

PO-CH/NL/0178
PART A

Alex
Lawson

PART A

SECRET

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PO -CH /NL/0178



PART A

DD: 25 years

6/9/95

Begins: 28/1/88

Ends: 6/7/88 (CONTINUED)

CHANCELLOR'S 1988 PAPERS
ON THE PRIVATISATION OF
THE ROVER GROUP

NL/0178

PO -CH

PART A

6/201

I am writing with a conclusion on para 18, but a number of points (it all has to be done).

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CHANCELLOR

I am showing this to you early. Ld. Young is seeing Day tomorrow a.m. (X over). We could pass on any particular points to Ld. Young's office.

FROM: M A WALLER

DATE: 28 JANUARY 1988

cc Chief Secretary
Financial Secretary
Sir P Middleton
Mr Anson
Mr Monck
Mr Turnbull
Ms Roberts

ROVER GROUP (RG): MEETING AT NO.10 ON WEDNESDAY 3 FEBRUARY

This is a brief for next Wednesday's meeting with the Prime Minister and Lord Young to hear Graham Day's views on placement and the treatment of the minority shareholders. I am putting the briefing up well in advance of the meeting to provide early warning of the tentative and unquantified basis of the proposition which Graham Day is likely to put to Ministers on 3 February.

SUMMARY

2. There is general agreement that the 1988 RG Corporate Plan now formally presented to Government does not provide a feasible basis for placement. RG and their advisers believe that it should be possible to enhance the Group's prospective performance to make it sufficiently attractive to potential investors. But, as yet, RG have not produced hard evidence on this, nor on the possible net cost to the Government of placement. Day will be seeking Ministers agreement on Wednesday to taking out the minority shareholders (the rationale for doing so is different from that advanced before) and to continue examination of the placement option by opening discussions with a small number of key institutions. On the objective tests to be applied on the route to placement, there is a difference of view between officials and RG on the nature and definition of the tests.

3. Our recommendation is that you agree to Mr Day's request, subject to the conditions listed at the end of the brief which we designed to ensure that Ministers are kept fully informed of progress and to prevent RG bringing forward expenditure into 1988 thereby increasing the possible write off

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bill for the Government. The basic grounds for doing are essentially that it would be unreasonable and confrontational to stop further work on placement in the absence of specific evidence that it is not feasible. Overall, however, we remain sceptical about the prospects.

BACKGROUND

4. At the meeting at No. 10 on 1 December Graham Day was asked to prepare a paper and flowcharts by the end of January showing the timetable and decisions needed to achieve a successful placement. The route to placement was to be punctuated by objective tests of progress to avoid drift and to enable a swift transition to the trade sale route if placement went off course. (A record of the discussion is at Flag A - top copy only.)

X / 5. As of today, I understand that the paper Day intends to submit will amount to not much more than one page, supported by a proposed list of hurdles and key dates. This may change after Lord Young sees Day tomorrow morning to review the position reached at official level. Subject to the outcome of that meeting Lord Young will minute the PM and you giving his view on progress to date and the case for continuing with the placement option.

6. The timing of the meeting allows for half an hour discussion of issues by Ministers before Day's presentation. The discussion is likely to be focussed on the following issues:

- i. Plans for placement
- ii. Tests and review points
- iii. 1988 Corporate Plan
- iv. Minority shareholders.

ISSUES

i. Placement Plans

7. RG, advised by Schroder Wagg and Price Waterhouse, have established a critical path - summarised at Flag B - to a final decision to proceed

with placement in October 1988, with the placement no later than end March 1989. As of now Day and his advisers cannot say a placement will be feasible: only that so far this cannot be ruled out.

8. The critical path assumes the need to convince investors in the development capital market that flotation of RG shares will be possible in 1991/92 yielding an annual return to investors of some 40% (high risk investments in this specialist market need to offer at least some 35% per annum to attract capital). They believe the forecast financial performance necessary to make the story credible is a path leading to PBIT in 1992 of some £250m. (This compares with a 1988 Corporate Plan forecast for PBIT of £143 million in 1992.) RG believe they have identified potential profit improvements which could achieve the 1992 target figure but which still leave performance well short of required performance in the earlier years (see Flag C). So far RG have been unwilling to indicate clearly how these improvements might be achieved.

9. The intention of the Government side was to be in a position by end January to advise Ministers in a preliminary way whether the RG placement story would be credible to institutions. Barings' advice, with which we agree, is that there is insufficient information available at this stage to advise one way or the other. RG fully recognise the need for a credible story - covering financial data, product plans and management - to tell the institution. But RG plans to give substance to a credible story will not be available until late February/early March. And RG do not envisage being in a position to advise on the cost to the Government of this disposal route until May. Given the likely scale of the cost and the political exposure involved, I suggest you should press Day for some clearer indication of his profit improvement plans (eg, might it include inextricably merging AR and LR).

ii. Tests and Review Points

10. There is a difference of view of the "tests" which should be applied to ensure that, once launched down what looks like a reasonably credible placement route, RG's performance in 1988 is consistent with achieving placement in early 1989. RG do not believe that it is possible to measure progress to placement purely on the basis of financial performance. They argue that the financial parameters for 1988 consistent with progress towards placement are likely to cover a wide range: what matters is the overall

story the Group has to tell. (RG have also been wary of being tied to a set of specific tests where a marginal failure in one area only could cause the Government to abort the placement option.) They have, therefore, tabled a list of "hurdles" which primarily relate to actions/reactions, rather than financial/product performance (Flag D).

11. Barings generally accept the RG analysis. But we have argued that this needs to be married to some quantitative measures for 1988 which can act as a reasonable indicator of consistency with the placement plan viz:

- cashflow against plan

- PBIT (actual for H1 and forecast full year)

- market performance

- progress in product development relative to capital expenditure.

In the absence of profit improvement plans (which in any case are not likely to impact significantly on 1988) we would propose using the 1988 Corporate Plan figures for these items.

12. We would not recommend that failure to achieve planned numbers would automatically trigger a trade sale. To that extent we would accept the RG/Baring view that it is the picture as a whole that counts. Instead this would prompt a review by Ministers of overall progress with placement plans. RG appear reluctantly ready to accept this.

iii. Corporate Plan

13. A note on the key issues in the 1988 Corporate Plan is at Flag E. For the reasons outlined above (paragraphs 6-7) the 1988 Corporate Plan is largely academic. You will wish to note, however, that:

- borrowings over the plan period increase from £695m in 1988 to £1109m in 1992.

- capital expenditure in AR is up by £65m on the 1987 Plan;

- total Varley Marshall liabilities are forecast to increase from £1300m in 1988 to £2129 million in 1992;

- cashflow remains negative over the plan period;

- RG's intentions to stay in the small car market have firmed up, as has its "Roverisation" strategy. ¶ On the assumption that RG will be moved into private ownership over the next 12-15 months we see no basis for objecting to this Plan. If this condition were not fulfilled, however, the Government would need to revisit the strategic issues to minimise its exposure..

iv. Minority Shareholders

14. RG and their advisers have produced new arguments which point unambiguously to the need to take out the minority before substantive approaches are made to institutional investors. The arguments, which are discussed in more detail at Flag F, relate essentially to the need to avoid running foul of disclosure provisions of the Stock Exchange listing requirements. In order to meet RG's placement timetable it would be necessary to announce a Scheme of Arrangement by end-February at the latest.

15. RG now regard removal of the minority as an essential prerequisite of placement (they list it as the first of their "hurdles"). The overall arguments for prior removal seem quite compelling. DTI and Barings accept they are generally valid, as do No. 10 Policy Unit (who are likely to brief the PM accordingly). But this does involve some considerable risk:

- the announcement of the Scheme, which will have to include mention of the intention to privatise RG, will raise the profile of the Government's privatisation plans before we have any basis for judging whether RG is placeable. (Removing the minority would also probably be a necessary step to facilitate a trade sale but not in the same timescale.)

- there is a real risk that the Scheme will not be accepted by the necessary 75% of those voting. If it failed it would be open to RG to stand in the market for a period and then to delist. But in the meantime both the attractiveness to the institutions of and timetable for placement will have been compromised.

- presentationally, removing private shareholders as a logical step to privatisation looks perverse and will prompt detailed questioning/speculation about the Government's and RG's intentions.

DISCUSSION

16. There are several areas of crucial concern to the Treasury:

i. Whether placement is feasible.

On the basis of work so far it is impossible to make an assessment. This will only become clearer after the completion of the profit improvement exercise and the initial soundings with institutions. Day's record to date in disposing of loss-making business and in turning RG round has been impressive. And there are indications that Honda are now seriously interested in a 15-20% stake which should be a positive factor from the institution's point of view. But there can be no certainty that it can be placed successfully. There must be limits to how far profits and cashflow can be improved in the timescale required. This point to Barings being present as observers at negotiating sessions with the institutions as a cross check on both institutional reactions (and on RG's willingness to volunteer HMG to meet higher write off costs). In any case the success or failure of placement will be as much a matter of prevailing market sentiment and conditions at the time of the placement.

ii. The nature, amount and timing of the public expenditure costs.

As yet have no firm indication of the amount at stake but it is unlikely to be much under the earlier estimates (ie, £³/₄-1 billion), covering not only retirement of borrowing and restructuring but also perhaps some contribution to working capital. On timing, the intention remains to place no later than end March 1989 and preferably as close as possible to the final decision point in mid-October so that all the expenditure is likely to fall in 1988-89. In the absence of any firm indication of the structure of the placement and the make up of the Government contribution it is difficult to be categorical about the incidence of payments but the scope for spreading any expenditure into later years now seems very limited. RG's advisers consider that the Government should be seen to make a clean break with the Company which argues for a one-off payment rather than phased injections.

The January economic forecast recently submitted to Ministers projects an outturn for the planning total in 1988-89 £1.1 billion above the

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White Paper plans. This does not include any identifiable allowance for an item as large as a Rover debt restructuring. Although, as the experience of this year indicates, the planning total for a year ahead can be undershot as well as overshoot, there are a number of areas where large claims on the Reserve seem unavoidable, eg, local authority current expenditure (where a much larger claim than this year is expected), health, EC contributions and use by MOD of its 'EYF' carry over. Thus GEP's expectation is that the Reserve will be under greater pressure next year than it was this.

The only way to ensure the bulk of expenditure fell outside 1988-89 would be to delay placement until after 1 April 1989. On balance, we would recommend against this: this might well lead to higher costs; and the window of opportunity for a successful placement is likely to be very narrow. This argues for pressing ahead as quickly as possible.

iii. Defensibility of price received for shares

Again we have no firm information on this but RG documents have mentioned a figure of up to £300 million. (This is broadly consistent with the likely nominal value of the shares once RG carry out the reduction of capital exercise to remove accumulated losses on their P and L account necessary to enable them to pay dividends.) A key area of vulnerability in relation to defence of the terms to the PAC here is the attitude of Ford who could announce publicly that they would be willing to pay more (probable since they would presumably pay a premium for 100% control and market share), even perhaps backing this up with a dawn raid after placement. (A Honda stake could act as a deterrent but if the raid was successful LR would then pass into foreign ownership.) Unless HMG were prepared to institute takeover protection (which we do not recommend), rebuttal ^{of the criticism} would essentially have to rest on the desire to maintain RG as an independent company with a wide spread of shareholders. Again, however, this argues for the Government's financial advisers being present at negotiations with the institutions.

iv. The value for money offered by the minority shareholders buyout

If placement on the lines suggested by RG is to proceed then taking

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out the minority now looks to be an essential first step. (Depending on the premium offered the total cost might be £12-15 million). But given the greater degree of political exposure on the privatisation issue this will generate, Ministers may wish to consider carefully how this will be presented to Parliament before giving the green light.

v. Tests/Review Points

There are no quantitative tests which provide an unambiguous measure of whether RG is on course for placement. What is required, however, is a set of tests and review points which will trigger consideration of alternative options as we move through 1988. Some of the hurdles suggested by RG are very subjective (eg, institutional reactions, hence the need for some independent check on reactions): others eg, half year PBIT results provide a useful quantitative check. If these can be linked with cashflow and product development/capital expenditure, with agreed review points in April, July and September, this should provide a reasonable basis for Ministers to monitor progress.

vi. Borrowings/Contingent liabilities

Given that the Government will be retiring RG's debts as part of placement, there will be a temptation for the company to bring forward capital expenditure and borrowing into 1988. This underlines the need to maintain a tight cap on borrowing. Since the profit improvement plans may increase borrowings in 1988 compared to the Corporate Plan, I suggest you press for the 1988 borrowing objective to be set at the 1988 Corporate Plan figure of £765 million (some £145 million lower than the indicative 1987 Plan figure for 1988).

CONCLUSION

17. The plans being brought forward by Graham Day contain a lot of gaps on key elements of the placement proposal. We have no basis on which to judge whether the placement will prove feasible and at what cost to the Exchequer. But placement cannot be ruled out. (A crucial element in this will be Honda's attitude). And Day is heavily committed to taking this forward and sees the minority action as the crucial first step, even though this opens up the privatisation to Parliamentary/public debate in a fairly explicit way. You will want to consider the political/presentational aspects

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of this carefully and to judge the future risks against the need to keep Day on side to maintain the credibility of RG's business and to keep his commitment to the alternative trade sale route should placement be shown to be impossible.

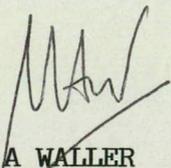
18. Given the Government's political and financial exposure I suggest you might want to make agreement to Day's taking the placement work forward subject to the following conditions:

i. Barings being present as observers at RG/advisers discussions with the institutions;

ii. examination of the wording of the Parliamentary statement and the circular to shareholders announcing the scheme of arrangement for the minority;

iii. achievement of the hurdles proposed by RG and monitoring cashflow and product development as set out in the 1988 Corporate Plan.

iv. 1988 borrowings to be contained within the end year figure set out in the 1988 Corporate Plan.


M A WALLER



SECRET

H/EXCHEQUER ANNEX A

C2/5/10

Mr Waller

CST
Sir P Middleton

Mr Anson

Mr Bugner

Mrs Lamax

10 DOWNING STREET

LONDON SW1A 2AA

From the Private Secretary

1 December 1987

ROVER GROUP PRIVATISATION

The Prime Minister this morning met Mr. Graham Day, Chairman of the Rover Group to discuss the prospects for privatisation. The Chancellor of the Exchequer, the Secretary of State for Trade and Industry and Mr. George Guise, No. 10 Policy Unit were present.

This letter records the discussion which took place before Mr. Day arrived.

Your Secretary of State said that performance this year had exceeded the corporate plan. Credit should be given to Graham Day for his achievement. Day now accepted that there was no possibility of flotation in the near future and the choice therefore lay between a trade sale and a placement. Volkswagen had been informed that there was no possibility of them acquiring Land Rover but they remained moderately interested in acquiring Austin Rover. There were, however, doubts that a deal would be achievable against union opposition in Germany. Ford were also still interested in acquiring Austin Rover but a deal with them would be impossible unless it were supported by Graham Day. Your Secretary of State said his preferred alternative would be to allow Graham Day to work towards a placement but to set in January a series of objective tests which would have to be passed along the road. If even one of them could not be met this would trigger a decision to proceed to a trade sale. Honda would take a stake in ARG as part of a placement. It would take the strong support of the Prime Minister to persuade Graham Day to settle for a sale to Ford. On a separate issue, British Aerospace were now interested in purchasing Land Rover if it became available. This would have the advantage that the permanent golden share in BAe would also protect the Land Rover business.

The Chancellor of the Exchequer said his preference would be to go ahead in January with a trade sale to Ford, both on political grounds and because the timing would fit more easily with the pattern of the public finances. If a trade sale were

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to go ahead, it would be important to consider Graham Day's own future. Lord Young's proposal would be a second best solution. The cost would fall in 1988/89 and the delay could jeopardise the prospects for a sale.

The Prime Minister expressed great scepticism about the likelihood of a successful placement within the timescale envisaged. However, in view of the other major changes now being sought by the Government, in steel, in shipbuilding and elsewhere, the sale of ARG to Ford, even without Land Rover, could not at present be contemplated. She therefore accepted that the route towards a placement should now be discussed with Graham Day. It would be most important to secure firm undertakings.

I am recording separately the discussion with Graham Day himself. You may wish to show the record to him as a means of ensuring that he fully understands the conditions on which the placement route would be followed.

I am copying this letter to Jonathan Taylor (HM Treasury).

(D.R. NORGROVE)

Jeremy Godfrey, Esq.,
Department of Trade and Industry.



10 DOWNING STREET

LONDON SW1A 2AA

From the Private Secretary

1 December 1987

Dear Jeremy,

ROVER GROUP PRIVATISATION

The Prime Minister this morning met Mr. Graham Day, Chairman of the Rover Group, to discuss the prospects for privatisation. The Chancellor of the Exchequer, the Secretary of State for Trade and Industry and Mr. George Guise, No. 10 Policy Unit were present.

In response to a question from the Prime Minister Mr. Day explained that he was not immediately concerned about the strength of sterling against the dollar and the possibility of slower growth in the United States. Only 3% of ARG production was committed to the United States and 80% of the company's dollar exposure next year had been covered forward. ARG would be more affected by damage to consumer confidence in the UK. The meeting then discussed the options for privatisation.

Day said he had explained to Volkswagen that it would not be open for them to bid for Land Rover. Management at the most senior level was still inclined nevertheless to try to make an offer. At a lower level VW management continued to see some possibility of buying ARG without Land Rover. On the other hand VW had its own difficulties in the United States, Brazil and in Europe itself, and the two-tier board structure would certainly cause difficulties and delays in negotiating a sale. Ford was the only obvious possible buyer. It had the cash, the company saw itself as a world class player in the next century, there was no two-tier board structure and the purchase of ARG would give access to the Rover and MG brand names. There would however be difficulty in carrying the deal through, particularly in that any uncertainty would damage ARG in the market place. It might be possible to allow an arbitrator to settle the details of the deal once it had been agreed in principle. However there might still be difficulties with the European Commission, the House of Commons, dealers, component suppliers and others. The DAF deal for example had taken seven months to negotiate. Day explained that in his view Ford would remain interested in buying ARG for some time to come. Were they to buy ARG they would probably continue the closure programme envisaged by the present ARG management.

Continuing, Day said he would like to be given the opportunity to explore the possibilities for a placement,

which would of course include Land Rover. Shares might be taken by dealers and by employees. The aim would be to produce by the end of January, with the help of Schroder Wagg, a flow chart showing the timetable and decisions needed to achieve a successful placement. It should be known by September or October whether a placement could be achieved. At various times before then decision points would be reached and at those times it would be possible to decide that a placement was not feasible. The options for a trade sale would then have to be pursued. ("We would have to bite the other bullet".) The placement might be implemented in January or February 1989 if its feasibility had been proved in the autumn. A successful placement might require profits before interest and tax of some £35-40 million next year. Institutions taking shares would probably look to float the company around five years later.

The question of price would need to be addressed. Debt owed to banks under the Varley Marshall assurances would need to be written off and Day said that some part of the Varley Marshall assurances relating to trade creditors and leasing would also need to be written off as a way of pre-funding part of the capital expenditure which would be incurred in later years. During the course of next year discussions with Honda would continue, aimed at bringing Honda to a point where they could decide whether they were willing to take a 20% stake in ARG at the time of the placement. It would be important to avoid any moral commitment to Honda until the end of the process in order not to create difficulties for a trade sale if that were to become the preferred course. There was no possibility of Honda being willing to buy the whole company. Day felt that any solution would require the minority shareholders to be bought out, and this should be completed before the Government and the company became committed to any particular course of action.

The Chancellor of the Exchequer said that the proposed flow chart would need to be full and precise, and the tests objective. There should not be scope for drift. The Treasury would wish to discuss with the DTI ways of spreading the costs between 1988/89 and 1989/90. It would help discussions with the European Commission if the shares were to be placed with European institutions. Lord Young said that it would not be right to place shares with Japanese institutions.

Concluding the meeting the Prime Minister invited Graham Day to prepare a paper and flowcharts for discussion at a meeting in January. She emphasised that she was herself dubious about the prospects for a successful placement. The meeting in January would also need to consider the question of buying out the minority shareholders.

I am copying this letter to Jonathan Taylor
(H M Treasury).

David

DAVID NORRGROVE

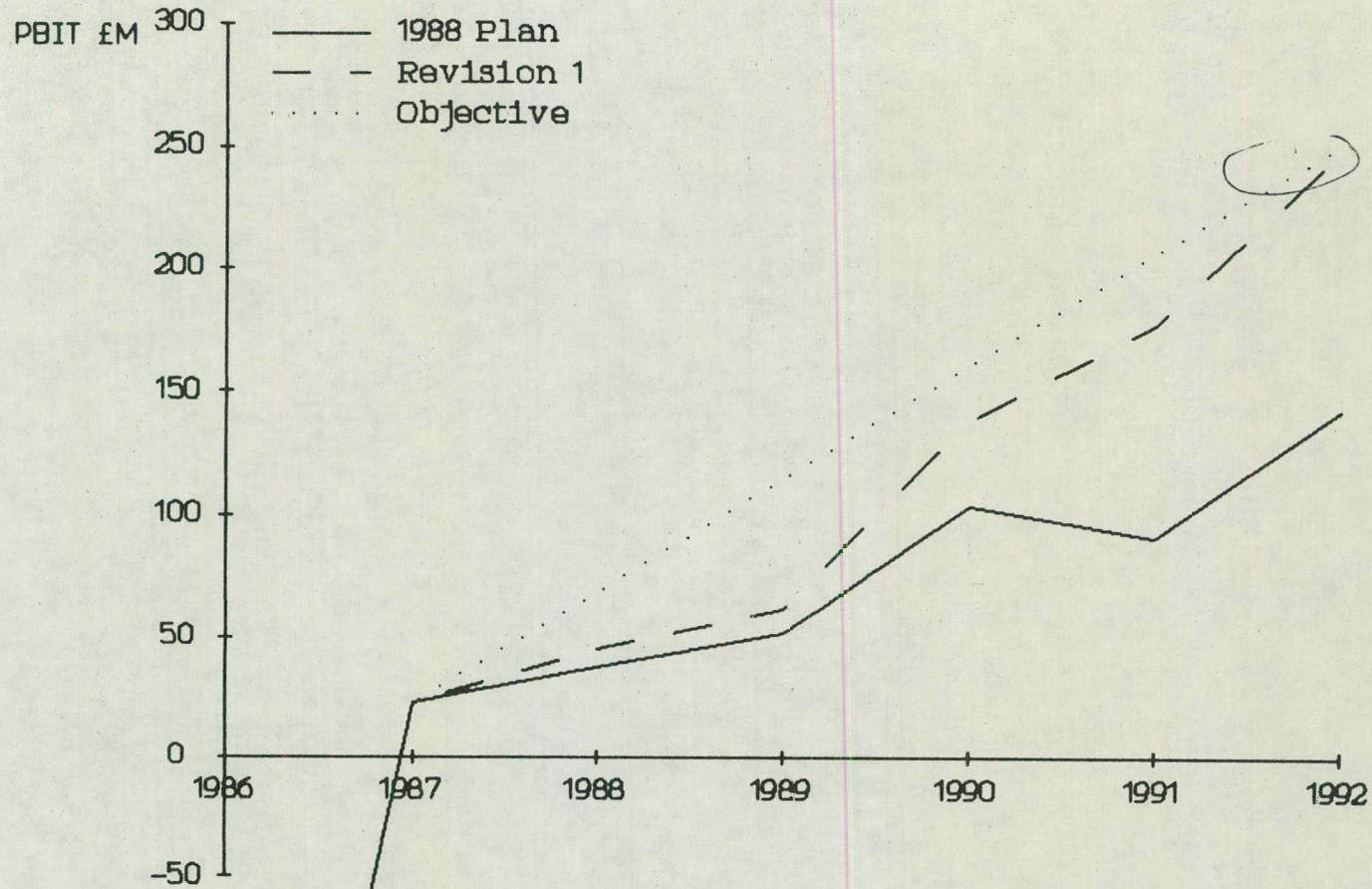
Jeremy Godfrey, Esq.,
Department of Trade and Industry

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RG PLACEMENT TIMETABLE

- Mid/end February, for announcement of Scheme of Arrangement for the minority.
- End February, for completion of profit improvement plans.
- March 15, for completion of a Preliminary Information Memorandum containing firm (but unaudited) financial projections.
- April 15, by which time initial soundings of a very limited number of key financial institutions will have taken place and the financial projections will have been reviewed by reporting accountants.
- End April, minority removed.
- April 30, for completion of the Main Information Memorandum which will be sent to the full range of potential investors.
- July 31, Honda to give a firm indication of their attitude to taking a shareholding.
- October 15, a firm decision to move towards completing the placing will be required of Government.

ROVER GROUP



1988 Plan	-350	23	38	52	104	91	143
Revision 1	-350	23	45	62	139	177	250
Revision 2							
Revision 3							
Revision 4							
Objective	-350	23	69	115	161	207	252

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RG PROPOSALS ON PLACEMENT HURDLES IN 1988

- | | <u>End of</u> |
|---|---------------|
| 1. Action taken to eliminate RG minority shareholders. | (February) |
| 2. Initial contacts with investors positive. | (April) |
| 3. Indicative terms of financial support required from Government acceptable to Government. | (May) |
| 4. Honda commitment. | (July) |
| 5. Achievement of half year results. | (August) |
| 6. August trading. | (September) |
| 7. EC consent to state aid to RG. | (October) |

SUMMARY OF 1988 CORPORATE PLAN

The 1988 Corporate Plan sets out the Group's business strategy and expected financial performance over the 5 years 1988-92. No account was taken of any possible privatisation options.

2. The plan's stated business objectives are to "achieve, sustain and improve positive cashflows and profitability leading to financial self-sufficiency". Certainly the Group's financial position has improved markedly in the last 12 months. Final figures are not yet available; but on the basis of the November forecast, Rover will have made an operating profit of just over £14 million in 1987 compared with a loss of £241 million in 1986. There are similar improvements at the pre-interest and net levels; and although cashflow will have been negative (to the tune of some £176 million), this is still a substantial reduction from 1986's outflow of £345 million.

3. Yet despite this improved performance, and further improvements expected over the next five years, it is highly unlikely that Rover will any nearer achieving its stated objective of financial self-sufficiency by 1992. The table below shows that over the plan period, the Group generates barely enough profit to be able to fund its capital expenditure programme, and that it is cash negative on its operations when restructuring costs are included. And this is before interest is taken into account, thereby showing that Rover's problems lie deeper than that caused by the burden of debt arising from past accumulated losses.

<u>£m</u>	<u>CUMULATIVE CASHFLOW 1988-92</u>
Operating Profit	358.8
Depreciation	788.2
Working Capital, Other	69.8

Cashflow From Own Resources	1,216.8
Capital Expenditure	(1,212.8)
Restructuring Costs	(181.0)

Net Operational Cashflow	(177.0)
Interest	(528.1)

Net Cashflow	(705.1)

4. Moreover, it should be stressed that these figures are themselves conditional upon the Group's overcoming substantial business risks; they are by no means a worst-case scenario. Quite apart from the usual external factors such as overall demand and exchange rate fluctuations, those risks include, on the cars business, the planned move upmarket through new model development and "Roverisation" of the company's image and products; the reliance on outside suppliers (notably Honda) for much of its engineering and technology, particularly engines; and the management of the rundown in production capacity through the closure of Cowley South. In Land Rover, there is the introduction of the new Jay product, which will give LR an entree into the growing personal transport sector of the 4x4 market, but will also expose the company to that sector's severe competitive pressures.

ELIMINATION OF MINORITY SHAREHOLDERS**Summary**

1. There is general agreement that removal of the minority shareholders by purchasing a sufficient portion of their shares is a necessary step for any route to privatisation. The issue for consideration is therefore when this should take place. An early Scheme would minimise disclosure problems, would give support to RG in seeking privatisation but would not allow the costs of £12-15m to be met this financial year. We recommend you support a decision to proceed with a Scheme of Arrangement.

Background

2. Rover Group view the removal of the minority shareholders as a first step (hurdle) to placement. This was first discussed in the context of the Leyland Trucks disposal in early 1987, and proposed again in the context of a trade sale last September.

3. The minority shareholders number 63,000 and represent about 0.2% of the company's equity. The current market value of their stake is about £9m.

Mechanism

4. HMG would offer to buy shares of the minority under a Scheme of Arrangement (under Section 425 of the 1985 Companies Act). If the Scheme achieved a majority by number representing 75% by value of the shares of those voting on it, and was then approved by the Court, it would become binding on all the minority shareholders. A premium price of 30-40% would probably be needed (on bankers' advice), representing a total cost of approximately £12m, assuming the present share price.

4. A timetable for such a Scheme would be 2-3 months depending on whether objections were made to the Court by shareholders. The quickest timetable, if Ministers agreed to the Scheme immediately would be an announcement in mid-February, with a document on ^{the} Scheme produced by mid-March leading to Court clearance by the end of April. The costs would be met by HMG via ^{the} Summer Supplementary and interim funding from Consolidated Fund. It is too late to secure payment in this financial year without paying in advance of need.

Arguments for Immediate Scheme

5. General: removal of minority would reduce potential obstacles to either a placement or a trade sale route to privatisation. It removes a potentially vocal challenge to the RG Board in pursuing privatisation options. The previous removal of the minority would greatly ease the confidentiality pressures on a trade sale.

6. Placement: shares are presently listed: Stock Exchange regulations on information disclosure make it difficult confidentially to discuss a placement with a small group of potential investors as the present plans for placement envisage. Delisting in isolation would be oppressive to the minority. Rover Group argue that the removal of the minority constitutes the first hurdle along a path to privatisation by placement and ultimately flotation. RG's advisers also argue that the potential investors would find the prospect of a continuing minority shareholding unattractive.

7. Provisions in the Companies Acts restrict the ability of investors to change RG's structure, for example, a capital reduction to take care of RG's accumulated debt is needed before the company is eligible to pay out dividend: potential investors will require this.

Arguments Against Immediate Scheme

8. There is no technical argument for the removal of minorities, or any particular reason why it should be the first step on the privatisation route. Rover Group are very keen for this to be implemented so to concede it reduces HMG levers on RG to, for example, quantify their plans.

9. There is a difficulty ~~over~~ presentation to the Court. A statement should place the Scheme within the overall context of a path to privatisation without being specific about the route to be used or other parties involved. This will require careful drafting to avert stirring up too much interest by the media and Parliament.

10. The scheme might fail because insufficient shareholders accepted the offer. In which case a compulsory delisting of shares would be needed and this possibility will need to be signalled in the Scheme of Arrangement document.

Conclusion

Recommend approval for an immediate Scheme of Arrangement for the removal of the minorities since this will facilitate any privatisation route. On timing, agreement to an immediate scheme allows implementation well before the expected placement decision date of October and therefore limits disclosure to the Courts.

SECRET
COMMERCIAL IN CONFIDENCE

FROM: M A WALLER

DATE: 2 February 1988

CHANCELLOR

cc. Chief Secretary
Financial Secretary
Sir P Middleton
Mr Anson
Mr Burgner
Ms Roberts

ROVER GROUP: MINUTE FROM LORD YOUNG

As foreshadowed in my minute of 28 January, Lord Young has now minuted the Prime Minister and yourself, following his discussion on Friday with Graham Day. The general tenor and content of Lord Young's minute is helpful to your concerns in relation to controlling the Government's exposure and obtaining the best deal possible for the taxpayer. Thus Lord Young highlights the rapidly increasing Varley Marshall liabilities (which partially reflects the changed assumption about LR disposal), signalling the need for major surgery to the business if disposal does not take place (paragraph 2); he proposes the establishment of borrowing objectives for RG (paragraph 2); and he proposes that Barings should be directly associated with the discussions with institutions (paragraph 7), though you will wish to emphasise that you see this as a continuing role for Barings throughout the path to placement.

Hurdles/Targets

2. As indicated in Mr Taylor's minute, you will wish to press for greater clarity and objectivity about the scope and meaning of the hurdles than is evident from paragraph 3 of Lord Young's minute. At present there is very considerable ambiguity about RG's hurdles (no doubt deliberately so in order to give RG maximum room for manoeuvre). Item 1 (minorities) relates to a Government decision to agree to action being taken to eliminate the minority. But if Ministers agree that the action should be launched then it is the vote on the scheme of arrangement (due April) which is the real hurdle, rather than the Government decision since a negative vote would seriously, if not mortally, damage the prospects for placement. There is a similar ambiguity about the Honda hurdle. RG do not necessarily accept that failure by Honda to take an equity stake would be vital to the prospects of a successful placement. But Barings believe that such a stake

is most certainly going to be a critical factor in convincing the institutions of the placement's attractiveness. You should press Day to remove these ambiguities and so avoid the danger of drift.

3. As far as quantified objectives are concerned RG are suggesting achievement of half year results and August trading (again meaning unspecified but presumably PBIT and market share/unit sales respectively). RG have yet to provide a calendarised budget so that we have no idea what figures they have in mind but it will be very helpful to officials' discussions with RG if Ministers made clear to Day that these figures must be realistic and testing targets. Moreover, by themselves they are not an adequate measure of RG's performance during 1988. You will therefore want to press for quantified targets for not only PBIT but also cash flow and capital expenditure/product development achieved against budget to ensure greater objectivity of the tests.

4. In his minute Lord Young says that he has told ~~that~~ Graham Day that failure at any of the hurdles listed in Day's letter would automatically precipitate a trade sale. This may be tactically right in order to cement in place Graham Day's moral commitment to the alternative route if placement looks impossible. (Failure to secure the minority buyout and a Honda commit are critical points and, self-evidently a wholly negative reaction from the institutions would constitute the end of the placement proposal.) But, as I indicated in my earlier minute, there may be a fairly wide range of results for quantitative measures (such as half year PBIT and August market share) which would remain compatible with a placement. In the discussion prior to Day's arrival you may therefore want to clarify with the Prime Minister and Lord Young whether any failure to achieve quantitative targets should precipitate an immediate move to a trade sale or a review of progress/options.

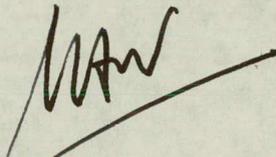
No.10 Policy Unit

5. I understand that the Policy Unit are likely to provide briefing for the Prime Minister which is quite hostile to and critical of the unquantified and uncertain nature of the Day proposition. In doing so they have been influenced by a generally favourable impression of LR and the worry that a key feature of RG's profit improvement programme may be the operational merger of LR and AR to the detriment of the former in terms of its attractiveness and suitability to be sold off as a separate business. This concern may well be justified, though we have registered with RG that their plans must not foreclose or prejudice the trade sale option, (i.e. such a merger must not take place until after placement).

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This underlines the need for Ministers to press Day hard on his emerging thinking about how and over what timescale he intends to raise the Group's performance to the level necessary to make it an attractive placement/flotation prospect.

In addition to the AR/LR merger, RG have indicated to officials that possible options are bringing forward by 2 years the introduction of the Montego replacement (R9), continuation of the pensions contribution holiday and taster price increases. While these may improve financial performance it is questionable whether they will convince hard headed institutional investors that management has in place a robust plan for improving the fundamental operating performance of the Group.



M A WALLER

We examined this item with 47 in the context of the Trucks deal. The clear conclusion was that Brussels would want to open a procedure to determine whether and how such a quasi-covered bank loan should be treated in relation to state aid rules. As its

CONFIDENTIAL

- 1. MR WALLER
 Roberts says, this would bring Varley Marshall capital stage which would be a very unwise development. And unless the procedure was closed it could not make use of the bank money. "Parting" it is a trust account would be very much a temporary expedient.
- 2. PS/CHANCELLOR
 to carry over the odd work or two before EC approval: not really appropriate in the case

FROM : HM ROBERTS
 DATE : 16 / 2 / 88
 cc PS/Chief Secretary
 Sir P Middleton
 Mr Anson
 Mr Monck
 Mr Burgner
 Mr Turnbull
 Mr Call
 Mr Watts

Handwritten notes:
 Thanks. I am asking for a cost falls, so as to save. X
 2. Liked it. No later in strategy on RG/1882

ROVER GROUP is very unlikely that a procedure on cars could be used until June/July. *MM 12/2*
 Your minute of 12 February asked whether refinancing by Government of commercial bank debt covered by the Varley-Marshall assurances would be regarded as state aid by the EC Commission. The aim would be to make payments this financial year. This note summarises the issues. The background is Government plans to privatise RG either by means of a trade sale or a placement of shares by the end of 1988-89: both options are likely to involve writing off the Group's debt.

Definition of state aid

2. Articles 92 and 93 of the Treaty of Rome are the basis of the Commission's interest. In summary these prohibit "any aid granted by a Member State in any form whatsoever which distorts competition..." and require the Commission to "keep under constant review all systems of aid". The Commission is known to interpret this remit widely: it looks at various devices including loans, soft loans and equity and has shown interest in the existing Varley Marshall assurances. DTI have little doubt that whatever the Commission's conclusion it would wish to investigate any refinancing of debt as a state aid case.

Varley Marshall assurances

3. The total contingency covered by the Varley Marshall assurances is considerably higher than the total debt which we might expect to write off in the context of a privatisation. To the debt of about £700m (at end 1988) must be added contingent liabilities for redundancy costs, creditors and future product liabilities making a total of about £1300m (at end 1988).

4. The Commission has already shown some interest in the basis and extent of these assurances but show no inclination to pursue the matter strongly at present. However a proposed new device for financial support of Rover Group will cause the Commission to question the standing of the Varley Marshall assurances under the Treaty. Such an action by the Commission would probably cause RG Directors to consider their legal position vis a vis the Group's creditors and to call into question continued trading leading to liquidation and crystallising of the total £1300m contingent liabilities.

Handwritten note: You can't rephrase these

Handwritten note: T. Stally (implausible)

Handwritten note: Mr Waller will do a role on this.

Handwritten note: very probably

Handwritten note: a danger of

Timing

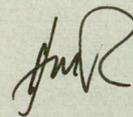
5. The absolute minimum time for processing a state aid case by the Commission is over 3 months : the Leyland Trucks disposal at 3 1/2 months was seen as a significant achievement. Until Commission consent is given the aid is not legal. At the time of the RG equity injection last year various devices were explored to overcome this contingency including "parking" the money a trust account pending Commission approval. Such an approach would be complex but might be feasible.

Mechanics

6. If this route was adopted any Government loan would have to come from a Vote via the late Spring Supplementaries the timetable for which is tight : Estimates would need to be presented in the House by the end of next week if they were to be included in the Consolidated Fund Bill. Alternatively, on a slightly longer timetable, a separate Consolidated Fund Bill could be presented but this would entail a debate and such exposure would not be welcome given the delicate state of privatisation negotiations. Thus the safer route to expenditure in this financial year might well require a decision this week.

Conclusion

7. This approach does not seem feasible given that the EC Commission are likely to interpret any such action as a state aid, leading them to question the status of the Varley Marshall assurances generally, with the attendant risk to the continued financial viability of the business.



MS HM ROBERTS

SECRET AND PERSONAL

FROM: M A WALLER

DATE: 19 February 1988

CHANCELLOR

Ch
X overbet looks
✓ dodgy - AA

cc. Sir P Middleton
 Mr Monck
 Mr Burgner

MAW

ROVER GROUP: BAE's INTEREST

You asked for a report on where matters stand in relation to BAE's possible interest in acquiring Rover Group.

2. The latest contact between BAE and DTI was between BAE's Finance Director, Bernard Friend, and the Head of DTI's Vehicles Division on Wednesday afternoon. Friend made the following points:

- BAE remained very interested in the prospect of acquiring of RG. While there was not detailed discussion on the possible terms of the takeover Friend indicated that they would be looking for a contribution from HMG to enable them to retire all the Group's debts "plus a little". A further condition would be that BAE would have exclusive rights to bid for RG i.e. the Government would not entertain bids from other parties.
- On timing of BAE's decision to announce publicly the intention to negotiate, Friend said that, subject to the views of Lygo (who returns to the UK tomorrow), BAE should be in a position to put the matter to their Board for clearance on about 26-27 February.

BAE's continuing interest is helpful, though not surprising. Clearly they have carried out the same sort of analysis we have and have concluded that, subject to adequate retirement of RG's debts, the acquisition would have a positive impact on their balance sheet and earnings per share (though the impact on cashflow is much more problematic). The size of the HMG dowry remains open to negotiation but the exclusivity issue is a difficult one legally and presentationally for the Government, particularly if the deal involves nil or merely nominal consideration for the business. The attitude of other possible bidders and the treatment of the minority will be key factors. On the latter point, Friend indicated to DTI that they recognised this as a problem and would, in principle, be prepared to treat the minority generously.



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We need to consider what we do if state expression of interest for acquisition of shares in companies is not respected

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PRIME MINISTER

Ch. "Florentine" memo BAE

JF 23/2

CH/EXCHEQUER	
REC.	22 FEB 1988
ACTION	MR WALLER
COPIES TO	CST
	SIR P. MIDDLETON
	MR ANSON
	MR BURGNER

22/2

ROVER GROUP PRIVATISATION : FLORENTINE

I should report that Florentine are continuing to express strong interest in acquisition of RG.

Exclusive Negotiations or Competitive Bidding

2 Day believes that Florentine will ask for negotiations to be on an exclusive basis. Considering proposals from other trade buyers might enable us to pay a smaller dowry, but I believe the commercial and political arguments are strongly against a public competition. Austin Rover's weak market position could collapse under a prolonged period of uncertainty, and political handling of other foreign bids would be very difficult to control in the House and in the press. Accordingly, unless the Law officers see difficulties, I propose to tell Florentine at the appropriate time that we are willing to give exclusive negotiations a clear run provided an acceptable timetable can be agreed and Florentine are willing to deal with RG's minority shareholders. But I have warned Day that if Florentine withdraw, we would want to review all privatisation options again.

Government Financial Support

3 We will want to settle ballpark figures on financial support before a public announcement. We would not wish a deal to founder on alleged misunderstandings of the Government's position



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MARKET SENSITIVE

once negotiations have been publicly disclosed. Day believes Florentine's demands could be limited to paying only nominal consideration for RG and writing off bank debt, though they will undoubtedly press for some help with future working capital requirements. I propose that Day should report on financial discussions through officials in the first instance, as in the DAF negotiations, but I will need to see the chairmen of both companies to underline the Government's bottom line shortly before decisions are reached.

EC State Aid Case

4 If Florentine go forward, I propose that we should push the unavoidable state aid application in Brussels in the same way as on the truck and bus businesses. I would forewarn Commissioner Sutherland on the day of the announcement, seeking his co-operation to move matters forward with all possible speed. The truck and bus state aid case took four months to complete. The cars sector is more sensitive and Florentine's restructuring plans may well be unclear for a time. But by the end of the commercial negotiations, we should aim to secure a high level of confidence that Sutherland would recommend an acceptable deal to the Commission.

Assurances on the Future of RG

5 As with DAF, we might ask Florentine to provide a letter indicating their broad intentions on the future of the RG businesses. However, I believe we should be prepared to make plain in the House that Florentine would be free to respond to commercial pressures in managing RG.



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Honda

6 Honda are concerned to understand more clearly the Government's intentions on privatisation of RG. They have conveyed to me detailed questions about our preferred privatisation route and the role we envisage Honda might play. Florentine remain very keen that Honda should be involved in any deal of RG. If negotiations go forward RG would need to talk to Honda before an announcement is made. I would plan to send a signal to Honda indicating that the Government welcomed the negotiations and looked forward to Honda's continued participation with RG. Florentine remain very keen that Honda should be involved. If Florentine were to withdraw, I would take forward exchanges when I visit Japan on 10 March: that would provide a good opportunity to probe directly Honda's willingness to move closer to RG and to participate in any placement plans.

Timetable

7 RG have advised their board that Florentine may be preparing to cast a fly over them. Florentine have sounded one or two of their key board members. Officials have agreed with RG and Florentine the contingency statements at Annex A which accommodate the possibility that Florentine might decide to withdraw if their plans are disclosed prematurely.

8 Florentine are working towards a decision on 26 or 27 February or whether to make a formal approach to RG to enter negotiations. In the subsequent few days, rapid exchanges would need to take place with RG, Honda and officials to clear the ground for an



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early announcement. The need to put the proposal to colleagues and for the companies to set up communication arrangements suggests 7 March.

9 I am copying this minute to Nigel Lawson and Patrick Mayhew. I would value your and Nigel's agreement that we should take matters forward as I propose.

Jeremy Goddard

for DY
(Approved by the Secretary of State
and signed in his absence)

Department of Trade & Industry
22 February 1988



the department for Enterprise

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ANNEX A

CONTINGENCY STATEMENT

I should like to make a statement about Florentine and Rover Group. Florentine have been giving preliminary consideration to approaching Rover Group to explore the possibilities for developing links between the two businesses. Florentine have now decided to make a formal approach with a view to entering discussions. It is too early to speculate on the outcome of these discussions.

BACK OUT STATEMENT

I should like to make a statement about Florentine and Rover Group. Florentine have been giving preliminary consideration to approaching Rover Group to explore the possibilities for developing links between the two businesses. As Florentine have made plain, they have decided to address other strategic opportunities and will not be making an approach to RG.

Mr Day is continuing to review options for privatisation of the Group and will report to the Government in due course.

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FROM: M A WALLER
DATE: 25 February 1988

1. MR MONCK *MM*
2. CHANCELLOR OF THE EXCHEQUER

cc Chief Secretary
Sir P Middleton
Mr Anson
Mr Burgner
Mr Rolan

ROVER GROUP PRIVATISATION: FLORENTINE

*You have
this
pp.*

This is a brief for the discussion at No.10 at 5.00pm this evening, on Florentine's offer to acquire Rover Group contained in Roland Smith's letter to Lord Young of 24 February. Lord Young has already outlined some of the elements of a possible Government negotiating stance in his minute to the PM of 22 February.

SUMMARY

Mr.

2. The Florentine letter is silent on any consideration (must be presumed to be zero) and many of the key terms pose major difficulties for the Government. As such it must be seen as a first/^{and outrageous} shot from what we know to be tough and slippery negotiators.

3. There are two main Treasury concerns here:

(i) against the advantages of the Government disposing of RG (and the awkward decisions associated with it), the overall balance of risks and advantages associated with the Florentine deal, ie the sizeable contingent liabilities associated with the two companies (£1.5 billion for Varley Marshall assurances and some £1 billion in respect of Government guarantees for the Florentine's share of the development costs of each Airbus model); Florentine's role as a key defence contractor; the risk of future requests for Government money, perhaps before the next Election, for one or more of Florentine's mainstream businesses; and the difficulty of establishing a firm defence against such demands.

(ii) The financial defensibility of the terms of the deal with Florentine in relation to the size of the debt retirement and the value of the assets acquired.

4. Ministers will wish to consider these issues very carefully before committing the Government publicly to negotiate with Florentine, thereby placing the company

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in a position of considerable negotiating strength unless Ministers decide in advance they are ready to break off - after what would be a short negotiation if exclusivity were to be agreed (despite the problems - see paragraph 12 below) - if Florentine will not settle within, or more likely at, the limit of financial terms set by the Government.

ISSUES FOR CONSIDERATION

5. Lord Young's minute focusses essentially on preconditions/terms for an RG/Florentine deal. But you will also wish to consider the related but prior question of the wider implications of such a deal for possible future demands on the Exchequer. While not wishing to second guess Florentine's industrial and financial judgements, the Government is entitled to take a view on this issue to the extent that the deal is likely to increase the chances of Florentine seeking assistance in the future to maintain the viability of its mainstream business. The possible risks in this area must be set against the wider advantages of a Florentine option in terms of delivering a UK solution supported by Graham Day which offers golden share protection to LR.

Industrial/Financial Logic

6. We confess to be somewhat mystified by Florentine's motivation. Discussions between Day and the Chairman of Florentine have indicated a number of motives for the acquisition. In roughly descending order of importance, these appear to be:

(a) to make the company a less easy/attractive takeover target. As noted in my minute of 19 February, work carried out by both our accountants and Barings (DTI advisers) indicate that the acquisition of RG would be likely to have a favourable impact on Florentine's balance sheet and earnings per share, provided that existing RG bank debt was retired. And Barings calculate that, if the Government retired some £700m of debt this would make the RG business broadly cash neutral over the next 5 years, thus avoiding RG being a substantial drain on Florentine. But it is questionable how seriously this "improvement" would be taken by financial analysts/lenders. RG also has substantial accumulated tax losses (£3½ billion) which BAe may be able to utilise or, ^{much} more likely, on sell to a future trade buyer for the car business (notably Ford). Against this must be set the risk of a downturn in the car market generally which would subject RG's business to considerable financial stress which could impact on the parent. At best the RG acquisition

is thus likely to wash its face. But it could impose a substantial cash drain, as well as diverting scarce management talent from the mainstream business, unless Florentine are prepared to on-sell all, or part of, RG to another trade buyer. (Florentine is now set to record a loss in 1987 on account of exchange rate losses on Airbus sales and has recently reiterated its request for Government assistance.)

(b) Synergy/symmetry, between Florentine and RG/Honda

It is difficult to see much, if any, read across between car making and Florentine's mainstream business; and Honda are not an obvious partner for an entry into the Japanese market since they are not part of a larger engineering group - all of their business is in automotive products.

(c) To obtain the services of Graham Day

In the event of an acquisition the current Group Chief Executive could be expected to be replaced by Day. But acquiring a problematic car business seems a very expensive and cumbersome way of recruiting new top management talent!

7. On the face of it the proposed deal is of questionable industrial and financial logic. Florentine are under-capitalised for the business they are in and, in DTI's view, short of good management talent to handle their existing commercial problems. At present, therefore, RG can be seen as a rather substantial poison pill acting as a disincentive to putative bidders for Florentine. The risk is that the pill could prove highly damaging for Florentine. This would have major financial consequences for the Exchequer both in relation to Airbus inter-governmental guarantees (where HMG is committed to underwrite the costs of the development work on Airbus derivatives - for the A330/340 this amounts to some £850m) and the possible implications for the defence budget (see para 9 below).

8. There must be a considerable danger that taking on RG will lead to major problems for both the cars and mainstream business which might well materialise this side of the next Election. In these circumstances, any undertaking from Florentine, as part of an RG deal, that they would not expect further Exchequer support for any part of the enlarged Group might count for little (see paragraph 12 below).

9. There are also unwelcome implications for Florentine's role as a key defence contractor:

- the proposal in its own right could divert senior management resources away from the effective delivery of key defence contracts (eg the ALARM recovery programme, European Fighter Aircraft (EFA));

- any adverse financial impact could read straight across to the company's ability to finance its involvement in the EFA. There may in any case be a question mark over BAe's existing ability to finance this massive programme. It may therefore be well worth asking the Secretary of State for Defence *who has now or Commission Consulted so far* to reconsider the timing of decisions on the future of the EFA programme until uncertainties surrounding Florentine can be sorted out.

10. A more rational commercial outcome would almost certainly be for Florentine to find a home with a major industrial company such as GEC or Thorn-EMI (both of whom expressed an interest in acquiring the business in 1985 - and who might bid again to pre-empt Florentine's move on RG). These would provide the necessary financial strength for Florentine to operate successfully in the highly capital intensive and cyclical mainstream business.

Defensibility of Terms of a Possible Deal

Note behind 11. The terms now offered by Florentine is significantly more ^{clear} than the one discussed in outline at No.10 on 3 February. The key issues are set out below.

(a) Exclusivity

12. Florentine want exclusive rights to the deal. This is on a par with the DAF/Leyland Trucks negotiations which had to be defended publicly against accusations from PACCAR that they would pay more and maintain more jobs in the UK. It would certainly be much more difficult to ride off criticisms of exclusivity on the RG deal. Much would depend on the attitude of other potential bidders (eg Ford, VW, Chrysler, Fiat). On AR Ford could probably be the most troublesome (if it wished), given their long-standing association with the UK and the likely substantial positive consideration they might be prepared to pay for AR's market share, the large accumulated tax losses and the modern production facilities at Longbridge (which Barings suggest could be worth several hundred million pounds). And, despite the current strike, there are sure to be willing bidders for LR (eg Lonhro, who bid last time, GKN, and David Brown also have very recently expressed interest)

at a substantial positive consideration (Barings suggest this could be £200-£250m).

13. The Government would have to defend what looks almost certain to be a poorer financial deal from Florentine on the grounds that it preferred a UK solution and wanted in any case to avoid a competition which could seriously undermine commercial confidence in RG. This is essentially a matter of political judgement but we believe that prolonged uncertainty about the future of RG could undermine dealer/customer confidence in AR and thereby precipitate a collapse and capitalisation of Varley Marshall liabilities. We believe this points to pressing Florentine very hard to close ^{any} deal very quickly to minimise the period of political exposure and uncertainty (see paragraph 15 below).

(b) Government Financial Support

*"Liability" or
"yes explain"*

14. Florentine are demanding a debt and "liability" free RG, together with sufficient "working capital" for the next few years (a disguised method of financing future capital expenditure) - all for zero consideration. This is unacceptable. We suggest that Ministers should impose a ceiling, limited to **bank debt** but that it should be made clear to the company that the Government believes there is a strong case for a significant countervailing positive consideration on account of LR, the tax losses and productive assets (which Barings value in total at up to £950m*). Clearly there may be a trade off between the size of the Government injection and any positive consideration from Florentine. And presentationally a substantial positive contribution would be easier to defend against charges that the RG business were being sold on the cheap. The size of the bank debt will depend to some extent on when a deal might be finalised. RG/Florentine believe it should be possible to close a deal in 2/3 months. The longer it takes the nearer it gets to RG's peak borrowing period in June/July to finance stock build up for the August new registration sales. We have yet to see a calendarised budget for 1988 but the bank borrowing figure in May could be some £500m, rising to over £800m in June/July. We would need to monitor the movements of borrowings very carefully to ensure that RG were not switching normal trade credit over to bank borrowings. The positive value of RG assets would point to pitching the starting point for negotiations a long way below the peak 1988 figure and aiming for a much lower figure if there is no positive consideration. This should also help in negotiating the deal through the EC.

* LR = £250m
Tax = £300m
Plant = £400m.

Handling/Timing of Negotiations

15. On negotiations Lord Young was proposing that they should be handled, both pre and post announcements by Graham Day (as per DAF), with him, Lord Young, coming in at a late stage (pre announcement) to "underline the Government's bottom line". Though this procedure worked satisfactorily for DAF, the circumstances here are different: the accelerated timetable now being proposed - with an announcement on Tuesday March 1 makes this difficult; there is a clear conflict of interest here for Graham Day who stands to be Chief Executive of the enlarged group; and both parties are - to one extent or another - recipients of Government support. If the accelerated timetable is to be delivered without compromising the Government's position then we think the negotiations on key terms must be handled at Ministerial level, presumably by Lord Young (though the PM's intervention with Smith may be necessary to deliver terms which are acceptable to the Government). Whatever happens, however, we do not believe Florentine's letter should rest unanswered for any length of time - they should receive a quick reply indicating that the present terms are unacceptable.

16. But you will also wish to consider carefully whether the overall timing/procedure proposed is acceptable:

- an announcement next Tuesday runs a severe risk that the Government will be bounced into costly and problematic framework for negotiations.

- if Ministers are not satisfied about the key terms then it would probably be better to delay announcement until 8 March, despite the danger of a leak, provided that Florentine had received a formal *negative* response to their initial proposal.

17. An alternative approach might be to seek to close a deal by, say, Thursday 8 March. Barings initial view is that this would be possible, allowing sufficient time for Ministers to have considered advice on key financial aspects (eg valuation of the RG business, including Revenue advice on the tax losses).

(c) Assurances on future of RG

18. For political/presentational reasons it will be necessary for Florentine to provide "voluntary" undertakings on the future of the RG business. But there is a clear point of substance underlying this - a radical retrenchment or a major disposal (eg of the cars business, to say, Ford) relatively shortly after the acquisition would open the Government up to charges of bad faith and generate considerable Parliamentary/public pressure for intervention. Ministers will therefore need to have some assurance from Florentine that (subject to major exigencies in the vehicles markets) they have no radical plans for changing the size or shape of the business. ^{in the near future} (The Florentine golden share does not bite on disposals but there is an informal agreement to consult the Government on major asset disposals.)

(d) Honda

19. Lord Young's minute does not reveal that relations with Honda are now in a very delicate state following a rather bizarre approach to Honda by Hal Miller MP during which he managed to raise serious question marks in the company's mind about the commitment and good faith of RG and HMG. Communications with Honda will therefore need to be carefully handled to ensure they maintain their present commitment to model by model collaboration. And it will be essential to establish whether a decision by Honda to complete the R8 model development but then to develop their own facilities at Swindon would be a show-stopper for Florentine.

(e) The Minority

20. Not mentioned in the Florentine letter but we understand they do wish this problem to be dealt with by HMG. This maximises the Government's political exposure and runs the risk of failure, thus perhaps comprising Florentine's ability subsequently to acquire the minority stake compulsorily under the Companies Act takeover provisions.

21. As you know we have looked at phasing/spreading the Exchequer payment. On the present timetable all the payment would be in 1988-89 since there would

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be no contributions to restructuring. In any case a clean break seems best given the general background to the deal.

Fallback/Alternatives

22. Lord Young has circulated with his minute draft statements to cover a premature leak of Florentine's interest or a decision by them not to open negotiations. These have been cleared at official level and, subject to your views, seem acceptable. As you have pointed out it does not cover the treatment of other possible bidders who may express an interest once the announcement is made.

23. If Florentine go away, Lord Young has made it clear that all options are back on the table on the grounds that, if Florentine or their major institutional shareholders do not like the look of RG, then neither will the institutions targeted for placement. Moreover, failure of negotiations with Florentine could well trigger a loss of confidence in RG's future with the attendant dangers of crystallisation of the Varley Marshall liabilities. Ministers may therefore wish to consider at *today's* meeting both the attitude to competing bids and the preferred fallback option if the Florentine deal lapses. None would be easy but a trade sale to Ford of the cars business and a separate sale/MBO of LR would seem the least problematic.

SUMMARY

24. In overall terms the case for the Florentine option is fairly finely balanced with the advantages of a Day supported UK solution and golden share protection for LR needing to be set against the dangers to the mainstream business and the Government's financial and political exposure. As far as the possible terms of a deal are concerned we therefore suggest you make the following points:

(i) the Government's contingent exposure for both these businesses is very large. The deal should be carried through quickly and in such a way as to minimise the likelihood of these liabilities crystallising. But the Government must be ready to break off, otherwise Florentine's negotiating position is very substantially strengthened;

(ii) there is a very substantial defence interest in the future handling of Florentine which points to the need to consult Mr Younger (particularly over the timing of EFA decisions)

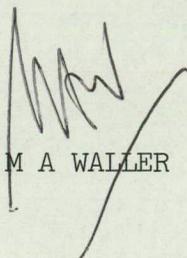
(iii) the existence of substantial tax losses, the positive valuation of RG's assets (particularly LR) and existence of alternative bidders who may be willing to offer positive consideration point to adopting a very tough stance on the issues of exclusivity and the Government contribution. Exclusivity should only be granted in return for: a very quick deal (a maximum of say, one month for negotiations though consideration could be given to closing the deal within the next two weeks); Florentine dealing ^{with} the minority; and a small net cost to the Exchequer involving a substantial positive contribution (perhaps £200-£250m) in return for retirement of bank borrowing of ^{no more than} £500 million. But you will need to press Lord Young on what figures he believes to be realistic in the light of Barings advice on valuation, *and how he would fulfil his responsibilities to defend them.*

(iv) any injection would be a full and final settlement. Florentine must accept that no further money will be forthcoming in respect of the deal or on account of the existing mainstream business. (Florentine must also recognise that, *to* the *extent* the deal improve their capacity to raise finance, this will need to be taken into account in any future negotiation on eg launch aid);

(v) assurances should be sought about radical restructuring/disposals but these must be subject to over-riding commercial considerations and the need to avoid calls for further Exchequer injections.

(vi) the need for Ministers to take control of negotiations on key terms and to avoid being bounced into an early announcement (pointing to an early written response to Florentine);

(vii) the need to be clear about a fallback option if the Florentine option goes away. *This would require another trade sale (probably Ford) or change in RG's strategy, which might well mean a replacement of Mr Day who has only done half the job he was hired for. (Mr Quirk may be able to suggest names)*



M A WALLER

SECRET AND PERSONAL

FROM: M A WALLER

DATE: 26 February 1988

ch / Do you want to see the docs. at
'X' + 'Y' in para 6? If so, we can get
them on Monday
am.
26/2

1. MR MONCK

2. CHANCELLOR

Despite the attractions of getting shot of Rover, even a deal at net £500m (especially given exclusivity) looks hard to justify in PAC terms, weak in industrial terms (see para 10), and a rather transparent way of

shifting responsibility for decisions about the future of the Group.

Our advice is certainly against going to £750m net. If your colleagues press for this, you should insist on (a) a quick deal with no scope for upping the price and (b) firm undertakings on no on-sale for 5 years. (So far we have no formal

advice from Barings on valuation. We have

told the DTI this should be provided before negotiations or decisions. We understand Barings' advice would be that £750m net is a poor deal.) *MM*

cc. Chief Secretary
Sir P Middleton
Mr Anson
Mr Burgner

FLORENTINE

This note provides advice on what might be a justifiable/defensible consideration for a Florentine/RG deal (taking account of the valuation of RG's assets and the Government's actual and contingent liabilities in respect of the Company). It also provides advice on the value and treatment of the tax losses and what restrictions might be put on these being passed on to another trade buyer; and on the methods by which the Government could seek to avoid early disposal of the assets and/or Land Rover passing into foreign ownership.

2. Lord Young is seeing Roland Smith at 6.30 on Sunday evening. Lord Young will report the outcome to the PM and you *early* on Monday morning.

Consideration

3. The meeting at No.10 yesterday deputed Lord Young to negotiate with Florentine on the basis of a deal involving a net consideration of £500m (probably involving debt retirement of £750m offset by a consideration for the RG business of £250m). We have stressed to DTI officials the need to ensure that Lord Young does not go beyond £500m at Sunday's meeting.

4. Setting aside the possible longer term implications of the deal, in assessing how far it might be justifiable or defensible to go beyond this figure there are two factors to be taken into account, i.e. the value of the assets and the Government's actual and contingent liabilities.

(i) The value of the assets

5. In considering the negotiating stance which HMG should adopt, Barings have advised that it would be possible to argue that RG's assets are worth some £950m comprising:

- £250m for the Land Rover business. This valuation, which is broadly consistent with the price set for the GM deal, is based on a PE of 10. This seems reasonable for the sector in which LR are operating, particularly given the very strong growth in the middle/upper range of the 4WD market, the continuing success of Range Rover and the likely attractiveness and competitiveness of RG's proposed entry into the personal transport 4WD sector (i.e. concept Jay).
- £300m in respect of RG's accumulated tax losses of some £1.65 billion: (not £3½ billion as Barings had originally advised). Barings have taken the cash value of the losses at about £600m (taking the standard rate of CT at 35%) and have calculated what these might be worth to, say, Ford on the basis of their current tax payments projected forward over a 10 year period (the tax losses could in principle be applied over a much longer time period but with an increasing degree of uncertainty and lower discounted value). They have calculated the NPV of this figure to be about £400m and then applied a fairly heavy discount factor to arrive at the value of £300m for what Ford might be prepared to pay. These losses would, however, be only of any substantial value to another vehicle manufacturer (see paragraph 11 below) so that the enlarged Group could only benefit from them by RG returning to profitability or on-selling to another vehicle maker. The value to Florentine would therefore be much lower.
- £400m for the RG productive capacity, plants/land etc: Barings point out that Nissan are investing some £390m in a 200,000 pa car plant. RG's current vehicle making capacity is some 500,000 much of it in recently modernised facilities (financed by the taxpayer). Multiplying up but applying a hefty discount factor produces the figure of £400m. But, like the tax losses, the capacity is mainly of value to another vehicle manufacturer.

Clearly, therefore, one needs to impose a fairly heavy discount factor in respect of the tax losses and plant valuations. Nevertheless, one is driven to a minimum figure of £250m (i.e. LR only) with justification for pitching this a good

bit higher (say £400m allowing, for example, for the value of the Cowley site).

6. Another way of looking at it is to consider the possible earning power of the assets in terms of operating profit and cashflow pre and post possible debt retirement. The answer here depends on which set of earnings projections are used: the 1988 Corporate Plan figures (which are in BAe's possession and therefore underpin their offer), point to a very low valuation. But RG now consider these to be quite conservative. The updated figures (which have been passed to BAe today), reflecting RG's profit improvement plan, suggests a significant positive net worth. The starting point for the calculation is the size of debt retirement necessary to make RG cashflow neutral over the plan period (1988-92). To produce a neutral cashflow outcome Barings calculate that HMG would have to inject:

- Some £900m under the original corporate plan scenario; but
- Only some £460m under the profit improvement plan (cf end 1987 borrowings of £406m and on average forecast figure for 1988 of £485m).

The earnings trend associated with on the latter scenario would be a positive, upward one, producing for a PE range of 3-10 valuations of around £100-400m (based on 1988 earnings of some £36m).

(ii) HMG's Actual/Contingent Liabilities for RG

7. Under the original 1988 Corporate Plan Varley Marshall liabilities were forecast to rise steadily by £800m from £1.5 billion to £2.2 billion ^{by 1992}. (The profit improvement plan might reduce the 1992 figure to perhaps £1.8 billion).

9. The actual liabilities which HMG could face as a result of this contingent liability depend crucially on the scenario postulated as an alternative to a Florentine takeover:

- loss of customer/dealer confidence could precipitate a collapse in the RG business leading to crystallisation of the liabilities as the company was liquidated. The net cost (allowing for redundancy payments offset by asset sale proceeds) could in theory be close to the VM figures.
- a sale of AR to, say, Ford (with a separate sale of LR) would keep the business in being and, providing the Government were not facing a distress sale following collapse, one could expect that the net costs of such

a deal might be quite moderate (both on account of the factors outlined in paragraph 4 and because of the premium Ford would pay for market share).

- continuation in public ownership (if that were acceptable on broader grounds) would involve a requirement for a further Government cash injection if the profit improvement plan were not delivered and/or Honda could not be persuaded to inject money. (This could be £300-400m on the basis of the corporate plan figures).

8. In summary, the likely net worth to Florentine of RG depends crucially on which of the future scenarios is accepted. The original 1988 Corporate Plan would suggest that something over £900m would need to be injected into the balance sheet to make it cash neutral (effectively liquidating debt and injecting sufficient money to finance capital expenditure). On the other hand, the profit improvement plan (yet to be endorsed by Day or the RG Board) would indicate that a net injection of no more than £500m would be justified. In practice the outcome for the business is likely to fall between these two scenarios. If one accepts the case for handing over RG totally debt free (cf criticisms on Rolls Royce privatisation of this approach) this might point to a net injection of perhaps £600 million. Anything above this figure would be generous. And in terms of the contingent risks to HMG, a net figure as high as £750m looks rather bad value for money. But in essence the justification for any figure above £500m looks shaky: the criticisms which anything over this figure might attract are essentially a matter of degree.

Justification for Higher Injections

10. BAe believe that the Government would be willing to do a deal at net £750m, RG having apparently told them so (BAe are also reporting back to RG on discussions with DTI). So there is a strong chance that HMG will be under great pressure to inject at least £750m to get Florentine to take on RG. (Discussions after you left the No.10 meeting suggested even higher figures). Assuming a £250m consideration for presentational reasons the gross figure would be £1 billion. This would be very difficult to defend publicly:

- HMG injected into RG £680m only some 12 months ago. A further £750m would bring the total to ^{nearly} £1.5 billion i.e. equal to current VM liabilities;

- It would be difficult to argue convincingly that the alternative to the deal was crystallisation of liabilities since that would indicate that HMG were willing to see AR collapse rather than go to Ford.
- the takeover has no underlying industrial logic. (RG is hardly a Saab).
- Florentine have no spare management capacity; and
- they are not terribly financially strong so it would be difficult to argue that the merger will secure the longer term future of RG.

11. Against this background there is a strong case for sticking very hard to a net figure of not much more than £500m. If Ministers decided to go beyond that then the justification would have to be:

- (i) As the PM has made clear, HMG has all along been looking for a solution which provided the prospect of long-term viability under private sector ownership in the UK.
- (ii) AR and LR have both shown recent improvements under Mr Day's Chairmanship but financial performance has continued to be compromised by the burden of debt attributable to past losses.
- (iii) Despite improved performance the future looks uncertain for RG as a small volume car manufacturer. Its prospects would be enhanced by being part of a larger, successful manufacturing company.

Nonetheless defending a net figure of £750m+ before the PAC and the EC would be problematic because in effect it would involve providing finance for future capital expenditure rather than just relieving the business of historic debts.

Use/Treatment of Tax Losses

12. As noted above, Florentine will be unlikely to be able to use the RG tax losses, except to the extent that RG generate positive earnings. As far as on-sale to, say, Ford is concerned, the attached note from the Revenue (Annex A) indicates that there is no way of preventing Ford utilising these losses (which could cost the Exchequer up to £600m in tax receipts over a 10 year period), short of legislation or persuading RG directors to act in a way contrary to the company's commercial interests. The only other way to prevent utilisation in these circumstances would be to secure an arrangement which would preclude

Florentine on-selling the cars business. This is addressed in the next section.

Protection against Disposal

13. DTI officials are currently preparing a paper on protection but the main conclusions appear to be:

- (a) a golden share is the only certain way of preventing LR falling into foreign ownership. Imposing one of LR without doing the same for AR would be presentationally difficult. And, more importantly, Florentine would be totally opposed to the idea.
- (b) a side letter from Florentine giving an undertaking not to dispose without consultation and a best endeavours undertaking, subject to market conditions, not to sell against the Government's wishes. This would not have the force of law but could be drawn on for presentational purposes.

14. Florentine have indicated that they might be prepared to go along with

- (b). But it would not make LR secure against foreign ownership or prevent on sale of the cars business into its associated tax losses to Ford

Summary and Conclusions

15. The deal on virtually any terms which seem feasible looks questionable because of the lack of industrial logic and Florentine's relative commercial weakness. And any figure over £500m would be difficult to defend in terms of value for money. Unfortunately - due, it seems, to signals from RG - Florentine have a £750m* figure firmly in mind, with nil consideration or £1 billion if we press for £250m consideration for presentational reasons. (At a much earlier stage, the PM suggested to Graham Day that she would be willing to see RG off the Government's hands for £1 billion, but this was before the truck/bus deal). We think therefore there is a strong case for sticking at a net figure of £500m and being prepared to see the proposal fall.

16. On tax, Florentine can only make very limited use of RG's losses - they are only of real value to another vehicle manufacturer with substantial UK tax liability but, short of legislation, there is no way the Exchequer could stop this being used if AR was sold on. This underlines a possible motivation for Florentine on-selling and the link with possible mechanisms for limiting Florentine's ability to dispose of all or part of RG. The only certain method would be a golden share but Florentine would be most unlikely to accept this (even if it were time limited).

M A WALLER

* almost certainly subject to "due diligence" and other events which Florentine could use to push up the car price deal.

RESTRICTIONS ON USE OF ROVER GROUP'S LOSSES

1. We understand the proposal to be that the Rover Group would be acquired by "Florentine". Florentine might choose to keep Land Rover and sell-on the volume car business (which we refer to as 'Austin Rover ') to Ford or another company which is not a motor manufacturer. This note explains the general tax position but takes no account of the information available to the Inland Revenue about the tax affairs of these companies (we have no authority to waive confidentiality in respect of their tax affairs).

2. We understand that the tax losses of the Rover Group are about £1.65 billion, nearly all in Austin Rover. At a corporation tax rate of 35 per cent these tax losses could, in the right circumstances, reduce tax receipts by about £0.6 billion.

3. The tax losses from a company's trade for an accounting period can be set against its other income or capital gains, or against the income or capital gains of other members of the same group of companies. Alternatively the losses can be carried forward and set against future profits from the same trade, but not against any other income or capital gains.

4. So any future trading losses of Austin Rover could be set against the profits of other members of the group of companies, whether this is Florentine, Ford or some other company.

5. But any existing losses (ie, the £1.65 billion) could be set against only the future profits of the trade currently carried on by Austin Rover. If this trade does not change, the loss to the Exchequer arising from these tax losses will depend upon the future profitability of the trade. If the activities of Austin Rover were to change fundamentally (eg, if it were to stop manufacturing cars and start manufacturing ships) this would be the cessation of the trade of car manufacturing and the tax losses could not be set against the profits from manufacturing ships (ie, the tax losses would be useless).

6. But the trade could be modified without causing it to cease. For example, large parts of Ford's UK car production activities could over a period of a few years be transferred to Austin Rover. The combined car production activities would form part of a single trade, and this would be the trade presently carried on by Austin Rover. So the existing tax losses of Austin Rover could be set against the future tax profits of this combined trade.

7. The only other restriction which could in principle apply is an anti-avoidance provision to prevent loss buying. If, within the 3 years following Ford's acquisition of Austin Rover, there were a major change in the nature or conduct of Austin Rover's trade the tax losses would become useless. Although the position is not entirely clear, this would not apply if the transfer of activities from Ford to Austin Rover were done gradually. So Ford might for the first 3 years not be able to make as full a use of Austin Rover's existing tax losses as it would be able to do subsequently.

Denial of tax losses

8. We have no power to prevent the tax losses being used by a purchaser of Austin Rover. This could be done by specific legislation in the Finance Bill. Or it could in principle be done by requiring the Rover Group board to arrange the disposal in such a way that the tax losses were not transferred. But the board might well object and the position of minority shareholders would have to be considered. Neither course seems attractive.

Conclusion

9. The £1.65 billion of existing tax losses will be available to set against any future profits from Austin Rover's trade. But otherwise they are unlikely to be of much value to any purchaser of Austin Rover which is not a motor manufacturer. The value to a motor manufacturer will depend upon its level of profits, but ultimately the tax loss could be about £0.6 billion.

SECRET AND PERSONAL

FROM: M A WALLER

DATE: 29 February 1988

- nd amials (hmt...)*
1. MR MONCK
 2. CHANCELLOR

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

FLORENTINE

This is a brief for your meeting with the Prime Minister and Lord Young at 5.30pm this evening to hear Lord Young's report on the outcome of further negotiations with Florentine and to consider the content and timing of a Parliamentary statement.

Present State of Play

2. We understand that Lord Young has now agreed with Florentine that they should open negotiations on acquiring RG on the following terms:

- a net cost of £650m (gross cost to be subject to further discussion on the size of the consideration during the negotiation period);
- the net figure to be on an "as is/where is" basis, with no warranties or other contingent liability (if due diligence reveals major problems for Florentine then the deal would be called off);
- the enlarged group would only be able to utilise up to £500m of the £1.65 billion of RG's accumulated tax losses;
- Florentine to deal with the minority (method unspecified);
- there would be some form of assurance/protection for HMG against immediate on-sale of RG companies.

3. Subject to discussion between DTI officials and Florentine over the terms of a draft exchange of letters between Lord Young and Smith, and the outcome of tonight's meeting at No.10, Lord Young intends that the deal should be put to

Cabinet tomorrow morning and announced to Parliament the same afternoon. Honda will be informed tomorrow afternoon, via the Japanese Ambassador.

Discussion

(i) Terms

4. The costs, benefits and risks of the outline deal now in prospect were discussed in detail in my minute of 26 February. Much of the substance of the minute has been superseded by decisions now taken by Ministers. The terms now agreed by Lord Young:

- (i) remove any scope for upping the cost and involve a lower net cost to Exchequer than the £700m on which Lord Young had authority to settle. Nonetheless it remains an expensive deal. DTI's advisers (Barings) have not yet delivered their advice on valuation because DTI are anxious to water down the comments in draft. We understand Barings consider the Government could have received a considerably better deal by a limited auction. Barings are unlikely to put a figure on the costs of exclusivity but based on heavily discounted estimates of worth of RG we believe the cost of exclusivity (ignoring any wider considerations) could be at least £250m, i.e. the difference between the current consideration proposed (£100m) and the possible net worth of LR (£200m), DAF shareholding (£90m) and the value of the AR plan^k and tax losses (say £50m).
- (ii) secures an undertaking that Florentine deal with the minority. This could be either by Florentine compulsorily acquiring the minority on takeover or leaving the minority shareholding intact. Given the possible key position of the minority (cf. ~~the~~ Attorney General's recent letter and paragraphs (iii) and (iv) below) we believe compulsory acquisition on generous terms is the preferred alternative for HMG and that therefore Florentine should agree to do this as part of the deal.
- (iii) require some, as yet unspecified, protection against on-sale. Barings are looking further at this via HMG having, for a 5 year period, an option to acquire all RG's trademarks in the event of on-sale of the business but in a way which does not require approval by the minority. (Only a golden share would make LR absolutely secure against foreign takeover).

(iv) leaves open how the limitation on Florentine's/RG's ability to use tax losses could be implemented. We have discussed this with the Revenue and DTI's lawyers who now believe there are two options (legislation aside):

- HMG can write off some of its equity stake in RG. Under the tax acts this would result in the cancellation of an equivalent amount of tax losses.
- Florentine/RG can, in the sale and purchase agreement, contract only to use £500m of the accumulated losses. Either route might require a vote by the minority (hence there would be advantage in Florentine taking them out) but, subject to further advice on this point, our clear preference would be for the first approach since it extinguishes the losses so that they cannot be used in the event of on-sale under any circumstances.

(ii) Impact on Florentine's Viability

5. As in the case of valuation, we have not seen Barings' advice on viability of the enlarged group because the draft is still subject to discussion with DTI (who have asked it place more emphasis on the possible, but very questionable, synergy between the two groups). But we understand Barings will say that there is no immediate (say over the next two years) danger of the enlarged group running into financial trouble, though noting that a large element of their current cash reserve represents customer pre-payments and the substantial off balance sheet liabilities associated with export finance arrangements under which the terms of non-ECGD covered bank borrowing provides for the financing banks to have recourse to Florentine. (In the recent Jordan Tornado contract the banks indicated that they did not want to extend recourse to the company beyond what they had already taken. Nor were Florentine prepared to accept such an additional charge - £65m - on its balance sheet because it would restrict its future borrowing capacity.) Beyond 2 years the uncertainties surrounding both businesses and the lack of industrial logic of the takeover make it difficult to give assurances about the longer term health of the group.

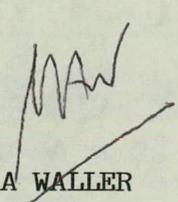
Presentation/Handling

6. Attached is a draft Parliamentary statement which has yet to be approved by Lord Young. Something on these lines seems acceptable but you will wish to discuss with Lord Young how he intends to ensure that Florentine briefing of

analysts now (as well as after any deal is signed) does not suggest that the company have agreed very favourable financial terms with the Government. Given the questionable industrial logic of the acquisition it is clearly in Florentine's interest to put a very favourable gloss on the financial basis of the deal, to the detriment of the Government's public position on value for money.

Conclusion

7. The outline terms of the deal now struck by Lord Young with Florentine provide a cap on the Government's contribution to debt write off etc. and also secure outline agreement to assurances about the future of the Group and the limitation on the use of tax losses and their on-sale. But there remain serious question marks about the value of the deal and the underlying industrial logic and therefore possible impact on the longer term viability of Florentine. On neither of these key issues have we so far seen definitive advice from DTI's financial advisers. As far as outstanding terms are concerned, I would suggest that you press Lord Young to secure Florentine's agreement to acquire the minority (because this eases problems in relation to minority consent on key issues such as tax losses). But the exact method by which protection against disposal and neutralising tax losses can be achieved will have to be dealt with in more detailed negotiations. On presentation, I would suggest you stress the need to ensure that Florentine play essentially the same tune as the Government in order to avoid giving added weight to the inevitable criticism that the Government is proposing to sell RG off on the cheap.


M A WALLER

FLORENTINE: DRAFT PARLIAMENTARY STATEMENT

As the House is aware, it is the Government's aim, during the term of this Parliament, to return Rover Group to private ownership. Rover's Chairman, Mr Graham Day, has in recent months been examining options to achieve this objective.

2. I wish to inform the House that an approach has now been received from Florentine who have declared a serious interest in acquiring the whole of the issued share capital of Rover Group subject to the satisfactory outcome of studies and discussions which have now been put in hand. These are expected to be completed by the beginning of May. I shall, of course, inform the House of the outcome of these discussions at the earliest opportunity. In the meantime, I am sure that the House, like the Rover Group Board and HMG, will welcome this expression of interest.

The Rt. Hon. Lord Young of Graffham
Secretary of State for Trade and Industry

Paul Gray Esq
Private Secretary to the
Prime Minister
10 Downing Street
LONDON
SW1A 2AA

65

CH/EXCHEQUER	
REC.	10 MAR 1988
ACTION	Mr Waller
COPIES TO	Mr P Middleton
	Mr Monck
	Mr Bugner

Department of
Trade and Industry

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Telex 8811074/5 DTHQ G
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Direct line 215 5422
Our ref DW3DMJ
Your ref
Date 9 March 1988

Dear Paul

RG PRIVATISATION : EXCLUSIVITY : ALTERNATIVE OFFERS

You told me that the Prime Minister had asked Lord Young about the legal position on exclusivity. Lord Young thought it would be helpful to send you the enclosed note. Our external lawyers, Slaughter & May, have seen the papers and endorse the advice given in DTI.

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

Yours

Jeremy Godfrey

JEREMY GODFREY
Private Secretary

*Post has at
Low 10/10/87
many look to ✓ check with.
It was ~~not~~ a v. much better
one than Hong. ~~But~~
~~Post~~ ~~has~~ ~~at~~ ~~Low~~ ~~10/10/87~~ ~~many~~ ~~look~~ ~~to~~ ~~check~~ ~~with.~~ ~~It~~ ~~was~~ ~~not~~ ~~a~~ ~~v.~~ ~~much~~ ~~better~~ ~~one~~ ~~than~~ ~~Hong.~~ ~~But~~*

CONFIDENTIAL

EXCLUSIVITY : LEGAL ADVICE

Could a third party who has aggrieved by exclusivity challenge it in the courts?

1 Judicial review would not be available because exclusivity is not in the category of administrative decisions to which the courts are willing to apply this remedy.

2 Subject to what is said below about an early deal with BAe, a frustrated bidder other than BAe would have no basis in law to challenge the sale to BAe or his not being considered - there is no right in a bidder to have his bid accepted even though it may be the most favourable in its terms.

3 In the context of an offer to minority shareholders, using the compulsory purchase provisions in the Companies Acts, exclusivity would be fireproof unless the minority could show that the financial terms offered to them were unreasonable in failing to take account of any reduction in the value of the terms that could be attributed to exclusivity. The offer would therefore have to take account of any rival offers that were on the table prior to clinching a deal with BAe, and the RG Board would have to be given enough information about the BAe and other offers (if any) to enable them to recommend the BAe deal to its shareholders.

CONFIDENTIAL

CONFIDENTIAL

In the event of an early deal with BAe, would a frustrated bidder (who had meant to make a bid before the end of April but had not done so before the close with BAe) have any rights to challenge the sale to BAe?

4 There is nothing in the exchange of letters of 29 February which would create any such rights.

5 In our view, nothing was said by Ministers in Parliament on 1 March that amounted to a guarantee that rival bids would be considered right up to the end of the exclusivity period; it was not suggested that negotiations with BAe would require the whole of the period for successful completion; and the only assurance given was that prior to the final decision on the BAe offer the terms of any rival bids there might be at that stage would be looked at. In any event, statements in Parliament cannot found legal rights and care will be taken to ensure that statements made outside Parliament are consistent with the policy Ministers have agreed.

CONFIDENTIAL

*This is clearly
a v. difficult decision.
Baul (a) no other British
seller can come
forward*



CHANCELLOR

FROM: FINANCIAL SECRETARY

DATE: 9 March 1988

*(b) there is serious
doubt about our
ability to give the
party to whom we
are selling - either to
(RAF) available
that is v. significant
but it is a fact.
(c) we paid £680 million
to buy the BAE
one has to be
sure of the
value of the
asset*

ROVER GROUP/BRITISH AEROSPACE

Is it really too late to look for alternatives to the BAe bid for RG? Could I urge that if the negotiations at any stage run into any difficulty, we seize the opportunity to invite others to bid? I must say that I regret that we have given BAe these exclusive rights.

2. Roland Smith seems to have persuaded some analysts that a knock-down price for a RG unencumbered by debt will be good for BAe's earnings (that must be right! At least in the short-term). But I must say that my doubts about the proposed deal have grown stronger.

3. I am sceptical for several reasons:

(i) A certain amount of moonshine has been talked about the synergy between the two businesses. But the differences are far greater than the similarities. One is a monopoly supplier of military aircraft to the Government (though it competes internationally - with considerable Government support - for other Governments' business); the second supplies to the intensely competitive consumer market for cars. BAe does not sell any consumer goods.

(ii) Having been sponsoring Minister for BAe in the DTI and Procurement Minister in the MOD, I do not believe BAe have any management strengths to contribute to RG.

*(As. As. to
costs of
market
Parker
a
Dorman
Shale
Dorset
from
the
adv.)*

- (iii) BAe have a lot of problems of their own, particularly on the civil side. RG would add to these.
- (iv) I do not know Professor Smith very well, but his record as a Company Chairman does not fill me with confidence from what I have read.
- (v) The history of companies in the UK trying to diversify out of trouble is not encouraging. Leaps into new areas are, I suspect, best left to specialists such as Hanson or BTR.
- (vi) The terms of the deal are indefensibly generous to BAe. When the wider world finds out that so far from "giving RG away" we are actually paying BAe £650 million to take RG, we can, I think, expect to receive fierce criticism - particularly since the end-1987 RG balance sheet shows debt outstanding of only £400 million, and in view of the fact that others have not been allowed even to bid. I am not sure what the EC or PAC will make of this.

4. Against this:

- it achieves privatisation now
- it is a British solution!

5. One can understand why David Young can hardly believe his luck and no-one wants to look a "gift-horse" in the mouth.

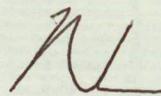
6. But surely it is not enough to say "If BAe believe they can make a success of it and persuade their shareholders then who are we to disagree?" We are the shareholders of RG and we need to be persuaded that it is the most profitable (or least expensive) deal for us. And as a Government we need to be sure that the deal is in the interests of the UK motor and aerospace industries. We do not

want both companies to come back for further state assistance a few years down the road. Even if this deal does not destroy both companies the strain of RG is likely to make BAe as a civil aircraft manufacturer even more dependent on launch aid.

7. We know that there are other companies who might be interested. We were forced to retreat from dealing with two of them last time. Since then the adverse consequences of our decision for the UK volume truck industry have become more apparent.

8. I wonder whether Parliamentary and public opinion generally is not now readier to face up to the real issues. Do we have to go on making an increasing number of industrial decisions on narrow nationalistic grounds?

9. I believe we are in danger of making a great mistake and would strongly urge that we look for the slightest hiccup or hesitation in the negotiations as a pretext for widening the field to include other companies, including UK-based multinationals to whom I believe we have every reason to be grateful and none to be hostile.



NORMAN LAMONT

SECRET
COMMERCIAL IN CONFIDENCE

FROM: M A WALLER

DATE: 21 March 1988

CHANCELLOR

cc. Chief Secretary
Financial Secretary
Mr Anson
Mr Monck
Mr Burgner

ROVER GROUP/BAe

1. This is a brief for your meeting at No.10 tomorrow with the Prime Minister, the Secretary of State for Trade and Industry and the Foreign Secretary. It deals with the question of the terms of a possible offer to the minority raised in Mr Taylor's minute of 18 March.

2. The main purpose of the meeting is to discuss tactics viz-a-viz the EC. But it will also provide an opportunity for Lord Young to report back on his latest thinking about key terms of the Government's deal with BAe (i.e. treatment of the minority, sterilisation of tax losses, restrictions on on-sale of RG and the run out of the Government's obligations under the Varley Marshall assurances). There is now considerable urgency about all this since Lord Young, prompted by concerns about alternative expressions of interest, is proposing to close a deal with BAe and to announce it to Parliament on 29 March, (subject to clearance by the EC, BAe's shareholders and the Takeover Panel).

3. As at the time of dictating this minute, Lord Young has yet to take a final view on any of the issues listed above and is unlikely to do so before this afternoon. Moreover, DTI have not yet put a number of the key proposals to BAe - they will be doing so in the course of this evening. Lord Young intends to minute you and the Prime Minister either late today or tomorrow setting out his proposed negotiating stance in relation to both BAe and Brussels. If necessary, I will submit supplementary briefing

Now arrived (immediately behind)
He shall get further advice
from Mr Waller tomorrow am.

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tomorrow morning in the light of that minute and DTI Officials' report on their meeting with BAe.

Objectives

4. The focus of this meeting is the negotiating tactics which Lord Young should adopt with Commissioner Sutherland when he sees him tomorrow. You will wish, therefore, to be assured that the tactics Lord Young is proposing to adopt maximise the chance of the Government receiving timely Commission clearance for the BAe deal without in any way prejudicing the Government's negotiating position with BAe. But you will also wish to use the meeting to ensure that:

- (i) There is no question of the deal with BAe going beyond the terms agreed by Ministers on 29 February; and
- (ii) There is some discussion and agreement on the most acceptable contingency plan in the event that the deal with BAe falls through.

Recent Developments

5. Since the announcement on 1 March, there have been three firm alternative expressions of interest in acquiring RG, i.e. from Ford, Melton Medes and Lonhro. Ford is as expected. Melton Medes is a relatively small general engineering company which, on the face of it, does not look to be a serious bidder (though this cannot be ruled out entirely). Lonhro's expression of interest is in association with Toyota. None of the three have mentioned figures, though Lonhro has indicated its willingness to negotiate within the very wide range of figures which have been quoted in the press.

6. Prompted by concerns about a full scale alternative bid, Lord Young now intends to close the deal with BAe and announce it to Parliament on 29 March. BAe have agreed to this accelerated timetable but there are a number of very crucial issues on which

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either BAe's position has not yet been established or on which Lord Young has yet to make recommendations. These are discussed in paragraphs 7-15 below. But the shape of the deal Lord Young now appears to favour involves a £750m injection (less £100m consideration for Land Rover) in return for a conditional "security" which eliminates £750m of tax losses and allows HMG to invoke repayment of some or all of the money if BAe dispose of the businesses and/or trade marks within five years.

Price/Warranties

7. BAe are still carrying out their due diligence exercise and, pending the outcome of their researches, are maintaining a reserve on the size of any injection and/or warranties. Lord Young's formal position on price is clear i.e. £650m net and not a penny more. However, in his letter of 1 March to Professor Smith, Lord Young, contrary to the terms of the agreement with you and the Prime Minister (recorded in Paul Gray's letter of 28 February), did leave open the possibility of warranties going beyond formal title to the shares. We understand that Lord Young has subsequently made clear to Professor Smith that there is no question of substantive warranties but you will wish to confirm at the meeting that the deal is for £650m and no warranties.

Treatment of the Minority

8. In their letter of 29 February BAe accepted that it was for them to deal with minority shareholders in RG, "as may be necessary". The position on this remains open. BAe have yet to indicate whether, and if so how, they would seek to treat the minority. But legal advice from both their advisers and DTI's is now that BAe could not compulsorily acquire the minority shareholding under Section 428 of the 1985 Companies Act because it would constitute differential treatment of classes of shareholders (even if the price offered to the minority was an extremely generous one). This advice, which runs contrary to the Attorney General's views expressed in his letter of 29 February, means that short of primary legislation, the minority cannot be removed compulsorily: this is very troublesome since the existence

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of an entrenched minority constitutes a very significant bar to many of the alternative methods of sterilising tax losses and preventing on-sale.

9. The non-compulsory options available to BAe for dealing with minority therefore are:

- (i) a "skewed" offer i.e. better terms for the minority related to current market value of the RG shares (70-80p) at a cost of some £10 million;
- (ii) making the same offer to the minority as to HMG; if the consideration paid to HMG was about £100m this would amount to some 2p per share;
- (iii) seeking Takeover Panel clearance for a "white wash" procedure i.e. getting the minority to vote specifically on absolving BAe from making available to them the same offer as it was making to HMG.

10. Option (i) is unattractive for the reasons you expressed in Mr Taylor's minute to me of 18 March. And it would be unlikely to silence the more vociferous minority who have spoken of wanting £5 per share. Given the tenor of the advice on Section 428 which suggests that compulsory acquisition is ruled out, there would seem to be little justification for a skewed offer. Option (ii), though neutral and consistent with normal Takeover Code obligations, would no doubt involve a public row with the minority because of the contrast between the terms on offer and the current market price for RG shares. Option (iii) is an unusual one, rarely used under Takeover Panel provisions. It would enable the minority to remain as shareholders of the RG subsidiary of BAe. This would enable BAe to attempt to take out the minority in due course through a Scheme of Arrangement.

11. On the face of it option (iii) looks attractive but I understand Lord Young's current preference is for option (ii) on the grounds that it is neutral and most defensible route in

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overall terms, particularly given that the Government is likely to have problems with the minority whatever price is offered.

Sterilisation of Tax Losses/Restrictions on On-Sale

12. A major element of the terms of the outline agreement on a BAe deal was that only £500m of RG's accumulated tax losses of £1.65 billion should be available to the merged company. Ministers also agreed that there should be an effective block to BAe on-selling RG for five years. In conjunction with their advisers and the Inland Revenue, DTI have been looking at ways of giving effect to these elements of the deal. Many of the options which have been examined - including restrictions on trade marks enshrined in a sale and purchase agreement - give an undesirable locus to the minority because they give rise to differential consideration for HMG. As such there would need to be a vote of the minority shareholders (from which HMG would be excluded from voting its shares) thus giving the minority effective right of veto over the whole deal. DTI have assumed - rightly in our view - that the minority should not be given the opportunity to have such a stranglehold on key elements of the deal. Against this background DTI and their advisers have tabled three options:

- (i) a novel and possibly controversial use of the Industrial Development Act 1982 to advance money to RG by way of a repayable grant. This would turn the injection into taxable income (and thus eliminate tax losses protanto) and the grant would be repayable in full if BAe on-sold the RG business within the next five years. But this route would require multiple orders, subject in draft to the affirmative resolution procedure, raising the financial limit in the 1982 Act by £200m tranches, and a further order sanctioning a single payment in excess of £10m. Thus, while technically probably intra vires, it could be procedurally and politically controversial.
- (ii) use of the Industry Act 1980 powers "to acquire securities" to cover a payment to RG in return for "a

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certificate of conditional grant". This certificate would in fact be a series of time limited debentures whose value to the holder consisted of the right to require repayment in full if agreed conditions were breached (i.e. if the businesses were sold within five years). Tax losses would be reduced as under option (i) but the debentures would be issued to different RG subsidiaries in order to eliminate tax losses in a selective way on the basis of those most likely to be used and thus most valuable to the company.

- (iii) reliance on usual Industry Act 1980 procedures to subscribe for RG equity, coupled with an enforceable undertaking from BAe (enshrined in the sale and purchase agreement between HMG and BAe) that they would not claim RG tax losses in excess of £500m, nor on-sell the business for five years. But there is some doubt as to whether such an enforceable undertaking would not be regarded by the Takeover Panel as giving rise to differential consideration for HMG, thus causing the familiar problem viz a viz the minority.

13. Given the possible Parliamentary difficulties with (i) and the minority problems with (iii) I understand that Lord Young currently favours (ii) i.e. the certificate of conditional grant. But this route (like option (i)) would reduce useable tax losses to some £900m (£1.65-£0.75bn), not the £500m agreed by Ministers, though DTI's advisers believe that by selective targeting of the tax losses the NPV of the tax losses could be reduced to some £500m. (This selective approach might also be consistent with a rapid reduction in Varley Marshall liabilities - see paragraph 14 below). Under option (ii) (and (i)) BAe would be required to disclose the resulting contingent liability in the notes to their accounts. For this reason it is doubtful whether such an arrangement would be negotiable with BAe in view of concerns they

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have expressed recently about the burgeoning scale of contingent liabilities on their balance sheet (e.g. sales financing arrangements for both military and civil aircraft) and the possibly unhelpful impact of the restriction on their share price and borrowing capacity. This would be particularly true if the restrictions on on-sale covered both trade marks and operating assets. But BAe might be prepared to agree to a restriction related only to trade marks since this would enable them to dispose of assets etc. Whether this is acceptable to Ministers is dependent on how strong form of assurance is required. If the main concern is ownership of Land Rover then the trade mark approach would achieve the necessary restraint. (There remains a separate question over whether this approach constitutes differential consideration under the terms of the Takeover Code and thus requires a vote of the minority.)

Varley Marshall Joseph (VMJ) Assurances

14. VMJ liabilities currently stand at around £1.4 billion, split roughly equally between borrowings and trade creditors. If past practice in respect of disposal of RG companies is followed then the Government will announce that, from the date of sale, the Government will accept no further responsibility for ensuring that the obligations of RG are met. Legal advice is, however, that existing obligations at the time of the announcement would continue to be covered by the assurances; and that the obligations could only be removed from HMG by agreement with each of the creditors individually (an impractical proposition).

15. Exposure to the existing obligations would reduce quite rapidly since bank debts would largely be repaid from HMG's cash injection and trade creditors turn over roughly every six months. The majority of existing liabilities would be repaid/turned over in 3-5 months, though some £250-350m (mainly leasing and wholesale finance) would remain in place for at least a year. A cleaner break would be achieved by securing an indemnity from BAe under which they promise to meet all RG's obligations from the date of sale. I understand Lord Young favours adopting this negotiating stance with BAe and I recommend you press very strongly for its

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inclusion as a key term for the deal. But Lord Young is likely to seek agreement to a fall back involving the natural run out of HMG's obligations. I recommend you do not accept this but agree instead to a fallback whereby BAE agree to take over responsibility for the obligations after 4, or at most, 6 months.

EC Timetable/Tactics

16. Lord Young is seeing Commissioner Sutherland tomorrow to impress on him the need for a positive EC response to the deal. While a formal notification of a State Aid application has been lodged, no figures have been put to the Commission. The key issue is therefore what Lord Young should say about the cost of the deal. Given the shortage of time between now and the proposed announcement there would seem to be only two options i.e.:

- (i) Go in with a high debt write off figure (say £850m) to provide Sutherland with room to negotiate the figure down.
- (ii) Come clean at the outset that the figure is £750m gross (£650m net), emphasising the political constraints within which HMG is operating and making it clear there is no scope for a reduction.

17. It would be possible to justify either position on the basis of the RG debt figures at 31 December 1987 (around £600m, partially as a result of a change in accounting treatment of inventory deposits - which will have to be noted in the accounts - to bump up the borrowing figure) and likely future restructuring costs. I understand Lord Young favours option (i) and that he intends to fit in another meeting with Sutherland before the proposed Parliamentary statement on 29 March to attempt to reach a final understanding on £750m gross. Diaries may make this difficult and, in any case, formal EC closure of the state aids procedure is unlikely to take place until June. (The French currently have a state aid application in respect of Renault

*He has:
see his
minutes
behind.*

on 23 March

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COMMERCIAL IN CONFIDENCE

before the Commission ~~but~~ the French Government are seeking to play off closure procedures until after the French elections in May. It would clearly be in the UK's interests for these cases to be processed together).

18. Our preference would be for option (ii), both because of the danger of knowledge of the higher figure leaking back to RG/BAe (thus affecting BAe's negotiating position) and because the very truncated timetable makes any sort of meaningful negotiation pretty problematic. But I suggest you should be guided by the Foreign Secretary on tactics here.

Links with Launch Aid

19. BAe may attempt to take advantage of the desire for an accelerated deal by pressing the Government on outstanding issues on the A330/340 launch aid contract (notably a clause which would enable HMG to reduce launch aid payments if BAe subcontracts Airbus work). BAe are currently dragging their feet over bringing negotiations to a head. I recommend that you seek agreement that there should be absolutely no linkage conceded between the RG/BAe deal and launch aid/Airbus issues.

Contingency Plans

20. Given the probably unwelcome nature of the form of the restrictions on on-sale and the weight of adverse comment about the acquisition of RG, it is not impossible that BAe may decide to walk away from the deal. It would be worthwhile, therefore, briefly reviewing fallback options at tomorrow's meeting. These appear to be:

- (i) sale to single bidder (Ford or VW)
- (ii) limited auction (between e.g. Ford and VW)
- (iii) open auction
- (iv) keeping RG in public ownership pro tem.

Our preference would be for (ii) as a means of reducing the cost to the Exchequer and minimising the growth in contingent liabilities associated with either the uncertainty generated by (ii) or the investment/cash requirements of RG under public ownership.

Conclusion

21. Exclusivity, coupled with the further acceleration to what was already a tight negotiating timetable must run a considerable risk that HMG will be forced to concede too much ground on important elements of the deal unless HMG sticks very firmly to key principles i.e.:

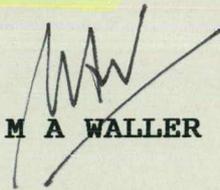
- no more than £650m
- a clean break (i.e. no substantive warranties or hang over of VMJ)
- watertight limitations on tax losses of over £500m
- workable and defensible restrictions on on-sale. (Extensive restrictions on both on-sale of trade marks and RG assets would be very unpalatable to BAe. But if Ministers are primarily concerned about foreign ownership of Land Rover a bar to on-sale of trade marks would be quite effective while leaving BAe some room for commercial manoeuvre in respect of the rest of the business.)

Re VM - BAe to (w/...) for all family take over after 4/6 months

22. As yet none of the elements are firmly in place with BAe. You will therefore wish to press Lord Young very hard for an assessment of the likely acceptability to BAe of what he is proposing and the feasibility of bringing a deal to a satisfactory conclusion by 29 March. The risks of an unsatisfactory deal and/or breakdown (and the possible adverse impact on EC attitudes) needs to be weighed very carefully against the dangers posed by possible firming up of alternative bids during a more protracted

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period of negotiation. Acceleration increases the risk of an adverse PAC finding of an excessive net payment to BAe with weak assurances which has been prompted by the Government rushing to pre-empt a quantified bid by Ford or Toyota.


M A WALLER

SECRET

FROM: M A WALLER

DATE: 22 March 1988

CHANCELLOR

cc. Chief Secretary
Financial Secretary
Mr Anson
Mr Monck
Mr Burgner**ROVER GROUP/BAe**

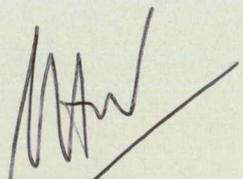
1. Lord Young's minute of yesterday provides a brief summary of the main subjects which need to be addressed at today's meeting, and which are discussed in more detail in my note. It raises no new issues but the brevity of information provided emphasises the need to press Lord Young on the approach he proposes to adopt with both BAe and Commissioner Sutherland.

2. DTI's officials' report on yesterday's negotiations with BAe suggest that BAe intend to take out the minority by a Scheme of Arrangement after they acquire HMG's shareholdings (but the company have not indicated which offer route they intend to adopt in the meantime - see paragraph 9 of my brief) and that they are strongly opposed to indemnifying HMG for existing Varley Marshall liabilities. Lord Young's minute makes no mention of pressing BAe to indemnify HMG for existing obligations - for the reasons set out in my brief (paragraphs 14-15) I recommend you press him to do so, with the fallback of BAe agreeing to take over responsibility for the obligations after 4 or 6 months.

3. BAe have not responded substantively to the concept of a conditional grant and are awaiting from DTI details of the conditions which would trigger repayment of the grant. As foreshadowed in my brief, Lord Young believes that BAe may resist the notion of a grant repayment being triggered by premature disposal of the business or use of more than £500m of accumulated tax losses. Nonetheless, given the generous nature of the £650m injection highlighted by DTI's advisers, we recommend that you

SECRET

strongly support sterilisation of any tax losses over £500m. With the conditional grant route proposed by Lord Young, this would require grant repayment to be triggered by the use of any of the £400m or so out of the total of the some £900m of accumulated tax losses which would remain after the £750m injection (see paragraph 13 of my brief).



M A WALLER



FROM: A C S ALLAN
DATE: 22 March 1988

CHANCELLOR

ROVER

Gerry Grimstone rang me (Schroders are advising Rover). He was extremely concerned that the Government side (ie DTI) was not getting its act together and was failing to get the problems sorted out in a sensible way. He was convinced that there were mechanisms which could be put in place to secure the Government's objectives on tax losses, disposals etc; but there was no sign that anyone had a grip on how to achieve this. There had not been a single meeting where all three parties and their advisers had got together; everything was being done bilaterally.

2. There was some acrimony between DTI and BAe at working level (partly because of other problems eg. on launch aid). And DTI were not very close to their advisers (Barings). Kleinworts (who are advising BAe) had just lost Bay Green to Hill Samuel.

3. The main problem was that nobody seemed to be charged with running the show. He thought it would be very helpful if you could probe a bit at this evening's meeting, which he seemed to know all about - presumably because he had had lunch today with Graham Day. He said Day was also concerned about these points and the message was on behalf of both of them.

4. He quoted as an example the bond idea which Slaughters^(advising DTI) had suddenly produced yesterday. He fully understood the need for safeguards against disposal of Land Rover. But mixing this up with the bond caused BAe very great problems with its credit rating (because of the potential 5 year liability). This was something which could be sorted out in other ways, but time was very short.



5. Equally, BAe had asked for a huge list of warranties. They were certainly asking for too much, and there were ways of dealing with the various issues where BAe did have a strong case. But no one had yet discussed this properly.

6. He said he would be very willing to brief Nick Monck or Mike Waller if you thought that would be helpful. I was non-committal.

7. I said I would pass all this on to you. Gerry is clearly not a disinterested party, and Day is undoubtedly pushing very hard to get the deal sewn up for an announcement before Easter.

A C S ALLAN

*Nick Monck
VRA*



10 DOWNING STREET
LONDON SW1A 2AA

CH/EXCHEQUER	
REC.	23 MAR 1988
ACTION	MR WALLER
COPIES TO	CST, PMG
	MR ANSON
	MR MONCK
	MR BURGNER

23/3

From the Private Secretary

22 March 1988

What is the status of this?
John

Dear Jeremy,

MAGPIE

Ex Flanking!

The Prime Minister held a meeting this afternoon with the Foreign Secretary, the Chancellor of the Exchequer and your Secretary of State to discuss the latest position on Magpie. Mr. George Guise, Policy Unit, was also present.

Your Secretary of State said that the Attorney General had advised that exclusive negotiations could take place with British Aerospace but that any other offers received before conclusion of a deal would have to be considered. Your Secretary of State said he had now received two further approaches from other companies, but no specific offers had been made.

Continuing, your Secretary of State said he saw great advantage in now concluding the negotiations with British Aerospace and making a statement before Easter. Any contract made within this timescale would be conditional on an Extraordinary General Meeting of BAe's shareholders, and to formal approval by the European Commission of the write-off arrangements. Your Secretary of State explained he would be meeting the relevant Commissioner, Mr. Sutherland, on 23 March for an initial discussion, and would open the negotiations by indicating the need for a net government contribution of £850 million. He would present this not as a state aid but as the writing-off of past losses. He would stress the need for a quick decision from the Commission but not indicate the precise timing of any planned announcement. In further negotiations with Mr. Sutherland he would scale down the proposed net Government contribution to the £650 million already agreed with BAe.

The Prime Minister expressed concern about moving towards a conditional contract and statement before Easter. She felt it was essential to ensure that all aspects of the proposed deal with BAe had been thoroughly explored. It was

agreed, however, that further consideration of the timing of any announcement should be deferred until the points of substance had been considered.

Discussion then turned to the handling of the minority shareholders. Your Secretary of State explained that BAe would be pressed to make a generous offer to them. In discussion it was suggested that there would be advantage in BAe not making an early move to resolve the position of the minority shareholders. If negotiations were proceeding with them between the date of any statement and final clearance of the deal by an EGM and by the Commission the minority shareholders would hold a substantial negotiating card; it would therefore be preferable for BAe to defer the buying out of the minority shareholders until later. Your Secretary of State agreed to suggest to BAe that they should adopt this approach.

Your Secretary of State explained the proposed method of capital injection to meet the objectives of preventing an on-sale of the company and limiting the available tax losses. The position of the minority shareholders restricted the options. Your Secretary of State had concluded the best approach would be for the capital injection to take the form of a conditional grant under the Industrial Development Act. Since there was a limit of £200 million under the powers provided by that Act, this approach would involve the need for four affirmative resolutions. But it provided a good means of limiting the available tax losses to £500 million and gave a mechanism for ensuring recovery of the grant if BAe sought to sell off the business within five years of the initial sale.

Your Secretary of State described the proposed arrangements for winding up the remainder of the Varley Marshall assurances. It would not be possible to bring to an end immediately the Government's moral liability to trade creditors, since these were rights held by third party companies. But your Secretary of State envisaged the assurances being run down over a period of perhaps five months as trade credit was rolled over. In discussion of this point, concern was expressed about the risks faced during the period of run-down and about whether that period could be artificially extended. It was also noted that the period of run-down could probably not start at the time of an announcement but only once the deal had been ratified by an EGM and the Commission.

At this point, the Prime Minister had to leave the meeting, but discussion continued amongst the others present.

Your Secretary of State then expanded on the restrictions that would be placed on BAe's freedom of action under the terms of the proposed conditional grant. It was not possible or desirable to limit BAe's freedom over disposal of all its assets. But it was envisaged that the Government would have the right to trigger re-payment of the grant by BAe if they were to sell off the whole of the company or any of its trade marks, or to dispose of a substantial part of the business

as a going concern. In discussion it was agreed it would be essential to establish that BAe accepted this conditionality; it was noted that they had been resistant to an alternative approach previously explored of a bond rather than a conditional grant.

Your Secretary of State explained that a potential difficulty for the deal arose from the Voluntary Restraint Agreement on imports of cars. Although BAe had not themselves raised this point, if any change were to be made in the VRA, BAe might have reasonable grounds to argue that this should have been disclosed before a contract had been signed. Your Secretary of State felt that, given the advice he had received, it would be necessary to defer any possible review of the future of the VRA for the "foreseeable future". It was noted this might involve a period of 18 months. After discussion it was agreed that officials should look quickly at this point and prepare further advice by the morning of 24 March.

The question was raised whether it would be necessary to institute procedures for your Department to monitor the conditional grant once it had been made. Your Secretary of State thought this was unlikely, but again it was agreed that officials should look into this matter urgently and prepare advice by 24 March.

Discussion then turned to the handling of your Secretary of State's exchanges with Commissioner Sutherland. It was felt that following the initial meeting on 23 March, it might be necessary for a further meeting to take place at the end of this week or early next week. Your Secretary of State would need to consider carefully how he handled the concessions in moving from the opening figure of £850 million to the lower figure of £650 million. But it was noted that these concessions would have to be offered before the date of any statement, since the final figure would need to be announced at that stage. With any early statement, there was no possibility of a final Commission approval having been obtained; that stage might take a further six weeks or so.

Concluding their discussion, the Foreign Secretary, Chancellor of the Exchequer, and your Secretary of State agreed that further work was needed on the details of the mechanism for the capital injection and the wind-down of the remaining Varley Marshall assurances. The Government also needed to be fully satisfied that BAe were not seeking any warranties, and would not raise this issue during the period between the signing of a conditional contract and completion of the deal. Officials also needed to complete the further work previously agreed on any review of the VRA and arrangements for monitoring the conditional grant. It was agreed that the results of all this follow up work should be reported to the Prime Minister later this week, together with the outcome of your Secretary of State's meeting tomorrow with Commissioner Sutherland. Further consideration would then need to be given to the position reached and to whether the Government should move towards a statement before Easter.

I am sending a copy of this letter to Tony Galsworthy (Foreign and Commonwealth Office) and Alex Allan (HM Treasury).

*Yours,
Paul*

(PAUL GRAY)

Jeremy Godfrey, Esq.,
Department of Trade and Industry

**SECRET
MARKET SENSITIVE**

*Ch/ Passed comments below on to Mr Waller.
He confirmed that the restriction did
apply to advertising.*

CHANCELLOR

FROM: M A WALLER

DATE: 24 March 1988

cc Chief Secretary
Financial Secretary
Mr Anson
Mr Monck
Mr Burgner

*25/3
24/3
also applies
makes (an) my own
Loy's letter
says it
don't cut*

ROVER GROUP/BAe

1. This note reports developments on negotiations with BAe on the key elements of the prospective deal. It reflects the outcome of a meeting between Lord Young and Professor Smith this morning which now seems to offer reasonable prospects of agreement between HMG and BAe on terms. Lord Young is likely to minute you and the Prime Minister this evening summarising the outcome, with a view to a meeting at No.10 either tomorrow or more likely on Monday (i.e. as scheduled) to seek your and the Prime Minister's endorsement. Subject to any last minute difficulties with BAe or the EC this should enable all the necessary legal and other arrangements to be put in place for an announcement on Tuesday.

These pps. are not attached, behind.

Terms of the deal

2. The main elements of the agreement reached between Lord Young and Professor Smith are as follows:

- (i) **Method of injection:** This is to be via the 1980 Industry Act powers to acquire securities, with the injection being by means of a "certificate of conditional grant". Legal advice is now firm that the 1980 Act may be used in this way (thus avoiding the controversial use of the 1982 Industrial Development Act).

SECRET
MARKET SENSITIVE

- (ii) Restriction on on-sale: Professor Smith has accepted that, as a condition of the injection of money by HMG, if BAe on-sell the business without Government consent the company will have to repay the full value of any proceeds less any costs BAe have incurred in financing the Rover Group business in the meantime. This arrangement is much less draconian than Lord Young's original proposal which was that all of the injection could be repayable by BAe in the event of unauthorised on-sale. As such, the contingent liability to repay represents much less of a threat to the overall financial position of the company and is therefore likely to be seen in a more favourable light by the market. It does not remove the danger that, in the event of BAe getting into financial difficulties and wishing to on-sell, HMG would be faced with the unenviable choice of either invoking the terms of the repayment clause (thereby precluding any substantial benefit to BAe of on-sale) or allowing a politically unattractive sale (e.g. Land Rover to a non-UK company) to go through with no penalty in order to sustain the financial position of BAe. If HMG take this power, then in all probability they would come under severe pressure to use it for wider political reasons despite possible damage to BAe's financial viability. But provided Ministers are clear that they are willing to take this risk the agreement now reached between Lord Young and Professor Smith does provide a reasonably effective lever over on-sale.
- (iii) Sterilisation of tax losses: BAe have agreed to a penalty clause attached to the injection which would ensure that they would gain no benefit from tax losses in excess of the £500m limit set by Ministers.

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- (iv) Warranties: BAe appear to have now dropped any claim to warranties, either between signature of the agreement and its becoming effective (i.e. after EC approval is obtained) or after the sale becomes unconditional
- (v) Varley Marshall Assurances: Lord Young has agreed with BAe that they will use the cash injection to repay bank debt immediately and that trade creditors will be allowed to turn over within the normal cycle (i.e. 2-5 months). For the first 6 months after the agreement goes unconditional HMG will remain liable to meet existing obligations (with a counter claim on RG) but thereafter BAe have agreed to indemnify HMG for any liabilities which crystallise and which relate to the period prior to BAe acquiring Rover Group. Effectively this is the fallback position we recommended in my brief for last Tuesday's meeting and is a satisfactory outcome.

EC Tactics

3. Lord Young's discussion with Commissioner Sutherland yesterday produced no substantive outcome. Lord Young apparently conceded no ground on the scale of the injection (i.e. the negotiating figure of £850m) and Sutherland remained totally non-committal about the EC attitude. Lord Young's intention is to have another meeting with Sutherland on Monday but, subject to the outcome of that discussion, he is minded to announce on Tuesday a deal with BAe involving £800m injection with a consideration of £150m. The purpose of this is to give Sutherland leeway for knocking down the scale of the gross injection by £50m. HMG would then reduce the consideration to £100m thus leaving a net injection of £650m.

VRA

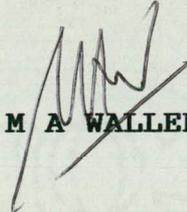
4. Lord Young is likely to minute confirming his view that the review of the cars VRA should be dropped to avoid contractual disclosure difficulties with BAe. Though this is inconsistent

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MARKET SENSITIVE

with the general thrust of the Government's Competition Policy and will continue to impose costs on the car-buying public (put at between £100-700m a year), we reluctantly conclude that you should agree to this because of the disclosure problem.

Conclusion

5. Subject to seeing the terms of Lord Young's minute, the agreement now struck with Professor Smith seems likely to be the best that HMG can expect. While it remains a costly deal in terms of the net capital injection, your position in respect of tax losses now seems fully safeguarded and there are no hostages to fortune in the form of substantive warranties. HMG's liability is also limited in respect of Varley Marshall liabilities. As far as the on-sale restrictions are concerned, the proposed solution looks to be a neat one in relation to BAe's objection to the original proposal. Provided Ministers are content to have this power - which they may find very difficult not to use in response to strong political pressure in the event of BAe on-selling to a foreign car company - then the proposal seems an acceptable one.


M A WALLER

APB. M.

The deal does not reflect favourably on the/ HMB
 regarding activities or the market. Assessment of
 Leyland Bus that said all the alternatives than
 on offer were very unattractive.

1. MR WALLER 13/5/88
2. CHANCELLOR

FROM: H M ROBERTS

DATE: 13 May 1988

cc PS/Financial Secretary
 Mr Monck
 Mr Burgner
 Mr Leniston

An important
 aspect - known
 here, wh. sh.
 will be for
 justification

ROVER GROUP: LEYLAND BUS

You asked for advice on the estimated £24m payment by Volvo for Leyland Bus compared with £4m management buyout (MBO) cash consideration on privatisation in January 1987.

2. We do not know the exact terms of the sale to Volvo since Leyland Bus is now in the private sector but DTI believe that the price paid by Volvo is probably nearer £25-30m than the £24m quoted in the press.

Privatisation deal

3. The actual consideration paid in the management buyout was subsequently reduced to £1.2m from the original £4m following a protracted audit of Leyland Bus as the terms of the deal permitted. But this does not reflect the overall cost of the sale to Rover Group and HMG. A total of £133m was paid out by RG to Leyland Bus to cover debt write-off (£76m), restructuring including a plant closure (£42m), and strengthening of the balance sheet (£15m). This represented a net injection of £132m which fed through to the HMG's cash injection to Rover Group of £680m in February 1987 to cover the sale of both Leyland Bus and Leyland Trucks.

4. The deal was accepted because Leyland Bus were on the verge of bankruptcy, following a collapse of the UK market and prospective loss of the BR Engineering Ltd account on the latter's privatisation. All the available options represented a negative net present value even after assuming debt retirement, an illustration of ^(to then pursued) poor market prospects. The MBO was a cheaper option for RG (and thus the Government) than either closure of Leyland Bus (involving substantial redundancy payments) or attempting to keep the operation open (which would have required a substantial further capital injection by HMG) against a very uncertain market prospect. Alternative bidders Laird

and Aveling Barford initially had less advantageous NPVs than the MBO. After a deterioration in the MBO NPV to a comparable level to these alternative bids they were ruled out because of potential competition policy problems and poor credit-worthiness respectively.

Volvo's Bid

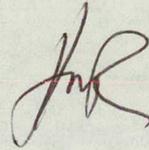
5. Though Volvo initially showed some interest in purchasing Leyland Bus early in 1986 they later withdrew without making a firm offer. The price paid by Volvo presumably reflects the potential cost/availability to Volvo of any other method of expansion in the European market, the restructuring and debt write-off conducted prior to privatisation, and Leyland Bus' clear status as an ongoing business which reflects a recovery in the current and future prospects in the UK market for the company's type of product.

Conclusion

6. The Leyland Bus disposal now looks to have been expensive, given that only some 14 months after sale to the MBO for a pittance, Volvo are prepared to pay a substantial positive consideration for the business. This is, of course, with the benefit of hindsight and does not take account of conditions then prevailing:

- Rover were in dire financial trouble across the board and there was a need for retrenchment and restructuring to enable management to concentrate on the company's core business;
- the then outlook was bleak for the standard bus business in the wake of UK deregulation and poor prospects in Leyland's traditional markets;
- continued RG ownership would have been inconsistent with the general policy stance on public sector ownership of RG companies and would have required injection of Government money to meet operating costs which would have been challenged by the EC Commission.

7. Leyland Bus management (and their financial backers Bankers Trust) have undoubtedly made a very handsome profit on the deal. This is in part a tribute to their percipience and courage in taking a flyer on what then looked to both RG and other commercial operators to be a very doubtful commercial prospect.



MS H M ROBERTS

SECRET

FROM: M A WALLER

DATE: 8 June 1988

CHANCELLOR

cc. Chief Secretary
Financial Secretary
Sir P Middleton
Mr Anson
Mr Lancaster
Mr Monck
Mr Burgner (or)
Ms Roberts

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N/A
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European
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to 100 to 10
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ROVER GROUP: NEGOTIATIONS WITH THE EC

1. This is a progress report on Lord Young's negotiations with Commissioner Sutherland over the Rover Group state aid package. It calls for no immediate action on your part.

2. Lord Young met Commissioner Sutherland yesterday evening in an attempt to reach agreement on the net capital injection figure into the Rover Group balance sheet as part of the BAe acquisition deal. Lord Young's meeting last week with Sutherland had left both sides very far apart with the Commission arguing for a £400m reduction in the net injection of £650m provisionally agreed with BAe (uncomfortably close to our assessment of the objective value of the deal). Last night's meeting was a short one during which Sutherland showed absolutely no inclination to budge from the figure he had tabled the previous week. Lord Young apparently pointed out the political downside of the Commission pursuing this hard line since it would be certain to torpedo the BAe deal. Sutherland merely noted this and signalled no intention to move his negotiating stance.

Assessment

3. DTI officials who accompanied Lord Young believe that there is genuine steel in the Sutherland position and that it is unlikely he will be prepared to countenance recommending to the full Commission approval of the RG injection unless HMG are

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prepared to reduce the net figure by at least £200m. BAe's formal position is that they will not agree to any net reduction in the package but DTI believe a deal could be struck with a net figure of some £100m lower than currently on the table (i.e. £550m net). Anything beyond this would lead a very high risk of BAe withdrawing from the deal, though DTI officials accept that even a £200m reduction would actually leave BAe with a very favourable positive impact on their balance sheet. There are thus considerable practical constraints on the ability of BAe just to walk away.

Next Steps

4. Movement will now only be obtained by pressure at the highest political levels. Lord Young is having a bilateral meeting with the Prime Minister this afternoon at which he is likely to discuss tactics with her. He is likely to suggest that the Prime Minister should write to Delors expressing concern at the delay in settling the case and indicating that, if satisfactory outcome cannot be reached quickly, it will be necessary for her to take the matter up with Delors at the Toronto summit. At the same time Sir Geoffrey Howe might also speak to Delors to stress the political sensitivity of the deal and the need for a favourable outcome (the UK Commissioners will also be lobbied).

5. On timing, the intention is that this should all happen before Lord Young sees Commissioner Sutherland again in Strasbourg in the middle of next week. Assuming it is possible to reach an accommodation with Sutherland the likeliest date on which the case would go to the full Commission for approval is 13 July, a good bit later than we had hoped and requiring that the Parliamentary announcement before the Recess anticipate a satisfactory outcome to the BAe EGM needed to ratify the deal.

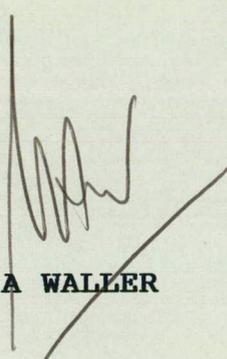
Conclusion

6. Having done a thorough analysis of the UK proposal and (not unexpectedly) identified the considerable padding in the deal, the Commission are proving even more difficult than had been thought.

She has
now done
so - see
b id.

SECRET

The underlying reason for this is not entirely clear. It may be a negotiating stance which Sutherland is deploying in order to get concessions from the UK in other areas of policy to which he attaches importance (notably EC mergers policy, though there has been no explicit sign of this so far). Or it may also be associated with covert lobbying by the Germans which has involved letting senior Commission officials know that VW were shut out of a prospective deal. Clearly next week's meeting between Lord Young and Sutherland will be a crucial one. Lord Young will report back to you and the Prime Minister on the outcome with a view, if necessary, to there being a discussion on future handling of the Commission and possible contingency plans for dealing both with BAe's reaction to a considerable reduction in the net value of the deal to them and alternatives to a sale to BAe. On the former issue, given where we are on Airbus it would be highly desirable to keep the two issues as far apart as possible but it must be likely that there will be pressure (particularly from BAe) for concessions in the Airbus front if the Commission stand firm on a very sizeable reduction in the value of the net package. But any covert increase in launch aid would be problematic not only because of likely US reaction but also perhaps on account of awkward questioning which it might stimulate from the Commission and Parliament.


M A WALLER

dti

the department for Enterprise

SECRET - MARKET SENSITIVE

The Rt. Hon. Lord Young of Graffham
Secretary of State for Trade and Industry

Paul Gray Esq
Private Secretary to the
Prime Minister
10 Downing Street
LONDON
SW1A 2AA

CH/EXCHEQUER	
REC.	16 JUN 1988
ACTION	Mr Waller
COPIES TO	PS/CST, PS/FST Sir P. Middleton Mr Anson Mr Monck Mr Burgner

Department of Trade and Industry

1-19 Victoria Street
London SW1H 0ET

Switchboard
01-215 7877

Telex 8811074/5 DTHQ G
Fax 01-222 2629

Direct line 215 5422
Our ref PS4ASZ
Your ref
Date 16 June 1988

Dear Paul,

... As agreed, I attach a draft letter for the Prime Minister to send to M Delors which has been approved by my Secretary of State and cleared by our lawyers.

The letter has been prepared with a view to possible public use in the event of a major public breakdown in discussions with the Commission. Unless and until that happens, its content and existence is of course market sensitive.

The letter concentrates on the merits of the Rover aid case. Bearing in mind the possibility of publication, our advice is that the strongest political argument - the effect on UK attitudes to the Community - is better delivered orally, either by the Prime Minister or by Sir David Hannay in Brussels.

... The supporting Annex is not included in view of the detailed note on the background already provided to Delors on 10 June (copy enclosed). Any additional note would need to go into a level of detail which in this case my Secretary of State does not feel appropriate.

I am copying this letter and enclosure to Geoffrey Howe and Nigel Lawson, and to Sir Robin Butler.

Yours ever,
Neil Thornton

NEIL THORNTON
Private Secretary

Ext. Copy 3 of 4
Int Copy - of 7

pp3 - M. BF 23/6
(to J)

2/16
also - 1 str.
1/16/88
By whom?

S E C R E T
M A R K E T S E N S I T I V E

DRAFT LETTER : PRIME MINISTER TO PRESIDENT DELORS

I was very concerned to learn from David Young that, at a further meeting on 15 June with Commissioner Sutherland, no progress was made towards resolving the outstanding issues related to the British Aerospace acquisition of Rover Group.

As the Secretary of State has stressed, this venture would represent the final and most important stage in the return of Rover Group businesses to the private sector. The British Government would no longer stand behind the obligations of the company which would be exposed fully to the disciplines of the market-place - a development which, in the context of the European motor industry, I assume you would welcome.

Rover Group has made encouraging progress in the past year or so but there remain substantial commercial risks attached to the long-term development of the businesses. Its viability depends critically on a restructuring of the balance sheet to remove the huge burden of debt which has accumulated during many years of losses. This is a fundamental condition of the agreement with British Aerospace and, without it, the deal will not go ahead.

David Young has explained to Commissioner Sutherland in exhaustive detail the background to the acquisition and the basis of the financial package he has negotiated. I firmly believe this represents a reasonable balance between the opportunities and risks confronting British Aerospace. I am therefore anxious that in the appraisal there should be full recognition of the significance of the deal and the commercial realities which underpin it.

I am equally concerned at the potential damage to the businesses if there is continued uncertainty about their future.

I urge you to make every personal effort to ensure that progress is rapidly made towards a mutually satisfactory solution.

THE ROVER GROUP STATE AID CASE

Note for the President of the European Commission

Policy Objectives of the UK Government

1. The UK Government believe that the sale of its 99.8% shareholding in the Rover Group plc (RG) to British Aerospace plc (BAe) will achieve shared UK and Community objectives by:

- i) enabling the UK Government to complete its withdrawal from intervention in the vehicle manufacturing industry;
- ii) enabling RG to contribute to restructuring in the European vehicle industry by responding freely to the disciplines of the open market;
- iii) preserving competition between European and other vehicle manufacturers.

The Terms of the Deal

2. Following a time limited exclusive negotiation with BAe, on 29 March 1988 the UK Government announced agreement to sell its shareholding in Rover Group to BAe for £150m. The agreement is subject to EC Commission approval of the state aid element involved in meeting RG's £800m indebtedness, and to BAe shareholder approval.

3. RG's tax losses have been constrained by extinguishing two thirds of its trading tax losses, and by preventing any RG tax losses being offset against profit or capital gains in other BAe businesses. The residual value of these tax losses has thus been reduced.

4. The Government have declined to give any warranties to BAe relating to RG's performance or products. BAe will assume responsibility for all RG's existing, future and contingent liabilities. The result is a clean break for the UK Government from all future financial risks and liabilities of RG.

5. BAe have given an undertaking to retain the RG businesses for at least five years. Should BAe sell either the RG cars business or Land Rover within five years, the UK Government is empowered to recoup any economic benefits. BAe will thus bear very major risks in running these businesses for five years.

6. The UK Government have not sought to constrain in any way BAe's freedom to manage the RG businesses. This includes the freedom to make such changes to capacity as market conditions suggest necessary.

Exchanges with the Commission

7. The development of exchanges with the Commission is set out at Annex A. The UK Government have endeavoured to keep the Commission as fully and promptly informed as possible about the progress of commercial negotiations and the details of the terms agreed with BAe.

8. On the substance of the case Commissioner Sutherland has expressed concern that the exclusive negotiation with BAe failed to establish a market price; and that the price is too low. However, the UK Government agreed with the independent commercial judgement of the RG Directors that the RG businesses were too fragile to survive an auction. The disclosure of preliminary talks with Ford in Spring 1984 led to RG's share of the UK car market falling two percentage points and to RG losing £250m in sales revenue; RG has never recovered.

9. The price negotiated with BAe reflects the very poor past record of RG which last made a profit (before extraordinary items) in 1976; the current minimal trading profit; the constraints on the use of RG's tax losses; and forecast negative cash flow and poor profits for several years to come.

10. On debt Commissioner Sutherland has expressed concern that £300 million of the estimated £800 million indebtedness at completion is composed of what the Commission regard as ineligible items. The UK Government have explained that £725 million of the indebtedness is derived from the independently audited RG 1987 statutory accounts. The remainder is accounted for by the adverse effect of the strike at Land Rover this Spring and the interest charges on the historic debt between 1 January 1988 and estimated completion in Summer 1988.

11. Commissioner Sutherland has also expressed concern that Rover Group is being sold debt free. BAe will not purchase RG except on a debt free basis given its track record, poor financial prospects for the rest of the decade and the risks associated with the RG businesses.

Timing Constraints

12. RG remains a highly fragile business. There is a grave danger that any prolonged uncertainty about its future ownership will severely damage it. The commercial vulnerability of the Group is compounded by the acute level of political interest in RG. Doubts about the outcome of negotiations with the Commission are already attracting attention in the UK Parliament. If it does not prove possible to announce Commission clearance before the UK Parliament rises in the second half of July political speculation and commercial uncertainties will threaten the future of RG. If this is to be avoided Commission approval is needed by early July at the latest.

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ROVER GROUP STATE AID CASE

Timetable of key events

- | | |
|-----------------|---|
| 1 March | HM Government announced its intention to enter exclusive negotiations with British Aerospace for the sale of Rover Group. Lord Young had telephoned Commissioner Sutherland in advance of the public statement. |
| 14 March | HM Government formally notified Commission under Article 93(3) of its intention to provide capital to Rover Group. |
| 23 and 28 March | Lord Young reported developments in commercial negotiations to Commissioner Sutherland. |
| 29 March | Terms of agreement between UK Government and British Aerospace announced, subject to approval of European Commission and British Aerospace shareholders. |
| | European Commission opened formal procedure. |
| late April | Commission letter circulated to other member states seeking comments. |
| April/May | Provision of detailed information to DGIV. |
| 26 May | Lord Young discussed DGIV appraisal of Rover case with Commissioner Sutherland. |
| 7 June | |
| [15 June] | |

Apr 3 pl.

FROM: M A WALLER

DATE: 22 June 1988

CHANCELLOR

cc Chief Secretary
Sir P Middleton
Mr Anson
Mr Monck
Mr Burgner
Ms Roberts
Mr Reed (IR)

*Thank
he would
need to work
this into*

ROVER GROUP/BAe DEAL: TAXATION ASPECTS

1. It is evident from recent Ministerial exchange with the Commission (both Lord Young/Sutherland and Prime Minister/Delors) that some change in the treatment of RG's tax position is likely to figure in the Commission's proposals for a settlement to the RG/BAe state aids case. This minute outlines the possible options and the benefits and costs to the Exchequer.

Negotiating Gap

2. As indicated in the record of the PM's talk with Delors (Gray/Thornton of 20 June) the Commission is likely to propose a reduction in the debt write off in return for an agreement to reduce the restrictions on the use of tax losses by BAe. On the basis of Sutherland's position the gap needing to be filled by tax benefits is very large; a minimum of £100m assuming BAe would be prepared to accept a reduction in the net value of the deal of up to £100m and the Commission's bottom line is a reduction in debt write off of £200m. (Sutherland is currently arguing for a lot more than this: a £260-300m reduction in the debt write off and RG to be left with £100m debt on their balance sheet).

Charles Powell's letter (attached) provides a fuller a/c.

Value of Tax items

3. There are three elements to the tax position of Rover Group which are relevant to the deal:

- (i) Some £1600m of accumulated trading losses of which BAe have agreed to use only £500m: it would be possible to alter the contract to allow BAe/RG to utilise more or all these tax losses. But the practical financial effect from BAe and RG's point of view would be very limited because RG would not be able to utilise these losses for some very considerable time and they cannot be thrown sideways to offset BAe's mainstream Corporation Tax charge. BAe are therefore likely to attach little if any monetary value to any easing in the restrictions on the use of these.
- (ii) Capital losses from past disposals of assets which are currently estimated at £200m and, at current tax rates, represent a potential benefit of some £70m. Unlike trading losses these can be utilised elsewhere in a group of companies so that they could be thrown sideways to be used by BAe. The precise monetary value that BAe would place on them would clearly depend on whether the company expected to realise capital gains on disposal of assets. But, given the substantial holdings of buildings and land in BAe's balance sheet, it would be surprising if they were not able to utilise these losses in a tax efficient way.
- (iii) Disclaimed capital allowances: these are tax allowances to compensate a company for the depreciation of certain capital assets. In the past RG have not claimed certain allowances since this would have increased the Group's accumulated trading losses for Corporation Tax purposes. The effect of disclaiming them is that they become available for

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use in future years on a 25% per year reducing basis. Like capital losses they can be transferred to other companies in the same group. The precise amount of disclaimed capital allowances is difficult to determine in the absence of a final settlement of RG's tax position for past years. DTI's advisers suggest that a minimum figure would be of the order of £60m and a maximum of £300m, giving rise to a potential benefit in the range £20-100m at current rates of tax.

4. Under the current terms of the deal BAe have agreed not only to limit the size of trading losses to be utilised by RG to £500m but have also undertaken that the capital losses and capital allowances would only be used within Rover Group, thus limiting substantially their value to BAe. If HMG were to relax these conditions then there is, on the taxation side of the deal, £90-170m nominally available to offset the reduction in debt write off for which the Commission are pressing. The net present worth to BAe would be less than this because the taxation benefits could probably only be realised over a number of years.

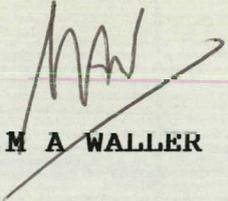
Summary and Conclusion

5. There clearly is some scope for changes in the taxation arrangements to be used to offset the adverse impact of a reduction in the debt write off. But the precise role which tax might play is problematic both in terms of the value which BAe might place on a less restrictive treatment of tax and the substantive and presentational problems for Government. On the former point, BAe will no doubt attempt to down play strongly the benefits of the taxation elements compared with a cash injection up front. And for the Government a substantial relaxation of the tax restrictions may be just as difficult to defend to Parliament as a major reduction in the net value of the deal.

6. From the Exchequer's point of view a £ for £ replacement of debt write off by lower taxation receipts is in principle unwelcome. Other things being equal, it would be preferable to

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see the net cost of the deal (by whatever route) reduced. If, however, Ministers judge that for both commercial and political reasons BAe could not be pushed to accept a debt write off reduction of more than £75-100m then the tax route, perhaps coupled with reclassification of some of the injection as assistance for investment/restructuring, may well be the least damaging and problematic of the options now on offer. This assumes crucially that the Commission are prepared to move substantially from their current very tough negotiating stance.


M A WALLER

SECRET

Personal to CAB.

It is vital to get across to Lord Young as the Prime Minister the points on the end, particularly the first two, though the third is also important for the Sundry.

FROM: M A WALLER
DATE: 29 June 1988

mp

- 1. MR MONCK
- 2. CHANCELLOR

cc. Chief Secretary
 Sir P Middleton
 Mr Anson
 Mr Burgner
 Ms Roberts
 Mr Reed (IR)

*** CST
 I agree with the advice.*

*Ch.
 For info. - CST is, of course, going to the PM's meeting in your plane.*

ROVER GROUP/BAE

1. This is a position report on negotiations over the RG/BAE deal, both in London and in Brussels. You may find it helpful in case, as looks possible, Lord Young wishes to have a further off the record discussion with yourself and the Prime Minister in the margins of tomorrow's Cabinet.

Brussels

2. The gap between the Commission's and UK positions now appears to have narrowed to some £200m, primarily as a result of the possible use of regional assistance for investments at Longbridge and Solihull to replace some of the debt write-off (e.g. wholesale vehicle finance which the Commission understandably regard as working capital). The precise figures and details of what might be eligible for assistance are still be nailed down by DTI officials. The current intention is that the possible eligibility of substantial proportion of RG's Midlands investment programme for RSA could be prayed in aid as a justification for some £150m of the capital injection by HMG.

3. There are two main options on the table here:

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- (i) some element of the capital injection being reclassified as aid for capital expenditure in recognition that it would otherwise be eligible for RSA;
- (ii) actual payments of RSA, whether paid up front in a discounted lump sum or spread over the life of the capital programme (as is usual under RSA guidelines. Either option would involve some element of clawback if the expenditure did not take place. (There would also need to be a bar on eligibility for further regional assistance).

4. The "notional" RSA approach (option (i)) is preferable to actual RSA payments (whether spread over the life of the capital investment or made up front on a discounted basis) since it avoids doing serious damage to RSA policy generally and ensures all the money is spent this financial year. But it is a fairly blatant device to avoid embarrassment on the Commission's part about sanctioning a Government injection which involves provision of interest-free working capital (i.e. operating subsidies for RG).

5. The other major element in the equation is some easing in the restrictions in the use of tax losses (see paragraph 8(i) below) which DTI have hitherto argued to the Commission would be virtually valueless to BAe/RG.

6. At the political level, the Prime Minister had another fairly bruising confrontation with M. Delors, emphasising that, if the deal fell through, the blame would fall squarely at the feet of the Commission (Powell to Thornton of 28 June). Delors reiterated his desire to see the issue brought to a speedy and successful conclusion. Behind the scenes, the UK is in touch with the Secretary General of the Commission (David Williamson) in order to attempt to close the negotiating gap. (The forthcoming note from the Commission is not to be taken as the last word.)

Negotiations with BAe/Rover Group

7. You have seen a copy of Roland Smith's letter to Lord Young of 28 June. This suggested that Lord Young had been exceeding his current negotiating mandate without Treasury authority. (The propositions had not been discussed with the Treasury apart from your oral exchange with Lord Young related to my note of 22 June on tax and some preliminary discussion of 8(iii) below). But DTI officials, who were not present, describe the letter as a very partial record of last Monday's meeting. Lord Young intends to reply to Smith within the next 24 hours indicating that there may be scope for reducing the gap between the UK and EC position and that, as a result, some of the wheezes suggested by Smith would not need to be employed. I have pressed DTI to include in the draft, whether or not anything of the sort was said to Smith, a clear statement that BAe must accept that there will be a substantive reduction in the net consideration (at the moment there is nothing on the record on this and BAe's position is that HMG must make up any shortfall in full by whatever means are at their disposal).

8. On the proposals in the 28 June letter:

- (i) Treatment of trading losses: It will be made clear to BAe that trading losses cannot be moved sideways to be set off against BAe profits (as already recorded in Mr Taylor's letter of yesterday). But DTI, their advisers and the Revenue are currently looking at the feasibility of establishing an intra-group leasing company which would be responsible for the purchase of capital assets and would lease them back to Rover Group on an arms length basis, in the initial period at least at a fairly low charge but rising over the period over the lease to recover the full economic cost of the investment. The effect of this - which would be rather like a low start mortgage deferring interest - would be to increase Rover Group's trading profit, thereby enabling them to utilise their accumulated trading losses more quickly. (It would

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also assist in enhancing the value of the disclaimed capital allowances). In principle, BAe could do this anyway but would be looking for some increase in the £500m of losses currently available under the funding agreement; certainty about the Revenue's interpretation of Section 483 (i.e. a ruling on what would constitute a material change of business); and acceptance that such an arrangement would be outside the ring fencing applied to the capital losses and capital allowances. The Revenue's immediate reaction to the lease proposal was that this would be an acceptable arrangement in terms of tax policy and law, subject to seeing the proposition in more detail.

- (ii) Spreading BAe's consideration for Rover Group over 18 months: We understand that this was not a Lord Young suggestion and that DTI are not minded to make any concession on this front.
- (iii) Grants towards RG's capital expenditure: This is the RSA route referred to above. The difference between the DTI and BAe position is that DTI are essentially using some form of notional RSA as a means of replacing some element of the debt write-off. BAe are pressing for additional capital grants to close the gap between the UK and EC position - this is unacceptable.
- (iv) Reducing the restrictions on disposal of RG business from 5 to 2 years: Again a BAe idea which currently at least DTI believe to be presentationally unacceptable and therefore would require collective Ministerial consideration.
- (v) HMG to cover the cost of minority buy out: Again a substantial shift from the current arrangement and, though probably not very costly, presentationally difficult.

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- (vi) Restructuring the Wholesale Vehicle Financing: very much in BAe/RG's court but the Commission are looking essentially at the substance rather the form of this item and regard it unequivocally as working capital.
- (vii) HMG to order Rover vehicles: Again reportedly a BAe idea which would involve serious value for money issues, as well as probably offering rather little in the way of closing the gap.

Next Steps/Timing

9. DTI are having a meeting with RG/BAe on that tax point this afternoon which I shall be attending. Subject to the outcome of that meeting and further feedback from the Commission on progress at the Williamson end, DTI officials will recommend to Lord Young a reply to Smith which tables a paper on the tax issue. This will indicate in broad terms the possibilities associated with the leasing idea and the greater value that this might impart to both the trading losses and the capital losses/allowances. The intention is not to attempt to put a figure on the value but to set the paper clearly in the context of BAe having to accept that there will be a significant reduction in the net value of the deal but that the tax element may go some way to easing BAe's position. Thereafter DTI officials will be seeing DGIV on Friday to make further progress on both the regional assistance and tax issues with a view to Lord Young attempting to reach a final settlement with Commissioner Sutherland early the following week. Lord Young would intend to put the final shape of this deal to you and the Prime Minister over this coming weekend. Assuming agreement is reached ^{with} for Sutherland it is likely that the deal will go to the full Commission on 20 July with a Parliamentary statement shortly thereafter.

Comment

10. The gap between the UK and Commission positions is narrowing and DTI officials believe that by using the notional RSA and the tax points it should be possible to close the gap further to

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perhaps around £120m. Assuming this is right then clearly the key issue is what BAe are prepared to accept. So far they have hardly budged an inch on their contention that the net value of the deal must be maintained (having retracted the tacit acceptance of some reduction by Professor Smith at an earlier stage). BAe have proved to be characteristically tough negotiators (Smith's letter of 28 June is a good example of this) and Lord Young will need to make absolutely crystal clear to Smith that they must accept some net reduction, even though HMG may be prepared to remove some of the burden by easing restrictions on the use of tax losses. The fact remains that, even with a £120m reduction (excluding easement on the tax front) BAe would be getting a very good deal. Going beyond help on the tax fronts to the sorts of ideas described in paragraphs (ii), (iv), (v) & (vii) would involve BAe extracting far more than their pound of flesh from the Government.

Summary

11. In the light of the above in any discussion with Lord Young I suggest you emphasise the following points:

- (i) against the background of the Commission's position on a net reduction in the value of the state aid and the generous nature of the original deal, BAe must accept a real cut in the net consideration. (This figure would hardly be less than the £75m mentioned by the Prime Minister to Delors).
- (ii) Lord Young should reserve the Government's final positions on any relaxations on the tax elements of the deal until the Revenue are clear that the ^eproposals are acceptable in terms of tax legislation and policy.
- (iii) on the notional RSA element the clear preference should be for payment this year rather than stretching into the Survey period.

even BAe
shd see the practical
force of this point
NM.

M A WALLER

18/236
BRITISH AEROSPACE



BRITISH AEROSPACE
PUBLIC LIMITED COMPANY
11 STRAND
LONDON WC2N 5JT
Telephone: 01-930 1020
Facsimile: 01-839 4774
Telex: 919221

From: CHAIRMAN

Direct Line: 01-389 3923

SECRET

Rt. Hon. Lord Young of Graffham,
Secretary of State for Trade & Industry,
Department of Trade & Industry,
Room 803,
1 Victoria Street,
London, SW1H 0ET.

28th June, 1988.

My dear David,

ROVER GROUP

This letter is to confirm our discussions yesterday evening. You indicated that some £175 million is required by the European Commission as a reduction from the previously agreed £800 million cash injection into Rover (net £650 million, including payment of £150 million by British Aerospace to HMG for the shares of the Rover Group). The points set out below were covered:

1. Consideration will be given to the granting of additional Rover trading tax losses brought forward, over and above the presently agreed level of £500 million. It is your view that such additional trading tax losses could be made available for offset against trading profits of British Aerospace and you asked for our estimate of what the figure would be in order to meet the shortfall in the cash injection to Rover. Provided that these losses can be offset with immediate effect, then our estimate would be around £600 million, taking account of the time element in absorbing these losses against British Aerospace profits.

We would require a commitment in writing from the Inland Revenue to support this treatment.

2. The consideration payable by BAe for the Rover shares could be spread over 18 months, without any interest charge, with stage payments to be agreed.
3. Grants against Rover Group's capital expenditures over the next few years, over and above those that are normally claimable by the Company, would be available on special terms for certain classes of assets.

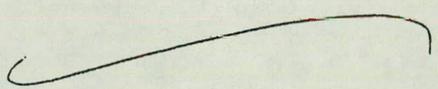
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4. HMG would reduce the period of time during which BAe is restricted in the disposal or sale of major businesses or brand names from 5 years to 2 years. This might be related to adverse changes in business conditions, which resulted in sales volumes reducing by 15% - 20% from 1987 levels.
5. British Aerospace would conclude the purchase of the Rover minority shares in agreement with you, and the cost thereof would be met by HMG.
6. We are in contact with Rover Group executives on the possibility of restructuring the wholesale vehicle financing as straight commercial bank debt. Needless to say we fundamentally disagree with the Brussels view that this is other than debt required for the business.
7. You said that you would look into the possibility of HMG placing significant orders for Rover vehicles over the coming years.

My understanding is that you wish to resolve this matter by the end of this week. You will appreciate that we will need to be in a position to explain clearly to our shareholders the basis of any changes from the originally agreed deal.

Yours sincerely,

Roland Smith





Inland Revenue *Ch.*

Policy Division
Somerset House

FROM: J H REED

DATE: 30 JUNE 1988

As shopetial, a clear non-starter. Content to write to Lord Young as proposed - 396

1. MR MCGIVERN
2. CHANCELLOR

ROVER GROUP/BAe

We look at this very carefully and are satisfied that Rover's existing losses could not be set-off against BAe's profits without a change in the law.

*OK as Am-J, n
JHG
30/6*

We understand that Lord Young is pressing for the existing trading tax losses of Rover Group to be made available to be set against the profits of BAe. This note, which has been seen in draft by Official Treasury, examines the scope for this and there is attached a draft letter for you to send to Lord Young.

Existing law

2. A company's current trading losses can be set against its other income and against the profits of other members of a group of companies. Any losses not used in this way can be carried forward to be set against future profits of the trade but cannot be set off in any other way. So Rover's brought forward trading losses could not be set against the profits of British Aerospace. This is a straightforward matter of law and there is no scope for any exercise of Revenue discretion to allow the set-off of losses.

3. In other circumstances, for example if BAe were a car manufacturer, there might be scope for BAe's profitable activities to be transferred to the Rover company with the tax losses and for these losses to be set against the future profits from the combined activities. But we cannot conceive of any way in which this could be done with BAe's (largely aerospace) activities, except very gradually over a long period of time - which would not be of any significant value

cc Chief Secretary
Sir P Middleton
Mr Anson
Mr Monck
Mr Burgner
Mr Waller
Ms Roberts

Chairman
Mr Painter
Mr McGivern
Mr Deacon
Mr Campbell
Mr Reed
PS/IR

to BAe. If BAe were to attempt this we would have to challenge any claim to loss relief and we do not see the Courts allowing the relief. DTI's tax advisers and BAe's tax advisers have reached the same conclusion; and indeed this understanding of the law is accepted throughout the tax industry.

4. Our advice is therefore that it is not possible for Rover's existing tax losses to be set against BAe's profits to any significant extent.

New law

5. In principle, it would be possible to legislate to allow this use of Rover's tax losses. The legislation could be either general or it could be specific to BAe.

6. General legislation, however it worked, would be likely to be very expensive. There is currently just under £20 billion of unused tax losses being brought forward. General legislation would facilitate the bringing together, by takeovers, of profits and losses and so the cost could well run into £billions.

7. If the legislation were limited to BAe the cost would be much less. If you wish, we shall send you a note about the way the legislation could work (although we have not consulted Parliamentary Counsel and we cannot yet guarantee that there would not be any problems). But we imagine that Ministers would not be attracted by the idea of tax legislation favouring BAe.

8. It is also doubtful how much value such a legislative relief would have for BAe. From the figures given by BAe to DTI, it is clear that BAe's own taxable capacity is limited and the leasing scheme (referred to in paragraph 8(1) of Mr Waller's note of 29 June) would erode it substantially. We cannot reliably estimate the value of such a relief and we do not expect that DTI could either - so much depends on BAe's

future tax liabilities which in turn depend upon its profitability. However our guess is that the value of a relief allowing Rover's losses to be set against BAe's future profits would run into tens of £millions but not exceed £100 million. The value would be increased if the losses could be set against BAe's past profits, but this would be an even greater divergence from the existing tax system.

9. The proposals in relation to leasing (and associated assistance from the Revenue over prior clearance for such a scheme) have already been put to BAe in outline. Their initial reaction was to place very little additional value on the proposals, although we and DTI's tax advisers believe they might be of significant benefit to BAe (the DTI's advisers suggest at least £50 million). We understand that, after further reflection, the company are likely to say that removing the restriction on capital allowances might be worth a total of £17 million but that the rest of the proposals offer no additional benefit. But there must be a substantial element of negotiating tactics in their response. The draft letter therefore refers to these positive Government proposals.

Conclusion

10. We assume that you will wish to discourage this idea. The attached draft letter takes this line.



J H REED

Pre type final

LORD YOUNG

PRIME MINISTER

as no meeting prospects

ROVER GROUP/BRITISH AEROSPACE

I understand that

There was a brief discussion yesterday at the Prime Minister's meeting about the scope for allowing BAe to set Rover's past tax losses against BAe's taxable profits. The meeting recognised very considerable difficulties with the proposal and further work has confirmed this.

I can confirm that this proposal raises very considerable opposition, but no task.

In no just place,

The Revenue have confirmed that it is not possible for this set-off of tax losses to be achieved under existing law. BAe are aware of this and I believe that your officials have been given the same advice by your department's tax advisers.

not only to avoid of interest

Amending the tax law generally to allow relief to be given in this way would be likely to be very expensive, because it would facilitate the bringing together, by takeovers, of tax losses (which currently total about £20 billion) and profits. The cost could well run into billions of pounds.

since

of course

In principle, this cost could be greatly reduced if the tax relief were to be made available to BAe only. But I am sure that you share my view that this would be quite indefensible. Against this background I cannot support legislation on either basis.

quite apart from the problem of hybridity

I conclude, therefore, that

I think we have to make it clear to BAe that this idea is not a runner. But what is on offer on the tax front should be attractive to them. Your officials and mine have been looking at ways of relaxing the restrictions in your agreement with BAe. The relaxations under

consideration (concerning the use of capital allowances, capital losses and leasing arrangements) would be of substantial value to BAE, particularly since the Revenue would ~~look~~ ^{be happy in no circumstances to prepare (S)} in advance at BAE's proposed use of these relaxations and advise them whether they would be effective for tax purposes. This reassurance, which the Revenue do not normally give, would be of real assistance to BAE in maximising the value of the relaxations and thereby helping to bridge the gap opened up by the Commission's attitude. I understand that DTI's tax advisers suggest that this ^{legitimate advice} package would be worth at least £50 million. ^{to BAE. themselves} BAE heavily discount this ^{figure} but, in keeping with their usual approach to Government, ^{this must be made manifest & put down to} there must be a lot of negotiating tactics in this.

I am copying this letter to the Prime Minister and the Foreign Secretary. *Geoffrey Howe*

NIGEL LAWSON



10 DOWNING STREET
LONDON SW1A 2AA

Handwritten: PJP
✓ IT
Wagner

From the Private Secretary

30 June 1988

Dear Terry,

ROVER

The Prime Minister had a brief discussion this morning with the Foreign Secretary, your Secretary of State and the Chief Secretary, HM Treasury about the latest position on discussions with the European Community Commission on Rover.

I should be grateful if you and copy recipients would ensure that this record is seen only by named recipients on a strict need to know basis.

Your Secretary of State reported that little further progress had been made. Commissioner Sutherland was showing no willingness to move further than a demand for a reduction of £360 million in the package, although this could be reduced to £210 million if agreement could be reached on reclassifying part of the package as regional aid. Your Secretary of State had also spoken to the Chairman of British Aerospace (BAe), and his impression was that the company could be persuaded to accept a reduction in the package of some £100-125 million. On this basis, there was a remaining gap in the negotiations of some £85-110 million.

Continuing, your Secretary of State said he saw great difficulty in bridging this remaining gap. But he would like to explore the possibility of enabling the trading losses of the Rover Group to be available to BAe for tax purposes. He understood that, if £600 million of these losses were made available, they could be worth £175 million to BAe. This approach would cause no difficulties with the Commission and would therefore be a means of squaring the circle.

In discussion, it was argued that care should be taken in not pressing BAe to accept further reductions in the package; there was a substantial danger that this would threaten the sustainability of privatisation of Rover. Serious doubts were also expressed, however, about the likelihood of the Inland Revenue accepting that trading losses in a car business should be available for tax purposes to an aircraft business.

Summing up the discussion, the Prime Minister said that, although there were serious doubts about the feasibility of this approach, the possibility should be explored with the Inland Revenue of trading losses in Rover being available for tax purposes to BAe. It would also be helpful if the Foreign Secretary could clarify whether it was possible to bring the issue to a head in the full European Commission if Commissioner Sutherland remained reluctant to bring a proposal forward to his colleagues.

I am copying this letter to Alex Allan (HM Treasury), Tony Galsworthy (Foreign and Commonwealth Office) and Jill Rutter (Chief Secretary's Office).

*Yes,
Paul*

PAUL GRAY

Jeremy Godfrey, Esq.
Department of Trade and Industry

SECRET

FROM: M A WALLER

DATE: 1 July 1988

CHANCELLOR

cc. Chief Secretary
 Sir P Middleton
 Mr Anson
 Mr Monck
 Mr Burgner
 Ms Roberts

ROVER GROUP/BAE

1. This is a brief for the meeting now scheduled for 2.30pm on Monday at No.10 to discuss future handling and tactics in the light of the Commission's latest stance on the capital injection.

Commission position

2. The latest report of the Commission's position (i.e. as at 2.30pm today) is that Sutherland intends getting a Commission decision on 13 July based on the following figures:

Debt Write Off	Tax/Regional Aid	Total
£440m	£150m	£590m

In other words Sutherland intends that there should be a cut of the gross figure of £210m. But this assumes that the Commission accept the UK's argument that the additional £150m should be made available to BAe via notional (or actual) regional assistance, rather than through carry forward of tax losses. This is by no means a foregone conclusion. At a meeting with senior DGIV officials this morning, DTI officials were told that the Commission would only be prepared to countenance some £50m of regional assistance. This is because any higher figure would lead to the balance between aid intensity and restructuring on the Rover Group deal moving unfavourably in comparison with what was

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done on Renault. DGIV's attitude is also, apparently, conditioned by a belief that RG's accumulated trading losses are worth a lot more than we or the Company are admitting, particularly in view of RG's generally improving profit performance.

3. If the Commission cannot be moved to increase regional assistance then the gap would increase to £310m. Given the current financial components of the deal this looks unbridgable. In these circumstances Ministers would be faced with three broad choices:

- (i) Exert further political pressure at the highest level to remove the roadblock on regional assistance.
- (ii) Offer BAe financial assistance via another route which is less open to attack from the Commission. Two possible, though extremely unpalatable candidates are more preferential treatment for defence purchases (e.g. advancing/increasing orders for substantial items of equipment) or increased launch aid for Airbus. Either route is obviously fraught with difficulties. On the defence side, such an approach would deal a major, if not fatal blow to all the attempts to improve value for money in defence procurement. This would have major continuing costs to the Exchequer. Agreeing to BAe's demands on launch aid would weaken our position in relation to launch aid generally (Rolls Royce have now submitted a formal application for £100m assistance for the RB524J/L). Perhaps more importantly, it would invite a renewed attack by the Americans on Government assistance to the Airbus programme. This might well lead the US to invoke retaliatory action which would be very damaging to the commercial prospects of Airbus.
- (iii) See the RG/BAe deal collapse. This would clearly be highly politically embarrassing and could also generate sufficient commercial uncertainty about the future of RG to undermine the improvement in its

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competitive position, thus threatening its return to profitability and, possibly survival. There would be a need, therefore, to move very quickly to indicate how the future of the Group was to be secured. Trade sale buyers are waiting in the wings (notably Ford and Volkswagen, and possibly Nissan in conjunction with Lonhro). But all involve substantial presentational difficulties. The alternative might be a leveraged management buyout/share placement on the lines of the arrangements discussed in outline earlier this year. Graham Day (who we know to be thoroughly disillusioned with BAe's senior management abilities and style) is working on this option so that it might be activated quite quickly. Any of these approaches would involve some form of Government write-off of debt and would therefore require clearance by the Commission. But, on the assumption that either a trade sale or buyout/ placement would involve no more than the Commission are prepared to countenance on the BAe deal, then it might be possible to put arrangements in place quite quickly.

4. Clearly option (i) is something which would need to be pursued with great vigour. But if the Commission cannot be moved then of the alternative methods of assistance to BAe launch aid looks the least damaging, though still very problematic. If the deal collapses the least damaging commercial route would be a trade sale. This minimises the short term risk of major commercial damage to Rover Group's business and thereby heads off the possible crystallisation of the £1.6 billion of Varley Marshall liabilities.

5. On the assumption that the Commission can be persuaded to accept £150m of regional assistance, then it does seem to me that we have the makings of a deal with BAe provided Lord Young plays it very tough with the company. The main elements would be as follows:

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	<u>£m</u>
- Remove ring fencing on capital losses/ allowances plus leasing	50
- Cash flow benefit from RG's improved 1988 trading results	80
TOTAL	<u>130</u>
- Reduction for BAe	80

Presentationally RG's improved trading position since the beginning of the year would be helpful in defusing criticism about the real size of the reduction enforced by the Commission and the willingness of Government and BAe to accept it.

6. As a final sweetener to BAe e.g. if they play the line very hard that the tax elements of the deal are not worth anything like £50m, it would be possible to offer some movement on one or two of the items contained in Professor Smith's letter of 28 June. These could include spreading the receipt of the consideration over an 18 month period (perhaps worth £10-15m) and offering to meet the cost of buying out the minority (£15m). But these items would be deal clinchers and DTI would need to look carefully before Lord Young offered them to see whether the Commission might be likely to attack them as quasi-state aids.

Timetable/Next Steps

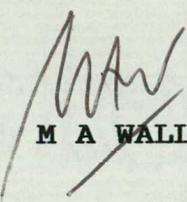
7. Lord Young is currently scheduled to have a meeting with Sutherland on 5 July. There would be no point in this if the gap remained at £310m or the £210m gap could not be bridged in a way which was acceptable both to the Government and BAe. Before, therefore, Lord Young goes to see Sutherland it will be necessary to determine what is BAe's bottom line and the Government's reaction to it. Assuming the gap can be closed in one way or

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another then Sutherland would put the deal to the Commission on 13 July, though if further time were needed, it would be possible to slip this by a week. There would need to be a Parliamentary announcement immediately following Commission approval.

Conclusion

8. If the Commission are immovable on regional assistance then the gap is too large to bridge without going beyond the confines of the RG deal. Unless the Government is prepared to countenance collapse of the deal or alternative disposal it would probably be necessary to offer launch aid to compensate. This minimises the risk of any extra cost falling on the Exchequer. If the gap is only £210m it can be bridged in a way which we believe to be commercially sensible for BAe and presentationally acceptable for HMG.



M A WALLER



1. Jonathan
2. Chy

Chy Interesting.
NB also CST role, behind.

ROVER

Mike Waller reports that Lord Y saw both Day and Smith, separately, this morning.

Day said that if the deal falls through he can put together another option in 10 days, not involving Honda. Debt write-off of £550 m, but no money to offer up-front.

Smith was pushed hard and said prepared to accept cut of £150 m. Mike Waller thinks he will accept - £210 m eventually.

Finally, apparently Phillips + Drew rang DTI this morning to say VW may make statement on their position this afternoon

mpw.

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COPY NO 1 OF 8 COPIES



FROM: CHIEF SECRETARY

DATE: 4 July 1988

CHANCELLOR

ROVER

I have seen Mr Reed's note of 30 June and Mr Waller's of 1 July.

2 As I recall, David Young conceded last Thursday morning at the meeting with the Prime Minister that BAe could accept a reduction of £125 million in the net consideration (I have not seen the Minutes so I don't know if this is recorded but my recollection of this is quite clear).

3 This narrows the gap to under £100 million and ought presumably to be the starting point of discussions on Monday, and ought not to be overlooked as part of the elements of the deal Mr Waller sets out in Paragraph 5 of his note.

for 

for JOHN MAJOR

(Approved by the Chief Secretary
and signed in his absence)

SECRET

FROM: M A WALLER

DATE: 5 July 1988

CHANCELLOR

Ch.
[seen by Ch.]
✓✓cc Chief Secretary
Sir Peter Middleton
Mr Anson
Mr Monck
Mr Burgner
Ms Roberts**ROVER GROUP/BAe: FINAL COMMISSION POSITION**

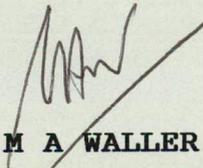
As requested, I attach a note on various tax aspects of the RG/BAe deal, including the issue of increasing the carry forward of trading losses. In practice, this now looks to be academic since the terms of the deal which Lord Young now appears to have reached with Commissioner Sutherland involves the existing cap of £500 million on trading losses remaining unchanged. This minute briefly records the latest position against the likelihood of being a meeting at No.10 some time tomorrow at which Lord Young will report back on both the Commission and BAE attitudes.

2. The Commission have now agreed to an injection to write off debt to the tune of £469 million, coupled with an up front payment of regional assistance of £78 million, a total injection of £547 million. (The Commission argued that unringfencing the capital allowances/capital losses would be worth at least £25 million but that the remaining gap of £28 million would have to be bridged by other means ie not involving state aids or tax concessions). Assuming BAE will accept a cut of some £200 million in the value of the deal, there is therefore a gap of £53 million to be bridged.

3. I understand that Lord Young is seeing the Chairman of BAE at 6.00pm this evening. He intends to argue that unringfencing the tax allowances is in fact worth at least £50 million to BAE (we agree with this, particularly if it is linked with some form of leasing deal - see paragraph 7 of the attached minute). DTI officials advise that Lord Young is not minded to offer any concessions on deferred consideration or help with buying out the

minority (neither issues were discussed with the Commission on advice from UKREP who would expect them to take a dim view of both propositions).

4. If Lord Young secures BAe's acquiescence to these terms then this would not be a bad outcome. It would require careful presentation domestically, placing major emphasis on RG's improved trading performance, the more generous tax treatment and, perhaps, also hinting that a negotiating cushion was built into the original figure. A major area of exposure is likely to be a scale of restructuring to which the Government/BAe is committed (ie some 29% of RG's nominal productive capacity). The Commission are pressing for this figure to be included in the papers going to the full Commission meeting on 13 July for approval. It could therefore become public via leaks from Commission Cabinets or via questioning of Commissioner Sutherland in the European Parliament by EMPs (Sutherland apparently told Lord Young that he would be forced to reveal the figure if asked).



M A WALLER

SECRET

FROM: M A WALLER

DATE: 5 July 1988

CHANCELLOR

cc Chief Secretary
Sir Peter Middleton
Mr Anson
Mr Monck
Mr Burgner
Ms Roberts
Mr Reed (IR)

ROVER GROUP/BAe DEAL: TAXATION ASPECTS

Following yesterday's meeting at No.10 I have, as requested, discussed with the Revenue and DTI's tax adviser the likely cost to the Exchequer of increasing the carry forward of trading losses from £500 million to £800 million.

2. The additional cost to the Exchequer is in principle 35% of £300 million ie £105 million. But the net present value depends crucially on when these extra trading losses are set against Rover Group's (RG) trading profits. This in turn depends on forecasts of RG's income and expenditure sometime into the future, including both income from trading performance and the company's capital expenditure profile.

3. Trading performance is obviously subject to a considerable degree of uncertainty. But on the basis of the more bullish forecasts about the group's performance - reflecting this year's overall improvement - the earliest that RG would be able to start utilising the additional £300 million would be in 1992. If all the additional trading losses were offset against profit in 1992 then the NPV of the costs of the Exchequer would be some £72 million (using a 10% discount rate). But it is much more likely that the losses would be fairly evenly spread over the years 1992-1994. Discounting at 10% produces a NPV cost of some £66 million.

4. I would regard these figures at the higher end of the range of likely outcomes. Given the general over capacity in the

European motor industry and the intense competition, even in niche markets, it is more probable that the trading losses will be utilised over a longer timescale. Moreover making early use of the additional losses would depend upon moving certain tax deductions out of the Rover Group, in particular interest payments and capital allowances. (If these were transferred to BAe eg by a leasing deal, this would also provide an immediate tax saving for BAe but until we get better figures from BAe we cannot quantify this effect.) However, we believe BAe would not risk major changes of this sort without Revenue assurances about the tax effect.

5. As far as BAe is concerned, the company attach little or no value to increasing the carried forward trading losses because of the uncertainty about the timing of their use, thus implying a much higher discount rate than the Government might be prepared to accept. But such an increase would be presentationally helpful in explaining their willingness to accept a substantial reduction in the net consideration.

6. You also asked about the leasing arrangements which were mentioned in the margins of the No.10 meeting. The Revenue have looked at various proposals from BAe which fall into two broad categories:-

i. The establishment of an arms length leasing arrangement covering Rover Group's new plant and equipment. Revenue consider this to be broadly acceptable, subject to their being an economic rent charged over the lifetime of the lease, even if charges are backend loaded.

ii. Sale and lease back of RG's existing plants and equipment. The Revenue are opposed to this because it would encourage widespread avoidance.

7. We consider that the £30-£50 million range of figures of benefit from unringfencing the deferred capital allowances excludes possible benefit to BAe and Rover Group of such an arrangement. ^{no in 6/11 clause} BAe claim that they would have anyway entered into

such an arrangement but, in the absence of Revenue assurances, we are inclined to doubt this.

Make up of the BAe Package

8. Taking account of the calculations in paragraphs 2-4 above the various elements of the reduction package proposed by Lord Young now look to be as follows:-

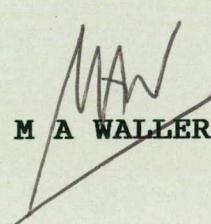
	Cost/Value £m
i. Improvements in RG's trading position already achieved (eg lower interest costs; quicker recovery from LR strike)	80
ii. General improved trading performance/DAF	80
iii. Unringfencing capital allowances	30-50
iv. Spread payment of consideration over 2 years	10-15
v. Lump sum payment towards costs of acquiring minority	15
vi. Additional £300m of trading losses	0-70 (rounded)
TOTAL	<hr/> 215-310 <hr/>

9. Assessing these items on how far they benefit BAe, (i), (iv) and (v) are of unarguable benefit to the company. Formally (iv) and (v) could be counted as extra state aid (the Commission's attitude to them is, as yet, unknown). And it would

be very difficult and inadvisable to disguise the minority payment (if that is what is meant the record of the No.10 meeting) because of PAC and propriety problems. (iii) is subject to dispute as to the actual numbers but the more detailed material supplied by the company tends to suggest that a figure of £50m is perfectly justifiable. (ii) is of much more questionable benefit to BAe, having apparently been plucked out of the air by Lord Young and implying an element of double counting with (i). (vi) is also problematic. It undoubtedly would cost the Exchequer £105 million at some time in the future. But, given the considerable uncertainty about the timing of utilisation its value to BAe now is debateable. On balance, given the uncertainty about the timing of the crystallisation of the tax cost, we think you could concede up to £300 million as a price for securing BAe's acceptance of a reduction in the debt write off of £210m.

Conclusion

10. The estimate of the true cost of granting an increase in the carry forward of tax losses is problematic. But on reasonable assumptions the present value of the cost to the Exchequer does not look to be large. Subject to your views, although cost is a significant factor it does not look to be decisive. At least as important are the presentational advantages and disadvantages of increasing the tax carryforward figure. In total the package could be used as a justification for acceptance of the Commission's reduction of £210m. But there would be major problems in attempting to conceal the assistance towards the minority buy out.


M A WALLER



Waller
NOT:

Ch.

See, first, Mike Waller's last minute, behind.

2. Smith has now come back on last night's offer. He is prepared to live with it provided: he also gets:

(a) £15 million cash - to cover the minority, + "BAe's costs";

(b) a relaxation of the on-sale conditions. At present, the conditions are that BAe can offset against any benefits from on-sale any costs in the business they are selling. Smith wants them to be able to offset any losses in any other part of BAe/Rover - i.e. a sort of cash sideways relief;

/over

FROM : M A WALLER
DATE : 6 JULY 1988

CHANCELLOR

cc Sir P Middleton
Mr Monck
Mr Burgner
Ms Roberts

ROVER GROUP : POSSIBLE SHARE PLACEMENT

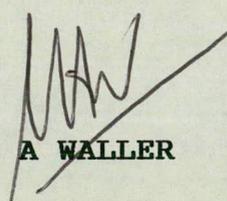
As of this afternoon, BAe are maintaining that they will not accept the terms of the debt write off/tax package sanctioned by the Commission, even if supplemented by HMG agreeing to deferred consideration and some easement in the foreign shareholding limits. There must continue to be a fair amount of negotiation in BAe's stance and further work is going on at official level with BAe to refine estimates of the benefits of the tax elements of the deal. Nonetheless, there is now quite a strong possibility that BAe will not close the deal. It is therefore possible that Lord Young will seek a very quick collective discussion of possible alternative methods of disposal of the Rover Group business. You may therefore find it helpful to have a brief note of the options which are currently front runners.

2. We understand that, currently, Lord Young favours the placement route recently revived by Graham Day. Details of the proposal are extremely scanty but Day has indicated he would be in a position to formulate and announce proposals within the next 10 days based on a debt write off of £550 million (ie basically the figure now sanctioned by the Commission). We have no details on the level and method of payment of consideration for the Rover Group business, though Day is reported to have indicated that it would not be possible to put cash on the table (thus implying a deferred consideration, perhaps in the form of preference shares/debentures). If Ministers were minded to allow Day to run with this idea, it would be essential to ensure that the terms of the deal on offer were examined very carefully before any commitments were made by HMG. For example, it would be presentationally and substantively difficult to justify closing a deal with the Rover Group and their supporting institutions on

terms which were not on offer to BAe (eg in respect of the level of payment of the consideration). And any significant element of deferment could well fall foul of the Commission's state aids regime. If, therefore, Lord Young raises this idea substantively with you and the Prime Minister I would suggest you press for all the details to be committed to paper and subject to rapid but careful scrutiny by officials and their advisers.

3. The other clear alternative is a trade sale, with Ford or Volkswagen as the main candidates. We have no way of knowing on what terms either company might be prepared to take on Rover Group, though at an earlier stage VW asked for not only debt write off and assistance for restructuring but also a contribution to future capital expenditure. Nor are the industrial implications (eg in terms of siting of major production and R & D facilities, model ranges and employment consequences) at all clear. The only way it would be possible to find this information out is to ask the companies to bid. It is clear, however, that there are potentially major competition problems with a Ford acquisition since this would give the company some 45% of the UK market.

4. Whichever alternative were to surface as the front runner, it would be essential to minimise uncertainty about the future of Rover Group. Prolonged speculation could well do major damage to RG's commercial performance, thereby raising serious question marks over the possible crystallisation of the £1.6 billion of Varley Marshall liabilities. This points to a rapid but careful analysis of the options.



M A WALLER

PS. Rover Group's shares were suspended by the Stock Exchange (with the acquiescence of Schroder, RG advisers) at 16.40 pm following a rise in their share price from 61-74p today. This looks to be an attempt by RG to bounce BAe and HMG into a quick decision, thereby increasing the attractiveness of the placement route. Lord Young is likely to see BAe this evening and insist on a final answer.

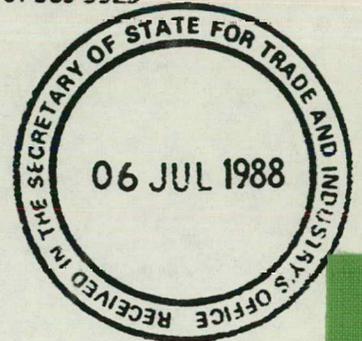
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CH/EXCHEQUER	
REC.	-7 JUL 1988
ACTION	MR WALLER
COPIES TO	CST, FST
	SIR P MIDDLETON
	MR MONCK PS/IR

Direct Line: 01-389 3923

From: CHAIRMAN
Professor Roland Smith

Rt Hon Lord Young of Graffham,
Secretary of State for Trade and Industry,
Department of Trade and Industry,
Room 803,
1 Victoria Street,
London, SW1H 0ET.



6th July, 1988.

My dear Lord Young,

ROVER GROUP

Ch. This letter amplifies the "conditions" which we were told about not right. Many of them are non-starters.

We have now had a number of meetings to discuss the reaction from the European Commission in Brussels to the acquisition terms originally agreed between us. I am conscious of the difficulties that you have met and, whilst the Commission's attitude to some matters (such as the WVF facility) seems totally illogical and unjustified, I accept your assurance that, unless a package substantially on the lines described by you is agreed, the Commission will refuse to give its consent.

I have made the point several times that British Aerospace wants the Rover deal to go through, but we have to be concerned with any material deviation from the original terms and our ability to explain that to the City and, of course, still recommend as a Board (with all the responsibilities which that infers) the resultant transaction to our shareholders.

Since our meeting this morning, it has not been possible for me to speak again to my Board and I cannot guarantee that they will support the new proposals. However, what I can say is that I will recommend them to do so if acceptable commitments are given to British Aerospace, prior to any announcement being made, with respect to the following points :-

1. HMG's cash injection into Rover will be not less than £547 million, of which £78 million represents regional aid potentially refundable to the extent that associated expenditures are not incurred. At this time, you have not been in a position to tell me precisely the relevant conditions and I have to make the obvious reservation that these conditions must also be acceptable to my Board.

/2.

2. The "ring fences" will be removed from the tax losses of £500 million, the brought forward capital losses of about £200 million and deferred capital allowances of about £300 million. Moreover, the Inland Revenue will give written rulings in advance to certain proposals to be made by British Aerospace with a view to optimising the tax benefits to British Aerospace, to the extent, of course, the proposals lie within Revenue discretion, and HMG will use its best endeavours to ensure that Revenue clearance is not unreasonably withheld.
3. The whole of the purchase price of £150 million payable by British Aerospace will be deferred for 12 months without any interest charge accruing.
4. The present arrangements agreed in the Funding Agreement, whereby certain payments fall to be made to HMG in the event that there is a disposal of certain parts of the Rover Group within five years of the Completion Date, will be modified so that the "economic benefit" to BAe/Rover is assessed not only in relation to the particular part, but after recognising the effect of any adverse development in any other part of the Rover Group.
5. HMG will agree to bear the whole of the acquisition costs incurred by British Aerospace and Rover including the cost to British Aerospace of acquiring the minority interests in the Rover Group, these costs being presently estimated to total some £15 million.
6. HMG will accept that the effective acquisition date is the earliest date possible in 1988 having regard to relevant accounting and other considerations.

You have separately assured me that British Aerospace's proposal to re-cast the limitation upon foreign-held shares as presently stipulated in British Aerospace's Articles of Association, will be favourably considered and that HMG would not dissent from a proposal which the British Aerospace Board may decide to recommend to its shareholders. In this connection, I refer you to a letter and memorandum * which I think I handed to you or your officials in draft last year explaining and justifying BAe's alternative proposal.

/I have

* copy enclosed

No! (As we have made plain to LdY. hmpteen times).

As you made clear to LdY., he will need to consult colleagues (esp. Mr Younger) on this.

I have separately mentioned to you my Board's growing concern regarding a number of issues affecting the relationship between the Company and H.M. Government, both in the civil and military fields, and if the Board accepts these revised terms for the Rover acquisition, you should appreciate that it is their sincere hope there will be some demonstrable evidence of HMG's responsiveness to that concern.

Finally, we must keep a close eye on the proposed timetable and all the work that remains to be done to keep to it, including the drafting of Supplemental Agreements, BAE's circular to shareholders and Rover's Scheme documentation. This will require a concerted effort by everyone involved to achieve the desired result. I understand, incidentally, that your officials have already indicated agreement to an inevitable extension of the Completion Date provided in the current Agreements.

Yours sincerely,

Roland Smith

AA 1/5 flush

- 1. OK
- 2. Ring for cap allowances
 2. cap allowances
 from hand
 100% (12) clearance OK
- 3. OK
- 4. subject to business
- 5. OK
- 6. OK

for shareholding: minutes contained
 agreed, but I have per forward a proposal
 Trade-off with other BAE/Gen. Issues: ~~that~~ not on
 of back cover