Pancras station and promotion of tourism and economic regeneration at Ashford and Ebbsfleet.

4 European Commission-press release, May 2015, available at: http://europa.eu/rapid/press-release_IP-15-4976_en.htm. On 13 May 2015 the European Commission approved the planned merger involving the acquisition of sole control of Eurostar International Limited by the French rail operator SNCF. Under the deal in question here, SNCF has negotiated a new shareholder agreement giving it sole control of Eurostar. In order to resolve the Commission's competition concerns, Eurostar, SNCF Mobilites and SNCB offered commitments designed to ensure that any new entrant would have fair and non-discriminatory access to: (i) standard and cross-Channel areas and services, such as ticket offices, passenger information services and cross-Channel areas in stations in France and Belgium currently managed by SNCF and SNCB; (ii) maintenance centres in France, the UK and Belgium currently managed by SNCF, Eurostar and SNCB for services such as overnight storage, servicing and cleaning of trains and light maintenance; (iii) train paths currently used by Eurostar at peak times, should a new entrant not be able to obtain such access through the usual procedure for path allocation by the infrastructure managers. The Commission takes the view that the commitments offered reduce the barriers to entry for new operators seeking to offer international rail passenger transport services on the London–Paris and London–Brussels routes. The Commission has therefore concluded that the planned merger, as modified by the commitments, does not raise any competition concerns. The decision is conditional upon full compliance with the commitments.

5 Eurostar will fund its investment in new trains in 2015 and 2016 from borrowings and the cash the business generates.

Figure 3
Map of Eurostar's core routes

Eurostar's two core routes make up the majority of its revenue



Source: National Audit Office analysis; UBS Information Memorandum

Figure 4
Eurostar's historical results

Profit and loss account	2011 (£m)	2012 (£m)	2013 (£m)	2014 (£m)
Revenue	824.7	829.4	882.2	890.8
EBITDA	87	116.1	133.1	142.1
EBITDA margin	10.5%	14.0%	15.1%	16.0%
Interest	9.4	1.2	1.7	13.4
Tax	-0.6	31.8	16.0	4.8
Profit after tax	20.8	88.0	72.3	13.6
Dividends	0.0	6.2	16.3	18.6
Capital expenditure	185.0	32.0	84.0	107.0
Balance sheet				
Total assets	1,090.2	1,129.8	1,197.8	1,281.8
Total liabilities	350.9	354.9	345.9	476.8
Cash in bank	120.4	191.3	231.8	297.8
Net cash after borrowings	46.5	118.7	136.7	152.9

Notes

1 EBITDA is a measure of the cash profit generated by the business and stands for Earnings Before Interest, Tax, Depreciation and Amortisation.

2 At the date of sale the 2014 results were not publicly available.

Source: National Audit Office analysis; Eurostar financial accounts

1.10 The government's main objective in selling the Eurostar shares was to 'maximise value for money'. It aimed to achieve this by:

- maximising net proceeds (sale proceeds less transaction costs);
- maximising certainty of deal closing; and
- minimising post-sale residual risks to the government.

1.11 The outline business case also noted that to achieve value for money there needed to be a deep and efficient market for the asset and the net present value (NPV) of a sale should be greater than or equal to the NPV of retaining the shares.

1.12 Some government asset sales are justified on the basis that the sale will result in improved efficiency for the business. However, this was not the case with Eurostar – the business has its own management team so the shares had been managed as a purely financial minority holding. The business performance was not forecast to change whether the shareholding was held or sold. The question for the government was therefore whether the future income from the shares was worth more to it than to a private investor. Its economic analysis concluded that hold and sell values were similar and ministerial submissions stated there was no strong economic argument to sell the holding other than the positive impact on PSND (public sector net debt) in the short term.

Part Two

Preparation

2.1 This part explains how the government considered options and prepared for the sale process.

Exploring sale options and timing

Feasibility report

2.2 In February 2014 the Department for Transport (DfT) appointed UBS to act as financial adviser in preparation for the sale. UBS's first task was to prepare a feasibility report for the sale. As part of the review it considered sale options. It proposed that a private sale (rather than an initial public offering (IPO) sale on the stock market) would be the best route. UBS noted that, as well as allowing for a more controlled sale process, this would be the preferred option for the majority shareholder, SNCF, whose cooperation was important to a successful sale.

2.3 UBS also performed a market sounding exercise with potential investors. It concluded that there was sufficient buyer interest to run a successful competitive private sale process.

Sale timing and business performance

2.4 As part of the feasibility report, UBS considered the timing of the sale. Similar analysis was also included in the sale business case. The government decided to sell in early 2015 due to the benign market conditions and good terms available with SNCF. However, it acknowledged that there would be some possible advantages to a later sale (**Figure 5**).

2.5 Eurostar International Limited (Eurostar) has ordered 17 new international passenger trains, the first of which is due to come into service at the end of 2015. The new e320 trains have higher seating capacity (around 20% greater), allowing for more passengers at peak times. Eurostar is also planning new routes. It began a new service from London to the South of France in 2015 and plans to offer a new direct service from London to Amsterdam from 2017. This new direct service to Amsterdam is only possible with the new trains as, unlike the older trains, the new e320 trains will be compatible with the signalling system in the Netherlands.

Figure 5

National Audit Office summary of the timing considerations included in sale business case

Advantages of selling now	Advantages of selling later
• Benign market conditions	• New rolling stock benefits fully valued by bidders
• Good terms available with other shareholders	• Benefit of new routes understood
• Competitor not yet emerged	• Longer track record means may get more credit for the significant increase in profits

Source: National Audit Office analysis; Eurostar sale final business case

2.6 Eurostar profits have grown year-on-year since incorporation, providing confidence for potential investors. However, the introduction of the new trains is forecast to increase profits from 2016, described as a 'hockey stick' increase in the government's sale business case. This is because the new trains are forecast to increase revenue due to an increase in passengers while many of the costs will stay fixed (for example, track access costs per train)[6] or fall (more cost-efficient trains). If the government had waited until the new trains had come into service (and investors could see these higher profits realised) it may have been able to get a higher price. Nevertheless, these forecast higher profits are dependent on new, unproven trains and an increase in the growth of passenger numbers. Eurostar's borrowing will also need to increase to cover some of the investment costs.[7] The investors bidding for the shares were made aware of the expected increase in profits so this should have been captured in the prices bid with an appropriate discount applied to reflect the uncertainty and risk due to the introduction of new trains (**Figure 6** overleaf).

2.7 The government and its financial advisers anticipated that Eurostar's dividends could increase in the future, particularly in the 2020s after the capital investment in new trains is complete (**Figure 7** on page 21). In a valuation annex to the sale business case the government forecast that Eurostar would pay dividends amounting to in excess of £1 billion in cash (undiscounted) over the coming 10 years. The level of these dividends is subject to business risk and is therefore uncertain, but if they are paid the 40% owner's share of these dividends (previously owned by the government) would be able to pay off the capital and interest of approximately £0.5 billion of government debt issued in 2014-15.[8]

6 The high speed rail track access charges are per train. The access charge for the use of the Channel Tunnel is a per passenger charge so this will increase with passenger numbers.

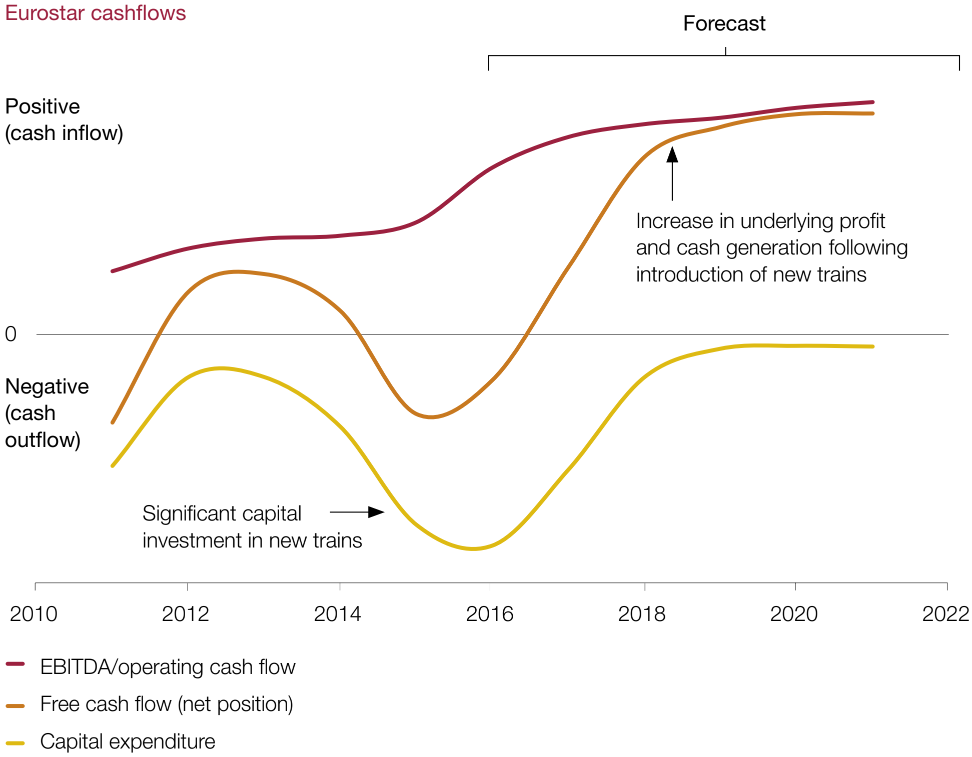
7 The investment in the new trains will be funded from Eurostar's profits and increased borrowing. The sale of the government's stake does not raise any new capital for the company as it is not an issue of new shares.

8 The average cost of government borrowing was less than 3% in 2014-15. If the dividend levels forecast by the government to be paid to the 40% owner over the next 10 years are discounted by 3% they give a figure of around £0.5 billion.

Figure 6

Project team cash flow forecast for Eurostar (operations and capital investment)

The government and its financial adviser expect that Eurostar's free cash flow will increase significantly after the new trains have been paid for



Note

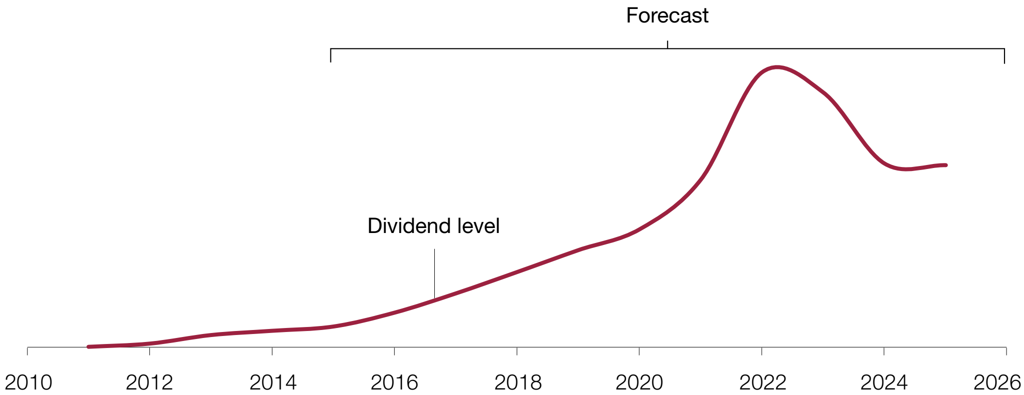
1 The graph is indicative. It is a stylised illustration of forecasts produced by the government and its financial adviser.

Source: National Audit Office analysis; Eurostar sale final business case – Valuation Annex

Figure 7

Project team dividend forecast for Eurostar

The government and its financial adviser expect that Eurostar's dividends will increase significantly in the future



Note

1 The graph is indicative. It is a stylised illustration of forecasts produced by the government and its financial adviser.

Source: National Audit Office analysis; Eurostar sale final business case – Valuation Annex.

Preparing shares for sale

Transfer of shares to avoid a perceived conflict of interest

2.8 In April 2014 the DfT appointed Freshfields as its legal adviser. The focus of Freshfields' initial work was to transfer the shares from DfT to another government department.[9] Eurostar was part of a consortium bidding for the East Coast franchise, which DfT was awarding later in 2014, so it was agreed that to avoid any perceived conflict of interest the shares should be transferred away from DfT. The legal advisers were originally asked to prepare to transfer the shares to the Department for Business, Innovation & Skills (BIS) but a few weeks before the transfer took place the government decided to transfer the shares to HM Treasury instead.

2.9 The transfer of shares to HM Treasury was completed on 18 June 2014 and DfT had no further involvement in the sale after this point. Staff from the Shareholder Executive (ShEx), part of BIS, had been supporting the project prior to the transfer and would have continued to do so whether or not the shares were transferred. As these arrangements were already in place, a senior responsible owner (SRO) and project team from ShEx took on the work from DfT. The project team was responsible for the day-to-day project management but reported to officials and ministers at HM Treasury, who were ultimately accountable for the sale. Staff involved at the 3 different departments told us that the process had worked well and the transfer of the shares and responsibility had been managed smoothly.

9 The shares in Eurostar prior to the transfer were owned by London and Continental Railways (LCR), which is 100% owned by the Department for Transport.

Transaction protocol agreed with pre-existing shareholders

2.10 In order to get the maximum price for the shares it was important to generate interest from as many investors as possible. Initially the majority shareholder, SNCF, had wanted a veto on the bidders at each stage. However, the government and its advisers resisted this request. A transaction protocol was agreed that allowed the other shareholders to meet the bidders but did not allow any veto.

New shareholder agreement to attract investors

2.11 The government, SNCF, SNCB and the Eurostar board agreed changes to the shareholders' agreement, some of which were designed to attract potential bidders (**Figure 8**). In particular, the dividend policy was strengthened to encourage investors, such as pension funds, who would be looking for assets that provide an annual income. Over the long term the new policy means that the company will be paying most or all of the free cash flow it generates as dividends to investors. The project team believed that the new agreement provided value for the 40% shareholder. The team gave a provisional view that if the sale should not proceed and the government made a policy decision to become a long-term holder of the shares it should adopt the new shareholder agreement. However, while there was still a policy to sell the Eurostar shares the existing agreement should be retained.

2.12 Although SNCF owns 55% of the shares in Eurostar the old agreement did not give it full control of the board. A key benefit for SNCF of the new agreement was that it gave SNCF overall voting control and therefore the ability to fully consolidate Eurostar's profitable operations into its accounts. SNCF and SNCB also had the right to pre-empt the sale at a 15% premium to the agreed sale price. Negotiations with the other shareholders took longer than anticipated – the agreed form of the new shareholders' agreement and transaction protocol was finalised in October 2014.

Advisers' fees and other transaction costs

2.13 The total costs of the transaction were £8.2 million, around 1.1% of the sale price of the 40% stake sold and the preference share. As would be expected, the highest fees were paid to the government's financial adviser UBS (fees totalled £3.7 million), and its legal adviser Freshfields (fees totalled £2.8 million), who had both been involved throughout the sale process (**Figure 9**).

2.14 UBS was appointed following a competitive process from 10 bidders for the financial adviser position. UBS's fee was not the lowest – one bidder proposed a fee that would be capped at less than £1 million. However, UBS's fee was at the lower end of the prices bid and following negotiations with DfT it agreed to further reduce this fee.

Figure 8
Summary of key changes to the shareholder agreement

Area	Summary of change
Dividend policy	Dividends to be a fixed percentage of net income or net cash sweep (subject to debt limits). This represents an improvement relative to the previous agreement.
Sell-on rights	The shares can be sold on, subject to certain conditions, with the same rights provided for a new buyer.
Dispute resolution	If a dispute cannot be resolved following an escalation process, the new shareholder has a 'put option' to sell their shares to the other shareholder at a premium to the fair market value of the shares with no minority discount factored in.
Control	Overall voting control to the majority shareholder SNCF.

Source: Eurostar sale final business case; National Audit Office analysis

Figure 9
Transaction costs

Name	Role	Cost (£m)
Main advisers		
UBS – financial adviser	Feasibility study (fixed fee)	0.075
	Sale execution (success fee)	3.596
Freshfields – legal adviser	Inter-departmental transfer	0.511
	Sale legal work	1.498
Freshfields	Legal VDD report	0.811
Other vendor due diligence (VDD) providers and advisor fees		
KPMG	Financial VDD report and sale support	1.191
Roland Berger	Commercial VDD report and sale support	
Atkins	Technical VDD report and sale support	
Willis	Insurance VDD report and sale support	
Intralinks	Virtual data room provider	
EY	Independent valuation (fixed fee)	
Other costs		
Eurostar	Management incentive package	0.298
	Legal costs reimbursed	0.187
Total transaction costs		**8.167**

Note

1 Most of the VDD providers were paid on a fixed fee basis. The exceptions were Freshfields, which was paid on a billed time basis for all of its work, and Intralinks, which was paid a fee based on the amount on information stored.

Source: National Audit Office analysis

2.15 UBS had a good knowledge of the Eurostar business. SG Warburg, which later became part of UBS, was one of the original shareholders of London & Continental Railways (LCR) and acted as its principal financial adviser. UBS continued this work and was the financial adviser for LCR at the time of the High Speed 1 (HS1) sale in 2010.

2.16 The fees for Freshfields were paid on a billed time basis rather than a fixed fee. DfT, which procured the legal advisers following a competitive tendering process, considered that a fixed fee arrangement was not appropriate given that it was not possible to know at the outset the exact scope of all the work required. The transfer of shares from the DfT to HM Treasury was more complex and therefore more costly than expected, with the legal work costing £0.5 million. Although the legal adviser's fees were at a discount to scale rates, some of the fees were high relative to the costs of the civil service staff who were working on the sale project team.[10] HM Treasury was concerned about the significant legal fees being incurred during the sale process and considered re-procuring the legal adviser or altering the contract to a fixed fee basis. However, it decided that a change of legal team midway through the process would have been inefficient and problematic due to the time-critical nature of the work.

2.17 Other costs included reimbursing Eurostar any external legal costs during the process and providing an incentive package for Eurostar management upon completion of a successful sale. In November 2014, after the sale process had begun, HM Treasury agreed to pay up to £300,000 to Eurostar management to recognise the significant work required of Eurostar staff involved in the sale. The project team's submission for HM Treasury approval noted that the level of incentive payments was low compared with some other government asset sales and those in the private sector. The incentive payments were split between approximately 20 staff. Around half of the package was for 4 executive board members. The project team considered the incentive package represented good value; Eurostar staff had performed well, making presentations to potential bidders, assisting with vendor due diligence and responding to a rigorous question and answer process.

10 The legal adviser was procured through the CCS (Crown Commercial Service) Legal Services Framework, Lot 8: Major or Complex Projects.

Part Three

The sale process

3.1 This part explains the sale process for the 40% stake in Eurostar International Limited (Eurostar).

Project management and governance

3.2 HM Treasury was ultimately accountable for the project following the transfer of shares from Department for Transport (DfT). However, the senior responsible owner (SRO) and most of the project team were at the Shareholder Executive (ShEx), part of the Department for Business, Innovation & Skills (BIS) (**Figure 10** and **Figure 11** overleaf).

Figure 10

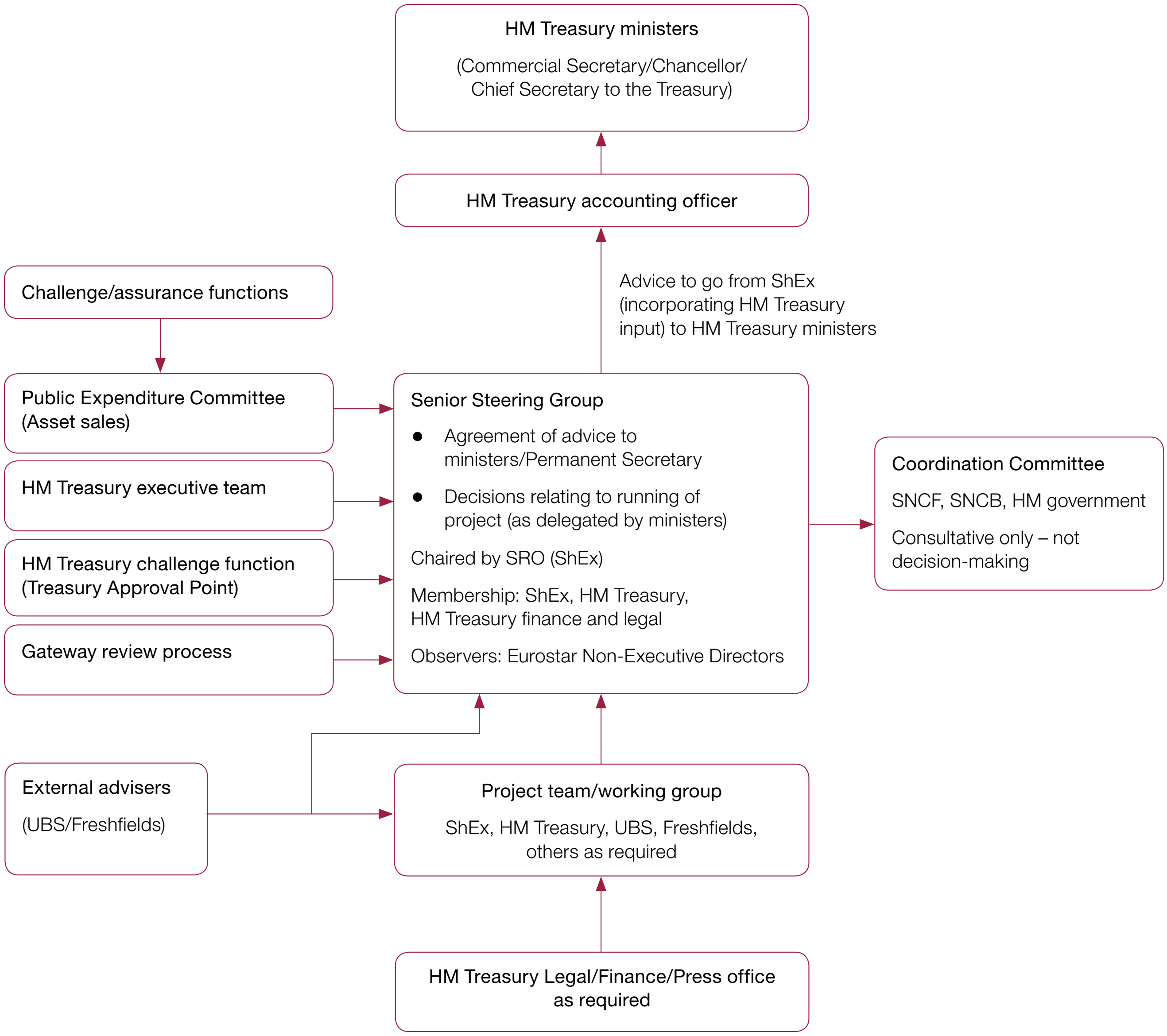
Project timeline – key events

Date	Event
DfT accountable for sale	
April–June 2013	DfT prepares case for sale of Eurostar stake, which is approved by its internal investment committee.
November 2013	Cabinet Committee endorses project outline.
February–April 2014	DfT appoints UBS as financial adviser and Freshfields as legal adviser.
May 2014	Preparations begin for transfer of shares and project ownership to BIS.
HM Treasury accountable for sale but ShEx staff have day-to-day project management responsibility and SRO	
June 2014	Decision is made to transfer shares to HM Treasury rather than BIS. However, staff in ShEx (part of BIS) will still take the lead on the project.
August 2014	HM Treasury appoints vendor due diligence providers.
September 2014	Cabinet Committee approves sale launch. Outline business case approved.
October 2014–February 2015	Sale process (see Figure 12).
March 2015	Winning bidder announced.
May 2015	EU Commission clearance received and financial close of deal.

Source: National Audit Office analysis

Figure 11

The governance structure of the sale after the transfer from Department for Transport



Source: Eurostar sale final business case

3.3 As part of the governance of the project, 3 gateway reviews were conducted – in May 2014, September 2014 and January 2015.[11] Project documents noted that the project timetable was challenging – there was very little room for delay as any sale agreement needed to be finalised before the General Election purdah period began in March 2015.

Running a competitive auction

Attracting expressions of interest from a broad array of parties

3.4 The sale process, summarised in **Figure 12** on pages 28 and 29, formally started on 13 October 2014, when the sale was announced by HM Treasury. A pre-qualification letter and a briefing document were placed on the gov.uk website inviting expressions of interest by 31 October 2014. Some of the bidders had already been approached by UBS prior to this point as part of the feasibility report. Other bidders told us that they knew about the sale as they had been contacted by other banks.[12]

3.5 The government received 22 credible expressions of interest (including 2 consortia). All 22 interested parties fulfilled the relevant criteria and so were eligible to bid. The financial adviser judged that this initial level of interest was sufficiently high to generate a competitive process and so generate a good sale price. HM Treasury ministers gave approval for the bidding process to begin.

Initial bids based on information memorandum and draft contract

3.6 On 3 November 2015, following the signing of a non-disclosure agreement, the potential bidders were given a detailed information memorandum prepared by UBS. This set out details of the company including its past and expected future financial performance.

3.7 The government received 7 Round One indicative offers on 8 December: 3 were from two-party consortia; the other 4 were single-party bids. One of the single-party bidders was a local authority pension fund which had not been among the initial 22 bidders because its expression of interest had just missed the deadline. This fund had not been aware of the sale before the announcement in October 2014 so it had less time to prepare an expression of interest. However, the sale process was flexible enough to allow this prospective buyer to enter the process and make a bid as it met all the relevant criteria.

3.8 The equity values in the proposals covered a wide range, from £350 million to £635 million (with a mid-point of £400 million and an average of £431 million). The 7 bids were all above the central 'hold' valuation. The project team believed that the highest offer was based on a scenario where on-rail competition never arrives.

11 Gateway reviews are independent peer reviews conducted to provide assurance for projects.
12 The possibility of a sale was first made public in the *National Infrastructure Plan*, December 2013.

Figure 12
Summary of sale process

	Pre-qualification process	Round One
Timing	Oct 2014 3 weeks	Nov–Dec 2014 6 weeks
Purpose	Invite potential investors to express interest and check that they are eligible to bid.	Provide information on the business for eligible bidders and receive initial bids.
Information provided to potential investors	Letter and summary briefing document that sets out: • how the process would work; • how to respond; • minimum criteria to progress; and • overview of Eurostar business.	Process letter explaining how initial bids should be submitted. Detailed Information Memorandum produced by financial adviser setting out the past and forecast financial performance of Eurostar.
Number of potential investors	22 expressions of interest	7 initial bids
Bid range (average)	n/a	£350 million–£635 million (£431 million average)
Result	22 potential investors met the necessary criteria so were eligible to bid. One expression of interest, from a European trade buyer is seen as potentially sensitive by SNCF and SNCB. However, they met the necessary criteria so there were no grounds to exclude them.	Seven initial bids were received in Round One. Five of these bids progressed to the next stage. Two bidders were rejected: one bidder requested significant changes to the shareholder agreement and another bidder had been hoping to form a consortium with this bidder so also left the process.
Action and key information required from bidder	Submit a pre-qualification letter by 31 October 2014 setting out information such as: • bidder identity; • confirm bidder criteria (see below); • investment rationale and strategy; • relevant experience; • source of finance; • potential conflict of interest; and • board and investment committee approval.	Submit initial 'indicative offer' by 8 December 2014 for 40% equity stake in Eurostar alongside other information requested as part of pre-qualification. Information to identify risks in obtaining EU merger control clearance.
Key assessment criteria	Grounds for exclusion include: • no relevant experience; • unable to invest £35 million of equity; • unable to close deal by early 2015; and • participation would distort a competitive sale process.	Indicative offer primarily evaluated on the amount bid but also on certainty of closing the deal in a timely manner. Freshfields provided advice on the competition risk attached to each bidder.

Note

1 The division and timing of the different sale phases is approximate.

Source: National Audit Office analysis

Round Two/Final offer	**Winning bidder**
Dec 2014–Feb 2015 12 weeks	Mar–May 2015 12 weeks
Provide the shortlisted bidders with further detailed information and access to management.	To finalise the sale.
• vendor due dilligence (VDD) reports; • management presentation; • depot site visit; • new e320 train tour; • sessions with the VDD providers; • meetings with SNCF and SNCB; and • meeting with independent chair of the board.	No further information provided.
3 bids (of a potential 5)	1 winning bidder
£482 million–£585 million (£532 million average)	£585 million
Three of the five potential bidders made bids in Round Two – all increasing their bids significantly. The two bidders which withdrew from the process included the highest bidder from Round One.	The highest bidder, at £585 million, was selected.
Submit 'final offer' by late February 2015 for 40% equity stake in Eurostar alongside confirmation and further details on other information requested previously.	Finalising of the share purchase agreement and transfer of funds to HM Treasury once EU clearance had been given.
Final offer primarily evaluated on: • amount bid. However, also consideration of: • contractual terms offered; • certainty of closing deal by March 2015 (or shortly thereafter); • ability to enable continued operation of Eurostar; and • any other issues identified.	n/a

3.9 Of the 7 bidders, 2 were rejected. These 2 bidders were considering working together as a consortium. One of these bidders asked for significant changes to the revised shareholder agreement which were not acceptable, forcing both bidders to drop out.

Provision of further information and access to management for a shortlist of serious bidders

3.10 On 15 December 2015, 5 bidders were invited to Round Two and given access to vendor due diligence (VDD) reports on the Eurostar business covering 5 areas (legal, financial, commercial, technical and insurance). In early January 2015 one of the 5 remaining bidders withdrew from the process to focus on another opportunity.

3.11 The remaining 4 bidders attended:

- a management presentation with Eurostar's chief executive officer, chief financial officer, director of strategy and commercial director;
- a site visit of Eurostar's Temple Mills depot to see the maintenance operation and tour the new e320 train;
- sessions with the VDD providers: Roland Berger, KPMG and Atkins;
- meetings with SNCF and SNCB; and
- a meeting with the independent chair of the Eurostar board.

3.12 In addition to the face-to-face meetings, bidders were also invited to participate in a formal written Q&A process with the company of up to 500 questions per bidder.

Final bids

3.13 The bidders had to submit bids in late February 2015. The consortium that had bid the highest price in Round One, decided very late in the process not to bid. We contacted the consortium to discuss its involvement in the sale but it declined to comment (**Figure 13**).

3.14 The remaining 3 bidders provided their best and final offers on 26 February 2015. All bidders increased their bids significantly, which suggests that the process had the desired effect of increasing bidders' confidence in the business. The average of the 3 final bidders first bids was £405 million and this increased to an average of £532 million in the final round, an increase of around one-third (31%). We spoke to the 3 bidders about their views on the sale process – they were all positive about how the transaction had been run. We were told that the timetable to assess the business and prepare bids was sufficient yet tight, particularly as it ran over the Christmas period.

Figure 13

Round One and Two bids

Round	Number of bids	Range (£m)	Comment
Round One	7	350–635	The £635 million bid was an outlier – it was more than 30% greater than the next highest bid. The bids averaged £431 million.
Round Two/ Final bids	3	482–585	Five bidders were invited to bid. One pulled out early and another (that had made the highest indicative offer) decided not to bid at the last moment. The 3 final round bids averaged £532 million.

Source: National Audit Office analysis

Assessing the bids

3.15 The final bids were assessed primarily on the headline price that the buyer was willing to pay. However, bidders were told that the contractual terms offered, certainty of completion and ability to enable the continued operation of Eurostar would also be taken into consideration. The final business case provided a framework to assess the different bids. For example, if the purchaser agreed to pay some or all of the price at a later date this deferred consideration would be discounted by the government's cost of borrowing to provide a present value.

Sale proceeds

3.16 A binding contract for the sale of the UK government's 40% holding for £585.1 million was signed on 3 March 2015 with Patina Rail LLP, a consortium of Caisse de dépôt et placement du Québec (CDPQ) and Hermes Infrastructure (Hermes). This bid was £55 million (10%) higher than the second-highest bidder. Neither SNCF nor SNCB exercised their pre-emption rights. Following EU merger clearance, the deal was closed on 28 May 2015.

3.17 CDPQ is a Canadian investor that manages funds primarily for public sector pension plans. CDPQ owns approximately three-quarters of Patina Rail LLP (which owns the 40% stake in Eurostar) and the remaining part is owned by Hermes, a UK-based fund. The Hermes fund involves participation by public and private sector pension schemes, including some local authority pension funds and the Nuclear Liabilities Fund, Santander UK and BT.[13,14,15] These partners will benefit from the long-term returns that Eurostar is expected to provide.

13 The Nuclear Liability Fund invests so that it can fund the eventual decommissioning of 8 nuclear power stations operated by EDF. If the eventual liabilities are greater than the fund assets, HM government will fund the shortfall.

14 The Santander pension fund supported the purchase through the Hermes fund and a segregated mandate with Hermes, leaving it with around 4% ownership of Eurostar.

15 The BT pension scheme is the largest single investor in the Hermes fund.

Part Four

Valuation

4.1 This part examines the valuations of the 40% stake in Eurostar International Limited (Eurostar) prepared by the government and its advisers.

Valuations by government and its advisers

4.2 Valuations are important as they are used in business cases alongside other factors to support advice to ministers and senior officials about the value for money of asset sales.

4.3 Before the sale the government performed and commissioned a number of valuations. The financial adviser, UBS, performed a valuation which had a central point of £305 million.[16] The government's hold valuation was very similar. Later in the sale process, November 2014, the government decided to engage a third party, EY, to perform an independent valuation. This was to reassure the government that its own valuation was reasonable. EY was not involved in the sale process at any other stage but was aware of the other valuations and assumptions before it began the work. It valued the shares slightly higher, with a central point of £315 million (range of £265 million to £370 million). Official documents noted that this higher hold valuation should be adopted for the purposes of assessing the value for money of the sale and that a sale price below these levels would be unlikely to provide value for money. However, the project team told us that an offer just above this level would not have been recommended automatically. The ministerial submissions provided valuation ranges and the assumptions used to derive them. The Valuation Annex to the final business case included raw data used to construct the valuations, such as the expected profits and dividends of Eurostar for the next 10 years.

16 The £305 million valuation was made using information available just prior to the sale launch. UBS told us that there was no request for an update following the Round One bids.

4.4 The final price of £585.1 million was 58% higher than the maximum price of any of these valuations (£370 million) and 92% higher than the government and its advisers' central valuation (£305 million). Part of the reason the price offered by the winning bidder was higher than the valuations can be explained by benign market conditions and a well run sale process which attracted competing bids. Earlier valuations prepared by the Department for Transport (DfT) and UBS (when pitching for the work) were closer to the final price but these were not included in any of the submissions provided to ministers so were of no relevance to the sale decision. The project team told us that these earlier valuations were not used as they were based on public information and not on the detailed information that was available at a later stage.[17] We consider that the main reason these earlier valuations were higher was due to the use of lower discount rates (**Figure 14** overleaf).[18]

Understanding the valuation

4.5 The table in **Figure 15** on page 35 sets out the main assumptions in the 3 valuations used in the sale business case and ministerial submissions.

Key assumptions

Competition

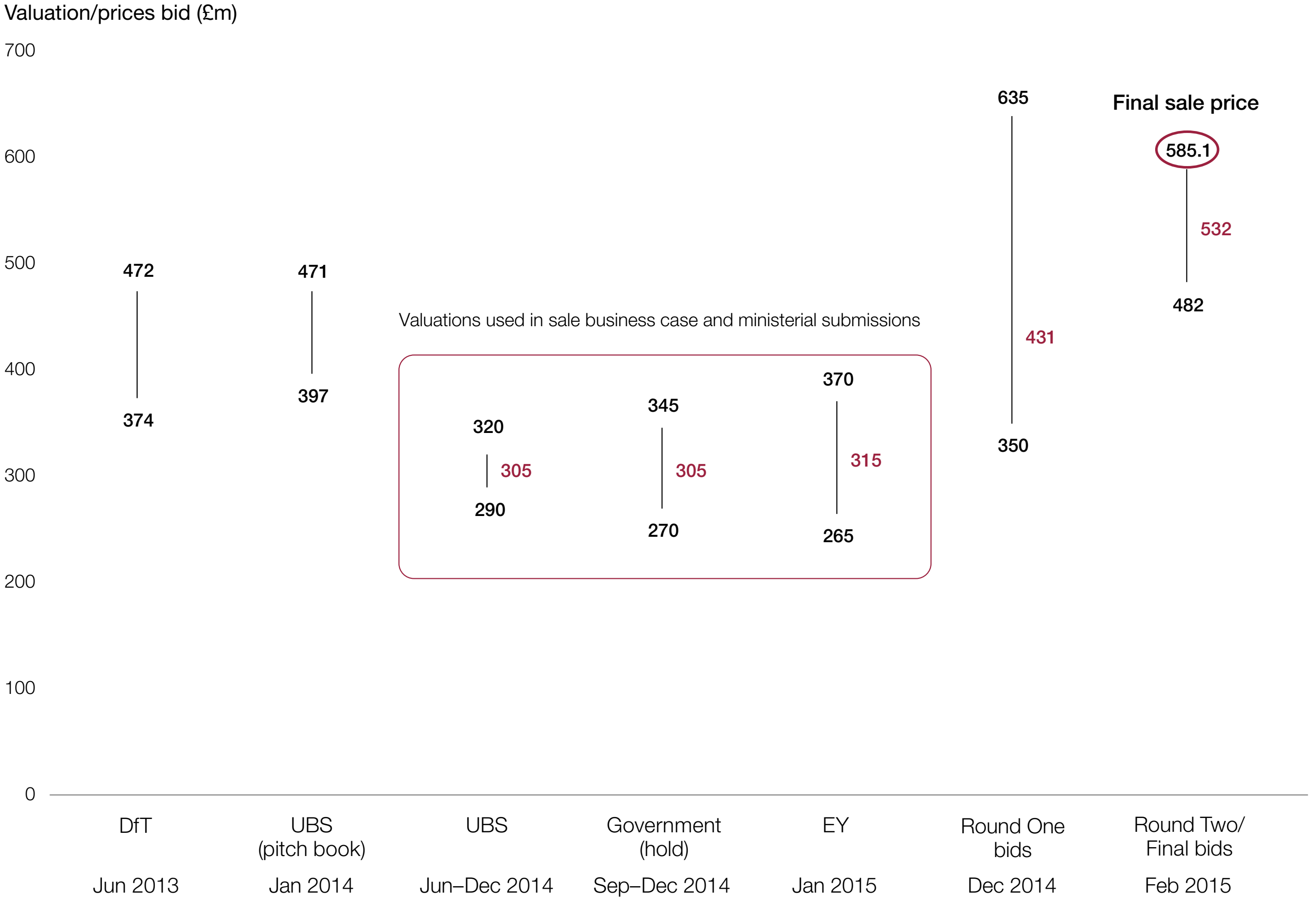
4.6 European rail regulation has permitted on-rail competition for international passenger services since 2010. There are currently no public statements of a firm date to run a train service by any potential competitor.[19] Any potential competitor must receive all the relevant authorisations, negotiate access to the infrastructure and procure a fleet of new trains for operation through the Channel Tunnel, all of which would take a number of years. Eurostar has considered scenarios showing the potential impact of on-rail competition on different time scenarios.

4.7 The commercial vendor due diligence provider, Roland Berger, analysed the investment case for a potential competitor ("Newco") which entered the market in the 2020s. It forecast that over the long term Newco could achieve a return on its investment: the investment's cash flow profile is such that Newco would be making losses in the first 5 years of operation and it would take well over a decade before its cumulative profits outweighed its losses. Roland Berger considered that this appeared risky amid the significant uncertainty over operations, costs and timing of service introduction which a market entrant would face.

17 UBS told us that the pitch book valuation was based on limited public information whereas the later valuation was based on more extensive work. It noted that a number of risks to the business became apparent to it during the feasibility/preparation phase – it chose to reflect these with a higher discount rate.
18 The first UBS valuation used a discount rate of 11%–14% whereas the later valuation used 14%–20% with 17% applied for the central valuation. The early government valuation performed by DfT used a discount rate of 8.5%–9.5% whereas the later valuation performed by the sale project team used a discount rate of 12.2%.
19 In 2010 the German train operator Deutsche Bahn announced that it planned to offer cross-Channel services from London by 2013. In 2014 it announced that its plans were on hold due to operational challenges.

Figure 14
Valuations and bids

The final bids received were much higher than the valuations



Notes

1 Red numbers indicate the central valuation quoted in the business case for the 3 main valuations and the average of the two rounds of bids.

2 The first 2 valuations were based on public information and not on the detailed information that was available at a later stage and for this reason were not included in the sale business case and ministerial submissions.

Source: National Audit Office analysis

Figure 15

Summary of key assumptions in the 3 valuations

Valuation	UBS valuation	Government hold valuation	EY independent valuation
Value £m (range)	305 (290–320)	305 (275–345)	315 (265–370)
Key assumptions			
Method	Dividend discount model (DDM)	Discounted cash flow (DCF)	DCF
Discount rate	17%	12.2%	9.5%–11%
Minority discount	None	20%	30%
Terminal value	5.5 times EBITDA	1.5% growth	2.5% growth
Competition arrives within 10 years	Yes	Yes	Yes
Other adjustments	No	Several one-off downward adjustments	Downward adjustment for expected future capital expenditure

Notes

1 The discount rate used by UBS was based on an equity IRR (Internal Rate of Return) targeted by a potential investor. UBS's central valuation was based on a 17% IRR, but they also modelled a range of IRRs (14%–20%) and exit multiples of 4.5 times – 6.5 times EBITDA.

2 The discount rate used by government and EY were based on estimates of Eurostar's cost of capital.

Source: UBS, HM government and EY financial models; and National Audit Office analysis

4.8 The central case for all of the valuations forecast that a competitor would arrive in the 2020s. However, scenarios with no competition arriving were modelled. Our review of the models shows that a scenario with no competition increases the value significantly. Although competition in the 2020s was consistent with Eurostar's business plan, we believe that a 'no competition' valuation should have been made clearer in advice to ministers. This would have allowed them to understand the potential advantage to an investor, and opportunity cost to the taxpayer, from any deal.

Discount rate

4.9 Discount rates are used to discount future cash flows to provide the net present value (NPV) of an investment. For example, if an investor receives £10 million today it will be valued at £10 million. However, if the £10 million is expected to be received at a later date it will have a lower NPV due to factors such as inflation. In addition, there may be risks and uncertainty linked to receiving income in the future. Higher discount rates are applied in order to reflect an increased level of risk about future cash flows. A higher discount rate corresponds to a lower NPV for the value of an investment.

4.10 The discount rate used by UBS was 17%, the mid-point of its range of 14%–20%. This was significantly higher than the 11%–14% that it used when it first valued the company in the pitch book valuation.[20] There was no clear explanation as to why investors would require such a high rate of return. The government's own hold valuation, based on the HM Treasury Green Book methodology, used a discount rate of 12.2%. EY's independent valuation noted that there was "rigour in the underlying assumptions and thought process". Nevertheless, it considered that the 12.2% discount rate would have been lower if the Capital Asset Pricing Model used by corporates had been used.[21]

4.11 Other sources also suggest that a lower discount rate could have been used. SNCF's 2014 accounts disclose that high-speed services in France and Europe, similar but not including Eurostar, have a discount rate of 7.9%–9.2%.[22] In 2009, when the Eurostar business needed to be valued in order to determine the relative equity shares of the UK government and the other shareholders, an 8.5% discount rate was used.[23] UBS was an adviser at the time and used the 8.5% rate to value the company. DfT's early valuation of Eurostar in June 2013 used a discount rate of 8.5%–9.5% for this reason.

4.12 The financial performance of Eurostar has improved since this valuation in 2009 and underlying interest rates have fallen. Had a discount rate of 8.5% been used, as was done in 2009, the valuations prepared by both UBS and the government would have been significantly higher.

Minority discount

4.13 An investor with a controlling stake can direct company strategy. An investor with a minority holding has less influence, so the value of its stake is theoretically subject to a minority discount to capture this. The more protections there are for the minority shareholders, the lower the discount should be.

4.14 The government's valuation applied a 20% minority discount and the EY valuation used a discount of 30%. It is difficult to estimate minority discounts reliably because a new owner of the shares will need to consider how various factors, such as the illiquidity of the shares, aspects of the shareholder agreement (for example, protections for the minority holders, dispute resolution procedures, exit rights) affect the price it is prepared to pay. The new shareholder agreement states that if there were a dispute between the shareholders that could not be resolved the minority holders would be bought out at a premium to the fair value of their stake and this fair value would be calculated with 'no minority discount'.

20 The pitch book valuation is the valuation that UBS performed when it submitted its bid to act as the government's financial adviser for the sale.

21 The Green Book approach uses a risk-free rate of 2.5% in real terms, which when combined with the inflation assumption of 2.5% used in this case, gave a nominal risk-free rate of around 5% whereas the current risk-free rate of government borrowing is significantly lower. The other elements used to derive the 12.2% included an equity market risk premium of 6% and an asset beta of 1.2.

22 SNCF, *2014 Financial Report*, February 2015, Note 8.2.2.

23 UBS told us that the 8.5% rate used in 2009 was a WACC (Weighted Average Cost of Capital), as per instruction of its client not a cost of equity as used in the Eurostar sale valuation. UBS did not formally opine on this 8.5% rate in 2009, but provided some benchmarking which implied that it was not unreasonable.

4.15 The shareholder agreement was designed to ensure that over the long term most or all of the free cash flow the company generated was paid out as dividends to investors. The new investor would be holding the shares for dividend income. There is no indication that any of the potential investors wanted strategic control of the company; rather, they were happy for SNCF to take the lead given its rail expertise.

Dividend yield

4.16 UBS's sale feasibility report, of June 2014, said that dividend yield was a good cross-check of the valuation.[24] It therefore checked its valuation against the expected dividend to calculate an expected average annual dividend yield for the investor over the first 5 and 10 years of the investment. It noted that some investors would be targeting a 5% dividend yield. One investor said they would typically seek a minimum yield of 4%–5%.[25]

4.17 The improved dividends in the new shareholder agreement were incorporated correctly in the hold valuations. The expected dividend figures used by UBS, which were updated in December 2014, showed that the dividend yield started at a relatively low level before increasing to high levels. A valuation of around £300 million to £400 million gave a 5-year average annual dividend yield of 8%–10% – double the level investors had said they would seek. Using the 5-year average dividend yield of 5% as a guide would have resulted in the valuation being closer to £600 million. Dividend levels in the following 5 years were forecast to increase further such that the 10-year average annual dividend yield was forecast to be more than 15% for the valuations of around £300 million produced by the government and its advisers.

Price–Earnings multiples

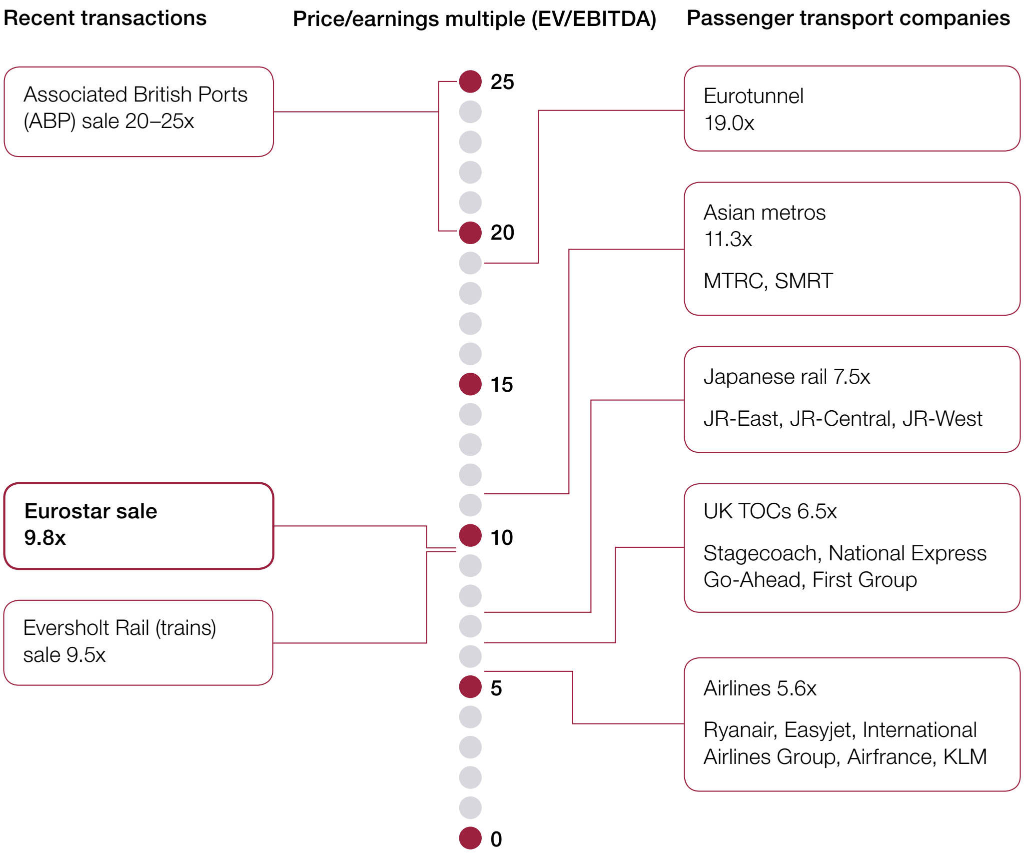
4.18 Another method of valuation which was highlighted in the financial adviser's feasibility report was to consider the value of Eurostar as a multiple of earnings. The report said that Eurostar did not have any close comparators so that it was difficult to value the company on this basis. However, the report did provide information on the value/earnings multiples of different passenger transport companies, and it noted that some investors might use UK TOCs (Train Operating Companies) as comparators. The actual sale price equated to a multiple of 9.8 times annual earnings (**Figure 16** overleaf).

24 Dividend yield is the dividend divided by the value of the shares. The lower the targeted dividend yield, the higher the price an investor would be willing to pay and vice-versa. An investor targeting a 5% dividend yield would pay £100 million for shares paying a dividend of £5 million, whereas if they were targeting a 10% dividend yield they would be only willing to pay £50 million for shares paying a dividend of £5 million.

25 The feasibility report included feedback from potential investors. Most investors did not provide figures for the dividend yield they would be looking for. However, one mentioned targeting a 5% yield and another mentioned a 4%–5% yield.

Figure 16

Earnings multiples of other transport companies and recent transactions



Notes

1. The value earning multiples are based on Enterprise Value (EV) divided by EBITDA (Earnings before Interest, Tax, Depreciation and Amortisation).
2. The EV/EBITDA multiples of the passenger transport companies are taken from the UBS feasibility report, which was updated in September 2014.
3. The Eurostar sale multiple is based on the sale price of £585.1 million for the 40% stake and EBITDA and net debt for 2014 as forecast in the Information Memorandum.
4. The stake in ABP was sold in March 2015. Eversholt Rail is a UK rolling stock company sold in January 2015.

Source: UBS feasibility report (updated September 2014); Information Memorandum; Trade-press articles; National Audit Office analysis

Illustrative exercise: valuation sensitivity analysis

4.19 Without seeking to challenge the integrity of the 3 valuations, we are in a position to use the benefit of hindsight to examine the gap between the final price and the valuations. This sensitivity analysis demonstrates that credible valuations above £500 million could have been supported without changing the business plan or assumption about competition, but rather by using a lower discount rate and lower minority discount for the shares, drawn from evidence available to us. This sensitivity analysis is not intended to represent an alternative valuation of the shares in Eurostar. Rather, it represents an illustration of the sensitivity of the valuation to two important assumptions. In practice, bidders would make their own assumptions and apply their own approach to valuation and discounting, taking into account a range of factors. Starting with the 3 financial models used to value Eurostar we have changed 2 key assumptions (discount rate and minority discount) to see what different results they gave. We reduced the discount rate to the lowest end of the various estimates, 8.5%. This was the rate used to value Eurostar in 2009 and also is the mid-point of the discount rate used by SNCF in its accounts to value similar business units.[26] We also examined the effect of applying different minority discounts. If the discount rate is reduced to 8.5% and the minority discount is reduced to zero, the 3 models provide valuations of £541 million (UBS), £593 million (government) and £666 million (EY). Both the government and EY models used minority discounts of 20% and 30% respectively in their valuations. Using a lower minority discount of 10% (while still applying a discount rate of 8.5%) produces valuations of £534 million (government) and £599 million (EY). A valuation of between £500 million and £600 million gives a 5-year average dividend yield of around 5%–6%, similar to the 5% that UBS said investors would expect (**Figure 17** overleaf).

4.20 It is difficult to assess whether or not competition will emerge. All of the valuations assumed that it would emerge in the next 10 years as their central scenario.[27] The valuation of Eurostar is particularly sensitive to the likelihood of competing rail services emerging. UBS also modelled a valuation without competition emerging. This increases the valuation by between 40% and 50% depending on the discount rate used.[28] This provides some indication of the theoretical upside for the investors should no competitor emerge.

26 In any competitive sale process such as this, there is a natural tension between the buyer and the seller. Investors will want to achieve as high a return as possible (corresponding to a higher discount rate). The focus of this exercise is to show how lower discount rates correspond to higher valuations, reflecting the fact that the seller is incentivised to maximise proceeds.

27 The valuation by EY and the government applied a probability weighting to different competition scenarios including a 10% probability that no competitor would emerge.

28 An alternative way of thinking about the difference is that the 'with competition' scenario is around one-third lower than the 'no competition' scenario.

Figure 17
Illustrative sensitivity analysis applied to the 3 valuation models

Minority discount applied	UBS model (£m)	Government model (£m)	EY model (£m)
None	541	593	666
10% discount	487	534	599
20% discount	432	475	532
30% discount	379	415	466

Note

1 All analyses based on a discount rate of 8.5%, as was used as a weighted average cost of capital when Eurostar was valued in 2009.

Source: National Audit Office analysis

Part Five

Redemption of the preference share

5.1 This part examines the valuation and redemption of the preference share.

2010 incorporation

5.2 Standard tax rules allow a company to carry forward losses to offset against future taxable profits. At incorporation in 2010, Eurostar International Limited (Eurostar) carried forward its historic tax losses from the UK part of the operation, to offset against future taxable profits. The preference share allowed the government to recoup some of the value of Eurostar's historic losses as it was due to receive a dividend of 70% of the tax losses utilised once a threshold had been reached (**Figure 18**).[29]

Figure 18
Preference share

Before it was restructured, the UK part of Eurostar had been a loss-making business. In the 11 years between 1998 and 2008 it lost around £1.8 billion.

At incorporation in 2010, Eurostar carried forward its historic UK tax losses against future profits, thus reducing future UK corporation tax because standard tax rules allow it to carry forward losses to offset against future taxable profits.

At the time of incorporation, it was agreed that the government would be paid a dividend of 70% of the benefit of tax losses utilised once a threshold of £425 million accumulative taxable profits had been reached.

After around 5 years of profitable trading this threshold was reached – the first preference share dividend payment was due to be paid no later than 1 October 2015.

Source: National Audit Office analysis

29 The preference share dividend was equivalent to the government receiving 70% of the corporation tax that Eurostar would have paid if it had not inherited tax losses above the £425 million threshold.

Valuation and redemption of preference share

5.3 The redemption of the preference share was a separate transaction from the sale of the 40% Eurostar stake, but took place at the same time. The government could have chosen to hold the preference share even if it sold the 40% stake.

5.4 During the summer of 2014 (before the sale process began) the government and its advisers negotiated an agreement that Eurostar could redeem the preference share for £172 million. This payment by Eurostar was factored into the forecast financial information provided to bidders. Bidders for the 40% stake in Eurostar were given the opportunity to express interest in purchasing the preference share for more than the redemption price. None of the bidders for the Eurostar stake expressed interest in it. It was redeemed by the company when the sale of the 40% stake was agreed in March 2015.

5.5 The government's financial adviser estimated that the total cash dividends, before the application of any discount rate, from the preference share over the coming 10 years was £243 million, with 90% of this amount paid by 2021. The price agreed, £172 million, was slightly lower than the government's initial asking price of around £180 million. However, the government considered that the negotiation on the price provided a good deal as it was higher (by 8.9%) than its hold valuation of £158 million, which factored in future risks to the company's profitability and used a 12.2% discount rate.[30] The company's other shareholders (SNCF and SNCB) were under no obligation to agree to redeem the share. They took the view that parting with cash now would give a worthwhile return as Eurostar would no longer need to pay a preference share dividend over the next 10 years.

5.6 Part of the rationale for the sale of the preference share was a reduction in public sector net debt. One way to consider the value of future dividend income is to discount it by government borrowing costs. This provides an estimate of £216 million for the total government debt issued in 2014-15 which could have been paid off (alongside interest accrued) from the expected dividends (**Figure 19**). However, this figure does not factor in the higher risks to these dividends; the overall preference dividend and its timing would be subject to Eurostar's profitability as well as potential future changes in UK tax law. Nevertheless, Eurostar is forecast to continue to be profitable, so is expected to utilise its historic losses and therefore would have paid preference share dividends had the share not been redeemed.

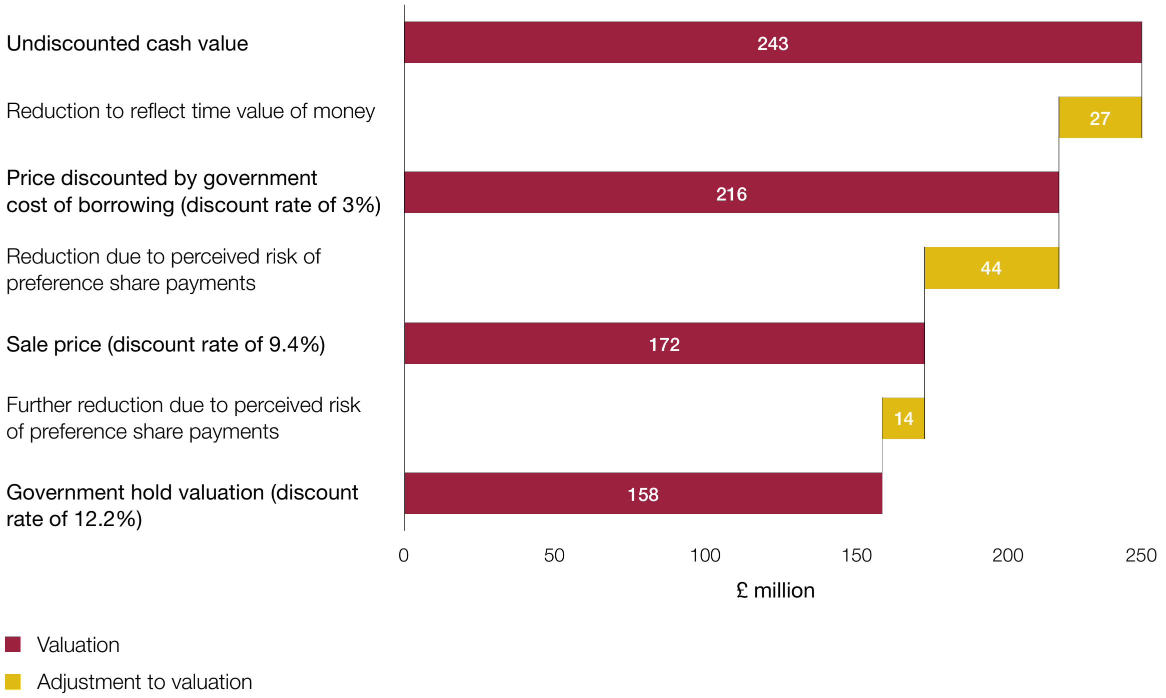
5.7 The redemption of the preference share provides the government with a clean break from Eurostar.[31] It also provided a way for the taxpayer to extract some of the cash from Eurostar's balance sheet.

30 The hold valuation discounted the expected future dividend income at an annual rate of 12.2%. This is the same discount rate that had been used in the hold valuation of the 40% stake.

31 Residual liabilities of British Railways Board under the Channel Tunnel usage contract are outside the scope of this report.

Figure 19
Preference share valuation

The preference share valuation reduces as the discount rate increases



Notes

1 The average cost of government borrowing in 2014-15 was less than 3%.

2 The difference between the sale price and the government's hold valuation is primarily due to different views of the risk linked to the preference share dividend payments.

Source: National Audit Office analysis

Appendix One

Our audit approach

1 This study examined whether the government achieved its sale objective of maximising proceeds from the sale of its stake in Eurostar and the redemption of the preference share. It covers:

- the background to the sale, including the taxpayer's past involvement in Eurostar;
- preparations for the sale;
- the sale process;
- valuations of the 40% stake prepared by government and its advisers; and
- the redemption of the preference share.

2 Our audit approach is summarised in **Figure 20**. Our evidence base is described in Appendix Two.

Figure 20
Our audit approach

HM Treasury's primary objective	The government's policy is to sell assets where there is no policy or strategic rationale to retain them. The 40% stake in Eurostar was identified as a potential candidate for disposal for sale as there was no strong policy rationale for holding it. HM Treasury's main objective in selling the Eurostar shares was to 'maximise value for money'.		
How this will be achieved	It aimed to achieve this by: • maximising net proceeds (sale proceeds less transaction costs); • maximising certainty of deal closing; and • minimising post-sale residual risks to the government.		
Our study	The study examined the extent to which HM Treasury maximised net proceeds from the sale while also achieving the other sale objectives.		
Our evaluative criteria	Was there a sound business case in place which appropriately considered factors such as the sale method and timing?	Did the preparations for the sale maximise the chance of a good sale outcome?	Was the sale process run effectively and competitive tension between the bidders achieved resulting in a good sale price for taxpayers?
Our evidence (see Appendix Two for details)	We interviewed the government's project team and the financial and legal advisers. We reviewed key documents including the financial adviser's feasibility report and the sale business case. We undertook quantitative analysis of valuations.	We interviewed the government's project team, the financial and legal advisers, Eurostar and some of the vendor due diligence providers. We reviewed key documents including the Information Memorandum and the sale business case.	We interviewed the government's project team, the financial and legal advisers, and some of the bidders for the shares. We undertook quantitative analysis of the valuations and the bids made.
Our conclusions	We give our conclusion on value for money on page 10 of the report.		

Appendix Two

Our evidence base

1 Our conclusion on whether the government achieved its sale objectives of maximising net proceeds from the sale of its stake in Eurostar and the redemption of the preference share was reached following an analysis of evidence collected between May and September 2015. Our main methods are outlined below:

Document review

- We reviewed documents including the government's sale business cases and ministerial submissions.
- We reviewed the financial adviser's feasibility report.
- We reviewed the Information Memorandum prepared by the financial adviser as well as the vendor due diligence reports.

Quantitative analysis

- We undertook quantitative analysis of the financial models used to value Eurostar, to understand the basis of the valuations. This included a review of the underlying assumptions used.
- We analysed information on Eurostar's past and expected future financial performance.
- We compared the level of the bids made during the sales process.

Interviews

- We undertook semi-structured interviews with a range of government officials from HM Treasury, the Department for Transport and the Shareholder Executive.
- We also held a range of semi-structured interviews with Eurostar, the government's financial and legal advisers, its independent valuation expert and some of the vendor due diligence providers.
- We spoke to a number of bidders for the shares (including the winning consortium) as well as the majority shareholder of Eurostar.

Appendix Three

Restructuring and history

1 We have published 3 previous reports on the High Speed 1 (HS1) project, of which the UK stake in the Eurostar train service is one part.[32] The most recent report dealt with the physical completion of the project in 2007, the restructuring of London & Continental Railways (LCR) and the sale of HS1 Limited in 2011. In that report we concluded that the whole HS1 project was not value for money when considering benefits to transport users of faster journey times and increased rail capacity alone, but that there are wider benefits expected from the project. The Department for Transport (DfT) has recently published an evaluation of HS1 which assessed some of these wider benefits.[33] DfT had originally told the Committee of Public Accounts that it would publish this document by summer 2013.[34] This evaluation was not available during our fieldwork so we have not commented on it in this report.

2 In 1996, the DfT awarded a contract to a consortium of private sector companies (LCR) to build a high-speed railway between London and the Channel Tunnel (now called High Speed 1 or HS1) and run the British arm of the Eurostar international train service (Eurostar UK). However, passenger numbers and revenue were significantly lower than the winning consortium had forecast and so more government support was needed (**Figure 21** overleaf). The project underwent 2 major restructurings: in 1998 the government provided debt guarantees, and in 2008 it took LCR into public ownership, assuming its debts of some £5 billion.

Restructuring the business 2008–2010

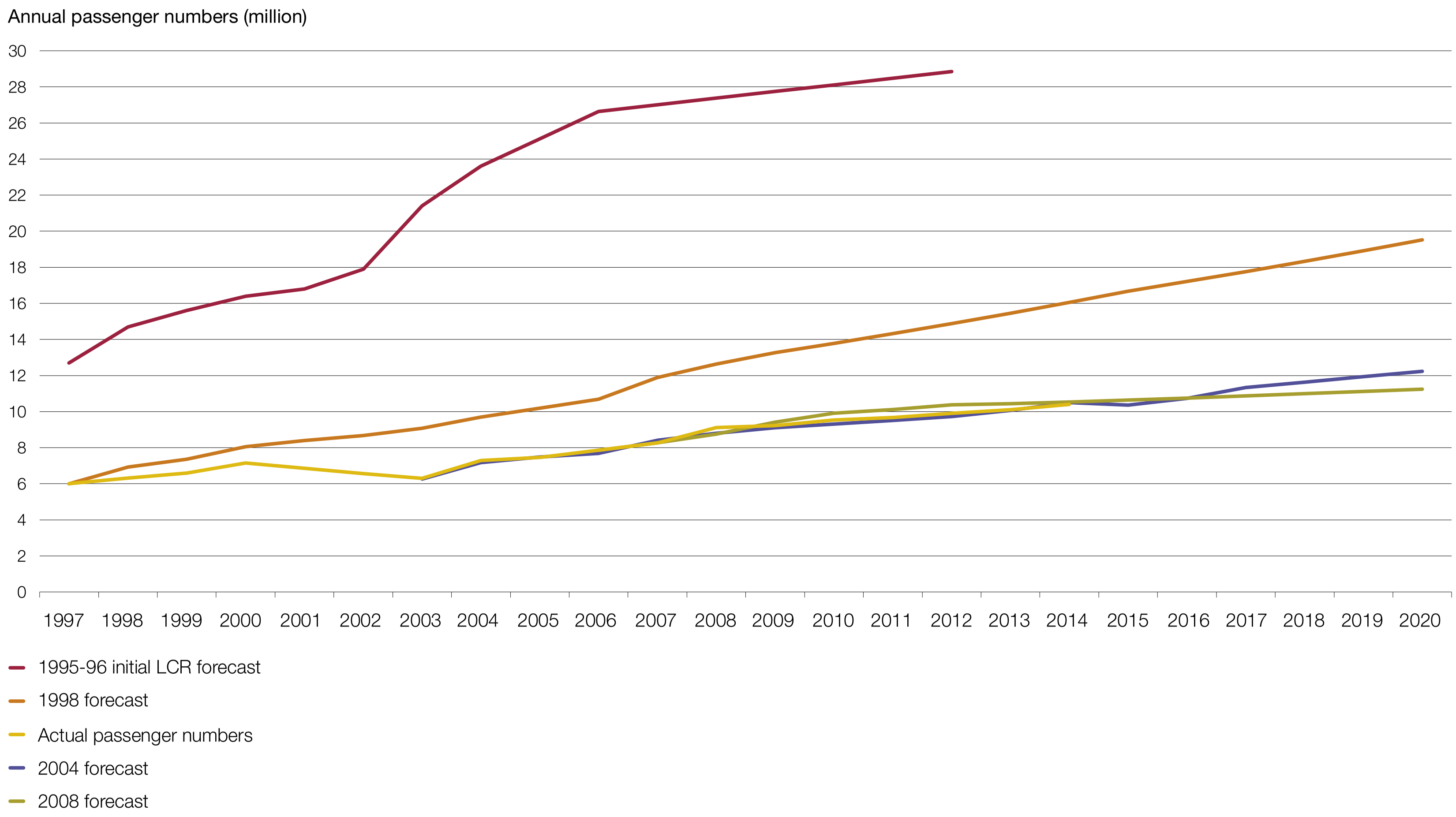
3 As part of the restructuring first announced in 2008, the LCR business was split into 3 distinct parts which could be sold separately: Eurostar UK (which ran the train services), HS1 (which owned the track/infrastructure and received fees for its use) and the property portfolio. HS1 and Eurostar have now been sold and the property is currently on sale (**Figure 22** on page 49).

32 Comptroller and Auditor General, *The Channel Tunnel Rail Link*, Session 2000-01, HC 302, National Audit Office, March 2001; Comptroller and Auditor General, *Progress on the Channel Tunnel Rail Link*, Session 2005-06, HC 77, National Audit Office, July 2005; Comptroller and Auditor General, *The completion and sale of High Speed 1*, Session 2010–2012, HC 1834, National Audit Office, March 2012.
33 Department for Transport, *HS1: first interim evaluation*, 15 October 2015.
34 HM Treasury, *Treasury Minutes*, Cm 8467, November 2012, page 24, paragraph 2.2.

Figure 21

Forecast and actual passenger numbers

Passenger numbers are significantly lower than was originally forecast

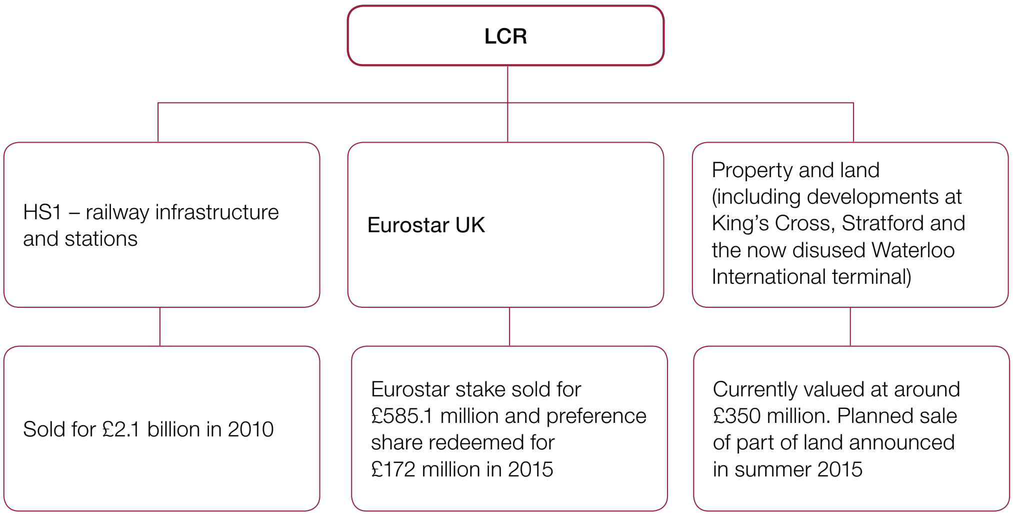


Source: National Audit Office analysis; Eurostar website for actual passenger numbers

Figure 22

London & Continental Railways (LCR) structure following restructuring

LCR was split into 3 parts which could be sold separately



Note

1 Prior to incorporation the British arm of the Eurostar international train service was known as Eurostar UK. Following incorporation the entire company was known as Eurostar International Limited (Eurostar) of which the UK government owned a 40% stake.

Source: National Audit Office analysis

4 Before it was restructured, Eurostar UK had been a loss-making business. In the 11 years between 1998 and 2008 it lost around £1.8 billion. In order to sell Eurostar UK, it needed to be a profitable business. To this end, the investment recovery charge (IRC), which Eurostar UK paid to use the new high-speed track in the UK, was reduced significantly. This charge had been set at an unsustainably high level in order to try to repay the project debt.[35] The IRC was reduced by 80% from £10,937 per train to £2,150 per train. This saved Eurostar an estimated £140 million per year.[36] The reduction in the IRC had the desired effect and Eurostar UK made its first profit in 2009.

5 Although the reduction in the access charges benefited Eurostar UK it resulted in increased taxpayer costs in other areas. The new charging regime based on total time spent on the route meant that the charges paid by the domestic operator, SouthEastern Trains, increased substantially.[37] These increased charges were paid for by an increase in the taxpayer subsidy to the franchisee. The domestic operator's track access charges were also guaranteed by the taxpayer for 30 years.

35 The new regime for charges for access to HS1, reflected the requirements of EU law that access charges should not discriminate between users and should not exceed the costs of operating the route plus a rate of return which the operators could afford to pay.

36 Assuming 16,000 services a year as set out in the State Aid submission.

37 Fees were reallocated to reflect the total time spent on the route. As the domestic operator had more and slower services than Eurostar it pays more. The domestic operator's fees were previously lower than those of Eurostar.

6 Information included in our previous reports shows that the total taxpayer investment in the whole HS1 project, including Eurostar, was more than £8 billion and if other taxpayer costs are included the calculated cost is in excess of £10 billion.[38] It is difficult to separate past taxpayer investment in Eurostar from the other parts of the LCR business. However, some of the costs are clearly attributable to the Eurostar business. We estimate that UK taxpayers have spent approximately £3 billion on the Eurostar train service (**Figure 23**).

Figure 23

Taxpayer costs directly attributable to Eurostar

Description	Cost (£m)
Cash grants received in 1996	415
Eurostar short-term loans and leases paid off as part of initial restructuring in 1998	604
Costs associated with 2008-09 restructuring	
Prepayment of Eurostar rolling stock leases	177
Cancellation of loan for European Night Services lease termination	110
Cancellation of loan that had built up to cover Eurostar's pre-2008 losses	1,687
Costs associated with 2010 incorporation	
Capital injection in newly incorporated company	40
Pension support	59
Total	**3,092**

Source: Department for Transport financial information; National Audit Office analysis

38 Comptroller and Auditor General, *The completion and sale of High Speed 1*, Session 2010–2012, HC 1834, National Audit Office, March 2012. Figure 9 of the 2012 report calculated that the net government support for the project was £8.2 billion – this was net of £1 billion net income from the sale of HS1. It also did not include other amounts such as the net cost of King's Cross St Pancras underground remodelling, the cost of Temple Mills maintenance depot and the expected taxpayer costs of subsidy for domestic services of £2.9 billion.

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