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Privatisation

Whose flame has burnt the brightest?

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Executive summary

Privatisation: Whose flame has burnt the brightest?

- Much of the UK's privatisation programme took place between the early 1980s and the mid-1990s: subsequent sales have been few. Undoubtedly, privatisation attracted many private investors to the market, many for the first time.
- Following the 50.2% sale of British Telecom (BT) shares in 1984, which was the first mass privatisation, other utility stocks were sold off, notably British Gas (BG), the English and Welsh water companies and virtually all the electricity supply sector.
- The transport sector saw several sales, notably in aviation with British Airways (BA) and British Airports Authority (BAA), along with various railway, ports and bus companies.
- Many privatisation stocks have materially outperformed the FTSE-100 since their flotation – the 12 Regional Electricity Companies (RECs), all of which were bought out during the bidding frenzy in the late 1990s, being examples. In addition, quoted water companies, such as Pennon, the owner of South West, and Severn Trent have seen share price rises of between 10x and 15x.
- National Grid, which was privatised via the RECs, is now valued at a formidable £36.5bn; it is one of the EU's most valuable utilities. The various components of the dismembered British Gas have generally prospered, despite Centrica's recent plunge. Among the transport stocks, BAA has been the star performer; it was taken over for £10.3bn in 2006.
- However, there have been serial underperformers. Railtrack, most controversially, was re-nationalised with compensation at ca.15% of its peak value. British Energy became a virtual dotcom stock and collapsed when power prices fell sharply. Welsh Water's owner, Hyder, also failed, despite the very favourable financial settlement put in place for its core business at flotation.
- Furthermore, BT – the originator of widespread privatisation – has seen its share price perform dreadfully. The current price is little changed from its fully paid flotation price in 1984. More recently, shares in Royal Mail, privatised in 2013, have plunged as letter volumes decline.

1980s and early 1990s were prime years for privatisation

During the period of Conservative Government in the 1980s and early 1990s, an extensive privatisation programme was undertaken, with a raft of publicly owned companies being sold to the private sector.

Many of these companies prospered; there was also considerable takeover activity, especially in the energy sector, while a few privatised companies failed.

A key driver of the privatisation programme was to deliver greater efficiencies – and to reduce prices, especially for utility customers.

Investment was the driver

Funding large investment programmes was also regarded as a priority since, under state ownership, securing capital expenditure funding had always been a challenge. The Water Authorities and British Rail, Railtrack's predecessor, had been particularly affected by serious levels of under-investment.

The quest for a share-owning democracy

Allied to these financial factors was the political determination to create a share-owning democracy – on a similar basis to the property-owning democracy of previous years.

Millions of new shareholders attracted

Part privatisation of British Telcom (BT) in 1984 and, subsequently, of other utilities attracted the interest of millions of new investors – the innovative 'tell Sid' campaign devised to sell shares in British Gas (BG) was peculiarly effective.

In recent years, various spectacular failings, especially of much of the banking sector in 2008/09, have driven away many private investors from the market, but they may return. This issue was discussed in two previous leading articles for the Hardman and Co Monthly in *January* and *February* 2020.

Major privatisations

Prior to the part sale of BT shares in 1984, there were various low-profile disposals of government-owned stakes predominantly to institutional shareholders; they included shares in Cable and Wireless and the now BAE Systems, *inter alia*.

In subsequent years, the sale of stakes in BP and Enterprise Oil – the latter was eventually acquired by Shell – also took place.

The table below lists the largest privatisations – all of which were directed towards private investors.

Major privatisations

Company	Year of flotation
British Telecom	1984
British Gas	1986
British Airports Authority	1986
British Airways	1987
British Steel	1988
10 English/Welsh water companies	1989
12 English/Welsh regional electricity companies	1990
2 English/Welsh electricity generators	1991
2 Scottish electricity companies	1991
Northern Ireland Electricity	1993
British Energy	1996
Railtrack	1996
Royal Mail	2013

Source: Hardman & Co Research

The BT part sale in 1984 launched mass privatisation

The unprecedented 50.2% initial sale of BT in 1984 set trends in several respects that were copied by many overseas governments. First, private investors were heavily incentivised to apply for shares. Secondly, a price regulation system was imposed on BT, to prevent its customers being exploited. At that time, BT was an effective monopolist (outside Hull, which had its own network), despite the participation at the fringes of Cable and Wireless' Mercury subsidiary, while mobile telephony was still in its infancy.

Then came British Gas – sold like soap powder

In 1986, it was BG that was privatised – on the back of a very high-profile advertising campaign. Controversially, BG remained a gas monopoly for many years, thereby requiring a complex – and much debated – price regulatory system revolving around its Transco subsidiary.

Then transport

Thereafter, the privatisation focus moved to the transport sector, with British Airports Authority (BAA), the owner of the UK's key airports, being floated, followed by its major customer, British Airways (BA), in 1987.

In 1989, water…

Following the re-election of the Conservative Government in 1987, the water sector in England and Wales was next to be sold, led by Thames. It was the first regionally based privatisation and it proved very popular.

… followed by electricity

The complex disaggregation of the electricity supply industry enabled its almost total privatisation from 1990 onwards, led by the 12 Regional Electricity Companies (RECs). The £5.2bn sector valuation figure was widely seen as being desperately generous to investors – and so it proved. And, like water investors, they applied in very large numbers.

Subsequently, the first tranche of shares in both leading generators, National Power and PowerGen, were sold; this process was followed by the two integrated Scottish companies, ScottishPower and Scottish Hydro-Electric. North Ireland Electricity's privatisation followed in 1993.

The three post-1993 privatisations were less successful

Significantly, the three major privatisations since 1993 have all been far less successful. British Energy collapsed on the back of low electricity prices; it was essentially – and dangerously – a price-taker. Railtrack was controversially re-nationalised in 2001, while the share price of Royal Mail is currently languishing at almost 50% below its 2013 flotation price.

Bar Network Rail and NATs, the cupboard looks bare

Looking forward, the privatisation cupboard is quite bare. Network Rail, with net debt of over £54bn, is a possible – if somewhat theoretical – candidate, along with NATS, the air traffic control business. Scottish Water and Northern Ireland Water, too, could be floated, despite political opposition locally.

Privatisation winners

Virtually all the utilities privatised in the 1980s and in the early 1990s have delivered decent returns – and, in some cases, mightily impressive ones.

Four of the best performers

The four stand-out investments are two of the quoted water companies, namely Pennon and Severn Trent, National Grid and British Gas; all have delivered quite remarkable value for many for their investors.

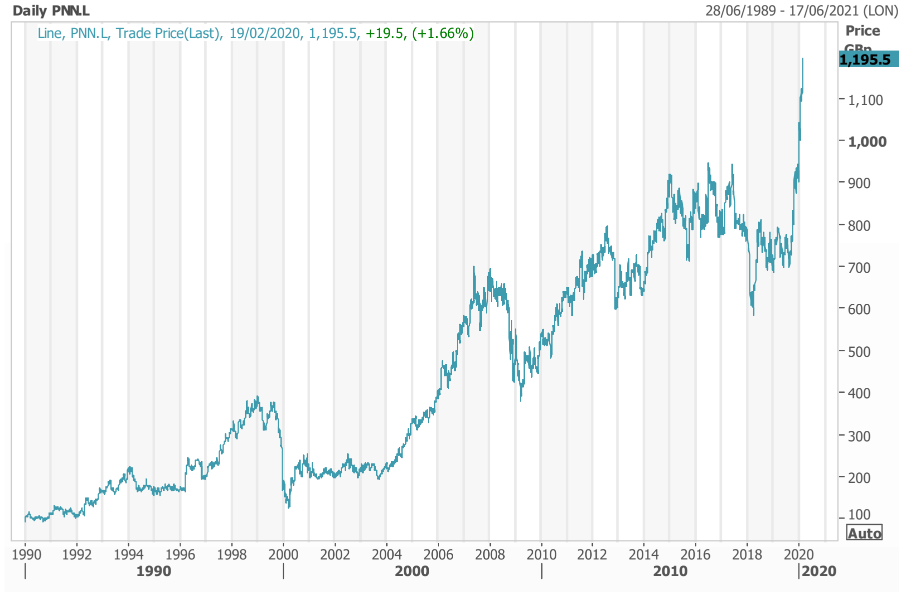
Leaving aside Hyder, the holding company of Welsh Water, which failed in 1997, the remaining nine privatised water companies have delivered good shareholder returns. However, of the nine, only three remain publicly quoted.

Pennon prospers

Pennon, with its successful – if volatile – Viridor waste business has truly prospered, with a current share price, after adjustment for a 3/1 scrip issue in 2006, of ca.£35, compared with the 240p flotation price in 1989; this is equivalent to a staggering ca.14.5x increase since 1989.

Pennon's very impressive share price graph, based on the post-scrip issue price, is reproduced below.

Pennon – share price performance since flotation



Source: Hardman & Co Research

Severn Trent, which – apart from the integration of Dee Valley and Hafren Dyfrdwy, two small water companies – effectively remains the same business as at flotation. Its share price at £26 is now more than 10x its 1989 flotation price, once some minor adjustments are made.

The share price of United Utilities, the third quoted water company, has also risen appreciably over the same period.

National Grid's shareholder returns have been impressive

National Grid was indirectly privatised through the flotation of the 12 RECs in 1990, each of whom held a share in the business, as listed below. An implicit value has also been ascribed to each stake, based on National Grid's current £36.5bn market value; it should be noted that National Grid has undertaken various fundraising initiatives, in part to finance its burgeoning US investments, since it was demerged in 1995.

REC National Grid shareholdings

REC	NG share (1990)	NG value (£bn) (2/2020)
Eastern	12.5%	4.6
East Midlands	8.4%	3.1
London	10.5%	3.8
Manweb	5.5%	2.0
Midlands	9.2%	3.4
Northern	6.5%	2.4
Norweb	8.2%	3.0
Seeboard	7.3%	2.7
Southern	11.0%	4.1
South Western	6.3%	2.3
Swalec	5.4%	2.0
Yorkshire	9.2%	3.4

Source: Hardman & Co Research

Now one of the EU's biggest utility beasts

From comparatively modest beginnings, National Grid, with its £36.5bn capitalisation, is now one of the most valuable utilities in the EU after Italy's ENEL (£69bn) and Spain's Iberdrola (£61bn). Its current £62bn Enterprise Value (EV) figure should be compared with the £5.2bn value placed initially on the REC sector in 1990. Even if a 20% National Grid value were accorded to the latter figure, this would amount to an imputed flotation value of just £1.04bn.

Significantly, too, National Grid's share price has rallied of late, as the graph below shows, following the decisive General Election result last December, which removed any real threat of some form of re-nationalisation undertaken by an incoming Labour Government.

National Grid – share price performance since flotation

Source: Hardman & Co Research

Split into three entities

Since its privatisation in 1986, British Gas has been demerged into three major entities. The key E and P division was sold to Shell in 2016 for ca.£47bn – at a time when oil and gas prices were high.

To that figure, the value of the gas transportation business should be added; after demerger, it became the core business of Lattice, which merged with National Grid in 2002. The assets of the struggling Centrica, whose very poor share price performance in recent years is illustrated below, should also be included.

Centrica – 5-year share price performance

Source: Hardman & Co Research

12 RECs disappeared in a takeover frenzy

The 12 RECs, all of whom were taken over during a frenzy of corporate activity in the mid/late 1990s, also provided highly impressive returns for most investors. All the take-out prices were far in excess of the very modest £5.2bn value – including the National Grid shareholdings – placed on the sector at flotation.

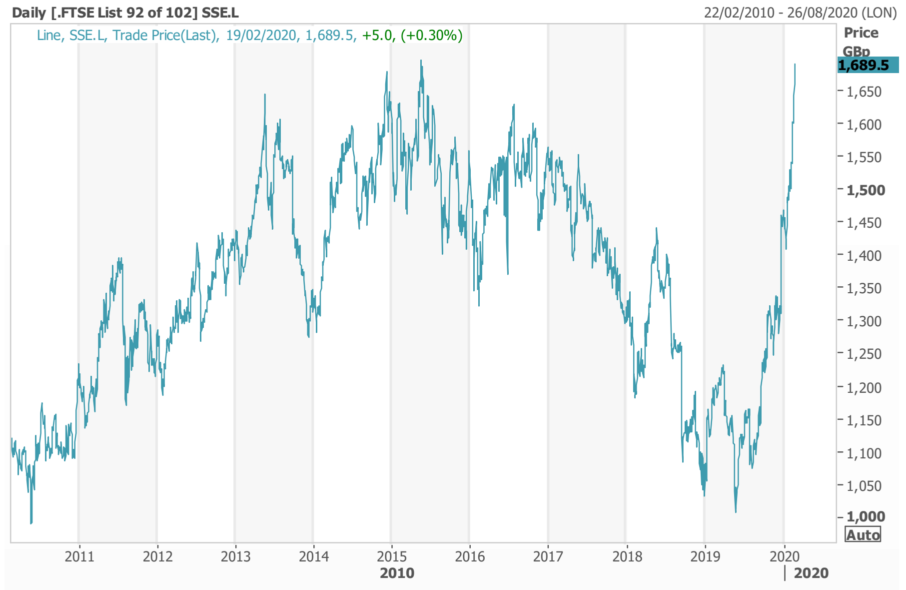
Elsewhere in the electricity sector, shareholder returns from the two UK generators, National Power and PowerGen, were also impressive, although they were less than those of most RECs.

While Drax Group remains quoted, encompassing the eponymous – and legendary – 3,960MW coal-fired/biomass plant acquired indirectly from National Power, it is Scotland's integrated SSE that provides a more valid comparison.

SSE is now a top renewables player

Having acquired Southern Electric in 1998, SSE has continued to invest in renewable energy – an undoubted boost to its share price rating, as the graph below shows.

SSE – 10-year share price performance



Source: Hardman & Co Research

The issue of SSE's renewable generation valuation, along with those of other renewable energy infrastructure funds (REIFs), was addressed in Hardman and Co's recent sector publication, *UK Renewable Energy Infrastructure Funds – A 20/20 Vision*.

On the privatised transport front, there have been some obvious winners led by the BAA, which has been disaggregated in recent years; Heathrow and Gatwick airports are now in different ownership.

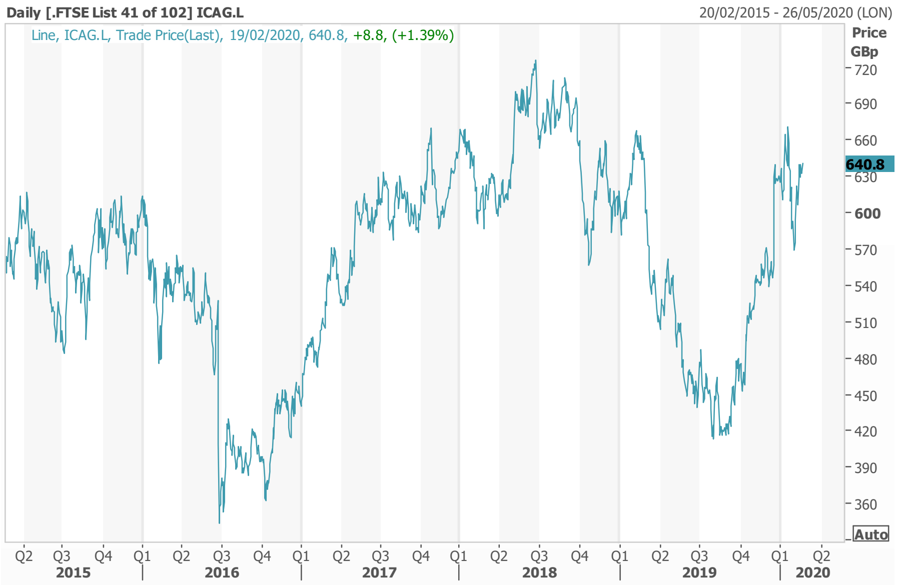
Heavy profits on BAA privatisation

Nonetheless, starting out in 1987 with a flotation value of £1.3bn, BAA was bought in 2006 by a consortium led by Spain's Ferrovial for £10.3bn.

Its major client, BA, was privatised in 1987 at 125p per share; it has performed well – until the recent coronavirus concerns. Its share price, now quoted within International Airlines Group, is robust currently: volatile oil prices have been a key factor in recent years as they have a heavy impact on the annual fuel bill and, consequently, on the share price rating.

Reproduced below is a 5-year graph for IAG, which also incorporates leading Spanish airlines, including both Iberia and Vuelig. It does not include the very adverse risks implied by the spread of coronavirus.

IAG – 5-year share price performance



Source: Hardman & Co Research

ABP sold for a good premium

There have been other transport privatisations that have materially benefited shareholders, especially where acquisitions have been involved, such as the privatised Associated British Ports, which was sold for £2.8bn to a Goldman Sachs-led consortium in 2006.

Strong performance from the FTSE-100

In assessing any degree of share price outperformance, it is necessary to recognise that the market has performed strongly – despite the 2008/09 banking crisis – since the early 1990s as the FTSE-100 data in the table below, dating back to 1985, illustrates.

5-year FTSE-100 performances

Year	Value
1985	1,232
1990	2,423
1995	3,066
2000	6,930
2005	4,814
2010	5,413
2015	6,556
2020	7,542

Source: Hardman & Co Research

Any outperformance of the market, therefore, needs to have seen at least a trebling of the underlying share price, after any material adjustments, from the late 1980s/early 1990s period.

Privatisation losers

Dire BT performance

Within the privatised portfolio, it is perhaps inevitable that there would be some failures. Ironically, it was the performance of the first major privatisation stock, BT, which has been particularly dire.

Flat adjusted EBITDA for a generation

For more than 20 years, its underlying annual EBITDA – once a raft of adjustments has been made, especially for the £12.5bn EE mobile telecoms acquisition – has been becalmed at ca.£6bn.

Flat share price too

Furthermore, BT's current share price – more than 35 years after its market debut – is almost identical to its fully paid flotation price back in 1984. The surge in its share price around the turn of the century – driven by the TMT (Telecoms, Media, Technology) bubble – proved to be illusory; indeed, in 2001, it launched a massive £5.9bn rights issue.

The graph below, which goes back to 1985 – shortly after the first tranche of BT shares was floated – illustrates this very poor performance, during a period when the FTSE-100 has more than trebled.

BT – share price performance since 1985

Source: Hardman & Co Research

Prior to the first BT share offering in 1984, the Government sold a minority stake in Cable and Wireless, which had flourished under the banner of the British Empire. Having sold its pivotal Hong Kong Telecom business, Cable and Wireless' demise was rapid. As a result of some dreadfully ill-advised – and extremely expensive – acquisitions, it was finally split up, with much of its UK fixed line network going to Vodafone.

The British Steel story is also depressing. Having been privatised in 1988, it was eventually bought – under Corus, its new name – by India's Tata conglomerate in 2007. Subsequently, it has been progressively wound down.

Two utility casualties

Welsh Water and British Energy are two privatised utilities that failed to prosper: eventually, both effectively folded and many shareholders lost out. The collapse of the Hyder-owned Welsh Water took place within a decade of the latter being privatised with a large and guaranteed customer base, a real 6.5% annual price increase for its first five years in the private sector and a healthy cash balance at flotation.

British Energy – dotcom stock

British Energy, which owned all the major UK nuclear plants, including the Pressurised Water Reactor (PWR) at Sizewell, was always very vulnerable to low power prices. When they did indeed plunge, British Energy was caught short – leaving many shareholders nursing heavy losses.

Railtrack also went down

Another high-profile casualty was Railtrack, which was suddenly nationalised in 2001, ostensibly due to a massive capital expenditure liability. Eventually, after prolonged legal hearings, shareholders received compensation of ca.260p per share – Railtrack's share price had peaked at over £17.

Nor is Royal Mail too clever

Another loser, to date at least, has been Royal Mail. It was privatised in 2013 and, after initial enthusiasm, has struggled. Letter volumes are falling fast, industrial unrest remains a real risk and issues related to its pension fund liabilities endure. The graph of Royal Mail's sorry share price performance below reflects these serious challenges.

Royal Mail – 5-year share price performance

Source: Hardman & Co Research

Conclusion

Clearly, stock selection of privatised companies has been key. Some companies were very severely under-priced at flotation and their share prices boomed subsequently; others have stumbled badly.

National Grid vs. British Energy – which prevailed for investors?

The energy sector provides a good comparison. Both National Grid and British Energy were privatised in the early 1990s; the former is now one of the EU's most valuable utilities, while the latter collapsed within a few years of being brought to market.

Caveat emptor.

About the author

Nigel Hawkins is the Utilities sector analyst at Hardman & Co.

Nigel is responsible for analysing the UK Utility companies, including those privatised in the 1980s and 1990s, as well as newer arrivals in the sector. He has been involved in the Utilities sector since the late 1980s, as a feature writer at Utility Week magazine and as an analyst at Libertas Capital. Prior to that, he was the Telecoms analyst at Williams de Broë. Between 1989 and 1995, he worked at Hoare Govett as the Water and Electricity analyst.

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Nigel joined Hardman & Co in February 2016. He holds a BA (Hons) in Law, Economics and Politics from the University of Buckingham. He is an associate of the Institute of Chartered Secretaries and Administration and a senior fellow of the Adam Smith Institute.

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