UKSA

To Northern Rock Shareholders

06 April 2008

UK Shareholders Association
BM UKSA
London
WC1N 3XX

Phone: 0870-70-60-600
Email: uksa@uksa.org.uk
Web: www.uksa.org.uk

Northern Rock Shareholders Action Group – Update No. 31

Results for 2007

Last Monday the financial results for Northern Rock for the year ending December 2007 were published together with the new Chief Executive's business plan for the future – copies can be obtained from the company's web site at: http://companyinfo.northernrock.co.uk .

As we forecast in our last note, the results showed a substantial loss for the year due to large write downs and provisions. However the loss (and the associated reduction in net assets) were less than some people were forecasting. The loss before tax was £167m compared with a profit of £626m in the prior year, and as you might expect most of the losses arose in the second half of the year. However the "underlying profit" was £421 million for the year, only slightly lower than the previous year, and the difference arises from the "exceptional" impairments of assets, non-recurring expenses and other adjustments.

Very substantial provisions have been made for the holdings in SIVs and CDOs (those complex financial instruments that are the source of many current problems) – in effect writing off most of them (total £421m). In addition £243 million was recorded as a provision against residential and unsecured loans, mainly against the latter. Whether these provisions are reasonable or excessive it is difficult to determine. Plus there are £127m of non-recurring expenses which includes professional fees and fees to the Tri-partite Authorities of £38m, and charges due to reduction in the value of the new head office that was being built which is no longer required and on "accelerated write offs of capitalised software" with no explanation given – but this kind of write off certainly suggests that the new management was keen to make a clean sweep of all possible costs.

All these adjustments result in a net asset value per share of about £3 (ignoring "Foundation shares") in comparison with well over £4 at the half year. However that's still a lot more of course than the Government is wanting to pay in compensation to shareholders.

A Going Concern?

One interesting point that might be overlooked by many readers of the report as it's in the part that many people habitually skip when reading Annual Reports is that the accounts were prepared by PriceWaterhouseCoopers on the basis that the company is a "going concern". They do hedge this around to some extent by pointing out that the company is reliant on facilities from the Bank of England, which are themselves subject to clearance from the European Commission on the provision of state aid. However, in essence the auditors accepted the view that it was a going concern and continues to be so, contrary to the proposed basis for valuation by the Government!

The Business Plan

Ron Sandler's "Provisional Restructuring Plan" certainly makes interesting reading although it must dismay Northern Rock employees considerably as it involves a major reduction in operations and hefty job cuts. Repayment of the Bank of England debt is scheduled by 2010, with release of Treasury guarantees to depositors a year later. But at least he plans to keep the "Northern Rock" brand.

However, substantial losses are forecast for 2008 due to restructuring costs, with break-even only achievable by 2011. Whether this is reality or whether it is an attempt to manage the expectations for shareholder compensation and to impress the trade unions (with which Mr Sandler has yet to consult) is uncertain.

One point worth noting in the Restructuring Plan is that it makes it clear that the company did not draw on the Bank of England "facility" which was arranged in September 2007 until after the "run" on the bank caused retail deposits to be withdrawn which may be relevant to the culpability of Adam Applegarth discussed below.

Making Adam Applegarth a Scapegoat

Much of the press barely reported on the publication of the accounts, but concentrated their stories on the inclusion in those accounts of the compensation terms paid to former Chief Executive Adam Applegarth. These stories were accompanied by a "mug shot" of Applegarth looking unshaven and haggard. The compensation paid was £760,000 which was less than his legal entitlement (he seemed to be on 12 months notice). It seems unlikely to have been possible for the company to have negotiated a lesser figure – indeed it is clear that Applegarth consulted lawyers on the matter because the company even paid his legal costs. So I suggest one has to be accept this situation regrettable though it may be.

As we have said before, there were many factors that led to the problems faced by Northern Rock, but the actions of the Government in the handling of the crisis were probably as damaging, if not more so, than the defective business strategy allegedly pursued by the board of Northern Rock. Unfortunately many people find it easier to personalise the matter by making Applegarth a scapegoat whereas those in the Treasury and the Bank of England who were just as culpable are faceless bureaucrats. And the Government and Labour politicians have been only too quick to pin the blame on those who could not defend themselves against these allegations easily. It's great for the Government to be able to divert attention onto one individual and away from their own actions and inactions.

It is of course worth pointing out that the compensation paid to Applegarth might have been partly determined by his willingness to sign an agreement promising not to talk. Is it not odd that he has said nothing about the affair since he has left the company?

So far as shareholders are concerned though, we should be worrying more about the compensation terms likely to be offered to us from the Government than about the amounts of the pay offs to former directors which we can do little about at this point in time.

Brussels Launching Inquiry into State Aid

The European Competition Commissioner has announced an inquiry into whether the Government's actions over Northern Rock constitute illegal state aid. Both the British Bankers Association and the Building Societies Association have expressed concern about the current position where Northern Rock might compete aggressively for deposits.

Note that this is not an inquiry into the nationalisation per se, but we have asked Euroshareholders (the European wide association of national shareholder groups) to put forward a complaint about the compensation terms. We are representing quite a number of shareholders in the Shareholder Action Group who are based outside the UK.

Status on Legal Action

There has been no news from the Government on the appointment of a valuer to assess compensation, so it is plainly going to be some time - probably months – before we see anything from that process.

As you are probably aware, both our group and SRM Global submitted a "letter before action" about two weeks ago to the Government challenging the Compensation Order as being contrary to human rights legislation. We understand RAB Capital have also submitted a similar letter. No response has been received from the Government to date, and it seems it may be delayed past the three week deadline we gave.

Freedom of Information Requests

Apparently both us and the Conservative Party submitted requests under the Freedom of Information Act to see, among other things, the Goldman Sachs report on which the decision was based to go for nationalisation. Those requests have been rejected on the grounds of cost to supply the information (exceeding £600). This is of course a nonsense as the report is readily available and could no doubt be emailed within seconds. An obvious example of the Government's keenness to avoid any scrutiny of what happened, which will be challenged.

Will Preference Shareholders Get Preference?

One matter that arose in Parliament last week when the "Transfer Order" was debated was whether preference shareholders will get preference in the Compensation terms. Northern Rock had £400m of preference shares which get priority for repayment on a liquidation. The preference shares were confiscated at the same time as the ordinary shares. Whether the preference shareholders will get the first slice of any compensation offer is not at all clear – the Government seems to be leaving it up to the valuer to decide. But the financial institutions who mainly hold these shares are saying it would undermine the normal principle of the priority for those holders if the valuer decided otherwise. If they do, any amount available to compensate ordinary shareholders would be reduced accordingly and might reduce the payout to you.

Roger Lawson
Communications Director, UK Shareholders Association; and
Chairman, Northern Rock Shareholders Action Group
Email: uksa@uksa.org.uk
Web: www.uksa.org.uk
Direct telephone: 020-8467-2686

Note that all previous "Update" notes on Northern Rock that we have issued are present on the following web site page: www.uksa.org.uk/NorthernRock.htm