

To Northern Rock Shareholders

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Northern Rock Shareholders Action Group – Update No. 15

EGM Notice

The company has just issued a notice of an Extraordinary General Meeting to shareholders. Accompanying this note is some more explanation of that and a recommendation on how to vote. IT IS VERY IMPORTANT THAT YOU READ IT AND TAKE ACTION IMMEDIATELY.

Other news since our last update note to shareholders, with some general comments also, is as follows:

Nationalisation and a Fair Value of the Shares

There has been a lot of speculation in the media that the Government is seriously considering Nationalisation of Northern Rock and they have clearly been preparing some contingency plans in that regard. However senior Government figures are still saying that they would prefer the company to find some other solution via the “strategic review” process that is being followed.

One difficulty for the Government is that any Nationalisation would require fair compensation to be paid to shareholders, and Jon Wood of SRM Global has already gone public with some comments to the effect that they have taken legal advice on this matter and believe the Government would need to pay no less than £4.10 per share. That would be equivalent to £1.7 billion for the whole company, and is probably based on the net asset value of the business.

This is no doubt a figure that the Government would be reluctant to pay, and may try to avoid doing so, although there is clearly a hint of possible legal action if it did not. But it also demonstrates that any idea of “temporary nationalisation”, with a quick disposal thereafter, is not likely to be feasible because it may take a long time for the open market value to recover to that level. In reality the Government might find it was saddled with the company for a very long time.

We are opposed to nationalisation as a solution because there are numerous disadvantages for all stakeholders, irrespective of whether a fair price is offered.

Note that SRM Global increased their stake in the company recently to 9.7% and RAB now have 6.7%.

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Goldman Sachs and the Olivant proposal

The Government have apparently asked Goldman Sachs to search for additional funding to assist either of the "bidders" as obtaining loans to replace the loans from the Bank of England seems to be a major problem for both Virgin Group and Olivant. These difficulties mean that it is likely to be at least mid January before these proposals can be firmed up.

It is also been reported in the press that Olivant have been asked to increase the amount of cash put into the company by their proposal with a figure of £200m to £300m being mentioned. This is on the grounds that the company needs a stronger financial base to avoid any risk of future difficulties.

Extension of Government Guarantees

On the 18th December, H.M. Treasury announced that it had extended its guarantees to Northern Rock to cover wholesale deposits at the request of the company. This was dubbed "creeping nationalisation" by some media commentators, but it simply looks to us more a case of the Government ensuring that the company is more attractive to potential bidders and their funding partners. The Government reiterated that it would not withdraw those guarantees and the similar ones for retail depositors without giving three months notice.

The Osborne Letter, other Press Comments and Mervyn King's Comments to the Treasury Select Committee

George Osborne, Shadow Chancellor of the Exchequer, had an article published in the Financial Times on the 17th December. It is symptomatic of the negative media comments and gross distortions that have appeared in many newspapers in the last few weeks. For example, the Daily Telegraph ran a front page headline on the 19th December which said that the "*Rock rescue costs us £1,800 each*" – they were referring to the total guarantees that had now been given but as there is no cost on a guarantee unless it is invoked, this was grossly misleading.

In response to the Osborne article I sent an "open letter" in response which included the following comments (the full response is on our web site if you wish to read it):

"Your analysis of the failings in handling the Northern Rock crisis in today's Financial Times are undoubtedly correct. But to suggest that the shareholders are currently 'holding the taxpayer to ransom, when those shares would be worthless without the Bank's support' shows some basic misunderstandings of law and of investment valuation.

Many listed companies have large debts on their balance sheet. Without the support of those loans, they would be unable to continue trading. In that sense they are just as much dependent on their lenders as Northern Rock is dependent on the Bank of England. Does that mean all those companies are worthless? Obviously not.

Just because a company is reliant to some extent on its creditors does not mean that the creditors own the company. The company is owned by its shareholders and any loans provided by its bankers are provided on agreed terms and conditions. In the case of Northern Rock, those terms are indeed onerous and there is no doubt that the Bank of

England could immediately cause the company to fail by withdrawing those loans. But that would hardly be in anyone's interests."

Mervyn King, Governor of the Bank of the England, commented to the Treasury Select Committee that "*Reaching a reorganisation of Northern Rock is made much more difficult by the fact that the shareholders can block a sensible discussion*". In our view this is a pretty outrageous statement when shareholders are simply trying to protect their own interests, something that seems to be being ignored by the Government and the press. The shareholders have even lost confidence in their own board of directors in that regard, hence the requisition of the EGM. In addition shareholders have actually encouraged proposals such as that from Olivant, and have shown a willingness to support a rights issue. It is nonsense to suggest that shareholders are unwilling to participate in any sensible discussion of possible solutions.

The Position of Northern Rock Employees

Some of you reading this note may be employees of Northern Rock, and one such person has commented to me that he thought the Virgin Group offer was more attractive because they had guaranteed jobs in the future. Without going into a lengthy explanation of why this may be a mistaken view, I would just like to comment that you should study such promises with care. Few wise business people give unqualified commitments in perpetuity about levels of employment, and of course neither Virgin Group nor Olivant have completed their due diligence process so may have no detailed understanding of the state of the business and how their future plans will develop. We have a meeting lined up with Unite the main trade union at Northern Rock to discuss our common interests in ensuring that a viable business plan is put in place which is the best protection of future jobs in any company.

Letters to the Directors, the Chancellor and the Treasury

Lengthy letters have been written by us to all the Directors of Northern Rock, to the Chancellor of the Exchequer and to the Treasury summarising our current views and making some suggestions. The following are some brief extracts of what was said to the Directors:

1. Small shareholders seem to be overwhelmingly opposed to the Virgin Group proposal – at least so far as it stands at present. There are numerous concerns with many aspects of this proposal, which have been detailed in the recent notes we have sent shareholders. But in summary these are:

A – It does not properly value the existing assets or future prospects of the company and transfers a major proportion of that to Virgin Group at too low a price.

B – It leaves existing shareholders as minority shareholders in a group controlled by Virgin Group and hence by Mr Branson.

C – The way the deal is structured, small shareholders may be put off subscribing for the rights issue. And many small shareholders simply do not have the cash to subscribe for a rights issue.

D – We have major concerns, as do many shareholders, about the proposal to "rebrand" the company and the general experience of banking that is being brought in.

I think many shareholders think that there may be an unexpected "culture clash" here and would rather see Northern Rock concentrate on its more traditional strengths – a simple offering to depositors based on efficient back-office systems.

The only thing that seems to be attractive in the Virgin proposal is the guarantee to retain jobs, and that may be a mirage.

So as we have already publicly stated, we would likely recommend to shareholders that they vote against the Virgin proposal as it stands, even if there is no other proposal on the table!

2. The Olivant proposal is more reasonable in our view and although this also involves a substantial rights issue of course, at least existing shareholders would retain majority ownership of the company if they took up the rights. This is a more "saleable" proposition to small shareholders, even if some would still have difficulty in taking it up. It is also capable of being implemented rapidly which is a major advantage.

Note that we have been concerned for some time about the lack of active management of the business of Northern Rock. In any company where a "strategic review process" is followed, which is effectively an active disposal process, the time of the company's top management is often grossly diverted to responding to numerous questions from the bidders, and producing the necessary information in response to "due diligence" inquiries. Meanwhile the morale of the bulk of the staff is undermined by the uncertainty of their future, and the changes of management as people come and go. These two processes can be severely damaging to the health of a business if allowed to run for more than a few weeks, and it's been months already at Northern Rock. If a business is facing difficulties, and requires determined action to get it back on its feet, as Northern Rock undoubtedly does, then having strong, active management in place is essential.

Indeed Luqman Arnold of Olivant has said that he would like to get in there as soon as possible before it is too late, and we agree with him on that.

The appointment of a new Chief Executive may help, but it is far from the ideal solution. Although the company has taken some steps to revive its fortunes with revised offers to depositors and competitive interest rates, you surely need to be doing a lot more in this area. In essence you need to be communicating vigorously and appropriately with your past customers to re-instil confidence in the business.

3. However, I understand the delay in selecting any proposal to recommend to shareholders is probably the difficulty of obtaining commitments on the required third party loans to repay some of the Bank of England funding. It has been obvious for weeks, if not months, that this was likely to be a problem, and there is no easy way around this.

I hope that the Government is clear on this point, and we are writing to the Chancellor of the Exchequer to reiterate it. Ultimately the Government has to accept that the impossible cannot be achieved if the attitude of banks and conditions in the interbank market continues to deter lenders. In that case the best solution is that suggested by John Redwood in the House of Commons last week, namely to quote from him: *"Why does the hon. Gentleman ignore the fourth option, which involves the Bank of England acting as a tough but fair bank manager with repayment schedules and proper cash-flow monitoring of the bank's progress? It would then be for the bank to work out whether it needed to put itself into a kind of voluntary run-off and do it in an orderly fashion or whether it could actually grow the business. Would that not be the best option?"*

This was always likely to have been a more realistic proposition than the search for an "instant solution" via the strategic review process and should still be considered in our view.

What else can the Government realistically do? Assuming that it is a high priority to maintain Northern Rock as a going concern, to protect the interests of depositors and to protect the jobs of employees, while retaining confidence in the UK banking system, then the Government has to face up to reality and I hope that you will encourage them to do so. The alternatives of Nationalisation or Administration make no logical sense to anyone who has thought through what the implications would be."

Are Shareholders Becoming Fatigued?

It is obvious to me from talking to a few shareholders that some are selling at this time simply because they are becoming despondent. The negative media comments, the lengthy time it is taking to resolve the crisis, and the persistent worries about what might happen are encouraging some shareholders to sell simply so they can remove the problem from their minds.

Our past notes, and this one, contain some information on the underlying value of the assets of the company, and what it might be worth if it manages to recover. Personally I am quite optimistic about the prospects for Northern Rock and I don't even think the brand is irreparably damaged. There are many companies that have been in worse circumstances, with more damaged reputations, than Northern Rock and have yet managed to rebuild their businesses in due course.

Although many shareholders will be showing a capital loss on their Northern Rock shares, some realised and some unrealised, what matters when looking at investments is solely the future prospects, not the historic baggage.

Therefore let us look to the New Year with more confidence. It only requires a few sensible decisions to be made by the Board and by the Government for the start of 2008 to be a turning point in the fortunes of this company.

The above comments are my personal views alone, and should not be construed as investment advice!

Best wishes for Xmas and the New Year to all of our readers.

Yours sincerely

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