

**UK Financial Investments Ltd**

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**PUBLICATION ON THE SALE OF  
NORTHERN ROCK PLC – FEBRUARY 2012**

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# 01

## Executive summary

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## Sale process launched after full review of options

The former Northern Rock was taken into Temporary Public Ownership (TPO) in February 2008 before being split into two legal entities, Northern Rock plc (the Company) and Northern Rock (Asset Management) plc, on 1 January 2010. From this point the shareholdings in both companies were managed by UK Financial Investments Ltd (UKFI) as part of the Government's Wholly-Owned portfolio<sup>1</sup> of financial services investments.

- Northern Rock plc was created as a smaller, well capitalised, deposit-taking and mortgage-providing bank which would be returned to the private sector; and
- Northern Rock (Asset Management) plc was formed from the residual former Northern Rock balance sheet and, as a capital-efficient financial institution, would run-down the remaining closed mortgage book and repay the Government loans and other creditors.

During 2010 and 2011, UKFI worked with Northern Rock plc to release the Government guarantees on deposits, operationally separate the two companies and restructure the cost base that Northern Rock plc inherited from the former Northern Rock.

In June 2011 the Chancellor of the Exchequer announced that he had decided to launch an open and transparent sale process for Northern Rock plc in line with State aid rules, allowing any interested parties to bid, including mutuals. This did not mean that other options to return Northern Rock plc to the private sector had been ruled out. However, the independent advice provided by UKFI was that a sale process was likely to maximise potential value for the taxpayer and should be explored as a first option. This was based on an assessment of the full range of options for returning Northern Rock plc to the private sector which was led by UKFI. Deutsche Bank AG (Deutsche Bank) provided independent corporate finance advice to UKFI and Northern Rock plc on the assessment of the options.

During the assessment of options to return Northern Rock plc to the private sector and the subsequent sale process, UKFI consulted with the board of Northern Rock plc which, having considered its specific responsibilities, agreed with the conclusions that UKFI reached on the best option to return the Company to the private sector. In providing its corporate finance advice, Deutsche Bank took into account UKFI and Northern Rock plc's commercial assessment of the options for the Company.

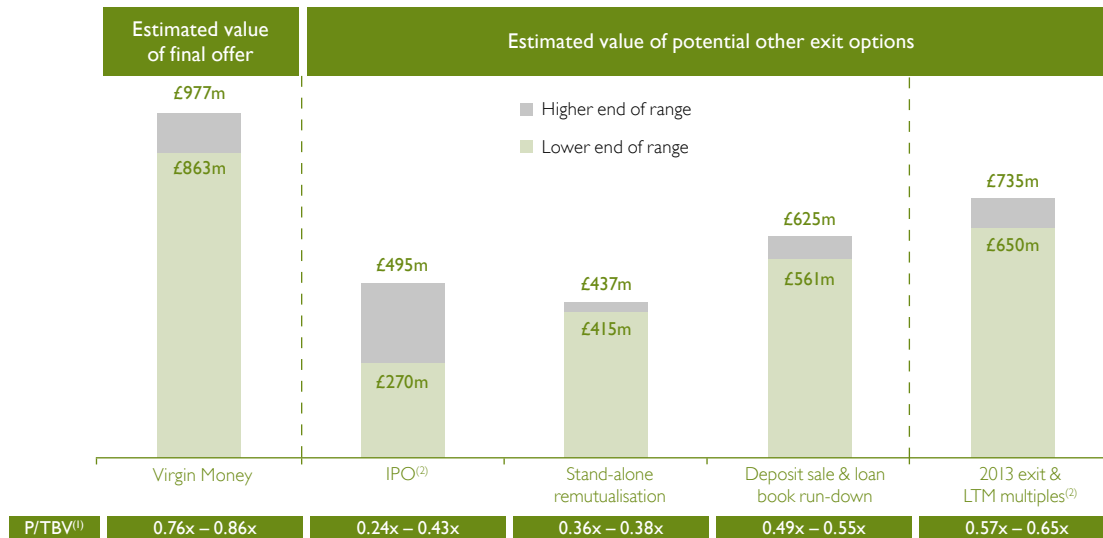
## Sale to Virgin Money maximises value for the taxpayer

The sale process attracted interest from a number of parties including mutuals, although no mutual submitted a final bid. The process concluded with the sale of Northern Rock plc to Virgin Money Holdings (UK) Limited (Virgin Money) on 1 January 2012.

The transaction consideration comprised £747 million cash on completion plus other cash and non-cash elements such that the taxpayer can receive up to c. £1 billion in total. Deutsche Bank estimated that the value of the transaction consideration to taxpayers was in the range of £863 million to £977 million. UKFI, having taken advice from Deutsche Bank, concluded that a sale to Virgin Money was the option that would maximise value for the taxpayer. The transaction met UKFI's mandated objectives to create and protect value for the taxpayer as shareholder, paying due regard to financial stability and competition and it met the European Commission sale deadline of 31 December 2013.

<sup>1</sup>Northern Rock plc, Northern Rock (Asset Management) plc and Bradford & Bingley plc

Figure I – estimated value of Virgin Money offer and other potential options to return Northern Rock plc to the private sector



Source: Deutsche Bank, as at 8 November 2011

<sup>(1)</sup>P/TBV (Price/Tangible Book Value) shows the multiple of value compared to the estimated tangible book value of Northern Rock plc at completion of the sale

<sup>(2)</sup>IPO is Initial Public Offering (or flotation) and LTM is Last Twelve Months

The value range of the sale to Virgin Money was assessed to be higher than all other options to return the Company to the private sector namely an IPO, a stand-alone remutualisation, a deposit sale and loan book run-down and a later exit from TPO in 2013.

- An IPO of Northern Rock plc was valued at less than half of the Virgin Money offer\* and the prospects for a successful IPO were remote in the market conditions at the time.
- A remutualisation of the Company was valued at less than half the value of the Virgin Money offer\* due in part to the need for HM Treasury to gift some equity to members, and the long term nature and risks of the returns to HM Treasury from retaining investments in mutual capital instruments.
- A deposit sale and run-down of Northern Rock plc's loan book would require significant new funding, most likely from the Government, and would have been likely to still have a value about a third lower than the Virgin Money offer\*.
- The market value of the Company in 2013 was estimated to be around a quarter less than the Virgin Money offer\*. This would have required the successful delivery of the Northern Rock plc business plan in the challenging economic environment as well as a recovery of UK bank trading multiples to their last twelve months average.

The Virgin Money offer was both higher and substantially more deliverable than the competing bid received from another party at the end of the second round of the sale process and, overall, represented a multiple of c. 0.7 times to c. 0.9 times the tangible book value of Northern Rock plc against comparable UK banks' trading multiples at the time of c. 0.5 times.

\*based on mid-points of the value ranges

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### Attractive competition outcome

The Virgin Money offer was also more attractive than the IPO, remutualisation and deposit sale and loan book run-down options from a competition perspective. Virgin Money and Northern Rock plc combined has £19 billion total assets, 75 branches and 4 million customers, bringing together two entities with complementary product sets and distribution channels with the potential to develop into a challenger bank<sup>2</sup> in the future.

Virgin Money has plans to expand into the personal current account market and make a staged entry into offering products to small and medium sized enterprises. Customers will see the existing branch distribution retained and rebranded as Virgin Money, with the cross-sale of new products and the introduction of new IT systems to support multi-channel distribution.

### Optimal timing for the sale

UKFI considered carefully the issue of timing and recommended to the Chancellor that a sale to Virgin Money at the end of 2011 was in the best interests of taxpayers.

The sale fulfilled the European Commission State aid requirement to exit majority ownership of Northern Rock plc by 31 December 2013. It could not be guaranteed that market conditions and associated valuations would improve before the European Commission sale deadline. Neither was there any certainty that the two parties who had made offers at the end of the sale process would still be interested in the future, especially as Virgin Money had made it clear that their valuation of Northern Rock plc would decrease as they made further significant investment in their own organic plan and the other party's offer was conditional on events that had a high degree of risk.

In considering the issue of timing, UKFI took into full account that valuations in the UK banking sector had declined significantly. UKFI recognised that Northern Rock plc faced significant challenges as a small bank operating in a difficult economic environment and that by selling now, HM Treasury would no longer be exposed to these risks impacting the value achieved.

Against this background, the significant premium that Virgin Money's offer represented versus trading multiples at the time, the uncertain outlook for the Company and the economy, and the European Commission State aid deadline, all supported the decision to accept Virgin Money's offer.

### Positive returns expected across the former Northern Rock companies

The Government provided £37 billion of funding into the two companies that comprise the former Northern Rock, i.e. Northern Rock plc and Northern Rock (Asset Management) plc.

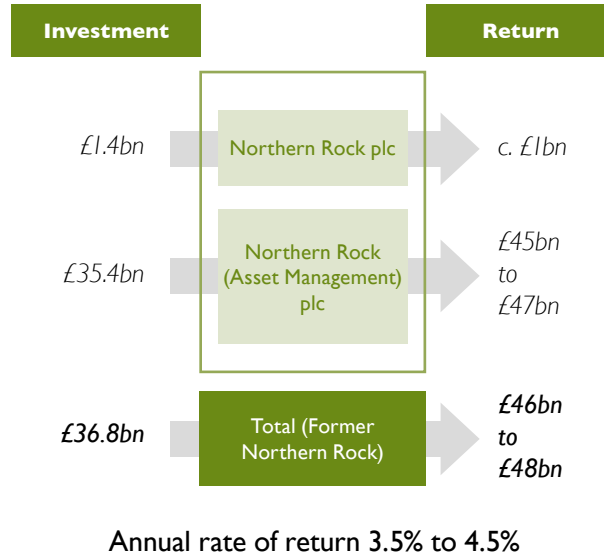
Over time, the return of cash from these companies to the Government is expected to total between £46 billion and £48 billion. This includes<sup>3</sup> the consideration from the sale of Northern Rock plc and the loan repayments, interest, guarantee fees and equity value at wind-up from Northern Rock (Asset Management) plc. This means that, in cash terms, the companies are expected to more than repay the original funding provided by the taxpayer.

However, this cash is expected to be returned over a period of around 10 to 15 years from 2012 as Northern Rock (Asset Management) plc is run-down and the remaining Government loan is repaid. This is equivalent to receiving an annual rate of return on the Government's intervention of 3.5% to 4.5% per year and compares to the Government's estimated notional annual funding costs during the period of intervention of 3.9%.

<sup>2</sup>The Independent Commission on Banking defines challenger banks as 'those that are large enough to be a threat to the incumbents, but small enough to have an incentive to compete for new customers' - ICB Interim Report (April 2011)

<sup>3</sup>The returns of cash exclude additional cash flows that the Government will receive in tax paid by the companies

Figure 2 – Government investment and expected return in the former Northern Rock



Source: UKFI analysis, Northern Rock plc sale consideration, Northern Rock (Asset Management) plc business plan  
 Note: of the £46 billion to £48 billion expected return, £18 billion has been received to date since the initial Government intervention in September 2007



# 02

## Introduction

## **This publication**

In line with the Government's commitment to transparency, this publication sets out the background to and the rationale for the decision to return Northern Rock plc to the private sector through its sale to Virgin Money.

The former Northern Rock was split into the current, smaller mortgage and savings bank, now named Northern Rock plc, and the much larger closed mortgage book, now named Northern Rock (Asset Management) plc, in January 2010. Recognising the need to present a consolidated view of the impact of the Government's intervention on both elements, we have also outlined in this document an estimate of the overall taxpayer return from the Government's intervention in the former Northern Rock. This takes into account taxpayer support injected into both companies and compares this to the sale proceeds of Northern Rock plc and the longer term payback expected from the current business plan of Northern Rock (Asset Management) plc. We also include an overall assessment of taxpayers' expected return from the three companies that comprised the Government's Wholly-Owned financial services investments, i.e. also incorporating Bradford & Bingley plc.

A significant amount of information contained in this report was commercially sensitive prior to the completion of the transaction on 1 January 2012. Following completion, UKFI is now able to release information in the public interest, which sets out the rationale for the sale and certain related information. Inevitably in a sale process which involves a competitive auction between a range of commercial parties, some detailed information continues to be confidential or cannot be disclosed without damaging the commercial interests of the Government.

At the time of this publication the National Audit Office is conducting its value for money study into the sale of Northern Rock plc and is due to publish its findings before the Parliamentary recess of summer 2012.

## **UKFI's remit**

UKFI was created in November 2008 as part of the UK's response to the financial crisis.

The former Northern Rock had been taken into TPO in February 2008 and following a legal and capital restructuring of the company which split the former Northern Rock's businesses into two on 1 January 2010, UKFI became responsible for the management of HM Treasury's investments in the two entities, Northern Rock plc and Northern Rock (Asset Management) plc. This was in addition to UKFI's role in managing the taxpayer's investments in Bradford & Bingley plc, The Royal Bank of Scotland Group plc and Lloyds Banking Group plc.

UKFI's overarching objective is to manage these shareholdings commercially to create and protect value for the taxpayer as shareholder and to devise and execute a strategy for realising value for the Government's investments in an orderly and active way over time within the context of protecting and creating value for the taxpayer as shareholder and where applicable, as provider of financial support, paying due regard to the maintenance of financial stability and acting in a way that promotes competition.

Following a competitive tender process, UKFI and Northern Rock plc appointed Deutsche Bank to provide independent corporate finance advice in relation to the assessment of options to return Northern Rock plc to the private sector and the subsequent sale process. In providing its corporate finance advice, Deutsche Bank took into account UKFI and Northern Rock plc's commercial assessment of the options for the Company.

# 03

Background on Northern Rock plc

### **Former Northern Rock taken into TPO**

In 2007, the former Northern Rock was affected by the severe reductions in global liquidity, which had a significant impact on its ability to raise sufficient funding. The bank had become increasingly reliant on wholesale lenders and the deteriorating environment for wholesale funding led to a situation where it required liquidity support from the Bank of England, and HM Treasury put in place guarantee arrangements for the retail and wholesale deposits held by the former Northern Rock. The bank initiated a strategic review to look at the range of options available to it, all of which required substantial continuing support from HM Treasury and the Bank of England. HM Treasury decided to take the former Northern Rock into a period of TPO with effect from 22 February 2008.

### **Development of the former Northern Rock post-TPO**

For the remainder of 2008, the former Northern Rock focused on repaying the Government loan facilities by accelerating mortgage redemptions. It restructured and realigned the business with a view to repaying Government funds and returning it to the private sector. However, the external economic environment deteriorated further during 2008, particularly with the global banking crisis intensifying in the second half of the year. There was a further contraction in liquidity in the market, lending conditions continued to tighten and the UK housing market declined more rapidly than previously forecast. In response to the changes in the external environment, the former Northern Rock embarked in the autumn of 2008 on a review of its business plan in close consultation with the Government. This led to a revision to the former Northern Rock's strategy in February 2009 when it announced an increase in mortgage lending capacity and began to slow down its mortgage redemption programme.

The UK Government applied successfully for State aid approval from the European Commission, which was granted in October 2009 and on 1 January 2010 the business was restructured into two legal entities: Northern Rock plc and Northern Rock (Asset Management) plc. This separation of the former Northern Rock reduced the amount of capital support required from the taxpayer compared to keeping the former Northern Rock as one entity and it created:

- Northern Rock plc, a smaller, well capitalised, deposit-taking and mortgage-providing bank, with the aim for it to play an active role in the mortgage market and which would be returned to the private sector; and
- Northern Rock (Asset Management) plc, a large, closed mortgage book formed from the residual former Northern Rock balance sheet which, as a capital-efficient financial institution, would run-down the remaining balance sheet and repay the Government loans and other creditors.

### **Formation of Northern Rock plc, a new retail bank**

Northern Rock plc was formed as a new savings and mortgage bank that held and serviced all pre-existing customer savings accounts and some pre-existing mortgage accounts. As of 1 January 2010, the Company had total assets of £22.5 billion of which £10.3 billion were mortgages, and held total retail deposits of £19.4 billion. Northern Rock plc was authorised and regulated as a deposit taker by the Financial Services Authority (FSA) and offered savings and mortgages products. In line with regulatory requirements, the Government injected £1.4 billion of equity to capitalise the bank at inception. It was recognised in the Company's business plan that this equity would decrease in its early period of development when the Company was forecast to be significantly loss-making. The new Northern Rock plc was much smaller than its predecessor. It held approximately 0.9% of the stock of UK mortgages and its share of the UK retail deposit market was approximately 1.5%. The Company operated through 75 branches, alongside internet, post and telephone channels.

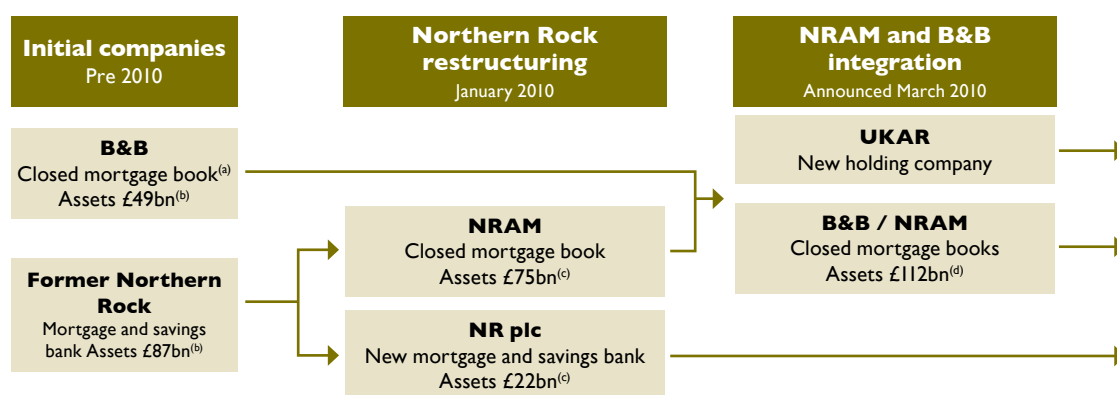
HM Treasury recognised that Northern Rock plc was a strongly capitalised and highly liquid bank with an independent future and, in February 2010, it announced a three month notice period for the lifting of the Government guarantee arrangements relating to Northern Rock's retail deposits (except for fixed term accounts existing at the time which retained the guarantee for the remaining term of the product). Northern Rock plc's retail savers remained covered by the Financial Services Compensation Scheme (FSCS). In November 2010, HM Treasury also lifted the Government guarantee arrangements on Northern Rock plc's wholesale liabilities after giving three months' notice.

### Establishing UKAR and achieving full operational separation

During 2010, UKFI established UK Asset Resolution Limited (UKAR) as the single holding company under which Northern Rock (Asset Management) plc and Bradford & Bingley plc were integrated with a common governance and management structure. This allowed UKAR to proceed with implementing plans to manage the closed mortgage books of both companies on common platforms and ensured a continued focus on customer service, arrears management and efficient operations, maximising value for the taxpayer.

During 2010, UKFI worked with HM Treasury, Northern Rock plc and Northern Rock (Asset Management) plc to separate the two companies operationally. This was achieved by the end of 2010 which was a State aid requirement of the European Commission. The operational separation of the companies and release of the deposit guarantees positioned Northern Rock plc to be returned to the private sector in due course and allowed Northern Rock (Asset Management) plc to focus on the orderly run-down of its closed mortgage book and repayment of the Government funds and other creditors.

**Figure 3 – Restructuring of Wholly-Owned companies<sup>4</sup>**



### Restructuring during 2010 and 2011

During 2010 and 2011 UKFI worked with the management of Northern Rock plc to restructure the cost base that the new smaller bank had inherited from the former Northern Rock and which needed to be reduced to allow the bank to return to profitability.

In 2010, Northern Rock plc's first year of trading, the Company undertook significant restructuring. The Company continued to support capacity in the UK mortgage market, with gross mortgage lending (including retention business) during 2010 of £4.2 billion. This led to net residential lending of £1.9 billion in the year, increasing mortgage balances to £12.2 billion at 31 December 2010. A loss of £224 million was reported for the year reflecting the ongoing high cost base of the Company and the difficult trading environment for a small bank dependent upon retail funding, including the prevailing low interest rate environment and subdued mortgage market.

<sup>4</sup>B&B is Bradford & Bingley plc; NRAM is Northern Rock (Asset Management) plc; NR plc is Northern Rock plc; and UKAR is UK Asset Resolution Limited

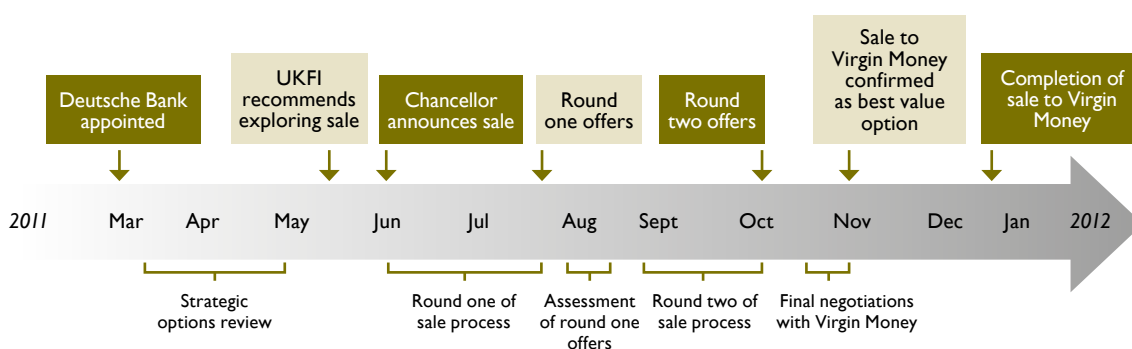
(a) Branches and retail deposits sold to Santander in September 2008. (b) Assets as at 31 December 2009

(c) Assets as at 1 January 2010. (d) Assets as at 31 December 2010

In the first half of 2011, the Company grew the mortgage book to £12.5 billion although tough trading conditions and the deterioration in the macro-economic environment continued. In parallel, operating expenses were reduced however the Company reported a further loss in this period.

Given the continued loss-making profile of the business, the European Commission deadline, the challenges of the forward looking economic environment and the importance of enabling management to focus on a clear strategic direction, a decision was taken in late 2010 to initiate work to investigate options for maximising value and optimal timing for returning the Company to the private sector. This culminated in the sale of Northern Rock plc to Virgin Money on 1 January 2012.

Figure 4 – timeline for the assessment of strategic options and subsequent sale



# 04

## Strategic options assessment

### Assessing a full range of exit options

During late 2010 and early 2011, UKFI and HM Treasury developed an evaluation framework for the assessment of strategic options to return Northern Rock plc to the private sector; consistent with UKFI's overarching objective to protect and create value for the taxpayer as shareholder, paying due regard to financial stability and competition.

Following a competitive procurement process, Deutsche Bank was appointed in March 2011 by UKFI and Northern Rock plc to act as independent corporate finance advisers.

A full range of options was analysed, including:

- a sale process where Northern Rock plc could be acquired by a new entrant or in-market player; including remutualisation through a sale to an existing mutual organisation;
- a stand-alone remutualisation of the Company;
- a public share offering (IPO); and
- a sale of some or all of the assets and liabilities to one or more parties (a deposit and loan sale/ run-down).

An explanation of these options is covered later in this publication.

The assessment of the options indicated that a sale to a single buyer would be likely to deliver the greatest value to the taxpayer. This assessment was based principally on the synergies that would result from a combination (including capital benefits, cost efficiencies and revenue enhancements), the strategic premium a bidder might be willing to pay and the assessed potential bidder interest in the Company. At this stage of the assessment, UKFI considered other options for the returning the Company to the private sector to be relatively less valuable to the taxpayer.

During the options analysis, UKFI worked with Northern Rock plc to review the Company's business plan and with Deutsche Bank to consider the likely valuations implied by the business plan on each of the exit options. UKFI, with the support of Deutsche Bank and Northern Rock plc, considered the timing and risks attached to the Company returning to profitability including factors such as the scale of the cost reduction challenge, the uncertain macro-environment and the implications of low interest rates continuing for a longer period. UKFI also worked with Freshfield Bruckhaus Deringer LLP (Freshfields), who were appointed legal advisers to UKFI and Northern Rock plc, to consider the legal considerations and implications of each of the exit options.

UKFI assessed the relative potential for capital to be extracted from Northern Rock plc under each option to ensure that all sources of potential value for the taxpayer were understood. This assessment included considering the ability of Northern Rock plc to extract capital in advance of an exit as well as the potential for a future owner to reflect in their purchase price the value of capital synergies to be extracted post-exit.

UKFI's assessment included consideration of relevant factors which were judged to impact the risk-adjusted value to the taxpayer of the exit options<sup>5</sup>.

<sup>5</sup>Risk-adjusted value incorporated an assessment of risks including execution, value realisation, legal, regulatory and European Commission approval risks



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### **Paying due regard to competition and financial stability**

UKFI, working with HM Treasury, also assessed the strategic options for the Company from a competition and financial stability perspective, the latter with appropriate input from the FSA and the Bank of England.

The competition assessment covered criteria on market concentration, challenger status and customer impact. Given the Company's current scale and focus on mortgage and savings products, the competition assessment did not raise material concerns on the impact of a sale on market concentration. Moreover, UKFI and HM Treasury viewed a sale which contributed to the development of a new or emerging challenger bank<sup>6</sup> as an enhancement of competition in the UK market relative to stand-alone options.

Impact on customers was assessed during the sale process when there was sufficient detail on dimensions of innovation, quality, choice and price relating to specific options.

The financial stability assessment considered the risk profile of each option's business model, the degree to which regulatory requirements would be met, any potential detrimental customer reaction, the risk of a failed process and any systemic risk created. UKFI and HM Treasury did not identify any material issues in the financial stability assessment of the strategic options.

### **Reassessment of options**

UKFI, with support from Deutsche Bank, carried out an assessment of all options by considering their relative valuations during the strategic options phase, which UKFI considered together with the assessment of the competition and financial stability characteristics of each option. This was reassessed using refreshed information and assumptions at key milestones during the subsequent sale process.

Further detail on the assessment of the different factors is described in the section below on the transaction outcome.

<sup>6</sup>The Independent Commission on Banking defines challenger banks as 'those that are large enough to be a threat to the incumbents, but small enough to have an incentive to compete for new customers' - ICB Interim Report (April 2011)

05

Sale process

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## Exploring a sale process

In June 2011 the Chancellor of the Exchequer announced that he had decided to explore a sale of Northern Rock plc. The sale process was confirmed to be open, transparent and in line with State aid rules, allowing any interested parties to bid, including mutuals.

Deutsche Bank together with UKFI managed the sale process and engagement with the potential purchasers at arms' length from HM Treasury. HM Treasury and Ministers did not engage directly in the commercial negotiations with potential purchasers.

## Bidding process

In June 2011, Deutsche Bank had initial contact with 52 parties about participating in the sale process, of which 24 signed confidentiality agreements and received an Information Memorandum. Of these 24 parties, ten were private equity firms. The remaining 14 parties comprised four mutuals, eight new and emerging challengers from the UK and overseas, and two existing UK financial institutions. Although contacted, no large UK incumbent banks chose to pursue the opportunity.

A sale process was executed with two rounds of bidding, during which a number of parties actively participated. In the first round, parties could submit initial non-binding bids, whereas parties were asked to submit final binding bids at the end of the second round. Five parties were involved during the two rounds of the sale process and two bids were received at the end of the second round. Whilst mutuals participated in the sale process, none provided a final bid.

At each stage throughout the transaction, UKFI, with advice from Deutsche Bank, made an assessment as to whether to continue or to postpone the sale process. UKFI's recommendation at each stage, taking into account the bidding information available and the deteriorating market conditions, was to continue to explore the sale option.

## Continuing to pursue a sale process

Following second round bids, UKFI completed a reassessment of all options, taking into account the bid values, updated capital guidance for Northern Rock plc on a stand-alone basis received from the FSA in early October 2011, and refreshed assumptions based on the current market conditions that were declining during this period. UKFI decided, having considered a range of factors including advice from Deutsche Bank, that pursuing the sale route, given the offers received, was more attractive for taxpayers than the alternative exit options, including a sale at a later date before the European Commission deadline of 31 December 2013 expired. As such, UKFI made a recommendation to the Chancellor to continue discussions with the second round bidders.

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Transaction outcome

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## Transaction outcome

In November 2011 UKFI agreed to sell 100% of the share capital of Northern Rock plc to Virgin Money in a transaction where the Government received £747 million cash on completion with the potential in the future to receive up to c. £1 billion in total. The total consideration comprised the following components, further detail on which is contained in the appendices:

- Cash of £747 million on completion and a further expected c. £50 million cash within six months of completion;
- Tier 1 Capital Notes of £150 million with an annual coupon from 2013 of 10.5% (£15.75 million); and
- Additional cash consideration of £50 million to £80 million receivable upon a future profitable IPO or sale in the 5 years following the transaction.

Prior to reaching final agreed terms, UKFI had granted a short period of exclusive contract discussions to Virgin Money and during this time UKFI, with support from Deutsche Bank, negotiated increased value above Virgin Money's second round offer.

## Virgin Money transaction is the highest value option

Before agreeing the transaction and signing contracts with Virgin Money, Deutsche Bank and UKFI carried out a final assessment of the proposed Virgin Money transaction against the other bid and other non-sale options from a value, competition and financial stability perspective.

The value range of the sale to Virgin Money was assessed to be higher than an IPO, a stand-alone remutualisation, a deposit and loan book sale/run-down and the market value in 2013. The Virgin Money offer was higher, substantially more certain and deliverable and it carried significantly less execution risk than the other second round bid. The other offer was conditional upon a number of factors including securing financing, completing due diligence and other material conditions.

The chart below shows the estimated value of the Virgin Money transaction<sup>7</sup> compared to the estimated value of potential other options to return Northern Rock plc to the private sector.<sup>8</sup> These values are taken from financial analyses prepared by Deutsche Bank as at 8 November 2011, are subject to a range of assumptions and are attributable to a number of sources.

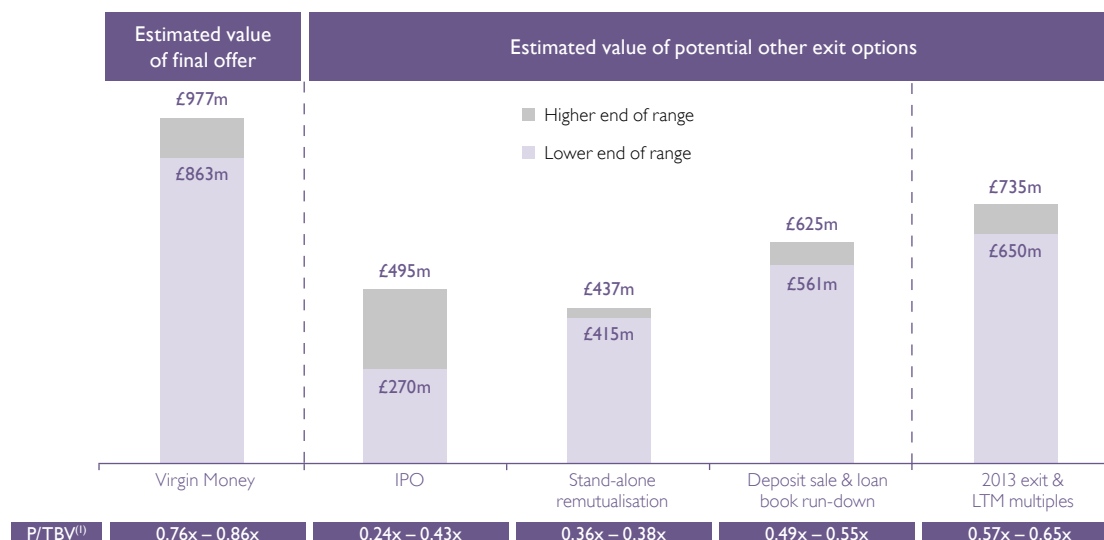
Deutsche Bank also provided UKFI with a fairness opinion on the financial terms of the bid by Virgin Money. This opinion concluded, on the basis of certain assumptions and qualifications, that the total consideration received from the sale was fair to HM Treasury from a financial point of view.

Deutsche Bank's financial analyses and fairness opinion were delivered to UKFI prior to signing of the sale and purchase agreement with Virgin Money. The board of Northern Rock plc made its own assessment of the proposed transaction and agreed with the conclusions that UKFI reached on the best option to return Northern Rock plc to the private sector.

<sup>7</sup>The aggregate 'headline' cash value of the Virgin Money final offer is higher than the estimated value of £86.3m to £97.7m. The latter is based on cash received on completion plus the following expected cash flows which are discounted to reflect the time value of money: further cash in the second quarter of 2012 relating to the net asset value of the Company at completion; Tier 1 Capital Notes and associated interest coupons; and additional cash consideration payable upon Virgin Money delivering a future profitable IPO or sale

<sup>8</sup>The ranges of valuations are shown to reflect an estimated lower and higher end of valuations

Figure 5 – estimated value of Virgin Money offer and other potential options to return Northern Rock plc to the private sector



Source: Deutsche Bank, as at 8 November 2011

<sup>(1)</sup>P/TBV (Price/Tangible Book Value) shows the multiple of value compared to the estimated tangible book value of Northern Rock plc at completion of the sale

<sup>(2)</sup>IPO is Initial Public Offering (or flotation) and LTM is Last Twelve Months

## IPO

Deutsche Bank assessed the value of an IPO to be between £270 million and £495 million which was less than half the estimated value of the Virgin Money offer\*.

Under an IPO the proceeds would have been influenced by the prevailing pricing of UK banking stocks, investor demand for the Company's stock and the percentage of the stock which could be sold under an IPO. Market conditions had been deteriorating during 2011 and the value of a potential IPO had declined in line. Given these conditions, and other factors such as questions over investor appetite in a stand-alone bank of the limited scale of Northern Rock plc, UKFI recognised that the prospect for a successful IPO was remote and would at a minimum require a return to normalised equity markets.

## Stand-alone remutualisation

Deutsche Bank assessed the value of a stand-alone remutualisation to be between £415 million and £437 million which was less than half the estimated value of the Virgin Money offer\*.

A stand-alone remutualisation would have involved transferring ownership to mutual members, with HM Treasury converting the majority of its current investment in Northern Rock into mutual capital instruments to be retained by HM Treasury. These instruments would earn an annual dividend or coupon and, contingent on a market developing, could be sold at some point in the future.

The value of a stand-alone remutualisation option was constrained due to the need for HM Treasury to gift equity to members and the long term nature and risks of the returns to HM Treasury from the mutual capital instruments. The value of the stand-alone remutualisation option is in any event uncertain, due to questions over the achievability of placing a significant debt-like burden on a mutual in the form of interest bearing mutual capital instruments.

In addition to assessing the option of a stand-alone remutualisation, UKFI encouraged mutuals to participate in the sale process. Of those mutuals that showed interest, none went on to submit a bid for the Company.

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## Deposit sale and loan book run-down

Deutsche Bank assessed the value of a deposit sale and loan book run-down to be between £561 million and £625 million which was about a third lower than the estimated value of the Virgin Money offer\*.

A deposit and loan book sale would have involved the separate sale of Northern Rock plc's retail deposit base and its loan book. However, a sale of the loan book in the prevailing market would have been likely to require discounts to the par value of loans and would have created significant losses. An alternative of running-down the loan book over time was assessed. This could have yielded higher returns than a sale of the loan book, but would have required upfront additional funding, to allow the retail deposits to be cash-matched and sold. This funding would most likely have needed a significant additional injection of taxpayer funds from the Government, requiring further State aid approvals. Under this alternative, any equity value in the business would effectively have been trapped until the loan book was run-off and funding repaid.

## Exit in 2013

Deutsche Bank assessed the market value of the Company in 2013 to be between £650 million and £735 million which was around a quarter less than the estimated value of the Virgin Money offer\*.

In estimating the market value in 2013, Deutsche Bank used a number of methods based on UK bank trading multiples. These were applied to potential future earnings and book values of Northern Rock plc and then discounted to reflect the time value of money. The estimated value assumed, amongst other things, the successful delivery of the Northern Rock plc business plan and that UK bank trading multiples would recover to the average level in the prior 12 months to November 2011, otherwise the estimated valuations could have been lower.

## Assessing competition and financial stability

From a competition perspective, Virgin Money and the other second round bid were viewed as enhancing competition in the UK market relative to stand-alone options, such as an IPO or a stand-alone remutualisation. From a financial stability perspective, both Virgin Money and the other bid were acceptable.

Virgin Money and Northern Rock plc combined has £19 billion total assets, 75 branches and 4 million customers, bringing together two entities with complementary product sets and distribution channels. The combination creates no concerns about concentrating market share and provides the potential to develop into a challenger bank in the future.

Virgin Money has plans to expand into the personal current account market and make a staged entry into offering products to small and medium sized enterprises. Customers will see the existing branch distribution retained and rebranded as Virgin Money, with the cross-sale of new products and the introduction of new IT systems to support multi-channel distribution.

## Timing of sale

UKFI took into consideration a full range of issues on timing, including advice received from Deutsche Bank. UKFI's recommendation to the Chancellor was that agreeing a sale to Virgin Money at the end of 2011 was in the best interests of the taxpayer and an exit should not be delayed.

As part of the agreement for the UK Government to provide State aid to rescue Northern Rock, the European Commission imposed a number of requirements upon the UK, one of which was that HM Treasury must exit majority ownership of Northern Rock plc by 31 December 2013<sup>9</sup>. All such requirements of the European Commission are legally binding conditions for the approval of aid under the Treaty of the

<sup>9</sup>"the United Kingdom will exit majority ownership of BankCo by 31 December 2013. In this context, TPO is deemed to be exited if the United Kingdom has sold at least 50% + 1 of BankCo's shares to a non State-owned or controlled entity (or entities) and the United Kingdom has lost control over BankCo within the meaning of Council Regulation (EC) No 139/2004 of 20 January 2004 on the control of concentrations between undertakings". A redacted version of this requirement was published by the European Commission: see COMMISSION DECISION of 28.10.2009 ON THE STATE AID n° C 14/2008 (ex NN 1/2008) implemented by the United Kingdom for Northern Rock

\*based on mid-points of the value ranges

Functioning of the European Union and HM Treasury was therefore bound by its commitments to the Commission unless the Commission agreed to reopen its decision of October 2009. The UK Government had extensive discussions with the European Commission before and during the sale process and HM Treasury considered that the European Commission would not have granted an extension to the sale deadline without a sale process having first been explored. Furthermore, HM Treasury considered that an extension would not subsequently have been granted once the sale process had yielded an offer from a credible purchaser at a value that was higher than other exit options and prevailing market valuations.

In considering the issue of timing UKFI took into full account that valuations in the UK banking sector had declined significantly. It could not be guaranteed that market conditions and associated valuations would improve before the European Commission sale deadline of 31 December 2013 and HM Treasury would otherwise have continued its full exposure to Northern Rock plc's uncertain financial performance as a result of the challenging operating environment.

The European Commission sale deadline meant that any later sale process closer to this deadline could have faced significant potential risks in terms of UKFI's ability to achieve full value for taxpayers. A sale process close to the deadline would have run the risk of HM Treasury being perceived by potential purchasers as a forced seller, which could have undermined competitive tension and sale proceeds.

Additionally, there was no certainty that the two parties who had made offers at the end of the final round would still be interested in the future, especially as Virgin Money had made it clear that their valuation of Northern Rock plc would decrease as it made further significant investment in its own organic plan and the other party's offer was conditional on events that had a high degree of risk.

UKFI recognised that Northern Rock plc faced significant challenges as a small bank operating in a difficult economic environment and that by selling now, HM Treasury would no longer be exposed to these risks impacting the value achieved.

The sale process had commenced in June 2011 directly following a review of strategic options for returning Northern Rock plc to the private sector which started in March 2011. UKFI had not recommended pursuing a sale earlier than this as Northern Rock plc needed to meet a number of restructuring milestones before being ready for sale. These included the operational separation from Northern Rock (Asset Management) plc which concluded in December 2010; the lifting of the retail and wholesale Government guarantees in May and November 2010; and the commencement of the Company's business plan to restructure costs and demonstrate to potential purchasers visibility of returning the Company to profitability.

Against this background, the significant premium that Virgin Money's offer represented versus current trading multiples, the uncertain outlook for the Company and the economy, and the European Commission State aid deadline, all supported the decision to accept Virgin Money's offer.

### **Achieving commitments from Virgin Money**

Virgin Money made a number of commitments relating to the acquisition:

- There will be no compulsory redundancies beyond those already announced by Northern Rock plc for at least three years from completion;
- The total number of Northern Rock plc branches will be retained, and in due course extended as the business' growth allows;
- The combined business will compete strongly in the UK retail savings and mortgage markets – launching current accounts in 2013 and, in due course, lending to small businesses;



- The operational headquarters of Virgin Money will be based in Newcastle; and
- Upon completion, Northern Rock plc's current commitment to the Northern Rock Foundation will be extended immediately, in respect of Northern Rock plc's existing business, to the end of 2013. This gives Virgin Money and the Northern Rock Foundation time to agree how they will work together after that.

### Ensuring legal protections for Government

Freshfields acted as legal advisers to UKFI and Northern Rock plc and advised on the sale and purchase agreement (SPA). The SPA was entered into between HM Treasury, Northern Rock plc and Virgin Money and sets out the terms and conditions of the transaction, including details of the consideration paid by Virgin Money and the contractual protections in the form of warranties and indemnities provided by the parties. The SPA included important benefits and protections to defend the taxpayer's interests. Detailed terms of the SPA are commercially sensitive and confidential however the following features are noted as examples of the benefits and protections achieved for HM Treasury:

- With the exception of a small number of matters which carry limited risk, all of the warranties provided by HM Treasury to Virgin Money were given subject to the awareness of the Northern Rock plc executive management team. This limits the circumstances in which Virgin Money would be able to claim under these warranties;
- A substantial amount of information (in the region of 70,000 pages) was disclosed against the warranties provided, thereby reducing the circumstances in which Virgin Money would be able to claim under these warranties;
- Save for a standard tax indemnity, which carries limited risk on the basis that Northern Rock has been loss-making since the restructuring in 2010, no other indemnities were provided by HM Treasury in respect of Northern Rock plc;
- The economic and time-duration limitations on any future HM Treasury liability under the warranties and tax covenant are either within, or at a more favourable level than, general market practice seen in the sale of UK companies at the time of sale; and
- Reasonably detailed warranties were provided by Virgin Money in respect of its group's business and operations which supports HM Treasury's acceptance of the Tier 1 Capital Notes which form part of the sale consideration.

### Liaison with the FSA and European Commission

The UK Government has interacted regularly with the FSA and European Commission to discuss the performance and prospects for the Company for a significant period, including prior to when the former Northern Rock was taken into TPO. UKFI and HM Treasury communicated with the European Commission at key milestones during the strategic options review and the subsequent sale process. This included sharing the final transaction consideration along with a comparison to the alternative options and the other second round offer, and the European Commission indicated no concerns on the overall process or the proposed transaction. During December 2011, the proposed change in control of Northern Rock plc to Virgin Money and its investors received approval from the FSA and merger clearance from the European Commission.

# 07

Combined cash flows from the Government's intervention in the former Northern Rock

## Analysing cash flows

The former Northern Rock was legally separated on 1 January 2010 into Northern Rock (Asset Management) plc and Northern Rock plc. Recognising the need to present a consolidated view of the impact of the Government's intervention in the former Northern Rock, UKFI has calculated the expected returns to HM Treasury from both elements of the former company: Northern Rock plc and Northern Rock (Asset Management) plc. This has been performed by analysing:

- historical cashflows since the initial Government intervention in Northern Rock in September 2007; and
- expected cashflows from Northern Rock (Asset Management) plc business plan and the Northern Rock plc sale.

## Positive returns expected across the former Northern Rock entities

The Government provided £36.8 billion of funding into the two companies that comprise the former Northern Rock, i.e. Northern Rock plc and Northern Rock (Asset Management) plc.

Over time, the return of cash from these companies to the Government is expected to total between £46 billion and £48 billion. This includes<sup>10</sup> the consideration from the sale of Northern Rock plc and the loan repayments, interest, guarantee fees and equity value at wind-up from Northern Rock (Asset Management) plc. This means that, in cash terms, the companies are expected to more than repay the original funding provided by the taxpayer.

However, this is expected to be returned over a period of around 10 to 15 years from 2012, as Northern Rock (Asset Management) plc is run-down and the remaining Government loan is repaid. This is equivalent to receiving a positive annual rate of return on the Government's intervention of 3.5% to 4.5% per year and compares to the Government's estimated notional annual funding costs during the period of intervention of 3.9%.

## Figure 6 – estimated cash returns from HM Treasury's investment in the former Northern Rock

|  | Cash invested by HM Treasury | Cash return to HM Treasury   |
|--|------------------------------|------------------------------|
| Northern Rock plc                          | £1.4 billion                 | c. £1 billion <sup>(a)</sup> |
| Northern Rock (Asset Management) plc       | £35.4 billion                | £45 billion to £47 billion   |
| Total i.e. the former Northern Rock        | £36.8 billion                | £46 billion to £48 billion   |
| <b>Annual rate of return: 3.5% to 4.5%</b> |                              |                              |

<sup>(a)</sup>based on fees from 1 January 2010 for the Government guarantees on retail and wholesale deposits; cash received on completion of sale on 1 January 2012; and additional expected cash flows from the sale; further cash in the second quarter of 2012 relating to the final calculation of the net asset value of the Company at completion; the redemption of Tier 1 Capital Notes and their associated interest coupons; and additional cash consideration payable upon Virgin Money delivering a future profitable IPO or sale.

<sup>10</sup>The returns of cash exclude additional cash flows that the Government will receive in tax paid by the companies

### Positive returns also expected across all UKFI's Wholly-Owned companies

An estimate for the three companies that comprised the Government's Wholly-Owned portfolio of financial services investments, namely Northern Rock (Asset Management) plc, Northern Rock plc and Bradford & Bingley plc, yields an overall positive annual rate of return of 4.0% to 5.0% to HM Treasury, higher than the Government's estimated notional annual funding costs during the period of intervention of 3.9%.

The Government provided £64 billion of funding into Northern Rock (Asset Management) plc, Northern Rock plc and Bradford & Bingley plc. Over time, the return of cash from these companies to the Government is expected to total between £95 billion and £97 billion. This means that, in cash terms, the companies are expected to more than repay the original funding provided by the taxpayer.

Expected cash returns are based on the latest business plans for Northern Rock (Asset Management) plc and Bradford & Bingley plc at the time of this publication, which are based on expectations of future performance according to the latest economic forecasts. The expected cash returns represent nominal cash flows. Expectations of returns will vary in line with business performance and as the forward looking view of the macro-economic environment changes.

Cash flows exclude taxation. Further information on the expected cashflows and assumptions are outlined in the appendices.

# 08

## Appendices

## Appendix I – Remit of UKFI

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UKFI was created in November 2008 as part of the UK's response to the financial crisis.

UKFI is responsible for managing the Government's shareholdings in The Royal Bank of Scotland Group plc and Lloyds Banking Group plc, collectively the "Market Investments". UKFI is also responsible for managing the Government's 100% shareholding and loans in UK Asset Resolution Ltd (UKAR). UKAR was formed during 2010 to integrate the activities of Northern Rock (Asset Management) plc and Bradford & Bingley plc, collectively the Wholly-Owned companies. UKFI managed the Government's 100% shareholding in Northern Rock plc from Northern Rock plc's formation on 1 January 2010 and up to its sale to Virgin Money on 1 January 2012.

UKFI's overarching objective is to manage these shareholdings commercially to create and protect value for the taxpayer as shareholder and to devise and execute a strategy for realising value for the Government's investments in an orderly and active way over time within the context of protecting and creating value for the taxpayer as shareholder and, where applicable, as provider of financial support, paying due regard to the maintenance of financial stability and acting in a way that promotes competition.

More detail on UKFI's role, remit and ownership approach is set out in our Framework Document and Investment Mandate with HM Treasury and our Framework Documents with our Wholly-Owned companies. These can be found on our website [www.ukfi.co.uk](http://www.ukfi.co.uk).

## Appendix II – Sale consideration

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Total consideration for the sale of Northern Rock plc comprises the following components:

- Cash: HM Treasury received cash of £747 million on completion on 1 January 2012 and an expected further c. £50 million cash in the second quarter of 2012 relating to the net asset value of the Company at completion.
- Tier I Capital Notes: Virgin Money issued to HM Treasury on completion Tier I Capital Notes (Notes) with a par value of £150 million and an annual coupon from 2013 of 10.5%. The terms of these Notes have been designed to be compliant with current General Prudential (GENPRU) requirements and the expected requirements of forthcoming Capital Requirements Directive (CRD4) regulations which will implement Basel III guidelines into European law. Accordingly they include features such as principal loss absorption and discretionary interest coupons. Virgin Money has indicated that it intends the Notes would be exchanged, or purchased by the acquirer, upon an IPO or sale, without reducing the amount and quality of the firm's capital resources, which would allow HM Treasury to exit its investment.
- Additional cash consideration: HM Treasury will receive additional cash consideration payable upon Virgin Money delivering a future profitable IPO or sale in the next five years. The maximum payment would be £80 million if this occurred in 2012; £70 million in 2013; and £50 million in 2014 to 2016 inclusive.

## Appendix III – External advisers

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UKFI and Northern Rock plc were advised by certain external parties in relation to the review of strategic options and the sale process. UKFI and Northern Rock plc sought to minimise fees and ensure best value for money for the taxpayer in the selection, appointment and during advice received from advisers. Total costs incurred for external advisers are c. £3.2 million<sup>11</sup> as outlined below. The total costs are significantly lower than the costs that would normally be paid for external advisers on transactions of this size.

<sup>11</sup>Fees stated include expenses and exclude applicable VAT. Fees represent costs incurred up to completion of the sale of Northern Rock plc

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### Corporate Finance advisers - Deutsche Bank

Deutsche Bank were appointed in March 2011 to provide corporate finance advice to UKFI and Northern Rock plc following a competitive tender process involving 19 potential advisers. Deutsche Bank acted exclusively for UKFI and Northern Rock plc and for no one else. Deutsche Bank were paid a fee of c. £1.84 million following completion of the transaction in January 2012. This fee compares favourably to fee proposals of up to £7 million received from other potential advisers on this assignment. The fee is also in line with the lowest proposal put forward in the tender process and is significantly lower than the fee that would normally be paid for corporate finance advice of this nature on transactions of this size.

### Legal advisers – Freshfields

Freshfields were appointed in May 2011 following a competitive tender process comprising parties selected by Northern Rock plc and from UKFI's legal panel. The total fees and disbursements up to completion of the transaction were c. £765,000 with further additional amounts relating to further post-completion advice.

### Vendor due diligence and accounting – Deloitte

Deloitte were appointed in May 2011 following a competitive tender process. UKFI negotiated reduced rates at all levels of the Deloitte team plus additional volume discounts. Total Deloitte fees up to completion of the transaction were c. £486,000 with a potential additional fee relating to any further post-completion advice.

### Other advisers and providers

Further advice and support was provided by KPMG, Intralinks, Maitland and Templar Advisors. The aggregate of these costs was c. £138,000.

All advisers were able to charge appropriate expenses where they were incurred in line with the UKFI expenses policy.

## Appendix IV – Combined expected cash flows of the former Northern Rock

UKFI's assessment reflects expected cashflows<sup>12</sup> in respect of Northern Rock (Asset Management) plc and Northern Rock plc which in turn are based on a number of assumptions:

#### For Northern Rock (Asset Management) plc:

- Government loan: £26.9 billion Government loan in 2007, which was repaid down to £15.6 billion by the end of 2008 due to an active customer redemption strategy (and down to £14.3 billion by the end of 2009) followed by an increase to £22.8 billion by 1 January 2010 as an additional £8.5 billion was provided by HM Treasury to effect the split of the former Northern Rock. The loan is interest bearing, and HM Treasury is considering increasing the interest rate from its current level of Bank of England Base Rate + 25 basis points. Based on Northern Rock (Asset Management) plc's current business plan the loan is due to be repaid in 10 to 15 years from 2012.
- Government guarantees: Since January 2010, a flat monthly fee has been charged for Government guarantees provided over certain wholesale borrowings
- Equity value at wind-up: An estimated equity value at the point when the Government loan is repaid in 10 to 15 years from 2012
- Business plan: The assessment is necessarily only an estimate due to the long term nature of the expected cash flows and their dependency upon the macroeconomic environment which in particular will impact net interest income, impairments and the redemption rates of mortgages. Expectations of returns may vary as new information comes to light.

<sup>12</sup>The assessment of expected returns is unaudited however it has been subject to an internal verification process

**For Northern Rock plc:**

- Government equity: the Government injected £1.4 billion into Northern Rock plc to capitalise the Company at inception on 1 January 2010. Equity capital had decreased due to losses in the bank to c. £1.2 billion at the end of 2010 and was expected to be below £1.2 billion at the end of 2011
- Government guarantees: Northern Rock plc inherited two sets of funding guarantees: Retail deposit guarantees with a charge of 0.5% which were released in May 2010 with c. £500 million of balances still under guarantee at the end of 2011 (the last retail deposit will mature in March 2015) and Wholesale deposit guarantees with a charge of 2.0% which were released in October 2010 with c. £4 million of balances still under guarantee at the end of 2011
- Sale consideration: the Northern Rock plc sale consideration including £747 million cash; expected further cash payment in the second quarter of 2012 relating to the net asset value of the Company at completion; Tier 1 Capital note and interest coupons; and additional consideration receivable upon a future profitable IPO or sale in the next 5 years. Expectations of returns may vary as new information comes to light.



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## Appendix V – Expected cash flows of Bradford & Bingley plc

As with Northern Rock (Asset Management) plc UKFI's assessment of expected cashflows<sup>13</sup> is based on a number of assumptions. Bradford & Bingley plc is similar to Northern Rock (Asset Management) plc in that it is focused on the orderly run-down of its closed loan book and repayment of Government funds and other creditors.

- Working capital facility: The Government provided an initial facility of £2.3 billion at the end of 2008, rising to £8.6 billion by the end of 2009. First repayment was made in December 2011. The facility is interest bearing, and HM Treasury increased the interest rate from Bank of England Base Rate + 150 basis points to Bank of England Base Rate + 500 basis points in August 2011
- Statutory debt: Bradford & Bingley plc received loan funding of £18.4 billion to fund the deposits sold to Santander UK in 2008 of which £15.7 billion was from the FSCS and £2.7 billion was received directly from HM Treasury. Based on Bradford & Bingley plc's current business plan this lending is forecast to be fully repaid in 10 to 15 years from 2012. Bradford & Bingley plc does not pay interest on the Statutory debt. The FSCS borrowed £15.7 billion from HM Treasury to fund its loan to Bradford & Bingley plc and it pays HM Treasury an interest rate on this funding
- Government guarantees: Guarantees are provided by the Government with regard to certain wholesale borrowings and derivative transactions for which the Government receives fees
- Equity value at wind-up: An estimated equity value at the point when the Government funding is repaid in 10 to 15 years from 2012
- Business plan: The assessment is necessarily only an estimate due to the long term nature of the expected cash flows and their dependency upon the macroeconomic environment which in particular will impact net interest income, impairments and the redemption rates of mortgages. Expectations of returns may vary as new information comes to light.

All creditors, including the Government, are expected to be repaid in full by Bradford & Bingley plc and the intervention in the company is forecast to yield a positive annual rate of return of 5% to 6% to HM Treasury. This reflects a total investment from the Government of £27 billion and a total return to the Government of c. £49 billion. This means that, in cash terms, Bradford & Bingley plc is expected to more than repay the original funding provided by the taxpayer.

<sup>13</sup>The assessment of expected returns is unaudited however it has been subject to an internal verification process

## UKFI CONTACTS

This document can be found on our website at: [www.ukfi.co.uk](http://www.ukfi.co.uk)

**General enquiries should be addressed to:**

Enquiries

UK Financial Investments Limited

2nd Floor; Oceanic House

1a Cockspur Street

London

SW1Y 5BG

E-mail: [enquiries@ukfi.co.uk](mailto:enquiries@ukfi.co.uk)