

To Northern Rock Shareholders

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Northern Rock Shareholders Action Group – Update No. 11

The status of the “strategic review” and the “tricks” that could be used to deprive you of your shares.

The latest news on Northern Rock, and what you can do to help preserve the value of your shares, is given below.

Board Changes

On Friday the 16th November the company announced that two new non-executive directors had been appointed (John Devaney and Simon Laffin), and that four non-executive directors had retired with immediate effect (Sir Derek Wanless, Nichola Pease, Adam Fenwick and Rosemary Radcliffe). The justification was that a simplification of the board would make it easier to reach quick decisions during the “strategic review” period. Our comments are that it is not unusual for a new Chairman to wish to bring in some new faces, but the dominance of a board by directors who have no historic stake in the past decisions, and probably no current shareholding, is not always wise.

In addition it was announced that Adam Applegarth had submitted his resignation and this had been accepted, but he had agreed to stay on as a director and chief executive during the strategic review process until the end of January. Our comment is that clearly Mr Applegarth had no long term future at the company if confidence in its management was to be restored, but it now makes it important to put in place a new management team as soon as possible.

Incidentally the Guardian ran a story criticising Mr Applegarth for selling shares worth £2.6 million “*while urging employees to keep buying*”. These were made some time before the company’s difficulties became apparent and some were done when the share price was near its peak. The full story can be seen at: www.guardian.co.uk/business/2007/nov/15/northernrock.banking. Note that these sales would have been publicly reported at the time of course.

The Proposals Received So Far

On the following Monday the company reported on the approaches it had received as part the “strategic review” process and following the issue of an “information memorandum”. It simply noted that discussions with interested parties were proceeding, but did note that one contemplated offer was “*materially below the market price at the close of business on the 20th Nov*”. That of course had a negative impact on the market share price. Note though that the company is still awaiting some proposals.

At the same time the Treasury issued a statement of the "Principles for Assessing Northern Rock Proposals". This simply reiterated what we already knew – namely that the Government would like to get its money back as soon as possible while promoting "financial stability" and protecting depositors. They emphasised the protection of the taxpayers' interest, but on the positive side, they did not specifically rule out any on-going support for the company past the strategic review period. They even said "*The Tripartite Authorities will assess proposals in light of the full range of strategic options available, including any proposals to meet Northern Rock's liabilities to the public sector without any change in ownership of its business or assets.*"

The Chancellor's Statement

Later the same day the Chancellor of the Exchequer, Alistair Darling, made a statement in the House of Commons concerning Northern Rock. Some key points he made were "*The Board [of Northern Rock] is legally responsible to its shareholders for the future of the company*". But as the Government has a legal duty to protect the interests of taxpayers and is a major creditor, "*the Government has to agree therefore to any proposals for the future of Northern Rock*".

All he said thereafter was that in essence the Government will consider any proposals carefully and is giving the Company time to consider its strategic options. In our view this was a sound and unremarkable statement. It did at least suggest that the Government is not going to panic and take a rash decision about what to do.

Negative Press Comment

The reporting in the media on the above statements from the Company and the Chancellor was unfortunately hysterical in the extreme in some cases. Some suggested that both the taxpayers (as represented by the Government) and the shareholders would lose everything. The share price again reacted accordingly.

Note that some media commentators have compared the loans to Northern Rock to Government budgets for defence or education; and Lib Dem MP Vince Cable even compared it to the expenditure on so many "Millenium Domes" without even the benefit of a few rock concerts as a result. This is all nonsense. Lending money at a commercial rate of interest when there is a great certainty of also getting the loans repaid is very different to current expenditure – particularly when it is on white elephants like the Dome that nobody wants.

Why Nationalisation is a Bad Idea

Other newspapers suggested that the company should be nationalised and this is also being promoted by the Liberal Democrats (we have written to them pointing out the folly of this idea). Why would nationalisation not be wise? Because instead of the Government having at risk just the £25 bn of loans they have made to the company, and possibly for the deposits they have guaranteed, if they owned the business they would in fact be potentially responsible for all the liabilities of the company which is a very much larger sum. They would also presumably have to pay some fair value to the existing shareholders, and then have the problem of managing the business – and UK Governments have always shown a total inability to run any commercial organisation profitably. Why do this when they can already dictate what happens to the company? Even the Chancellor of the Exchequer suggested it was questionable in his response in the House, indicating that the LibDems seemed to be changing their tune on it fairly rapidly.

Why Administration Would Also be Problematic

Another alternative that has been suggested is for the Government to put the company into Administration (a form of “receivership” where an accounting firm effectively takes over the management of the business in the interests of creditors, and the directors and shareholders have no say thereafter). In theory the Government is a preferred creditor and would get priority for repayment of at least most, if not all, of the £25bn it has lent Northern Rock. However, Administration would normally freeze the assets of the company at least for a while so that Administrators could determine the total assets and liabilities and ownership thereof. This would likely freeze retail depositors, or precipitate another run on the bank by them. It would also probably prompt an immediate wind up of the “Granite” mortgage securitisation vehicles, thus creating even more potential liabilities for the Government. But see below for a possible way around these problems.

Note that such Administration would not normally result in any value to ordinary shareholders and your shares would instantly become worthless. In an Administration the assets are often sold off rapidly at below market value, and mortgage assets are almost impossible to sell in the current marketplace, so with the hefty costs of Administration on top there would probably be nothing left over for ordinary shareholders after creditors had been paid.

The Proposals

So far as we know, the proposals received to date by the company are as follows (although more are expected in the new few days):

J.C.Flowers – Their consortium would provide £15bn to replace some of the Government loans immediately, with the remainder repaid by 2010. They would also inject £1bn of working capital. Existing shareholders would only be paid a nominal amount for their shares.

Virgin – This group would also put in £1bn in cash as well as merge in the “Virgin Money” operation. They would repay £10bn of the Government funding immediately with the remainder probably over 2 to 3 years. This merger would enable existing shareholders to retain a stake while being heavily diluted, and the brand would be renamed.

Olivant – This proposal from Luqman Arnold is more of a “management buy-in” than a bid although they would subscribe for some new shares. It seems to be primarily based on an aggressive restructuring plan to enable repayment of the Government funding over a few years. Shareholders would of course retain their holdings with some minor dilution.

The Process from Here

The Directors of Northern Rock will no doubt be considering all the proposals they have received as part of the strategic review, and they may negotiate on the terms of specific proposals. Thereafter they would normally decide on their preferred outcome, and then put their single selected option to a vote of shareholders – typically with a strong recommendation to vote for it. Such recommendations can even take the form of “if you don’t vote for it we’ll put the company into receivership” although as pointed out above, this would create enormous problems for the Government in this case, and for stability in the UK financial markets as the collapse of the company would almost certainly cause difficulties for other banks. So shareholders might choose to call that bluff.

Any sale of the company as a whole, or a major disposal of assets, or major restructuring or new share issue, would normally require a vote of shareholders under the UK Listing Rules for publicly quoted companies. So all of the proposals mentioned above would likely require a shareholder vote. In the case of an offer for the whole company, this is usually in one of two forms: an outright bid, or a "scheme of arrangement". The latter usually is associated with a restructuring of the share capital and typically requires a 75% majority vote (of those who bother to vote) plus the approval of a Court. If approved, you will receive the same value for your shares in cash as everyone else, or any replacement shares that may be offered.

For a simple bid, the bidder needs to acquire 90% of the shares to enable it to force you to sell your shares at the offer price. In theory a lesser number can mean you can remain a minority holder, perhaps in a private "delisted" company where the shares are no longer publicly quoted, but normally if a bidder gets past the 50% mark then other shareholders tend to accept in due course.

Clearly though in this case, there are enough shareholders (not just private individuals) that obtaining even 50% for a bid that offered only a "nominal" figure to ordinary shareholders, such as the proposed J.C.Flowers bid, would be exceedingly unlikely to win sufficient support in our view.

Other possible proposals such as that from Virgin Group do not assume total control is obtained by the bidder, but that a large number of new shares are issued that gives the bidder some control, and while you would retain your existing shares they would be heavily diluted. If the number of shares in total issued by the company is doubled (which may be the magnitude of the change), then the effective value of your shares is halved because the same assets are then represented by twice as many shares.

Are there Ways Around these Issues?

If the Government wanted to force the Directors to accept a bid from a third party such as the J.C.Flowers' one, contrary to the likely wishes of shareholders, how could they get around the need for a shareholder vote? Well there is one possibility which is in essence a "dirty trick" and legally very questionable. This is to do a "pre-packaged administration" where a buyer is lined up, the required contracts put in place, and the prospective Administrator agrees in advance of being appointed to immediately dispose of the company to the bidder as soon as they are appointed. This nicely sidesteps the requirement for a shareholder vote and has been done in the past (although in rather different circumstances where the Directors of the company might have been able to justify it rather more easily). We would challenge the legality of this process in the case of Northern Rock, and as there are other available options in this case that protect the position of other "stakeholders" including the Government, we see no justification for its use.

Morally it is exceedingly dubious as it is a way of extracting the company from the ownership of the shareholders, without their consent. We are asking you therefore to write to the Chancellor of the Exchequer making a few points on this. We also suggest you send a copy to your M.P. with some urging to make representations on the issue.

In addition of course, this process cannot be followed without the connivance of the Directors, which we very much hope they will not even consider as we would view it as a breach of their duty to shareholders to protect your interests. We are therefore asking you to write to the Chairman of Northern Rock to make the same points to him.

Some proforma letters you can use to write to these people are given at the end of this note, but they would be even better if turned into your own words. Please do send off these letters as soon as possible.

Why is the Current Share Price So Low?

Many shareholders have asked me why the share price keeps falling, and what should they do. I cannot tell you whether to buy or sell shares for legal reasons so it is impossible for me answer the second part of that question. Clearly on fundamentals the current share price seems to undervalue the company based on the forecast profits in the "information memorandum" issued by the company and on the net assets reported in its accounts. There may be a fear that the net assets are misrepresented, or could be undermined by a collapse in the housing market. But it seems more likely that the price reflects the risks and uncertainties associated with what the Directors and the Government may decide to do – with such distrust of Governments in recent years it may not be surprising that confidence is low (I know of depositors in Northern Rock who don't even believe the guarantees they have been given by the Chancellor). You should therefore factor in your views on what might happen to adjust your valuation of the company accordingly.

Note that we have no knowledge at this time that the Directors or the Government are considering Administration.

Meetings for Shareholders

To remind you, UKSA has arranged two meetings for Northern Rock shareholders: On Monday the 26th November at 1.0 pm at the Royal Station Hotel, Neville St, Newcastle-upon-Tyne, NE1 5DH and on Wednesday the 28th November at 10.30 am at St.Columba's Church, Pont Street, London, SW1X 0BD. All shareholders are welcome.

Please attend one of these meetings if you have any questions on the matters discussed in this note. It is unfortunately not always easy for us to respond individually to queries that come in via phone or email as we have now got more than 3,000 individual people who have responded to our campaign and the number is growing rapidly, plus the questions are sometimes quite complex. Unlike other groups involved in this affair, we have very limited funding and have no full time staff who can spend the hours needed to deal with a multitude of queries.

Thanks for the Donations

Thanks to all those who have sent us donations which are at least covering some of our past expenditure. Please support us financially if you can and give a donation if you have not already done so. A donation form is present on our web site at: www.uksa.org.uk/Northern_Rock_Appeal_Letter.pdf

And thanks for the notes expressing support for what we have been doing – it makes it all worthwhile if we know we are doing what you would like.

Yours sincerely

Roger Lawson
Communications Director
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Direct telephone: 020-8467-2686

Rt Hon Alistair Darling MP
Chancellor of the Exchequer
HM Treasury
1 Horse Guards Road
LONDON
SW1A 2HQ

Concerning the affairs of Northern Rock

Dear Mr Darling,

As a shareholder in Northern Rock I am very concerned that steps might be taken to deprive me of the ownership of those shares. At present the interests of shareholders seem to have been generally ignored on the debates as to what to do about the problems at the company. Obviously we understand that the Government wishes to have the loans that have been made to the company repaid as soon as possible. But the interests of all stakeholders, including the owners of the company, need to be adequately considered also.

Any outright offer for the business seems unlikely to include a repayment of all the Government funding by the end of February. We suggest that the best solution is one where the company remains independent, puts in a new management team and draws up a plan for repayment of the loans as soon as possible. This might include extensive restructuring and the obtaining of finance from third parties to replace some of the loans from the Bank of England immediately. Such a solution seems perfectly practical to us – after all if the bidders can obtain funding secured against the assets of Northern Rock, then so can the company, provided there is confidence in the management.

We would consider it morally outrageous if any attempt is taken to sidestep the obligation to consult the shareholders and pass a vote by shareholders for any sale or major asset disposal. We hope that after due consideration you will see that this would undermine confidence in the UK stock market by investors generally. There is no need to do this when better solutions are available that would also meet the needs to protect jobs in the North East of England and to protect the depositors.

Yours sincerely

Bryan Sanderson
Chairman
Northern Rock Plc
Gosforth
NEWCASTLE UPON TYNE
NE3 4PL

Concerning the affairs of Northern Rock

Dear Mr Sanderson,

As a shareholder in Northern Rock I am very concerned that steps might be taken to deprive me of the ownership of those shares. At present the interests of shareholders seem to have been generally ignored on the debates as to what to do about the problems at the company. Obviously we understand that the Government wishes to have the loans that have been made to the company repaid as soon as possible. But the interests of all stakeholders, including the owners of the company, need to be adequately considered by the Directors when deciding on a way forward.

Any outright offer for the business seems unlikely to include a repayment of all the Government funding by the end of February. We suggest that the best solution is one where the company remains independent, puts in a new management team and draws up a plan for repayment of the loans as soon as possible. This might include extensive restructuring and the obtaining of finance from third parties to replace some of the loans from the Bank of England immediately. Such a solution seems perfectly practical to us – after all if the bidders can obtain funding secured against the assets of Northern Rock, then so can the company, provided there is confidence in the management.

We would consider it morally outrageous if any attempt is taken to sidestep the obligation to consult the shareholders and pass a vote by shareholders for any sale or major asset disposal. In our view it would be a breach of duty by the Directors of the company if you failed to recognise the primary interest of the shareholders in this matter, and although we recognise that the interests of other stakeholders including the employees and creditors such as the Bank of England must be respected, the best solution in this case is one that meets all their needs as well as ours.

Yours sincerely

To _____, M.P.
The House of Commons
London
SW1 0AA

Concerning the affairs of Northern Rock

Dear

As a shareholder in Northern Rock I have written to the Chancellor of the Exchequer and enclose a copy of my letter.

As you can see, I am very concerned that the Government might panic and take an unwise decision about how to deal with the problem of obtaining rapid repayment of the loans from the Bank of England.

I would ask you to consider this matter and make representations to the Chancellor or other Government ministers to ensure that the company is not forced to take steps that are prejudicial to my interests.

If you are unclear on the issues involved here (and unfortunately some of the press and media comment has been grossly misleading) then please contact me to discuss the matter, or you may care to go to the web site of the UK Shareholders Association (the relevant page is www.uksa.org.uk/NorthernRock.htm) who are campaigning on behalf of the 180,000 smaller investors in this company.

Yours sincerely
