## Northern Rock - Shareholders Are Not Seduced By Virgin

The future of Northern Rock, the beleaguered UK bank still remains uncertain after the deadline of 4 February 2008 for bids from interested parties.

The UK government is seeking to convert the estimated GBP25 billion of loans into bonds which will be sold in the open market. In order to make these bonds attractive, the government will guarantee them.

It has now emerged that in addition to requiring a fee for the guarantee, which could be as much as GBP400 million, the UK government is insisting that the guarantee is limited to 3 years. This means that the bonds will only have a 3 year life, and at the end of that time they will need to be replaced by alternative funding.

In practice, Northern Rock will have to seriously downsize, if not decimate, its mortgage portfolio. It can only achieve this target by actively encouraging mortgage holders to migrate to other bank and building society lenders.

Due to the severity of this requirement by the government, one of the bidders, Olivant, has pulled out.

This leaves 2 proposals on the table for Northern Rock.

The offer from Sir Richard Branson, of the Virgin group, is considered to be the front runner. Virgin's offer is complex and involves merging Northern Rock into Virgin Money.

Northern Rock currently has 420 million shares in issue. Existing shareholders will be asked to subscribe to a rights issue and purchase 6 new shares at 25 pence for each share they currently hold. This equates to GBP1.50 x GBP420 million which equals GBP630 million of new money.

Total shares held by existing shareholders will then be 420 million times 6, which equals 2,520 million, plus the original 420 million, which equals 2,940 million shares.

Virgin proposes that there will be 6,600 million shares. The current shareholders will hold 2,940 million while Virgin will hold 3,660 million. This means that the existing shareholders will see a dilution of their combined stake to 45%, while Virgin holds a majority 55%.

Virgin will purchase 2,600 milllion shares at GBP25 pence which equals GBP650 million. In addition, they will receive a further 1,000 million shares as Virgin Money will be merged with Northern Rock. This values Virgin Money at GBP250 million and most commentators consider this a highly inflated figure.

What this means is that Virgin is acquiring Northern Rock for a cash payment of GBP650 million. When one considers that Northern Rock has some GBP100 billion of assets, is one of the top 5 UK mortgage lenders with a market share of 20 percent, this seems a most attractive deal for Sir Richard Branson.

Many consider the Virgin bid to be favoured by the UK government. Indeed Sir Richard just happened to be with the Prime Minister as part of a UK trade delegation to China in January 2008, and he has a longstanding relationship with the Labour Party which was nurtured during the Blair years.

The Virgin group is a private entity and not listed on any stock market. As such its financial structure is opaque. Sir Richard is a persistent self publicist, and a shrewd and ruthless operator. He does have an informal, beach bum appearance. Unlike most beach bums from the Caribbean, Sir Richard owns his own private island of Necker. Concerns have also been expressed at his non UK status for tax purposes and the likelihood that very little tax will be returned to the exchequer if and when Virgin sell the revamped bank in several years time.

In fact Mr Vince Cable, a Liberal Democrat MP, has made reference to Branson's past unlawful behaviour in that he allegedly evaded purchase tax in 1971 and agreed to pay penalties in order to avoid a criminal prosecution.

From the viewpoint of shareholders, the Virgin offer is unattractive. Many shareholders bought their shares 1 year ago when they were priced at GBP12. Due to the adverse publicity, the shares are currently just under GBP1.

Many shareholders are incensed that Branson will be purchasing shares at just 25 pence. Even in the current and extraordinary market conditions, the shares are quoted at around 4 times this figure. The Virgin proposal also expects shareholders to subscribe to a rights issue based on a purchase of a further 6 share at 25 pence for each existing share held. This would raise GBP630 million.

The new money provided by existing shareholders is only slightly less than the GBP650 million which will be injected by Virgin. However, Virgin acquires a 55% controlling stake in the company.

Although the UK government have provided major funds for Northern Rock, it should be remembered that from a legal standpoint, the company is owned by the shareholders, and not the government. The shareholders have already flexed their muscles at the Extraordinary General Meeting of 15 January 2008 at which a resolution was passed to limit the authority of the Directors to issue shares. Clearly, any rescue plan for Northern Rock would need the approval of existing shareholders. At present, there appears very little chance of the shareholders handing over the company to Sir Richard Branson.

The response to this exercise of shareholder power by the UK government is lamentable. They issue repeated threats to nationalise the bank if shareholders are uncooperative. These threats are empty gestures as the spectre of nationalisation haunts New Labour, and the record of public ownership in the UK is, as elsewhere, unimpressive. Talk of temporary nationalisation, as a way of cheating shareholders of their rights, demonstrates the cynical disregard of the government for UK company law. This is a measure which would certainly meet with a legal challenge from shareholders.

The alternative proposal is an internal rescue plan. Some GBP500 million of new funds would be raised from a rights issue. This is feasible as existing shareholders are far more likely to subscribe additional funds to this proposal which effectively safeguards their interests rather than give funds to a company which is being handed to Sir Richard Branson.

On 10 February 2008, several banks have offered to securities around one half of the loans provided by the government to Northern Rock. This means that the UK government would need to guarantee some GBP13 billion of bond issues as opposed to GBP25 billion. On balance, this move will weaken the Virgin bid.

## About the Author

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