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HOW TO SELL THE FAMILY SILVER

LESSONS FROM THE ROYAL MAIL SALE

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SUMMARY

- Now that a further round of public asset sales looms, the Government must ensure that it does not repeat the mistakes made in the privatisation of Royal Mail.

- In the sale of Royal Mail shares about £500 million was lost due to the Government's decision to use a flawed, centrally planned, procedure – as advised by the participating banks.

- Rather than being fair and open public offerings, the Royal Mail sales were instead effectively a "placing" to "priority applicants" – a procedure formerly prohibited by Stock Exchange rules except for in very small issues.

- It was claimed at the time that the "priority applicants" were pension funds and other institutions representing the general public and long-term holders. However it is clear from market events that these were either chosen poorly or with different criteria in mind.

- Indeed seven of the 20 largest selected "priority applicants" sold all of their shares after the issue, and a further four sold most. The beneficiaries (about half) who sold their shares immediately made a profit of £300 million at the expense of the taxpayer. Pension funds, and other genuine long-term investors who were overlooked in the allocation, were substantial buyers.

- Rather than placing sales under the guidance of advisers, the Government should follow a free market approach that seeks to reveal the true value of the assets for sale.

- Tenders, not placings, are by far the most efficient procedure for an Initial Public Offering. Tenders should be universal for large new issues, public or private.

- The Government should therefore take the lead in setting a good example. For the client, tenders represent the best approach for making a major new issue. However the procedure is opposed by the issuing houses, who would then have to make do with their disclosed and negotiated remuneration.

- In future sales, all investors should be invited to submit tenders showing how many shares they want, and the maximum price they are prepared to pay. All shares should then be allocated at the striking price which would be the lowest price on which all the sales shares would go.

1. INTRODUCTION

The Summer Budget of 2015 stated that sales of government assets (mainly the Lloyds and RBS shares acquired during the financial crisis, and its remaining tranche of Royal Mail shares) will:

> *"…raise approximately £31 billion in 2015-16, achieving value for money for the taxpayer and further reducing public debt. Overall, planned sales for 2015-16 amount to the largest privatisation proceeds in a single year ever. This is over £10 billion higher in real terms than the previous record in 1987-88."*

The question is: how should this best be done?

During the major public asset sales overseen by Margaret Thatcher in the 1980s, the privatisation process was undermined by the use of "book building" and "priority applicants". Despite warnings of the use of such discredited methods,[1] the Government made the same mistakes in the first round of Royal Mail share sales in 2013, again failing to secure a true, competitive, and fully revealed value.

For all forthcoming sales, the Government now has full information on what went wrong in past rounds. This paper makes positive suggestions on how these matters can be handled in the best interests of the public and indeed for everyone who does not have a tempting conflict of interest.

The Government must learn two key lessons in particular before undertaking a further Initial Public Offering (IPO):

- Why pay fees to 'advisers' to estimate a figure which can be quickly established by the market? This is a "planner's" approach, and advocates of such, when things go wrong, simply try to do it better next time. Free markets offer a far better approach.
- As with the original privatisations, a secondary objective of the Royal Mail share sale was to widen share ownership by offering individual small shareholders a discount. Again, this had limited success. The amount and form of any such discount should be a political decision and not a by-product of how much under-pricing the advisers manage to negotiate.

2. A LITTLE HISTORY

In the interest of private enterprise and free, active and innovative capital markets, Margaret Thatcher's privatisations were welcome. Privatisation was hugely successful in its intended primary aim of converting bureaucracies into successful competitive businesses.

However, despite this success, the procedure followed during the initial privatisations was flawed. Rather than being fair and open public offerings, they were instead effectively a "placing" to "priority applicants" – a procedure generally prohibited by Stock Exchange rules except for in very small issues. Indeed when the Stock Exchange was alerted to this, it responded by changing the rule. As a consequence, some 15% of the potential proceeds were lost to under-pricing, and half of this (£2.5 billion) was absorbed by the underwriters.[2]

It was claimed that the "priority applicants" were pension funds and other institutions representing the general public and long-term holders. But there are substantial indications that some shares were kept in-house by the sponsoring banks and their associates. At the time there was no firm

[1] See John Chown, *No to Underwriting: How the Coalition can avoid being ripped off*, Centre for Policy Studies, 2011.

[2] During this period the author mounted a major, but in retrospect unfortunately discreet campaign against this procedure and eventually had a partial success thanks to Lord Wakeham.

evidence, but anecdotal evidence from the City suggested a figure in the region of 10% of the total – although this percentage may be even higher.[3] It certainly was with Royal Mail.

3. THE ROYAL MAIL – WHAT HAPPENED

In the Royal Mail case, the Government offered 650 million shares at a price of 330p each. Of these, 162 million were offered to the general public and 473 million to "priority applicants".

3.1 How was the price determined?

The participating banks were paid a fee to organise the issue (the Government presumably assumed that they would get best advice) and used the old procedure of placing the shares to priority applicants – in preference to, say, a tender offer. Given this, they had two roles:

- to suggest an appropriate price;
- to identify and nominate "priority applicants", "high-quality investment list" or "Pilot Fish Institutions"[4] who could be relied upon to be solid firm long-term holders.

3.2 How well did the banks do?

The shares closed at 450p on the first day of dealings, when 250 million shares were sold (more than the total number allocated to the public). Once the early investors seeking swift returns were satisfied, the price rose to over 550p. Six months later, the market price was 58% more than the sale price and peaked as high as 87% (615p). It is probable that a tender offer would have captured at least an extra pound per share for the Government. Focusing only on the 473 million shares which went to priority applicants, this suggests that a sum in the region of £500 million was lost to under-pricing. Given the £1.98 billion total proceeds from the sale, this represents an effective loss equivalent to 25% of the value raised.

Indeed this figure is a conservative estimate that considers only the short-term price rise from 450p to 550p following the conclusion of the sale. Others have estimated even higher net losses. In 2014 the Business, Innovation and Skill Committee reported that as much as £1.2 billion (60% of the value raised) may have been lost in the sale.[5]

Following concerns that the sales was under-priced, the National Audit Office (NAO) produced an excellent report.[6] Although their formal role was to look at specific events, they had influence on subsequent developments.

Following the NAO Report, Lord Myners was asked to prepare a "review of the book building process" – inviting this author, among others, to give evidence.[7] Myners produced an excellent analysis that noted that alternative approaches to public offerings should be "actively encouraged" – however, given his terms of reference, Myners confined himself to suggesting improvements to the existing procedure.

[3] See John Chown, *No to Underwriting: How the Coalition can avoid being ripped off*, Centre for Policy Studies, August 2011.

[4] Pilot fish are institutions with whom a seller engages at an early stage in a sale process to test potential demand and price range expectations. Typically they are institutions who are considered to be likely to be supportive investors in the company, as well as representing a broad range of investor types.

[5] Business, Innovation and Skills Committee, *Royal Mail Privatisation*, July 2014.

[6] National Audit Office, *The Privatisation of Royal Mail*, April 2014.

[7] Lord Myners et al., *An Independent Review for the Secretary of State for Business, Innovation & Skills: IPOs and Bookbuilding in Future HM Government Primary Share Disposals*, December 2014.

Page 10 of the NAO Report mentioned "the inherent limitations of the standard process" (i.e. book building) "that is not effective at revealing demand for shares at prices above the high end of the range, [...] and lacks the flexibility for a price increase if demand exceeded expectations".

The NAO Report (page 10) points out that the procedure used "lack[ed] the flexibility for a price increase if demand exceeded expectations." Page 44 shows that all institutions applied for over 10 billion shares but could only be allocated 473 million. This should have been a warning sign. "Priority investors" were allocated 18.4% of their application, "institutions targeted" 5.8% and "other high-quality investors" less than 1%. 506 applicant institutions got nothing. Certainly a highly selective list: but by what criteria was it made?

Page 48 of the Report reveals that seven of the 20 largest selected "priority applicants" sold *all* of their shares after the issue, and a further four sold most. The beneficiaries (about half) who sold their shares immediately made a profit of £300 million at the expense of the taxpayer. Pension funds, and other genuine long-term investors who were overlooked in the allocation, were substantial buyers.

The Myners report (page 34) is more informative and lists 21 "Pilot Fish Institutions" showing the "number of shares allocated, and still held on the first day of a selection of months". 11 of these, allocated a total of 131 million shares, sold most, or all, immediately – with their total holdings down to 24 million by the beginning of November. This casts doubt on the credibility of the procedure utilised, and preferred, by the banks involved.

In its recent study into the investment and corporate banking market, the Financial Conduct Authority (FCA) has announced that it has found evidence that some banks may seek to reward favoured investor clients when allocating shares in an IPO.[8] The FCA has now launched an investigation into the market in IPOs over concerns that banks are systematically involved in conflicts of interest.[9]

4. ISSUE PROCEDURES

As noted, Royal Mail, as with the early privatisations, was an IPO. The forthcoming sales will be of companies with an existing listing. As explained below (Section 5), the 'tender' procedure can be adapted.

There are three main ways of making an IPO:

- **Offers for sale**, when a prospectus is published at a fixed price, and all investors, large or small, can apply. These are normally underwritten.
- **Tenders**, whereby bids are invited that must be submitted within a finite deadline – common for large issues of the past but now virtually unknown.
- **Placings**, a simple offering by the issuing house directly to its clients. These are generally disapproved of because of the obvious conflict of interest, and only permitted under (now dropped) Stock Exchange rules for *very* small issues. Placings have now, alas, become commonplace.

Financial institutions boast to their clients that a new issue which goes to a premium is a "success". However the *real* cost to the issuer

8 Financial Conduct Authority, *Investment and corporate banking market study*, March 2015.

9 *Financial Times, FCA investigates IPO market for conflict of interest*, April 2016.

(government or private) is the difference between the *net* proceeds to the issuer or vendor after professional and issuing house charges, underwriting etc and the amount the investing community would have been prepared to pay (judged by opening dealings). Of course, there will be costs: some value has to be left on the table for the subscribers, but nothing like as much as that observed in past offerings.

This raises two questions:

- Is there a conflict of interest: is the adviser putting its own interests before those of the client?
- Is there a way of saving this expense and getting a better deal for the client?

The answer to both is: definitely, yes.

Some shares may have been placed with their directors and senior management, but even if they were not, placings give profitable patronage opportunities to intermediaries, who expect, and receive favours in return. They give the worst outcome for the client, but by far the most profitable for the adviser.

Offers for sale *seem* more open but these days the sponsors take great care to make sure that they are under-priced so that their generous underwriting commissions are unlikely to result in a loss.

Tenders are by far the most efficient and fairest procedure, and should be universal for large new issues, public or private – although for many years they have been virtually unknown. The Government should take the lead in setting a good example. Tenders represent, for the client, the best procedure for making a major new issue. However the procedure is opposed by the issuing houses, who would then have to make do with their disclosed and negotiated remuneration.[10]

Issuing a tender is a straight forward procedure. As with any other issue, tender documents are drawn up by lawyers and accountants. The services of a bank are required to handle the money and provide advice. However, and again, 'placing power' is not necessary. Indeed it may be prudent to appoint a smaller, up-and-coming, bank for this advisory role – one more likely to adopt the task with enthusiasm.

5. HOW TO HANDLE THE FORTHCOMING SALES

Many of the future government sales will be of companies which already have a listing and an established price. Selling a large block, though, cannot be achieved by simply offering shares to the market. The banks will, inevitably, lobby hard to repeat a version of their disastrous "book building", "priority applicants" and "over-charging for underwriting" procedures. But on no account should the Government follow this advice. Instead they should use, and actively encourage the use of, the tender process.

All investors, institutional or private, domestic or foreign, should be invited to submit tenders showing how many shares they want, and the maximum price they are prepared to pay. All shares would be allocated at the striking price which would be the lowest price on which all the sales shares would go (investors bidding exactly

[10] Some years ago, when the author was on the Technical Committee of the Association of Corporate Treasurers, he was actively involved in trying to show treasurers how to deal on equal terms with banks. The author teased one Committee colleague that the colleague's company had just announced an issue which totally ignored this. The colleague replied that his department had not been consulted, and that the whole matter had been settled between his Chairman and that of the Merchant Bank on a grouse moor.

the striking price would be allocated the due proportion of their requirements). It is important to encourage foreign and private investors, to guard against the risk of a boycott by City insiders. Sovereign wealth funds could be useful allies, but for this reason the maximum number of shares which could be applied for might have to be limited.

Now to the small investors. In both Margaret Thatcher's privatisations and the Royal Mail IPO, "Wider Share Ownership" was a secondary objective and there was no objection to a degree of under-pricing which benefited the small investor, and the employees. However in all these cases, investors only received a small holding and many of those took a quick profit. Normal private investors, as well as self-administered charities and pension funds, were squeezed out completely.

This can be easily dealt with within the framework proposed. The Government should decide what proportion of the issue will go to small investors; and how much discount they should receive. This needs careful study, and should not be an accidental by-product of negotiations with the banks (In the previous cases, this was effectively determined by the banking syndicate). Ideally the price should be calculated to be an attractive opportunity for genuine investors (including new ones) but *not* an obvious risk-free opportunity for a quick turn, remembering that the subscribers would get the shares free of broker's commissions and Stamp Duty. A loyalty bonus should be offered if the holder retains the shares for a stated period or periods and the pricing should ensure that genuine investors would get a realistic proportion of what they wanted.

Finally, there should be a limit on the maximum which could be applied for at a discount. The pricing and size should aim at ensuring that there is a good chance of getting something reasonably near this figure. Those wishing a larger holding (existing reasonably substantial investors) could of course tender. The minimum tender might be the same figure as the maximum preferential application. The issue could be an offer for sale at a fixed price at the same time as the tender. Applications could be at a stated discount (say 5% plus the loyalty bonuses) to the striking price of the tender, or there could be a separate offer for sale when the market price was known.

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ISBN 978-1-910627-30-3