



Report by the  
Comptroller and  
Auditor General

# Department of Trade and Industry: Sale of Government Shareholding in British Steel plc

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This report has been prepared under Section 6 of the National Audit Act, 1983 for presentation to the House of Commons in accordance with Section 9 of the Act.

John Bourn  
Comptroller and Auditor General

National Audit Office  
22 January 1990

The Comptroller and Auditor General is the head of the National Audit Office employing some 900 staff. He, and the NAO, are totally independent of Government. He certifies the accounts of all Government departments and a wide range of other public sector bodies; and he has statutory authority to report to Parliament on the economy, efficiency and effectiveness with which departments and other bodies use their resources.

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# Report

## Introduction

1. Since 1982, the Committee of Public Accounts have examined departments on a number of occasions about the arrangements made for the sale of Government shareholdings in major publicly-owned companies. In their latest report on this subject, the Thirty-fourth Report of Session 1987-88, the Committee reported on the sales of shares in British Gas plc, British Airways plc, BAA plc and Rolls Royce plc.

2. The Committee's enquiries were based on four Reports from my predecessor and myself. These showed that generally departments and the Treasury had given careful consideration to previous Committee recommendations and had sought appropriate professional advice before reaching important decisions.

3. On the evidence of the above sales the Committee made a series of wide ranging recommendations directed towards the rôles both of the departments and the Treasury. They recommended that when preparing companies for sale departments should restrict injections of new capital to a minimum and should continue to make a careful assessment of the most appropriate methods of sale in order to maximise proceeds. The Committee welcomed the reductions achieved in the cost of primary underwriting but recommended that departments should seek to extend competition into the sub-underwriting field. The Committee were also concerned that departments should ensure that they were able to protect taxpayers' interests effectively when future profit and dividend levels were being forecast. The Committee were concerned at the high costs of marketing in two of the sales and emphasised that departments should exercise a tight control over all categories of expenditure.

4. The Committee noted the co-ordinating rôle of the Treasury and recommended that they review the final outcome of the 1987-88 sales and investigate particular issues in order that the knowledge gained in those sales could be made available to guide departments in future privatisations. The Government accepted the majority of the Committee's recommendations and agreed that the experience gained in past sales should influence the conduct of future offers. They agreed that the Treasury, as co-ordinator, should pass onto sponsor departments the lessons learned from earlier sales.

5. This Report records the results of an examination by the National Audit Office of the arrangements made by the Department of Trade and Industry (the Department) for the sale of the Government's shares in the British Steel Corporation. This was the first privatisation to follow the October 1987 stock market crash and the Government was particularly concerned to ensure that this sale was a success. The main

issues addressed by the National Audit Office examination were whether the Department had taken full account of the previous recommendations of the Committee of Public Accounts as agreed by the Government and whether the Department had achieved their objectives. To allow a ready comparison with the findings of previous National Audit Office Reports on the sale of Government shareholdings this Report has been structured along similar lines.

### **Background**

6. The United Kingdom steel industry has moved between the public and private sectors at intervals since the Second World War. In 1949 it was nationalised; from 1953 it was largely de-nationalised and from 1967 the majority of it was re-nationalised when some 14 of the major United Kingdom steel producing companies were formed into the British Steel Corporation. At the time of this amalgamation these companies accounted for approximately 90 per cent of the country's crude steel production and employed more than 250,000 people.

7. During the 1970s the British Steel Corporation invested heavily to replace obsolescent plant and to expand capacity to meet projected demand. But the expected increase in demand failed to materialise and this and over-capacity in the industry led the Corporation to incur severe financial losses during each of the 10 years up to 1985-86. By 1979-80 the annual loss had risen to £1.784 billion and between 1975-76 and 1979-80 the Government had been called upon to provide some £3.3 billion to support the Corporation's activities. Between 1980 and 1985, the Government invested a further £4.5 billion to finance redundancy and rationalisation costs, capital expenditure and increases in working capital. During this period the Corporation reduced its workforce from over 160,000 to around 53,000.

8. The Corporation returned to profitability in 1985-86 and thereafter steadily improved its financial return to the point where it made a trading profit before taxation of £381 million in 1987-88. In February 1987 the Department appointed Samuel Montagu to give preliminary advice on the feasibility and timescale of a privatisation of the Corporation in view of its improved profit record and prospects. Subject to certain preliminary pre-conditions for a sale and the state of the stock market at the time of the sale, the advisers felt that a sale through public offer would be feasible and might raise proceeds in the range £1.4 billion to £1.8 billion.

9. In December 1987 the Secretary of State for Trade and Industry announced that the Government intended to privatise British Steel. He said that the Corporation's improved performance meant that it could be privatised in line with the Government's commitment to returning successful state industries to the private sector as soon as practicable. In February 1988 the Government introduced the British Steel Bill which made provision for the property, rights and liabilities of the British Steel Corporation to be transferred to a new public limited company. The Bill was to change the legal status of British Steel from a public



corporation to a public limited company but it was intended that the successor company should be regarded for all practical commercial purposes as the same company. The Bill received Royal Assent on 29 July 1988.

10. The Department's principal objectives for the sale were:

- (a) subject to market conditions, to return the British Steel Corporation to the private sector through a public offer for sale no later than August 1989 but to aim for a sale by the end of 1988;
- (b) to maximise the net proceeds of sale consistent with the achievement of a healthy aftermarket; and
- (c) to relinquish all financial obligations including existing commitments at the date of privatisation.

11. These objectives were broadly consistent with those of previous privatisations. But, in setting them, the Department recognised that they had two important difficulties to overcome. The first was that the steel making industry was perceived to be cyclical in nature and had recently been subject to a period of very heavy losses. The second difficulty was that the general loss of confidence in the stock market following the October 1987 crash was likely to reduce public support for the sale. For these reasons the Department did not view the sale as particularly appropriate for widening share ownership but accepted that the objective of widening share ownership should not be overlooked.

## **Preparations for sale**

12. One of the main areas of concern for the Department in preparing the Corporation for privatisation was to adjust the accounts to a form that would be appropriate for a public limited company. The Corporation's Balance Sheet had a large accumulated deficit reflecting its many years of heavy losses and no revenue reserves to underpin future dividends. The British Steel Act provided the Minister with powers to reduce the Corporation's capital, to create distributable reserves and to reduce the Corporation's tax losses. In this connection the Department had to decide whether the Corporation should be allowed to transfer to the new Company the substantial tax losses and capital allowances which had been built up over the years, whether the Company should pay a dividend for 1987-88, and whether new capital or debt should be introduced to adjust the equity/debt gearing ratio. Each of these issues was considered separately.

### **Capital reconstruction**

13. In determining the Company's capital structure the Department's aim was to produce a sound balance sheet that would meet the requirements for a public limited company, reflect the recent trading success of the business and attract potential investors. The Department were conscious of value for money considerations and were anxious to avoid any suggestion that the Government had provided a subsidy or state aid to the new Company.

14. Samuel Montagu's initial concern was the value of the Corporation's net assets. Although the Corporation had adopted valid accounting principles for the depreciation of assets, the aggregate value

of net assets was substantially more than was likely to be raised in capital from the market. This was because in the market, the value of the Company would be assessed primarily against its earnings potential and the nature of the steel business, rather than the realisable value of its assets. The advisers considered at some length with the Department and Treasury the possibility of reducing asset values. However, after careful consideration, all parties agreed that to adjust asset values had more disadvantages than advantages.

### **Capital allowances, losses and revenue reserves**

15. Following years of heavy losses the Corporation had accumulated substantial capital allowances and tax losses. These amounted to £1.6 billion and £1.9 billion respectively. Under existing tax legislation, capital allowances were available to be carried forward to the new company. The tax losses, however, were not quite so easily dealt with.

16. In order to increase the value of the company on sale, the Corporation management wished to carry forward all tax losses on privatisation. However, the Department were concerned that this would lead to accusations of unfair treatment from steel producers in Europe and the United States. The Department were also aware of previous experience which suggested that the carrying forward of tax losses would be heavily discounted by the City when considering the value of a company and that transferring these losses to the new company would not represent good value for the taxpayer. The Department eventually agreed that the accumulated tax losses of £1.9 billion should be substantially reduced to a carried forward balance of some £171 million. This latter figure represented the value of timing differences as between the charging of depreciation in the accounts and the capital allowances which had been accumulated for tax purposes.

17. At 2 April 1988, the Corporation's accumulated deficit was some £642 million. Following advice and discussions with the Corporation, the Department agreed to set off this deficit against capital. The Corporation was also concerned that the new Company should not be burdened with new loan stock. The Department agreed that the only long-term debt at vesting day would be the existing borrowing of £53 million.

18. The Department also concluded that the new company should have sufficient distributable reserves to potential investors about future dividend prospects. Although the Corporation had made profits since 1985 no dividends had been declared and the Department agreed that none should be made for 1987-88. In the autumn the Department agreed that the Balance Sheet of the new company should show a distributable revenue reserve of £381 million, equivalent to the profits of the Corporation during 1987-88.

19. The overall effect of these changes on the structure of the Corporation's balance sheet as at 2 April 1988 is set out below:

	Balance sheet at 2.4.88				Revised balance sheet at 2.4.88
	£m	£m	£m	£m	£m
Capital	3,980	(642)	(1,957)	(381)	1,000
Statutory Reserve					
Restricted			1,957		1,957
Distributable				381	381
Retained Profit/(Loss)					
Company	(642)	642			
Subsidiaries	96				96
Total Retained Profit/(Loss)	(546)				
Total Capital and Reserves	3,434				3,434

### Formation of the Company and transfer of business

20. On 26 July 1988 British Steel plc was created with an authorised and issued share capital of £50,000, the whole of which was owned by the Government. On 5 September 1988 all the property, rights and liabilities of the Corporation were transferred to the new company under the terms of the British Steel Act 1988. In November 1988 the authorised capital was increased to £1.3 billion and on the date of the offer the authorised and issued share capital was as follows:

<u>Authorised</u>	<u>Issued</u>
2,600,000,000 Ordinary Shares of 50p each	2,000,000,000 Ordinary Shares of 50p each
1 Special Rights Preference Share of £1	1 Special Rights Preference Share of £1

The special share carries no voting rights but entitles the Secretary of State to attend and speak at general meetings and allows him until 31 December 1993 to prevent any one person (or group of persons acting in concert) from controlling more than 15 per cent of the equity.

### The timing of the sale

21. The Department, together with the Treasury, their advisers and the Company, considered three alternative dates on which to offer the Company for sale. These were late November 1988, late January 1989 and July 1989, although the final date was discounted as a first choice at an early stage.

22. The Department and the Treasury considered the balance of arguments between a pre or post-Christmas sale finely balanced, and

agreed that practical and political considerations pointed to a November sale. November gave a clear run-in on planning the sale, without the interruption of Christmas. It was also the earliest possible date, and the Government wanted to privatise British Steel as soon as possible. British Steel themselves favoured November, and the enthusiasm of their top management was considered important to the success of the sale. The Department recognised that the January date would give them slightly longer to prepare the market and the Company for sale. For the Treasury, the January date was unattractive because of prospectus disclosure problems prior to the budget.

23. The Department and their advisers were aware that in general stock market strength tended to be higher in January than November and that institutional liquidity followed the same pattern. They also gave special attention to the need to be able to provide profit forecasts which met Stock Exchange requirements and provide a firm profit forecast for the full year 1988-89. They recognised this second aspect would not only be essential for investors, but would be a key feature in the valuation of the Company and the determination of the offer price. In principle, the earlier in the financial year that a profit forecast is made, the greater the uncertainty and the greater the contingency allowance necessary for unforeseen events. Whilst the Department recognised that a fairly confident profit forecast could be made for up to three months ahead, beyond that period the forecast would become increasingly uncertain.

24. In view of the importance of this issue, in deciding between the November and January dates the Department and their advisers attempted to measure the effect of the uncertainty. However, neither were able to quantify with any precision or confidence the extent to which, assuming an improving market, proceeds might be increased if the sale was delayed until January.

25. The Department's conclusion was that although the November date raised certain problems and a significant effect on proceeds could not be ruled out, they could not quantify this. Therefore, after due consideration they considered that the uncertainty over proceeds did not constitute a sound basis for moving to a January target date. In these circumstances the Department and the Treasury agreed that the sale should take place in November 1988. This date was in line with the Government's objectives for an early sale, was the Company's favoured date and was seen to avoid any problems associated with Christmas.

### **Arrangements for sale**

26. Following competition, the Secretary of State appointed the following principal firms to provide advice:

Samuel Montagu	— main financial advisers
Norton Rose	— legal advisers
Rowe and Pitman	— lead brokers
Dewe Rogerson	— public relations advisers
Coopers & Lybrand	— reporting accountants

Other firms were also appointed to provide advice and assistance on overseas sales, advertising, printing, share information, etc.

27. In all previous privatisations the bank acting as the main adviser to the Government and as sponsor to the issue also acted as the lead underwriter. However, following the difficulties experienced with the British Petroleum sale in 1987, the Government decided to separate these two rôles for the British Steel sale. Thus, in October 1988, after competition, the Department appointed N M Rothschild to act as the United Kingdom lead underwriter.

28. In considering the arrangements for sale the Department, with their advisers, reviewed a wide range of options based on a preliminary review of the field by Samuel Montagu. The considered the target market for British Steel shares; whether the issue of shares should be phased; the methods of sale; whether there was a need for an overseas offer; and whether they should adopt the firm placing of shares. The Treasury were consulted regularly on these issues.

29. In considering the target market the Department accepted that the offer would not be directed primarily at widening share ownership. Their advisers considered that the history of the Company and the nature of its business meant that it would be difficult to market successfully, even to the experienced investor. They saw little opportunity for attracting the small private investor. From the outset, therefore, the sale was directed primarily but not exclusively at the institutional and more experienced investor.

### **The phased sale**

30. The Department and their advisers were agreed at their preliminary meetings that, provided they were satisfied that there was sufficient market capacity, they would opt for a 100 per cent share offer. All parties recognised that in certain circumstances a phased sale might offer pricing advantages. But because of the planned timetable for future privatisations, any continuing Government shareholding in the Company could not be disposed of for several years. The Treasury agreed that the Department should plan for a 100 per cent sale but not close off the possibility of selling a lesser proportion if forecast proceeds or market considerations indicated that a phased sale might be more beneficial. In the event it was decided that a phased sale would not be undertaken.

### **Method of sale**

31. The Department's early consideration of the method of sale centred on three main options, a fixed price sale, a full tender and a partial tender offer. The fixed price offer had the advantage of being simple to operate, was well understood and had been used very successfully in the majority of privatisations.

32. The Department's advisers recognised the benefits of tendering and noted that either a full or partial tender offer would be particularly beneficial if difficulties were encountered in settling the offer price, if there was a sudden and unexpected demand for shares or if the offer price needed to be varied between different categories of investor. The advisers were aware of the case of the BAA plc share offer where a

partial tender offer had applied to some 25 per cent of the issue and Government proceeds had been increased by some £56 million. At the outset the Department and the Treasury favoured the combination of a fixed price and partial tender offer but as their advisers became increasingly concerned about the strength of the equity market, the Department felt it necessary to consider a dual fixed price offer.

33. Under a dual price offer shares would be offered to the institutions and overseas investors at one price and offered to the retail market at a separate price, probably discounted. In marketing terms, a dual priced offer could be used to stimulate higher demand from a particular group of investors. However, the innovatory nature of the dual priced offer, the possibility of reduced proceeds from a discounted offer and the greater risks involved led the Department to drop this option.

34. As the offer date drew closer, the Department were being strongly advised that the equity share market was becoming increasingly uneasy and that higher interest rates and adverse trade figures were contributing to a weaker market. In these circumstances the Department took the view that it was much more important that the British Steel offer should be successfully underwritten than that the Department should attempt difficult pricing options to increase proceeds. The Department and the Treasury agreed that they would not proceed with a tender offer or a dual price offer and that the sale should be conducted as a fixed price offer.

### **The overseas offer**

35. The Department and its advisers researched the prospects for overseas offers in the United States of America, Europe, Japan and Canada. These researches suggested that there would be firm overseas demand for such shares in each of these markets provided the marketing campaign and the price were right. The Department concluded that the offer as a whole would benefit from tapping this additional demand — which their advisers estimated could absorb up to £950 million in shares. It was therefore agreed with the Treasury that the offer should be extended overseas to the level indicated by their advisers.

### **The sale offer**

36. Following the decision that the offer should be on a single fixed price basis the Department needed to decide how to distribute the offer between the United Kingdom public, its institutional investors and the overseas markets. As indicated above the Department's advisers considered that market conditions made it unwise to rely on strong private investor demand in the United Kingdom market. They therefore recommended that the Department should consider a high level of firm placing with United Kingdom institutional investors as this would provide greater certainty and reduce the size of the retail offer in the home market. Although the Treasury had concerns about firm placing it was accepted that market conditions at the time created a high degree of uncertainty and the advisers' recommendations were therefore accepted. Consequently the Department fixed the volume of firm

placing with institutions at 50 per cent of the shares on offer in the United Kingdom — the maximum allowed by Stock Exchange rules.

37. In advance of the share offer, the Department provisionally allocated one-third of the offer to the UK public, one-third to United Kingdom institutions and one-third to overseas markets. A degree of flexibility was to be retained in these provisional allocations, in that, if the public offer in the United Kingdom was over-subscribed by 1.5 or twice the total number of shares on offer in the United Kingdom, then a proportion of first the overseas allocation and secondly the UK institutional allocation would be fed back into the public offer. This was the first Government sale in which such a dual trigger clawback mechanism had been used.

38. On 23 November Samuel Montagu, on behalf of the Secretary of State, offered for sale two billion Ordinary shares in British Steel plc, of which a maximum of 884.4 million was placed with United Kingdom institutions (660 million of them on firm placing), 451.6 million were offered to the general public and British Steel employees and 664 million were offered for sale overseas in the United States of America, Canada, Japan and Europe. In order to take account of the changes from the provisional allocations of shares set out in paragraph 36 above, the claw-back triggers were revised so that 166 million shares would be recovered from the overseas allocation if applications for shares in the United Kingdom exceeded 1.75 times the number of shares on offer there. Similarly, 224.4 million shares would be recovered from the United Kingdom institutions if demand from the general public in the UK was more than 2.25 times the number of shares on offer in that market.

### **Underwriting**

39. The Department and their advisers decided that the offer should be fully underwritten except for the 16 million shares reserved for the free and matching offers to British Steel employees. They also decided that the conventional structure of primary and sub-underwriting should be adopted for the 1,320 million shares to be underwritten by UK institutions. Following past practice the institutions engaged in a primary underwriting competition which produced an average underwriting commission rate of 0.0716 per cent of the total value of the shares at the offer price (£1.18 million). This rate was significantly higher than that achieved for the 1987 British Petroleum sale (0.018 per cent) and was marginally above the rates for the BAA and Roll Royce sales of 0.053 and 0.061 per cent respectively.

40. The arrangements for sub-underwriting were similar to those used in previous sales, whereby certain United Kingdom institutions (Priority Applicants) were invited to apply for the shares on offer on the basis that they would be:

- (a) guaranteed an allocation of 50 per cent of these shares (firm placing shares);
- (b) provisionally allocated a further 17 per cent of shares (provisional placing shares); and

(c) committed to undertake to purchase the balance of any shares not otherwise allocated in the public and employee offer (commitment shares).

41. The Secretary of State agreed a commission rate of 1.25 per cent for the provisional placing and commitment shares. This was the normal market rate for such business and the commission amounted to £10.313 million. However, no sub-underwriting commission would be paid on the firm placing shares. This was the first Government privatisation in which firm placing shares were handled without commission, even though this is normal practice in most commercial flotations. As a result of the savings made in this area the average primary and sub-underwriting commission rate for the sale of shares in the United Kingdom was reduced to 0.697 per cent, the lowest percentage achieved for all Government sales to date.

42. The Secretary of State entered into separate agreements with overseas underwriters in respect of the 664 million shares offered abroad. In aggregate this commission rate was 1.13 per cent of the value of shares offered abroad and amounted to £9.41 million. This rate was lower than for three of the five previous Government offers made available to overseas buyers. Over these five sales, overseas underwriting commission ranged from 1.00 to 4.24 per cent.

43. Interest payments were also made to the United States, Canadian and Japanese underwriters to compensate them for making early payment of their first share instalment which was necessary to ensure synchronisation with the UK offer. These interest payments amounted to some £330,000.

### **Sales incentives**

44. Special arrangements were made for the preferential treatment of British Steel employees in the offer for sale. These incentives comprised an initial free allocation of shares, a scheme under which employees would receive two free matching shares for each one purchased up to a value of £165, a discount on further share purchases up to a value of £2,200 and the opportunity to apply for shares up to a value of £10,000 as a priority applicant. The minimum benefit to an employee taking full advantage of these incentives was calculated at £620 plus £2 for each year of continuous service. An employee with 40 years service could therefore benefit by up to £700. Comparable figures for the British Gas sale were £570 and £650 and for the Roll Royce sale £571 and £649. The cost to the Government of the free, matching and discount share offers is estimated to be in the region of £18 million. Pensioners and deferred pensioners were given the benefit of priority applications but they did not receive the same pricing concession as employees. The Department and the Treasury agreed that loyalty bonuses would not be offered to small investors.

### **Payments by instalments**

45. The Department, with the Treasury's agreement, opted for payment by two instalments. Instalment facilities would not only ease



the cash demands on the market and phase the receipts to the Government but be a potential marketing consideration in the share pricing strategy. The Department recognised that the dividend for 1988–89 would be seen by the experienced investor as a valuable return on the partly paid share price.

### **Company valuation**

46. Detailed discussions on share pricing and valuation began in earnest in September 1988. Samuel Montagu advised that, although the asset value of the Company was in the region of 180 pence per share, the most suitable form of valuation for the Company was the earnings basis. This view was supported by the Department's other advisers who recognised that the Company would be seen by investors as one where growth would be steady but not spectacular. They therefore concluded that the prime indicator on pricing should be the forecast dividend yield, supplemented by the price/earnings ratio.

47. The Department did not seek an independent adviser on pricing since the functions of the Government financial adviser and lead underwriter were separated in this sale.

48. In September 1988 Samuel Montagu gave advice on the pricing of the offer based on the assumptions available at that time. These were that the offer would be on a fixed price basis, that the Company's forecast profits for 1988–89 would be in the range £450 to £550 million, and that the tax charge would be between 20 and 25 per cent. Samuel Montagu found it difficult to find comparable companies from which to select an appropriate price/earnings multiple but as a guide referred to the performance of a number of heavy engineering companies in the United Kingdom and a range of overseas steel companies in Europe, the United States and Japan. As a result of these and other researches they concluded that the Company would need to produce a required yield of between six and eight per cent per annum and declare annual dividends of around £120–£140 million. Using these broad guidelines, the firm suggested that the Company had a value of between £2,200 million and £2,880 million.

49. In October 1988 the Department, the Treasury and their advisers considered the Company's latest profit forecast of £468 million for 1988–89. In the knowledge that the Company was expected to need profits of at least some £200 million per annum before interest to finance working capital and capital commitment expenses, the Department put forward £160 million as its opening position for the annual dividend. On the basis of the same profit forecast, the Company argued that the dividend should not be greater than £130 million.

50. By 21 October, following the half-yearly profits of £270 million, the Company's forecast profit for 1988–89 had been revised to £550 million. There then followed further discussions with the Company, whose Directors eventually agreed that the annual dividend for the full year should be forecast at £150 million. The Department considered that this agreed dividend level represented a very satisfactory outcome. On this revised basis the dividend represented a yield of eight per cent on a

capitalisation of £2.5 billion. In the event the actual British Steel profit for the full year to April 1989 was £593 million.

### Share pricing

51. In determining the share offer price, Samuel Montagu had recommended that the price should be fixed within the range 125 to 140 pence and that shares should be priced in multiples of five pence, as had been adopted for the pricing of earlier Government share sales. But they advised that if a price towards the top end of this range were to be chosen there would be difficulty underwriting the sale and a slippage of retail interest. In these circumstances they advised that the offer price should be set at a discount of 7-10 per cent to ensure that the issue could be successfully underwritten, that investors would apply for the issue and that there would be a healthy aftermarket.

52. The timetable for privatisation required the price to be set on 22 November 1988 and announced the following day. At the early pricing meetings the United Kingdom advisers favoured a price between 125 and 130 pence, whereas advice from overseas suggested that demand there was stronger. During the week preceding the price announcement date, a series of meetings was held between the Department, the Treasury and their advisers. These meetings considered carefully market conditions and the anticipated levels of demand in the United Kingdom and overseas.

53. On the 20 November the Department held a series of meetings with the overseas lead managers with the following results. In the United States (with a 12 per cent allocation) the advisers indicated that the success of their sale was dependent on the strength of the United Kingdom market for the shares. They recommended that a price of 130 pence be set only if there was a near certainty that the offer would be over-subscribed at that price and both levels of clawback triggered. In Japan (with a 10 per cent allocation) the advisers recommended that, provided the share yield was likely to exceed seven per cent and, subject to the United Kingdom offer being perceived as a success, the sale price could go up to 140 pence. In the other two markets (Europe eight per cent and Canada three per cent) both sets of advisers indicated that they would be content with an offer price in the region of 130 to 135 pence.

54. At the penultimate pricing meeting on 21 November, Samuel Montagu reported that overseas investors were eagerly awaiting the price and, subject to the background outlined above, they felt that the overseas markets could support an offer price of between 130 and 140 pence. In the home market, advisers reported that the situation was more volatile and that any decision needed to take account of the impending October trade figures (due to be announced on 25 November). Samuel Montagu's view was that a sale at 130 pence could be achieved successfully and sub-underwritten but that a price above this would be difficult to underwrite. They also indicated that at a price of 125 pence the retail interest was likely to be significant and that it would be easy to underwrite the issue. Four other firms of advisers had also made it clear that, in order to generate increased retail interest and

promote a successful sale, their preference was for 125 pence. At a price below 125 pence Samuel Montagu advised that it might be seen that the Government had little confidence in the Company.

55. On the basis of the above advice the Secretary of State and the Financial Secretary to the Treasury agreed that, subject to confirmation the following day, the offer price would be 125 pence, to be paid in two instalments of 60 and 65 pence. At this price the Company had a market capitalisation of £2.5 billion, a gross dividend yield of eight per cent and a price earnings ratio of 5.7 (4.9 on an after-tax basis). On 25 November 1988 the Government announced the United Kingdom trade figures for October. These revealed a record trade deficit of £2.4 billion and resulted in a two per cent fall in stock market prices with the Financial Times 100 share index falling 38 points by the close of dealing on the day the figures were announced.

## Results of sale

56. The offer closed on 2 December 1988, by which time some 650,000 valid applications had been received from the United Kingdom market seeking a total of some 1.5 billion shares. This resulted in the offer being some 3.3 times subscribed and activated the claw-back arrangements referred to at paragraph 38 above. In total some 390 million shares were recovered from the overseas markets and the United Kingdom institutions in order to meet the demands of United Kingdom applicants.

57. In common with previous privatisations where issues have been over-subscribed, the allocation of shares favoured small investors. All valid United Kingdom applications for up to 1,000 shares were met in full but those applying for more than 1,000 shares had their applications scaled down. Employee applications were met in full, as were priority applications from pensioners. The final allocation of shares after claw-back was as follows:

	Provisional		Actual	
	No. of shares Million	%	No. of shares Million	%
UK General				
Public & Employees	451.6	22.6	842	42.1
UK Institutions	884.4	44.2	660	33.0
Overseas	664	33.2	498	24.9
	<b>2,000</b>	<b>100</b>	<b>2,000</b>	<b>100</b>

58. The value of the shares offered for sale at the fixed price of £1.25 amounted to £2,500 million. After deducting the value of free and discounted shares to employees, the gross proceeds from the sale are estimated to be £2,482 million (net £2,436 million — see Appendix 1).

### **The aftermarket**

59. On the first day of trading, 5 December 1988, the partly paid share traded at between 60.5 and 63 pence, closing at 62.75 pence. This represented a premium of less than five per cent on the partly paid price and two per cent on the fully paid price. When the offer price was set on 23 November, the Department's advisers expected the shares to trade in the immediate aftermarket at a premium of about 12 per cent (fully paid). From 23 November to 5 December 1988, the Financial Times 100 share index, and the Industry group share index moved down approximately 3.3 and 4.5 per cent respectively. This general trend in share prices helps to explain why the British Steel share premium was some 10 percentage points lower than expected.

60. For the remainder of 1988, the British Steel partly paid shares traded at between 58.75 and 61.5 pence. During January 1989 the share price increased from 60 to 77 pence, broadly in line with the movement of the Financial Times 100 share index and the Industry group index.

### **The costs of the sale**

61. The Department estimate that the overall net costs of the sale, excluding departmental administration and stamp duty, will total some £45.5 million (Appendix 1), representing some 1.83 per cent of gross sale proceeds, and this is the lowest overall figure for all Government privatisations. British Steel plc have estimated their costs of privatisation to be around £30 million.

### **Summary and conclusions**

62. The sale of the Government shareholding in British Steel plc took place in difficult stock market conditions and to some extent, was influenced by the past poor performance of the Company. There was substantial evidence on the Department's papers that they and the Treasury had given careful consideration to the previous recommendations of the Public Accounts Committee, with particular reference to the capital structure of the Company, the methods of sale, the reduction of underwriting costs and the use of an independent pricing adviser. The Department always sought the advice of their consultants and the Treasury before determining the course they would adopt.

63. The National Audit Office found:

#### on the preparations for sale

(a) The Department allowed the Company to carry forward capital allowances of £1.6 billion and tax allowances of £171 million and agreed a capital reduction of some £642 million to eliminate the Company's accumulated deficit. They also waived their rights to a dividend in 1987-88 and agreed to the creation of a revenue reserve within the Company of £381 million to safeguard future dividends (paragraphs 15-19).

(b) The Department and the Treasury agreed that the balance of advantage lay with a November 1988 sale (paragraphs 21-25).

on the arrangements for sale

- (c) A number of firms were appointed to advise on the sale including a lead underwriter to act independently of the main financial adviser (paragraphs 26–27).
- (d) The option of a phased sale was considered fully but the Department, in conjunction with their advisers, decided that the balance of advantage lay with a 100 per cent sale (paragraph 30).
- (e) The Department examined four alternative methods of sale and decided, in the light of professional advice, that it should be on a fixed price basis (paragraphs 31–34).
- (f) Overseas sales would increase competition within the sale and maximise demand (paragraph 35).
- (g) The Department provisionally allocated two-thirds of the available shares to the UK market and one-third overseas. To underpin a high take-up of shares in the United Kingdom the Department arranged a 50 per cent firm placing of shares with United Kingdom institutions. A proportion of the provisional share allocations to the overseas market and to the United Kingdom institutions were however recoverable for redistribution to the United Kingdom public if home demand was high (paragraphs 36–38).
- (h) The whole of the offer for sale was underwritten, except for 16 million shares reserved for employees (paragraph 39).
- (i) No sub-underwriting commission was paid by the Department on firm placing shares and the overall commission rate across primary and sub-underwriting was the lowest so far achieved in recent Government share sales (paragraph 41).
- (j) British Steel employees were given a limited number of free shares but the Department and Treasury agreed that loyalty bonuses would not be offered to small investors (paragraph 44).
- (k) The prime indicator used for valuing the Company and setting the offer price was the forecast dividend yield supplemented by the price/earnings ratio. The Company's directors agreed that the projected annual dividend should be estimated at £150 million and this gave the company a yield of eight per cent on a capitalisation of £2.5 billion (paragraphs 46–50).
- (l) The share offer price was fixed at 125 pence to be paid in two instalments of 60 and 65 pence (paragraphs 51–55).

on the results of sale

- (m) In the United Kingdom the public offer was 3.3 times subscribed and shares were re-allocated from the provisional overseas and UK institutions' allocations to help meet public demand (paragraphs 56–58).
- (n) In the immediate aftermarket the shares traded at a premium of only some two per cent on the fully paid price, some 10 percentage points below the price anticipated by advisers (paragraph 59).

(o) The overall costs of sale as a percentage of gross sale proceeds are the lowest achieved in recent Government privatisations (paragraph 61).

### **Achievement of objectives**

64. The three main objectives set for the sale were:

- (a) to return British Steel to the private sector no later than August 1989;
- (b) to maximise the net proceeds of sale consistent with the achievement of a healthy aftermarket; and
- (c) to relinquish the Government's financial obligations to the Company at the date of privatisation.

65. As described above, the Department successfully achieved the first of these objectives through a public offer for sale in November 1988. There had been considerable past support from the taxpayer and some restructuring of the Corporation's accounts. Until the mid-1980s considerable sums of public money had been injected into the Corporation to restructure the industry and replace obsolete plant. And, in the immediate run-up to the sale, the Department eliminated the remaining trading losses from the Balance Sheet, allowed the carry forward of £171 million tax losses, waived the Government's rights to a 1987-88 dividend and allowed the creation of a distributable revenue reserve to underpin future dividend payments.

66. On the second objective of maximising net proceeds consistent with achieving a healthy aftermarket, the National Audit Office note that stock market conditions during 1988 were difficult, as indicated at Appendix 3. Advisers had indicated that by delaying the sale until January 1989, a number of uncertainties might have been reduced. From the Government's point of view, however, a sale shortly before the budget posed possible problems relating to prospectus disclosure. The modest premium which developed in initial trading after the sale (paragraphs 59 and 60) suggests that the Department's selection of 125 pence was the maximum price per share that could be achieved consistent with a healthy aftermarket.

67. On the final objective of relinquishing all Government financial obligations, the successful flotation of British Steel plc has achieved this objective.

# Appendix 1

## Estimated receipts from and costs of sale of shares in British Steel plc

	£ million	£ million	£ million
<b>Value of shares offered</b>			<b>2500</b>
<i>Less value of:</i>			
Free shares given to employees		5.2	
Matching shares given to employees		11.9	
Discount shares to employees and pensioners		0.7	17.8
<b>Gross proceeds of sale</b>			<b>2,482.2</b>
<b>Costs in respect of offer</b>			
Underwriting	21.3		
Selling and Broking Commissions	1.7		
Receiving Bank Costs	4.3		
Marketing Costs	11.6		
Advisers Fees	5.6		
Overseas Costs	2.8		
Other costs (excluding Stamp Duty)	0.2		
		47.5	
<i>Less:</i>			
Interest received on Application money		2.0	
<b>Net costs</b>			<b>45.5</b>
<b>Net proceeds of sale</b>			<b>2,436.7</b>

## Appendix 2

### Proceeds and costs of sale in recent sales of government shareholdings

Company	Date of sale	Equity sale proceeds	Expenses	Net proceeds
		£m	£m	£m
Cable and Wireless	1981	224	7 (1)	217
British Aerospace	1981	149	6 (2)	143
Amersham International	1982	63 (3)	3 (4)	60
Britoil	1982	548 (5)	17 (6)	531
Associated British Ports	1983	22 (7)	2	20
Enterprise Oil	1984	393	11	382
British Telecom	1984	3,863	263	3,600
British Gas	1986	8,091 (8)	360	7,731
British Airways	1987	892	42	850
Rolls Royce	1987	1,348	29 (9)	1,319
BAA	1987	1,278	95	1,183
British Steel	1988	2,482	46	2,436

**Notes:**

- (1) Excludes £35 million subscribed by the Government for new shares.
- (2) Excludes £100 million capital injection and £55 million PDC dividends foregone by the Government.
- (3) Excludes proceeds paid to the Company and interest on amounts held temporarily in respect of unsuccessful applicants.
- (4) Excludes Stamp Duty (£0.86 million).
- (5) Excludes £88 million debenture repayment.
- (6) Includes maximum possible cost of incentives for small shareholders.
- (7) Excludes £25 million paid by the Company to the Consolidated Fund and interest held temporarily in respect of unsuccessful applicants.
- (8) Includes £2,500 million debenture repayable to the Consolidated Fund.
- (9) Excludes capital injection of £283 million.



## Appendix 3

### Summary of changes in the monthly averages of the Financial Times All-Share Index during 1988

Month	% Change from previous month	% Difference between average highs and lows
January	+6.7	3.5
February	-0.6	5.1
March	+3.5	6.1
April	-1.0	4.0
May	+0.2	2.6
June	+3.7	4.1
July	+1.1	1.2
August	-1.1	7.4
September	-3.7	5.4
October	+4.1	3.6
November	-0.9	4.5
December	-3.6	3.2

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## Reports by the Comptroller and Auditor General Session 1989-90

The Comptroller and Auditor General has to date, in Session 1989-90, presented to the House of Commons the following reports under Section 9 of the National Audit Act, 1983:

Department of Trade and Industry: Sale of Rover Group plc to British Aerospace plc . . . . .	.HC 9
Quality Control of Road and Bridge Construction . . . . .	.HC 21
Publicity Services for Government Departments . . . . .	.HC 46
Text Processing in the Civil Service . . . . .	.HC 85
Invalidity Benefit . . . . .	.HC 91
Grants to Aid the Structure of Agriculture in Great Britain . . . . .	.HC 105
The NHS and Independent Hospitals . . . . .	.HC 106
Department of Trade and Industry: Promotion of Quality and Standards . . . . .	.HC 157
Bilateral Aid to India . . . . .	.HC 162
Regenerating the Inner Cities . . . . .	.HC 169
The Royal Mint . . . . .	.HC 195
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Department of Trade and Industry: Sale of Government Shareholding in British Steel plc . . . . .	.HC 210



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