PO-CH/NL/0293
PART B

Part. B.

SECRET

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Begins: 23/4/87.
Ends: 13/7/89.

PO -CH /NL/0293

PART B

Chancellor's (Lawson) Papers:

BRITISH LEYLAND AND
ROVER GROUP
PRIVATISATION

PO -CH /NL/0293
PART B

Disposal Directions: 25 Years

[signature]

20/10/95.

4659

DEPARTMENT OF TRADE AND INDUSTRY
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PS/ Secretary of State for Trade and Industry

CONFIDENTIAL
COMMERCIAL IN CONFIDENCE

Ring Mike Waller.

23 April 1987

David Norgrove Esq
Private Secretary to the
Prime Minister
10 Downing Street
London SW1A 2AA

Is this worse than expected?

CH/EXCHEQUER
REC. 23 APR 1987 23/4
ACTION Mr Waller
COPIES TO CST FST Sir P Middleton
Mr FER Butler
Mr Monck
Mr Burgner

Dear David,

ROVER GROUP

The Prime Minister may wish to be aware that Rover Group's preliminary accounts for 1986 are due to be published on 8 May. Although the size of the losses has effectively been trailed in the circulars for the Rover Group EGM that took place on 27 March, there is no doubt that the actual figures will give rise to some adverse publicity. This may be revived with the sending out of the full audited figures on 22 May and the holding of the Annual General Meeting on 18 June. Although this timetable does of course increase the risk of Rover Group being in the political spotlight in June, my Secretary of State believes that we must accept the RG Board's view that it is commercially vital to dispose of this historic bad news well before the key August selling period for cars.

The figures to be released of course relate to the period prior to the reconstruction of the commercial vehicles businesses. Prudent accounting practice requires that provision should be made for all the costs of that reconstruction, some of which will actually fall some time ahead. This is responsible for the bottom line loss of £899m now anticipated. Of course the trading level loss in 1986 (£350m) was also very poor and the need to turn this round quickly remains essential. Elimination of the commercial vehicle losses will contribute but the residual businesses will need to perform much better; we and Treasury officials will be monitoring this

JG3AYP

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carefully. It is encouraging that RG's management accounts for the first two months of this year show the Group performing slightly ahead of budget though of course one must be wary of extrapolating from such a short period.

In order to counterbalance the historic 1986 figures with up to date evidence of the better trading performance this year, RG will publish 1987 first quarter trading results alongside the preliminary 1986 figures. Some may argue that this is a new departure to divert attention but my Secretary of State believes it should help to underline the new direction the Group can move in following the commercial vehicle disposals.

I am copying this letter to Alex Allan at the Treasury, and to Andrew Lansley (Chancellor of the Duchy's office).

Yours ever,

Michael

MICHAEL GILBERTSON
Private Secretary

JG3AYP

569/7/SC

CONFIDENTIAL
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FROM: M A WALLER

DATE: 24 April 1987

CHANCELLOR

cc. Chief Secretary
Financial Secretary
Sir P Middleton
Mr F E R Butler
Mr Monck (or)
Mr Burgner
Mr Fletcher
Mr Bent

ROVER GROUP: 1986 RESULTS

The Private Secretary letter from Mr Channon's office to No.10 reports the amount and timing of announcement of the Rover Group's (RG) 1986 results. The letter is essentially for information only and calls for no intervention by Treasury Ministers. However, you may find it helpful to have a rather fuller explanation of how Rover Group have managed to arrive at such a horrendous bottom line figure of a loss of £899m.

2. The last point at which Ministers collectively considered the financial performance of Rover Group was in the context of the 1987 Corporate Plan which was presented to Mr Channon on 22 December last. A comparison of the Corporate Plan forecasts for 1986 and the outturn reported in yesterday's Private Secretary letter is attached to this note. Taking the main items in turn:

(i) At the trading level pure operating losses have deteriorated by some £54m between the Corporate Plan and end 1986. This essentially reflected the very marked decline in ARG's market share towards the back end of last year - in November market share fell below 13% and for the year as a whole was only somes 15.6% (2.8% below budget). This deterioration has been evident in monitoring returns subsequent to the presentation of the Corporate Plan. To the increased operating loss RG have added some £116m of exceptional items for which no provision was included in the Corporate Plan. These exceptional items mainly cover provisions for the writing down of under-utilised assets at ARG and Land Rover, and ARG restructuring costs.

(ii) Extraordinary items. The Corporate Plan allowed some £304m for extraordinary and other minor items. This has risen to £444m in the final figures, the increase of £140m reflecting higher provisions than originally forecast against disposals.

3. In summary, the main reason for the massive deterioration in what was already going to be a bad year for Rover Group is essentially the need for very substantial exceptional and extraordinary items to cover the costs of restructuring and to reflect accurately the true value of what up to now had been considerably over valued assets on RG's books. There is also no doubt that the size of the provisions reflects Mr Day's desire to get as much bad news as possible out of the way in respect of the 1986 performance thus maximising the chances of RG turning in a much more respectable financial performance for this year.

4. As far as 1987 is concerned, clearly the crucial factor will be ARG's performance. For the first 2 months of 1987 market share has been just under 17% compared with the budgeted figure of 14.7%, though there are signs of this share slipping in March and the first days of April. As far as financials are concerned, LBIT and total earnings are running ahead of budget. But it is early days yet and it remains to be seen whether the Group's financial performance will hold up under what will again be a very competitive environment in the car market, with Ford in particular offering a very substantial threat to ARG's market share.

M A WALLER

569/7/SC

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ROVER GROUP: 1986 FIGURES

	CORPORATE PLAN £m	FINAL £m	CHANGE £m
. Operating Loss	180	234	+ 54
. Exceptional Items	-	116	+ 116
Loss PBIT	180	350	+ 170
. Interest	102	105	+ 3
. Loss BT	282	455	+ 173
. Extraordinary and other items	304	444	+ 140
. **TOTAL**	**586**	**899**	**+ 313**

569/12/SC

CONFIDENTIAL
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FROM: M A WALLER

DATE: 24 April 1987

CHANCELLOR

cc. Chief Secretary
Financial Secretary
Sir P Middleton
Mr F E R Butler
Mr Monck (or)
Mr Burgner
Mr Fletcher
Mr Bent

OK

ROVER GROUP: BORROWING OBJECTIVES FOR 1987 AND 1988

A key element in the Government's agreement to the 1987 Rover Group (RG) Corporate Plan was the need to re-establish confidential objectives for the end-year utilisation of RG borrowing facilities. This condition was set out in Mr Channon's letter to Mr Graham Day of 19 February and was to apply to end-year facilities for both 1987 and 1988 - see penultimate paragraph of Mr Channon's letter (Flag A). (The reason for the use of the terminology "confidential objective", rather than our preferred formulation of a "cap", is that the imposition of a formal constraint on RG's borrowing would run foul of the Directors' fiduciary duties and might also well cause problems with RG's bankers if it became public knowledge).

2. In conjunction with DTI officials and their advisors (Barings), we have now discussed with RG's Finance Director the appropriate level of the borrowing objectives for this year and next, taking account of changes since the forecast for borrowings were compiled for the 1987 Corporate Plan which are listed in the attached table (Flag B). In summary the figures presented by RG are as follows:

	1986	1987	1988
	£m	£m	£m
Corporate Plan	1006	630 1/	758
Cum. cash flow changes	(23)	14	171
Equity change	-	(23)	(23)
Latest view	983	621 2/	906
Variance B/(W) Plan	23	9	(148)

1/ assumed equity injection of £650 million.

2/ after equity injection of £673 million (not of £7m capital duty).

As the table makes clear, the 1987 figure is a slight improvement on the Corporate Plan forecast, though not to the full extent of the higher than assumed level of equity injection. For 1988, however, there is a marked deterioration against the Corporate Plan forecast. We have therefore sought with Rover Group to establish the sensitivity of the forecasts to changes in trading conditions and other major variables and the scope for reducing the borrowing in order to minimise the Government's contingent liabilities under the Varley Marshall assurances.

3. For **1987**, there remain uncertainties over the final disposal costs for Truck and Bus, perhaps in the order of £5-8m. For Trucks the figures reflect remaining uncertainty about the allocation of costs of the investment programme for Freight Rover and the possibility of RG having to meet the costs of moving sites. For Bus, the uncertainties centre on the continuing deterioration of the trading position of the company and a dispute between the auditors and the MBO on the finalisation of the 1986 accounts. The only other major factors effecting the size of the 1987 borrowings relate to the timing rather than the absolute size of financing requirements i.e. ARG capital expenditure (see paragraph 6 below) and spending on the costs of the Truck merger with DAF, both of which benefit 1987 at the expense of 1988 borrowings. To the extent that there are likely to be any changes in these figures, it is likely to be slippage into later years.

4. Given the uncertainties on Daylight and Bus disposal costs and the lack of scope elsewhere for reducing financing commitments, our conclusion is that the borrowing objective of around £620m for 1987 is a realistic and taut one.

5. For 1988 the situation is much less satisfactory, involving a forecast pretty close to the figure which existed prior to the Government's equity injection. Of the deterioration from the plan of £148m just on £100m reflects the cumulative effects of higher 1986 trading losses (an increase of £57m in the LBT compared with the Corporate Plan) and higher costs of closures etc associated with the Trucks deal (£43m worse than planned).

6. The remainder is essentially accounted for by a change in the profile of ARG's 3 main capital expenditure programmes (K Series engine, small gearbox and AR8). This involves slippage of £28m in 1987 into 1988 and the bringing forward of expenditure from later years into 1988 - a net cumulative increase in borrowing by end 1988 of £52m. This reprofiling does not involve an overall increase in expenditure over the plan period (in fact it reduces it by some £11m). It was on this basis that Mr Channon agreed to the reprofiling as part of his formal approval for the individual project elements of the Corporate Plan. But DTI officials were also under the impression that RG would be able to offset the increased annual financing requirement from elsewhere within their programmes so that there would be no increase in borrowing. During our discussions with RG we pressed them to say how they could eliminate the impact of the reprofiled capital expenditure on the 1988 borrowing figures. The short answer from RG was that they could not, apparently reflecting a misunderstanding between DTI and RG. RG argue that the only thing they could do was to take a slice out of capital expenditure. In practice this would mean reversing the decision which the Secretary of State had already made to allow RG to accelerate capital expenditure. We do not think it would be sensible to press this issue, particularly given that the expenditure will not be incurred until 1988 and will be subject to review well before then.

Conclusions

6. The important control figure for the moment is the 1987 borrowing objective. We think this is acceptable and would recommend you agree to it. As far as the 1988 figure is concerned, under the terms of the Secretary of State's letter to Graham Day any objective would be subject to review in the context of the 1988 Corporate Plan (if not a lot earlier). The existing 1988 forecast figure is highly unsatisfactory and, given the uncertainties surrounding it, is not one which we would recommend Ministers to give unqualified endorsement. Subject to your views, therefore, we have agreed with DTI officials that RG should be made aware of Ministerial concern at the increase in Varley Marshall liabilities resulting from the higher borrowing in 1988; that emphasis should be placed upon the uncertainties surrounding the end 1988 figure; and that RG should be told that, in reviewing the 1988 Corporate Plan, it will be essential to find ways of substantially reducing the 1988 borrowing to close to the 1987 Corporate Plan figure. On this last point, though RG argue that reduced capital expenditure would be the only way of bringing the figure down there are other options in prospect for 1988 i.e. a contributions holiday on payments into ARG's pension funds which could be perhaps save £50m in 1988 and the possibility of flotation of RG's marketing company in the States (which might yield £20m).

7. DTI have drafted the attached letter for Mr Channon to send to Graham Day reflecting this general approach (Flag C). The draft incorporates in manuscript amendments we have agreed with DTI. I would be grateful to know whether you are content for Mr Channon to write in these terms.

M A WALLER

Mr Burn

Could you

(a) ensure proper circ of this letter in Whitehall

(b) consider what systems need to be set up to enable us to take forward the points it raises.

Can we agree 19 February 1987 who / how / when for the detailed discussion on the borrowing objective. Next monitoring meeting.

Mr Smith

re (a): pl copy Mr Walter, Mr Guise + Ms Valentine (Borrowings) then return to me for (b)

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Secretary of State for Trade and Industry

A

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19 February 1987

PS/SS
PS/SecBd
Mr Mountfield
Mr Coulthin
Mrs Bell

20/2

J Graham Day Esq
Chairman
The Rover Group plc
7-10 Hobart Place
London
SW1W OHH

cc Mr Manzie
Mr Burgess
Mr Bard
Ms Slade

Dear Graham

Not on all fours with its formulation as suggested.

I am pleased to be able to tell you that following consideration of The Rover Group's Corporate Plan I can now reply to the Plan's proposals. The Government have approved the Plan (subject to the consideration set out below) and I shall be making a statement in the House today. I should, however, like to inform you personally of some of the major concerns which I have had since receipt of the Plan on 22 December.

24/2

Overall I have been encouraged by a plan which combines more realistic and achievable forecasts than in previous years with a firm commitment to privatisation. Deals have now been concluded on Unipart and Leyland Bus, and a decision made on a new way forward for Freight Rover and Leyland Trucks: on the assumption that the latter deal is completed I have in this letter restricted my attention to the major residual businesses, Austin Rover and Land Rover. This is a reflection of the great progress that has been made in the implementation of our declared policy of returning Rover Group businesses to the private sector. Clearly the volume cars business is some way from this ultimate aim, but I am concerned that in the meantime avenues for collaboration or for sale of Austin Rover products should be fully explored; I hope that the regular monitoring of Rover Group companies will cover the progress being made in this direction. Any operations financed outside the scope of Government assurances can only help to smooth the path towards the private sector.

DW3BRV

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The Austin Rover Company Plan projects a negative cash flow throughout the plan period, and thus fails to meet Rover Group's stated business objective. Further, there are clearly substantial risks involved in achieving the projected results. In particular I have noted the critical dependence of Austin Rover on Honda and AR8, and the need to improve the real and perceived quality of Austin Rover cars in order to attain the upmarket position which the plan seeks. On the other hand I have noted the reductions in capital expenditure against previous plans and the strategy of keeping manufacturing capacity in line with projected volumes. Despite the risks, my colleagues and I have agreed to endorse this plan (though not without some hesitation on the major K series programme) as seeking to provide for a process of consolidation and improvement which, if successfully managed, would put ARG in a position where it could be prepared for later sale or flotation. I look forward to charting the success of the proposed strategy in the context of the annual corporate planning cycle, when options open to the company will be reviewed in the light of commercial progress. I should also like to record that proposals to allocate or bring forward the notional capital spend in latter years of the Plan will need to be approved by Government in the normal way.

The key element of the Land Rover Company Plan is the proposed Jay programme, to take the company into the personal transport sector. I appreciate the need for Land Rover to broaden its product base, and have therefore decided to accept this Plan. I know that you will be reviewing the company's progress and the privatisation options towards the end of this year; the Government will wish to be closely associated with this review. Meanwhile I hope you will keep under review the prospects for advancing the timetable from the current indicative date for privatisation of 1 January 1989 - especially since, as I see it, the risks surrounding the Jay programme may argue for proceeding sooner rather than later.

Particularly in the light of the imminent removal of the Group's own Articles limit on borrowings as a multiple of shareholders funds, I believe that it would be appropriate to re-establish a confidential objective for the end-year utilisation of RG borrowing facilities. I propose that this should be set at a figure consistent with the end-1987 net borrowings and leasing commitments projected in the Plan (as adjusted for example for the additional borrowings carried over at the end of 1986 not foreseen when the Plan's financial figures were drawn up and the removal of the FR component from the projections). A similar figure for end-1988 will also be established subject to review in a year's time. I propose that RG staff and DTI and Treasury officials should discuss urgently the precise figures to be used. I should stress that this

DW3BRV

is designed to act as a control mechanism within the strategy set out in your Plan. If the regular monitoring of the Group projects that the objective is likely to be breached at the year end there should be immediate discussions between us about the reasons and options.

More generally I should like to highlight the importance I attach to receiving regular reports from my officials on Rover Group's trading performance: I am sure you will agree that monitoring the achievement of the Group against the strategy in your Plan is a vital aspect of the relationship between RG and Government.

Yours,

PAUL CHANNON

Paul

DW3BRV

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(15)

ROVER GROUP

ESTIMATED CHANGES TO 1987 CORPORATE PLAN BORROWINGS

CASH FLOW £M	1986	1987	1988	Cum. 86-88	
Corporate Plan cash flow	(369)	(274)	(128)	(771)	
ADJUSTMENTS TO PLAN ASSUMPTIONS					
1986 trading:					
1986 PBT Losses	(57)	-	-	(57)	
1986 year-end Operating Assets	80	(80)	-	-	
Impact of Divestments:					
Removal of Freight Rover	-	(3)	9	6	
Removal of African Operations	-	2	2	4	
Daylight costs higher	-	(43)	-	(43)	
Daylight spend profile	-	76	(76)	-	
'Exco' working capital	-	(15)	15	-	
Bus disposal costs higher	-	(14)	-	(14)	
Bus spend profile	-	10	(10)	-	
DAB disposal proceeds	-	7	-	7	
LVISA closure costs	-	(5)	-	(5)	
Other:					
Interest on higher borrowings	-	-	(7)	(7)	
Higher 1987 interest rates	-	(6)	-	(6)	
Other 1987 budget changes	-	6	(6)	-	
ARG capex profile	-	28	(80)	(52)	1/
ARG vendor tooling costs	-	-	(4)	(4)	
Total changes to Plan cash flow	23	(37)	(157)	(171)	
Cash Flow - Latest view	(346)	(311)	(285)	(942)	

BORROWINGS £M	1986	1987	1988
Corporate Plan	1006	630 2/	758
Cum. cash flow changes	(23)	14	171
Equity change	-	(23)	(23)
Latest view	983	621 3/	906
Variance B/(W) Plan	23	9	(148)

1/ this item is recovered in later years.
2/ after equity injection of £650 million.
3/ after equity injection of £673 million (net of £7m capital duty).

Group Controller's Office
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(C)

DRAFT LETTER TO RG (SoS TO DAY/COCHLIN TO HANKINSON)

In [my] [the Secretary of State's] letter of 19 February [to Graham Day] confirming approval of the RG Corporate Plan it was proposed that a borrowings objective should be set for the Group consistent with the Corporate Plan strategy and borrowings profile for the years 1987 and 1988. It was agreed that DTI and Treasury officials should discuss with RG staff the adjustments necessary to the figures in the Plan to cater, for example, for additional borrowings carried over into the start of the Plan period and for the outcome of negotiations on the disposal of the commercial vehicle businesses.

Following the tabulation Rover Group provided to the Department on 15 April 1987, [I] [the Secretary of State] have/has agreed that the borrowings objective for the end of 1987 should be £621m (to include leasing commitments). If at any stage the regular monitoring of the Group projects that the objective is likely to breached at the year end there should be immediate discussions between [us] [the Secretary of State and Graham Day] about the reasons and options.

The letter of 19 February also proposed that a similar figure be established for the end of 1988 subject to review in the next Corporate Plan cycle. Given the existence of the Varley-Marshall-Joseph assurances, [my Secretary of State is] [I am] concerned at the sharp increase in end-1988 borrowings shown in your latest projections compared with the Corporate Plan. These revised figures suggest borrowings rising to a level not far from the one shown at the 1986 year-end. Whilst a major element of this increase is the final outturn of 1986 trading performance and the outcome of the disposal negotiations, a significant contribution comes from the revised ARG capital expenditure profile. In [~~agreeing~~ noting] therefore [~~to~~] a current indicative figure of about £900m for the end-1988 However, by 1988 the borrowings will have to be supported by a smaller range of activities, albeit that they should be by then profitable ones

reduce the increase over the plan to the greatest extent possible.
In I would hope that improved trading performance and other cost savings could

objective [I] [Ministers] expect that every effort will be made to offset at least the adverse capital expenditure element so that the review process due later this year will see a move back towards the Corporate Plan profile.

564/4/SC

SECRET

FROM: M A WALLER

DATE: 25 June 1987

1. MR MONCK

2. CHANCELLOR

There are great attractions in Lord Young's proposals but also major risks. Mr Day would clearly have to be won over for a start. Before embarking again on the Ford option your colleagues need to face the difficulties, and be certain of carrying it through.

AM 25/6

cc. Chief Secretary
Sir P Middleton
Mr F E R Butler
Mr Burgner
Mr Turnbull

ROVER GROUP

This is a brief for your meeting at No.10 at 3.00 pm on Friday 26 June to discuss the future of Rover Group with the Prime Minister and Lord Young.

BACKGROUND

2. ARG and LR are currently operating on the basis of the 1987 Corporate Plan approved by the Government earlier this year. Annexed are financial summaries for the period 1987-91. Varley Marshall liabilities are forecast to rise from £1.4 billion to £1.6 billion over the plan period. ARG and LR performance in terms of sales and cash flow for the year to date is comfortably ahead of budget, though in May ARG's market share fell to 13.5% i.e. below the modest 14.5% share assumed for the Corporate Plan.

3. Immediately after the Election DTI officials submitted papers to Lord Young on options for the future of Austin Rover (ARG) and Land Rover (LR). These canvassed a very wide range of possibilities ranging from disposal within a very short timescale of both ARG and LR (either in separate trade sales or as a package) to continuing on the basis of the 1987 Corporate Plan with the object of a possible flotation of ARG in the early/mid 1990s e.g.:

(a) for ARG, trade sale to Ford, a European major (either VW or Fiat) or to a Japanese company (including both Honda and Toyota);

(b) for **LR**, a trade sale to Jaguar or other possible British buyers (e.g. a management buy out, Lonhro, Hanson Trust) or possible interested foreign buyers (notably BMW, who have already expressed an interest);

(c) a package deal comprising both ARG and LR with the intention of LR providing a sweetener for the deal thereby widening the range of possible bidders (e.g. possibly to include big UK financial conglomerates like Hanson and Lonhro).

4. These papers were prepared by DTI officials in consultation with No.10 Policy Unit and ourselves. But DTI also held low key talks with Mr Day about the future direction of the businesses. Not unexpectedly he takes the view that he wants to pursue the 1987 Corporate Plan strategy for ARG with a view to turning the business round, to the point where it can be floated into the private sector.

PURPOSE OF MEETING

5. For your information only, DTI officials have told us informally that, at a meeting with Lord Young on Monday to discuss the options, Lord Young's preferred options were for immediate action (i.e. within the next 12 months) to:

(a) arrange a trade sale of Land Rover to Jaguar; and

(b) sell ARG to Ford.

Lord Young has therefore instructed DTI officials to prepare 3 papers covering the modalities of: the LR/Jaguar sale (which is to include a golden share provision to prevent LR falling into the hands of a foreign-owned company); the ARG/Ford disposal; and the steps required to take out the existing minority shareholders in Rover Group which DTI's advisers believe is essential to circumvent possible opposition to the proposals from the RG Board.

6. We understand Lord Young wants to move very quickly on this. He is seeing Graham Day on Friday morning to hear his views and proposes to see Sir John Egan on Monday for exploratory talks.

The purpose of Friday afternoon's meeting, for which there will be no papers, is to sound out the Prime Minister and yourself on the strategy described in paragraph 5 above which is both ambitious in terms of timescale and politically highly charged.

COMMENT

7. The present ARG Corporate Plan is problematical since it does not offer the prospect of a commercially viable business. While easiest politically in the short-term, it involves an escalating contingent call on public expenditure via the Varley Marshall, assurances and does not avoid politically difficult closures (e.g. at Cowley South). Failure to achieve the plan's modest objectives could mean that the resulting adverse expenditure and employment consequences would come towards the end of the present Parliament.

8. On the other hand, Lord Young's preferred strategy in respect of ARG is very high risk. Without opening negotiations with Ford there can be no certainty about Ford's real intentions either towards the concept of an ARG takeover or in respect of the ARG capacity and workforce. It will require a very high degree of commitment to carry the deal through against what will certainly be very strong Parliamentary and public opposition (it would give Ford perhaps 45% of the UK market and would involve charges of undermining British manufacturing industry). Mr Day and the RG Board may well strongly oppose the deal. And, if the negotiations became public prematurely (which is likely) or the deal falls through, irreperable damage could be done to ARG's market position with very substantial public expenditure and employment implications.

TREASURY INTERESTS

9. There are a number of interrelated Treasury interests. These are to ensure that:

(i) decisions on options take full account of the need to minimise public expenditure and to allow for the orderly resolution of HMG's liabilities under the Varley Marshall assurances;

(ii) disposals are done in a way which, for LR at least, provides effective competition between possible buyers;

(iii) the financial and wider economic implications for whatever option chosen are fully examined and taken into account.

(i) Public Expenditure Implications

10. LR borrowings are currently about £80 million and are forecast to remain at this level over the next 2-3 years. Depending on how hard a deal can be negotiated with the prospective buyer, the sale price of Land Rover could be in the region of £100-200 million. So there would be unlikely to be any substantial public expenditure cost, even if the Government agreed to underwrite any rationalisation costs.

11. For ARG, we could be expected to have to pick up the cost of repaying all of ARG borrowings (currently around £500 million) together with very substantial rationalisation costs. Any estimate of the total cost involved at this stage must be very speculative but we would not expect it to be much under £750 million and it could be much higher if the ARG business slides on the knowledge of the Ford bid becoming public. A major collapse in dealer and customer confidence in Rover Group products could crystallise the Varley Marshall liabilities. On the worst case scenario DTI's advisers, Barings, estimate these to be £2 billion on liquidation i.e. including redundancy costs and netting off debtors, creditors and saleable assets.

12. The timing of any payments will clearly depend on how quickly it will be possible to close the deal, but it would probably be possible to pay it all this financial year or next or spread it over the 2 years. The latest report on the state of the Reserve indicates a small prospective overrun on the planning total. This did not include any provision for Rover which, if included this year, could turn a small overrun into a very large one. If the practical constraints on settling a deal allow a choice, there would be a need to consider whether it would be better to carry the full cost this year or to allow it to enter into the Survey arithmetic.

Full cost this year without question

(ii) Competition

13. Lord Young is proposing that there should be no competition for the disposal. For LR we think this is unjustifiable both from the point of view of financial propriety and value for money. The absence of competition clearly makes for easier handling of negotiations but leaves nearly all the negotiating cards with Jaguar. The Government would be open to criticism by the PAC that we have not got best value for public money which would be difficult to refute. It would also create considerable presentational difficulties associated with refusing to negotiate with other possible interested parties (notably Lonhro and the MBO who expressed an interest in the Land Rover sale last year); it would strengthen the RG's Directors case that they were being forced to act against the commercial interests of the company; and the approach would sit uncomfortably with the Government's general policy of encouraging greater competition in the economy.

14. Similar in-principle arguments apply in the case of ARG. On the other hand, the difficulty and sensitivity of handling approaches to other possible bidders (who, if not interested, might be expected to take pre-emptive action to secure some of ARG's market share) and, on the face of it, the absence of any immediately obvious alternative bidder point to a direct negotiation with Ford. But there is also a question mark over just how serious Ford might be in their intent to take over the company. We understand that the President of Ford has written to the Prime Minister implying an interest in receiving Government proposals on an ARG sale but that this is couched in sufficiently open terms not to commit Ford to anything specific. It is possible that Ford may be planning to use this as a ploy to undermine confidence in ARG thereby enabling Ford to capture some of ARG's market share.

(iii) Commercial and Economic Implications

15. On the basis of the 1987 Corporate Plan, **LR** is scheduled for disposal in early 1989. Lord Young's plan would be to bring this disposal forward by about a year (i.e. to early 1988 - it would be very difficult to do this any sooner). While there is no immediate reason for urgency, we will know very little more in terms of the commercial prospects for LR in 1989 than we will at the beginning of next year - the key issue is the success of the launch of Range Rover in the States on which we will have a clear

idea by the end of this year. And we would not gain much in proceeds by waiting. LR are currently planning to take on labour because sales of Range Rover are supply constrained. It is therefore unlikely that there will be any significant employment impact as a result of an earlier disposal.

16. On ARG, an early disposal to Ford (or any other feasible buyer), would be on essentially distress terms and could well involve the planned closure of one of ARG's existing major plants. The main candidate at the moment is Cowley which would involve direct job losses of about 10,000 with knock-on effects on component suppliers of possibly another 20,000-30,000 job losses. (Under the existing Corporate Plan, Cowley South is scheduled for closure in 1989 anyway, involving the loss of 2,000 jobs.)

HANDLING

17. As you will be only too well aware, there are major handling and presentational difficulties associated with any radical option for the future of Rover Group. Factors bearing on this are as follows:

(i) The attitude of the RG Board and whether the Government is prepared to override them - Mr Day and many members of the Board are likely to be very strongly opposed to Jaguar/Ford solutions. Mr Day has already indicated that he is wedded to the idea of continuing with the present plans until the 1990s with a view to flotation. The Board may therefore, in the first instance, stand on their legal duties to safeguard the strict commercial interests of the company (including the interests of the minority - see below) and then threaten to resign. Against this background, it is unrealistic to expect news of the ARG/Ford negotiations to be kept under wraps.

(ii) The minority shareholders - these continue to remain a vocal source of oposition to the company and Government plans for Rover Group. As noted above, Lord Young has asked officials to prepare a paper on how best to take out the minority. But it is not at all clear, short of primary legislation, whether any scheme the Government can come up with would succeed in removing the more troublesome and vocal minority shareholders.

(iii) Parliamentary oppostion - there is likely to be major Parliamentary opposition to an ARG disposal to Ford, not only from Opposition backbenchers but also from Government MPs with constituencies in the Oxford and West Midlands areas. Following so soon after consideration of the 1987 Corporate Plan there would inevitably be charges that the Government planned to do this all along and that it marks another step in the destruction of British manufacturing industry. While it would be possible to argue that this represented the only viable long-term prospect for ARG, this might be difficult to square if the RG Board were publicly opposed to the move.

(iv) the attitude of Honda to a possible Ford takeover - Honda are contractually committed to the development of the AR8 until the early 1990s. They have made it clear that they would not want to stay with ARG in the event of a Ford takeover. But it is possible that, even with a Ford takeover, they would continue with the collaboration until they could develop their Swindon site into a full blown manufacturing operation. (Currently there is no evidence of Honda's desire or intention to take a substantial equity stake in ARG - this is unlikely to change with the prospective disposal to Ford.)

(v) The proposal for a golden share to protect LR from foreign takeover - this is attractive presentationally. It is also something Jaguar management want to make them a less easy takeover prospect when their golden share matures in 1990 (over 49% of Jaguar shares are already held by the Bank of New York as agent for American Depositary Receipts trading on the over-the-counter market). It would not, however, be an attractive proposition for Jaguar shareholders because of the adverse impact on their share price. Moreover, Jaguar and LR would need to trade on an arms length basis during the currency of the share to facilitate divestment, thus reducing the scope for rationalisation in the short-term. If

Jaguar were taken over by a foreign bidder then HMG would have to stand as bidder of last resort for LR assets. There might also be difficulties in justifying the existence of the share to the EC Commission.

(vi) <u>the attitude of the EC</u> - who are likely to prove even more resistant than before to the idea of further aid to RG, though the existence of large counterpart in the form of substantial closures would be a strong plus point.

<u>SUMMARY</u>

18. The key problem here is ARG. There are three possible alternatives - stick to the current plan, sale to Ford or closure. What Lord Young is proposing is ambitious and, in the short run, likely to be expensive in public expenditure terms. On the plus side it offers the prospect, though not a reliable one, of a relatively early withdrawal from Government commitments to the business which at the moment shows little prospect of long term viability. As such, it should provide the opportunity to liquidate, albeit at very substantial public expenditure cost, the large contingent call on public expenditure represented by the Varley Marshall assurances. And it provides some assurance for the future of the business. Unless Mr Day achieves a remarkable turnround in ARG there must be a strong chance that the company will be in ~~a~~ no better position at the end of this Parliament than it is now. The Government would then be faced with the prospect of the company remaining an indefinite pensioner or disposing of it at no less disadvantagous terms - at a time not of the Government's chosing.

19. But the Ford option is a very high risk one involving the need for commitment to carry the deal through, despite strong Parliamentary and public opposition. The risks of introducing competition and the Government's consequent negotiating weakness with Ford would add to the political difficulties of announcing a fait accompli to Parliament. If the deal fell through for any reason the commercial damage to ARG could well cause irrepareable damage to, and possibly the collapse of, the company. This could be very costly in terms of public expenditure and job losses.

20. In discussion with the Prime Minister and Lord Young we suggest that you should seek to ensure that:

(i) the risks of the ARG/Ford deal are fully appreciated and accepted, particularly in respect of forcing through the deal against the opposition of Graham Day and the RG Board;

(ii) there is agreement that the Government will be able to carry through the deal once negotiations are opened with Ford, even if they become public knowledge prematurely.

21. For LR, we suggest that you should press for greater competition and that the use of a golden share should be weighed carefully against the possible impact on the price Jaguar are prepared to pay for LR.

22. We understand No.10 Policy Unit will be briefing the Prime Minister in broadly similar terms.

M A WALLER

Addressee Only

1987 CORPORATE PLAN

AUSTIN ROVER GROUP

SUMMARY OF PERFORMANCE

		1985	Fcast 1986	1987	1988	1989	1990	1991
Revenue	£M	2233.0	2238.5	2420.0	2670.0	2880.0	2990.0	3025.0
UK Exports	£M	274.5	375.0	614.0	714.0	759.0	790.0	796.0
PBIT	£M	(9.3)	(105.0)	(30.0)	20.0	45.0	75.0	75.0
Profit Before Tax	£M	(44.3)	(159.4)	(83.9)	(42.2)	(17.1)	2.3	2.7
Retained Earnings	£M	(66.6)	(229.9)	(88.9)	(77.2)	(25.1)	(7.7)	(7.3)
Cashflow In/(Out)	£M	(66.4)	(230.5)	(116.2)	(118.2)	(43.1)	(22.7)	(48.3)
Capital Expenditure	£M	145.4	97.4	99.8	161.0	156.0	161.0	191.0
Year End Assets	£M	594.1	594.7	622.0	663.0	681.0	696.0	737.0
Average Assets	£M	594.2	594.4	608.4	642.5	672.0	688.5	716.5
Year End Borrowings	£M	293.4	499.9	456.1	574.3	517.4	540.1	538.4
Sales volumes	000	466.5	433.0	433.7	434.3	434.2	432.5	424.9
Manpower	000	41.2	38.8	35.3	32.4	31.4	30.0	27.9
PBIT/Sales	%	(0.4)	(4.7)	(1.2)	0.7	1.6	2.5	2.5
PBIT/Assets	%	(1.6)	(17.7)	(4.9)	3.1	6.7	10.9	10.5
Return on Shareholders Funds	%	(15.0)	(171.2)	(53.6)	(53.2)	(13.5)	(1.7)	(1.2)
Debt: Equity Ratio		50: 50	84: 16	73: 27	87: 13	76: 24	78: 22	73: 27
Economic Profit/Sales	%	31.7	31.6	31.6	31.3	31.3	31.3	31.3
Fixed costs (excluding Depreciation)/Sales	%	27.5	30.6	27.0	24.9	24.2	23.2	23.0

Addressee Only

1987 CORPORATE PLAN

LAND ROVER GROUP

SUMMARY OF PERFORMANCE

		1985	Fcast 1986	1987	1988	1989	1990	1991
Revenue	£M	435.6	449.4	493.7	546.5	584.7	628.3	708.8
UK Exports	£M	276.4	268.8	302.7	336.0	362.5	386.8	427.4
PBIT	£M	3.6	4.7	13.4	15.6	25.3	29.1	41.6
Profit Before Tax	£M	(5.2)	(6.7)	4.2	6.1	15.5	18.8	31.7
Retained Earnings	£M	(7.9)	(5.8)	4.7	6.2	15.6	18.9	31.8
Cashflow In/(Out)	£M	(35.0)	(3.9)	(4.8)	2.6	1.1	3.1	12.4
Capital Expenditure	£M	18.2	11.1	22.1	25.8	30.4	35.6	36.3
Year End Assets	£M	187.2	185.3	194.8	198.4	212.9	228.7	248.1
Average Assets	£M	173.7	186.3	190.1	196.6	205.7	220.8	238.4
Year End Borrowings	£M	72.7	76.6	81.4	78.8	77.7	74.6	62.2
Sales volumes	000	43.8	39.4	38.4	39.4	40.4	41.9	47.0
Manpower	000	8.3	7.9	7.9	7.5	7.7	7.9	7.9
PBIT/Sales	%	0.8	1.0	2.7	2.9	4.3	4.6	5.9
PBIT/Assets	%	2.1	2.5	7.1	7.9	12.3	13.2	17.4
Return on Shareholders Funds	%	(4.7)	(6.2)	3.7	5.1	11.5	12.2	17.1
Debt: Equity Ratio		39: 61	41: 59	42: 58	40: 60	36: 64	33: 67	25: 75
Economic Profit/Sales	%	26.1	28.3	29.3	28.1	28.3	27.7	27.7
Fixed costs (excluding Depreciation)/Sales	%	21.9	23.7	22.9	21.8	20.6	19.9	18.7

C10/18

Annex C

pup

SECRET

FROM: A W KUCZYS
DATE: 26 JUNE 1987

MR WALLER

cc PS/Chief Secretary
Sir P Middleton
Mr F E R Butler
Mr Monck
Mr Burgner
Mr Turnbull

ROVER GROUP

The Chancellor was grateful for your briefing for the meeting at No.10 today.

2. In paragraph 12 of your note, you say:

"The timing of any payments will clearly depend .... but it would probably be possible to pay it all this financial year or next or spread it over the 2 years .... there would be a need to consider whether it would be better to carry the full cost this year or to allow it to enter into the Survey arithmetic."

3. The Chancellor has commented:

"Full cost this year, without question."

AWK

A W KUCZYS

SECRET AND PERSONAL

NO COPIES TO BE TAKEN

CH/EXCHEQUER

REC. 29 JUN 1987

ACTION Mr Walker

COPIES TO CST FST Sir P Middleton Mr F ER Butler Mr Burgner Mr Monck

pup

10 DOWNING STREET

LONDON SW1A 2AA

From the Private Secretary

26 June 1987

Dear Tim,

ROVER GROUP

The Prime Minister this afternoon held a meeting to discuss the prospects for privatisation of Rover Group. There were present your Secretary of State, the Chancellor of the Exchequer and Mr. George Guise (No.10 Policy Unit).

Your Secretary of State said that the golden share in Jaguar would expire in December 1990. It was very likely that Jaguar would then prove attractive to a bidder, which might be a company like BMW. It would almost certainly not be possible to block such a bid on grounds of public interest, particularly if the bidder were a company from within the European Community. If such a bid were to succeed the result would be damaging to the Government. One possibility might be to arrange a trade sale of Land Rover to Jaguar, with a fresh golden share whose life might extend for another five years beyond 1990.

In discussion it was noted that the purchase of Land Rover with a golden share which would extend to Jaguar as a whole would require the consent of shareholders. Very nearly half of Jaguar shares were held in ADRs. An extension of the golden share would reduce the share price and it was not clear why existing holders would agree to this unless Land Rover were sold at below its proper value. This would however be unacceptable to the Government itself and to Parliament and it would be necessary to allow others to bid. Matters other than the price offered by bidders would need to be taken into account, including for example the strength of the bidders in distribution. It was noted that one possibility would be to sell Land Rover with a golden share which did not extend into Jaguar as a whole; the difficulty of acquiring Jaguar without Land Rover could well prove to be a deterrent to potential bidders.

The meeting considered whether there would be merit in reviving discussions about a possible sale of Austin Rover Group (ARG) to Ford. Such a sale would almost certainly be financially advantageous and it might also now be politically a little less difficult: there would be less surprise and the sale would not be caught up in the hysteria which had surrounded the discussions over the possible sale of Land Rover to General Motors. It would nevertheless be an extremely difficult decision. There would be concern amongst component suppliers in particular, and great opposition in Parliament: the House would have to be told as soon as discussions began. If discussions were to begin again they could not this time be allowed to fail. It was also very relevant that the Government in February 1986 had given an undertaking "that the right way to end the uncertainty is to make it clear that the possibility of the sale of Austin Rover to Ford will not be pursued".

The Prime Minister stressed the absolute importance of securing the support of Mr. Graham Day for whatever changes were proposed. Your Secretary of State stated his belief that Day would be prepared for Land Rover to be sold separately from ARG provided he could be given an assurance that he could continue with his recovery programme for ARG until late 1988 before he was expected to make recommendations on the future of the company, whether sale, flotation or retention by the Government. It was agreed on this basis that your Secretary of State should hold a strictly personal discussion with Sir John Egan on whether Jaguar would be interested in acquiring Land Rover.

The options for a golden share in Land Rover alone or in Land Rover and Jaguar together would need to be further considered.

The meeting discussed briefly whether it would be right now to seek to buy out the minority shareholders in Rover Group. This had been ruled out earlier on the grounds that it would give the appearance that the Government was trying to create greater secrecy about the Group. However there would also be substantial advantages to a buy out.

I am copying this letter to Tony Kuczys (H.M. Treasury).

Yours,

David

DAVID NORGROVE

Timothy Walker, Esq.,
Department of Trade and Industry.

813/37/SC

SECRET
COMMERCIAL IN CONFIDENCE
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Annex E

ROVER GROUP: ELIMINATION OF MINORITY SHAREHOLDERS

Summary

Lord Young's letter of 29 September (Appendix 1) is seeking the agreement to a scheme of arrangement designed to buy out the remaining 63,000 Rover Group (RG) minority shareholders. At the premium on the current share price recommended by DTI's financial advisers, the cost to the Exchequer would be up to £17m payable in this financial year. If the scheme is to be completed by Christmas decisions will be needed next week in order to complete notification and Court formalities before the Christmas vacation.

BACKGROUND

2. Lord Young is resurrecting a slightly modified form of the proposal Mr Channon put to you and the Prime Minister last February for removing the minority which you opposed and which was subsequently turned down (copy of your letter attached - Appendix 2). Lord Young is proposing a Scheme of Arrangement under Section 425 of the 1985 Companies Act under which HMG would offer to buy out the minority. In order to become binding on all shareholders the scheme must be approved by a majority of 75% ~~in~~ by value of their shares amongst the minority shareholders voting in person or by proxy at an EGM to consider the scheme. (HMG would be legally prevented from voting its shareholdings.) If approved by the required percentage of shares, the scheme would then need to be sanctioned by the Companies'Court after which the remaining minority shares would be purchased by HMG and RG shares would then be delisted.

3. In order to ensure a high probability of success the offer price would need to be set at a significant premium to the current market price of RG shares. Barings, DTI's financial advisers, recommend a premium of 35-45%. On the current share price of around 90p the total cost could be some £17m.

4. The only change from the February scheme is that RG are no longer proposing to say that, in the event of failure to secure the scheme's acceptance, RG would intend to delist the shares after a limited period (during which HMG would stand ready to buy the shares in the market). RG intend that the latter offer, however, would still form part of the overall package. But we now understand from DTI officials that this would be for decision only in the event that the Scheme of Arrangement failed.

RATIONALE

5. RG's and the Secretary of State's reasons for wishing to buy out the minority now are different and difficult to present publicly. RG's reasons are:

(i) to eliminate the abnormal speculative market in RG shares which bears no resemblance to underlying net asset value - a move which would be welcomed by the Stock Exchange;

(ii) to respond to the desire of some shareholders who wish to extract themselves from this anomolous minority position;

(iii) to avoid continued voicing of critical views by some of the minority which is claimed to injure RG's reputation.

(iv) to avoid the need to consult a minority of the shareholders on major asset disposals.

6. Lord Young's main reason for agreeing to RG's request is that removing the minority would, at the same time, prevent the RG Board deploying the argument that possible Government privatisation plans for the Group, to which the Board were opposed, were not in the interests of <u>all</u> the shareholders, including the minority. DTI point out that the previous Board used this as a delaying tactic in respect of the Unipart disposal and that Mr Day has indicated he might well do so if faced with the prospect of separate disposal of Land Rover and/or sale to Ford.

ASSESSMENT

7. There are two key issues here i.e. what the Government is buying for its money and whether the proposed Scheme of Arrangement is reasonably assured of success.

What the Money will Bring

8. It would remove a <u>procedural</u> barrier to the Government pursuing privatisation options unwelcome to Mr Day and the RG Board which they have deployed before. And, even in the absence of such opposition, it would speed up the process of a trade sale by lessening the number of procedural steps required. (Elimination <u>now</u> is not necessary under Mr Day's prefered flotation options.)

9. On the other hand a scheme:

(i) sits slightly oddly with plans to privatise the company;

(ii) could invite criticism that the Government has something to hide and is seeking to do so at a time when it is pressing for generally greater transparency in company dealings;

(iii) may require a confidential approach by HMG to the Courts to seek the Court's agreement to non-disclosure of e.g. talks with VW or Ford (see 14 below);

(iv) lead to criticism of sharp practice if a trade sale takes place shortly after the Scheme goes through;

(v) could fail.

Chances of Scheme Acceptance

10. A very important factor affecting response by the minority and the Courts to the Scheme is the premium being offered over the prevailing share price. The premium proposed by Barings reflects their judgement of the figure which is both necessary to achieve success - taking account of an analysis of recent minority buyouts - and to provide a reasonable defence that the premium is over generous and therefore a waste of public money. (It takes no account, however, of the recent rise in the share price which has been partly prompted by press speculation about a possible minority buy out).

11. RG have not yet been consulted on the premium but would no doubt press for a high figure, given that they are not footing the bill (we examined at an early stage whether RG could be made to meet the costs of the exercise but this was ruled out on legal grounds). It will also be necessary for an independent adviser to be appointed to advise the minority on whether the offer is a fair one in the light of the current and prospective trading prospects for RG. But, as the current net asset value of the shares is around 5p, at a time when the Group is still reporting losses, it must be very likely that a 35-45% premium would be deemed to be a fair offer.

12. Even with a generous offer success cannot be guaranteed. The sentimental/emotional attachment of <u>some</u> minority holders clearly does take precedence over strict financial considerations. On this basis of rational

financial appraisal shareholders might well have sold up when the share price touched 103p earlier this year (though the rumours of a Government buy out offer, coupled with speculation about flotation of the whole Group within the next 3/4 years, would have pulled the other way).

13. It is very difficult to come to any firm view on the prospects for success. As the attached analysis of RG minority shareholdings shows (Appendix 3), 99% of individual shareholders with holdings of 2,000 shares or less own 54% of the traceable shares. 22% of the traceable shares are in holdings of 200 or less. By contrast some 26% of the total minority shareholding is owned by just 80 holders with holdings in excess of 10,000 shares, with over half this latter group being accounted for by just 12 shareholdings of 50,000 shares or more (nearly all of which are corporate holdings). Virtually all of the larger shares could be expected to vote in favour of the Scheme of Arrangement but, given the preponderance in total shareholdings of small shareholders, it is their voting intentions which are likely to be crucial i.e. whether and which way they vote.

14. Another key aspect of this issue is the attitude of the Court to the Scheme of Arrangement. An important point here, which is not mentioned in Lord Young's letter, is the need for disclosure of the Government's possible plans for disposal of the remaining RG companies. In seeking approval for the scheme from the Courts, RG and the Government would need to assure the Court that there was appropriate disclosure during the passage of the Scheme of Arrangement (mid-October to mid-December) of exchanges related to the disposal of RG's assets. Such exchanges might be regarded by the Court as material to the interest of the minority shareholders, since they could result in an improvement in the balance sheet of a company in which their minority shareholders were deciding whether or not to sell their equity stakes. While it would be possible to argue that, at the premium being offered, any possible disposal was immaterial to the position of the minority shareholders, Counsel's strong advice is that the Government should disclose this potential problem to the Court and seek approval, if necessary, for non-disclosure of information to the minority. This could be done by means of a confidential application by the Secretary of State <u>in camera</u> to the Court. If the Court officials were satisfied that exchanges were not material and need not be disclosed they could issue directions to that effect. There are, therefore, acceptable legal procedures which could be deployed to meet this problem, assuming over the period in question the Government were actually considering sale to third parties. (In the unlikely event that the Court ruled that the talks were material the Government would be faced with the choice of revealing them or withdrawing the offer.)

813/38/

COMMERCIAL IN CONFIDENCE
CONFIDENTIAL

FROM: M A WALLER

DATE: 8 July 1987

PS/CHANCELLOR

cc. PS/Chief Secretary
Sir P Middleton
Mr F E R Butler
Mr Kemp
Mr Monck
Mr Burgner

ROVER GROUP: MR DAY's SALARY

You may wish to be aware that the Rover Group's Appointments and Remuneration Committee has recently reviewed Mr Day's salary and has approved an increase of £20,000 (i.e. 15%) with effect from 1 May 1987. Mr Day's current basic salary is £130,000, exclusive of any bonus payments. The increase therefore takes his annual salary to £150,000.

2. In reaching this decision the Committee apparently was influenced by a recent Charterhouse Survey which showed, for a company of Rover Group's size, a median salary of £173,000 and an upper quartile salary of £242,000 for Chairman and Chief Executives. This survey also indicated that rates of increase at Board level were somewhere between 10-12½% and on a rising trend.

3. This information is unlikely to become public knowledge until the Rover Group accounts are published for 1987 i.e. towards the middle of next year. Even then, the accounts will not show the full value of the increase because it will only cover the period 1 May-31 December 1987. On top of these figures there will be added any bonus paid in respect of 1987 and benefits.

MAW

M A WALLER

566/42/SC

SECRET
COMMERCIAL IN CONFIDENCE

~~Janet~~ Pl arrange for Tom Burgner to see the minute below

FROM: M A WALLER

DATE: 22 July 1987

CHANCELLOR

cc. Chief Secretary
Sir P Middleton
Mr F E R Butler
Mr Monck
Mr Burgner

Thanks

~~Janet~~

ROVER GROUP

/below

Lord Young's minute to the Prime Minister of 21 July is a brief position report on his discussions with Sir John Egan and Graham Day following the meeting with yourself and the Prime Minister on 26 June.

2. On disposals Lord Young has left the ball with Sir John Egan and Graham Day:

- the former is considering Jaguar's possible attitude to a takeover of Land Rover in the context of the company's longer term strategy. Lord Young expects no response on this until September/October.

- Graham Day has promised to provide a note for Lord Young in the latter half of September spelling out the strategy and timetable for a possible flotation of the whole of the remainder of Rover Group (i.e. Land Rover as well as Austin Rover). We understand from DTI officials that this may involve a timetable for flotation sometime before 1990. This implies quite a dramatic turnround in the cars business with performance well above that assumed in the 1987 Corporate Plan. We also understand that Graham Day made it clear he was adamantly opposed to any early disposal of Land Rover but that Lord Young made it equally clear that he remained to be convinced of the case for keeping Land Rover as part of Rover Group.

3. The other issue canvassed between Lord Young and Graham Day was the removal of the minority. Both Lord Young and Mr Day agreed that it would be desirable to take out the minority, but, as Lord Young's minute indicates, they are conscious of the need for careful presentational handling. This is a point we have also emphasised to DTI officials, who have been commissioned to prepare the paper for Lord Young, as well as the public expenditure implications (depending on the terms of any offer, the cost could be £12-18m which would have to go through DTI Votes and represents a potential claim on the Reserve this year or next). In view of this, and the fact that you strongly registered your concerns on the difficulties of taking out the minority when it was last proposed in February, I do not think you need to comment in advance of seeing DTI proposals on the handling ofthe minority.

M A WALLER

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DEPARTMENT OF TRADE AND INDUSTRY
1-19 VICTORIA STREET
LONDON SW1H 0ET
TELEPHONE DIRECT LINE 01-215 5422
SWITCHBOARD 01-215 7877

Secretary of State for Trade and Industry

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29 September 1987

Passed on to MH.

CH/EXCHEQUER
REC. 29 SEP 1987 ✓29/9
ACTION: MR HALLER
COPIES TO: CST
SIR P. MIDDLETON
MR FOR BUTLER
MR MONCK
MR BURGNER

The Rt Hon Nigel Lawson MP
Chancellor of the Exchequer
HM Treasury
Parliament Street
LONDON
SW1

Chy, The PM wants to discuss this with you + Ld. Young on Monday afternoon. (We have tried, unsuccessfully to shift this to another time). JS 30/9

* Advice ASAP. [illegible]

Dear Nigel,

ROVER GROUP (RG)
ELIMINATION OF THE 0.2 PER CENT MINORITY SHAREHOLDERS

Graham Day has urged me to consider again the proposal RG advanced in February this year to take steps to eliminate the private shareholders in RG who now hold only 0.2 per cent of the equity. Based on the current share price the cost would be of the order of £14.6m-£17m to be met in this financial year. My officials have been discussing the arguments with yours.

RG point to the commercial disadvantages and costs of retaining the minority. In particular, any privatisation option would be complicated by the continued existence of the minority. There is also one other point we should consider. Informal soundings of Graham Day suggest he is strongly opposed to the separate sale of Land Rover and Austin Rover and would be very reluctant to entertain any talks with Ford, if they were again interested. While I do not wish to anticipate conflict, I would prefer not to leave the RG Board in a position where they can deliberate at length on whether privatisation options to which they are unsympathetic are in the interests of <u>all</u> the shareholders including the minority. Any disagreement with the RG Board would of course pose wider political problems than dealing fairly with the minority shareholders, and we shall need to do everything possible to settle on agreed solutions. But on balance I am inclined to set in train this ground-clearing step.

DW2CFH

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My officials have considered the problem which could arise in connection with disclosure of any discussions on disposal of RG assets while the necessary Scheme of Arrangement is in train : the planned completion date is mid-December. How significant a problem this might prove to be would depend on how quickly we move forward on RG privatisation. But I am satisfied that confidential approaches could be made to the Court, if necessary, to seek approval that sensitive commercial exchanges related to disposals need not be disclosed to the minority shareholders voting to sell their equity in RG. While this is a potential awkwardness I fear that it is likely to become more, not less, problematic as we draw up increasingly firm plans for privatising the remaining RG businesses. Consequently I favour taking action on the timescale Graham Day proposes. I would welcome your agreement to meeting the cost of this measure as a charge on this year's Reserve.

I am copying this letter to the Prime Minister.

Yours,

David

LORD YOUNG OF GRAFFHAM

DW2CFH

999-49

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	SIR P. MIDDLETON
	MR F E R BUTLER
	MR MONCK
	MR BURGNER
	MRS COMAX

PRIME MINISTER

ROVER GROUP : PRIVATISATION

We are to meet on Monday to discuss the position on the minority shareholders. I thought you might like to be brought up-to-date on the privatisation issues.

2 John Egan has told me that Jaguar would not be interested in buying Land Rover in the foreseeable future. This seems to leave three broad options: trade sales to either Ford or Volkswagen, or a placement with institutions followed by a full flotation.

3 Some months ago Ford indicated that they would like to meet me in the Autumn. I am due to have dinner with Ford's US Chairman, Donald Peterson, on 13 October, which will give him the opportunity to suggest revival of talks on Austin Rover. Ford have not previously regarded Land Rover as a necessary part of any deal but, if it were on offer, they would probably be interested.

4 Volkswagen have very recently expressed their interest in acquiring both Austin Rover and Land Rover. According to Graham Day, they would not want Austin Rover alone. Rover Group are to hold an initial "fact-finding" meeting with Volkswagen on 5 October. I have asked Rover Group to have no further meetings with Volkswagen unless and until I tell them they may.

JF5CEE

999-49

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5 If Rover Group's business and financial performance continues to improve, Graham Day hopes it might be possible to arrange placements of the majority of shares with institutions and employees perhaps in 1989/90. We might need to retain a stake of around 25 per cent but would no longer have contingent liabilities under the Varley-Marshall assurances. If all went well, a full flotation might follow a year or so later.

6 Rover Group's performance has improved and by the end of the year, they are likely to break even or be marginally into profit, before interest and tax. However it is most unlikely that there will be any spectacular improvement in performance until new models come on line, which will not be until 1989 at the earliest. My assessment is that the placement/flotation route will probably not lead to privatisation until the mid-1990s.

7 I believe that a trade sale offers the only sure prospect of a swift return of Rover Group to the private sector. However, it is difficult at present to judge the relative merits and risks of the Volkswagen and Ford options. I would welcome a brief discussion of this on Monday.

8 I am copying this minute to Nigel Lawson and Willie Whitelaw.

D Y

2 October 1987

CHANCELLOR OF THE EXCHEQUER

Could go 88p a share

Ch.

Rover Group

I understand that DTI have been discussing with RG the premium over the current share price they would offer, should we agree to buy out the remaining shareholders.

2. RG, and their advisers Hill Samuel, want a premium of £1.50. This is 20p above the maximum DTI/we have been prepared to contemplate. DTI, us, and Barings think it absurd.

3. You may like to be aware as background to this afternoon's meeting.

JS 9/10

813/26/SC

SECRET
COMMERCIAL IN CONFIDENCE
MARKET SENSITIVE

FROM: M A WALLER

DATE: 2 October 1987

CHANCELLOR

cc. Chief Secretary
Sir P Middleton
Mr F E R Butler
Mr Monck
Mr Burgner
Mrs Lomax

ROVER GROUP: MEETING AT NO.10 ON MONDAY 5 OCTOBER

We understand there are likely to be two items on the agenda for discussion on Monday between the Prime Minister, Lord Young and yourself:

(i) Future privatisation prospects of Rover Group (RG), on which Lord Young will be minuting the Prime Minister and you later today or early on Monday. - just arrived: attached as Appendix 1.

(ii) Proposals for a Scheme of Arrangement designed to buy out RG minority shareholders (as proposed in Lord Young's letter to you and the Prime Minister of 29 September). - Appendix 2

2. These two issues are very closely inter-related: Ministers need to decide when and how they wish privatisation proposals to be taken forward <u>before</u> deciding on whether a Scheme of Arrangement <u>now</u> is justified. This note summarises the issues and suggests a line to take.

<u>Privatisation prospects</u>

3. RG's financial performance so far this year is running ahead of budget, resulting from both improved trading results and some slippage in capital expenditure (Annex A). Varley Marshall liabilities as at end June stood at £1449m and are forecast to rise to £1551m by 1991 (Annex B).

4. Privatisation was last discussed at a meeting under the PM's chairmanship on 26 June (copy of my brief for the meeting at Annex C - top copy only - and of David Norgrove's note of the meeting at Annex D). At that meeting, it was agreed that the Government should, at all costs, take Graham Day and the RG Board along with them on whatever

privatisation path was prefered. At that time, Mr Day was opposed to Lord Young's prefered option for Austin Rover Group (ARG) i.e. sale to Ford. Day was also opposed to separate disposal of ARG and Land Rover (LR) - again contrary to Lord Young's wish to pursue the prospect of a separate sale to Jaguar. The outcome of the meeting was that no exploratory talks were to take place with Ford but that Lord Young was authorised to talk to Sir John Egan on a personal basis.

5. The current state of play is set out in Lord Young's minute of [2] October. - not yet seen Jaguar have told Lord Young that they would not be interested in acquiring LR until the end of next year at the earliest. Mr Day remains adamantly opposed to a sale to Ford and/or separate disposal of LR and has, instead, been holding exploratory talks with the President of VW/Audi about the German company taking a majority stake in the whole Group (i.e. ARG <u>and</u> LR). Mr Day's prefered solution, however, remains a placement and eventual flotation of the Group within the next 3/4 years. Mr Day conveyed these views at a rather frosty meeting with Lord Young earlier this week and will putting a paper setting out his proposals in slightly more detail to Lord Young in the middle of next week, after a meeting he intends to hold with VW on 5 October to discuss their proposals in rather more detail.

6. Lord Young's minute makes clear he is very sceptical about the prospects of turning RG round sufficiently to make placement and flotation a reality within the foreseeable future. He therefore sees some form of trade sale as the only option in the short to medium turn. But Lord Young expresses no clear preference between Ford or VW as a possible buyer. He is planning to see the President of Ford on 13 October and will be seeking a steer from Monday's meeting on whether and how he should respond to any overtures from Ford about possible acquisition of RG or ARG.

7. Thus the position on privatisation essentially has not moved on very far from where we were at the end of June. Lord Young's and Mr Day's preferences are essentially unchanged, except that VW has now appeared on the scene. Hence the problems remain as before. There are three possible alternatives - go on with Mr Day's prefered plan, sale to Ford/VW or closure. What Lord Young is proposing is ambitious and, in the short run, likely to be expensive in public expenditure terms because we would have to write off all or nearly all RG's debts (currently forecast at £500/600m end 1987). On the other hand, it offers the prospect, though not a reliable one, of a relatively early withdrawal from Government commitments to the business which at the moment - subject to anything new Mr Day may have to say - shows little prospect of long term viability. As such, it should provide the opportunity to liquidate, albeit very substantial public expenditure costs, the large contingent

?

call on public expenditure represented by the Varley Marshall assurances. And it provides some assurance for the future of the business. Unless Mr Day achieves a remarkable turnround in ARG there must be a strong chance that the company will be in no better position at the end of this Parliament than it is now. The Government would then be faced with the prospect of the company remaining on indefinite pensioner or disposing of it at no less disadvantageous terms - at a time not of the Government's choosing.

8. But the Ford or VW options are very high risk (even if Mr Day would support the VW option), involving the need for commitment to carry the deal through, despite what is likely to be strong Parliamentary and public opposition (VW's interest in LR as well as ARG could add to presentational difficulties). Engaging in a competition between VW and Ford will almost certainly lead to premature disclosure of proposals. And if the deal fell through for any reason the commercial damange to ARG could well cause irreparable damage to and possibly the collapse of, the company. This could be very costly in terms of public expenditure and job losses.

Eliminating the Minority

9. Lord Young's minute is rather light on some of the more detailed and problematic aspects of the proposal. These are discussed in the note at Annex E. In summary on almost any scenario involving the privatisation of RG, it will be necessary, at some point, to take steps to remove the minority shareholdings. The key issue is when. This turns on Ministerial views on the privatisation options discussed above. If Mr Day's plans are allowed to stand there is very little substantive arguement for pressing forward with a Scheme of Arrangement now. (They amount to very little more than relieving the irritation to RG caused by continuing criticism of the Group by a minority of the minority.)

10. If, however, Ministers decide to press forward with a sale in the course of next year then the minority becomes more of an issue. In these circumstances, the argument for action now is that it prevents Day and the RG Board deploying oppression of the minority arguments in an attempt to delay privatisation proposals which are uncongenial to them. (It also removes a procedural requirement from the complicated chain of actions associated with a trade sale.) But it would do nothing to address the underlying presentational and practical problems caused for the Government if they were to push through proposals against Mr Day's wishes. In these circumstances Mr Day's ultimate sanction would be resignation - a threat he has made it clear he is ready to use.

11. Against this must be set:

(i) the difficulty of defending to the PAC the benefit the Government would be obtaining by spending up to £17m. We could not deploy the underlying reasons publicly and would have to stand on the point that this was an essential step in returning RG to the private sector;

(ii) the danger that the Government will be accused of trying to stifle information about Rover at a time when it was pressing for much greater transparency in company affairs;

(iii) The Government could be accused of sharp practice if trade sale were to take place not long after the Scheme of Arrangement were implemented, despite the fact that the premium offered was generous in relation to any possible deal on offer ;

(iv) despite offering a generous premium, there can be no absolute guarantee of success. For the scheme to be accepted and share acquisition made compulsory 75% by value of the <u>votes cast</u> must be cast in favour of acceptance.

<u>Suggested Line to Take</u>

12. As far as privatisation options are concerned, our advice differs little to that we offered back in June. In your discussion with the Prime Minister and Lord Young we therefore suggest that you should seek to ensure that:

(i) the risks of sale to Ford or VW are fully appreciated and accepted, particularly in respect of possibly having to force through the deal against the opposition of Graham Day and RG Board. At the moment, it would seem that there might be less opposition to a VW deal than one with Ford. But Day's prefered option is undoubtedly flotation and there can be no guarantee that he would not react adversely to being pressed in the near future to accept any form of trade sale.

(ii) there is agreement that the Government will be able to carry through any deal once negotiations are open with Ford or VW even if they become public knowledge prematurely.

(ii) Very careful consideration will need to be given to the question and handling of some form of competition between VW and Ford. On the one hand, it makes any deal finally struck more defensible in relation to price etc.; on the other, it must increase substantially the risk of premature disclosure.

13. On the elimination of the minority, we suggest that you say that the case for pressing ahead now with the elimination of the minority is far from proven and that any decision would be premature until the Government has a clearer idea of what it wishes to do with the company: an important factor here must be Mr Day's promised paper on options, on which Ministers might well wish to hold a further discussion with him. Given the price sensitivity of the minority buy out proposal, this would point to a decision against the idea at this stage rather than any form of delay which will greatly increase the risk of a leak of price sensitive information.

14. We understand that No.10 Policy Unit will be briefing the Prime Minister in broadly similar terms.

M A WALLER

5014/065/njo

Annex A

CONFIDENTIAL

ROVER GROUP MONITORING: PERIOD 6: JUNE 1987

1. ROVER GROUP

1. **Performance**

	Year to Date		Full Year		1986
	Actual £m	Budget £m	Forecast £m	Budget £m	Acutal £m
Profit & Loss Account					
Sales	1,528.3	1,357.1	2,795.2	2,738.7	3,412.0
(LBIT)	(7.3)	(25.1)	(11.1)	(25.0)	(349.9)
(LBT)	(39.5)	(71.2)	(90.1)	(115.6)	(455.0)
Cashflow (out)	(32.9)	(280.3)	(332.2)	(344.6)	(345.3)
Extraordinary items	-	0.2	-	0.2	(430.0)
Balance Sheet					
Operating assets	(93.0)	89.5	140.6	111.4	120.4
Borrowings	321.7	569.1	621.0	633.4	962.0
Capex	(41.4)	(84.5)	(128.2)	(147.3)	(172.8)
Share capital & reserves	317.6	288.5	261.0	239.2	(312.6)
Gearing	101.3%	197.3%	237.9%	264.8%	-

Sales

2. Revenue to date is 13% ahead of budget at £1,528.3 million. Exports are 22% ahead of budget at £529 million.

Profitability

3. In June the group made a profit before interest and tax of £3.8 million, bringing the loss to date to £7.3 million, 71% better than budget.

Cashflow

4. the cashflow situation continues to improve. In June there was a cash inflow of £53.5 million bringing the outflow to date to £32.9 million, compared to budgeted outflow of £280.3 million. This improvement in the cash situation is due to reductions in the year to date working capital requirements.

Annex B

VARLEY-MARSHALL-JOSEPH OBLIGATIONS

	June 30 1987	End-Year 1987	1988	1989	1990	1991
Borrowings	321.6	509.2	680.3	615.1	676.4	696.8
Leasing		118.4	73.8	41.0	21.0	10.0
	919.3					
Creditors		550.9	603.0	580.2	597.2	594.6
Inventory Deposits	150.5	155.0	155.0	155.0	155.0	155.0
Contingent Liabilities	33.0	45.0	45.0	45.0	45.0	45.0
Contracts Placed	24.7	50.0	50.0	50.0	50.0	50.0
	1,449.1	1,428.5	1,607.1	1,486.3	1,544.6	1,551.4

UK MARKET SHARE (ARG)
1987

Half Year	July	August
15.5%	15.6%	14.5%

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CH/EXCHEQUER
REC. 06 OCT 1987 6/10
ACTION MR WALLER
COPIES TO CST
SIR P MIDDLETON
MR F E R BUTLER
MR MONCK
MR BURGNER
MRS LOMAX

PMP

10 DOWNING STREET

LONDON SW1A 2AA

From the Private Secretary

5 October 1987

Dear Tim,

ROVER GROUP: PRIVATISATION

The Prime Minister held a meeting this afternoon to discuss the privatisation of Rover Group on the basis of your Secretary of State's minute of 2 October and his letter to the Chancellor of 29 September. There were present your Secretary of State, the Lord President, the Chancellor of the Exchequer, the Lord Privy Seal and Mr. George Guise (No. 10 Policy Unit).

Your Secretary of State explained the position very much along the lines of his minute of 2 October. Sir John Egan would not wish to consider the acquisition of Land Rover in the foreseeable future, which meant at least 18 months. The Rover Group was now showing a small operating profit and might indeed on that basis be in the black for the year as a whole. Graham Day in July had shown more interest in a flotation than in a trade sale. However, it was now clear that both VW and Ford might be interested in acquiring the Rover Group and Graham Day had last week accepted that no flotation would be possible until the early to mid-1990s. Day had seen VW today and would meet them again on 6 November. At the meeting today Land Rover had not seemed quite as important to VW as when the possibility of a sale had first been mooted by them. Day considered that a sale to VW would be preferable to a sale to Ford. A sale to VW would be more bearable if VW were to secure a quotation in London and employee shareholdings.

In discussion, the difficulty, perhaps the impossibility, of selling Range Rover/Land Rover to a foreign buyer was noted. On the sale of Austin Rover Group, Graham Day's hostility to a sale to Ford would be an important factor. He might, however, be prepared to go along with a sale to VW. The support of the Rover Group board would be important and the effect on component suppliers and on distributors would also need to be taken into account. The European Commission would accept a debt write off more easily in a sale to VW. On the other hand, a sale to a German car company could still cause greater difficulties with some people than a sale to American company, though even on this attitudes were now changing. A competition between VW and Ford to buy the company would not be desirable.

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Summing up the discussion, the Prime Minister said that your Secretary of State should not encourage Ford's interest in Austin Rover Group. A further meeting on the possible sale of ARG to VW and on the question of buying out the minority shareholders should be held after the Prime Minister's return from Vancouver and before Graham Day's meeting with VW on 6 November. In the meanwhile a very restricted group of officials should prepare a full paper on the questions raised by the possible sale and the possible buy out of the minority shareholders. This should consider among other things whether it was essential for the minority shareholders to be bought out before a sale or whether both operations could be carried out simultaneously. The effect on component suppliers and distributors of a sale to VW should be considered. The Treasury should be kept closely in touch on the financial implications including in particular the implications of any write off of debt. One possibility might be to spread the write off over a period and this should be studied. One thing was clear: the Government should only embark on discussions with VW if there were a firm prospect of success, in view of the political difficulties and the damage to Austin Rover if the discussions were again to fail.

I am copying this letter to Alex Allan (H. M. Treasury).

Yrs,

David.

DAVID NORGROVE

Tim Walker, Esq.,
Department of Trade and Industry

1988 CORPORATE PLAN : AUSTIN ROVER FIGURES Annex F

The following shows preliminary 1988 Corporate Plan figures compared with the 1987 Corporate Plan.

	1987	1988	1989	1990	1991
PBIT					
1987 AR Plan	(30)	20	45	75	75
1988 AR Plan	0	20	40	75	100
Gross Capital Expenditure					
1987 AR Plan	103	256	174	123	194
1988 AR Plan	112	262	229	195	127
Cash flow (pre-interest)					
1987 AR Plan	(62)	(56)	19	50	24
1988 AR Plan	(42)	(130)	(33)	33	128

On these proposals, AR's 5-year total for capital expenditure would be raised by some £70-80m, with asdverse implications for cash flow for 1988 to 1990.

SECRET

ROVER GROUP

The Rover Group plc
7-10 Hobart Place
London SW1W 0HH
Telephone: 01-235 4311
Telex: 926880

9 October 1987

Rt Hon Lord Young of Graffham PC
Secretary of State
Department of Trade & Industry
1 Victoria Street
London
SW1H OET

Dear Secretary of State

I undertook to let you have a brief memorandum on the "privatisation" of the remaining Group businesses. That memorandum is enclosed.

I look forward to a discussion on the memorandum leading to a general agreement as to preferred alternatives.

I am circulating the memorandum to my Board colleagues. In due course the Board will review and consider all options as the work on each progresses. This will enable me to reflect the Board's views to you.

Sincerely
Graham

J GRAHAM DAY

CONFIDENTIAL

Memorandum for The Secretary of State for Trade and Industry

Re: Rover Group Privatisation

1 INTRODUCTION

In the 20 months to the end of 1987 all of The Rover Group's interest or a majority shareholding in 15 businesses will have been sold to or merged with private sector interests. Those businesses in 1986 had a combined turnover of approximately £1 billion (comprising approximately one third of The Rover Group gross revenue at 1986 figures). The businesses which were wholly owned by the Group employed approximately 20,000 persons, some 28 percent of 1986 total Group employment.

Entering 1988 the Group will comprise only Austin Rover and Land Rover, including their subsidiaries such as overseas sales companies, together with minority interests in five businesses now in the private sector.

Improvement during 1987 in the financial positions of Austin Rover and Land Rover, offer some encouragement to plan now for their return to the private sector.

2 BACKGROUND

The financial decline of the Group and in particular of Austin Rover and Land Rover has been halted and reversed. Over the next three to four years the anticipated Group financial performance may be characterised as one of fairly stable, modest operating profitability but cash flow will be inadequate to fund the curtailed capital programmes, now underway and planned, and to service the significant bank debt which has been built up over past years. While I appreciate that the following view may have an historically familiar ring, I believe that given the attainment or betterment of Corporate Plan objectives during 1987, a satisfactory level of profits is possible from 1992 onward together with cash flow generation at a level which would make the Group self sustaining (aside from the servicing and repayment of the historical debt).

The disposal of the 15 businesses referred to above and a meaningful plan for the financial recovery of the two remaining Group manufacturing businesses have been undertaken in a very short time compared with the actions required in respect of some of the state owned industrial concerns which have been returned to the private sector, eg Rolls Royce, or of those which are returning to commercial health and now may be considered for privatisation eg British Steel.

The Rover Group as now constituted is engaged primarily in the manufacture and sale of passenger vehicles, a mature industry having underlying global over capacity and subject to intense competition. Nevertheless, over the past 20 years other financially troubled passenger vehicle manufacturers have been returned to full commercial health, eg BMW, Volkswagen, Fiat and Chrysler, or are currently recovering, eg, PSA and Renault. For the Group or its constituent parts to join this list, the improving 1987 performance of both Austin Rover and Land Rover must be sustained and the burden of the accumulated debt removed. On this basis, it is considered possible to privatise both businesses, within the life of the current parliament.

The acceptability of any solution and its timing are recognised as issues requiring determination by Government and I shall put forward proposals in due course.

3 THE BUSINESSES

Austin Rover and Land Rover have different and changing corporate reputations and are at different stages of recovery. The Rover Group minority interests in private sector businesses can be addressed when the futures of Austin Rover and Land Rover are known.

3.1 Austin Rover

Austin Rover in all its incarnations has had a chequered history for well over a decade and in retrospect can be seen to have been in decline for much longer. The consequences of the absence of a comprehensive strategy consistently developed and adhered to are not possible to remedy in a couple of years because of factors such as the length of product development cycles and the lag in market perceptions. The chequered history and business cycle do not assist privatisation.

During 1987 Austin Rover has reduced costs, stabilised its domestic sales volumes, increased export sales and improved its existing product range, including in quality. The results of the push for export sales which became apparent in the latter half of 1986, strengthened in 1987; one car in three is now exported. Some 75 percent of UK car exports in 1987, worth perhaps £1 billion, will be attributable to the Group.

Austin Rover is now expected to break even or better at the operating level for 1987 with an improving cash flow, in both cases a marked improvement on the 1987 Corporate Plan figures and a dramatic turnaround from 1986 actuals. While Austin Rover's new strategy is implemented progressively, further improvement in financial operating results will be modest. The marked improvement anticipated at the end of a further three to four years is predicated upon a full realisation of this strategy.

3.2 Land Rover

The Land Rover Group benefits from a public perception which is more favourable than reality. It is trading profitably with improving cash flow; however these are assisted significantly by its parts business which was moved into the Land Rover Group on January 1, 1987.

The world wide market for the Land Rover vehicle continues to decline to that of a specialist utility (including military) vehicle. The Range Rover, a seventeen year old product, is enjoying an "Indian summer" market which will have to be stretched into the early 1990's until it is replaced. An additional product, code named "Jay", which is being developed cheaply off the basic Range Rover chassis and with carry-over power train, mechanical and other elements, will be introduced in late 1989/early 1990 and will provide needed product breadth and hence revenue and profit.

The consolidation on a single site at Solihull, now in its first full financial year of operation, is an important contributing factor in Land Rover's recovery.

4 CONDITIONS AND METHODS

4.1 Conditions

All options require the matter of minority shareholdings to be addressed for serious commercial reasons.

In order to conclude a successful privatisation of both remaining businesses, it will be necessary, as in the case of Leyland Truck and Leyland Bus, to repay the historical debt presently funded by bank borrowings on the strength of the VMJ Assurances. This will require E.C. approval.

4.2 Methods.

Broadly there are two methods for privatising what remains of the Group. These are trade sale and re-flotation. Trade sale may mean the sale of Land Rover and Austin Rover separately or together as a package. A re-flotation may involve a placement of a majority shareholding with financial institutions prior to a flotation.

Planning must focus on the privatisation of both remaining businesses, together or separately. To address now only that which is clearly possible, the sale of Land Rover, without having an agreed plan for Austin Rover, may leave the latter in its present ownership for an indeterminate period. Therefore, the sale of Land Rover should not be undertaken before any options for privatising both businesses together and Austin Rover alone have been identified and assessed.

4.2.1 Trade Sale

Since the sale of Land Rover alone is easily achievable, in considering the trade sale alternatives we will primarily seek to identify in addition those companies which may have an interest in both businesses together and in Austin Rover alone. It is not expected that there will be many alternatives in either instance. (For example, for Austin Rover alone I believe the only obvious candidate is Ford).

In any trade sale, there will be important policy and political questions to consider such as the impact on the export of finished vehicles and on the UK supplier base including recently privatised companies such as Unipart and Istel, which are still critically dependent on ARG business.

Furthermore, great care will have to be taken in any approaches which may be made. While the Austin Rover business can sustain groundless rumours of the present kind, the dealer body and markets, both domestic and overseas, are highly unlikely to sustain again public debate about credible, specific discussions. In consequence, any trade sale of the combined businesses or of Austin Rover alone, will require a pre-emptive move, ie, announcement following the deal; there can be no competitive tenders. The shortest possible period of negotiations involving the absolute minimum number of persons will be crucial. However, the purchaser's view of the Austin Rover/Honda relationship and Honda's own attitude to the potential deal will need to be established.

Land Rover's reputation is more robust and possibly at risk only to a debate about British or foreign ownership or about an unpopular or unsuitable candidate. Thus, should a separate sale of Land Rover be indicated, more normal methods of disposal are possible.

A trade sale is not constrained in time as is a flotation. Therefore, should genuine and acceptable candidates be identified, fairly prompt completion is possible.

The reality will be that trade sale opportunities, as identified, may not be susceptible to an orderly approach. It will be very important to assess these opportunities as they arise because should a generally attractive proposition not be seized then, it may be lost. This view recognises that a goal of achieving the 'best' deal may be illusory and in the context of a trade sale the goal should be to secure the earliest possible acceptable privatisation.

Nevertheless, every effort will be made to have as much order as possible and to develop alternative options for consideration.

4.2.2 Flotation

A successful re-flotation within the life of this Parliament cannot be assumed with a high degree of certainty now or in the course of 1988. Achieving an acceptable pattern of trading profitability, cash generation (apart from servicing the historical debt) and demonstrating a smooth and succesful pattern of new model introduction will be required. Assuming that these are achievable, a period of four to five years from now may be required before a flotation becomes possible. This could either coincide with election year or run into the next Parliament. Preliminary merchant bank advice confirms that a flotation should not be regarded as unrealistic and indeed that the adoption of such an objective would be a positive factor for the necessary development of the business.

Assuming that a flotation has attractions but that more certainty of disposal within the life of the current Parliament is desired, the alternative of a prior placement of a majority share will be developed and assessed. Under this alternative, share schemes for employees would be put in place, a majority of shares would have to be placed with institutions, a significant minority shareholding might be held by another vehicle manufacturer and possibly HMG might wish to maintain a minority shareholding of say 20/25% in order to secure some future financial benefit from the subsequent flotation. It is assumed that at the earlier event of placement, HMG would be released from VMJ obligations.

If this alternative is found to have validity, the placement stage may be possible in 1989/1990. The basic performance criteria would be the same as for a flotation but the removal of HMG's obligations as majority shareholders would be earlier. Also, the placement - flotation alternatives avoid many of the risks to the businesses implicit in trade sales.

A variation on re-flotation of a management/employee buyout is a possibility but cannot be developed without a very wide range of persons becoming aware as part of the process to determine willingness and commitment. Consequently, no work will be done on this possibility until all other alternatives have been developed and only then following discussion with the Secretary of State.

The work required to develop the re-flotation option in its various forms, excepting a buyout, has now commenced. This alternative, unlike trade sale, is more easily controlled.

I would welcome the opportunity to discuss these alternatives with you and your colleagues. I suggest that thereafter I might review progress with you on the development of the detailed planning, first in the context of our Corporate Plan discussions later this year and subsequently on a regular basis.

J GRAHAM DAY

9 October 1987

200/5/SC

SECRET AND PERSONAL

FROM: M A WALLER

DATE: 23 October 1987

Thanks. We must certainly [illegible] more. Meanwhile, I would [illegible]. We will need to consider options for spreading [illegible] & scrutiny [illegible] little [illegible].

CHANCELLOR

cc. Mr F E R Butler
Mr Monck
Mr Burgner

ROVER GROUP: PUBLIC EXPENDITURE OPTIONS FOR MEETING DISPOSAL COSTS

You asked for advice on the options for debt write off associated with the possible disposal of Rover Group (RG), including the scope for doing anything this year or spreading the costs over more than one financial year (Mr Taylor's minute of 5 October).

COSTS OF DISPOSAL

2. DTI estimate the possible net costs of a trade sale to VW at some £0.7-1 billion, made up as follows:

	£m
- Debt Retirement	570
- Redundancy costs	180-300
- Other rationalisation costs (net of surplus asset sales)	100
- Half year (1988) cash outflow to completion of deal	100-125
GROSS TOTAL	**950-1095**
Less Sale Proceeds	
- ARG	0-100
- Land Rover	55-150
NET COST	**700-1000**

3. These estimates are extremely broad brush and are based on the structure of the DAF/Leyland Trucks deal. It will not be possible to firm the estimates up unless RG enter into more detailed talks with VW to clarify:

- whether LR is an essential part of the deal.

- the extent of rationalisation/restructuring VW would undertake.

- the extent to which VW would press for a UK Government contribution to forward capital expenditure, something the Spanish Government did in the SEAT deal (we would certainly wish to resist the idea strenuously, which could add £250-400m to the costs, even assuming the EC were prepared to entertain the idea).

- the price which VW might pay for ARG/LR free of debt and restructuring costs.

__Timing of Expenditure__

4. There are three major factors affecting the timing of Government expenditure:

(i) __the speed with which a deal with VW might be closed.__

RG believe that, assuming the key elements of the deal are acceptable to HMG (e.g. treatment of LR, commitments on UK production and component sourcing, costs), it should be possible to sign detailed Heads of Agreement by Easter (i..e around the end of March). DTI consider this to be an ambitious timetable but if both companies give the task sufficient priority it should be deliverable. The forthcoming DTI paper on the VW deal will also canvass the idea, floated by Barings, of an accelerated timetable involving closed bids from VW and Ford in response to an invitation to bid setting out the key constraints. There would be no detailed negotiation in advance of the deal being signed - that would be left to post contract negotiation/arbitration.

(ii) __EC clearance procedures__

By dint of very considerable high level political pressure the UK managed last year to obtain Commission clearance for the Track/Bus deals in about 4/5 months. We could not expect to better this timetable, even if we used the Baring fast track approach or ran the VW/RG talks and Commission clearance procedures in parallel. Assuming the Government opened talks with the Commission early next month and again exerted high level political pressure (concerted with the German Government) we would thus be unlikely to receive Commission approval in this financial year.

(iii) The size and timing of VW's restructuring plans for RG.

Cowley South (2,000 jobs) is already slated for closure in 1989 but we do not know what other elements of RG's production and research facilities they might close or rationalise or over what timescale.

5. A subsidiary but important issue is the method by which the sale to VW would take place. If it involved a straight purchase by VW of HMG's shareholding then we would have to inject money into the company to clean up the balance sheet prior to sale. On the other hand, if VW acquired the assets, the debts could be left with a rump of RG to be dealt with over a period. But the scope for a protracted period of debt retirement would be limited by the willingness of RG creditors (and the EC) to accept such an arrangement. The technical difficulties associated with this latter course point to the repayment of RG's borrowings very close to the disposal. From an EC point of view there might, however, be greater scope after the disposal for spreading redundancy and rationalisation costs (and any HMG contribution to forward capital expenditure) because the payments could be more closely linked to the associated "contre partie".

ASSESSMENT

6. Assuming goodwill and maximum commitment of both VW and RG senior management it might be possible to close a deal by the end of this financial year. (The fast track route - assuming it is feasible - would certainly achieve this). EC clearance is more problematic given that, compared with the Truck/Bus disposal, we will effectively be about 2 months later in starting discussions with the Commission, even if Ministers approve such an approach at the beginning of next month. So, while not impossible, it will be very difficult to make any payments this year.

7. That said, if towards the end of 1987-88 (say late February, early March), the deal looked like being closed on terms acceptable to both HMG and the Commission it might be possible to activate the contingency measures you agreed at the end of 1986-87 for the Truck/Bus deal, i.e. lay a late Spring Supplementary Estimate in early March which assumes Commission approval by end March 1988 but, in the event of Commission clearance being delayed, stand ready to make the payment to RG in that financial year on the understanding that they could not apply the money to debt repayment until formal Commission clearance had been received. (This would be open to criticism by the PAC and Parliament of payment in advance of need.)

8. If the whole timetable slipped into late Spring/early Summer and the deal took the form of a share sale, then it would probably be necessary to meet the costs of debt repayment immediately the deal was closed and approved i.e. in 1988-89. It might, however, be possible to spread rationalisation (and any capital expenditure) costs over the period in which they occurred, say over the period 1988-89 to 1990-91.

CONCLUSION

9. It is very unlikely that we will be in a position to make any payments to RG in this financial year but the possibility cannot be entirely discounted. It should therefore be treated as an opportunity to be reviewed in the light of negotiations with VW and the Commission in late February/early March next year. If, as seems possible, the whole timetable slips then, assuming a deal with VW does go through, debt repayment of around £600m would certainly fall into 1988-89 with the possibility of rationalisation/redundancy costs (totalling perhaps £3-400m) being spread over the period 1988-89 to 1990-91 though with most of this expenditure probably taking place in the earlier years.

M A WALLER

BF 30/10

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* Attachments

CH/EXCHEQUER
REC. 30 OCT 1987
Mr Waller *
CST
Sir P Middleton
Mr FER Butler
Mr Monck
Mr Burgner
Mrs Lomax.

PRIME MINISTER

ROVER GROUP PRIVATISATION

We are to meet on 2 November to discuss further the privatisation options for Austin Rover (AR) and Land Rover (LR) and to hear Graham Day's views.

2 I have considered the memorandum on privatisation Graham Day sent to me on 9 October, and the paper officials have prepared on the options for trade sale (attached). I believe the key questions on which we need to focus on 2 November are these:

(i) do we wish to reach decisions on the options for AR and LR now, or early next year when we have received and considered Graham Day's Corporate Plan and his considered views on the prospects for a placement/flotation at the end of the decade?

(ii) do we wish to consider single or competing trade sale options? VW and/or Ford.

(iii) is inclusion of Land Rover negotiable or would we want it to be totally excluded from sale to VW or Ford? Or would we be willing to sell a minority stake?

(iv) if we seek a trade sale, can we contemplate three months of detailed commercial negotiation? Or

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should we consider a quick fire three week negotiation, even if this reduced the scope for gaining assurances from the successful bidder on future plans for UK operations?

3 I remain highly sceptical about the prospects for returning RG to the private sector through a placement or flotation. Accordingly I believe it important that we should now hear Graham Day's views. I attach a list of questions which we might put to him. We can then determine with colleagues the framework within which we would wish to consider RG's recommendations.

4 As we agreed, I also attach a note by officials on the RG minority shareholders. The minority could be eliminated in a variety of ways depending on how we privatise RG. But it remains the case that their continued existence could be used by the RG Board as a weapon to delay taking forward privatisation proposals they did not favour. That is the main argument for removing them now. I suggest we judge in the light of our discussion with Graham Day whether real conflict could arise. If we think that unlikely we could defer dealing with the minority until we settle privatisation policy for RG.

5 I am copying this minute and attachments to the Chancellor.

D Y

29 October 1987

DEPARTMENT OF TRADE AND INDUSTRY

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MEETING ON 2 NOVEMBER

QUESTIONS TO BE PUT TO GRAHAM DAY

1. How does Mr Day rate the chances of successful placement/flotation in the lifetime of this Parliament?

2. When will merchant bank advice be available to RG to support the feasibility of the placement option?

3. Would Honda be willing to provide long term commitment on collaboration to underpin a placement/flotation?

4. How does Mr Day rate the prospects of carrying through a trade sale?

5. Why does Mr Day believe VW represents the best trade sale option? What are VW's intentions for operations in the UK?

6. What about Ford? Would it really be any more difficult to carry through than VW?

7. What is Honda's reaction likely to be to a trade sale? Would the identity of purchaser be very material?

8. Wouldn't a very quick negotiating timetable - say three or four weeks - reduce the risk of premature disclosure and failure?

9. Would a separate sale of LR really diminish the prospects of successful privatisation of the rest of RG.

10. Could not the minority shareholders be dealt with when the route to privatisation is clearer? Would not action now raise unnecessary and damaging speculation?

ROVER GROUP PRIVATISATION

Note by the Department of Trade and Industry

CONTENTS

ROVER GROUP PRIVATISATION

Note by the Department of Trade & Industry

This paper, prepared in consultation with HM Treasury and No 10 Policy Unit, examines certain issues related to the return of Rover Group (RG) businesses to the private sector. In particular, it considers the possible sale of Austin Rover (AR), with or without Land Rover, to Volkswagen (VW) and offers some comparisons between this option and a disposal to Ford.

The paper also highlights some key questions for Ministerial decision, notably the timing of decisions on privatisation and their implementation; the possibility of the early trade sale of AR and LR, including the pros and cons of competitive bids; and the conditions which HMG might attach to their disposal.

A. PRIVATISATION OPTIONS

(i) ROVER GROUP : PROSPECTS OF PLACEMENT/FLOTATION

The 1987 Plan for RG set out a strategy for consolidating Austin Rover's (AR's) position as a 450,000 cars per annum producer while seeking progressively to shift its stance upmarket to concentrate on the executive and medium sectors, the latter on the basis of a crucial new car to be launched in 1989. It would thus arguably move away from head-on competition with the likes of GM and Ford who with their 1.4m cars per annum European production have greater economies of scale. Financial projections for RG and the two operating companies over the period of the 1987 Plan are at Annex 1.

Performance in 1987 has shown an encouraging start with both AR and LR doing better than Plan. The draft 1988 Plan is believed to confirm the upward trend on profitability for AR with better operating performance offsetting adverse exchange rate movements. However because AR has a heavy burden of capital expenditure (approaching £500m) in the next two years, it will be cash - negative even before interest at least until 1990. There are substantial risks attached to achievement of even the modest profitability improvement projected, notably the difficulty of sustaining performance until 1989/90 with no significant new models; the possibility of greater sterling appreciation against US and European currencies; and - crucially - the market acceptance of the new mid-range car.

Land Rover (LR) is in revenue terms about one fifth the size of Austin Rover. Its modest profitability and positive cash flow can thus only have a small impact on the overall RG figures. On this basis flotation or even placement of RG must be viewed as a high risk strategy, with or without LR, though the latter's inclusion in the package might intangibly improve the sale prospects.

(ii) TRADE SALE OPTIONS FOR AR

The only identified options are a sale of Austin Rover to VW or Ford. It is possible to draw only limited conclusions on their respective merits - in the case of VW on the basis of preliminary exchanges with RG together with experience of VW's takeover of the Spanish company SEAT. With Ford, views are based only on earlier and equally preliminary talks with ARG. With these caveats, and with major uncertainties about the intentions of the key players, the industrial arguments appear as follows:

(a) Motivation

Ford's earlier interest in AR was driven by a conviction that a global restructuring in the motor industry was inevitable and that only the most powerful would survive (particularly vis a vis the Japanese). Europe, with nearly 30% of the world market, was a key area and (having failed to acquire Fiat) Ford's attention turned towards AR which had a prominent position in the UK market and would add around 3-4% to Ford's overall European market share. Ford also had ideas on exploiting Austin Rover's "niche" brand-names including Rover and MG.

VW's broad strategy is likely to be based on similar considerations. AR would lift VW's European penetration by 3-4% but would increase their share of the important UK market from around 5% to 20%. As with the acquisition of the

Spanish Company, SEAT, a presence by VW in the UK would give VW further flexibility in manufacturing decisions and access to another relatively low-cost source of car assembly.

(b) New company structure

The present RG/VW discussions presume that VW would take effective control of the joint businesses: this is consistent with the SEAT precedent (see Annex 2). Ford would similarly expect control of Austin Rover. Whether this would be achieved by the sale of assets or by the sale of companies would be a matter for negotiation; the results of those negotiations would affect the treatment of RG's minority shareholders if they were still in existence at the time of the sale (see the separate paper on this subject).

One question which has arisen in VW's exchanges with RG is that of a retained Government shareholding in any businesses sold to them. VW apparently expect such a stake (say 10-20%) to be retained, conditioned as they are by the terms of the SEAT deal and by their own partly state-owned share structure. It is not known how much importance they attach to the idea, but they *may* favour keeping HMG involved as an insurance policy against future difficulties. However from HMG's perspective it appears that any presentational advantages in a retained stake as evidence of retained UK participation would be outweighed by the difficulty for the Government of standing back if the company subsequently encountered difficulties; similar advantages without that risk might be achieved by listing some VW shares on the London Stock Exchange.

(c) Relationship with Honda

AR's future is currently dependent on Honda for the supply of medium and large engines, and development of the new medium size car. Honda will also provide significant volumes for AR through sub-contract build of the medium car. We believe, other things being equal, both Ford and VW would wish to continue such collaboration but Honda's willingness to entertain this must be in some doubt. Honda have a specific assurance from HMG that if AR were taken over by a third party they could expand their own plant at Swindon into a full European manufacturing site thereby obviating the need for the existing collaborative links. However, the SMMT/JAMA quota understandings would prevent them summarily switching to sourcing all their cars for the UK market from Japan and it is thus probable that, even if Honda did decide to go it alone, their withdrawal from collaboration would be phased. They might therefore continue to collaborate on development at least up to launch of the new medium car, and on subcontract build into the early nineties.

In the context of last year's Ford talks, the question of whether Ford (who were keen to continue the collaboration) or RG or HMG should talk to Honda and when, became a very contentious issue. RG believed Honda wished to negotiate early withdrawal from all the collaborative links. If a slow and detailed negotiating framework is followed it would be possible to explore both the intentions of AR's bidder on collaboration with Honda, and the latter's response. If on the other hand a much quicker timetable is adopted, the bidder(s) would probably just have to make their own assessment of the likely Honda reaction. While the exclusion of Honda from any competition for AR might give rise to some later criticism from them, HMG would be able to argue that they had had ample opportunity over the years to show a real interest in taking a stake but had always stood back; in the most recent exchange with RG, Honda said again they were not interested in taking AR over.

(d) Model Rationalisation

Both Ford and VW have models competitive with those of AR throughout the range as the following table shows.

	VW/Audi	Ford	SEAT	RG
Supermini	Polo	Fiesta	Ibiza	Metro
Lower Medium Hatchback	Golf	Escort	Malaga	Maestro
Medium 4-door	Jetta	Orion		Rover 200
Upper Medium	Passat	Sierra		Montego
	Audi 80/ 90			
Executive	Audi 100 /200	Granada		Rover 800
				Range Rover

Detailed study would be required to establish the real degree and the effects of a conflict/compatibility across models taking account also of model replacement timescales and respective company strengths. Short term it would be possible for both Ford and VW to maintain existing manufacturing and marketing arrangements for all AR models. Over time these are bound to be dove-tailed into an overall model strategy which would be likely to lead to commonality in major components - engines and transmissions in particular whilst preserving some outward differentiation between models e.g. as with the Rover 800/Honda Legend.

(e) Manufacturing

AR already has excess capacity and the draft 1988 Corporate Plan provides for closure of Cowley (South Works) in 1989/90 with the loss of around 2,000 jobs. Any bidder is likely to demand at least this level of "restructuring".

Beyond this it is impossible on present information to judge the relative impact on jobs. For example, VW has shifted half its production of Polo to SEAT in Spain but, though the economics dictated this, German political and trade union pressure has prevented a larger switch. Ford, on the other hand, have responded to similar commercial pressure (the strong DM) by transferring a significant volume of car assembly activity away from the Continent to UK (in 1985 56% of total UK car sales was met from UK production; in 1987 this will have risen to 70%).

An important factor will however be the extent to which VW or Ford would be able to sustain the combined existing UK market share on acquisition of AR. This is likely to be far more difficult for Ford (Ford 29% + AR 15% = 44%) than for VW (VW 6% + AR 15% = 21%). The degree to which UK market share cannot be sustained (or offset by any gains from a wider European distribution) will in the end determine the pressure on cuts in UK manufacturing capacity. In the earlier talks with Ford, AR management maintained that merger would result in closure at least of the whole of Cowley (10,000 jobs). This was however never properly tested in discussion with Ford. VW's thinking is not known.

Apart from car assembly, changes in AR manufacturing capacity are likely to be felt most with "in-house" component production, notably engines and transmissions. This is an important source of employment within AR but it is one of the activity areas where VW might look for early "rationalisation". Some loss of production to Continental plants is possible. By contrast, Ford manufacture a major part of their requirements for engines (Dagenham and Bridgend) and transmissions (Halewood) in the UK which would therefore continue to benefit under any merger with AR.

(f) Component Sourcing

The consequences for the UK components industry of any sale of RG businesses are likely to prove a major topic of interest. As the sole UK-owned volume car manufacture, RG is vital to the maintenance of a large and competitive supply industry. In 1985, AR spent £802m on material and components in the UK (87% of their total purchases). Since two or three component industry jobs are generally reckoned to depend on each one in vehicle manufacturing, 100,000 or more jobs outside RG may depend in some way upon RG activity. RG point out that some suppliers, including the recently privatised subsidiaries Unipart and Istel, continue to depend on RG business for their survival.

Ford, spends around £700m on production materials and components in the UK each year. By contrast, VW placed orders worth only about £65m with 40 UK suppliers in 1986. VW have declared an intention to develop sourcing in the UK, and during the Minister of Trade's visit to VW in September 1987 plans were laid for a purchasing mission to the UK in May 1988 led by Dr Hahn. One must assume, however, that progress will be slow and selective.

Given the above balance of interests, UK suppliers are likely to regard any deal with VW with suspicion. The German vehicle assembly industry has proved a particularly difficult nut to crack because of the domestic loyalties of German management and engineers (who have a major say in relationships with suppliers) and the influence of trade unions on Supervisory Boards. It is instructive in this context that General Motors (who at Corporate level were determined to reduce dependence on German sources of supply) decided in 1986 to transfer their European headquarters from Germany to Switzerland so as to break the stranglehold German personnel exercised over procurement and general operational decisions. The reasons for this move will not have been lost on informed industry observers. Ford, who have traditionally achieved a very high level of local components in the vehicles built in the UK, have not been confronted with this problem on an equivalent scale.

(g) Research and Development

In their recent Report on the automotive components sector, the Select Committee on Trade and Industry recommended that whenever possible design authority of vehicle assemblers should be based in the UK, and called on the Government to provide inducements to ensure R&D facilities were retained or located in the UK. The location of R&D in a privatised AR is therefore likely to be a focus of attention.

RG's Gaydon Technology facility, plus the related AR work, represent the largest British-owned facilities for vehicle industry R&D. It seems probable that the bulk of their facilities are wholly duplicated by corresponding VW R&D, and there therefore must be some doubt whether VW would wish to maintain the present arrangements. Any reduction in UK activity might have a spin-off effect on the high-tech centre RG have built at Warwick University (which has done much to encourage automotive engineers and manufacturing automation specialists) and on RG's financial support for their suppliers' R&D.

Ford have a strong record on R&D in the UK spending some £124m in 1986. Although there would evitably be scope for rationalisation between Ford and AR facilities Ford ownership of AR might carry less of a risk of a drift of high technology work to the Continent. This is particularly important given the concentration of Ford's engine R&D acticities in the UK. The likelihood is that the power train centre for a VW/AR link would be in West Germany.

(h) Effects on Dealerships

Any merger is likely to lead to some rationalisation of dealerships. The following dealer networks might be affected:

AR	1100 dealers
LR	200 dealers
VW/Audi/Seat	480 dealers (Franchises controlled by Lonrho)
Ford	1000 dealers

The extent of any rationalisation is however likely to depend on the relative efficiency as well as geographical position of individual dealerships. When Leyland DAF was created earlier in 1987 a joint network of 56 dealers was planned, resulting in a total of 17 Leyland or DAF outlets being discontinued. Any change in distribution is however costly and might be expected to be managed over a considerable time-span. Disenfranchised dealers (if they are good enough) would probably find little difficulty in attracting alternative clients. The impact is however obviously likely to be more significant in a merger with Ford rather than VW given the former's more dominant market position.

(j) Effects for Management

It seems that initially at least VW intend to let SEAT operate with a fair degree of autonomy, much in the manner of VW's successful strategy with Audi. The stress would appear to be on the exchange of technical expertise rather than implantation of German management. It is difficult to see how VW would treat AR/LR on acquisition, but th-e most likely pattern would involve the retention of senior UK management, though not Mr Day or most main board directors, or some divisional directors. It would be reasonable to expect to see some VW managers in all the major corporate functions. It has always been the strong belief of Mr Day that a deal with Ford would result in wholesale replacement of staff at all levels and little retention of an autonomous decision-taking structure.

If detailed negotiations rather than a quick auction proceeded, it might be necessary to offer incentives to key staff in order to retain their motivation. Early thought will need to be given to the implications for the cost of any deal and to the possible future role of Mr Day.

(k) Competition

RG's current share of the UK car market is 15.2%; Ford have 28.8% and VW 5.5% (Annex 4). A merger of RG and either of Ford or VW would qualify for reference to the MMC on size grounds, and a RG/Ford merger would be caught on market share as well. In the important fleet sales sector, the combined share could be up to 60%. It seems likely that a strong case for reference of a RG/Ford merger could be mounted on competition grounds. We do not know whether ford would be keen enough to fight through an MMC inquiry lasting at least three months, to secure an RG which might itself be badly weakened by the process.

The reference decision would be one for the Secretary of State to take once he had received the advice of the Director General of Fair Trading. It would be important to seek confidential guidance from OFT as soon as firm proposals emerge (especially on RG/Ford), and to enable OFT to complete their consideration of them before HMG is committed to a particular decision.

(iii) <u>LAND ROVER</u>

VW have been emphatic that LR should be included in the package under discussion at this stage. Ford have not shown a similar interest.

VW have no product in the 4wd off-road market sub-sectors for utility, personal transport or luxury vehicles, already served by LR. They could also be interested in the military market for Land Rover; and in LR's 33% holding of Land Rover Santana in Spain, as a strategic complement to SEAT. Despite VW's reported attitude, it is doubtful whether they would immediately abandon discussions with RG if LR were removed from the package (though it is not clear how much tougher VW would then become in their proposals for a deal on AR alone).

The public perception of Land Rover is as a producer of a unique and successful British product and a "jewel" in the RG crown. While this does not corrspond with reality, pressure is certain to continue for LR to remain in British control. There is indeed no shortage of possible British trade purchasers, or other interested parties including a possible MBO.

B. FINANCIAL IMPLICATIONS FOR GOVERNMENT OF A DISPOSAL OF RG

VW have given a preliminary indication that (as secured on the SEAT deal) they would expect total elimination of RG debt, full funding of rationalisation costs plus a contribution to forward capital expenditure. Their expectations on the first two items might have been strengthened by knowledge of the terms of privatisation of RG's commercial vehicles businesses. The last item has however been discounted by officials who assume that HMG (and the EC Commission) would strongly resist substantial aid for capital expenditure by a privatised company (a 50% contribution to AR capital expenditure over 2/4 years would cost around £250m/£400m). Nevertheless as the calculations at Annex 6 demonstrate the total bill for HMG might still be of the order of £1 billion.

These calculations are assumed to apply to acquisition by VW <u>or</u> Ford.

As regards the <u>phasing</u> of payments by HMG, new money for RG has predominantly taken the form of HMG subscribing for new equity in the company using powers under Section 3 of the Industry Act 1980, a course which is only possible while HMG holds the controlling interest. If this route were used again it might be necessary to put in all the new funding up front in advance of completion of a deal. This approach would also enable state aid considerations to be taken forward in a single application. Alternatively, it might be possible to phase any public expenditure costs over more than one financial year. Phasing would be least difficult from the EC point of view in respect of those elements of costs which are likely to be incurred over a period i.e. rationalisation/ redundancy costs (£180-£300m) and future capital expenditure if any were conceded. This is because the timing of the Government payment could be linked to restructuring. Phasing of the repayment of RG borrowings (ca £600m) might also be technically feasible if the group's assets were to be transferred to the buyer, leaving the debts with RG. EC clearance for the procedure might however be more problematic. It is not possible to be more specific about the profile of expenditure until there have been further discussions at a commercial level.

C. EC CONSIDERATIONS

Government financial assistance to enable the remaining RG businesses to be returned to the private sector would need to be notified to the EC Commission under Article 92 of the Treaty of Rome as a state aid. The Commission are already looking closely at several other major state aid cases in the vehicle sector. The financial support necessary to secure a solution would be substantially greater than the £680m state aid for RG's commercial vehicle businesses on which Commission approval was secured in March this year. A second major UK case within such a short period of time could be expected to attract intense Commission attention.

The success of the state aid case on RG's commercial vehicle businesses can be attributed in large measure to early steps to take the Commission into HMG's confidence. The level and timing of high level political lobbying is crucial. In a further RG state aid case an early Ministerial exchange with Commissioner Sutherland would be indispensable to drive the application forward, to minimise the risk of the whole deal effectively becoming subject to detailed EC approval, and to achieve the completion of the Commission's procedures as quickly as possible. The Competition Directorate in the Commission have a strong record of preserving confidentiality on such approaches.

In terms of suitors, as in the case of the commercial vehicles businesses, the Commission would be inclined to look more favourably on a solution involving VW, offering European restructuring, rather than one involving Ford. Ford would be likely to be viewed as an American multinational despite their strong track record and commitment to Europe.

D. DOMESTIC PRESENTATION OF A TRADE SALE

In view of the risks of premature disclosure of even preliminary exchanges, Ministers may wish to consider now some of the difficult presentational issues resulting from a trade sale. Early press speculation about talks with potential suitors could be met by reference to exploring opportunities for collaboration. But well informed and substantiated questioning in the House or in the press could precipitate the need for rapid negotiations and early decisions. Mr Day strongly believes that AR would not stand another prolonged political debate about its future: creditor confidence could collapse, crystallising the Government's obligations under the Varley Marshall assurances, currently £1.5bn.

Were it decided to sell RG's operating companies to a foreign bidder, the risks and difficulties resulting from leaving the businesses in public ownership would need to be emphasised. In the case of the commercial vehicle business the demonstrable alternative to sale was closure. With both AR and LR expected to be profitable (before interest and tax) at the end of 1987, the risks of continuing to fund the businesses from the public purse may look less convincing.

Ministers will also need to meet the argument that British bidders should have been given an opportunity. In the case of AR, it seems very unlikely that a financially credible British bid could come forward, from the management or others. But were it decided to negotiate only with VW, very strong and well orchestrated protest from Ford, claiming to be more committed to Britain, would need to be anticipated.

In the case of LR, there could be many credible British bidders. JC Bamford, Lonhro, Aveling Barford and a management buy out all expressed strong interest in spring 1986, following the disclosure of the GM talks. Although Jaguar have said they are not interested at present, public debate on LR's future might draw them back. Other British interests could also come forward. Although LR is not as strong and successful a company as is popularly perceived, pressure to keep LR British could again prove strong. Ministers may therefore wish to reflect on whether they would wish to exclude LR from a sale of AR. Allowing separate competing bids for LR could prove a more popular course, though excluding respectable foreign bidders (such as BMW who have expressed interest) could prove a problem.

Were it decided to seek to sell either AR or LR to a foreign bidder, Ministers would also wish to consider how far they would wish to press for commitments on future plans for operations in the UK. In the case of past investments by overseas vehicle manufacturers it has been possible to secure assurances on the companies' commitment to the UK. These cover such areas as manufacturing locations, local content, relations with the component industry, R & D, the retention of UK management and export intentions. The announcement of the RG/DAF deal was helped by the Government's ability to demonstrate progess in obtaining such assurances. These assurances have been given on a "best endeavours" basis and are not legally binding but they have frequently proved important in the political defence of controversial investment and restructuring decisions. To secure assurances, it would be important for the Government to signal to any trade bidder at an early stage that it intended to seek commitments on their UK operations.

E. THE TIMESCALE FOR DECISIONS ON PRIVATISATION OPTIONS

Mr Day has been actively reviewing the options for privatising Austin Rover and Land Rover. He believes strongly that the possibilities for returning Austin Rover and Land Rover together to the private sector should be examined exhaustively before any decisions are taken on separate privatisation of Land Rover. Officials understand that he wishes to assess the prospects for eventual flotation of Austin Rover and Land Rover in parallel with preliminary exchanges with VW. Mr Day would hope to give a view to Ministers around the end of the year on which route he favours. Were Mr Day to recommend pursuing a deal with VW, RG believe that it might be possible to conclude a deal by Easter 1988.

Mr Day remains averse to contemplating a deal with Ford which he believes would lead to loss of any separate identity for Austin Rover. He believes, moreover, that any competitive tendering would result in premature disclosure, causing confidence in Austin Rover to collapse.

In considering Mr Day's views, Ministers will wish to reflect, however, on the possibility of alternative approaches to exploring the opportunities for a trade sale. Experience of previous RG privatisation initiatives suggests that there is a high risk of premature disclosure if large numbers of operational staff are involved in negotiations over several months. And negotiating with a single bidder weakens the Government's hand in forcing the best financial deal for the taxpayer. DTI's merchant bank advisors, Barings, believe that it would be possible to work to a much shorter timetable whereby HMG might invite confidential bids from VW and or Ford on the basis of certain key conditions which the Government would wish to see met. The bidders would be asked to supply within a matter of days an indication of the financial terms on which they would proceed; a deal would then be clinched with the preferred bidder in a matter of 2-3 weeks, with minimal involvement of operational staff in working at product plans and future strategy.

While acting with speed clearly has many attractions in purely commercial transactions, in practice major restructuring in the vehicle industry has often taken many months of detailed negotiation to achieve. Moreover quick agreement on the broad terms of a deal could leave exposed some important areas of political concern such as the detailed pattern of job losses. But if this route is considered attractive, Ministers may wish to decide whether they would be prepared to contemplate it now, seeking to conclude a deal before Christmas, or whether it should be considered in the New Year when Mr Day has presented his Corporate Plan and his conclusions on the feasibility of a flotation.

F CONCLUSIONS

In considering the key issues Ministers may find useful the following check list of questions.

QUESTIONS FOR MINISTERIAL CONSIDERATION NOW

(i) Do Ministers wish to reach decisions on the options for AR and LR now, or early next year when Graham Day's corporate plan has been received and his views on the prospects for placement/flotation at the end of the decade are known?

(ii) Do Ministers wish to consider a single or competing trade sale options? VW and/or Ford?

(iii) Is inclusion of Land Rover negotiable or totally excluded from sale to VW or Ford. Or would the Government be willing to sell a minority stake?

(iv) Are Ministers willing to consider say three months detailed negotiation on a trade sale? Or would there be advantages in a quick fire three week negotiation, even if this reduced the scope for gaining assurances from the successful bidders on future plans for UK operations?

QUESTIONS TO BE CLARIFIED WITH VW

In the light of discussion with Mr Day on 2 November Ministers may consider it appropriate to seek early clarification of VW on the following further points:-

(i) Are VW willing to consider AR without LR? What conditions will they seek if LR is excluded?

(ii) Do VW want a 100% stake?

(iii) Do VW expect to maintain Honda collaboration?

(iv) What are VW's general intentions for operations in the UK?

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ANNEX 1

ROVER GROUP FINANCIAL PROJECTIONS

£m

	1987 (A) Jan-August actual	1987 Full year Forecast	1988 (B)	1989	1990	1991
Sales Revenue	2124.7	3019.3	3263.0	3136.3	3269.7	3338.8
PBIT	18.4	14.2	51.7	66.2	99.3	104.2
PBT	(23.1)	(59.7)	(29.3)	(7.0)	13.2	17.4
Net Earnings	(28.3)	(70.9)	(66.7)	(45.5)	(10.9)	(7.1)
Cash Flow	23.0	(278.2)	(127.7)	96.7	(43.1)	(61.7)
Total Debt	265.8	567.0	756.3	658.6	700.2	710.0
Varley-Marshall exposure (C)	1449.1	1448.3	1607.1	1486.3	1544.6	1551.4

NOTES

(A) - 1987 figures are derived from Rover Group's August 8 management accounts

(B) - Data for 1988-1991 is taken from Rover Group's 1987 Corporate Plan and has not been adjusted for subsequent changes in corporate structure and financial performance/projections.

(C) - The Varley-Marshall assurances expose the Government to the total (gross) liabilities of the company. These are principally Bank borrowings, trade creditors, leasing commitments and inventory deposits.

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ANNEX 1

AUSTIN ROVER FINANCIAL PROJECTIONS

£m

	(A) 1987 Jan-August actual	1987 Full year Forecast	(B) 1988	1989	1990	1991
Sales Revenue	1827.7	2578.0	2670.0	2880.0	2990.0	3025.0
PBIT	(2.5)	0	20.0	45.0	75.0	75.0
PBT	(50.5)	(75.0)	(42.2)	(17.1)	2.3	2.7
Net Earnings	(51.7)	(79.5)	(77.2)	(25.1)	(7.7)	(7.3)
Cash Flow	11.5	(121.7)	(118.2)	(43.1)	(22.7)	(48.3)
Total Debt	537.7	670.9	574.3	517.4	540.1	538.4
UK Market Share %	15.2	15.1	14.5	14.5	14.5	14.5

NOTES

(A) - 1987 figures are derived from Rover Group's August 8 management accounts

(B) - data from 1988-1991 is taken from Rover Group's 1987 Corporate Plan.

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ANNEX 1

LAND ROVER FINANCIAL PROJECTIONS

£m

	1987 (A) Jan-August actual	Full year Forecast	1988 (B)(C)	1989	1990	1991
Sales Revenue	346.4	523.3	546.5	584.7	628.3	708.8
PBIT	14.6	19.7	15.6	25.3	29.1	41.6
PBT	12.7	12.5	6.1	15.5	18.8	31.7
Net Earnings	12.3	11.8	6.2	15.6	18.9	31.8
Cash Flow	27.0	(17.6)	2.6	1.1	3.1	12.4
Total Debt	(9.5)	33.3	78.8	77.7	74.6	62.2

NOTES

(a) - 1987 figures are derived from Rover Group's August 8 Management accounts

(b) - Data for 1988-1991 is taken from Rover Group's 1987 Corporate Plan.

(c) - The financial projections for Land Rover are for the period to 1991, although the Rover Group consolidation assumes disposal at the beginning of 1989.

FINANCIAL BACKGROUND

ANNEX 1

£m	Rover Group 1986	Rover Group Forecast 1987	VW (worldwide - incl SEAT) 1986 (1)	Ford (UK) 1986	Ford (Europe) 1986	Ford (Worldwide) 1986 (2
Sales	3412	3019	17598	4 374	c. 8 200	38010
PBIT	(350)	14	867	45		3365
Interest	(105)	(74)	(377)	64		(293)
Tax	(7)	-	(497)	(30)		(1075)
Other	(437)	(11)	200	-		(6)
Net P/(L)	(899)	(71)	193	79	339	1991
Capital Assets	773	757	3 486	964		11 084
Operating Assets (Liabs)	207	238	4 486	975		(3482)
Provisions	(327)	(135)	(4 856)	(122)		-
Assets Employed	653	860	3 116	1817		7608
Net (Debt)/Cash	(962)	(567)	332	(723)		1468
Total Net Assets	(309)	293	3 448	1 094		9070
Vehicle Production (000)	477.4	510.2	2776.6	466	c. 1450	c. 6000
Wholesales (000)	493.6	507.7	2764.6	656	1568.4	5984
Employees (000)	69.5	47.4	282	49	101	382
UK Car Market Share (%)	15.6	15.1	6.1	27.4	N/A	N/A
European Car Market Share (%)	4.0	3.9	14.65	N/A	11.7	N/A

M20AAG (1) At £1 = 3DM (2) At £1 = $1.65

ANNEX 2

BACKGROUND NOTE ON VW Annex 3

Size and Structure: Volkswagen AG is a West German public company with a market capitalisation of £3.8 billion. Its shares are quoted on the Frankfurt stock exchange and also listed in other European financial centres. The major shareholders are the Federal government (16%) and the State of Lower Saxony (20%). The Federal government recently confirmed its intention to sell its £600m stake by the end of 1987.

The parent company undertakes the production and marketing of VW vehicles in West Germany, and holds the shares of all major production and distribution subsidiaries. It owns 99% of Audi AG and 75% of the Spanish company SEAT. Its 98.4% holding in TA Triumph-Adler AG, VW's only major diversification, was deconsolidated in 1986, following its sale of Olivetti, of whom VW have 5%.

Table A of this annex shows VW's sales volume and markets. The company is the fourth largest car producer in the world with a market share of 7% and Europe's largest with 15%. Worldwide, in 1986 it had 282000 employees and produced 2750m vehicles, generating a turnover of some £17.5 billion.

Products and markets: VW has been traditionally strong in the medium-sized sector, where its Golf represents a third of output. There is little overlap of models in VW's range, but the Golf and several others are nearing the end of normal model lifespan in the industry. Table B shows Worldwide 1986 production by model.

VW has sought to gain strength across the board since 1985, both by spending heavily on its upmarket Audi range, and by taking a controlling industry in the Spanish small car producer SEAT. Its major markets outside Europe are the USA, and South America.

Performance: Figures for VW's turnover and profits since 1982 are shown in Table C. VW have recovered from losses made up to 1983, and while unit output has continued to grow at about 12% pa, financial results have been held back since 1985 by higher production costs, substantial investments, currency disadvantages and technical problems (mainly affecting US sales of Audi). Although VW was financially strong at the end of 1986 with net assets of £3½ billion, and net cash of £330m, its trading position was cash negative and its gearing is expected to increase substantially. This can be attributed to the heavy recent expenditure in acquiring SEAT and increasing R+D, as well as the commitment to some £2 billion of capital expenditure at SEAT. VW launched a £760m rights issue of preference shares in September 1986 to help find these projects. Allegedly fraudulent foreign currency dealings of £160m have damaged the credibility of VW management and further depressed the company's stock market performance; opportunities for raising large tranches of finance in the future may be limited.

SEAT: Having broken links with Fiat, and explored but not cemented ties with Toyota and Nissan, SEAT concluded a technological co-operation agreement with VW in 1982. This provided facilities for the assembly of Santana, Passat and Polo models at SEAT's Pamplona factory. The arrangement gave VW a presence in the highly protected Spanish market, and a lower cost manufacturing base, without financial involvement in SEAT.

SEAT continued to make losses, however, and in June 1985 VW, encouraged by the Spanish Government, signed a latter of intent to take a controlling financial interest in SEAT. Complex and protracted discussions took place on product policy and the necessary financing. (Accumulated losses by the end of 1984 were more than £750m and debt totalled over £1,250 million). The Spanish Government took over SEAT's debt of about £840m from INI (the state holding company), and put up a further £930m of "non returnable credit" in respect of funding for 1985 and 1986. After final agreement in March 1986, VW took a 51% stake in SEAT, and in December 1986 took up its option to increase this to 75%. It is expected that VW will take 100% control by the end of 1990. The total cost to VW has been about £400m. VW have also declared an intention to invest some £2 billion in SEAT, which the Spanish Government has said it will match.

The agreement included a cut of 2000-3000 in the workforce of 21000, with more cuts later, to be achieved by natural wastage as far as possible. Output would be increased by one quarter to

400000 cars a year by the early 1990s. Two thirds of production would be exported. The SEAT name would continue with distinct SEAT models coming forward as and when required.

The question arose whether the Spanish Government's action amounted to notifiable state aid under Article 92. The Commission noted that the Spanish Council of Ministers had signed a draft Royal Decree on 27 December 1985 effectively allowing financial operations to reconstruct SEAT's balance sheet to be completed by 1 January 1986. Since no aid had been paid after the date of Spain's accession, the aid was not notifiable. While the terms of the accussion treaty made existing Spanish industrial support schemes notifiable, it did not affect individual offers of the type in the SEAT case.

Prospects: VW face continued pressure in the market as European manufacturers continue to carry overcapacity, and as some state owned companies (RG, Renault) continue to make losses. Additional factors are the large resources of GM as a world automobile force, and the increasing Japanese penetration of markets. The 45% of total VW production which is exported from Germany is vulnerable to the strength of the Deutschmark. With their solid financial position, however, the VW/Audi/SEAT Group can be expected to develop irrespective of short-term market fluctuations and currency problems.

VW/AUDI/SEAT

Car Sales	VW			Audi			Seat		
	1985	1986	1987	1985	1986	1987	1985	1986	1987
West Germany	550	659	632	130	151	195	4	5	15
Italy	127	123	143	18	17	22	37	43	50
France	85	91	97	25	24	27	22	25	25
UK	84	89	82	20	19	21	0	6	12
Japan	13	20	22	5	6	7	N/A	N/A	N/A
Rest of World	921	963	895	165	147	127	147	129	128
Total	1780	1945	1871	363	364	399	210	208	230

Source:

Banque Paribas Capital Markets

Notes:

1987 figures: estimated

Total sales of VW Commercial Vehicles: 1985 219
1986 250
1987 249

TABLE A

Table B

PINNACLE

WORLDWIDE VW PRODUCTION BY MODEL

	Type	1986 Production ('000)
Audi 100/200	Executive	156
Audi 80/90	Upper medium size	173
Passat	"	352
Golf	Lower medium size	877
Jetta	"	275
Polo	Supermini	215
Ibiza	"	122
Other		381
		2551

Table C

VW: FINANCIAL RECORD

	1982	1983	1984	1985	1986	1987(1)
Turnover (DMbn)	37.0	40.0	45.7	52.3	52.8	55.0
Net income (DMm)	(300)	(215)	228	596	580	580
Earnings per share (DM)	1	16	45	63	42	41
Dividend per share (DM)	-	-	5.0	10.0	10.0	10.0

Notes

1 Forecast

2 £1 = DM3 approx (October 1987)

UK REGISTRATIONS (PASSENGER CARS)

	1985		1986		1986 Jan-Sept		1987 Jan-Sept	
	Units	%	Units	%	Units	%	Units	%
Rover Group	327,955	17.90	297466	15.80	250158	16.22	248722	15.19
VW	83,888	4.58	109237	5.80	91422	5.93	89507	5.47
Audi	19,989	1.09						
Seat	405	0.02	5917	0.31	4593	0.30	7185	0.44
VW/Audi/Seat	104,282	5.69	115154	6.12	96015	6.23	96692	5.91
Ford	485,620	26.50	515367	27.38	419264	27.19	471195	28.78
Others	914,551	49.91	954487	50.70	776446	50.36	820522	50.12
Total	1,832,408	100.00	1882474	100.00	1541883	100.00	1637131	100.00

Source:

SMMT: Monthly Vehicle Market Reports

Automotive Industry Data: 1986 Data Year book

ANNEX 4

PH

EEC Registrations (PASSENGER CARS)

	1985		1986	
	Units	%	Units	%
Rover Group	417398	4.35	406624	3.86
VW Audi	1172956	12.22	1362112	12.93
Seat	248905	2.59	184617	1.75
VW/Audi/Seat	1421861	14.81	1546783	14.69
Ford	1090583	11.36	1246903	11.84
Others	6671521	69.48	7330870	69.61
Total	9601363	100.00	10531180	100.00

Source:

Automotive Industry Data: 1986 Data Yearbook

Motorstat ORS 12 months 1986

EEC figure includes Ceuta, Melilla and Canary Islands

ANNEX 5

DISPOSAL COST ESTIMATES

ANNEX 6

Gross cost of disposal excluding any capital expenditure contribution:-

	LOWER	UPPER
Elimination of debt	£570m (a)	£570m (a)
Redundancy costs	£180m (b)	£300m (c)
Other rationalisation cost less realisable surplus assets	£100m	£100m
Half year 1988 cash outflow to completion of deal	£100m (d)	£125m (d)
Gross Cost	£950m (e)	£1095m

Net Cost:-

Gross Cost	950m		1095m
Less consideration received	-250m (g)		-50m (g)
Net Cost	£$^3/_4$bn	-	£1bn

By comparison a very approximate calculation carried out in June of the cost of a complete break-up of RG suggested that the bill to HMG could be as high as £2bn, though the amount would depend crucially on the levels of redundancy payments offered. There is no reason at this stage to believe that one or other trade sale option would be significantly more or less costly to HMG. Nor, given the limited synergy between AR and LR, is there any particular evidence that the total bill would be very different for separate deals for the two operating companies.

Notes on Cost Calculation

(a) Assumes that RG is sold fully debt free and that any variation on this aspect of the deal is subsumed in the consideration received; in practice there could be a trade off between debt elmination and consideration received.

(b) 7,500 jobs or ca 15% of current RG workforce.

(c) 12,000 jobs or ca 25% of current RG workforce.

(d) The new Plan projection for 1988 cashflow is not yet available; full year cash outflow for 1987 is curently estimated at £2809m. Range of £200-£250m for full year 1988 is estimated on the basis of some improvement from the 1987 performance but not to the extent of the 1988 projection contained in the 1987 Corporate Plan which predates rephasing of capital expenditure items. Deal assumed to be completed at end June 1988.

(e) £1200m if a capital expenditure contribution of £250m were conceded.

(f) £1495m " " " " of £400m conceded.

(g) Consideration determined as follows:-

In the case of the LR side of the business conventional techniques would suggest a value of £50-150m. Valuation of AR is much more problematic; although AR has some good production facilities, good marques in Rover and MG, and an extensive distribution netwoek, it has no profit record and no prospect of positive cashflow before interest until 1990. On this basis it is prudent to assume in cash consideration of £0-100m for AR, making a total of £50-250m for the combined entity against a book net worth of a recapitalised group of £850m.

RG MINORITY

(Official level paper prepared by DTI in consultation with Treasury and No 10 Policy Unit)

PURPOSE

To determine whether it is appropriate to take out RG's minority shareholders this year, or whether they are better dealt with later in the privatisation process.

BACKGROUND

2 RG's 60,000 minority shareholders are the rump of the private shareholders in the former British Leyland Motor Corporation who remained after the 1975 Scheme of Arrangement under which HMG took control of the company. Following successive dilutions they now represent only 0.2% of the company's equity. The current market value of their stake is [£11½m]. They are an anomaly whose position needs to be considered in relation to the privatisation of the Group.

3 Rover Group have argued first in the context of the Trucks disposal and more recently as a separate issue that early action should be taken to eliminate the minority. Following the discussion of Ministers on 5 October this paper seeks to show (paras 5-10) that alternative mechanisms do exist for addressing

the minority issue at a later stage under most of the privatisation scenarios that can be envisaged. It concludes by reviewing the advantages and drawbacks of early action.

MECHANISMS FOR REMOVING THE MINORITY

Scheme of Arrangement (Section 425 of Companies Act)

4 The option favoured by RG would be for HMG to undertake to take out the minority now, before further privatisation, through a Scheme of Arrangement. Under such a Scheme HMG would offer to buy the minority shares. If the Scheme achieved a majority by number representing 75% by value of the shares of those voting on it in person or by proxy and was then approved by the Court, it would become binding on all the minority shareholders. To complete a Scheme would take some two to three months.

5 Shareholders must be given sufficient information in the Scheme documentation (which itself is subject to Court approval) to enable them to make an informed decision on whether to accept the Scheme. Because the Scheme price would be far in excess of underlying asset values, there would be a strong argument that any prospective disposals which might be under confidential discussion would not so materially improve RG's balance sheet as to make the Scheme unattractive to a reasonable shareholder. But Counsel advise that it would be prudent to make confidential approaches to the Court, if any substantive negotiations

developed or seemed imminent, to seek a direction on non-disclosure. This would not however totally eliminate the risk of political criticism after the event.

Alternatives to an immediate S of A?

6 The alternative approaches to eliminating the minority would depend on the pattern of further privatisation. If privatisation proceeded by sales of individual operating companies or assets with RG Board support, the Group would be reduced eventually to a shell company which would need to be liquidated. Political pressure for payment to the minority could be met by the Government making an ex gratia offer. In the interim however EGMs of all shareholders would be required to approve significant disposals. EGM Circulars require extensive documentation sometimes raising difficult presentational issues.

7 If the Government wished to sell individual operating companies or assets, but the Board argued that such a course was not in the interests of the minority shareholders, progress on privatisation would be jeopardised. Implementing a Scheme once a dispute (even if not public) had arisen would almost certainly raise acute disclosure problems. It would be desirable to avert such a situation of prolonged controversy, which would be damaging both to HMG and the company.

8 If placement or flotation of the whole of HMG's stake in RG were contemplated, there would be no need to deal separately with the minority at all. Although RG argue that this would complicate any prior financial reconstruction, neither we nor Barings judge the effect as significant.

9 Finally, although it is most likely a trade purchaser would seek to buy operating companies or assets, they might for tax loss reasons want to buy the RG equity; two situations could then arise. First the offeror could propose the same terms to the minority as to HMG. HMG acceptance of the deal would give the 90% level necessary under Sn428 of the Companies Act to force the deal on all the shareholders. However although legally sound it would be politically difficult to eliminate the minority compulsorily at a few pence per share.

10 Alternatively the offeror could propose superior terms to the minority, seeking compensation from HMG. This would still secure compulsory elimination under Sn428. Both variants would be subject to possible delay and embarrassment if, as must be expected, the dissenting minority exercised their right to petition the Court against compulsory share transfer.

11 Demerger of Land Rover

Further flexibility in the manner of handling the minority could be introduced by demerging RG into its constituent operating companies. (That could also give extra freedom in structuring any deal with, say, VW). Effectively the minority would be given some form of direct or prospective preferential participation in Land Rover rather than the cash compensation which might be politically necessary under other scenarios. There are many variants on this theme which could be constructed under a Scheme of Arrangement.

ARGUMENT

12 In advance of knowing the form of RG privatistion it is only possible to address the question of whether to deal with the minority through a scheme of Arrangement now, not to choose between the various alternatives. As a focus for controversy over RG strategy the existence of the minority gives scope for uncontrolled and damaging publicity about the Group's affairs. They also divert disproportionate management time from the main task of running the business. Those are the commercial reasons why Graham Day is keen to see them eliminated. For HMG there is the additional reason that their elimination would remove any scope for the RG Board to pray in aid the "interests of the minority" as a procedural hurdle to privatisation proposals of which they disapproved. However early elimination would also carry considerable presentational risks. It would be problematic to construct a convincing public defence of the use of several

millions of taxpayers money on something which would be bound to be seen in some quarters as "nationalisation". It could be argued that this was necessary restructuring, to pave the way for privatisation of the whole group. But that would rekindle political interest in the Group and invite abstract speculation about what privatisation steps would follow.

CONCLUSIONS

13 The minority's existence could be addressed by:-

1) a Scheme of Arrangement now:

2) a final liquidation of RG following piecemeal disposal of the operating companies and other assets:

3) a placement/flotation of the HMG stake making the existing minority insignificant shareholders in the new share structure:

4) a trade purchase of the RG equity perhaps coupled with a special deal for the minority.

Additional flexibility could be given by demerging RG to give the minority a direct stake in what they may regard as its most attractive asset, Land Rover.

14 The key issue in determining whether to go for a Scheme now is the willingness of HMG, if necessary, to pursue some element of privatisation strategy that conflicted with the Board's wishes. In such circumstances the existence of the minority would strengthen the Board's hand, and any attempt to eliminate the minority in the midst of such a dispute would be fraught with difficulty. If however HMG sees the need to move with the support of Mr Day and his Board as a sine qua non, then it is dubious whether the commercial benefits from eliminating the minority now outweigh the risks in putting the political spotlight back on RG before the privatisation strategy is fully worked up.

SECRET
COMMERCIAL IN CONFIDENCE

FROM: M A WALLER

DATE: 30 October 1987

CHANCELLOR

cc. Chief Secretary
Sir P Middleton
Mr F E R Butler
Mr Monck
Mr Burgner (or)

ROVER GROUP

This is a brief for your meeting at No.10 on Monday 2 November at 10.30 to discuss options for privatisation of Rover Group (RG) with the Prime Minister, Lord Young and Graham Day. The purpose of the meeting is essentially to hear Graham Day's views on the options (Lord Young has provided a list of questions for this purpose). A further meeting is scheduled for 9.30 am on Tuesday 3 November to consider the Government attitude to disposal options at which Mr Day will not be present but to which Lord Whitelaw and Mr Wakeham have been invited. The meetings have been arranged early this week in order to formulate a Government view prior to a meeting scheduled for 6 November between Mr Day and the Chairman of VW.

2. The papers for Monday's meeting are:

(i) Lord Young's minute to the PM of 29 October setting out the key issues for discussion, together with a list of questions to be addressed to Graham Day (Flag A).

(ii) DTI papers on privatisation options (Flag B) and the minority (Flag C).

(iii) Graham Day's memorandum to Lord Young on privatisation (Flag D).

This adds up to rather a lot of paper. Lord Young's minute picks up the key issues. I suggest you only need to skim the DTI privatisation paper: the minority papers and Day memorandum are not essential reading.

Background

3. This meeting is the follow up to the discussion at No.10 on 5 October which discussed privatisation prospects and proposals for a Scheme of Arrangements

designed to buy out the minority shareholders. That meeting concluded that Land Rover (LR) could be not sold to a foreign company; that for a trade sale VW offered some advantages over Ford but that the competition between them to buy ARG was not desirable; and that DTI should prepare papers looking at the questions raised by a trade sale and the implications for the removal of the minority shareholders (see No.10's letter of 5 October to Lord Young's private secretary - Flag E).

4. On ARG's performance we have some tentative figures for the 1988 Corporate Plan (Flag F). These show a slightly improved operating performance on PBIT but at the cost of a £70-80 million increase in projected capital expenditure with correspondingly worse cash flows in the early years of the Plan period.

Treasury interests

5. We suggest that the Treasury's interests in this issue are to ensure that:

(i) decisions on options take full account of the need to minimise public expenditure and to allow the orderly resolution of HMG's liabilities under the Varley Marshall assurances;

(ii) In so far as is practicable, disposals are done in a way which provides for effective competition between possible buyers in order to minimise Exchequer costs;

(iii) The financial and wider economic implications of whatever option is chosen are fully examined and taken into account.

Key issues for consideration

6. These are identified in paragraph 2 of Lord Young's minute to the Prime Minister. Taking them in turn:

(i) Timing of Decisions

The choice here is essentially between reaching a decision on options for RG now, or early next year when the Government will have received and considered Mr Day's Corporate Plan and his views on the prospects for placement/flotation. The latter would clearly be Mr Day's preferred approach. As such, there is something to be said for accommodating Mr Day on this since this would be consistent with Ministers' agreement earlier this year that securing Graham Day's support was a pre-requisite for any privatisation option. On the other hand, delay by another couple of months or more might well rule out any possibility of closing a deal and securing European Commission (EC) approval in time for any substantial public expenditure costs to be paid out this year. Moreover, in substance it is difficult to see what the 1988 Corporate Plan and Mr Day's views on flotation are likely to add to the sum total of knowledge on this subject. The choice is liable to remain a stark one between pressing forward with a trade sale now or soldiering on to a possible placement and flotation in the early 1990s.

(ii) Single/competing trade sale options i.e. VW and/or Ford. Notwithstanding Graham Day's expressed preference for VW, Ford looks in fact to be the better of the two options on grounds of siting of R&D activity (they have major R&D facilities in the UK; VW have none); component sourcing (Ford spend over £700m on UK components; VW £65m though they are committed to increasing this); and the fact that they have expressed no interest in LR. Against this VW is likely to be more acceptable to the EC (a European rather than "American" rationalisation); and a VW deal is unlikely to require an MMC reference (a Ford/RG merger would give them 44% of the UK market; RG/VW would be 21%). On grounds of cost there is unlikely to be much in it. The DTI paper assumes that HMG will need to finance at least the ellimination of RG's debts and full rationalisation costs. The paper also suggests that VW might attempt to secure some contribution to future capital expenditure (on a parallel with the deal VW struck with the Spanish Government over SEAT). But this is something which officials would recommend should be resisted very strongly. So for either company we believe the bottom line would be between £700 and £1,000 million. (The question of phasing this expenditure is addressed in my note of 23 October - Flag G).

As far as competition for a trade sale is concerned, Ministers earlier concluded that a competition between Ford and VW would be undesirable because of the dangers of leaks etc. In principle, however, we think it would be very helpful in reducing public expenditure costs if some element of competition between VW and Ford could be engineered (see (iv) below).

(iii) Inclusion of Land Rover

This turns on both the political judgement about the acceptability of Land Rover passing to foreign control and VW's strength of feeling about having LR included in the deal (they have said LR is an essential element). On the latter point, the DTI paper identifies VW's absence from the 4-wheel drive market as a fairly strong motivating force for VW wishing to have LR included in the deal. Ministers will need to make clear in advance of any substantive VW/RG talks whether LR must be excluded from the deal.

(iv) Time scale for negotiation

The DTI paper floats the idea, first put forward by Baring, of a much truncated timetable for a deal with either VW or Ford involving an invitation from HMG to one or both companies to put in bids within a matter of days to be followed by a short, intense period of negotiation on an outline deal to be signed within 2/3 weeks. Detailed issues would then be settled by post-contract negotiation/arbitration. The attractions of this approach are that it minimises the risk of leaks and removes the possibility of a build up of Parliamentary and public opposition to any deal. The disadvantages are that a deal would be very broad brush and would thus leave exposed some important areas of political concern such as the detailed pattern of job losses and lack of detail of undertakings about component sourcing etc.

The Minority

6. As Lord Young's minute makes clear the question of how to deal with the minority is a second-order issue, the answer to which depends on how far the Government are prepared to push options to which Graham Day and the RG Board are opposed. Only if there is likely to be conflict with the RG Board would it be necessary to take action in advance of more general privatisation moves. As Graham Day's memorandum to Lord Young makes clear, he would much prefer placement and an eventual flotation of RG shares, covering both ARG and LR. He remains adamantly opposed to Ford because he believes that ARG would effectively be absorbed by Ford and would therefore lose any separate identity following the sale. He considers that VW offers a better prospect in this regard but, nonetheless, we understand his enthusiasm for VW is now waning and that he will seek the Prime Minister's support for him being allowed to have more time to formulate a placement/flotation option.

7. By contrast Lord Young remains extremely sceptical about the prospects for placement/flotation and believes that an early trade sale of ARG on a competitive, "fast track" basis should be carried forward. His preference is a sale to Ford rather than VW. If this option prevails then some pre-emptive action on the minority may be necessary.

Alternatives to Trade Sale or Flotation

8. If Ministers decided not to press ahead with the trade sale either now or in the new year, the question arises what alternatives exist for RG. The present Corporate Plan, which comes up for re-examination over the next few months, envisages that ARG will gradually move up market and that small car production - the mainstay of the company's cash flow at present - will cease in the mid 1990s. But, as paragraph 4 indicates, the 1988 Corporate Plan looks as though it will be more ambitious and, in the short term, more costly. We understand that the No.10 Policy Unit is likely to brief the Prime Minister that the real option for RG should not be a current strategy but the curtailed version concentrating on the upper end of the market involving ending the production of the Metro and Mini very quickly and concentrating on the Rover 800 and the new AR8 and LR products. The Policy Unit's reason for pressing this alternative is partly tactical in that it would put greater pressure on Graham Day to accept some form of trade sale. But there are financial drawbacks to the strategy of the kind they are proposing: the Metro is a major cash generator at present so phasing it out before its currently projected runout in 1991 would substantially increase RG's cash requirement. In addition there would likely be an adverse effect on the dealer network of a sudden withdrawal from the small car market which could substantially undermine the whole viability of RG's strategy. Pressing such a strategy on Day could cause a major row: this is not a reason for not pressing for an alternative strategy but it is very much a second best option to early disposal.

Conclusions

9. In narrow commercial terms there is everything to be said for the earliest possible disposal of RG. As Graham Day's memorandum admits, the next 3-4 years offer, at best, fairly stable, modest operating profit with cashflow inadequate to fund the Group's capital programme and to service its accumulated debts. Mr Day's 1988 Corporate Plan is likely to increase capital expenditure in the early years with the promise of better performance later on. This does have the all familiar ring of "jam tomorrow" associated with RG's performance under public ownership. If, as seems possible, competitive conditions tighten in Europe and other export markets in response to reduced economic growth then RG do not have the financial resources to compete effectively with the main volume car manufacturers. The result would be a further escalation in VMJ liabilities. Linking up with one of these majors therefore looks a sensible move.

10. But disposal carries major political and presentational problems. It should not be embarked upon unless there is a very high degree of commitment to carrying the deal through against what is likely to be very strong Parliamentary, public and, perhaps, RG Board opposition. If negotiations became public prematurely or a trade sale fell through, then this could well cause irreparable damage to ARG's market position thus crystallising Varley Marshall liabilities in a precipitate and highly uncontrolled way.

11. Monday's meeting provides the opportunity to test Graham Day's views on privatisation prospects as a basis for deciding on Tuesday whether and how to take forward privatisation options. We think it would be unwise for Mr Day to be under any illusion about the range of options which the Government is considering. We therefore think that the list of questions attached to Lord Young's minute to the Prime Minister should be put firmly to Mr Day, including the possibility of a trade sale to Ford. Given, however, Mr Day's known aversion to this type of option you might like a few minutes in advance of the discussion with Mr Day to discuss with your colleagues the strategy for handling him during the meeting.

12. If it is decided to carry forward the early disposal option Tuesday's meeting should seek to establish the essential conditions which would need to be attached to disposal i.e.:

(a) the degree of commitments which VW or Ford would need to give on siting of production/R&D activity and UK component sourcing;

(b) how LR would figure in any deal; and

(c) the overall scale and nature of costs which HMG would be prepared to bear (in particular, ruling out any contribution to future capital expenditure).

MAW

M A WALLER

SECRET

a Brief below AA

CH/EXCHEQUER
REC. 30 NOV 1987
ACTION Mr Waller
COPIES TO CST
Sir P. Middleton
Mr Anson
Mr Monck
Mr Burgner Mrs Lomax

Placement - What price? Looks OK to me

PRIME MINISTER

ROVER GROUP PRIVATISATION

We are meeting on 1 December to review progress on defining options for the privatisation of Austin Rover (AR) and Land Rover (LR). I attach a suggested agenda of issues which we might discuss first, and points we should open up with Graham Day.

Privatisation

2. We need to ensure that in January we are in a position to have a real choice on options. Day himself seems to be focussing on developing plans for a placement. It is absolutely critical that we should secure his support for whatever route we choose. A way forward may be to agree financial performance targets within which must be met to support a placement. We would need to ensure that these were sufficiently challenging and objective to provide solid milestones against which we could monitor progress. We would agree with him that if RG fell away from these targets, we would quickly seek a trade sale.

3. But before settling on this route with Day, I suggest we should use our meeting tomorrow to deliver clear the message that we look for comprehensive and even-handed advice on the options by the end of January.

RG's 1988 Corporate Plan

4. We should also discuss with Graham Day the presentation of RG's 1988 Corporate Plan to the Government. RG are

working towards delivering the Plan to Government before Christmas. I understand that no radical departures from the 1987 Plan are anticipated on capital expenditure and borrowings, and no new product decisions are needed this year.

4. I am copying this minute to Nigel Lawson.

DY
30 November 1987

DEPARTMENT OF TRADE AND INDUSTRY

ROVER GROUP PRIVATISATION
MEETING ON 1 DECEMBER

A. POINTS FOR DISCUSSION BETWEEN MINISTERS

1. End January Objective

- need to gather information and advice to secure a real choice for placement or trade sale if appropriate;

- need to plan to bring Graham Day on side then if Ministers decide on a trade sale for AR.

2. Placement

- prospects remain doubtful before the end of the decade;

- but need to hear Day's views;

- likely Honda would need to take a stake but their willingness to do so is unclear;

- need to consider whether Day should be given time to prove viability of a placement.

3. Trade Sale of AR

VW

- slightly equivocal on continuing talks from which LR is excluded;

- Day believes a deal with VW would take several months to complete;

- need to decide whether VW should be pursued further;

Ford

- Ministers and RG believe Ford are interested;

- RG believe Ford may be prepared to close a deal very quickly;

- need to decide whether Ford should be pursued further;

- past Parliamentary statements do not rule out this option;

- need to consider whether the competition policy issues set out in the note by officials can be handled satisfactorily;

Land Rover

- could be included in a placement of the whole of RG;

- alternatively, could be privatised separately by trade sale, management buy out or flotation in due course;

- could be protected by a golden share;

- sale of AR would require statement of Government intentions on LR.

4. Graham Day's Position

- keeping Day on side is absolutely critical;

- he appears to be focussing on placement option;

- need to ensure he presents even handed assessment of all options in January;

- personal word from the Prime Minister may be needed to gain his support for a trade sale of AR.

JG1BNP

B. POINTS FOR DISCUSSION WITH GRAHAM DAY

1. Current State of RG Business

- end year results anticipated?;

- market prospects for 1988?

2. Day's Thinking on Placement

- welcome sight of Schroders (RG's advisors) views before next meeting in January;

- important that Honda's position should be precisely defined in Day's planned meeting in Tokyo on 22 January;

- seek agreement on financial performance targets which would need to be met. Officials and HMG's advisors to agree with RG and their advisors before next meeting in January.

3. Day's Thinking on Trade Sale Possibilities

VW

- interest without Land Rover?;

- speed at which VW could negotiate a deal?

Ford

- interest?;

- speed at which Ford could negotiate a deal?;

- need for advisors to reach agreement on a negotiating timetable for a trade sale.

4. RG 1988 Corporate Plan

- delivery date to Government?;

- broad thrust of Plan?;

- inter-relation to prospects for a placement?

813/3i/SC

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FROM: M A WALLER

DATE: 16 December 1987

CHANCELLOR

cc. Chief Secretary
Financial Secretary
Sir P Middleton
Mr Anson
Mr Monck
Mr Burgner
Mr Turnbull

OK -

ROVER GROUP: BUYING OUT THE MINORITY SHAREHOLDING IN 1987-88

At the meeting at No.10 on 1 December to discuss Rover Group issues, it was agreed that the meeting scheduled for end-January to consider the critical path towards placement would also revisit the issue of buying out the minority shareholders. At my request, DTI have re-examined the timetable for carrying through a scheme of arrangement, to determine whether a decision taken at the end of January in favour of such a scheme would enable the costs to be met in this financial year. These costs could amount to £13-17m, depending on the premium offered.

2. DTI advise that, in order to make any payment by the end of March, Ministers would need to reach a final decision in favour of a scheme by 26 January at the latest. As this is somewhat earlier than the likely date for a further meeting at No.10, DTI have asked whether you would wish to press for earlier consideration of the minority shareholding. My preliminary response to them on this is that, given the relatively limited amount of public money at stake, the issue of timing should only be a relevant factor if there are other substantive arguments in favour of taking out the minority by the end of this financial year. This minute recommends that there are still no decisive arguments in favour of action on the minority separate from action to dispose of the Group.

Arguments

3. A detailed note on the steps necessary to eliminate the minority and the issues associated with this subject is attached. It is not essential reading but you may care to glance at it. The main point is that eliminating the minority essentially only removes a procedural barrier to the Government's pursuing

privatisation options unwelcome to Day or the RG Board. And, in terms of the options now being considered by the Government, taking out the minority would only be essential if a trade sale were to be pursued because Ford or VW would want 100% control and be very unlikely to agree to being saddled with a troublesome minority. On the other hand, no action on minority would be necessary under the placement route since 100% control would not be an issue for the institutions. Moreover, the arguments for action in isolation from wider privatisation moves are, if anything, rather weaker than they were when this issue was last considered in October. In particular, Mr Day has now pledged his support to the trade sale route (to which Day/Board opposition would be the greatest barrier) if RG fail to achieve the milestones set for progress to placement in early 1989. Assuming Mr Day honours this pledge, then the only argument for action now is the removal of one element in the legal and administrative procedures involved in completing a trade sale. This element is unlikely to add substantially to the formidable presentational problems of the trade sale route and would not create any delay since the necessary procedure could be fitted into the overall timetable (which would be governed by the need to seek EC clearance).

4. The arguments against action on the minority remain: the uncertainty of outcome; the additional Parliamentary/public exposure to discussion of Rover Group affairs; the difficulty of publicly defending the move; and the requirement to take the Courts into the Government's confidence in relation to possible privatisation plans.

Conclusion

5. There are no compelling substantive arguments for your pressing for early consideration of the minority issue. Nor is it likely that DTI or RG will be able to present a stronger case for early action at the Ministerial meeting at the end of January. Although it remains the case that we prefer, where there is a choice, for costs to be in 1987-88, the sums at stake are just not significant enough to tip the balance of argument in favour of seeking to settle the minority issue this financial year. If you agree, I would, therefore, propose to tell DTI that you do not wish to press for any immediate action in relation to the minority.

M A WALLER

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Annex

ROVER GROUP: ELIMINATION OF MINORITY SHAREHOLDERS

Summary

This note describes the form of, and issues arising from, a scheme of arrangement designed to buy out the remaining 63,000 Rover Group (RG) minority shareholders. The current share price is 75p. At the premium recommended by DTI's financial advisers (35-45%), the cost to the Exchequer would be around £13m. This could rise to some £17m if it was decided that there should also be a substantial premium on the highest RG share price achieved this year (103p). **For the money to be paid and in 1987-88 a decision to proceed with the scheme would be required no later than 26 January.**

BACKGROUND

2. The proposed Scheme of Arrangement would be under Section 425 of the 1985 Companies Act. It would involve HMG offering to buy out the minority: in order to become binding on all shareholders the scheme would have to be approved by a majority of 75% by value of their shares amongst the minority shareholders voting in person or by proxy at an EGM to consider the scheme. (HMG would be legally prevented from voting its shareholdings). If approved by the required percentage of shares, the scheme would then need to be sanctioned by the courts, after which the remaining minority shares would be purchased by HMG and RG shares would then be delisted.

3. In order to ensure a high probability of success, the offer price would need to be set at a significant premium to the current market price of RG shares. In early October, Barings, DTI's financial advisers, recommended a premium of 35-45% on the then price of 90p - a total cost of £17m. On the current share price of around 75p the total cost with a similar premium could be some £13m; but Barings may well argue the need to go for the higher figure to ensure it is well clear of the highest RG share price achieved this year (103p).

RATIONALE

4. RG's and the Secretary of State's recently stated reasons for wishing to buy out the minority now are different and difficult to present publicly. RG's reasons are:

(i) to eliminate the abnormal speculative market in RG shares which bears no resemblance to underlying net asset value - a move which would be welcomed by the Stock Exchange;

(ii) to respond to the desire of some shareholders who wish to extract themselves from this anomolous minority position at a more attractive price;

(iii) to avoid continued voicing of critical views by some of the minority which is claimed to injure RG's reputation.

(iv) to avoid the need to consult a minority of the shareholders on major asset disposals.

5. Lord Young's main motive has been the need to prevent the RG Board deploying the argument that possible Government privatisation plans for the Group, to which the Board were opposed, were not in the interests of all the shareholders, including the minority. The previous RG Board used this as a delaying tactic in respect of the Unipart disposal. In the past Day has indicated he might well do so if faced with the prospect of separate disposal of Land Rover and/or sale of the group to Ford.

ASSESSMENT

6. There are two key issues here: what the Government is buying for its money, and whether the proposed Scheme of Arrangement is reasonably assured of success.

What the Money will Bring

7. It would remove a procedural barrier to the Government pursuing privatisation options unwelcome to Mr Day and the RG Board, an argument which they have deployed before. And, even in the absence of such opposition, it would ease the process of a trade sale by lessening the number of procedural steps required. (Elimination now is not necessary under Mr Day's prefered placement option.)

8. On the other hand, a scheme:

(i) sits slightly oddly with plans to privatise the company;

(ii) could invite criticism that the Government has something to hide, and at a time when it is pressing for generally greater transparency in company dealings;

(iii) may require a confidential approach by HMG to the Courts to seek the Court's agreement to non-disclosure of e.g. talks with VW or Ford (see 14 below);

(iv) might lead to criticism of sharp practice if RG were to fail to achieve an early milestone so that a trade sale took place quite shortly after the Scheme went through;

(v) could fail; and

(vi) does not address the real presentational problem of Day/RG Board opposition to a trade sale.

Chances of Scheme Acceptance

9. A very important factor affecting the likely response by the minority and the Courts to the Scheme is the premium being offered over the prevailing share price. The premium proposed by Barings reflects their judgement of the figure which is necessary both to achieve success - taking account of an analysis of recent minority buyouts - and to provide a reasonable defence against the accusation that the premium is over-generous and therefore a waste of public money.

10. RG have not yet been consulted on the premium but would no doubt press for a high figure, given that they are not footing the bill (we examined at an early stage whether RG could be made to meet the costs of the exercise but this was ruled out on legal grounds). It will also be necessary for an independent adviser to be appointed to advise the minority on whether the offer is a fair one in the light of the current and prospective trading prospects for RG. But, as the current net asset value of the shares is around 16p, at a time when the Group is still reporting losses before tax, it must be very unlikely that a 35-45% premium over the current share price would not be deemed to be a fair offer.

11. However, even with a generous offer success cannot be guaranteed. The sentimental/emotional attachment of <u>some</u> minority holders clearly does take precedence over strict financial considerations. On the basis of rational financial appraisal, shareholders might well have sold up when the share price touched 103p

earlier this year (though the rumours of a Government buy out offer, coupled with speculation about flotation of the whole Group within the next 3/4 years, would have pulled the other way).

12. It is thus very difficult to come to any firm view on the prospects for success. As the attached analysis of RG minority shareholdings shows (see Appendix), 99% of individual shareholders with holdings of 2,000 shares or less own 54% of the traceable shares. 22% of the traceable shares are in holdings of 200 or less. By contrast some 26% of the total minority shareholding is owned by just 80 holders with holdings in excess of 10,000 shares, with over half this latter group being accounted for by just 12 shareholdings of 50,000 shares or more (nearly all of which are corporate holdings). Virtually all of the larger shareholders could be expected to vote in favour of the Scheme of Arrangement but, given the preponderance in total shareholdings of small shareholders, it is their voting intentions which are likely to be crucial.

13. Another key aspect of this issue is the attitude of the Court to the Scheme of Arrangement. An important point here is the need for disclosure of the Government's possible plans for disposal of the remaining RG companies. In seeking approval for the scheme from the Courts, RG and the Government would need to assure the Court that there was appropriate disclosure during the passage of the Scheme of Arrangement (February-March) of exchanges related to the disposal of RG's assets. Such exchanges might be regarded by the Court as material to the interests of the minority shareholders, since they could result in an improvement in the balance sheet of a company in which the minority shareholders were deciding whether or not to sell their equity stakes. While it would be possible to argue that, at the premium being offered, any possible disposal was immaterial to the position of the minority shareholders, Counsel's strong advice is that the Government should disclose this potential problem to the Court and seek approval, if necessary, for non-disclosure of information to the minority. This could be done by means of a confidential application by the Secretary of State in camera to the Court. If the Court officials were satisfied that exchanges were not material and need not be disclosed, they could issue directions to that effect. There are, therefore, acceptable legal procedures which could be deployed to meet this problem, assuming the Government were actually considering a sale to third parties over the period in question. (In the unlikely event that the Court ruled that the talks were material, the Government would be faced with the choice of revealing them or withdrawing the offer with all the attendant publicity that would entail.)

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Appendix

ROVER GROUP: ANALYSIS OF MINORITY SHAREHOLDINGS

Range	NON-GOVERNMENT TRACEABLE				NON-GOVERNMENT UNTRACEABLES	
	Holders		Shares		Holders	Shares
	Number	(%)	000s	(%)	(number)	(000s)
1-500	47184	(94)	3887.7	(32)	10269	607.6
501-2000	2494	(5)	2669.2	(22)	133	127.2
2001-5000	409	(1)	1407.9	(12)	15	43.3
5001-10,000	122	(")	977.5	(8)	-	-
10,000-49,991	68	(")	1324.1	(11)	-	-
50,000+	12	(")	1741.6	(15)	-	-
TOTAL	50289		12008		10417	778.1

ROVER GROUP

CH/EXCHEQUER
REC. 14 JUL 1989 ✓14/7
ACTION CST
COPIES TO

The Rover Group plc
7-10 Hobart Place
London SW1W 0HH
Telephone: 01-235 4311
Telex: 926880

13th July 1989

A.C.S. Allan Esq.,
Private Secretary to the Chancellor of the Exchequer,
H.M. Treasury,
Parliament Street,
London, SW1P 3AG.

Dear Mr. Allan

ROVER - HONDA AGREEMENT

I enclose a copy of the communication which has been distributed today throughout the Rover Group to describe the main elements of the agreement and to explain the benefits which it confers. I hope that the Chancellor of the Exchequer will find it of interest.

Yours sincerely

SIR GRAHAM DAY

ROVER GROUP

The Rover Group plc
Fletchamstead Highway
Coventry CV4 9DB
Telephone: 0203 675511
Telex: 31567

13th July 1989

NEW ROVER AND HONDA AGREEMENTS

Today we are announcing, with Honda, a significant further step in the collaboration between our two Companies, which began 10 years ago.

Up to now each project with Honda has been on a step-by-step basis with no commitment on either side to a longer term collaboration. Nevertheless it has been a unique and highly successful partnership with each programme – from the Triumph Acclaim in 1979 to the forthcoming R8 later this year – building greater trust and confidence in our ability to work together with commercial benefits on both sides.

We have now reached the point where our own plans for the future – to be an increasingly up-market, quality-orientated and successful manufacturer of distinctive products – require us to expand our investment and product programmes to meet the challenges of the motor industry in the 1990s, particularly within Europe.

In turn Honda is investing in the UK as a further extension of its worldwide business and sees Rover as its partner within the European market.

Based upon the past 10 years of successful collaboration, Rover Group and Honda are now cementing the relationship with a cross-shareholding in each other's business activities.

- Honda is to acquire a 20 per cent shareholding in Rover Group and is to set up a car manufacturing facility at its Swindon site.
- Rover is to acquire a similar shareholding in the expanded UK manufacturing operations of Honda.
- Honda will manufacture a new car range in both Rover and Honda versions which in Rover's case will be additional to the existing range.
- The Rover pressings plant at Swindon will supply panels for both Honda and Rover models to be produced at the Honda Swindon facility.
- Rover will build Honda Concertos, as previously announced, at Longbridge for Honda, alongside the forthcoming R8 car range. Engines for the Concerto and for some derivatives of the R8 will be made by Honda at Swindon.

This is an important, strategic step for both companies. For Rover, we believe it is essential we have an enduring and close partnership with Honda as part of our objective of being a strong and innovative car manufacturer. This new agreement is in addition to our own current £1 billion new model programme and will heighten our ability to compete at every level with our competitors.

There are a number of further stages to complete before these arrangements are finalised but it is expected that the deal will be concluded by the end of this year.

Sir Graham Day
Chairman

George Simpson
Managing Director