

To Northern Rock Shareholders

24 February 2008

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Northern Rock Shareholders Action Group – Update No. 25

Fair Compensation to Shareholders?

The Treasury has said that it will appoint an “independent” valuer to determine the compensation to be paid to shareholders in Northern Rock. However, the draft Northern Rock plc Compensation Scheme Order 2008, which can be read on The Treasury website, www.hm-treasury.gov.uk/consultations_and_legislation/banking/banking_specialprovision_bill.cfm, requires the valuer to assume that Northern Rock:

- (a) Is unable to continue as a going concern; and
- (b) Is in administration.

With such “terms of reference” imposed upon him any valuation will NOT be fair, unbiased and independent!

In our view it is grossly unethical to set the terms of reference in this way when clearly the company is not in administration and is a going concern. It would not be a going concern if the Government had demanded repayment of its loans but it has not done so and is unlikely to do so. Otherwise it continues to do business in a normal manner and has a surplus of assets over liabilities. The view that it is a “going concern” was reiterated by Ministers in Parliament and on television (see later).

By rigging the valuation in this way, they will ensure that the value put on the shares by the valuer will be negligible. In addition of course the Government has mismanaged the crisis at Northern Rock, which eroded the foundations of the company, and has continually threatened either nationalisation or a forced disposal of the company at a low value, which have eroded the share price. The Government cannot benefit from their own actions in this way to enable it to then acquire ownership at a minimal cost.

As the authorities must share much of the blame for what happened, and were in effective control of the company from 13th September 2007, UKSA believes that the valuation should be truly independent and unrestricted by Treasury dictate. We suggest that the valuation should be undertaken by a panel of say four valuers, from different professional institutions. Their brief should take into account the background circumstances; European law; published net asset values at 30th June and 31st December 2007 and U.K commonly accepted accounting principles. In addition none of the valuers so appointed should be employed by firms who receive any significant business from the Government. The advantage of such a truly independent panel is that it would be fair to all stakeholders, large and small, and avoid expensive and time-consuming litigation.

Legal Action?

As we have said repeatedly (for example I talked about it in 8 TV interviews alone on Monday the 18th), our group considers the compensation proposals to be unfair and indeed illegal under European Law – specifically the European Convention on Human Rights. We intend to actively pursue that and other possible legal issues subject to detailed legal advice on the best avenues to pursue.

We may of course need to raise substantial funds to do this and will be writing to shareholders who have registered their interest in this case in due course. But in the meantime there is already an Appeal Fund in place and our donation form is present at: www.uksa.org.uk/Northern_Rock_Appeal_Letter.pdf

Clearly there are also other major shareholders such as SRM Global who are considering legal action.

We have appointed David Greene of Edwin Coe as our legal representative. He represented shareholders in Railtrack which is a similar case in some regards (although different in others) and shareholders were given reasonable compensation after a lengthy legal suit when they were originally offered very little.

The Proper Basis to Value Northern Rock

The following is a note we received from Brian Sandilands, a qualified accountant, on this issue which I am quoting here as it matches very much my understanding of the proper way to value any business:

European law says that government can not take property (Northern Rock shares) of someone unless it's in the public interest and if they do they must pay fair market value for this property.

Fair market value is defined as:

“Fair market value”, a central standard of measuring business value, is defined as the price at which property would change hands between a willing buyer and a willing seller when the former is not under any compulsion to buy and the latter is not under any compulsion to sell, both parties having reasonable knowledge of relevant facts. See IRS Rev. Rul. 59-60, 1959-1, . Bulletin 237, codified at 26 C.F.R. § 20.2031-1(b).

The fair market value standard incorporates certain assumptions, including the assumptions that the hypothetical purchaser is reasonably prudent and rational but is not motivated by any synergistic or strategic influences; that the business will continue as a going concern and not be liquidated; that the hypothetical transaction will be conducted in cash or equivalents; and that the parties are willing and able to consummate the transaction.

These assumptions might not, and probably do not, reflect the actual conditions of the market in which the subject business might be sold. However, these conditions are assumed because they yield a uniform standard of value, after applying generally-accepted valuation techniques, which allows meaningful comparison between businesses which are similarly situated.

As you have probably heard the government wants the shares valued as if business is not a going concern, however that contradicts the definition of "fair market value".

Note that when valuing companies, a professional valuer will normally use a range of valuation methods such as earnings per share, net asset value, discounted cash flows, revenue multiples, and other ratios, and look at the comparable ratios for other similar quoted businesses (including possibly adding a premium for "control"). Net asset value is usually the minimum basis which was of course the basis used by those claiming it should be at least £4 per share.

When looking at the profits of the business, both historic and prospective figures over some years would be used to try and give some indication of the underlying "sustainable" profits.

They would also likely look at the market value of the business evidenced by the share price but would exclude the impact of any recent actions by the potential beneficiaries of the valuation (in this case the Government). In addition they would look at any recent offers for the business of which there were two in this case (Lloyds TSB and Virgin Group).

Some people have argued that as there were no bidders prepared to step in and take the company on, including repaying the £25bn of Government loans of course, without preconditions, then the business must have no value. But that is not so. Many valuations have to be done when there is no practical offer for the company on the horizon, or indeed ever likely to be made. For example, would you value BP or Shell at nothing simply because there is no larger company around who could afford to buy them? The answer is surely no.

In essence, valuation is a complex art which can take some weeks where the business is large and complicated as in Northern Rock, but it is based on well known principles that professional valuers and the law courts have established as a fair way to achieve an answer. Regrettably the Government seems to be trying to corrupt this practice.

Other Issues that Might Affect the Valuation

One of the complexities of Northern Rock that attracted the attention of Parliament during the passage of the nationalisation bill was the existence of the Granite securitisation vehicle. This is a trust created some years ago in the Channel Islands that was used to raise funds to back Northern Rock mortgages. The trust is not owned by Northern Rock (oddly enough the beneficiaries are a small charity that until recently seemed to know nothing about it), but is consolidated into the Northern Rock accounts as it is effectively a "poodle" of the company and is controlled by them. But it is not included in the nationalisation. Whether to include that in the valuation of the company might be debatable.

Another issue is that of the Northern Rock staff pension scheme. By using the assumption that the company is in administration, when it is not of course, this means that the valuation would have to assume that the pension scheme would have to be secured with insurance contracts thus increasing the liabilities of the company by £150 to £200 million. That is much higher than the current deficit of about £50 million and more pertinently assumes the scheme will be wound up when the indication from the management is that it will not be.

Discriminating Between Different Shareholders

It has been suggested to me that compensation should be based on some criteria that reduces the amount paid to recent speculators, and particularly the "hedge funds" that nobody seems to like, while giving more to long term holders or smaller shareholders.

It is a basic tenet of company law that all shareholders are equal and must be treated equally and UKSA would be very opposed to any attempt to set a precedent that would overturn this principle. It is one of the few aspects of company law that protects the interests of smaller shareholders.

Forcing the Nationalisation Through Parliament and the Ethics of the Government

Another demonstration of the antics of the Government to ensure little debate on the nationalisation was the speed with which the bill was forced through Parliament, which seemed totally unnecessary. In addition it was put through as a "public" bill (i.e. one of general applicability with no mention even of Northern Rock) when it should have been put through as a "hybrid" bill – in the latter case there would have been more debate, a slower process and private individuals who are affected can petition Parliament. The method chosen was therefore clearly an abuse of Parliamentary process which was totally unnecessary except to stifle debate and public representation on it.

The general approach of the Government to Northern Rock was well put by Tim Congdon in an article in the Financial Times. He said: *"Western Governments have deplored the Russian State's expropriation of privately owned oil companies. What the British Government have done with Northern Rock – by falsely representing a business transaction at market rates or above as "state aid", encouraging a frenzy of hostile and largely silly press comment, cajoling the management and shareholders, and finally imposing a compulsory nationalisation without compensation – bears comparison with President Vladimir Putin's devices to steal assets in the former Soviet Union"*.

Question Time and NRSSG

Thanks for those of our supporters who attended the BBC1 Question Time programme in Newcastle this week. Questions were raised about the plight of shareholders but all they got from the panel was sympathy. Robin Ashby of the Northern Rock Small Shareholders Group in Newcastle spoke for example (he runs a group based in Newcastle who are currently conducting a poll on their web site as to what shareholders consider a fair price for their shares). One particularly interesting comment from Government Minister Ruth Kelly was that the company *"will continue as a going concern under public ownership"*. This of course is a direct contradiction of what the Government is trying to dictate as the basis for valuing the business.

Volunteers for a Panel of Small Shareholders and Other Speakers

Note that we get repeated requests from the TV and Press to interview small shareholders on the subject of Northern Rock. They are usually looking for people who are not experienced stock market investors, who held Northern Rock shares perhaps because they acquired them in the original demutualisation, or can otherwise be classed as the "man or woman in the street". If you held less than 2,000 shares, and are willing to talk at short notice on TV, or radio, or be reported in the press, then please let me have your contact details (including a telephone number).

In addition we are looking for people based in London who could act as occasional media spokespersons for our group. Please let me have your contact details if you have any experience in this area.

More Committee Members Required

The Northern Rock Shareholders Action Group has a committee of six people at present (including myself as Chairman). We hoped the group would have a fairly short life but as we are now facing prolonged law suits we need one or two more people to strengthen our committee. We would be particularly interested in people with senior financial experience in business or those who could represent us in public and to the media. Please call me on 0208-467-2686 if you can assist. This is of course a part-time, unpaid role.

The Future of Northern Rock

There are a lot of questions about what will happen to Northern Rock in future – for example how many jobs will be lost, how much the business will shrink, how long it may remain nationalised before being sold off again, even whether the Government will be able to do more than simply run it into the ground. But as former shareholders this is no longer of concern to us and I will therefore not be commenting on those issues in future (as of today's date you no longer own shares in this company).

Incidentally some shareholders seem to be under the misapprehension that when the Government subsequently sells off this company (i.e. denationalises it), then they may recoup their shares or some interest in the company. THIS IS NOT THE CASE. It will undoubtedly be sold off as a "private equity" deal with someone else making fat profits in due course from the recovery of the company.

Should Shareholders Continue to Hold Deposits in Northern Rock?

One question that may occur to many shareholders is should they continue to support this business by keeping money on deposit with it? In a previous note I pointed out that Robin Ashby had encouraged shareholders to do that, and indicated I had followed his lead myself. Note that the UK Shareholders Association cannot give you advice on how you should invest your money, in Northern Rock, or elsewhere, in the same way as we deliberately avoided giving advice as to whether people should buy or sell the shares.

It does however seem likely that Northern Rock will reduce the competitiveness of their deposit rates as they are going to have to be exceedingly careful to avoid accusations of unfair competition by reason of Government support from other banks.

In addition as one shareholder put it to me, why would former shareholders continue to support this business by keeping money in it when the new owners have confiscated their property without fair compensation? All I can say is that if the Government does not offer a fair and independent valuation for such compensation very soon then I will personally be withdrawing all my deposits with the company, and putting some of it into our Appeal Fund.

Information for New Contacts

We have received a large number of new supporters for our campaign following the announcement of nationalisation – indeed we have been almost overwhelmed by the response with many commenting specifically on how oppressive and immoral the actions of the Government have been. These "Update" notes have been issued approximately weekly over the last few months (you can see all the past ones on our web site), but may be less frequent in future as legal action can be a long drawn out process and it will take time for us to gather support and funding.

One thing worth pointing out is that the actions of the Government in the last few weeks have been fairly typical of their approach to shareholders in public companies. Namely that we are seen as simply gamblers in the stock market with rights that can be ignored at their convenience.

The UK Shareholders Association has campaigned for many years to try to improve the lot of private shareholders and increase the strength of our voice in the political arena. But we need to increase the number of our members to really have an impact. Please consider membership (which has other benefits apart from supporting our campaigns) – details can be seen on our web site at: www.uksa.org.uk/Membership.htm .

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