

19 JUN 1979

- MR BRIDGEMAN
2. FINANCIAL SECRETARY
3. CHANCELLOR

stop info @ and no.

- cc Sir L Airey
Mr Littler
Mr F Jones
Miss Brown
Mr Lavelle
Mr Monck
Mr R G Ward
Mr Wicks
Mr Williams
Mr Bell
Chief Cashier
Mr George

SALE OF ASSETS BY MEANS OF CONVERTIBLE STOCKS

The Chancellor has asked for advice on a suggestion, made to him in a letter (attached) from Mr Hunter of L Messel and Co, dated 23 May, that there would be an advantage to the Exchequer in selling Government equity holdings by issuing a 10 year gilt convertible into the equity at a later date. The Financial Secretary has also asked about schemes of this sort (Mrs Diggle's minute of 29 May).

2. A point to note immediately about such a scheme is that sale of convertible gilts for this purpose would not in itself cause a reduction in the PSBR, but rather would count as a financing transaction. The PSBR would only be reduced (assuming, as with BP, that the equity sale itself did constitute a PSBR reduction) when the shares were actually handed over.* Thus although the monetary effects of a scheme of this sort would be very little different from those of an immediate sale of the shares the PSBR effect would be delayed until the option to convert was exercised.

*see end

3. A claim made for the issue of convertible gilts is that the shares (or the gilts) could be sold at a premium rather than at a discount in the case of direct sale of the shares. But in fact this is only likely to be true if convertibility is optional. In this case there is a chance that the investor will make a capital gain because the share price might rise above the option price, whereas if the share price fell the option to buy need not be exercised. Thus the investors would have a one-way option for which they would probably be prepared to pay. But an implication of this is that if the share price did fall the sale of shares might never occur.

4. If the conversion into shares were made compulsory within a certain period, the effect on the price obtainable by the Government is less clear cut and although a premium might be obtained this would be far

From assured. Whether or not a premium was obtained would depend, inter alia, on the length of the period during which the option could be exercised and the shorter the period the less the likelihood of a premium. In the extreme case of compulsory conversion on a fixed date in the future the sale would almost certainly be at a discount.

5. Whether the sale occurs at a discount or a premium under this scheme thus depends on the extent of additional risk taken on by the investor when buying convertible gilts rather than the shares themselves. If less risk is taken on, the sale will be at a premium and vice versa. In a world of perfect certainty about future share prices and dividends, however, there would be nothing to gain or lose by adopting the convertible gilt technique. Investors would in both cases examine the future stream of net returns available to them - in the case of a direct sale this would be the value of dividend payments and in the case of a convertible the value of interest payments initially followed on conversion by dividends - and would discount these to obtain a current market valuation. One option would yield a higher valuation than the other only insofar as the discounted net cost to the Government was higher in that case (ie only insofar as the interest payments on the convertible gilts exceeded the dividends on the shares, or vice versa). Thus in the absence of uncertainty the two methods would be equivalent as far as the cost to the Government was concerned.

6. In his letter Mr Hunter also argues that the price of the shares would be depressed to a smaller extent prior to sale if it were known that the method of sale was to be in the form of convertible gilts rather than an immediate sale. But this is likely to be only a timing effect. Investors would know that the shares would eventually be sold and that the share price would eventually reflect the increase in supply. They would take this into account when assessing the value of the option available to them when purchasing the convertible gilts and thus there is no presumption that the Government could obtain a higher price as a result.

7. There are further aspects of the method of sale of Government shares which could be described here, such as differential tax advantages of the different methods, but nevertheless our view remains that the method of sale proposed by Mr Hunter would only benefit the Exchequer insofar as the risk taken by investors was reduced, and in order to ensure such a reduction it would be necessary to present them with a wide range of options, and in the extreme case an option not to purchase.

In this case it could not be guaranteed that the sale of shares would actually take place within a reasonable period, and although this would not have significantly adverse monetary consequences, the gain to the PSBR could also not be guaranteed. * (see end)

8. Adoption of the technique suggested by Mr Hunter cannot therefore be recommended for the sale of assets in the current financial year, given that the Government envisages asset sales as a means of cutting the PSBR. The advantages of such a scheme in terms of increased return to the Exchequer are in any case somewhat doubtful. Accordingly, I attach a draft letter along these lines which the Chancellor might send to Mr Hunter.

C. J. Riley.

C J RILEY
19 June 1979

I entirely agree. This proposal is useless so far as this year's disposals are concerned - as my Private Secretary's Minutes of 29 May made clear. It might just have some relevance to the long term problem of selling shares in some of the less promising nationalised industries, or will be borne in mind in that context, although I am doubtful even if it will prove to be very far from zero.

I agree

J. H. B.

19:vi:79

* Latest advice suggests that it could well be the case that the PSBR is not reduced even when the shares are handed over.



PRINCIPAL PRIVATE SECRETARY

cc Sir L Airey
Mr Littler
Mr F Jones
Miss Brown
Mr Lavelle
Mr Bridgeman
Mr Monck
Mr R G Ward
Mr Wicks
Mr Riley
Mr Williams
Mr Bell
Chief Cashier)
Mr George) B of E

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The Financial Secretary has seen the attached note ^{by Mr Riley} and commented:

"I entirely agree. This proposal is useless so far as this year's disposals are concerned - as my Private Secretary's note of 29 May made clear. It might just have some relevance to the long term problem of selling shares in some of the less promising nationalised industries, and will be borne in mind in that context, although I am doubtful if it will prove the best way even then."

PCD

P C DIGGLE
20 June 1979