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To Northern Rock Shareholders

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Northern Rock Shareholders Action Group – Update No. 12

The status of the "strategic review" and Virgin offer

On Monday the 26th November, the company announced that the Virgin Group consortium had been selected as the "preferred bidder", and discussions with them were being taken forward. A copy of the announcement can be seen on the company's web site at: http://companyinfo.northernrock.co.uk . Virgin now need to do the necessary due diligence and firm up their proposals which may take some weeks. Note that the company has not ruled out consideration of other offers if these are quickly progressed – for example we understand that Olivant are still actively doing so.

The immediate reaction of the stock market was mixed with the share price wildly fluctuating but then showing some improvement – clearly the offer was as difficult to evaluate for stock market professionals as it was for amateur investors. Press and TV commentators also caused some confusion with many shareholders appearing to think that Virgin had offered 25p for their existing shares – this is not the case!

The Basis of the Proposal

Virgin is not offering to buy the existing shares. But they are intending to take control by acquiring 55% of all the shares in the company after a lot of new shares are issued. Currently there are 420 million shares in issue, and this will rise to 6,620 million after the new shares are issued.

In total £1.3bn of new cash will be injected into the business, plus the Virgin Money business – the latter being valued at £250m. Of the cash, half will be provided by the Virgin consortium and half by existing shareholders by subscription to a rights issue. In other words, you the existing shareholders will be asked to pay for 6 new shares at 25p for every one share you currently hold – in effect subscribing £1.50 per existing share to maintain a substantial interest in the company (but obviously less than you currently own as Virgin will own 55% and existing shareholders only 45%).

The upside is that if the company prospers, you will participate in the future growth and profits of the company. But of course you don't necessarily have to take up a rights issue and what happens in that case is somewhat crucial – see below for discussion on that.

How to Value this Proposal

An analysis of how one might value the proposal from Virgin is as follows:

At the half year results stage the net equity attributable to shareholders was £2.3bn, or some 550 pence per share. We estimate that "impairments" and excess interest costs may have reduced this to £1.9bn or 450 per share. At present there are 420m shares in issue in Northern Rock. After the Virgin bid there will be 6,620m shares in issue of which the present shareholders will hold 3,020m, and the Virgin consortium 3,600m. To "reach" 3,000m existing shareholders have to pay £650m (25 pence per share, 6 new shares for each one share we hold). Virgin also gets 2,600m shares at 25 pence each for £650m PLUS they get 1,000m new shares for the £250m value of Virgin Money.

If the deal goes ahead, existing shareholders will own 3,020m shares in total (420m existing plus 2,600m new ones) and Virgin will have 3,600m. This roughly matches the 55% figure that the Virgin consortium states it will have in the combined new entity which is to be rebranded with the Virgin name.

The "additional" £1.3bn added in capital plus the existing Virgin Money business will produce a business which will have combined assets of £3.4bn attributable to shareholders. Based on 6,620 million total shares, each share might be worth around 50 pence in round figures. What this means is that ONE old Northern Rock share plus six new shares will have a combined asset value of about 350 pence. Since the new six shares will cost 150 pence (25 pence per share) that implies that the EXISTING share is worth up to 200 pence.

As that is clearly more than the existing market price, it suggests that the City is calculating that the new entity will be worth substantially less and nearer to £2.5 Billion in total. The value may also be affected by the need to pay arrangement fees on the funding to replace the Bank of England's finance and by possible write downs on assets that will be put up for sale that we have not taken into account. Presumably also people are discounting the future profit stream, discounting the value of the assets or anticipating some difficulties that Virgin may face in resuscitating the business. Or perhaps they are discounting the possibility of the Virgin deal not being consummated. There would obviously be some risk of the company being forced into receivership or being nationalised if the Virgin proposal collapses and no other offer is made – we have covered what might happen then in previous notes.

Note that the discussion above values the business on the basis of an uncertain estimate of the "net equity" as it might appear in up to date restated accounts. It does not follow that this is necessarily the "right" way to value the business. Before the problems became apparent, the market price of the shares was much higher – this suggests that the business then was expected to grow profits substantially in the future, something which the current price does not appear to anticipate. The valuation given is based on assets rather than future projected profits or cash flows so may be on the conservative side. The purpose of setting out the above analysis is to help shareholders get a feel for what is happening, not to recommend a course of action or to suggest what the price ought actually to be.

Possible Negative Aspects of the Proposal

In effect, using the same figures given above, Virgin group is obtaining 55% of a business with assets of nominally £2.3bn for a contribution of £650m in cash plus the Virgin Money business. Even valuing the latter at £250m, that is an exceedingly good deal for them. But is the Virgin Money business really worth the value of £250m put on it though?

We understand historic pre-tax profits are of the order of £10m so that's a p/e of well over 25 allowing for tax which is exceedingly high for a financial institution in the current market place – most banks now trade on a p/e of less than 10. So it looks a rather inflated valuation to many commentators.

Another possible problem for private shareholders is that to participate in this proposal, and to maximise your returns, you will have to subscribe for the new shares. Small shareholders may not have the cash to stump up at the time, nor an inclination to raise their stake in Northern Rock – they may see this as doubling up on a speculative investment. What will happen if the rights are not taken up? There are two ways of doing this and we don't know for certain which will be used. In some cases rights not taken up simply lapse in which case Virgin would end up owning a lot more than 55% of the new company. The other way is to allow rights to be sold, in which case existing shareholders might obtain some cash for the "rights", and other institutions might pick them up.

We are of course not opposed to the concept of a rights issue for Northern Rock – many of our shareholder contacts have suggested that one is required. Other deals that may be put on the table may also involve a rights issue. Even private shareholders may look favourably on such a proposal if they view it as an investment in the future. But if it is structured to look like shareholders are simply being asked to subscribe to maintain a reasonable stake in the business, which they currently own outright, then they may take a different view.

Whatever approach is taken, any existing shareholders will end up as minority investors in a company controlled by a private entity (the Virgin consortium). Many investors in stock market companies prefer not to invest in such situations as it can cause "governance" issues to arise (see BSkyB for a recent example), and the share price can be negatively affected by the fact that it is clearly pretty invulnerable to bids from third parties.

Another problematic issue is abandoning the "Northern Rock" name which is undoubtedly an issue for many investors based in the north of England who are attached to that brand. And it is questionable whether Virgin is a good name for a bank. Does it have the right "connotations" for a respectable financial institution? You can judge that for yourselves. Note that apparently a fee will probably be charged by Virgin Group for use of the Virgin brand name.

Positive Aspects of the Proposal

There are some positive aspects of the proposal though. Clearly the company would continue as an independent business based in the north east of England, and most jobs would therefore be retained – although there are not likely to be any guarantees of that longer term. The Government at least gets some of it's funding back fairly quickly, the Tripartite Authorities seem happy with the deal and the Northern Rock foundation will continue to get a share of profits.

UKSA Suggests the Virgin Proposal Might Not be Acceptable to Shareholders

From our soundings of existing shareholders and the feedback we obtained from shareholders at the meetings we held in London and Newcastle, it is clear that there is considerable opposition to the Virgin deal from current individual shareholders. Taking into account the financial analysis (and thanks to Pradeep Chand for some assistance with that), we feel that it is not an offer that is likely to be accepted by shareholders if put to a vote, particularly if it is noted that RAB Capital and SRM Global have stated their opposition to the deal – SRM Global have apparently even increased their stake in the company recently, allegedly for the purpose of trying to block the deal.

Incidentally I have been assured by the Chairman of Northern Rock that shareholders will get to vote on any proposal once it has been firmed up.

The shareholders we have spoken to have generally said that they would like to see the financial value of the offer increased (it's simply too favourable to Virgin and not favourable enough to existing shareholders), or other offers on the table that would enable existing shareholders, particularly smaller shareholders, to participate more fully in the business going forward. Alternatively the company should simply stop the "strategic review" process and restructure and revive the business itself.

Yours sincerely

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