A Note on the Valuation of Bradford & Bingley Plc

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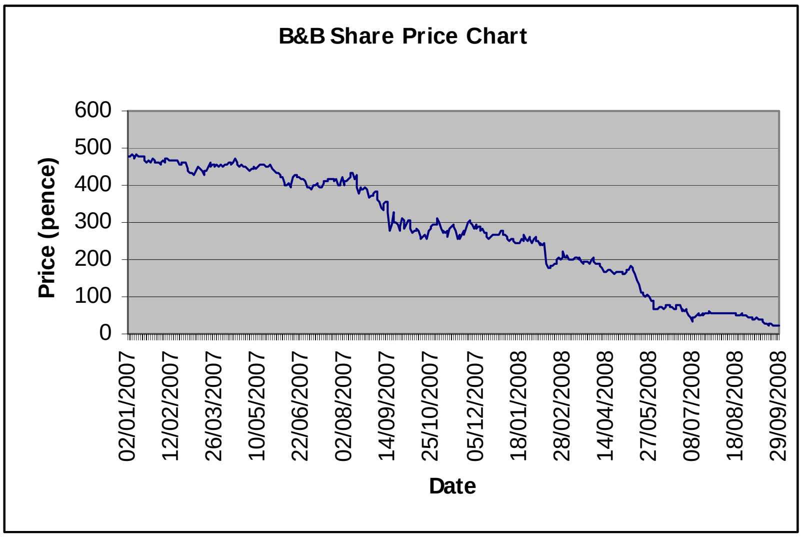
Because of the terms set in the Compensation Order and the Nationalisation Act, there will be a valuation process by an "Independent Valuer" to determination the compensation payable to shareholders for the confiscation of their property. This note attempts to give some guidance on the valuation principles and approach that is likely to be followed, and the factors that might affect the outcome. Because we do not have access to the internal management accounts of the company, nor their own projections of future events, we can only give very general guidance on the likely valuation.

Valuation Principles

In essence, when an "expert valuer" is asked to determine the commercial valuation of a business, they follow a few well established principles. In essence the valuation is assumed to be what a "willing buyer would pay a willing seller in a normal market".

Clearly if there is an "open market" price for the shares in a company, then that is often used as a good metric to determine the likely value, although the valuer may take account of information that was known at the valuation date but not publicly disclosed (and hence not reflected in the share price). For Bradford & Bingley the valuation date will be the date of nationalisation of course, and in general the valuer can only take account of the facts known at that date and likely predictable events going forward. So they could not assume any knowledge of subsequent events unless they were reasonably predictable and hence likely to be reflected in the then current market price.

A chart of the share price from January 2007 is given on the right.



The share price closed at 19.75p on the last day of trading, but was as high as 42p only three weeks before. However, in the case of Bradford & Bingley, the share price had obviously been impacted by the threat of nationalisation and the other exceptional events in the financial sector particularly in the few days and weeks before nationalisation was announced. After Northern Rock was nationalised in February 2008, Bradford & Bingley was suggested by many commentators to be next in line for the same treatment. The debacle of the “multiple” rights’ issues also undermined confidence in the company and its management. So this was clearly not a normal market and the price would have been distorted by the perceived threats to the company’s independent survival.

In previous nationalisations an average share price over some months has been used to avoid this problem. However, it seems more likely that in this case the approach to be used might be that applied when valuing unquoted companies. This relies on a more “fundamental” approach to what a trade buyer might pay for the business.

It is also worth pointing out that the valuation of a business is typically related to what the underlying or sustainable profits of the business are. In other words, exceptional events or write-offs may have only a limited impact on the valuation, because valuations are done on the basis of foreseeable future profits or cash flow over many years.

Valuation Methods

To value a business on fundamental methods, usually a combination of more than one approach is taken, with appropriate weighting given to each method based on the valuer’s expert view and the circumstances that apply. Usually the method depends on estimating the future profits of the business, or if there are no profits, then on the value of any realisable assets.

So one method is to look at the historic and prospective profits per share of the company, and look how the market values other similar companies in the same sector. This typically is done using price/earnings ratios (p/e ratios).

Another method is to look at the projected cash flow of the business over future years, and discount that back to a current value. I have not attempted to use that method because cash flows in this case are difficult to determine going forward.

The Profits of B&B

The statutory profit figures of Bradford & Bingley for the last two full years and the latest half year are as follows (with the earnings per share adjusted for the rights issue just before nationalisation):

	Post tax Profits £million	Earnings per share (pence)	Adjusted Earnings per share (pence)
Year end Dec 2006	177.7	28.1	12.0
Year end Dec 2007	93.2	14.9	6.4
Half year Jun 2008	(17.2)	(2.8)	(1.2)

The “underlying” profits (also adjusted to remove exceptional events) for the same periods were reported by the company as follows (see page 11 of the interim results report).

	Post tax Profits £million	Earnings per share (pence)	Adjusted Earnings per share (pence)
Year end Dec 2007	251.1	40.2	17.2
Half year Jun 2008	52.1	8.5	3.57

(based on 617.7 million shares in issue before the rights issue and 1446 shares thereafter from the 67 for 50 rights issue).

Stockbroker Collins Stewart published an analysis of Bradford & Bingley on the 3rd June 2008 which forecast adjusted earnings per share of 9.6p for the full year 2008, 6.8p in 2009 and 7.4p in 2010. This was based on the known loss in the first four months of the year, but not the half year results. However, their comments are worth noting which were as follows (the then current market price was 67p):

“There is clearly a major issue with arriving at the valuation of the bank. In earnings terms, it appears expensive relative to peers and has low earnings visibility. We feel that the loss generated in the first four months of the year means that stated (including Treasury losses) profit will be very low this year and that we feel the final dividend will be passed for 2008. In short, no yield support in 2008 and only limited support in 2009 (c. 3.5% we feel). However the bank is clearly trading at a material discount to book value which we estimate to be 112p per share by end-2008.”

Another important comment they make is *“The simulation part (loan losses) shows quite how sensitive the bank now is (running on very low margins) to rising loan impairments”.* There is more discussion on that issue later.

Returning to the issue of using the prospective “adjusted” earnings as a valuation yardstick, it would appear that the average earnings over the next three years would be 8p. What are the comparable price/earnings ratios of banks at the date of nationalisation? Regrettably since the collapse of Lehmans and the crisis in financial markets generally and the banking sector specifically, the market valuation of banks has depended less on their prospective earnings than whether they are viewed as “survivors”, ie. the quality of their assets and the strengths of their balance sheets seems to have taken priority. Therefore p/e ratios are all over the place – for example Barclays and Lloyds Group are currently on 1.2 and 1.5 according to today’s FT. But these are exceptional cases, with HSBC, Standard Chartered and Santander in the range 4.5 to 6.0. Obviously even the latter are much depressed over what they may have been only a few months ago. The more typical p/e for banks is probably 10.

If we assumed a p/e ratio in the range of 5 to 10, then the share price range would be 40 to 80p based on adjusted earnings of 8p.

The Assets of B&B

The Supplementary Prospectus for the Rights Issue, published in July 2008, gave the following expected “proforma” figures for the balance sheet after the rights issue (i.e. after the addition of £401 million in cash from the rights issue):

	£ million
Total Assets:	52,386
Total Liabilities:	50,774
Net Assets:	1,612

It is of course worth pointing out that the net assets figure in this case, as with many banks is the small difference between two very large numbers, so any erosion of the assets, or increase in liabilities can have a dramatic effect on the net assets and hence the assets attributable to the “shareholders equity”.

On the 25 September, the company announced subsequent write-downs of an additional £134m), reducing the net assets to £1,478m.

With 1,446m shares in issue after the rights issue, that equates to net assets per share of 102p.

It is unusual for any business to be sold for much less than its net assets because any buyer who did so could presumably dispose of or “wind-up” the assets and hence realise that value. In addition, that valuation ignores all the “intangible” goodwill built up by the business over many years, its brand awareness, the knowledge and experience of its staff and the potential future profitability. Companies are usually sold based on their likely profit potential but these are unusual times. So the net assets figure is usually only used to value “distressed” or unprofitable businesses, or those that are being wound up, and there were certainly lots of question marks over the future likely profitability of Bradford & Bingley.

A recent acquisition that might be viewed as comparable was the sale of Alliance & Leicester to Santander that happened some months before the nationalisation of B&B. Alliance & Leicester was a similar ex building society, but with probably a more conventional mortgage portfolio. It was sold for approximately net asset value although many people thought this was exceptionally cheap even then, and probably only possible because there were few buyers of banks or mortgage portfolios around at the time.

The Quality of the Assets and Future Profitability of B&B

Bradford & Bingley had a somewhat unusual mortgage portfolio which was heavily concentrated on “buy-to-let” and “self-certificated” mortgages. In addition they had an onerous contract with GMAC to take on lesser quality mortgages.

Apart from some admissions that the latter was a mistake, the company directors have suggested that there is no greater probability of default on their mortgages than with more normal ones (they even published a note entitled “Myths About the Buy-to-Let Market” to reassure investors on that point). But other commentators suggest otherwise. This comment on asset quality was contained in the Collins Stewart report mentioned above:

“Deliquency in group loans has clearly moved higher in both books [self-sourced business and acquired loans] but both the rate of deterioration and the absolute level of losses in the GMAC book are little short of startling.”

Undoubtedly B&B was vulnerable to both falling house prices and other problems in the housing market, and the general economic recession, which are likely to lead to rising defaults. Such prognostications were readily available at the time of the nationalisation of B&B, and indeed the impact of these events and forecasts for B&B may have been a factor in the decision by the Government to nationalise the company – unfortunately the exact reasons have not been disclosed at the time of writing.

However, the independent valuer will clearly take into account that the above factors would almost certainly have deterred potential buyers of the business and hence would affect the market value. The independent valuer is also likely to have access to the latest internal management information on default rates and loan “delinquency” and the company’s own future projections just prior to the nationalisation date, which we do not have at this time. Without that information, it is difficult to come to any definite or accurate conclusions on this issue.

The Rights Issue

One point bearing in mind is that Bradford & Bingley undertook a major rights issue only a few weeks before the date of nationalisation. This was priced at 55 pence per share and that price was presumably pitched by the company at a level that they considered reflected the future prospects of the company based on their own internal knowledge. It would also have been set at a level to meet the demands of the underwriters and the prospective subscribers based on expert advice given to the company, and hence it should have been a fairly accurate reflection of the likely valuation at the time.

The Sale of the Branch Network

One item of information we do know is that the Bradford & Bingley branch network was sold to Santander immediately after nationalisation for £612 million (that’s equivalent to 42p per share). This comprised 2.7 million retail deposit customer accounts and 197 branches (mainly leasehold). Active customer accounts are often considered as contributing significant value to any business and any valuation might compare what was paid for these accounts with other recent bank transactions. In effect, they give some indication of the “goodwill” attached to the retail side of the business. However, the Government seems to have completed this deal remarkably quickly – indeed in a matter of a few days, and it has been characterised as a “fire sale” by commentators. So it may not represent a fair value for the assets transferred in a normal market. The remainder of the Bradford & Bingley business effectively comprised the mortgage book and the profits that might arise going forward as interest in paid on those mortgages and they are redeemed in due course.

Other Factors

One difficulty in valuing Bradford & Bingley at the nationalisation date is the fact that according to the statement issued concerning nationalisation by the Treasury, there is the implicit suggestion that the company was about to have its banking licence withdrawn (although it is not spelled out exactly why it no longer met FSA regulatory requirements and we are still seeking answers to that question). Clearly a bank without a banking license is not worth as much as if it was a “going concern” because it would have to stop accepting new business, probably go into administration, and be wound up in due course.

But any buyer of the business with an existing banking licence might be able to take it over and enable it to continue to trade or integrate it into their business, so that does not necessarily rule out any value. But obviously the company would be in a "fire sale" situation which would depress its likely value.
If the company was likely to go into administration, then a valuation based solely on the asset value, with some discount applied, would be the most appropriate.

Although the company appears to have had adequate capital ratios (indeed better than many other banks after the rights issue), there is the question of liquidity. A bank that runs out of cash is probably not worth much. However, other than the withdrawal of funds and downgrading of credit ratings in the last few days before nationalisation, simply caused by the threat of nationalisation, there does not appear to have been a problem in this regard. In any case, we would argue that the threat of nationalisation, and the impact of that, should be disregarded in any valuation of the business. It is not reasonable that the acquirer of a business by force can benefit from their own actions prior to that event.

The terms of the Nationalisation Act indicate that any valuation has to be based on assumptions that any funding to the company by the Government is withdrawn (we are not aware of any such funding having been made), and that no future funding is provided by the Government. Therefore a valuer would have to determine whether the company would require additional funding in the future and whether it could obtain such funding from other sources. If it could not (for example, by another rights issue or placing), then administration or being placed in some alternative "run-off" mode would have to be assumed. With the credit rating of Bradford & Bingley having been reduced by most of the rating agencies, the chance of them "rolling-over" some of their money market funding in due course might be low. But the company had already taken steps to reduce its needs for future funding by cutting back on its new mortgage lending. Obviously knowledge of the company's business plan and cash flow projections would be key to understanding the risks here.

There are clearly going to be a lot of uncertainties attached to future scenarios, and the way to handle these is probably to take a weighted average figure of different valuations that arise from different outcomes based on the valuer's view of their likely probabilities.

One aspect worth bearing in mind in respect of the valuation of companies is that the acquisition of control of a company is usually at a premium to the stock market price. The price that buyers of a part share in a company are willing to pay is less than what they will pay when they have control. Such "control premium" is why bids for companies are usually higher than the market price and a premium ranging from 5% to 15% may be applicable. Clearly with nationalisation the Government has gained control so such a premium should be applied to the valuation, even if the stock market price is used as a guide.

Conclusion

Bearing all the above points in mind, my conclusion would be that a likely value for B&B would be in the range 40 to 80p, subject to more detailed analysis and the receipt of more information.

This takes into account:

a – The market share price before it was impacted by the threat of nationalisation.
b – The assets of the company, and the future risks to those assets.

c - The “adjusted” or “underlying” profits forecasts.
d – The marketability of the business in a normal market for bank assets.
e – The exceptional risk factors mentioned above.
f – The premium for control.
g – The uncertain risks attached to future funding needs.
h – The valuation based on the rights issue.
g – The value of the branch network when sold by the Government.

Roger Lawson

Important: This note only attempts to provide a very rough outline of the likely approach of any valuer to valuing this company using normal valuation principles, and the likely range of outcomes from such a process. With the limited information available on the financial position of the company at the time of writing, no closer estimate is possible. This document should not be construed or interpreted as containing the likely submissions that the Bradford & Bingley Shareholders Action Group may submit as representations to the independent valuer in due course.

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