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Mr. Adrian Bailey MP
Chairman
Business, Innovation and Skills Select Committee
Committee Office
House of Commons
London SW1A 0AA

18 October 2013

Dear Adrian,

BIS SELECT COMMITTEE INQUIRY INTO ROYAL MAIL PRIVATISATION

During my oral evidence session on Royal Mail privatisation on Wednesday 9 October I offered to write to you with further information on some of the areas of questioning. I am happy to provide, below, further background information on the valuation of the Company, the valuation of Royal Mail's property portfolio, the length of the Company Prospectus, and the rules relating to employees who leave the Company within three years of receiving their free share allocation.

Sale objectives and setting the price range

<u>Sale objectives</u>

The Government's primary objective in relation to Royal Mail and postal market reforms has been to safeguard the universal postal service in the UK. Richard Hooper concluded in his independent report of 2008 (updated in 2010) that the universal service was under threat. He recommended that Royal Mail needed access to private sector capital and commercial disciplines in order to become more flexible and responsive to the dynamics of the competitive markets in which it operates.

The Postal Services Act 2011 gave Government the powers to sell shares in Royal Mail in order to give Royal Mail future access to private capital and commercial disciplines. We published the objectives for the sale of shares on 25 April 2013:

"The Government will secure the universal postal service for the benefit of all users by securing Royal Mail's future through the introduction of private sector capital and associated disciplines.

This will be achieved through:

- delivering a sale of shares in Royal Mail within this Parliament;

- creating an employee share scheme that, as Parliament has decided, will lead to at least 10% of the company in employee ownership, to drive stronger staff engagement; and

- delivering a financial outcome for the taxpayer, which when considered in the context of the overarching policy objective, represents overall value for money.

Value for money has therefore been central to our strategy as we have taken forward the sale of shares through an Initial Public Offering (IPO). Delivering value for money is about more than just the level of proceeds received on day one. Our long-term strategy to safeguard the universal service and deliver value for money for the taxpayer involves not only getting good value for the initial stake sold but also getting good value for the residual stake held by Government (30% of the Company assuming exercising in full the Over-allotment Option), and leaving Royal Mail in a strong, sustainable position capable of accessing the capital markets in the future.

As I set out in my oral evidence to the Committee, we are focused on the long-term success of Royal Mail and believe that value for money should be measured over the medium term. Our objective required us to have a positive share price performance supported by a high-quality, long-term investor base and a Company that is operating successfully as a listed entity.

Setting the price of the initial stake

The practical consequence of the objectives set out above was that the final price was set at a level that ensured:

- a successful transaction execution;

- good value for this first sale;

- the possibility of further sales by Government at good value in the medium-term; and

- the Company being left in a position capable of accessing the equity markets in the medium to long-term.

The Committee asked me about how we had formulated the price range of £2.6bn to £3.3bn for 100% of the equity value of the Company included in the Prospectus published on 27 September. Our Global Coordinators (Goldman Sachs and UBS, together the "GloCos") recommended this price range following an exhaustive process culminating in a final price range recommendation provided ahead of the publication of the Prospectus. Our independent advisor (Lazard) endorsed the price range.

This process comprised a combination of rigorous market testing and extensive analysis of comparable companies in the sector.

Over the twelve months prior to IPO, Royal Mail's management met a range of high quality institutions of the type that would form the core of a long-term, supportive investor base. These included pension funds and life insurers in the UK and overseas.

In August 2013, as the date of the IPO approached, this list of potential investors was narrowed down to a focused group of approximately 20 investors, selected on the basis of feedback gathered during the investor engagement process and, in particular, their understanding of the risks inherent in the Company's industrial relations.

This was a key point in the transaction process. During the second half of August, management of the Company advised us that, in their view, a new pay agreement was no longer achievable prior to IPO and that the Communication Workers Union (CWU) were likely to ballot for strike action at or around the time of the bookbuild. This was not the base planning assumption that had been used prior to this point and we were aware that this development could be a significant negative factor for investors. In early September 2013, the management team and the GloCos therefore engaged further with this group of investors, in particular updating them as to the latest industrial relations (IR) position. The result of this change to the IR position meant that there were some potential investors who stated that they were not willing to invest at all and many others who focused on the business and financial implications of strike action. This process of engagement ahead of launching an IPO is known as 'pilot fishing'.

In addition to the market testing, a valuation assessment was made which included a review of comparable quoted postal companies (including Bpost, Deutsche Post, Austria Post and PostNL) on a range of key metrics such as valuation multiples and dividend yields.

Bottom of the price range: Based on the pilot fishing process, sufficient demand indications were received broadly to cover the book of shares to be sold. These demand indications were generally in the lower part of the price range announced on 27 September and indeed some were lower still. The GloCos judged that the bottom of the range was robust enough to factor in any reasonably foreseeable escalating IR situation during the offer process.

Top of the price range: Again based on pilot fishing, the GloCos initially suggested a top end of the range of £3.1bn (with potential for upward revision) and this subsequently moved to £3.2bn. However, following ongoing positive feedback in the investor education and further discussions between Lazard and HMG it was proposed that the top end of the range should be increased to £3.3bn. This was still regarded as compatible with securing a stable, long term shareholder base as a foundation for achieving value in future sell-downs of the Government's retained stake whilst also taking into account the material risks associated at the time with the ongoing IR situation and the market risks arising from possible US default and the fact that the recent IPO of BPost (a key comparable) was trading below issue price.

Final pricing: Given final demand indications from the GloCos, it was agreed that 330p was an appropriate valuation of our shareholding. This was endorsed by Lazard. Based on market benchmarks this represented a full year to March 2014(E) dividend yield of 6.1% based on the notional dividend of £200m for the full year described in the Prospectus and a full year March 2014(E) EV/EBITDA of 5.5x[1].

Revising the price range upwards late in the bookbuild was considered given the demand generated. However this was not pursued based on an assessment of the composition of demand in the order book and an assessment of where demand would taper off, especially from informed potential long-term investors. After the market was provided with price guidance on Friday 4th October, (narrowing the initial price range of 260p - 330p to 300p - 330p), a number of the key long-only accounts expressed concern over the possibility that the top of the range might be revised above 330p; a number of other long-only accounts also indicated order sizes reducing as the price rose up to 330p. In addition, execution risk was pointed to by the GloCos

[1] based on analyst consensus estimates

(including there being limited precedents with variable outcomes) as well as the necessity, should we re-price, to offer two days of withdrawal rights to retail investors with associated timetable and market risk. Consequently, the Glocos recommended against increasing the price range; this advice was endorsed by Lazard.

The Glocos subsequently advised us to expect a volatile aftermarket with the risk of a significant (upward) spike in share price given the momentum of the bookbuild, the likely shortage of initial supply of stock as the book was very long-term investor focused and allocations concentrated, the change in the industrial relations timetable and the considerable media interest that was predicting a substantial first day premium.

A scaling back of the number of shares offered for sale below the 60 percent maximum offer size was also considered on the basis that a higher price may be gained by selling later. This was not pursued because:

- there was insufficient confidence that a similar price could be secured later (and without the benefit of such a concerted marketing campaign);
- the allocation of a number of institutions would be scaled back so far that they may be unwilling to retain any holding, so constraining potential investor appetite for subsequent sales; and
- there were concerns about even greater aftermarket volatility if fewer shares were sold.

Property valuation

The Committee asked for clarification on the valuation of the Company's property portfolio, including the independence of the valuation that had been obtained.

Royal Mail's value depends, in large part, on its operating and financial performance driven, in particular, by its parcels strategy. The Company's asset value, including property, has not been a key driver of valuation. This is clear when comparing Royal Mail's net book value of £1.8 billion (as at 30 June 2013) with the market capitalisation on listing of £3.3 billion.

Based on Royal Mail's FY2012-13 audited annual report and accounts, the net book value of Royal Mail's land and buildings, based upon a historic cost accounting policy and excluding fit-out, was £724 million[2] as at 31 March 2013. This is consistent with the figure disclosed in the Prospectus. The Directors of Royal Mail also considered any increase in value of land and buildings based on market values. In the opinion of the Directors, when considering market values on an existing use basis, the aggregate market value of the Group's land and buildings exceeded its net book value by £310 million as at 31 March 2013 – this was also disclosed in the FY 2012/13 accounts. The incremental value of £310 million is based on expert and independent valuation advice provided to Royal Mail by BNP Paribas as part of a regular property valuation analysis.

The Prospectus additionally set out a description of Royal Mail's surplus properties. It details that three major sites in London, which form part of Royal Mail's UK freehold estate, have been recognised as surplus by the Company subject to completion of necessary separation and reprovisioning activities (the "London Development Portfolio"). These three sites are:

[2] Land and Buildings are recorded on the balance sheet at £1,105m including fit-out. Excluding fit-out of £382m the book value is £724m as per the Directors report (composed of £636m of freehold and £88m of long leasehold properties).

- a 14 acre site in Nine Elms, South London which was used formerly as the location of the Group's South London Mail Centre;

- a site of around eight acres that forms part of land owned by the Group at Mount Pleasant in central London; and

- a one acre site adjacent to Paddington main line railway station in central west London.

A key objective of Royal Mail in relation to the London Development Portfolio has been to generate value in the relevant sites by undertaking pre-development work, including obtaining planning consents and resolving issues identified with the legal title to the land. This has been with the aim of repositioning the portfolio for alternative use (which has tended to be residential use), thereby allowing Royal Mail to capture upside on disposal of the relevant property.

Royal Mail has, further, made a number of public press announcements relating to its intentions with the London Development Portfolio.

The generally accepted approach to the valuation of land for development is to start with what the end state completed development will be worth when built. This is known as the gross development value and it assumes that all consents and title issues are resolved. From the gross development value are deducted all costs including construction and finance costs and a developer's profit to arrive at what is known as a residual land value. This is how the three London development sites will be valued by developers in the property industry. Unfortunately a lot of press speculation has focused on the gross development value and this is very misleading.

As a proxy for the residual land valuation approach, the property industry sometimes looks at prices per acre for land recently sold in the area in question. This is not an accurate form of valuation. It does not take into account the density of the development scheme or the risks in the scheme, for example, whether the scheme has a planning consent. On this proxy basis, the most comparable precedents suggest that £10-15m per acre is an appropriate range for the Nine Elms site, suggesting a value of £140 - £210m. This fails though to take into account the relatively low level of building density set out in the planning consent to allow for a park, a key requirement of the planning authorities.

It is harder to find recent land deals of size around Mount Pleasant and so harder to use this proxy method of valuation for the land which will become surplus at that site. Any journalist or analyst choosing to value Mount Pleasant would need to bear in mind that this site currently has no planning consent for alternative use. Paddington is a much smaller site than the other two and it also does not have a full planning consent.

Taking into account the overall position of the surplus portfolio and the relative immaturity of these sites in terms of actual development, a combined value of £330m (as suggested in one of the equity research analyst reports) appears at the top end of any likely range.

The vast majority of Royal Mail's property assets will continue to be required for it to operate as the universal postal services provider to the UK. In the main, the portfolio is best valued as an inherent part of the ongoing trading performance. Given the continuing uncertainty around the potential value and timing of any disposal receipts on surplus land, the totality of disclosure and commentary in the Prospectus allowed investors to form their own view of potential value.

BNP independence

BNP Paribas Real Estate are an independent, external valuer for Royal Mail. Although they have worked with the Company for a number of years, they are currently instructed under a competitive tender contract awarded in 2010.

A valuation of a sample of the property estate is carried out each year in accordance with the guidelines as set out by the Royal Institution of Chartered Surveyors. The current valuation comprised circa 80% by value of the Royal Mail estate identified by reference to value and development opportunity.

BNP Paribas Real Estate did not provide the market valuations of the three high value Central London development sites at Mount Pleasant, Nine Elms and Paddington which were separately and independently valued by Jones Lang LaSalle. Jones Lang LaSalle was appointed to provide the market values due to its previous experience of these sites. The 80% figure given above includes these market values.

It is worth noting that BNP Paribas Real Estate previously had an estates management contract with the Company but lost this in a competitive tender process in 2012.

Royal Mail Prospectus

The Committee asked me to provide further clarification on the reasons for the length of the Royal Mail Prospectus. The following factors, when aggregated together, have all contributed to the increased length of the Royal Mail IPO Prospectus when compared against older precedents:

- Over the last 10-15 years there has been a general development as to what the market considers to be the acceptable level of disclosure in an IPO (and other capital markets transactions). A general trend for more detailed disclosure has evolved. For example, the “risk factors” are now more extensive (they extend to approximately 40 pages in the Royal Mail prospectus), as we well as greater detail being provided on the business, management, governance structures and material contracts.

- Full financial disclosure is required from a legal perspective. The Royal Mail Prospectus contains extensive financial information (approximately 68 pages of historical financial statements alone).

- The Prospectus followed the tripartite format, as permitted by EU law. This means there are three distinct sections that are taken as one in forming “the Prospectus”: the summary; the registration document (relating to the company); and the securities note (relating to the shares being offered). This allowed for a summary document to be reproduced separately and made available in Post Offices. One effect of the tripartite format is that it leads to an increase in length of the prospectus (when taken as one), given the need for repetition of definitions and standard legal language in each of the three sections.

- Furthermore, the Royal Mail offer included: (i) a retail element; (ii) an offer to institutional investors in the United States; as well as (iii) a statutory offering to employees. Including these elements as part of “the offer” increases the description and associated disclosure that is required.

To demonstrate the modern trend of larger prospectus documents in IPOs, the Esure prospectus (2013) was approximately 330 pages and Bpost (2013) was approximately 370 pages.

It is worth noting that the Prospectus is published by the Company and so the Company and its directors take responsibility for the Prospectus. Therefore, the length of the Prospectus can be assumed to be a function of (in part) the amount of disclosure the Company and its directors felt was required in order to fulfil their obligations in relation to the Prospectus content.

The Committee suggested that investors may not have had time to read the full Prospectus. The timetable was entirely consistent with market standards. The Prospectus was published on 27 September and the offer closed on Tuesday 8 October, eight business days later. The recent flotation of Foxtons had an eight-day book-building period between publication of the Prospectus and the offer closing, as did the Direct Line flotation. The timetable was set to ensure a robust commercial process and there has been no suggestion that investors have not had sufficient time to consider the investment proposition.

Employee Share Scheme

The Committee also asked about the policy for employees leaving the Company within three years of receiving their free share allocation.

Employees will be able to keep their shares and not have to pay Income Tax or National Insurance on the value of the free shares if they leave employment with Royal Mail as 'good leavers'. Leaving as a 'good leaver' includes leaving because of: an injury or disability, redundancy, retirement, death (the people managing their estate will get the shares) or if the part of the business in which the employee works is sold or transferred.

If employees leave the Company any for any reason other than as a 'good leaver' (e.g. they leave because of resignation or dismissal) the following scenarios apply depending on time of leaving; (i) if they leave within three years of the shares being allocated, they will lose their shares; (ii) if they leave between three and five years following allocation of shares, they will keep their free shares but pay Income Tax and National Insurance on those shares. The amount of Income Tax and National Insurance payable on such shares will be assessed on the lesser of the market value of the shares at the time the employee leaves, or when the shares were first awarded.

After five years following allocation, employees who leave for any reason whatsoever will be able to keep their shares and will not have to pay Income Tax or National Insurance on those shares.

Unlike other members of the public, there is a holding period on the employees' free shares (but not for those bought under the Employee Priority Offer). This is because we are seeking to align the incentives for the employees to the medium to long term. A holding period of three years (or five years for the full tax benefit) balances that objective against rewarding employees in the not too distant future. Those who are 'good-leavers' (as defined above) will keep their shares and be allowed to sell even if they leave before three years.

From time to time during the holding period, free shares forfeited by leavers will be given to employees who are eligible at that time. Before the fifth anniversary of the flotation, all remaining forfeited free shares must have been given to eligible employees as free shares on similar terms to the current arrangements, or, if the amounts in aggregate are less than

£500,000 and it is not practicable to make such a distribution to eligible employees, given to the Rowland Hill Memorial and Benevolent Fund or another charity for the benefit of postal workers or their dependants. These arrangements have been put in place to ensure that we meet our commitment under section 3 of the Postal Services Act 2011, by ensuring that at least 10% of shares in Royal Mail are owned by or on behalf of an employee share scheme for the benefit of employees of Royal Mail by the time the proportion of Royal Mail shares owned by the Crown is reduced to nil.

The Committee also asked about the possibility of employees selling options on shares. Employees accepted the free shares in accordance with certain terms and conditions which the Company informed employees of before the shares were given to them. One of these terms is that employees are restricted from accessing their free shares during the holding period of three years. They are not allowed to assign, charge or otherwise dispose of their interest in their shares during this holding period (except in the case of a reconstruction, takeover, or where they leave employment with Royal Mail as a "good leaver" as set out above). Although it would not be illegal for employees to grant an option over their shares to a third party during the holding period, this act would mean that the employee would forfeit their interest in those shares, and therefore would not be able to deliver the shares under that option.

Given the high level of public interest in the Royal Mail IPO, I am today placing a copy of this letter in the Libraries of both Houses.

VINCE CABLE

Secretary of State for Business, Innovation and Skills