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The first sale of shares in Lloyds Banking Group

United Kingdom: HM Treasury: Chancellor of the Exchequer

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Report
by the Comptroller
and Auditor General

HM Treasury and United Kingdom Financial Investments Limited

The first sale of shares in Lloyds Banking Group

HC 883 SESSION 2013-14 18 DECEMBER 2013

Our vision is to help the nation spend wisely.

Our public audit perspective helps Parliament hold government to account and improve public services.

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HM Treasury and United Kingdom Financial Investments Limited

The first sale of shares in Lloyds Banking Group

Report by the Comptroller and Auditor General

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Amyas Morse
Comptroller and Auditor General
National Audit Office

13 December 2013

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This study examines the value for money of the first sale of shares in Lloyds Banking Group

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This report can be found on the National Audit Office website at www.nao.org.uk/2013-lloyds

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Key facts

£3.2bn
proceeds from the sale

3%
discount to the market price at which the shares were sold

33%
of Lloyds Banking Group remaining in public ownership

77.4p	was the market price of the shares ahead of the sale
2.8 times	more demand than shares on offer
75p	was the price at which the shares were sold
4.3 billion	was the number of shares sold
74p	was the price of the shares at the end of the first week of trading

Summary

1 To maintain financial stability at the height of the financial crisis in late 2008, the government provided public support to the banking sector, including the purchase of £20 billion of shares in Lloyds Banking Group (Lloyds). In September 2013, the government sold just over 15 per cent of the taxpayers' shares in Lloyds to institutional investors for £3.2 billion. Following the sale, the government continues to be the largest single shareholder, with just under 33 per cent of Lloyds' ordinary share capital. A further sale of shares is likely in 2014.

2 This first sale was arranged by United Kingdom Financial Investments Limited (UKFI), a stand-alone company established in 2008 by the Treasury to manage the government's stakes in Lloyds and Royal Bank of Scotland. While UKFI devised and executed the strategy for selling the shares, the decision on the final form and timing of the sale rested with the Chancellor of the Exchequer.

3 We have stated in the past that we would return to the subject of banking interventions when the government disposes of the assets acquired, and did so for the first time in March last year with a published report on the sale of Northern Rock plc.[1,2] This report examines the value for money of the Lloyds share sale, particularly whether:

- the most appropriate sale method was chosen;
- the sale was timed and structured appropriately;
- the price obtained was reasonable; and
- whether there was a gain or shortfall for the taxpayer.

1 National Audit Office Strategy 2011-12 to 2013-14 (National Audit Office, November 2010), paragraphs 3.8 and 3.9.
2 Comptroller and Auditor General, *HM Treasury: The creation and sale of Northern Rock plc,* Session 2012-13, HC 20, National Audit Office, May 2012.

Key findings

Was the most appropriate method of sale chosen?

4 When planning to sell public assets, we expect departments to conduct a thorough review of all available sale options. In this case, there was a choice between: a private sale to another bank or large financial investor; or a wider offering of shares to institutional and retail investors.

5 UKFI did not receive any expressions of interest from other banks. In any case, a bilateral deal negotiated with another bank or large financial investor would have been difficult to justify unless the shares could be sold at, or at a premium to, the then prevailing market price. In such circumstances, UKFI correctly decided to explore options for a sale to a wider range of investors (paragraphs 1.6 and 1.7).

6 Selling all the shares in one go would not have been good value. At a market value of around £20 billion, the shareholding was too large for a single sale at a competitive price. A series of sales over a period of time was likely to produce better value (paragraph 1.9 and Figure 1).

7 A sale to both institutional and retail investors would have been too high-risk. A sale involving retail investors would have required up to six months of preparation, publication of a prospectus and an announcement of the date of the sale. This would have constrained UKFI's flexibility to conduct the sale when market conditions offered the best prospect of selling the shares at a fair price (paragraph 1.12).

8 To minimise risk, UKFI correctly decided to sell the shares over a 12 to 48 hour period. In the summer of 2013, economic conditions remained uncertain and there was also uncertainty on how central banks might begin to roll back monetary stimulus measures, such as quantitative easing, in an orderly way. Given such uncertainty, a sale of part of the shareholding, using a more flexible and timely process, offered the best defence against the risk that the financial markets might fall (paragraphs 1.11, 1.16 and 2.7).

Was the sale timed and structured appropriately?

9 Having chosen an appropriate sale method, we also expect departments to consider carefully whether market conditions are right for such a sale and, if so, how many shares could be sold.

10 UKFI commissioned an extensive analysis of the value of Lloyds. UKFI asked JP Morgan to analyse whether the market price of Lloyds shares reflected a fair valuation of the business. JP Morgan used three valuation approaches to construct a fair value range of 41p to 89p a share and this was reviewed by Lazard & Co acting as UKFI's capital markets adviser (paragraphs 2.3, 2.4 and Appendix One).

11 UKFI's judgement that a sale from August 2013 onwards offered good value was based on sound evidence. In the summer of 2013, Lloyds shares were trading at 73p to 77p, close to a 12-month high and at the upper end of the range of values implied by JP Morgan's analysis, reflecting a significant improvement in investor confidence following the Eurozone crisis and encouraging data on the UK economy (paragraphs 2.5 and 2.6, Figures 2 and 3).

12 The number of shares that could be sold was, however, limited. Although a sale over a 12 to 48 hour period would minimise exposure to market risk, the size of the sale was constrained by the short sale period, which favoured large institutional investors able to react quickly (paragraphs 1.11, 2.12 and 2.13).

Was the price obtained reasonable?

13 Where shares are already trading on the Stock Exchange, we expect departments to protect value by: maintaining confidentiality ahead of any sale; maximising competitive tension among potential purchasers; and setting a price which reflects demand and ensures a stable price for the shares in trading after the sale. It is also important to minimise the costs of arranging the sale.

14 The share price was unaffected by the prospect of an imminent sale. Although speculation around a sale appeared regularly in the media, share price movements in the two weeks ahead of the sale showed no unusual downward movement, suggesting that UKFI's plans had not become known to market participants (paragraph 3.2 and Figure 4).

15 Demand in the sale was high but depended on orders from investors who were not seen as longer-term holders of the shares. Demand for the shares at a price of 75p exceeded the number of shares on offer by some 2.8 times and compared well with similar sales. However, over three-quarters of this demand came from institutions that were seen as shorter-term investors. UKFI and its advisers received feedback from longer-term investors that demand had been subdued. Given the growth in the share price during 2013, further near-term price rises were expected to be limited (paragraphs 3.3 to 3.5, Figures 5 and 6).

16 The dependence on shorter-term investors limited the price at which the shares could be sold. UKFI's key objective in this first sale was to maximise price while ensuring a positive but stable aftermarket. Pricing the shares at 75.5p or 76p would have required allocating more than 60 per cent of the shares to institutions that were seen as shorter-term investors. If these investors sold their shares soon after the sale, there was risk of a weak aftermarket and negative perceptions affecting future sales. For this reason, UKFI priced the sale at 75p a share (paragraphs 3.6, 3.7 and Figure 7).

17 Nevertheless, the sale was at a smaller discount to the market price than seen in similar sales. As Lloyds shares were already traded on the Stock Exchange, their market price immediately before the sale provides a benchmark against which the price obtained can be measured. At 75p a share, the price represented a 3 per cent discount to the closing market price of just over 77p ahead of the sale. This discount compares well with the average discount of just over 4 per cent seen in the ten largest similar sales since 2008 (paragraphs 3.8, 3.9 and Figure 8).

18 Following the sale, the market price of the shares has held steady, lending support to UKFI's decisions on timing and pricing of the shares. At the end of the first week of trading the market price of the shares fell slightly from 77p to 74p. In the four weeks following the sale the shares traded at between 73p and 77p, mirroring changes in the FTSE 100 index (paragraph 3.10 and Figure 9).

19 UKFI does not hold detailed information on who sold and who bought shares in the aftermarket. Over 2.5 billion shares were traded in the four days after the sale but we have not been able to establish who was buying and who was selling in the aftermarket and whether allocations of shares to investors were a reasonable reflection of their actual behaviour after the sale (paragraphs 3.11 and 3.12).

20 Costs were lower than in similar sales. It is standard practice for investment banks, acting as book-runners to market a sale, to charge the seller of shares a fee, expressed as a percentage of the proceeds raised. However, following a competitive procurement exercise and negotiations, UKFI secured agreements with the book-runners that it would not be charged a fee (paragraphs 3.13 to 3.15).

Was there a gain or shortfall for the taxpayer?

21 There was a shortfall for the taxpayer of at least £230 million. A simple comparison of the price at which the shares were bought with the sale price produces a gain for the taxpayer of just under £120 million. However, taking account of the cost of borrowing the money to buy the shares produces a shortfall of £230 million. In 2009, the first report on maintaining financial stability published by the National Audit Office concluded that the scale of the economic and social costs from the collapse of one or more major UK banks was difficult to envision and that the interventions to support the banks were justified. (paragraphs 3.16 to 3.20 and Figure 10).

Conclusion on value for money

22 This first sale represented value for money. UKFI conducted a thorough review of its options, choosing a sale process that maintained flexibility on timing and allowed the transaction to be completed quickly once a decision to sell had been made. The sale took place when the shares were trading close to a 12-month high and at the upper end of estimates for the fair value of Lloyds' business. Furthermore, the shares were sold at a relatively low discount to the market price compared with discounts seen in similar sales, and the after-market in the shares has remained steady. The shortfall of at least £230 million should be seen as part of the cost of securing the benefits of financial stability during the financial crisis, rather than any reflection on the sale process, which UKFI managed very effectively.

Recommendations

23 Ahead of the next sale, **UKFI should analyse in detail who bought and who sold shares in the aftermarket and whether such behaviour was anticipated correctly in the pricing and allocation of shares.** Such information will help UKFI to deepen its understanding of the likely behaviour of individual institutional investors and of the types of institutions to which it would prefer to sell Lloyds shares.

24 When seeking authority to launch future sales and recommending the price at which shares should be sold, **the Treasury should take account of the cost to the taxpayer, particularly the cost of finance, when analysing the opportunity cost of retaining the shares as opposed to selling them.** Such an analysis would also provide the basis for more informed public reporting of outcomes immediately after future sales.

25 **Where departments are required to undertake longer-term projects requiring specialist skills, they should consider hiring experts directly and retaining them in-house.** Such a strategy may provide better value for money than buying in expertise for short periods on consultancy-type contracts. UKFI had a clear mandate to design and manage this sale and has provided the Treasury with greater expertise, along with a more independent focus and discipline regarding taxpayer value.

Part One

Choosing the method of sale

Background

1.1 From 2008, financial markets and banks suffered a sustained period of instability precipitating a global credit crisis and an economic downturn. In response, governments across the world intervened to support their financial systems. During 2008 and early 2009, the Treasury introduced a range of measures to:

- allow banks to pay claims and outstanding borrowings as they fell due; and
- ensure that major banks had sufficient capital to cushion them from losses caused by a further deterioration in the financial markets.

1.2 The scale of the support provided to banks by the UK taxpayer was unprecedented, reaching over £1 trillion in the form of guarantees, loans and purchases of shares.

Objectives

1.3 Responsibility for managing the taxpayers' shareholdings rests with United Kingdom Financial Investments Limited (UKFI), a stand-alone company established in 2008 by the Treasury to manage the government's stakes in Lloyds Banking Group (Lloyds) and Royal Bank of Scotland as well as two publicly owned banks: Northern Rock and Bradford & Bingley. UKFI has a number of objectives to:

- manage the shareholdings commercially to create and protect value for the taxpayer as shareholder;
- devise and execute a strategy for realising value for the government's investments in an orderly and active way over time; and
- pay due regard to the maintenance of financial stability and act in a way that promotes competition.

1.4 In his Mansion House speech in June 2013, the Chancellor of the Exchequer announced that options for selling shares in Lloyds were being considered and a sale would proceed only if it obtains value for the taxpayer. While UKFI devised and executed a strategy for selling the shares, the decision on the final form and timing of a sale rested with the Chancellor of the Exchequer.

Sale options

1.5 When planning to sell public assets, we expect departments to conduct a thorough review of all available sale options. There were two ways to sell the Lloyds shares:

- a private sale either to a domestic or foreign bank or to a large financial investor; or
- a capital markets transaction: an offering of shares or equity-linked securities to a wide range of institutions or retail investors (or both) in the UK and overseas.

Sale to another bank

1.6 Following the financial crisis, mergers and acquisitions activity among large banks had been muted and the only significant transactions involved the sale of weak banks to stronger banks. Lloyds, with a value of more than £50 billion in the summer of 2013 was ranked 14th in the world by market capitalisation, limiting to a handful the number of other banks with the financial resources to contemplate such a transaction. UKFI did not therefore receive any expressions of interest from other banks.

Sale to a large financial investor

1.7 The alternative was to sell a significant portion of the shareholding through a negotiated deal with a large financial investor, such as a Sovereign Wealth Fund. During 2012 and 2013, UKFI had been approached by three potential purchasers and informal discussions had taken place. A bilateral deal with a large financial investor would, however, have been difficult to justify unless the shares could be sold at, or at a premium to, the then prevailing market price. UKFI's discussions with these potential investors did not indicate that such a deal was likely. Nevertheless, UKFI continued informal discussions to assess the potential to involve such investors in any future capital markets transaction.

Capital markets transaction

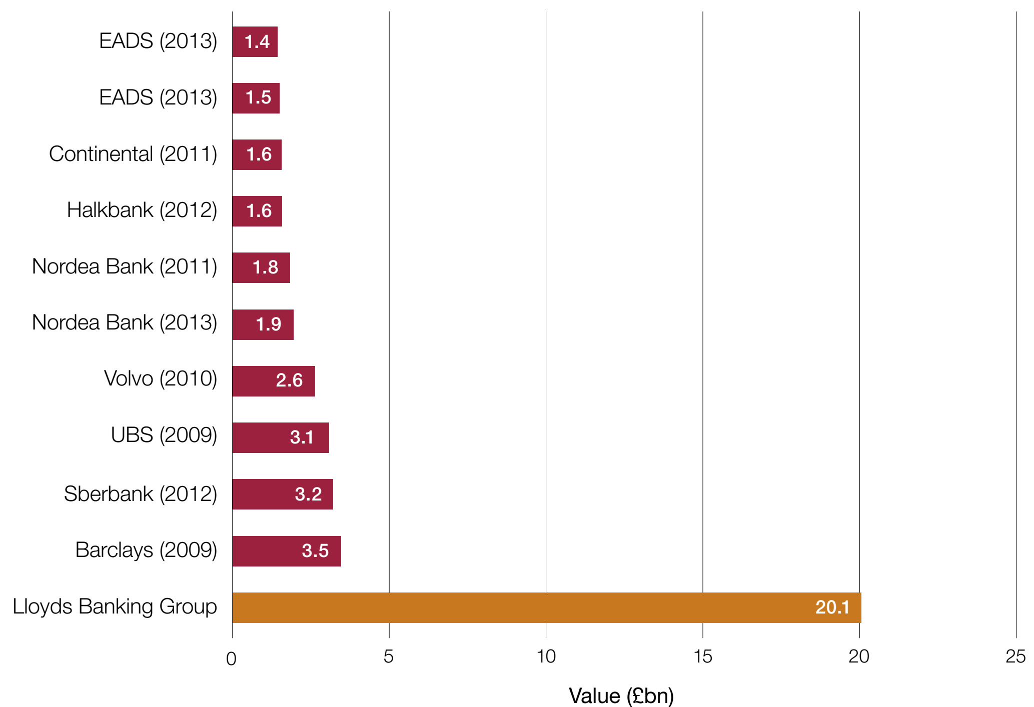
1.8 As a sale to another bank or a large investor was unlikely, UKFI had to address two key issues when considering a capital markets transaction:

- whether to hold a single sale of the entire shareholding or a series of sales; and
- how to minimise the risk of a change in market sentiment while a sale was underway.

1.9 At a market value of around £20 billion, the shareholding was well in excess of market capacity for a single sale at a competitive price. **Figure 1** illustrates how much larger a sale of the entire holding would be than recent comparable transactions. UKFI therefore decided that a series of sales over a period of time was likely to produce better value.

Figure 1

A sale of the entire shareholding would have been much larger than recent comparable sales



Note

1 Largest ten secondary share sales in the European market since 2008.

Source: JP Morgan, Dealogic, Bloomberg

1.10 The type of sale used at any point in a series of sales would be determined by market conditions at the time, as well as Lloyds' share price performance. There were a number of sale methods to choose from, as set out below.

Accelerated book-build

1.11 Investment banks, acting as book-runners, would market shares to institutional investors over a 12 to 48 hour period. Such a sale would not require publication of a detailed prospectus and would need little time to organise. This would minimise exposure to a change in the market, particularly if the transaction could be executed after the UK stock market closed and before it reopened the following day. However, the size of the sale could be constrained by the short execution period, which would favour large institutional investors able to react quickly.

Fully marketed offer

1.12 Shares would be sold to both institutional and individual investors. The inclusion of individual investors (often referred to as retail investors) would reduce reliance on demand from institutions and could be used to maximise competitive tension in the offer. Such a sale would have involved three to six months of preparation and marketing, publication of a prospectus and the announcement of a sale date. The lead time required would therefore increase exposure to market risk and limit flexibility on timing. But the potential size of a transaction would be increased by the prolonged offer period and the addition of demand from individual investors, who might also be prepared to pay more than institutional investors. This disposal method could be more appropriate for subsequent sales in periods of lower market risk.

Equity-linked offering

1.13 Rather than sell the shares directly, UKFI would sell a bond to institutional investors that could then be exchanged for shares at a set exercise price in the future. However, there was no guarantee that the shares would be sold as this would only occur if the share price exceeded the exercise price. This disposal method could be more appropriate for later sales, either to increase the size of the offer or as a standalone sale if market conditions were favourable.

Market 'dribble'

1.14 UKFI could arrange relatively small sales of shares on a regular basis during normal market trading. The number of shares sold each day would be restricted to an estimated 25 per cent of total daily trading volume in order to avoid creating downward price pressure. On the basis of average daily trading volumes during the summer of 2013, a sale of £1 billion (about 5 per cent of the shareholding) would take more than a month. A market 'dribble' could be an appropriate mechanism for disposing of shares at certain stages, including any residual holding at the end of a phased disposal programme.

Share buyback by Lloyds

1.15 In light of uncertainty around the amount of capital that banks will need under new international and UK rules, UKFI considered that Lloyds would continue to retain profits to increase its capital. Furthermore, Lloyds would also want to restart payment of ordinary dividends as soon as practicable, ruling out any share repurchase programme in the near term.

An accelerated book-build was the preferred method of sale

1.16 While the market backdrop in the summer of 2013 was broadly favourable, economic conditions had not fully recovered and there was uncertainty on how central banks might begin to roll back monetary stimulus measures, such as quantitative easing, in an orderly way. Given this continued uncertainty, UKFI considered that selling the shares at a fair price required a disposal method offering speed and simplicity of execution, such as an accelerated book-build. Other disposal methods would take significantly longer to plan and execute, increasing exposure to market risks.

1.17 Initiating the disposal programme with an accelerated book-build to institutional investors would not limit flexibility on the timing, size or method of future sales. After a standard lock-up period of 90 days during which the Treasury undertook not to sell further shares, further transactions could be arranged in line with market conditions at the time.

Part Two

Timing, structure and size of the sale

2.1 **Figure 2** overleaf shows the major influences on the Lloyds Banking Group (Lloyds) share price since the beginning of 2009. The FTSE 100 index had risen by more than 11 per cent over the year to the end of August 2013 and was trading close to its pre-financial crisis highs. There had also been strong investor interest in banks with the FTSE 350 Bank Index rising by 31 per cent over the year to August and Lloyds had been the strongest performer in that index, rising by nearly 114 per cent. Capital markets transactions had also increased, with £72 billion of shares issued in Europe up to August 2013, a 53 per cent increase compared with the same period in 2012.

2.2 Although the shares had performed strongly in 2013, United Kingdom Financial Investments Limited (UKFI) felt it needed to gain further assurance that the market price in the summer of 2013 reflected a fair value of Lloyds' business prospects. If such assurance could be obtained, decisions then needed to be taken on the structure and size of the accelerated book-build.

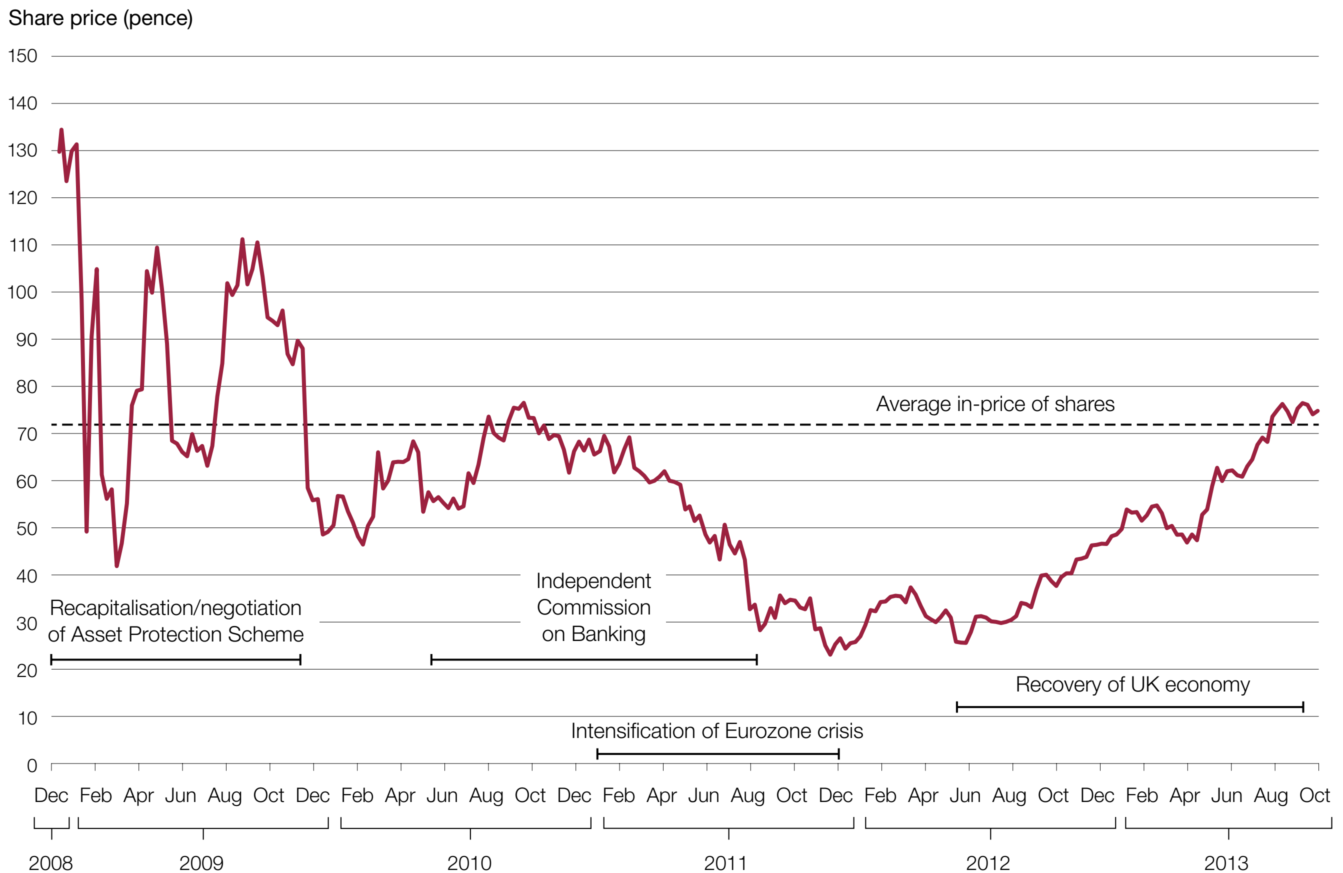
Valuing the shares

2.3 UKFI asked JP Morgan to analyse whether the market price of Lloyds shares reflected a fair valuation of the business. Lazard & Co, acting as UKFI's capital markets adviser, reviewed the analysis. Three valuation approaches were used:

- **Market based valuations:** reflecting market conditions in the summer of 2013.
- **Fundamental valuations:** including examining how the share price might change in response to changes in Lloyds' business results under various economic scenarios.
- **Stockbrokers' target prices:** reflecting their assessment of fair value and what the share price might be in a year's time.

2.4 A description of these valuation methods is at Appendix One. In determining whether the market price of the shares reflected fair value, JP Morgan and UKFI placed more emphasis on the market based valuations, which were then cross-checked to the fundamental valuations and brokers' target prices.

Figure 2
Major influences on Lloyds' share price since 2009

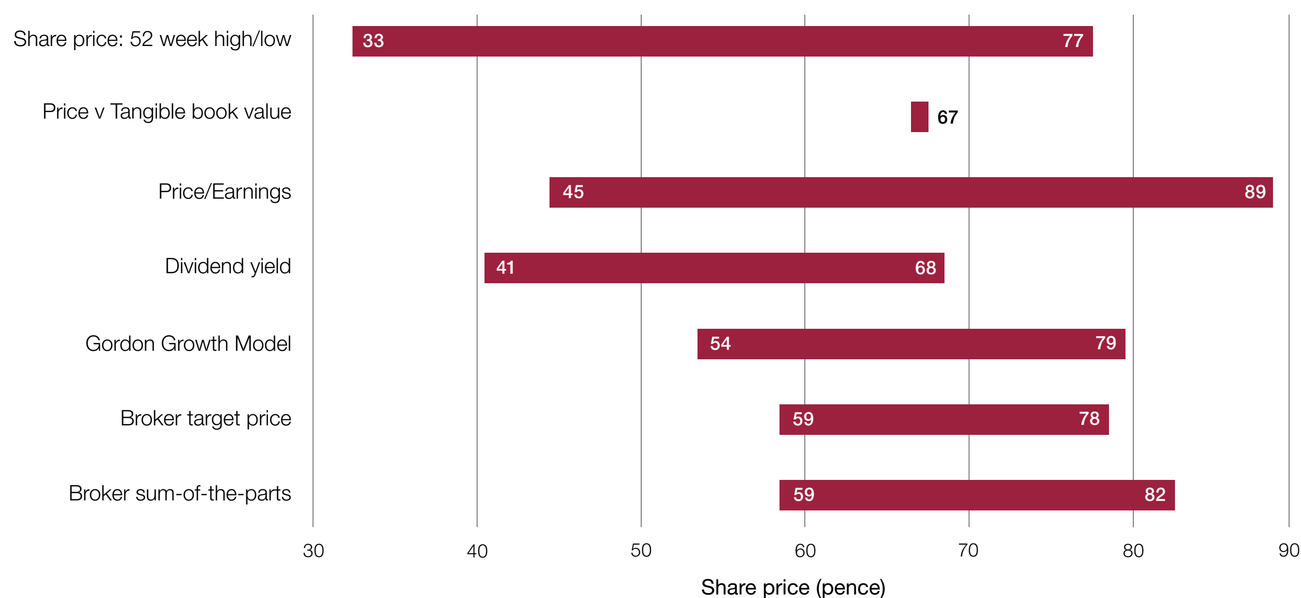


Source: Bloomberg, United Kingdom Financial Investments Limited

2.5 The range of valuations is shown in **Figure 3**. Applying a multiple either to book value or to earnings, the two approaches most widely used by investors, the market price of Lloyds shares in August 2013 of between 73p and 77p was at the upper end of the valuation range of 41p to 89p.

2.6 As investors were up to date with Lloyds' operational and financial performance following the release of its half-year results on 1 August 2013, a sale would have been possible immediately afterwards. Because the second half of August is usually a period in which capital markets activity is significantly reduced, the next opportunity for a sale was from early September to mid October. Following a close period of two weeks prior to Lloyds' statement of results for the third quarter of 2013 on 1 November, the window for a sale would re-open and remain open until mid December.

Figure 3
In August 2013, Lloyds' shares were trading at the upper end of the valuation range



Note
1 Based on data as at 27 August 2013.

Source: JP Morgan

Sale structure

2.7 For the first sale, UKFI aimed to get the best price while minimising exposure to changes in market sentiment. This meant putting a focus on the speed and simplicity of execution. A public announcement of the share sale could be made on the day of the transaction, allowing the Chancellor of the Exchequer to take a final decision in the minutes prior to the announcement. The sale itself could be completed less than 24 hours from launch and potentially overnight, further minimising exposure to market risk.

2.8 Once the sale had been launched, investment banks acting as book-runners, would invite investors to submit orders into a book of demand, stating their interest in terms of size and price. This process is known as a 'best efforts' accelerated book-build as the book-runners undertake to try to secure the best price possible, but without guaranteeing a particular price.

2.9 There were two ways that UKFI could achieve certainty on price prior to launching the sale:

- **Backstop:** the book-runners guarantee a minimum or backstop price. If the book-runners fail to secure buyers for all the shares at or above this price, they would undertake to buy the remaining shares at the backstop price. If a higher price than the backstop was secured, the extra proceeds could be shared between the Treasury and the book-runners; and a

- **Bought deal:** the shares could be sold to the book-runners at a negotiated or competitively determined price. The book-runners would then assume the risk for selling on the shares to institutions, retaining any gain and bearing any loss.

2.10 Both a backstopped and a bought deal transfer the pricing and execution risk from the Treasury to the book-runners. However, neither structure represented a completely transparent pricing mechanism in which UKFI could be certain that the price had been fully tested in the market. The price the book-runners agree to guarantee is either negotiated privately or can be subject to a limited competition between book-runners shortly before the sale takes place. In either case, the book-runners will factor in the risk they are bearing when deciding what price to guarantee.

2.11 In a backstopped deal, even with the prospect of a share of proceeds above the minimum price, the book-runners would be incentivised to manage their risk rather than achieve the best possible price for the taxpayer. Furthermore, if the book-runners did not succeed in selling the shares and had to retain them on their own account, a significant overhang of unsold shares could exist over which UKFI would not have any control and which could disrupt subsequent sales. UKFI decided correctly to retain pricing and execution risk.

Sale size

2.12 An initial sale of 3.6 billion to 7.1 billion shares (representing 5 per cent to 10 per cent of Lloyds' entire share capital) was seen by JP Morgan as an appropriate range to consider for an accelerated book-build. Investors would prefer to see the Treasury's holding reduced as fast as possible because the anticipation of future sales could limit any future increase in the share price. A sale of 5 per cent of the entire share capital represented approximately 13 per cent of the Treasury's shareholding, which would be seen by investors as a material reduction.

2.13 JP Morgan also considered that a sale of any less than 5 per cent of the entire share capital risked being perceived by investors as too small. On the other hand, a sale of 10 per cent of the entire share capital, at approximately £5 billion, would be 1.5 to 2 times larger than recent accelerated book-builds, and would test the limits of investor appetite for the shares. Against this backdrop, JP Morgan recommended an initial transaction size of 5 to 7 per cent (£2.5 billion to £3.5 billion) and UKFI correctly decided to sell 6 per cent.

Part Three

The outcome of the sale

3.1 Following approval from the Chancellor of the Exchequer, the sale was launched after the UK stock market closed on Monday 16 September 2013, when the shares were trading at just over 77p. The book-runners obtained offers from institutional investors and built a book of demand during the evening of 16 September. Lazard & Co, acting as United Kingdom Financial Investments Ltd (UKFI's) capital markets adviser, was present throughout the book-building and allocation process. A sale of just under 4.3 billion shares at 75p a share was completed before the market opened on 17 September, raising £3.2 billion. This part of the report examines whether:

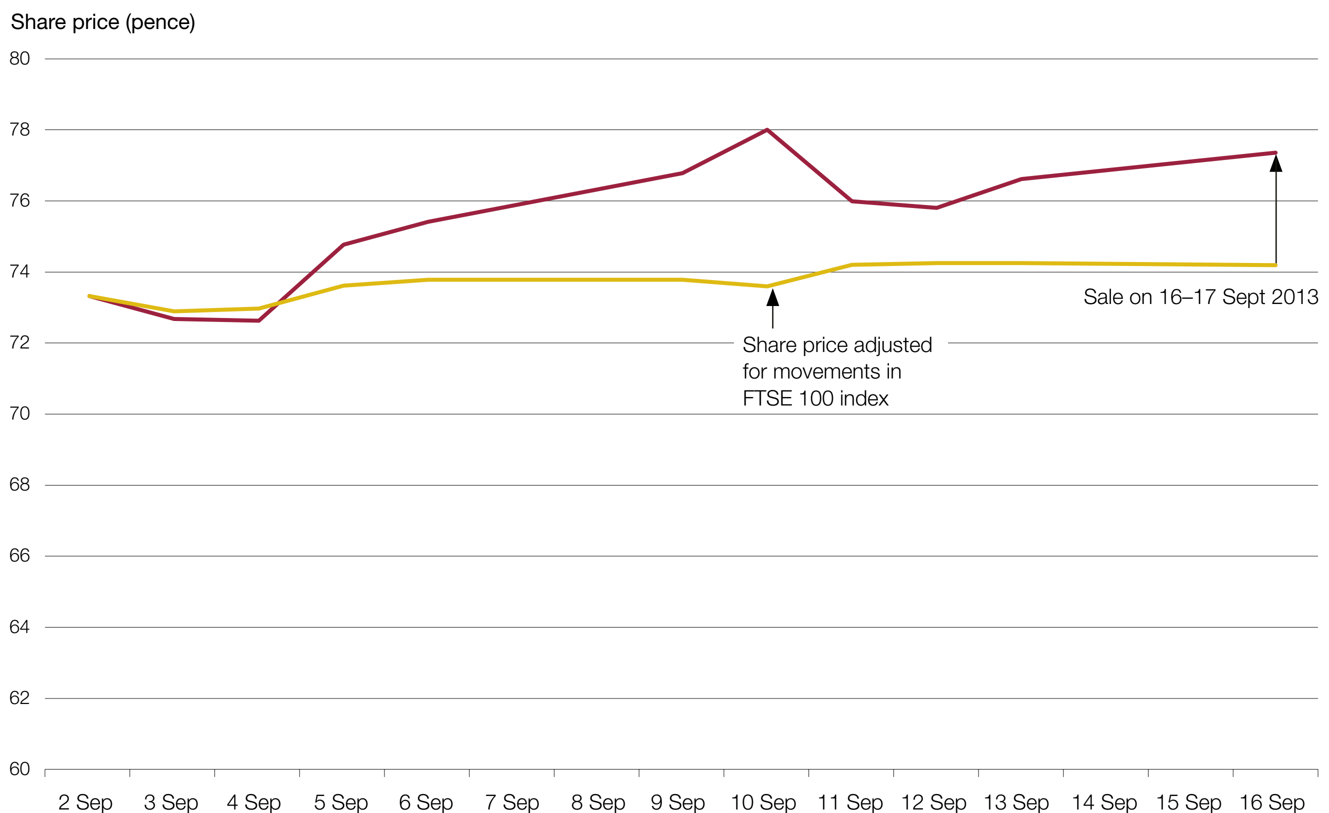
- the share price at the close of trading on 16 September reflected investors' valuations of Lloyds Banking Group (Lloyds), rather than the prospect of an imminent sale;
- the pricing of the shares and their allocation to investors was based on a thorough analysis of demand;
- the discount to the closing price at which the shares were sold was reasonable, in comparison with other sales;
- the shares performed in line with the market following the sale;
- the costs of arranging the sale were kept to a minimum; and
- whether the sale price represented a shortfall or gain for the taxpayer.

The closing price ahead of the sale

3.2 As UKFI would be selling shares that were already traded on the Stock Exchange, their market price immediately before the sale would provide a benchmark against which the price obtained could be measured. To maximise value, however, UKFI needed to guard against a fall in the market price. If it became known that a sale was about to take place, the price of the shares may fall in anticipation of additional supply in the market. Speculation around a sale had appeared regularly in the media throughout 2013. Speculation intensified in the summer as the market price of the shares approached and passed through the average price the Treasury had paid in 2009. Although speculation was mounting, share price movements in the two weeks ahead of the sale (**Figure 4**) suggest that UKFI's plans had not become known to market participants.

Figure 4

In the two weeks ahead of the sale, the share price rose slightly, indicating that the sale had not been anticipated by investors



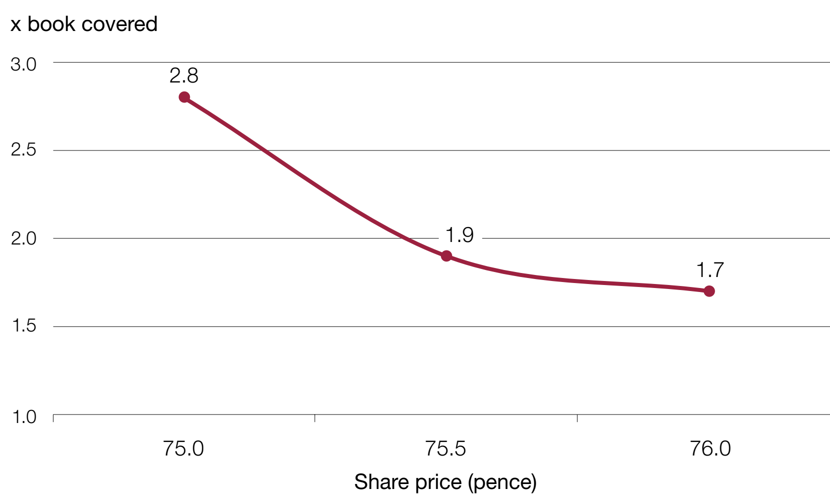
Source: Bloomberg

Demand, pricing and allocation of the shares

3.3 A key determinant of the sale price would be the presence of early demand from a wide range of institutions that exceeded the number of shares on offer. Within an hour of the sale opening on the Monday evening, demand had matched the number of shares on offer. To maintain momentum, UKFI instructed the book-runners to feed this information back to investors. During the following two hours of book-building, demand increased to 2 times the shares on offer. By the close of book-building at 10 pm, demand was 2.8 times the shares on offer at a price of 75p and fell to 1.7 times at 76p a share (**Figure 5**). This level of demand compares well with an average of 2.5 times coverage in other accelerated book-builds.

Figure 5

Demand for the shares fell away at prices above 75p a share



Source: United Kingdom Financial Investments Limited

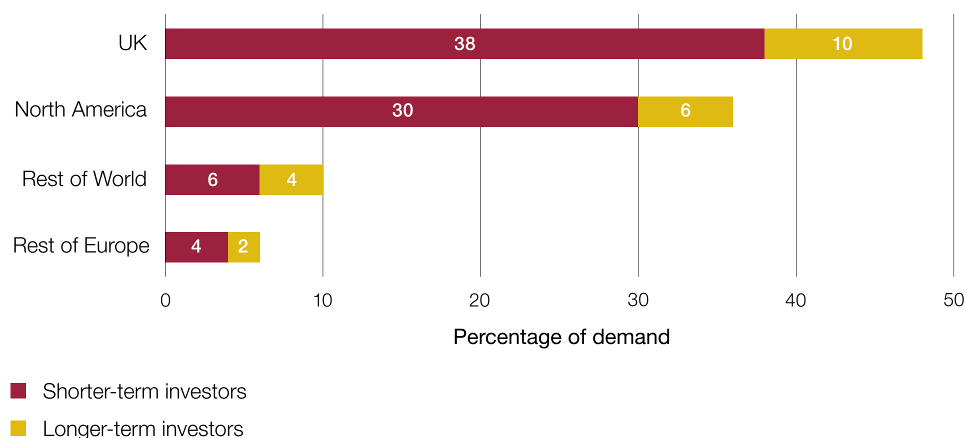
3.4 UKFI's overall objective was to maximise price while allocating shares to investors in such a way as to ensure a positive but stable aftermarket. This meant allocating shares to institutions that were likely to be supportive in the immediate aftermarket as well as over the longer term, rather than to institutions that were likely to seek to sell the shares soon after their allocation. To assist the allocation, each institution was classified as a longer-term investor (such as a pension fund) or as an investor that was likely to have a shorter-term investment horizon and might sell the shares soon afterwards.

3.5 At a price of 75p a share, 78 per cent of demand in the final book came from shorter-term investors (**Figure 6**), with longer-term investors accounting for only 22 per cent of demand. The book-runners considered that demand from longer-term investors had been subdued given the robust recent growth in the share price, which was thought to reflect a full valuation of Lloyds' business prospects, based on prevailing market conditions. The book-runners also advised UKFI that orders from shorter-term investors were inflated in anticipation of a significant scaling back of allocations. Any allocations in excess of shorter-term investors' true demand were likely to be sold soon after the sale, risking an unstable after-market and negative perceptions among longer-term investors in subsequent sales.

3.6 Pricing the shares slightly higher, at 75.5p or 76p (equivalent to additional proceeds of up to £40 million), would have meant that more than 60 per cent of the shares would be allocated to shorter-term investors, with similar concerns about a weak aftermarket and negative perceptions affecting future sales. For this reason UKFI, having secured the Chancellor of the Exchequer's approval, decided to price the sale at 75p a share and instructed the book-runners to aim to meet around 85 per cent of demand from longer-term investors, while restricting shorter-term investors to around 20 per cent. The final decision for UKFI was whether to accept the book-runners' recommended allocations to individual institutions.

Figure 6

Seventy-eight per cent of demand came from shorter-term investors



Source: United Kingdom Financial Investments Limited

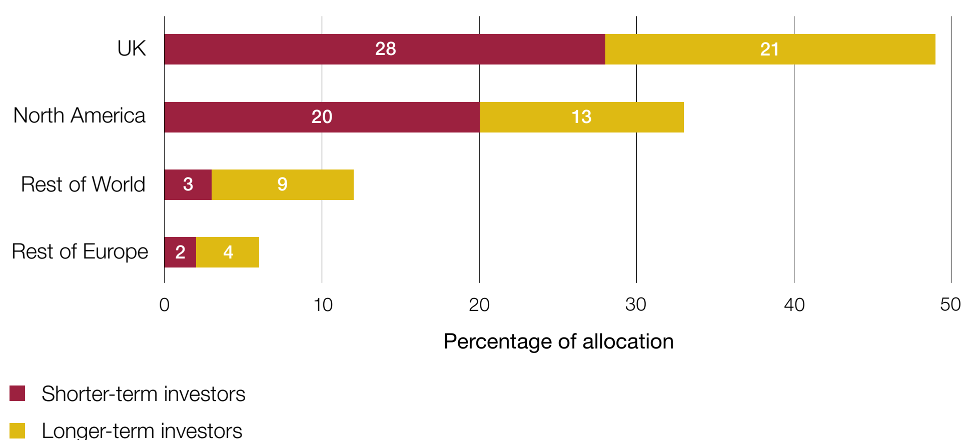
3.7 Lazard & Co discussed the allocations to investors with the book-runners to ensure they complied with the criteria set by UKFI. Ahead of the market reopening, UKFI discussed and agreed final allocations with the book-runners and Lazard & Co. Around 80 per cent of demand from longer-term investors was satisfied, while shorter-term investors received 25 per cent of the shares demanded. Given the much greater level of demand from shorter-term as opposed to longer-term investors, this still meant that 53 per cent of the shares were allocated to shorter-term investors and 47 per cent to longer-term investors (**Figure 7**).

Discount to the closing price

3.8 In any single sale of a large number of shares investors will usually only be willing to buy at a discount to the prevailing market price. There are a number of influences on the size of this discount, including the absolute size of the sale and its size relative to the average volume of trading in the shares each day and as a proportion of a company's issued share capital. Market conditions and the price performance of the shares in the run-up to a sale also play a part.

Figure 7

Fifty-three per cent of the shares had to be allocated to shorter-term investors



Shorter-term investors

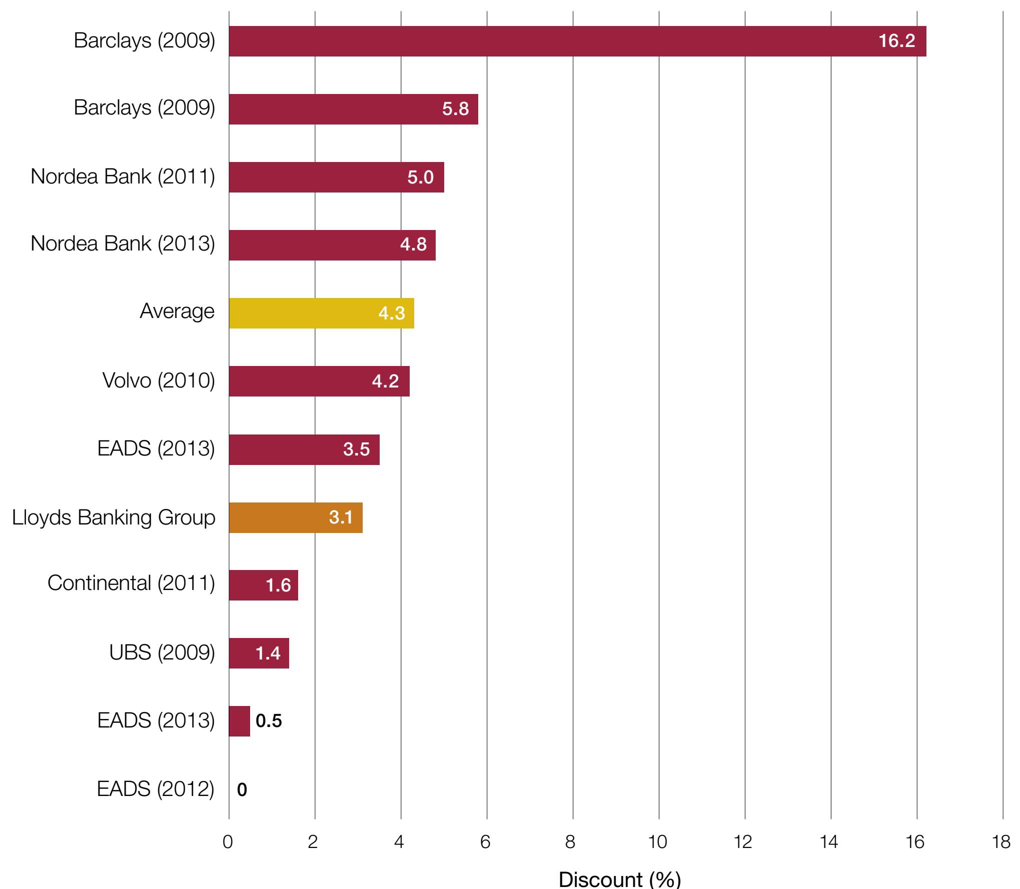
Longer-term investors

Source: United Kingdom Financial Investments Limited

3.9 Ahead of the sale, JP Morgan advised UKFI that a discount of 3 to 5 per cent to the prevailing market price could be expected. **Figure 8** shows that, at 3 per cent, the actual discount on the sale compares well with the average discount of just over 4 per cent for the ten largest accelerated book-builds since 2008.

Figure 8

The discount to the market price compared well with other sales



Note

1 Largest ten accelerated book-built sales in the European market since 2008.

Source: JP Morgan

The after-market

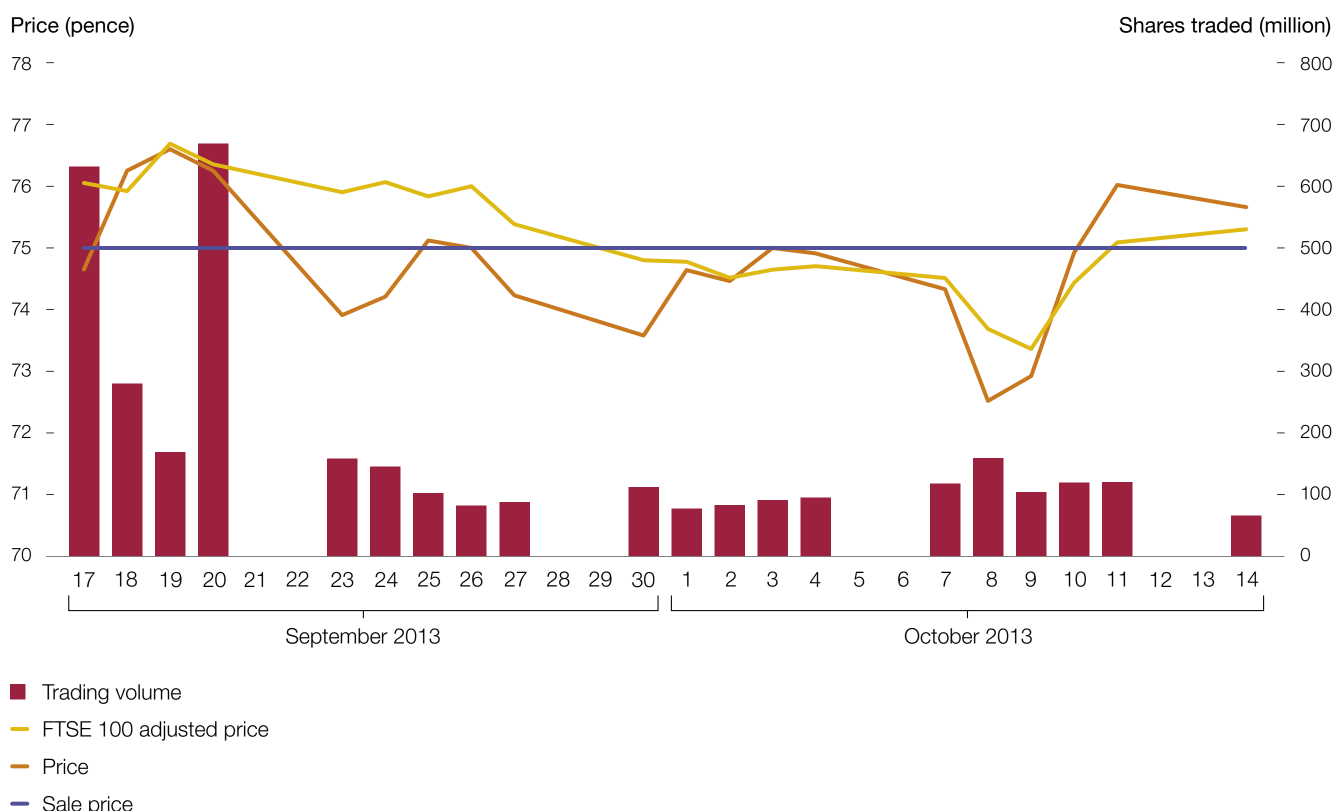
3.10 At the end of the first week of trading the market price of the shares fell slightly from 77p to 74p. In the four weeks following the sale, the shares traded at between 73p and 77p mirroring changes in the FTSE 100 index (**Figure 9**) and within the price range seen in trading since August 2013.

3.11 Over 2.5 billion shares were traded across all platforms in the four days after the sale with peaks of trading seen on the opening day (Tuesday 17 September) and on Friday 20 September, when investors had to pay for the shares. UKFI does not hold detailed information on who was selling and who was buying the shares in the aftermarket. To assess whether shorter-term investors had sold their allocated shares, we examined extracts from Lloyds' share register at the end of August and September.

3.12 The extracts from the register contained information on only four institutions regarded as shorter-term investors. One institution had reduced its shareholding by about 10 per cent, there was no change in two institutions' holdings, and one institution increased its holding by around 20 per cent. A possible reason for this limited information is that investors often use nominee accounts where shares are held on their behalf by stockbrokers. The use of nominee accounts facilitates the electronic trading of shares, which are typically 'pooled' so that there will only be one entry in the register, in the stockbroker's name. As a result, we have not been able to establish who was buying and who was selling in the aftermarket and whether allocations of shares to investors were a reasonable reflection of their actual behaviour in the aftermarket.

Figure 9

There was little change in the share price after the sale



Note

1 Trading volume figures for transactions on London Stock Exchange only.

Source: Bloomberg

Costs of arranging the sale

3.13 In July 2013, following a competitive process, UKFI established a panel of potential advisers and book-runners (who would organise and market the sale). The selection of JP Morgan, Bank of America Merrill Lynch and UBS Investment Bank as book-runners for the first sale of shares in Lloyds was reviewed by a non-executive member of the UKFI Board of Directors. Lazard & Co acted as UKFI's capital markets adviser and Slaughter and May provided legal advice.

3.14 It is standard in an accelerated book-build for the book-runners to charge a seller of shares a fee and buyers a commission, expressed as a percentage of the proceeds raised in the sale. Following negotiations, however, the agreements with the book-runners specified that no fees were payable by UKFI. This outcome reflected the strong competition among investment banks to win such a high-profile mandate and the opportunity to work on future sales. Information is not publicly available for fees charged on accelerated book-builds but, based on competitive quotes provided to UKFI, this fee could have amounted to up to £4.8 million. The fee arrangements also compared favourably with state disposals of bank shares in the US and Sweden.

3.15 In line with standard arrangements when listed shares are bought or sold, investors paid £4.7 million in selling commission to the book-runners. However, UKFI also negotiated this aspect of the sale with the book-runners and received a payment of 25 per cent (£1.2 million) of the commissions charged to investors. As the selling commission was paid by investors in addition to the 75p share price, it could be argued that the sale price was lower to the extent of this indirect cost, though in practice investors tend to see this as a standard transaction cost. Lazard & Co did not charge a fee for its role as capital markets adviser and fees for legal advice amounted to less than £100,000.

Taxpayer gain or shortfall

3.16 In 2009, the first report on maintaining financial stability published by the National Audit Office concluded that the scale of the economic and social costs from the collapse of one or more major UK banks was difficult to envision and that the interventions to support the banks were justified.[3] However, the final cost to the taxpayer would not be known for a number of years. As the majority of the support in the form of guarantees has been removed and the loans are being progressively repaid, the major determinant of the final cost will be the prices obtained for the taxpayers' shareholdings in Lloyds and Royal Bank of Scotland when they are sold.

3 Comptroller and Auditor General, *HM Treasury: Maintaining financial stability across the United Kingdom's banking system*, Session 2009-10, HC 91, National Audit Office, December 2009, paragraph 19.

3.17 The government's purchases of shares in Lloyds took place during 2009 at a gross cost of £20.3 billion, an average cost per share of 73.6p. Taking into account the fees the Treasury received from Lloyds for underwriting an issue of additional shares to existing investors in December 2009, the net cost was £19.9 billion (**Figure 10**), equivalent to 72.2p per share. Ahead of the sale, the taxpayer owned 27.6 billion shares, representing just under 39 per cent of Lloyds' ordinary share capital. Lloyds has paid no dividends on its ordinary shares since the share purchases.

3.18 A comparison of the average in-price of 72.2p a share with the sale price of 75p gives a gain, in purely cash terms, of just under £120 million. This gain does not, however, take account of the cost of funding the purchases of the shares.

3.19 The money needed to make the original investments in 2009 was provided from cash and by issuing Treasury Bills (very short-term borrowing). These short-term measures were replaced during 2010 and 2011 by longer-term funding in the form of Gilts (interest-bearing government bonds purchased by investors for periods of up to 50 years), at a cost of just under 3 per cent a year. If this cost of financing is taken into account, the sale resulted in a shortfall of £230 million. This shortfall should be seen as part of the cost of securing the benefits of financial stability during the financial crisis.

3.20 There are alternative methods of calculating a gain or shortfall. Using these alternatives would produce a larger shortfall, but they are considered by the Treasury to be more appropriate for making decisions on the allocation of resources within the normal limits of public expenditure, or reflect the commercial returns expected by a private sector investor in bank shares.

Figure 10

The support provided to Lloyds in 2009

Support provided	Date	£ billion
Initial agreements to purchase ordinary and preference shares in Lloyds TSB and HBOS	January 2009	12.96
Conversion of preference shares to ordinary shares	June 2009	1.51
Purchase of further shares in rights issue by Lloyds Banking Group	December 2009	5.85
Total		**20.32**
Fees received	December 2009	(0.38)
Net cash outlay		**19.94**

Note

1 All figures are in cash terms.

Source: United Kingdom Financial Investments Limited

Appendix One

Valuing the shares

Market based valuations

Share price performance

1 In the summer of 2013, Lloyds shares were trading close to a 12-month high. JP Morgan considered that the rise in the share price reflected a significant improvement in investors' confidence following the Eurozone crisis, combined with recognition of the substantial progress Lloyds was making in removing risks from its business and data showing an improvement in the UK economy.

Price to tangible book value

2 The ratio of share price to tangible book value (the assets that could be sold minus liabilities) is a widely used method to value banks. The valuation would be driven by investors' expectations for the level of profitability, compared with the equity capital needed to meet regulatory requirements. Lloyds had announced a plan to increase its capital by the end of 2013, in line with regulatory requirements and market expectations, reassuring investors that it would be appropriately capitalised. The analysis by JP Morgan indicated that the shares were trading at a slight premium relative to other banks on then current market estimates.

Price to earnings multiple

3 The ratio of share price to earnings is also a widely used method for the valuation of shares and can apply to either current or predicted earnings. If, like Lloyds, a company's profits are recovering, investors will tend to look at predicted earnings. At a share price of 14 times estimated earnings in 2013, Lloyds' valuation multiple was high compared with other banks (a multiple of just over 11). Historically, Lloyds traded at an average multiple of 10.9, similar to the broader UK banking sector (10.7). On the basis of estimated earnings for 2013, Lloyds' fair value should have been within a range of 45p to 89p and, using estimated earnings for 2015, would imply a similar range of 48p to 88p (discounted to 2013 price levels), if brokers' earnings forecasts were achieved. JP Morgan considered that the recovery in the UK economy and Lloyds' implementation of its business strategy should result in a strong recovery in earnings, but this would be subject to any adverse changes in financial market conditions.

Dividend yield

4 Investors also use dividend yield (dividend per share as a percentage of the share price) to value a company. Given that Lloyds was yet to restart dividend payments, JP Morgan undertook the valuation using analyst consensus expectations of what future dividends might be paid.

5 Comparable banks traded on a wide range of yields, from around 4 per cent to 7 per cent. Banks need to retain profits to have sufficient capital to grow lending, while maintaining their regulatory capital ratios. Raising the dividend does not therefore lead automatically to a higher share price. Typically, a high dividend yield implies that a bank would grow slowly over the long term as it retains relatively little profit to fund future expansion of the business. Although investors would ascribe value to the certainty of Lloyds paying dividends again, expectations of higher dividends in the future may not translate into a significantly higher share price.

Fundamental valuation

6 JP Morgan also considered two approaches to fundamental value, the Gordon Growth model and the dividend discount model. These models considered scenarios that differ from consensus forecasts and their impact on the price of Lloyds shares. The Gordon Growth model calculates a share price relative to book value with reference to the profitability, cost of equity and expected long-term growth rate of a business. In contrast, the dividend discount model assumes each year that all surplus cash is returned to the owners and the value of the company is the present value of those cash flows. Of the two models, the dividend discount model is more appropriate for an acquirer of an entire business rather than a minority shareholder, seeking to sell all or part of a shareholding. Typically a publicly listed company would not make a full distribution of profits as it would lead to dividends fluctuating with changes in financial results. Instead, companies will usually aim to deliver a more predictable and progressive dividend. JP Morgan therefore based its analysis on the Gordon Growth model.

7 For a retail and commercial bank such as Lloyds, profitability is largely determined by four key factors: the net interest margin on lending and other assets; growth in the volume of loans made; reduced losses on loans; and control of running costs. JP Morgan considered five possible scenarios up to 2015, adjusting these factors within a range of assumptions for the cost and expected return on equity. On this basis the Gordon growth model produced an indicative price range of 54p to 79p a share.

Stockbrokers’ target prices

8 Stockbrokers typically look forward 12 months and predict the share price based on their assessment of fair value. These target prices generate a wide range, reflecting the differing views of the 23 contributing brokers on variables such as the economy and the strength of Lloyds’ business. Excluding the most optimistic and pessimistic target prices, and discounting to a present value, the predicted share value was within a range from 59p to 78p. In addition to target price, some stockbrokers publish a valuation derived from separately valuing each of Lloyds’ major business units. Collating these estimates and discounting to a present value, produced a value ranging from 59p to 82p a share.

Appendix Two

Our audit approach and evidence base

1 This study examined the value for money of the first sale of shares in Lloyds Banking Group (Lloyds). We reviewed:

- whether the most appropriate sale method was chosen;
- whether the sale was timed and structured appropriately;
- whether the price obtained was reasonable; and
- whether there was a gain of shortfall for the taxpayer.

2 We applied an analytical framework with evaluative criteria which consider what arrangements would be optimal for a sale of shares already trading on the stock market. The evaluative criteria have been developed by drawing on the National Audit Office's previous work on asset sales, privatisations and commercialisations.

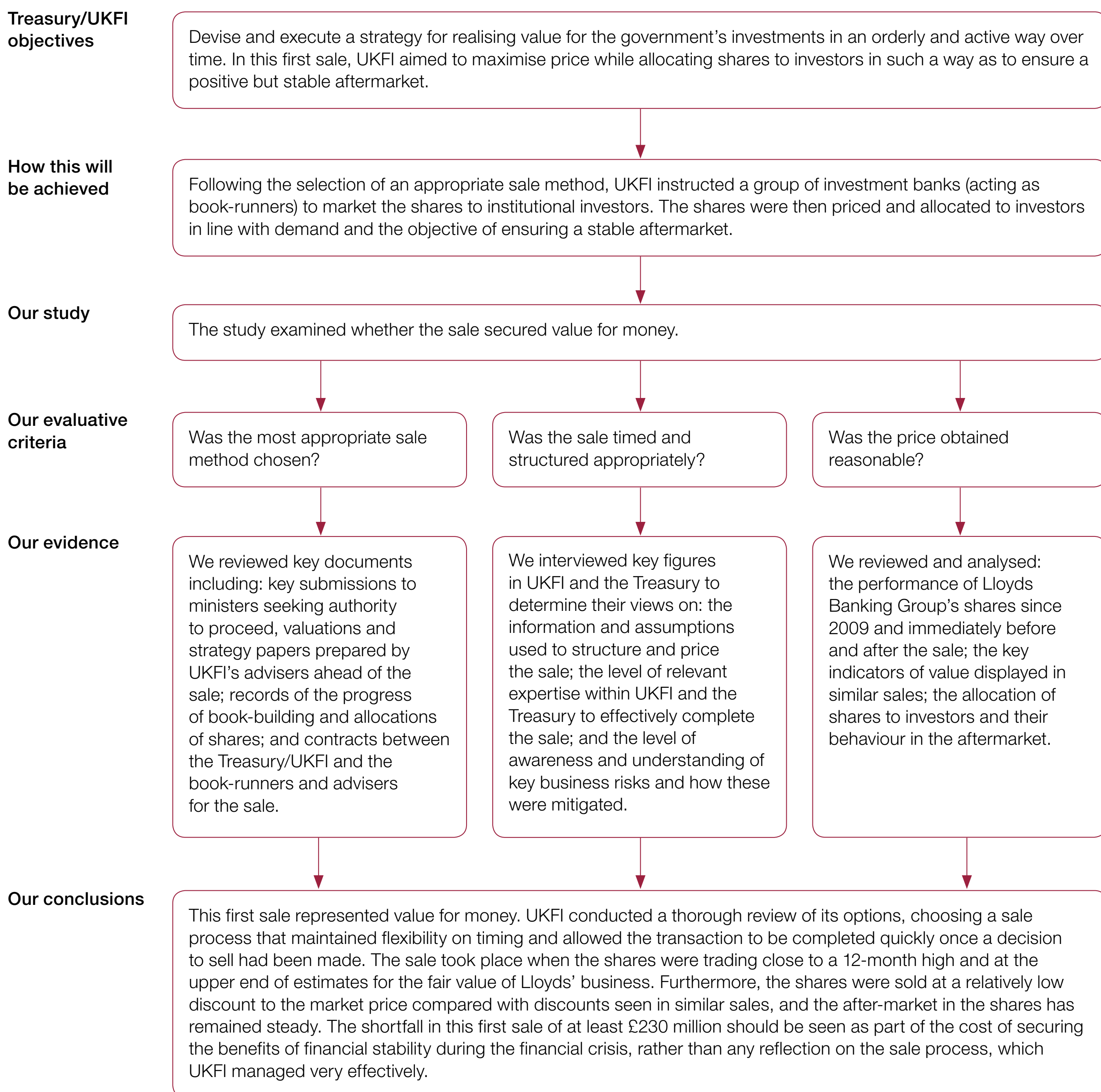
3 Our audit approach is summarised in **Figure 11** overleaf.

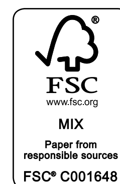
Our evidence base

4 Our conclusion on whether the first sale of shares in Lloyds offered value for money was reached following an analysis of evidence collected between September and November 2013. We assessed the degree to which all parties to the sale had the relevant information and expertise to price and structure the sale:

- We reviewed key documents including: key submissions to ministers seeking authority to proceed, valuations and strategy papers prepared by UKFI's advisers ahead of the sale; records of the progress of book-building and allocations of shares; and contracts between the Treasury/UKFI and the book-runners and advisers for the sale.
- We interviewed key figures in UKFI and the Treasury to determine their views on: the information and assumptions used to structure and price the sale; the level of relevant expertise within UKFI and the Treasury to effectively complete the sale; and the level of awareness and understanding of key business risks and how these were mitigated.
- We reviewed and analysed: the performance of Lloyds shares since 2009 and immediately before and after the sale; the key indicators of value displayed in similar sales; the allocation of shares to investors and their behaviour in the aftermarket.

Figure 11
Our audit approach





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