PREM 19/2256

M.T

PART 14

SECRET

CONFIDENTIAL FILING

THE FUTURE OF THE ROVER GROUP
(BRITISH LEYLAND)

INDUSTRIAL POLICY

PART 1: SEPT 1979

PART 14: OCT 1987

Referred to	Date	Referred to	Date	Referred to	Date	Referred to	Date
~~5.10.87~~							
~~8.10.87~~							
~~30.10.87~~							
~~2.11.87~~							
~~30.11.87~~							
~~2.12.87~~							
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~~2.2.88~~							
~~22.2.88~~							
~~26.2.88~~							
~~28.2.88~~							
29.2.88							

PT 14 ENDS

PREM 19/2256

Material used by official Historian
DO NOT DESTROY

PART 14. ends:-

PG to PM. 29.2.88

PART 15 begins:-

ROVER GROUP to PG. 1.3.88

CCB/UP

37

PRIME MINISTER

PM

FLORENTINE: CABINET DISCUSSION

Handling of Papers

Lord Young will let me have before Cabinet sufficient copies of his paper and draft statement to hand round. If you are content, I will deal with this in the same way as electricity was handled last week; I will hand them round at the appointed time and collect them back at the end of discussion.

Handling

You will wish to take this as the first item under Home Affairs. You will wish to invite Lord Young to introduce his paper and describe the action proposed.

You will want to consider how to order any subsequent intervention. You might want to hold back either or both the Chancellor of the Exchequer and the Secretary of State for Defence until after possible hostile interventions.

The issues to be settled are:

(i) agreement on the terms of the statement;

(ii) stress that Cabinet is now in possession of market sensitive information until dealings in the relevant shares are suspended;

(iii) you may want to write into the minutes that, given his absence in America, it will not be possible to advise the Secretary of State for Employment until the time of the Parliamentary statement (I have identified a Los Angeles number at which I can reach the Secretary of State at 1500 hours our time, 0700 hours local time).

PRCG

PAUL GRAY
29 February 1988

P.S. You may also like to glance at the attached Cabinet draft of the Cabinet Paper, draft statement and briefing for supplementaries.

PRCG.

dti

the department for Enterprise

1 of 2

CC/UP.

36

SECRET AND PERSONAL : COMMERCIAL IN CONFIDENCE : 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

Department of Trade and Industry

1-19 Victoria Street
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Direct line 215 5422
Our ref PS6AHZ
Your ref
Date 29 February 1988

Dear Paul

ROVER GROUP/FLORENTINE

... I am attaching a copy of the final draft of the Cabinet Paper, to which is attached the revised draft statement. I am also enclosing a copy of the present version of notes for supplementaries.

I am copying this letter and enclosures to Alex Allen (Treasury).

Yours

Jeremy

JEREMY GODFREY
Private Secretary

the enterprise initiative

SECRET - CMO

CABINET

ROVER GROUP

Note by the Secretary of State for Trade and Industry

Since the sale of the commercial vehicle subsidiaries to DAF last year, Rover Group (RG) Chairman, Mr Graham Day, has been reviewing options for the return of the remaining RG businesses, principally Austin Rover and Land Rover, to the private sector. Recent studies have concentrated on the possibility of placement/ flotation, though it appears that the prospects of achieving this within an acceptable time-frame seem remote.

2. However, an unexpected opportunity to dispose of these businesses has now arisen. I have recently received an unsolicited approach from British Aerospace Plc who have declared a serious interest in acquiring the whole of the issued share capital of RG. Subject to certain conditions they would like to open negotiations for the purchase of the Government's shareholding.

3. My subsequent discussions with BAe have focused on reaching a broad understanding with them on key issues to establish whether we could have sufficient confidence in a successful outcome to any negotiations to justify a public announcement. The main points at issue have been:-

PS1AKC

(a) Exclusivity of negotiation

BAe were insistent that they would not be prepared to enter into a competitive bidding situation and would be ready to enter into formal negotiation only if granted exclusivity. In view of the Part- holding with Mr Mellon, I decided to have agreed

A competitive tender would obviously be advantageous in securing the best financial terms but the risks inherent in this approach would be substantial. I share Graham Day's view that a competition, particularly one involving foreign bidders, would create a period of damaging uncertainty for the businesses and the dealerships and plunge the company's affairs once again into a politically controversial environment. This could lead to a sharp increase in the Government's contingency liabilities under the Varley Marshall assurances.

I have therefore agreed with BAe that we shall be prepared to deal with them on an exclusive basis but only for a limited period (until 1 May) after which we would be free to examine alternative options. This would, of course, leave us free to consider any other unsolicited bids we may have received from other parties.

(b) Government financial injection

BAe were looking for a Government cash injection sufficient both to write off all debt and related liabilities of RG and to make a worthwhile contribution to the working capital needs of the acquired businesses. In discussion, I have stressed the need for Government to emerge with a deal which was publicly defensible and which we could persuade the EC Commission to would approve under state aid rules. BAe have made a helpful response and I am satisfied that in negotiation we shall be able to arrive as a mutually acceptable figure.

(c) Restrictions on resale of the businesses

BAe were anxious to retain complete freedom to manage the acquired businesses according to commercial need. My concern was the possibility that, having acquired the businesses on arguably favourable terms, BAe would be free to on-sell to trade buyers at a potentially handsome profit.

I have made clear to BAe that we will need to devise a mechanism to ensure that they would not dispose of either of the businesses for a period of at least five years from completion of any purchase.

(d) Honda

BAe recognise the importance of the Honda collaboration to ARG and would wish this to continue. Graham Day has advised that, in his judgement, Honda can be expected to co-operate with BAe post-acquisition but I have undertaken personally to impress upon Honda that we would also welcome this.

4. INDUSTRIAL LOGIC

Linkages between the aerospace and motor industries are not uncommon. General Motors, Fiat and SAAB are among those companies who, as well as being major vehicle producers, have important aerospace operations. And Daimler Benz have been talking to MBB. For their part, BAe also anticipate R&D, engineering, manufacturing technology and overseas marketing synergies which would make acquisition of RG a sensible means of developing a larger and more broadly based business.

5. CONCLUSIONS

On the basis of the understandings reached with BAe, I believe that the prospects of a successful negotiation are good. A deal would also, I believe, be welcomed by RG's management, workforce, distributors, dealers and suppliers. As a British solution it would avoid the controversy involved in a foreign take-over and would have strong backing amongst our own supporters.

6. Subject to the agreement of colleagues, I would therefore propose to make an announcement to Parliament this afternoon in ... the terms of the attached statement.

M35 AAT

SECRET

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Revised

p.m 29.2.88

WHO MADE THE FIRST APPROACH?	Florentine made an initial approach to RG towards the end of last year. Following exploratory discussions, they indicated their formal interest in opening negotiations on 24 February.
WHEN?	
WHO'S BEEN HANDLING THE DISCUSSIONS?	Initial talks were held between RG and Florentine. Exchanges with Government did not take place till last month.

GENERAL MERITS OF DEAL

WHY NOT RETAIN TILL BUSINESS ROBUST ENOUGH FOR FLOTATION?	It is in the interest of the whole business that any specific opportunity that makes commercial and industrial sense should be explored.
WHY SELL NOW JUST WHEN RG IS TURNING THE CORNER?	I am naturally encouraged by Rover Group's improved financial performance. However, the aim of both the RG Board and the Government to return the company to the private sector has been on the record for some time.

LOGIC OF FLORENTINE TAKEOVER OF RG?	Synergies between these two industries have been successfully demonstrated in a number of countries. Examples are Saab, Daimler Benz and General Motors.
WHY JEOPARDISE FLORENTINE WITH THE ALBATROSS OF RG?	RG's improved performance was no doubt an important factor in Florentine's commercial decision to pursue negotiations for the acquisition of the Group.
HAS THERE BEEN ANY PRESSURE PUT ON FLORENTINE?	No. It was their commercial decision to make the approach.
INDICATES NO GOVERNMENT STRATEGY BEYOND DOCTRINAIRE COMMITMENT TO PRIVATISATION?	Our strategy is to seek a secure long term future for Austin Rover and Land Rover. That is what we are doing.
WHAT OTHER EXPRESSIONS OF INTEREST OR OTHER OPTIONS DID DAY CONSIDER?	This approach has come at a time when Mr Day has been reviewing a number of alternative ways forward for the business and on which the RG Board has not reached any final conclusions.

WHAT FACTORS DID HMG TAKE INTO ACCOUNT IN AGREEING SALE TO FLORENTINE?

No deal has been concluded but the talks could offer a solution that is in the best interests of all concerned.

CONFIRMS DAY WAS BROUGHT IN AS A HATCHET MAN/AUCTIONEER?

Mr Day's job is to run the company commercially in the interest of all concerned. Opposition scare-mongering!

WHY WAS X NOT GIVEN AN OPPORTUNITY TO BID [FOR PART/ALL]?

The Government's intention to privatise Rover Group has been on the public record for some time.

WILL FURTHER BIDS BE CONSIDERED?

Florentine wished to negotiate only on an exclusive basis. The RG Board has endorsed this taking into account the overall interests of the business. We therefore see no need to talk to anyone else provided we reach agreement on terms by the beginning of May.

[if pressed] Florentine has made exclusivity a precondition of opening negotiations. The RG Board believes that a competitive bidding process would create damaging uncertainty about RG's future and I share that concern.

WOULDN'T FORD HAVE PAID A BETTER PRICE?	Hypothetical question. If pressed: The negotiations with Florentine are only just commencing.
WHAT ABOUT POLICY OF ENCOURAGING WIDER SHARE OWNERSHIP?	The Government's policy remains to encourage wider share ownership. Florentine itself was returned to the private sector in a very successful two stage flotation.
IMPLEMENTATION OF DEAL	
WHEN WILL DEAL BE CONCLUDED?	I expect the outcome of the talks to be known around the beginning of May.
WILL THE EC COMMISSION BE CONSULTED?	RG's balance sheet would need to be strengthened immediately before any deal is concluded and HMG would of course follow the normal procedures for taking forward State Aid applications. I expect to start those procedures shortly.
WHAT ADVICE FROM DGFT?	The normal merger control procedures will apply. If pressed: I will decide whether or not a reference should be made to the MMC in the light of any advice I may receive from the DGFT.

WHAT ABOUT THE VIEWS OF THE WORKFORCE?	Employees will of course have the opportunity to express their views on future plans for the company through the normal machinery.
WHAT ABOUT THE VIEWS OF AND EFFECT ON RG's PRIVATE SHAREHOLDERS?	The RG Board is required to advise all shareholders on any offer that may result from these talks.

CONSEQUENCES OF DEAL

EFFECT ON EMPLOYMENT (AT SITE X)?	Discussions are at a very early stage. If they are successful I am sure Florentine would seek to develop Rover Group in the best overall interests of the business.
EFFECT ON SUPPLIERS?	I am sure that the importance of Rover Group for the components industry is fully recognised by all those concerned.
WILL MANAGEMENT/EMPLOYEES GET FLORENTINE SHARE OPTIONS?	Confident this is a subject to which Florentine will be giving careful consideration.
WHAT WILL HAPPEN TO EXISTING MANAGEMENT?	Florentine have made it clear they wish to utilise the skills of the existing management.

HOW MUCH WILL GOVERNMENT PROVIDE TO FINANCE THE DEAL?	Negotiations are proceeding and it is not possible to be precise about the detailed financial arrangements at this stage. However substantial strengthening of the RG balance sheet will be required.
EFFECT ON VMJ?	If these negotiations are successful and Austin Rover and Land Rover are returned to the private sector the Government will accept no further obligation for ensuring that the obligations of Rover Group are met.
EFFECT ON PREVIOUSLY PRIVATISED BUSINESSES?	All existing commercial links will be taken fully into account before decisions are reached.
WHAT HAPPENS TO DAF SHAREHOLDING?	Negotiations are on the basis of Florentine acquiring the whole of the Rover Group including its minority holdings.
DOES THE DEAL AFFECT THE INTENTION TO FLOAT DAF?	There will no doubt be discussions between Florentine and Leyland DAF on their future relationship.

EFFECT ON COLLABORATIVE LINKS WITH HONDA?

This is one of the points that will need to be pursued in the negotiations. But I very much hope Honda will see the benefits of the proposed deal as their continued involvement with Rover Group would be very much welcomed by the Government.

HAVE HONDA EXPRESSED A VIEW ON THE DEAL?

WHAT ARE FLORENTINES PLANS FOR THE BUSINESS?

Too early to say. Discussions are at a very early stage. We must wait and see what develops.

WHAT INVESTMENT WILL FLORENTINE PUT IN?

NEW GOLDEN SHARE?

I am not convinced this would be an appropriate mechanism but Florentine have made it clear that they would wish to hold and develop the businesses.

FLORENTINE'S EXISTING GOLDEN SHARE?

A deal would have no impact on Florentine's existing golden share which is concerned primarily with the ownership of that company and its directors' nationality.

WHAT ASSURANCES WILL BE SOUGHT FROM FLORENTINE?	The Government will naturally wish to pursue with Florentine their intentions for the business.
WHAT IS TO PREVENT FLORENTINE SELLING ON [THE BUSINESS] [LR] TOMMORROW?	
WHAT WILL NEW BUSINESS BE CALLED?	Much too early tó say.
WILL ROVER/LR/MG NAMES BE RETAINED?	I am sure Florentine will recognise the value of these historic marques.

OTHER ISSUES

STATUS OF 1988 RG CORPORATE PLAN? WHEN WILL IT BE APPROVED?	The detailed future plans of the company will be a matter for any new owners of the company.

SECRET

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MARKET SENSITIVE

DRAFT PARLIAMENTARY STATEMENT

As the House is aware, it is the common objective of the Government and of the Rover Group Board to work for the return of the remaining businesses to the private sector. Rover Group Chairman, Mr Graham Day, has in recent months been considering the options for achieving this.

I should inform the House that an approach has now been received from British Aerospace Plc who have declared a serious interest in acquiring Government shareholding in Rover Group, subject to the satisfactory outcome of negotiations which are now being put in hand. British Aerospace have asked that the negotiations be on an exclusive basis and I have agreed to this provided negotiations are concluded by the end of April.

I shall, of course, report the outcome of these discussions to the House at the earliest opportunity. In the meantime, I am sure that, like the Rover Group Board and the Government, the House will welcome this interest.

PS1AKB

SECRET

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PARLIAMENTARY STATEMENT

As the House is aware, it is the common objective of the Government and of the Rover Group Board to work for the return of the remaining businesses to the private sector.

Rover Group Chairman, Mr Graham Day, has in recent months been considering the options for achieving this.

I should inform the House that an approach has now been received from British Aerospace Plc who have declared a serious interest in acquiring Government shareholding in Rover Group, subject to the satisfactory outcome of negotiations which are now being put in hand.

British Aerospace have asked that the negotiations be on an exclusive basis and I have agreed to this provided negotiations are concluded by the end of April. If not, we would then be free to look at other options.

I shall, of course, report the outcome of these discussions to the House at the earliest opportunity.

In the meantime, I am sure that, like the Rover Group Board and the Government, the House will welcome this interest.

SECRET AND PERSONAL

Copies 1-8 to DT 1 (copy 2 to CDL c/o DT1)
9-12 to HMT
13 to MOD
14 to LP
15 to CO
16 to R Wilson (CO)
17 to G Guise
NB: copies 1-12 sent first post - all others at 1430 hours

Copy No. 18 of 19 copies

10 DOWNING STREET

LONDON SW1A 2AA

From the Private Secretary

29 February 1988

Dear Jeremy,

FLORENTINE

The Prime Minister held a meeting this afternoon to discuss the latest position. Those present were the Chancellor of the Exchequer, the Secretary of State for Defence, your Secretary of State, the Chancellor of the Duchy of Lancaster, the Lord President, Richard Wilson (Cabinet Office) and George Guise (No. 10 Policy Unit).

Your Secretary of State explained that discussions with Florentine had now reached a stage where he wished to go ahead with a statement to Parliament tomorrow.

Following discussion the Prime Minister said it was agreed that:

(i) your Secretary of State should bring the issue to Cabinet tomorrow and circulate at the meeting a brief paper and the terms of his proposed statement;

(ii) the statement should refer to negotiations with Florentine now being put in hand (rather than which are now in hand) and should explicitly refer to the arrangement for exclusivity until the end of April;

(iii) in handling supplementaries following the statements to both Houses of Parliament, your Secretary of State and the Chancellor of the Duchy of Lancaster should in general avoid being drawn on detailed points. They should defend the exclusivity arrangement on the grounds that this was "in the best interests of the company". They might care to use such lines as "the position is very delicate", "I cannot say anything further at this stage" and "the Government will take note of the views expressed". It would be particularly important to resist any calls for a commitment to consulting Parliament before any final contract was concluded;

SECRET AND PERSONAL

(iv) careful consideration would need to be given in the subsequent negotiations to the handling of the position of the minority shareholders, taking into account the advice in the Attorney General's letter received on 29 February.

I am sending copies of this letter to Alex Allan (H. M. Treasury), Brian Hawtin (Ministry of Defence), Peter Smith (Chancellor of the Duchy of Lancaster), Alison Smith (Lord President's Office), Trevor Woolley (Cabinet Office), Richard Wilson (Cabinet Office) and George Guise (Policy Unit).

Yours,
Paul

PAUL GRAY

Jeremy Godfrey, Esq.,
Department of Trade and Industry

Roves.

33

SECRET

COMMERCIAL IN CONFIDENCE

MARKET SENSITIVE

NBPM

RREG

22/2

The Rt. Hon. Lord Young of Graffham,
Secretary of State for Trade and Industry
and President of the Board of Trade,
Department of Trade and Industry,
1-19 Victoria Street,
London SW1H 0ET

Dear Secretary of State,

ROVER GROUP PRIVATISATION : FLORENTINE

WHPG.

Your minute of 22nd February to the Prime Minister proposes that, unless I see difficulties in the idea, negotiations with Florentine should be on an exclusive basis. We have spoken about this; this letter is in confirmation of my views.

I see no difficulties with the idea of exclusive negotiation, provided two steps are taken. I understand that these steps are in any event what you and Florentine would intent to do.

First, the exclusivity deal with Florentine should amount to no more than a statement of your intention that you will deal exclusively with them; you would then be free to take into account any unsolicited offers you may receive from other potential bidders, when you come to take a final decision on florentine's offer.

SECRET

COMMERCIAL IN CONFIDENCE

MARKET SENSITIVE

SECRET

COMMERCIAL IN CONFIDENCE

MARKET SENSITIVE

Secondly, Florentine should be required to structure any offer it may make so as to provide a premium for the minority shareholders in Rover Group, so as to take into account any diminution in the value of the deal for them resulting from the exclusion of other bidders. Unless this is done Florentine may be in difficulties in seeking to rely on the compulsory purchase powers in the Companies Act 1985 to buy out the minority shareholders after acquiring Rover Group. Further, unless it is done the directors of Rover Group may have difficulties in recommending the offer to the shareholders.

I am given to understand that Florentine will make a cash offer with a share alternative, and that the value of the latter will be such as to provide a suitable premium for the minority shareholders, on the understanding that you will accept the cash offer. This course will avoid any legal difficulty. There will, however, be a possibility of political criticism from our opponents, who may allege that by accepting the less valuable offer we have sold Rover Group for less than we could have done. I would suggest, however, that this can be easily countered by reference to our policy of not taking significant capital stakes in industry. I am copying this to the Prime Minister and Nigel Lawson.

Approved by the Attorney General and signed in his absence

SECRET

COMMERCIAL IN CONFIDENCE

MARKET SENSITIVE

INDUS POL : Rover : PE 46

SECRET
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ROVER GROUP: COMPARISON OF CORPORATE PLAN AND LATEST WORKING PROJECTIONS

PBIT/£m

	1988	1989	1990	1991	1992	5 Year Total
Corporate Plan	37.5	52.4	103.8	90.8	142.5	427
Revision*	49.3	61.5	131.7	153.3	252.2	648
B/(W) than Plan	11.8	9.1	27.9	62.5	109.7	221

CASHFLOW/£m - IN/(OUT)

(a) After interest

Corporate Plan	(269.3)	(122.4)	52.3	(102.5)	(173.2)	(615)
Revision*	(219.1)	(179.0)	8.5	45.4	58.7	(285)
B/(W) than Plan	50.2	(56.6)	(43.8)	147.9	231.9	330

(b) Before interest

Corporate Plan	(184.8)	(19.6)	157.9	7.6	(48.2)	(87)
Revision*	(141.8)	(85.0)	106.8	140.7	150.9	172
B/W than Plan	43.0	(65.4)	(51.1)	133.1	199.1	259

VARLEY MARSHALL/£m-Year end

Corporate Plan	1582	1760	1749	1910	2129	-
Revision*	1531†	1766†	1799†	1812†	1801†	-
B/(W) than Plan	51	(6)	(50)	102	328	-

*This revision is based on a working document produced by Rover Group on 18 February 1988 which is subject to review by reporting accountants.

†These figures assume that the change in VM is simply equal to the change in total RG debt; they do not take into account changes in other components of the calculation though there should be an element of self-cancellation in these by the end of the five year period.

SECRET AND PERSONAL COPY 13 of 16

SUBJECT cc MASTER

31

File Prem

10 DOWNING STREET

LONDON SW1A 2AA

From the Private Secretary

28 February 1988

Dear Jeremy,

FLORENTINE

The Prime Minister held a meeting this evening with your Secretary of State, the Chancellor of the Exchequer and George Guise of the Policy Unit.

Your Secretary of State reported on the discussions over the weekend with Florentine. He said that he had personally met earlier in the evening the Chairman and Chief Executive. Your Secretary of State had told them that the Government would be prepared to negotiate with Florentine on a "single tender" basis until 1 May. He said this evening's discussion had focused on the amount of any Government's write-off as part of a deal. Florentine had opened with a bid for a net £850 million. By the end of the meeting the respective positions were Florentine pressing for a net £700 million and your Secretary of State indicating to the Company that he would be prepared to seek his colleagues' agreement to net £575 million (comprising a gross Government write-off of £675 million offset by a payment by Florentine to the Government of £100 million). Continuing, your Secretary of State said he had agreed with the Florentine Chairman that:

(i) Florentine would buy just the Government's shares and would itself sort out the issue of minority shareholders.

(ii) The Government would give no warranties.

(iii) Florentine would agree to waive any tax losses in Rover Group exceeding £1 billion.

Your Secretary of State explained he had also discussed with Florentine the form of the undertaking to prevent Florentine selling the Rover Group to another Company. They had tentatively explored the possibility of the Government having an option to purchase the Rover Group's trade marks if Florentine sought to sell the Company within the next five years. The trade marks were the Rover Group's most valuable assets, and such an arrangement would have the effect of

preventing Florentine selling within five years.

In discussion it was agreed that the major problem with a deal along these lines would be how the Government could present it to Parliament, bearing in mind that Rover Group could well be worth significantly more to another motor manufacturer than it was to Florentine. For example, the tax losses in Rover Group would be worth substantially more to another motor company. It was also pointed out that Florentine were proposing, within the figures they had put forward, to acquire the Rover Group's 40 per cent minority shareholding in DAF; this was valued in the Rover Group's plans at £90 million.

Following further discussion the Prime Minsiter said it was agreed that your Secretary of State should resume negotiations with Florentine, and should seek to reach a broad understanding with them on a deal involving the lowest figure possible below £700 million for the net Government write-off. This figure would include Florentine's acquiring the minority DAF shareholding. Your Secretary of State should also make it clear to Florentine that any deal must involve an effective block on Florentine selling on the company within five years; further consideration should be given to whether the trade marks possibility was the best means of securing this. Your Secretary of State should also make it quite clear that there was no question of Florentine coming back in later negotiations to press for a larger write-off figure because of any further information about Rover Group that became available to them during the detailed investigation. Your Secretary of State would also indicate to Florentine that the Government were prepared to negotiate exclusively with Florentine until 1 May (though he would also ensure that, if they expressed interest meantime, other possible purchasers were waiting in the wings should the talks with Florentine break down). It was further agreed that your Secretary of State would report back to a further meeting of the group of Ministers at 5.30 tomorrow on the results of his further discussions with Florentine, together with a draft statement to Parliament spelling out the most favourable basis for presenting the deal. Decisions would be taken at that further meeting on whether to go ahead with a statement to Parliament on Tuesday 1 March and, if so, on the arrangements for notifying the Japanese Government and the European Commission.

I am sending a copy of this letter Alex Allan (H. M. Treasury).

Yours,
Paul

PAUL GRAY

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

SECRET

cc BUP

30

PRIME MINISTER

FLORENTINE

We have a slot at 1730 in Monday's diary for a further meeting to consider progress with the Florentine negotiations. But you might like to be considering over the weekend the handling of this issue if the negotiations do proceed reasonably smoothly. One possibility would be a short meeting on Sunday evening - see my PS below.

I am told that a further meeting today with the Florentine Finance Director has gone quite well and that he was not outraged at Lord Young's opening offer of £400 million. Lord Young will be meeting the Chairman of Florentine on Sunday ~~afternoon~~ evening. If a deal does seem possible after that, I think Lord Young would probably want to have a word with you fairly early on Monday to get authority to continue the process. Equally, if there are to be further negotiations on Monday, it is perhaps only fair to the Chancellor to give him an opportunity to express his views before things get much further.

The other dimension is that if you have no further meeting until that already arranged for 1730 on Monday it probably makes it impossible to have a statement on Tuesday. ~~Or~~ Although there are the arguments expressed yesterday against such a quick statement, that option should perhaps not be automatically ruled out.

You might therefore like to consider having a quick chat with Lord Young and the Chancellor early on Monday morning, to take stock of Sunday's meeting. This might be fitted in immediately before the Week Ahead Meeting. If you then gave the go-ahead to further negotiations and there seemed a prospect of a statement on Tuesday, you might ~~then~~ want to consider having an early word with the Lord President and the Chief Whip.

SECRET

You might also want to consider whether to invite one or two other colleagues to the 1730 meeting, which would be the occasion to decide whether or not a Tuesday statement went ahead. Mr. Younger has a particular interest for the reasons discussed yesterday. You might also want to involve one or more of say Sir Geoffrey Howe, Mr. Ridley and Mr. Parkinson before bringing the issue to Cabinet.

All this is contingency planning. Come Monday morning the whole issue may have gone away. But if it is still alive I will ask Tessa to have a word with you first thing on Monday about how you want to handle exchanges during the day.

PRCG.

Paul Gray
26 February 1988

P.S. Given the Monday diary pressures another possibility - which I mention with great diffidence! - would be a chat with Lord Young and the Chancellor on Sunday evening. Lord Young is seeing the Chancellor at dinner at 18.30 on Sunday. I have asked his office to ring me as soon as it is over, and to tell me whether Lord Young wants an early word with you. If I may I will then ring you to find out how you would like to handle things.

PRCG.

JA1BRD

10 DOWNING STREET

I think you will want to be alerted to this possible topic of conversation.

RLCG
26/2

Prime Minister

Alan Clark has asked me to pass you this privately. I do not think it is at all operational. But he may mention it when he lunches at Chequers tomorrow. CDP 26/2.

MINISTER FOR TRADE

27 II 88

Charles,

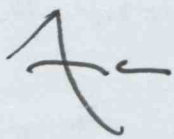
I apologise for using you as conduit for a report that is not really in the direct line of responsibility for either of us.

But I know the PM takes a close personal interest in the future of ARCH and these things can get distorted by the process of selective abbreviation. (I recognise, of course, that she

may not be all that well-disposed to the conclusion I tentatively suggest)

Anyhow, if you think its worthwhile, please put it in the weekend box.

Ta



29A

dti

the department for Enterprise

SECRET

To:

SECRETARY OF STATE

From:

ALAN CLARK

25 February 1988

MEETING WITH DR HAHN, CHAIRMAN OF THE BOARD OF DIRECTORS OF VAG

Dr Hahn visited the United Kingdom on 19 February and was Guest of Honour at a lunch which I hosted at Lancaster House on that day. A number of senior British industrialists and exporters were present.

2 When I visited Wolfsburg last October Dr Hahn and I had, at his request, a short private meeting without officials at which he had expressed, in guarded terms, his interest in buying Rover Group. At the time I made no commitment, other than to report this, and no comment as to any likely reaction in the United Kingdom.

SECRET

M03ALZ

3. Dr Hahn had asked if at the start of our meeting we could also have a short period of private discussion, and he was on this occasion accompanied by his Director of Strategy, Herr Rubess. In fact, far from being short the private discussion went on for nearly two hours (my apologies to those officials who were kept waiting in the outer office during this period). Dr Hahn was philosophic, and discursive. He lamented the comparative disadvantage - in educational terms - at which European blue collar workers stood in relation to those in Japan and Korea where, apparently, they need eight O' levels to qualify for the production line. He made a number of other general comments of this kind warning of perils in the Industrial East and the need for Europe to get its act together urgently. In particular he made the following points:

(a) The United States automobile industry was four-fifths penetrated by the Japanese already, either through direct sale; local assembly; or badge-engineered licenced building (the Chevrolet 'Love' pick-up is really a Toyota, etc etc).

(b) The mass market at its lower end would be dominated by the Pacific Rim second-liners - Korea, Malaysia, Singapore, Taiwan. Japan was moving upmarket, and their Third Wave would hit us in about 18 months with 12 cylinder Hondas; Toyotas with 'active' suspension; and other developments directly aimed at Mercedes, Jaguar and BMW.

(c) We must not underestimate the speed with which things were moving. It was only thirty years ago that the largest selling vehicle model in the world was the Chevrolet 4-door Fleetline 6. Today no-one knew what a Chevrolet was, or even looked like.

(d) A degree of protection for European industry was inescapable. But it would have to be invisible and arranged with great finesse. If competition was reduced, or even abated, it would have a disastrous effect on efficiency, and quality, and the consumer would soon 'rumble' it. Somehow we had to so order matters that the European industry was not completely obliterated while it adapted.

(e) Even within these parameters FIAT was going to be hit hardest as the 'godfather' agreements wound down in 1992. This would remove their domestic base and their quality was not adequate to survive a direct confrontation at the low end of the market, where they were presently strongest. Renault were qualitatively inferior at every point, and it remained to be seen how long the patience (and purse) of the French Government would endure.

5 As Dr Hahn kept referring back to the needs of VAG to establish a firm manufacturing base in the United Kingdom, I felt it might be appropriate to put one of the principal reservations concerning this - namely that union presence on the VAG Board could compel VAG to reduce their foreign production if their overall profitability came under pressure at some time in the future. Dr Hahn said this need not cause concern. The question of union pressure would not arise as he would designate the UK as the manufacturing base for a particular model run that would be part of their range. If the overall market contracted, production in the United Kingdom might do so in line with that, but there could be no question of shutting a plant at the periphery in response to union pressure as this would leave a complete gap in their overall production range.

6. Dr Hahn was brutally frank about the attractions of the United Kingdom. He said we were a low cost area. The key comparison for a worker hour was 19DM in Britain against 40DM in Germany. Yet a British location had considerable infrastructural advantages over Spain and Portugal.

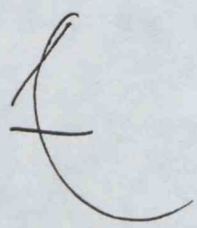
7 Dr Hahn said that he was <u>not</u> insistent on getting Land Rover/Range Rover in the package. But clearly he would like to do so. He was scornful about their existing management, and prospects without radical changes and greatly increased investment.

8 When I raised the question of sourcing, he said that he would have no objection to any agreement to purchase ARG carrying with it a commitment to source much more extensively in the United Kingdom for components for the <u>whole</u> VW range (at present VW's overseas sourcing amounts to a total of 27bnDM).

9 Dr Hahn said that he would need to decide this year. The company were in the throes of a major restructuring programme. They had already put 8bnDM into SEAT in Spain and they were ready to proceed with a major purchase. They would have no objection to having at least two British directors on the Board of Management.

CONCLUSION

Dr Hahn is amiable, but steely. He is genuinely anglophil and has educated his children here. He is also a great admirer of the Prime Minister and although he did not say so in so many words I think he was disappointed at not being allowed a few minutes in her company (and I blame myself for having been dissuaded, against my better judgment, not to request this). It is my opinion - and I express it in all diffidence for the direct responsibility is not mine - that his approach deserves very serious consideration. I suppose that there are distant echoes of Westland. If basic manufacturing capacity is to pass into foreign ownership should the new proprietor be American or European? But as a suitor VW has at least the advantage that they do not <u>insist</u> on the inclusion of Land/Range Rover. Dr Hahn gave me the very strong impression that he would be prepared to pay up this year which would, at least, allow us to draw a firm line under the disagreeable and expensive BL experience. If (for example) even half the money notionally set aside to make the corporation 'attractive' to the private sector over the next three years were to be loaned to Egan to enable him to take over Land Rover and sort things out there I feel that we should end with a good solution. Namely that the specialised vehicle industry remain wholly British, while we retain a good stake in the component and assembly side of the mass market.



SUBJECT
CC MASTER

FILE 29
DA.

10 DOWNING STREET
LONDON SW1A 2AA

From the Private Secretary

25 February 1988

Dear Jeremy,

FLORENTINE

The Prime Minister held a meeting earlier this afternoon to discuss the letter dated 24 February from the Chairman of Florentine to your Secretary of State. Those present were the Chancellor of the Exchequer, your Secretary of State, the Chancellor of the Duchy of Lancaster and Mr. George Guise, Policy Unit. Discussion focussed on the seven key issues identified in the Chairman's letter.

i) On point (i) your Secretary of State reported that the Attorney General had given oral advice that he saw no difficulty in allowing a "single tender" approach for Florentine. But your Secretary of State thought it essential to impose a time limit on that arrangement of 1 May.

ii) On point (ii) your Secretary of State reported that Rover Group had a representative in Tokyo who would be in a position to make contact with Honda at an appropriate time. He also thought it would be desirable for our Ambassador in Tokyo to call on the Honda Chairman to stress to him that the UK Government would most earnestly hope that Honda's relationship with the company should continue.

iii) On (iii) your Secretary of State reported that in discussions today with Florentine he understood them to be pressing for a write-off of the company borrowings as projected for the end of this year, which might be some £750 million, but not for the other elements of the Varley-Marshall assurances. Florentine would then be looking to acquire Rover for a nominal sum. Your Secretary of State pointed out that in considering any such deal attention needed to be given to the underlying value of Rover which might be looked at in three elements; first, the value of the tax losses which might be some £300 million; second, the value of Land Rover which might be put at some £250 million; and third, the

value of the other assets which, according to Barings, could be as high as £400 million. Against that any purchaser would however have to set the liabilities involved in contracting or shutting down parts of the business.

iv) Your Secretary of State's initial view was that in negotiation with Florentine the Government might work towards a deal involving a net write-off of £500 million. But he saw great presentational advantage in reaching such a figure by a two-stage process; a gross write-off of perhaps £750 million offset by a payment to the Government of say £250 million for Land Rover. In any event it was essential that broad figures were agreed with Florentine before any announcement; after that the Government's negotiating strength would be much reduced.

v) On point (iv) your Secretary of State said he saw no difficulties about providing for the continued services of Mr. Graham Day.

vi) On point (v) it would be necessary to give careful consideration to what if any restrictions or undertakings were essential for the Government. In discussion two major points of concern were identified; first, the danger of a sale to foreign owned interests of Land Rover, and second the rapid resale of Rover by Florentine at a profit to another company. A number of alternative approaches were possible on the second point, such as a time limited golden share arrangement, or considering whether the existing golden share provision for BAe could be extended to cover the sale of assets acquired from Rover.

vii) No particular difficulties were presented by points (vi) and (vii) in the Chairman's letter.

In subsequent discussion the following points were raised:

viii) The Government needed to be satisfied that a sale of Rover to Florentine would not imply the Government jumping out of the frying pan into the fire. Considerations to be borne in mind were the past management performance of Florentine, and the fact that the Government was heavily dependent on Florentine for strategically important products.

ix) It was important that in any deal with Florentine it would be for them to sort out the problem of minority shareholders in Rover; the Government would not itself buy these out first.

x) It was essential that any disposal of Rover should leave the Government with no continuing liabilities.

xi) The position had now been reached where it was no longer acceptable for Mr. Graham Day to act on the Government's behalf in the negotiations; these should now be led by your Secretary of State.

Summing up the discussion the Prime Minister said that your Secretary of State should now continue negotiations with Florentine keeping the Treasury and No.10 Policy Unit closely involved. He should indicate that the Government would be prepared to negotiate on a "single tender" approach, but only until 1 May. He could indicate that the Government would fully support and encourage a continuing relationship with Honda. The Government's financial advisers should urgently consider the financial position of Florentine with a view to obtaining reassurance about the company's viability as a purchaser. Urgent consideration should also be given to the terms of any conditions that might be imposed on the sale of the Rover Group, in relation to preventing (i) the sale of Land Rover to foreign interests and (ii) the onward sale of other parts of the business in the near future. As regards the financial terms of any sale to Florentine your Secretary of State had authority to indicate that a net write-off of up to £500 million would be acceptable to Government; but if Florentine continued to press for any higher package of assistance he would need to report back to colleagues.

The Prime Minister invited your Secretary of State to report back to a further meeting to be arranged for Monday 29 February. If an acceptable deal with Florentine then still seemed to be in prospect consideration would need to be given to the timing of any announcement that negotiations were under way.

I am sending copies of this letter to Alex Allan (HM Treasury) and Peter Smith (Chancellor of the Duchy of Lancaster's Office).

Yours,
Paul

(PAUL GRAY)

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

No. 1 of 2.

28.

dti

the department for Enterprise

SECRET/COMMERCIAL IN CONFIDENCE/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
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Our ref DC3AFE
Your ref
Date 24 February 1988

Prime Minister

As discussed this afternoon. Your meeting tomorrow needs to set the terms for further talks with Florentine. Lord Young will bring his proposals to the meeting. Florentine's opening demands look high.

If all went well the plan would be a further meeting of Ministers on Monday, report to Cabinet on Tuesday and a statement late that day. You will want to consider which Ministers to involve in a Monday meeting - ? eg Mr. Forte. PRC6 24/2

Dear Paul

FLORENTINE

As I told you on the telephone the Chairman of Florentine has written to Lord Young. This letter is to be discussed at a meeting at 5.00pm tomorrow and I am therefore enclosing a copy so that the Prime Minister and the Chancellor can have a chance to see it tonight.

I am copying this to Alex Allan (Treasury).

Yours

Jeremy

JEREMY GODFREY
Private Secretary

pmf

the Enterprise initiative

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COMMERCIAL-IN-CONFIDENCE

BRITISH AEROSPACE

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PUBLIC LIMITED COMPANY
11 STRAND
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Telephone: 01-930 1020
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IN STRICT CONFIDENCE TOTAL COPIES 9

From: CHAIRMAN COPY No. 9
Professor Roland Smith

Direct Line: 01-389 3923

TO (1) Mrs Bell VM2

FOR ADVICE (AND DRAFT REPLY IF APPROPRIATE) PLEASE BY: ASAP IF DEADLINE 24th February, 1988 CANNOT BE MET PLEASE PHONE IAN [illegible] FIRST [illegible]	COPIES TO (2) PS / KC (3) PS / RA (4) PS / SBH (5) Mr William (6) Mr Cochli (7) Mr Bunn (8) Mr Michell (9) PS / SOS

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 OET.

My dear Lord Young,

I am writing to confirm British Aerospace's serious interest in acquiring the whole of the issued share capital of the Rover Group plc ("the Company") subject to the conditions mentioned below.

As you appreciate, we have very limited information concerning the Company at this stage and we would require early access to the Company and its management in order to understand fully the Company's financial and business condition, the adequacy of provisions, any actual or contingent liabilities, future plans and projections and so on, and to satisfy ourselves that we can achieve a satisfactory return on our projected investment in the Company. We will also wish to explore the availability and possibilities for utilisation of tax losses. Likewise, finalisation of the acquisition would be subject to the satisfactory completion of a full due diligence exercise, negotiation of an acceptable Sale and Purchase Agreement with appropriate warranties, representations and indemnities, and the receipt of any necessary regulatory, shareholder or other approvals which may be required. I will, of course, also need to revert to my Board colleagues as soon as the final details are established.

However, before proceeding further and recognising the implications of this decision for British Aerospace, we require confirmation from you concerning a number of key issues, including :

The Attorney-General has now said he sees no difficulty about a "single tender" approach. RR 16.

(i) the sale of the Company will not be the subject of competitive tender or any form of auction;

(ii) our acquisition would not affect Honda's relationship with the Company or the support to the Company which we understand to be implicit in that relationship;

...../2

(iii) HMG will inject sufficient cash into the Company's business prior to completion to liquidate all borrowings and liabilities (taking account also of the seasonality of cash flows) and ensure an adequate working capital over the next few years (including the effects of the current industrial dispute);

(iv) acceptable arrangements are in place to ensure the continuity of the Company's senior management including the services of Mr. Graham Day;

(v) British Aerospace will be permitted to manage its investment in the Company and its assets without restrictions including, for example, the possible closure of facilities, reorganisation, foreign participation and future applications for stock exchange listing, if these actions or any of them are considered by management as necessary or conducive to the Company's or British Aerospace's interests;

(vi) the Company will continue to be eligible to receive any benefits, subsidies and other assistance available from Government in support of the Motor Industry or like businesses;

(vii) there will be no announcement concerning our intentions except by written agreement between us.

We will be pleased to meet with you to explain any points requiring clarification and to settle the programme for achieving our mutual objective. At the same time we could perhaps be informed of HMG's industrial strategy affecting the Company's business sector.

In view of the considerable amount of work that needs to be undertaken I would appreciate your early reply confirming the acceptability of British Aerospace's proposal as stated in this letter.

Yours sincerely,

Roland Smith.

Prime Minister
● Follow Lord Young's comments this afternoon. You will need to discuss with him and the Chancellor how things are a bit clear – late this week or early next.
RRC6
24/2

External 1 of 3

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27

CC SG

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COMMERCIAL IN CONFIDENCE
MARKET SENSITIVE

PM

PRIME MINISTER

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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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.

I think he needs before any announcement.

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.

This follows your comment this afternoon that Friday 4 March would not be possible in Parliamentary terms. But 7 March is "over other" day, so it might be better - if the news will hold - to wait till 8 March.

RRCG.

Jeremy Godfrey

for DY

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

Department of Trade & Industry

22 February 1988

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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.

26

SUBJECT cc MASTER

NOTE FOR THE RECORD

ROVER GROUP

The Prime Minister discussed briefly with Lord Young this morning the latest developments recorded in Jeremy Godfrey's letter of 5 February. The Prime Minister expressed her concern about the likely delays. Lord Young said he would ensure that a firm response was known by 27 February.

Rec.

Paul Gray

9 February 1988

dti

the department for Enterprise

B 1 of 2

25

SECRET

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

We may have been taken for a Rover ride

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

Prime Minister

X is disappointing, not least because my impression is that it reflects a reluctance to do much while Lygo is still abroad. It means that nothing much will now happen for a month, at which point we could be back to square one. But I don't see much point in trying to force BAe forward against their will.

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Direct line 215 5422
Our ref PS6ACY
Your ref
Date 5 February 1988

Dear Paul

RRCG
5/2

ROVER GROUP

Since the meeting on 3 February, Lord Young has spoken again with Graham Day and Professor Roland Smith. He has asked me to bring you up-to-date with developments.

X Professor Smith has assured the Secretary of State that BAe will confirm by the end of this month whether they wish to pursue substantive negotiations for the acquisition of Rover Group. He was reluctant to accelerate this timescale given the extent of the work needed before BAe could have sufficient confidence in the proposition to proceed with a public announcement. Graham Day (and our advisors, Barings) believe this to be realistic.

The Secretary of State has instructed Day that he should personally be kept in very close touch with the discussions, particularly when questions of the Government financial input arise.

dti

the department for Enterprise

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Day and Smith are seized of the need for absolute secrecy and only a small handful of people on each side will be involved. As a precaution, however, officials are discussing with the companies the line to be adopted in the event of premature, public disclosure. We will aim to circulate a draft line early next week.

I am copying this minute to Alex Allen (Treasury).

Yours

Jeremy Godfrey

JEREMY GODFREY
Private Secretary

the enterprise initiative

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4 copies → HMT

10 DOWNING STREET

LONDON SW1A 2AA

3 February 1988

From the Private Secretary

Dear Jeremy,

ROVER GROUP PRIVATISATION

I have now written separately recording the discussion the Prime Minister, the Chancellor of the Exchequer and your Secretary of State had with Mr Graham Day earlier today. This letter records the discussion that took place before and after Mr Day joined the meeting.

The Prime Minister expressed her deep concern about the way in which the Rover business was developing. The prospect as presented in the Corporate Plan was unsustainable and the possibility of a placement seemed non-existent. The material that Graham Day had put forward in support of his proposed exploration of a placement was totally inadequate and did not provide an acceptable basis for moving forward.

Your Secretary of State explained that following an earlier approach to Graham Day, Professor Roland Smith, the Chairman of BAe, had approached him the previous day to suggest the possibility of BAe purchasing Rover. Your Secretary of State considered this possibility was worth exploring.

In discussion concerns were expressed about BAe's motives in this approach and the likelihood of continuing demands from them both during and after any negotiations over Rover. On the other hand, a sale to BAe might offer some advantages compared with alternative approaches. It was agreed that the possibility should be explored in discussion with Mr Day, who was then invited to join the meeting.

After Mr Day left the meeting it was agreed that your Secretary of State should speak briefly to Professor Rowland Smith saying that Ministers had had a productive meeting with Graham Day who would now be getting in touch with Smith

to carry forward the discussions. The Prime Minister also noted, however, that if negotiations reached the point of considering the scale of any write off of bank debt that aspect would have to be handled personally by Ministers.

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

Yours,
Paul.

PAUL GRAY

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

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10 DOWNING STREET

LONDON SW1A 2AA

3 February 1988

From the Private Secretary

Dear Jeremy,

ROVER GROUP PRIVATISATION

The Prime Minister held a meeting this morning with the Chancellor of the Exchequer, your Secretary of State and Mr Graham Day. Mr George Guise, No.10 Policy Unit, was also present. The meeting considered your Secretary of State's minute of 29 January and the letter of the same date from Mr Day.

The Prime Minister said she was most disturbed by the figures presented in the latest Rover Corporate Plan. There was no realistic prospect of a placement on this prospectus. The Chancellor of the Exchequer pointed out that there was a continuing implied outflow of cash even discounting interest payments.

Mr Day said over the last year performance targets had been met and the business was now in a better position. The latest results would be the best for nine years. Although there were major problems still to tackle, the intensive phase of fire-fighting had now been completed. As agreed at the previous meeting he had been exploring the possibility of placement but had also been looking at other options. He now wished to report on an approach from BAe.

Mr Day explained that the first signs of BAe interest had developed before Christmas but they had strengthened in the last few days. It was still unclear how firm BAe's interest was but he considered the possibility worth pursuing. The approach had come from Professor Roland Smith, the new Chairman. There had been no discussion of the details of a possible deal but the outline would be for BAe to acquire the whole Rover business for a nominal sum after the Government had agreed to write off the accumulated bank debt. BAe had seen the Corporate Plan figuring. Mr Day had drawn to their attention the likely need for a net further cash injection of some £300m over the next five years to cover the projected shortfall between operating profit and capital expenditure.

Continuing Mr Day said there seemed to be a number of attractions for such a deal to BAe. They had their own balance sheet difficulties and the acquisition of the Rover

assets without any debt would improve BAe's own gearing. They apparently saw the scope for substantial rationalisation, and symmetry with BAe's existing operations particularly in Japan. Rover's manufacturing technology was also more advanced than that of BAe.

In discussion the following points were raised:-

(i) There must be a strong likelihood of BAe making additional financial demands on the Government, either during the negotiations, for example for redundancy costs, or in relation to subsequent business needs. It would be essential to keep any write off of debt to a minimum, and this should not cover the expected build up in bank borrowing during the course of 1988 to finance heavy capital expenditure.

(ii) If a sale to BAe went ahead it would be necessary to obtain an indemnity from the company to cover the other elements of the Varley-Marshall assurances. This had however been achieved in relation to the trucks business.

(iii) The scale of potential redundancies in the event of a sale to BAe or any other buyer should not be exaggerated given the economies already made and the high labour turnover rate in Rover.

(iv) Given the approach from BAe it would not now be possible for disclosure reasons to seek to buy out the minority shareholders in Rover before any sale to BAe. It was in any event desirable for the company to be sold with the minority shareholders still in place, leaving the purchaser to sort out this aspect.

(v) Once the possibility of a sale of Rover to BAe was reported to the Board of either company the listing requirements would require public disclosure of the discussions. There would in fact be some advantages for the Government in being able to negotiate in the open, not least because this would flush out the position of any other potential bidders. Once the point of disclosure had been reached it would be essential for a co-ordinated approach from all concerned, including statements to Parliament.

(vi) A key aspect of any deal with BAe would be the nature of the relationship with Honda. The latest indications were that BAe would place considerable importance on some Honda link. From the Government's viewpoint it would be important to avoid Honda taking a minority stake in Rover before any deal with BAe was finalised; that would greatly limit the

Government's available options if the BAe deal then fell through. This pointed strongly to any relationship with Honda during the period of negotiations with BAe being limited to a general umbrella deal.

(vii) It was essential for discussions with BAe to proceed as quickly as possible. Completion of any deal before the end of the present financial year was, however, unlikely, particularly given the time needed to secure European Commission blessing for a debt write-off.

(viii) Another critical feature of any deal would be the position of Mr Day himself. The indications were that BAe would want him to play a leading role in the newly merged company. Mr Day himself would want in the foreseeable future to step down to a part-time involvement, for example by splitting his existing combined job of Chairman and Chief Executive. It would therefore be necessary to explore the extent of personal commitment from Mr Day that BAe would be seeking.

Summing up the discussion the Prime Minister said it was agreed that the possibility of a trade sale of Rover to BAe should be explored as a matter of urgency. No action should be taken at this stage to buy out the minority shareholders in Rover. Mr Day should take the lead in the continuing talks with BAe, and would be acting on the Government's behalf. The aim should be to have reached a clear view by the end of February whether there was a realistic prospect of moving towards an early deal with BAe. Meantime it was important for all the parties to concert the appropriate form of words for use in any Parliamentary statement should that prove necessary.

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

Yours,
Paul.

PAUL GRAY

Jeremy Godfrey, Esq.,
Department of Trade and Industry

SLHASS

SECRET

22

PRIME MINISTER

MEETING ON ROVER GROUP: 3 FEBRUARY

You wanted to have another look at the papers following your talk with Lord Young this afternoon. These are:

- Flag A: Lord Young's paper of 29 January covering Graham Day's paper and the minutes of the December meeting.

- Flag B: a summary of questions to put to Graham Day drawn from George Guise's fuller note.

- Flag C: the Corporate Plan with George's annotations.

- Flag D: George Guise's full note (you may like to have another look through this before the meeting but I will take it out of your meeting folder for tomorrow).

other than the summary of Corporate Plan figures

Mechanics:

The meeting starts at 1100. But we have arranged for, say, a quarter of an hour session at the start without Graham Day. You also may like to bear in mind the desirability of asking Graham Day to leave by, say 1230 so that you can also have a round up session after he has gone.

The Chancellor has been shown George Guise's paper, on a strictly personal basis.

RRCG.

PAUL GRAY

2 February 1988

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PRIME MINISTER 1 February 1988

ROVER GROUP

The 1988 Corporate Plan.

This is hopeless both as a business strategy and a basis for the placement of shares. The key figures are set out below and in more detail in Annex A.

Figures in £m	1987	1988	1989	1990	1991	1992
PBIT	27.5	37.5	52.4	103.8	90.8	142.5
Pre-interest Cashflow	(124)	(185)	(19.6)	67.9	7.7	(48.2)
Sale of 40% DAF	-	-	-	90	-	-
Interest Paid	52.3	84.5	103	106	110	125
Net cashflow	(176.0)	(269.3)	(122.4)	52.3	(102.5)	(173.2)
Total debt	465	765	887	835	937	1110
Varley-Marshall exposure	1298	1582	1760	1749	1910	2129

A key point is that it is not interest which is killing the company but its own capital expenditure programme. Under these projections the assets under management do not generate enough cash flow to service the capital requirements and no sane investor would participate in such a business even if it were debt-free!

It therefore follows that this plan is not what management intend to follow. Hidden up their sleeves must be a far better cash conserving scheme. I have tried on several

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occasions to get Rover to examine alternative plans which conserve cash. Production would be concentrated on fewer sites and the hierarchy of management boards pruned. I was told that not only would this be impossible but that merely to ask the question was offensive to Graham Day and the professionalism of his team. Now, however, some individuals within Rover privately claim that there exists such a super plan and that it has been costed. They refuse to show it to Government or even to debate it within the Group outside a very small circle. I have attended meetings where the DTI officials responsible for Rover have been treated with dismissive contempt when they have tried to probe how the plan numbers might be improved.

Lord Young's paper effectively abdicates all control of Rover Group to Graham Day and his management throughout 1988 on the basis that 'I think we must give him (Day) the chance to succeed or fail.' So the DTI have presented us with a paper containing a Group Plan which nobody believes in and yet which they recommend us to accept.

The list of hurdles.

These performance tests upon which we placed so much reliance on our last meeting, have been left entirely for Rover to produce and the DTI have simply keeled over and accepted them. They are not hurdles at all in the sense in which you and the Chancellor intended at our meeting in December. They are simply stages along a path which, with lot of good luck and Government money, might lead to some form of placement with Honda holding the lion's share.

The DTI, advised by Barings, tried to place quantitative hurdles before the Rover management. Such quantities as cash generation, profit performance and debt levels would have been established as absolute markers against which to judge the company's progress. These have been rejected out

of hand by Rover and replaced by the set of vague indications which Lord Young has placed before you in his Annex B. These are generally subjective and seek to rely upon Rover's own judgement as to whether they have passed them or not. In particular, heads of potential institutional investors will talk very positively at Graham Day level. However, it is their investment managers who will make the hard cash decisions after they have seen the placement prospectus.

The Real Rover Plan

To accept Lord Young's paper as it stands is to wash Government's hands of the business by saying to Graham Day, "Tell us how much taxpayers' money you would like and we will give you the cheque later this year". We must be far more robust and probe Day hard about his real business plan is. Otherwise, Rover and their advisers will demonstrate that according to the 88 plan vast Government funds, well in excess of a billion pounds, are needed before the business can be placed. Once the funds have been agreed and put into the company, it will suddenly change its tune and operate according to the real plan. The vast improvement which structural change can certainly bring will not benefit the taxpayer one jot. It will serve only the new shareholders and the continuing management who will crow about how everything has been turned around!

Temporarily retained DWayland, 5/1/16

THIS IS A COPY. THE ORIGINAL IS RETAINED UNDER SECTION 3 (4) OF THE PUBLIC RECORDS ACT

Temporarily retained Wayland, 5/1/16

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RETAINED UNDER SECTION
OF THE PUBLIC RECORDS A

Temporarily retained CWayland 5/1/16

THIS IS A COPY. THE ORIGINAL IS
RETAINED UNDER SECTION 3 (4)
OF THE PUBLIC RECORDS ACT

Temporarily retained CHWayland 5/1/16

THIS IS A COPY. THE ORIGINAL IS RETAINED UNDER SECTION 3 (4) OF THE PUBLIC RECORDS ACT

Questions for Graham Day

1. If the 88 Plan really represents the best estimate Rover Group management can provide, what is the purpose of proceeeding with any more discussions about placement?

2. Since the elimination of all debt and therefore interest still does not return the Group to a sound financial position, upon what event does the future depend?

3. Is there any scope for major cost saving by integrating the three present company boards and managements into a single Rover executive?

4. What savings possibilities would there be in integrating the manufacture of Land Rover and Austin Rover at fewer sites.

5. Would such integration release any land of substantial value?

6. Why do Rover see the participation of Honda at a 'significant but not critical' shareholding as essential to the placement.

7. What is the danger that Honda will feel a moral commitment has been given to them which would pre-empt the possibility of a trade sale if placement does not work?

8. What level of Government funding does Day believe is likely to be necessary to place the company?

Conclusions

1. Lord Young and the DTI are trying to wash their hands of this business and leave everything to Graham Day. They are paralysed by the fear that any criticism or attempt at direction will cause him to resign. This is no way for a shareholder to behave. Indeed, it is unfair to Day to place him in such isolation even though he may think that is what he wants.

2. The Corporate Plan is an intellectual insult and certainly does not represent the optimum way of running this business. Varley Marshall exposure, the ultimate measure of both Government's support and vulnerability, is planned to rise to over £2 bn by 1992. This is quite unacceptable.

3. If the Corporate Plan is accepted in anything but a formal sense for public consumption, we are effectively handing Rover Group a blank cheque. They must be told that only if a sensible placement plan is put forward, will Government funds be forthcoming. Proper objective tests of performance must be established against a realistic plan.

4. The extent of Government dowry should be limited to some or even complete debt write off. Any claims for restructuring costs will need to be argued against the specific operating improvements anticipated. Government funding should not be made available for pre-financing future capital expenditure. Indeed, such funding is illegal under EC practice. If the company can only be placed on such a basis then it would be better to go directly for a trade sale.

5. Honda must not be given any moral or legal pre-emptive rights to a shareholding before placement is actually achieved. It could suit them well to take a small, spoiling shareholding to frustrate future trade sales elsewhere.

GEORGE GUISE

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ANNEX A

1988 Plan - Key Figures in £m	1987	1988	1989	1990	1991	1992	Total 88/92
UK Market Share ARG %	15.0	15.3	15.2	15.7	15.1	14.6	-
Sales ARG	2610	2736	2965	3385	3480	3630	
Sales RG	532	584	620	672	757	776	
Net Sales RG	3050	3175	3426	3898	4044	4200	18767
PBIT ARG	5	19.0	29.0	74.0	69.0	129.0	
PBIT RG	23.3	27.0	29.7	34.0	42.8	33.3	
Net PBIT RG	27.5	37.5	52.4	103.8	90.8	142.5	427
OP Cash Flow ARG	(5.2)	161	197	222	201	240	
Less ARG Capex	89.6	272.1	184	130	177	245	
Pre Interest Cash Flow ARG	(94.8)	(111.1)	13	92	24	(5)	
Pre Interest Cash Flow LRG	12.3	(20.8)	21.3	10.4	13.3	(18.6)	
Net Op Cash Flow RG	(123.6)	(184.8)	(19.6)	67.9	7.7	(48.2)	(148.2)
Less Interest	(52.3)	(84.5)	(102.8)	(105.6)	(110.2)	(125.0)	(526.5)
Add Sale of 40% DAF	-	-	-	90.0			90
Net Group Cash Flow	(176.0)	(269.3)	(122.4)	52.3	(102.5)	173.2	(615)
Total Group Debt	464.7	764.6	887.0	834.7	937.2	1110.4	-
Varley Marshall Exp.	1298	1582	1760	1749	1910	2129	-

Net Group totals are generally different from sum of ARG and RG because of other Group factors.

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- A VIEW FROM THE ECONOMIST INTELLIGENCE UNIT

The decline continues -

The Rover Group's share of the UK car market continues to weaken. Even allowing for the exclusion of Jaguar (which was privatised in August 1984) the company's penetration level has halved in little more than ten years. The majority of the damage occurred in the period 1975-79. The position was stabilised in the first half of the 1980s thanks to the availability of new models - Metro, Maestro, Montego - but the past two years have seen a further dip with market share estimated to be 15.4 per cent in 1987 compared with 17.9 per cent in 1985.

Development of Rover Group's Passenger Car Sales in the UK, 1972-87

		Change over previous year		Market share	
	Units	Units	%	%	% change over previous year
1972	542,440	26,176	5.1	33.1	-7.1
1973	529,577	-12,863	-2.4	31.9	-1.2
1974	415,368	-114,209	-21.6	32.7	0.8
1975	368,687	-46,681	-11.2	30.9	-1.8
1976	352,679	-16,008	-4.3	27.4	-3.5
1977	322,067	-30,612	-8.7	24.3	-3.1
1978	373,793	51,726	16.1	23.5	-0.8
1979	336,984	-36,809	-9.8	19.6	-3.9
1980	275,798	-61,186	-18.2	18.2	-1.4
1981	285,071	9,273	3.4	19.2	1.0
1982	277,260	-7,811	-2.7	17.8	-1.4
1983	332,725	55,465	20.0	18.6	0.8
1984	312,054[a]	-20,671[b]	-6.2[b]	-17.8[c]	-0.8[c]
1985	327,955	15,901	5.1	17.9	0.1
1986	297,466	-30,489	-9.3	15.8	-2.1
1987	300,000[d]	2,534	0.9	15.4	-0.4

a Excludes Jaguar. b If Jaguar is included the decline would be 13,127 units and 3.9 per cent. c If Jaguar is included the market share would be 18.3 per cent and a decline of 0.3 per cent. d EIU estimate.

Source: SMMT.

- on a broad front

Of the Rover Group's six main models - Mini, Metro, Maestro, Montego, Rover 200 and Rover 800 - only the latter two have recorded sales increases in 1987. The company's biggest selling model is the Metro (accounting for about 40 per cent of unit sales) followed by Montego (nearly 20 per cent), Rover 200 (16 per cent) and Maestro (15 per cent). The all-important executive car contender, the Rover 800, achieved sales of around 14,000 during the first eight months of 1987, which means that it will almost certainly be short of the 20,000 a year target originally set - and that in its first year when the impact should be strong.

New models will depend heavily on collaboration with Honda; the next introduction is scheduled to be the hatchback version of the 800 in mid-1988, followed by the R8 (Maestro/Rover 200 replacement) in 1989 and Metro replacement in 1990.

A difficult course ahead

The Rover Group faces a difficult period in determining its market strategy for the next few years. The company would like Austin Rover to be regarded as a specialist producer - as something above and apart from the hurly burly of mass marketing as typified by Ford and General Motors. This is entirely logical, because Rover Group needs to charge premium prices in the market place to compensate for its inferior economies of scale. The trouble is, of course, that the company is forced to compete in the mass market in order to secure volume and to indicate to the government that the investment from public funds has been put to good use. Rover Group is therefore particularly vulnerable to another discounting battle. Recent attention has been given to improving conditions at the dealer level - notably with regard to customer relations - and a new advertising approach has been adopted.

The big question is how can the decline in market share be reversed? And to that there is no easy answer. Research has shown that public perception of the marque differs from the reality, but image is crucial in the car market and is something which cannot be changed in the short term. The decision to delete the name Austin from the models and concentrate on Rover is effectively an admission of past shortcomings. A brand name is only as good (or as bad) as the product it represents.

Looking to the future, the obvious priority must be to stabilise market share at around the current level. Any attempt to retrieve lost ground could be highly expensive and run the risk of restarting hostilities against more powerful competitors. There is no reason, though, why this objective should not be achieved - provided that the new range of models scheduled for introduction over the next few years are manufactured with meticulous attention to product quality coupled with an attentive approach to customer relations. Longer term, if exports continue to build up in the satisfactory manner of the past couple of years, it is possible that UK market share considerations will assume less importance - in which case the much coveted premium position might be attainable.

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8. What level of Government funding does Day believe is likely to be necessary to place the company?

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the department for Enterprise

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PRIME MINISTER

ROVER GROUP (RG)

1. We are meeting on 3 February to consider RG's 1988 Corporate Plan (CP), to review progress on RG's preparatory steps towards a placement, and to look again at the case for taking out RG's minority shareholders. I discussed these issues with Graham Day today.

CORPORATE PLAN

2. The 1988 CP is essentially a holding strategy to take forward RG's businesses along the lines of RG's 1987 CP; it is not a basis for placement. My major point of concern is the forecast rapid increase in Varley Marshall liabilities from £1.3bn in 1987 to £2.1bn in 1992, even though most of the increase in 1989-91 compared with the 1987 CP profile is due to the different assumption on LR disposal. In other circumstances I would regard this as quite unacceptable, but I do not believe it is in our interests to open up a major debate with Graham Day on this now. Rather, I believe we should accept the CP, but only on the assumption that placement proceeds according to plan this year. We should make clear to Graham Day, however, that if placement flounders and a trade sale proves impracticable, we would wish to look at major surgery. Meanwhile, I suggest officials should agree borrowing objectives for 1988 and 1989 with RG.

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the department for Enterprise

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PLACEMENT

3. I attach a copy of Graham Day's note to me on progress (Annex A). I remain sceptical about the prospects for a placement but in order to obtain Graham Day's willing endorsement of Plan B (trade sale) I think we must give him the chance to succeed or fail. RG have proposed a list of key hurdles (amplified in Annex B). I have told Graham Day that failure at any hurdle would mean that we would wish to proceed to proceed with a trade sale. While I would have wished to see more quantitative tests in Day's list, I am prepared to accept his proposal but we should also make clear to him that officials will be monitoring closely the Group's financial and commercial performance through 1988. Initially, that willhave to be against the 1988 CP projections. RG's review of the prospects for improving profitability should, however, be available in March. We can then move to tracking performance against the enchanced trend which would be the basis for a placement.

they really do seem very vague. RRG

4. The fragility of placement underlines the critical role Honda would have to play. Day was encouraged by his meeting with Honda on 22 January where they said they would consider taking a "significant but not critical" shareholding. Honda have agreed to meet me during my visit to Japan next month. I will take that opportunity to assess the firmness of their intention, but in any event we will have to have their conditional agreement by the end of July.

?

5. Day believes that for placement to proceed it would be necessary to place the whole Group, including Land Rover (LR), and secure Honda involvement at Group level. I believe the political sensitivities could be handled if 80% of the share-holding went mainly to British institutions and, say, 20% to Honda. I am not attracted to the idea of a golden share. But

PS5ADJ

dti

the department for Enterprise

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I suggest officials might explore with RG what degree of protection against a hostile takeover could be arranged between placement and a flotation in the early 90s.

6. The likely cost to Government of privatising RG - whether by placement or trade sale - is not yet clear. If we have to write off debt and meet restructuring costs, as on the commercial vehicle businesses, the bill could run to £1bn, or more. But I believe we must resist any pressure to finance future working capital requirements. This would be a direct subsidy to the privatised business and would be virtually impossible to clear through Brussels. As it is, we shall have to exert maximum leverage on Sutherland in his last year as Commissioner.

7. We must make certain that the taxpayers' interest is safeguarded in RG's negotiations of financial terms with the institutions and Honda. I have registered this concern with Graham Day. I suggest that the Government's advisors, Barings, should be directly associated with the initial soundings of institutions, initially in a listening role.

RG MINORITY SHAREHOLDERS

8. The minority shareholders represent a major obstacle to privatisation, primarily because of their rights to information on negotiations either on a placement or a trade sale. Graham Day has constantly pressed the case for their elimination. I believe we could present such action as a signal of the Government's firm intention to privatise RG. We would need to pay some premium on the market value of the minority's shareholding, currently about £10m.

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dti

the department for Enterprise

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PARLIAMENTARY STATEMENT

9. Following our discussion with Graham Day, I shall consider the terms of a Parliamentary statement in mid-February on RG's CP. The statement might also re-emphasise in general terms our intention to seek to return RG to the private sector, and announce our intention to take action to buy out the minority shareholders as an early step to that end.

10. I am copying this minute to Nigel Lawson.

D Y

29 January 1988

Department of Trade and Industry

PS5ADJ

ANNEX A

ROVER GROUP

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

29 January 1988

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

SECRET

Dear Secretary of State

ROVER GROUP PRIVATISATION

At the Prime Minister's meeting on 1 December 1987 we agreed that I should offer for endorsement at our next meeting an outline of the key dates and "hurdles" to be surmounted in determining whether it would be possible in late 1988 or early in 1989 to place and subsequently float of the Rover Group.

The key tests which are designed to be objectively measurable and which progressively will show whether a placement will be feasible are as follows:

HURDLES

	End of
Minorities	(February)
Initial contacts with investors positive	(April)
Indicative terms acceptable to Government	(May)
Honda	(July)
Achievement of half year results	(August)
August trading	(September)
EC consent	(October)

If you and your colleagues are generally content, we shall refine and more precisely define them. I look forward to reviewing performance with you in April, July and October when a firm decision will be required to move towards completing the placement.

.../2

Directors J Graham Day (Chairman and Chief Executive) Sir Robert Hunt CBE DL (Deputy Chairman) NJ Carver OBE AFC (Group Executive Director) Sir Robert Clark DSC E W Dawnay Sir Archibald Forster
D R L Hankinson (Group Finance Director) Sir John Mayhew-Sanders B W Pomeroy Registered Office 7-10 Hobart Place London SW1W 0HH Registered in England 1213133

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In addition we have offered regular meetings with officials and advisers at 2-3 week intervals to monitor various parameters (e.g. profit and cash) as part of a wider view of how the business is progressing so that they may keep you informed of the background against which the privatisation work is taking place.

We shall include in that process information about how we believe we could improve profitability given the removal of some of the commercial constraints of state ownership; this work should be completed in March.

We shall also keep them abreast of discussions with Honda. At my meeting with the Honda President on 22 January he showed serious interest in the possibility of Honda taking a significant but not critical equity stake in the Rover Group. They wish to be able to justify such a course to their shareholders on financial as well as operational grounds; in the latter context they have mooted the possibility of wider collaboration on products. They have undertaken to give us a firm indication of their view by end July 1988.

On the basis of preliminary work which has shown no insurmountable obstacles and the general understanding of all involved in the steps which need to be taken, I am confident that the objective of a placement later this year is a valid one.

Sincerely

Graham

J. GRAHAM DAY

ANNEX B

RG PROPOSALS ON PLACEMENT HURDLES IN 1988

		End of
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)

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cc DTI

10 DOWNING STREET

LONDON SW1A 2AA

From the Private Secretary

4 December 1987

Dear Jeremy,

ROVER GROUP PRIVATISATION

You told me that DTI officials had suggested a couple of changes to the record of the Prime Minister's meeting with Graham Day which would help in showing it to him. I now enclose a revised version. The changes are, first, to have it that Day 'said' rather than 'agreed' that some part of the Varley Marshall assurances relating to trade creditors and leasing would need to be written off; and, secondly, to make it clear that it was Day who said that any solution would require the minority shareholders to be bought out before the Government and the company became committed to any particular course of action. I have also taken the opportunity to add into the Prime Minister's summing up the request that the meeting in January should consider the question of buying out the minority shareholders.

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

Yours,

David.

DAVID NORGROVE

Jeremy Godfrey, Esq.,
Department of Trade and Industry

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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,

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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 sucessful 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).

Yours, David

DAVID NORGROVE

Jeremy Godfrey, Esq.,
Department of Trade and Industry

SECRET

10 DOWNING STREET
LONDON SW1A 2AA

From the Private Secretary

2 December 1987

ROVER GROUP PRIVATISATION

I should like to add to my record of yesterday's meeting with Graham Day that the Prime Minister will wish in January to discuss the possibility of buying out minority shareholders, in addition to discussing the flow chart towards a possible placement of shares in ARG.

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

David Norgrove

Jeremy Godfrey Esq
Department of Trade and Industry.

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10 DOWNING STREET

LONDON SW1A 2AA

From the Private Secretary

1 December 1987

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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.

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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 ~~agreed~~ 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 sucessful 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).

Yours sincerely
Amanda Ross

pp DAVID NORGROVE

Jeremy Godfrey, Esq.,
Department of Trade and Industry

SECRET

SUBJECT cc MASTER

fleve 16

cc BG

cc BLP

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 discusss 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

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.

15

SECRET

PRIME MINISTER

ROVER GROUP PRIVATISATION

The Chancellor and Lord Young will arrive at 1100. Graham Day will arrive at 1130. The rest of the morning is then free until lunch-time. But it would seem a sensible idea for Graham to leave at 1230 so that you can have half an hour with the Chancellor and David Young to talk over Graham Day's position.

The attachments to Lord Young's minute provide first a list of points for discussion between Ministers and secondly of points for discussion with Graham Day. These cover the ground. A clear impression given by the paper is that Graham Day will have to be pushed by you into a trade sale if this is to happen at all, and it is not clear what Day's position would be if you made the attempt. Against this background it would be as well to be questioning about the advice given by Graham Day on Volkswagen's position and his view that a deal with VW would take several months to complete. He may well be right. But equally he may be grinding an axe.

I suggest that you make it clear to Graham Day that you want serious investigation and study of the options for a trade sale. You will also want to make it clear that the Government does not intend to give ARG an easy ride in preparing itself for a placement if that is the way the decision eventually goes. You will be very tough on the capital programme and on targets for the company.

David Norgrove
30 November 1987

MJ2BPP

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cc BUp

SECRET

PRIME MINISTER

30 November 1987

TOMORROW'S MEETING WITH GRAHAM DAY

You concluded our last meeting on November 2 by stressing that, if trade sales or privatisation routes did not take the Rover Group out of HMG's hands soon, the Government would not be prepared to finance continuing substantial capital expenditure for new models. Rover Group borrowings had to be contained.

When this message was reiterated to Graham Day last week by DTI officials, he became adamant that the 1988 Plan would build upon the same business strategy as the 1987 Plan and that he would brook no interference from Whitehall. Under his leadership, no alternative, less cash consuming business strategies, would be considered or even costed.

Alternative Business Strategies

For some time now I have been asking for the financial consequences of a low volume, high quality alternative strategy focussing upon the traditional Rover marque. To recap, the building of small cars would cease after the present Metro falls foul of EEC exhaust regulations in the early 1990s; the AR8 would be developed as planned and, of present ARG models, only the 800 series would continue. Land Rover would contribute only the successful Range Rover model with all other production, including the new J, being terminated.

These three continuing models would all be constructed at one, or maximum two, sites under a single management organisation with one chief executive. There would be no central London head office full of planners and advisers, no

West London building full of clerks and accountants, and certainly no plethora of management committees and boards across the Midlands. There would be a concentrated three model business with a minimal management and administrative support system on site.

The Three Options

No-one at the DTI is prepared to push Day into costing such a plan, because they fear his resignation. In extreme terms therefore we now have a choice of alternatives open:

1. We may relinquish the Rover assets to Graham Day's husbandry for the next few years, relying upon him to do the best for Government, the nation and the business. If he is minded to pursue trade sales he will do so and if not he will continue to operate the business under the Varley Marshall assurances.

2. We can recognise the consequences of losing Graham Day and plan for that eventuality. We would need to evaluate possible successors who could be put in place fast, and their appropriate terms of appointment, including the business strategy we would expect to be followed. We would also need to think about departure arrangements for Day and how to achieve the minimum public acrimony.

3. We can give the highest priority to a trade sale and enlist real co-operation from Day. I understand that the Volkswagen possibility is receding and that Peugeot and Fiat are non-starters. This takes us back to Ford which has problems both politically, in view of previous undertakings, and in terms of competition policy with the possibility of MMC reference.

The trade sale makes most business sense and, in the long term, is more likely to benefit the UK. Day would have to be pushed hard to achieve a trade sale to Ford, and you would need to take the lead in pushing him, possibly in a smaller group than even tomorrow's. Day would need to be unequivocally assured that it is your own preferred route, that political backing would be forthcoming once he had negotiated a deal, and that generous termination arrangements would be made for the senior Rover people who would have no future with Ford.

David Young's Position

David Young will argue in favour of a variant of Option 1. He has discovered that the task of disentangling from Rover is far more tricky than he believed after his appointment to the DTI in June and does not relish a protracted battle with Day. He will therefore support Graham Day's plan for a placement with a set of milestones against which to monitor operating progress. He will argue that this will lead to clearly defined targets which, if not achieved, would trigger a rapid move towards a trade sale - a procedure which Day will be honour bound to accept and implement.

Apart from the abandonment of Government assets to an individual for a period of years, the greatest weakness of such a plan is its unenforcebility. When any particular target is undershot there will be a host of consequential arguments as to why nothing can be done in that particular instance. Each under-achievement will have special pleadings to justify it and there will be enormous danger of drift.

If the placement option is accepted, it is therefore crucial that the set of targets are simple, few and quantitatively objective. In particular, sales volume and profit margins,

which are the result of complicated accounting treatment, must be augmented by hard cash flow and borrowing targets.

Furthermore, any discussions with Honda over the next few months (Graham Day is to visit Honda on 22 January and David Young in March) must not lead to undertakings, either implicit or explicit, that it will participate in the future placement as though that route were a foregone conclusion. The danger here is that some form of moral obligation to Honda will be used to exclude even the possibility of a trade sale, despite the fact that targets have been undershot.

Conclusions

1 It is inappropriate to reach hard and fast decisions tomorrow, particularly as Day is to return at the end of January having taken advice on placement.

2 The business has performed well under Day's management with good profit achievements bettering last year's prognosis. However, the basic business strategy is still one of high capital expenditure and continued overall cash drain.

3 Nevertheless, I continue to advise that Day should be disabused of any belief that he has a mandate to continue running a business with annual cash deficits well into the 1990s. It is crucial that the Rover plan be bolted down by clear targets for cash generation and reducing borrowings.

GEORGE GUISE

Addressee Only
SECRET

Paul Gray 15A
for retention

ROVER GROUP

1988 Corporate Plan

November 1987

Copy Number 24

Addressee Only

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ROVER GROUP

1988 CORPORATE PLAN

CONTENTS

SECTION	TOPIC	PAGE
1	INTRODUCTION	3
1.1	The 1988 Plan - Evolution	3
1.2	Planning Environment	3
2	GROUP POLICIES	5
2.1	Business Objectives	5
2.2	Privatisation	5
3	STRATEGIES AND PROSPECTS FOR AUSTIN ROVER	6
3.1	Progress & Strategic Development	6
3.2	Products (Cars)	8
3.3	Products (Engines and Gearboxes)	9
3.4	Honda	10
3.5	Financial Constraints	10
3.6	Prospects	11
4	STRATEGIES AND PROSPECTS FOR LAND ROVER	12
4.1	Strategies Continuity	12
4.2	Organisation Structure	12
4.3	Privatisation	12
4.4	Products	13
4.5	Prospects	13
5	MINORITY SHAREHOLDINGS	14

SECTION	TOPIC	PAGE
6	FINANCIAL ASPECTS OF THE PLAN	15
6.1	Key Assumptions	15
6.2	Financial Performance	15
6.3	Plan Sensitivities	16
6.4	Financial Schedules	16
	Rover Group	
	Summary of Performance	17
	Earnings and Balance Sheet	18
	Cash Flow	19
	Analysis of Plan Projections by Group	20
	Austin Rover	
	Summary of Performance	23
	Earnings and Balance Sheet	26
	Cash Flow	27
	Land Rover	
	Summary of Performance	28
	Earnings and Balance Sheet	32
	Cash Flow	33
	Analysis by Product Company	34

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ROVER GROUP

1988 CORPORATE PLAN

1. INTRODUCTION

1.1 The 1988 Plan - Evolution

Although a number of areas initially identified for action in the 1987 Plan have been developed further, there are no fresh strategic concepts in the 1988 Plan.

The 1988 Plan in virtually all respects has evolved from the 1987 Plan and the Group's performance against the first year of that Plan.

1.2 Planning Environment

1.2.1 Contrasting the 1987 and 1988 Plans

The overall environment within which the 1988 Plan has been developed is materially different from that of the 1987 Plan in virtually all respects.

The 1987 Plan followed a 1986 Plan which was neither approved nor achieved.

The 1987 Plan was developed in the wake of the destabilising General Motors and Ford discussions.

The 1987 Plan had to develop fresh strategies and tactics for dealing with all of the loss making and peripheral businesses and for revival and change in the core passenger vehicle manufacturing companies.

The 1987 Plan was developed during a period of significant management change at senior levels both in the Group and the subsidiaries.

In contrast, the 1988 Corporate Plan has been developed during the comparatively stable circumstances progressively achieved during 1987 and against the achievement or betterment of 1987 Plan objectives.

1.2.2 Economic Considerations

Demand for vehicles in 1987 has been strong in most markets and has reached record levels in some, eg, Britain. Following the October fall in world stock markets and the ensuing concerns about currency parities, consumer demand and economic growth, there is considerable uncertainty about the overall market for passenger vehicles, particularly in the early years of the 1988 Plan.

The Group has substantially protected itself in 1988 against currency shifts. Further, considering the strength of the United Kingdom domestic economy and the wide spread of export markets now served, pre-October planning assumptions that in each year overall volumes will increase marginally over those assumed in the 1987 Plan, have not been changed. There may be increased competition in markets which remain strong as product is displaced from weakening markets, but it is not yet clear whether the impact, particularly with respect to volumes and price levels, will be favourable or unfavourable.

While there is no firm basis in corporate planning terms on which greater caution or more optimism can be supported, contingency operational planning will be put in hand early in 1988 to cater for possible pressures on volumes and on prices.

2. GROUP POLICIES

2.1 Business Objectives

Business objectives for the Group and for its two remaining wholly owned manufacturing businesses, continue to be to achieve, sustain and improve positive cash flows and profitability leading to financial self-sufficiency.

In the context of cash flow, it is now clear that if no action is taken to deal with the accumulated debt arising from past losses, the chances of achieving financial self-sufficiency are minimal.

2.2 Privatisation

Work now in progress will identify, in the course of 1988, alternatives for returning the Group to the private sector during the life of the current Parliament.

In the 1987 Corporate Plan the Board confirmed its commitment to the return of all the Group's businesses to the private sector on terms which are both industrially and commercially sensible. By the end of 1987 this commitment will have been translated into action and achievement in respect of sixteen businesses at home and abroad. It is expected that two further businesses will be sold by the end of the first quarter 1988.

The 1987 Plan recognised that no ready solution for the privatisation of Austin Rover was then apparent and that, while Land Rover could be sold, its sale before 1989 would be significantly sub-optimal. In both cases, in different ways and to different extents, the basics of the respective businesses had to be addressed before industrially sensible alternatives could be developed.

The progress made by both Austin Rover and Land Rover during 1987 is such that their privatisation can now be contemplated. Disposal plans for minority shareholdings in five companies will be related to the privatisation of Austin Rover and Land Rover.

3. STRATEGIES AND PROSPECTS FOR AUSTIN ROVER (AR)

3.1 Progress and Strategic Development

During 1987 AR has made significant progress with the best financial results for nine years eliminating operating losses one year earlier than considered possible in the 1987 Plan.

The priority short-term objective in the 1987 Plan of reversing the deterioration in the volume of sales was attained and with improved margins in the UK retail market. This was essential to create a base for the future development of the business.

In the 1987 Plan the product plan was incomplete. In the 1988 Plan the product plan has been extended for the full five year period and across the product range.

Three areas, quality, cost reduction and commercial aspects, identified in the 1987 Plan as underpinning the fresh strategy for AR have been positively addressed and continue to receive significant attention.

3.1.1 Quality

Improvements in quality are attested by reduction in warranty costs despite, for commercial reasons, relaxation of the criteria on which warranty costs are met and by independent third party comparative assessments of fifteen European passenger vehicle manufacturers. Evidence of these improvements is further supported by internal audits, customer surveys and increased sales to those fleet customers who conduct their own research.

Continuing quality improvement will result primarily from organisational changes focussed on product engineering, changes in relationships with component suppliers and from changes in attitudes and commitment of employees. Lessons learnt through the collaborative relationship between Austin Rover and Honda will stimulate improvement in all these areas.

Various programmes have been put in place to raise awareness and motivate employees at all levels, to encourage them to put quality at the forefront of all activities, to understand what has to be done and how to accomplish it and to appreciate that now and in the future everyone's job ultimately depends upon quality delivered competitively.

3.1.2 Cost Reduction

A significant contributor to Austin Rover's financial improvement in 1987 was the reduction of cost. The principal areas identified for attention were indirect costs, inventory levels (both components and finished vehicles) and warranty costs. These will continue to be the primary targets for further cost reduction.

For the Plan period indirect costs will be reduced in real terms thereby lowering further the break-even point and thus increasing Austin Rover's robustness in an uncertain future market.

Minimum inventory procedures ("Just-In-Time") are critical to competitive manufacturing costs. Changes in organisation, plant and procedures and quality criteria for suppliers will interact to produce further cost reductions.

Pilot procedures developed during 1987 demonstrated an ability to sell from the distribution pipeline ie to operate with significantly lower stocks of 'finished' cars. These procedures will be further refined and deployed.

Warranty costs reduced during 1987 despite both the increase in manufacturing and sales volumes and a relaxation of the criteria for warranty payments. This is a major area for further cost reduction and hence contribution to profitability. Warranty cost reductions will be achieved on the basis of improving quality, enhanced reliability and better dealer performance.

3.1.3 Commercial Aspects

The domestic market position has been stabilised, changes in product presentation effected and disciplined relationships with dealer and other commercial interests progressively put in place. Fresh initiatives directed at the customer and at Rover brand development will be instituted from 1988. In the course of 1988 the export markets, now accounting for one third of sales, will be given a treatment similar to that of the domestic market during 1987.

While during 1987 Austin Rover's share of the domestic market fell, Austin Rover will have sold marginally more vehicles in the U.K. than during 1986. In the export market sales were up over 20 percent. The objective of securing improved margins and hence profitability rather than volume per se is being achieved.

A programme to be known as "Customer Care" has been the subject of a pilot scheme during 1987. This three prong programme will be introduced early in 1988 for implementation by all U.K. dealers over the ensuing eighteen months. The overall objective of the Customer Care Programme is to provide a uniform, significantly higher level of service by dealers to customers.

Commencing in late 1988 a programme termed "Roverisation" will be implemented in order to develop and link company image and product characteristics with marketing and sales objectives. The Roverisation Plan is a critical step in Austin Rover's transformation from a comparatively small multi-product manufacturer of cars similar to those produced by volume manufacturers to a producer of a limited range of more select, upmarket, highly specified vehicles.

3.2 Products (Cars)

The 1988 Plan sets out the strategy for the transition from the present five platform position to the planned three platforms.

The 1987 Plan identified two of the three platforms, the existing new 800 (large) and the mid-size R8 (then AR8) now being developed (medium), and indicated the need for more work at the small end of the market.

It was clear during the preparation of the 1987 Plan that the all new replacement for Metro (AR6) then being planned was unlikely to be economic. Now, in place of AR6, a partial Metro rebody incorporating the new 'K' series engine (R6) has been selected at about 20% of the cost of AR6.

The Metro platform with continuing refinement is considered to be suitable as the third platform (small) including for a total rebody after the 1988 Plan period, again at costs a fraction of the previous AR6.

A three platform strategy places AR below the volume car producers and equal to most specialists but above the smallest, both in numbers of platforms and in production volume.

The third platform will enable AR to maintain approximately one-third of total sales in the small sector (present sales are in excess of 40 percent) thus securing essential overhead recovery, profit contribution and product for the dealer network.

3.3 Products (Engines and Gearboxes)

Following from the 1987 Plan the range of engine development projects was reduced to concentrate on the 'M16' and the new 'K' series engines, sourcing other new requirements outside AR.

'A', 'S' and 'O' series engines will be phased out progressively as new car models are introduced. 'M16' and 'K' series engines will meet the upper middle and lower ranges requirements respectively. Engines will be procured from Honda for the middle range, sourced primarily from a new plant at Swindon, England and for the top range sourced from Japan. Diesel engines will be provided initially by the joint Perkins/AR 'MDi' type and later, probably, from Peugeot and VM.

The external sourcing of engines impacts negatively on AR's profitability but reduces the requirement for capital spend and working capital.

Gearboxes will be built by AR under various licences and bought in. No new gearboxes will be developed by AR.

3.4 Honda

AR's reliance upon Honda, except as a power train supplier, will lessen after the launch of R8 in 1989. Nevertheless, collaboration remains essential, and Honda remains the preferred partner. Therefore, discussions are continuing with Honda to identify whether a basis exists for a longer term, more formal relationship. This is the primary strategic issue arising out of the relationship.

As anticipated in the 1987 Plan the joint design and development of a new mid-sized car (AR's 'R8' - Honda's 'YY') is now in effect and a contract for AR's manufacture of increasingly significant volumes of 'YY' cars for Honda has also been signed. Manufacturing under this contract will begin in 1989.

The contract supply to AR by Honda of engines and gearboxes continues. Also AR and Honda currently manufacture relatively small volumes of cars each for the other.

3.5 Financial Constraints

For the purposes of both the 1987 Plan and this Plan the Group has recognised the reality of its overall financial position. Capital spend last year and intentions set out in the 1988 Plan, together with the moves to contain and reduce costs, reflect this recognition. Planned borrowing in the 1988 Plan is consistent with the 1987 Plan.

Lower cost alternatives to earlier product intentions have been developed which actually are considered to be superior.

In the 1988 Plan the launch of one model derivative has been postponed from 1991 to 1993. To enhance profit opportunities, capital spend on this programme should be brought forward to 1989 from 1991. Whether this can be achieved depends upon continued improvement in the Group's overall financial position and alternative funding arrangements including in the context of privatisation.

The decision to source significant volumes of engines outside Austin Rover is further evidence of capital spending constraint with profit earning implications. Similarly development of the V6 engine, which has successfully been brought to proto-type stage, and additional niche or flagship vehicles are not included in the Plan.

3.6 Prospects

Subject to current external economic and market uncertainties, the Plan demonstrates that Austin Rover should continue to improve its overall performance and in particular its profitability during the whole of the Plan period.

There is growing confidence that Austin Rover has the ability to deliver progressively the various internal elements of the 1988 Plan. The business is now robust enough to contend with possible dislocation in some export markets. However, a general and major slowdown bringing with it a return to competitive discounting would be severely damaging.

4. STRATEGIES AND PROSPECTS FOR LAND ROVER (LR)

4.1 Strategies Continuity

For the whole of the 1988 Plan period, assuming continued ownership by the Group, the strategies set out in the 1987 Plan based on a refocusing of Land Rover products, the continuing refinement and upgrading of the Range Rover product and the development of new product for the medium term will continue to apply.

Land Rover financial and operational performance during 1987 confirmed the pattern of recovery thought to be apparent during 1986. Initial implementation of the strategies set out in the 1987 Plan produced better than planned results in the first year.

4.2 Organisation Structure

Placing Land Rover Parts (Parts), Range Rover of North America (RRONA) and related minority shareholdings under Land Rover ownership in order that all Land Rover related businesses could be managed in a common interest produced in 1987 the intended results of a simplified, more effective organisation, reduced costs and contributed to profitability.

Land Rover corporate organisation is not now expected to change in any significant way during the 1988 Plan period.

4.3 Privatisation

In the 1987 Plan disposal of Land Rover was assumed for 1 January 1989. In this Plan no specific assumption is made. Privatisation alternatives will be developed as set out in paragraph 2.2.

No moves have been made as yet to secure savings and enhance competitiveness through greater co-operation between Austin Rover and Land Rover. Any such advantages are dependent upon results of plans for privatisation.

4.4 Products

4.4.1 Vehicles

Product strategy is to continue to improve the established Land Rover and Range Rover products, while developing a new private sector model (Jay) and a Range Rover replacement (Discovery).

The Land Rover product is targeted increasingly to a number of specialist market sectors both at home and abroad. Range Rover's continuing development has established it as the world's leading luxury 4x4 vehicle and at the top of that market in every respect. Jay is a new personal transport sector model based on the Range Rover chassis but effectively replacing the Land Rover County Station Wagon.

4.4.2 Engines

Development of engines continues in order to be able to offer, for the Plan period, a range of petrol and diesel engines which will meet operational and environmental requirements.

With the current exception of a single bought-in diesel engine, the Land Rover plan is to develop and manufacture all of the engines required for its vehicles.

4.4.3 Corporate Identity

In the early years of the Plan the Land Rover corporate identity will be strengthened taking into account existing and planned product development and the very large geographic scope of markets served by Land Rover with its base products and their multiple variants.

4.5 Prospects

Land Rover is expected to improve its operational and financial performance through the whole of the 1988 Plan period. Serving multiple markets, the business is not considered to be significantly exposed to softness in any particular market, eg the United States.

5. MINORITY SHAREHOLDINGS

The Group holds minority interests in five companies in the private sector, three in the United Kingdom, one in Australia and one based in the Netherlands. All of the companies are trading profitably with adequate financial resources. This position is expected to continue for the Plan period.

ROVER GROUP
MINORITY SHAREHOLDINGS

	Company	Country	% held	Business
1.	UGC	UK	22	Parts warehousing and distribution
2.	ISTEL	UK	25	Computer software and services
3.	Llanelli Radiators	UK	25	Component manufacturer
4.	JRA	Australia	20	Agency for sales & assembly of passenger vehicles and commercial vehicle manufacture
5.	DAF	Netherlands	40	Commercial vehicles

These interests were retained or acquired in consequence of disposal activities. In DAF the holding was acquired through a merger of commercial vehicle activities. The other shareholdings were retained to assist in protecting in the interim the commercial interests of the core businesses.

The Group is represented on the boards of all the companies in which minority shareholdings are held.

The declared intention of the DAF Boards and shareholders is that the company will be floated on the Amsterdam and London Stock Exchanges in the 1989/1990 period. The Group's interest is expected to be liquidated then.

The Group will address its other minority shareholdings in the context of privatisation plans for Austin Rover and Land Rover.

6. FINANCIAL ASPECTS OF PLAN

6.1 Key Assumptions

The financial projections within the Group Plan have been compiled by assuming the following:-

- Land Rover is retained within the Group throughout the period (the 1987 Plan assumed a disposal in 1989). The 1987 comparative figures have not been reworked to reflect this revised assumption.

- The burden of interest costs on debt arising from past losses has been substantially shifted from Austin Rover to Rover Group by increasing, by £500m, the interest-free "quasi-equity" portion of Austin Rover's intercompany funding - with effect from January 1, 1987.

- The 40% interest in DAF is divested for £90m at the end of 1990, with no gain or loss arising on disposal.

- Other associated company investments are retained throughout the Plan period.

- The ownership of Rover Group remains unchanged and (in contrast to the 1987 Plan) no equity injection is made by Honda in Austin Rover.

- Company pension contributions will resume at their previous level of £30 - £35m per annum on the expiry of the "holiday" in August 1990.

6.2 Financial Performance

On the basis of the latest forecasts, all of the financial performance objectives contained in the 1987 Plan will be achieved in respect of the 1987 financial year.

Looking forward, the Plan indicates that:

- Operating profit increases from £24.4m in 1988 to £133.3m in 1992. 1988 and 1989 are years of

continuing consolidation with the benefits of new-model introductions (R8 and Jay) being felt progessively from 1990 onwards. 1991 is adversely affected by the assumed loss of Jaguar pressings work at Swindon and by increasing development costs on a Range Rover replacement.

- Profit before interest (operating profit plus share of associated company profit) shows a similar trend, increasing from £38.9m to £142.5m over the period.

- Profit before tax, however, remains negative until 1992 because of the abnormally high interest costs largely associated with the need to fund past losses out of borrowings. Interest costs (which progressively include interest on interest) rise from £84m in 1988 to £125m in 1992 and exceed £500m in aggregate over the period.

6.3 Plan Sensitivities

As always, the Plan is particularly sensitive to changes in market size and exchange rates. Although the estimates of market size are considered realistic for individual years, history indicates that periodic downturns cannot be avoided. Although substantial protection against recent adverse exchange movements will exist until the end of the first quarter of 1989, it is certain that, over the Plan period, shifts in exchange rates will affect the balance of competitive advantage in ways which cannot currently be foreseen. The Group's exposure to exchange rate movements has grown as exports have increased.

6.4 Financial Schedules

Summaries of the key financial data for Rover Group and the operating subsidiaries is contained in the schedules which follow.

ROVER GROUP

SUMMARY OF PERFORMANCE

		1986	Fcast 1987	1988	1989	1990	1991	1992
Revenue	£M	3260.0	3024.4	3174.7	3426.4	3897.5	4043.8	4199.8
UK Exports	£M	768.1	1048.2	1096.9	1193.8	1278.2	1359.5	1417.9
Operating Profit	**£M**	**(240.9)**	**13.5**	**24.1**	**35.3**	**83.7**	**82.4**	**133.3**
Assoc. Co. Income		0.2	9.0	13.4	17.1	20.1	8.4	9.2
Exceptional Items	£M	(109.2)	-	-	-	-	-	-
PBIT	£M	(349.9)	22.5	37.5	52.4	103.8	90.8	142.5
Profit Before Tax	£M	(455.0)	(31.6)	(47.0)	(50.4)	(1.8)	(19.4)	17.5
Retained Earnings	£M	(899.0)	(40.8)	(52.9)	(58.0)	(10.7)	(25.3)	10.7
Cashflow In/(Out)	**£M**	**(325.4)**	**(206.5)**	**(269.3)**	**(122.4)**	**52.3**	**(102.5)**	**(173.2)**
Capital Expenditure	£M	145.1	116.7	287.3	211.0	173.8	223.8	316.9
Year End Assets	£M	652.4	815.1	1031.5	1095.9	1032.9	1110.1	1294.0
Year End Total Debt	**£M**	**962.0**	**495.3**	**764.6**	**887.0**	**834.7**	**937.2**	**1110.4**
Sales volumes	000	493.6	508.2	525.0	538.2	561.6	554.2	542.0
UK Exports	000	141.6	176.2	190.7	191.6	192.0	192.1	187.3
Production	000	477.4	508.8	528.0	536.4	554.4	552.4	540.4
Manpower	000	69.5	43.7	43.6	40.9	41.0	37.2	36.4
PBIT/Sales	%	(10.7)	0.7	1.2	1.5	2.7	2.2	3.4
PBIT/Average Assets	%	(37.1)	3.1	4.1	4.9	9.8	8.5	11.9
Return on Shareholder's Funds	%	-	-	-	-	-	-	5.8
Debt: Equity Ratio		148: (48)	61: 39	74: 26	81: 19	81: 19	84: 16	86: 14
Contribution/Sales	%	28.6	27.8	26.2	26.0	24.7	24.6	25.5
Incurred Fixed Costs/Sales	%	28.9	22.2	21.2	20.7	17.7	17.5	17.7

1988 CORPORATE PLAN

09-12-87

ROVER GROUP

EARNINGS AND BALANCE SHEET

	1986	Fcast 1987	1988	1989	1990	1991	1992
EARNINGS £M							
Revenue	3260.0	3024.4	3174.7	3426.4	3897.5	4043.8	4199.8
Contribution	932.8	840.5	831.7	891.1	963.2	996.2	1069.5
Fixed Costs							
- Incurred	(942.1)	(672.3)	(671.9)	(710.0)	(691.5)	(708.5)	(743.5)
- Depreciation	(160.3)	(137.0)	(136.0)	(147.3)	(177.9)	(170.0)	(157.0)
- Other	(44.4)	(16.0)	(15.0)	(14.4)	(13.1)	(12.8)	(12.7)
Total Fixed Costs	(1146.8)	(825.3)	(822.9)	(871.7)	(882.5)	(891.3)	(913.2)
Sundry Income/(Expense)	(26.9)	(1.7)	15.3	15.9	3.0	(22.5)	(23.0)
Operating Profit	**(240.9)**	**13.5**	**24.1**	**35.3**	**83.7**	**82.4**	**133.3**
Assoc. Co. Income	0.2	9.0	13.4	17.1	20.1	8.4	9.2
Exceptional Items	(109.2)	-	-	-	-	-	-
PBIT	(349.9)	22.5	37.5	52.4	103.8	90.8	142.5
Interest	(105.1)	(54.1)	(84.5)	(102.8)	(105.6)	(110.2)	(125.0)
Translation	(6.9)	(5.0)	-	-	-	-	-
Extraordinary Items	(430.0)	-	-	-	-	-	-
Other	(7.1)	(4.2)	(5.9)	(7.6)	(8.9)	(5.9)	(6.8)
Net movement in Reserves	(899.0)	(40.8)	(52.9)	(58.0)	(10.7)	(25.3)	10.7
BALANCE SHEET £M							
Capital Assets	772.8	723.4	884.9	961.1	881.3	940.8	1106.9
Operating Assets	206.8	272.7	224.8	176.1	171.7	169.3	187.1
Restructuring Provisions	(327.2)	(181.0)	(78.2)	(41.3)	(20.1)	-	-
Assets Employed	**652.4**	**815.1**	**1031.5**	**1095.9**	**1032.9**	**1110.1**	**1294.0**
Funded by:-							
Opening Shareholders Funds	586.4	(312.6)	319.8	266.9	208.9	198.2	172.9
Equity Injection	-	673.2	-	-	-	-	-
-Retained Earnings	(899.0)	(40.8)	(52.9)	(58.0)	(10.7)	(25.3)	10.7
Closing Shareholders Funds	(312.6)	319.8	266.9	208.9	198.2	172.9	183.6
Borrowings/(Cash)	**805.5**	**388.5**	**694.9**	**845.2**	**812.8**	**925.4**	**1108.9**
Leasing/other	156.5	106.8	69.7	41.8	21.9	11.8	1.5
Minority Interest	3.0	-	-	-	-	-	-
Total Funding	652.4	815.1	1031.5	1095.9	1032.9	1110.1	1294.0

Addressee Only

1988 CORPORATE PLAN

09-12-87

ROVER GROUP

CASH FLOW

	1986	Fcast 1987	1988	1989	1990	1991	1992
SOURCE OF FUNDS £M							
Operating Profit	(240.9)	13.5	24.1	35.3	83.7	82.4	133.3
Interest	(105.1)	(54.1)	(84.5)	(102.8)	(105.6)	(110.2)	(125.0)
Depreciation	160.3	137.0	136.0	147.3	177.9	170.0	157.0
Translation	(6.9)	(5.0)	-	-	-	-	-
Total Sources	(192.6)	91.4	75.6	79.8	156.0	142.2	165.3
APPLICATION OF FUNDS £M							
Net Capital Expenditure	(145.1)	(116.7)	(287.3)	(211.0)	(173.8)	(223.8)	(316.9)
Working Capital	67.5	(22.3)	47.9	48.7	4.4	2.4	(17.8)
Tax and Other	(12.6)	(18.2)	(2.7)	(3.0)	86.9	(3.2)	(3.8)
Restructuring	(42.6)	(140.7)	(102.8)	(36.9)	(21.2)	(20.1)	-
Total Applications	(132.8)	(297.9)	(344.9)	(202.2)	(103.7)	(244.7)	(338.5)
Cash Flow In/(Out)	**(325.4)**	**(206.5)**	**(269.3)**	**(122.4)**	**52.3**	**(102.5)**	**(173.2)**
Memo: Analysed as:							
Trading	(32.6)	105.0	205.3	228.3	352.9	251.6	268.7
Net Capital Expenditure	(145.1)	(116.7)	(287.3)	(211.0)	(173.8)	(223.8)	(316.9)
Operational Cashflow	(177.7)	(11.7)	(82.0)	17.3	179.1	27.8	(48.2)
Interest	(105.1)	(54.1)	(84.5)	(102.8)	(105.6)	(110.2)	(125.0)
Restructuring	(42.6)	(140.7)	(102.8)	(36.9)	(21.2)	(20.1)	-
Debt Transfers	-	-	-	-	-	-	-
Funded by:-							
Equity	-	(673.2)	-	-	-	-	-
Borrowings	**(379.7)**	**357.9**	**(332.9)**	**(156.8)**	**(58.1)**	**(113.8)**	**(184.7)**
Other funding	49.6	49.7	37.1	27.9	19.9	10.1	10.3
Divestment Proceeds	4.7	59.1	26.5	6.5	90.5	1.2	1.2
Movement in Funds	(325.4)	(206.5)	(269.3)	(122.4)	52.3	(102.5)	(173.2)

ROVER GROUP
1988 CORPORATE PLAN
ANALYSIS OF PLAN PROJECTIONS BY GROUP

09-12-87

	1986	1987	1988	1989	1990	1991	1992
SALES REVENUE £M							
Austin Rover Group	2116.0	2583.0	2736.0	2965.0	3385.0	3480.0	3630.0
Land Rover Group	445.5	533.6	583.7	620.4	672.4	757.0	776.0
LRL International Holdings	86.3	26.5	-	-	-	-	-
BLMC Engineering	-	-	-	-	-	-	-
Istel (Prior to Disposal)	60.8	26.5	-	-	-	-	-
Other	21.8	20.1	5.6	1.2	0.5	0.8	0.5
Assoc Companies	-	-	-	-	-	-	-
Disposed Companies	1025.0	-	-	-	-	-	-
Consolidation	(495.4)	(165.3)	(150.6)	(160.2)	(160.4)	(194.0)	(206.7)
Contingency	-	-	-	-	-	-	-
Rover Group	3260.0	3024.4	3174.7	3426.4	3897.5	4043.8	4199.8
CONTRIBUTION £M							
Austin Rover Group	542.0	656.6	669.0	719.0	780.0	795.0	863.0
Land Rover Group	128.2	162.0	165.8	173.1	183.2	204.2	207.5
LRL International Holdings	17.5	7.5	-	-	-	-	-
BLMC Engineering	-	-	-	-	-	-	-
Istel (Prior to Disposal)	60.8	26.5	-	-	-	-	-
Other	21.4	17.4	1.5	0.4	0.4	0.5	0.4
Assoc Companies	-	-	-	-	-	-	-
Disposed Companies	233.8	-	-	-	-	-	-
Consolidation	(70.9)	(29.5)	(4.6)	(1.4)	(0.4)	(3.5)	(1.4)
Contingency	-	-	-	-	-	-	-
Rover Group	932.8	840.5	831.7	891.1	963.2	996.2	1069.5
INCURRED FIXED COSTS £M							
Austin Rover Group	579.4	536.5	537.0	570.0	546.0	554.0	578.0
Land Rover Group	97.0	115.3	122.9	127.0	131.5	139.5	149.5
LRL International Holdings	18.5	4.6	-	-	-	-	-
BLMC Engineering	-	-	-	-	-	-	-
Istel (Prior to Disposal)	52.7	22.5	-	-	-	-	-
Other	19.4	20.6	12.8	13.5	14.2	15.2	16.2
Assoc Companies	-	-	-	-	-	-	-
Disposed Companies	239.8	-	-	-	-	-	-
Consolidation	(64.7)	(29.9)	(0.8)	(0.5)	(0.2)	(0.2)	(0.2)
Contingency	-	2.7	-	-	-	-	-
Rover Group	942.1	672.3	671.9	710.0	691.5	708.5	743.5

ROVER GROUP
1988 CORPORATE PLAN
ANALYSIS OF PLAN PROJECTIONS BY GROUP

09-12-87

	1986	1987	1988	1989	1990	1991	1992
OPERATING PROFIT £M							
Austin Rover Group	(162.4)	-	19.0	29.0	74.0	69.0	129.0
Land Rover Group	3.3	22.9	27.0	29.7	34.0	42.8	33.3
LRL International Holdings	(1.8)	2.3	-	-	-	-	-
BLMC Engineering	-	-	-	-	-	-	-
Istel (Prior to Disposal)	3.7	1.8	-	-	-	-	-
Other	(1.8)	(8.4)	(19.6)	(22.9)	(24.5)	(26.6)	(28.2)
Assoc Companies	-	-	-	-	-	-	-
Disposed Companies	(83.0)	-	-	-	-	-	-
Consolidation	1.1	(2.4)	(2.3)	(0.5)	0.2	(2.8)	(0.8)
Contingency	-	(2.7)	-	-	-	-	-
Rover Group	(240.9)	13.5	24.1	35.3	83.7	82.4	133.3
NET CAPITAL EXPENDITURE £M							
Austin Rover Group	99.9	95.0	272.1	184.0	130.0	177.0	245.0
Land Rover Group	7.1	15.1	33.8	27.2	43.8	46.8	71.9
LRL International Holdings	0.6	(1.6)	(0.2)	-	-	-	-
BLMC Engineering	-	0.5	(0.3)	(0.2)	-	-	-
Istel (Prior to Disposal)	5.9	4.6	-	-	-	-	-
Other	2.3	0.5	(18.1)	-	-	-	-
Disposed Companies	28.2	-	-	-	-	-	-
Consolidation	1.1	2.6	-	-	-	-	-
Contingency	-	-	-	-	-	-	-
Rover Group	145.1	116.7	287.3	211.0	173.8	223.8	316.9
CASH FLOW £M							
Austin Rover Group	(285.9)	(113.8)	(151.1)	(43.0)	31.0	(37.0)	(71.0)
Land Rover Group	44.5	(3.8)	(26.3)	16.4	6.2	9.9	(22.3)
LRL International Holdings	(6.5)	(2.9)	10.3	0.5	0.5	0.6	0.6
BLMC Engineering	-	(129.0)	(60.4)	(38.7)	-	-	-
Istel (Prior to Disposal)	0.1	3.4	-	-	-	-	-
Other	(120.2)	(431.0)	(56.6)	(59.0)	(76.6)	(81.9)	(83.4)
Assoc Companies	-	0.6	0.9	1.0	90.9	0.8	0.8
Disposed Companies	(118.2)	447.9	-	-	-	-	-
Consolidation	160.8	40.8	0.2	0.4	0.3	5.1	2.1
Contingency	-	(18.7)	13.7	-	-	-	-
Rover Group	(325.4)	(206.5)	(269.3)	(122.4)	52.3	(102.5)	(173.2)

ROVER GROUP
1988 CORPORATE PLAN
ANALYSIS OF PLAN PROJECTIONS BY GROUP

09-12-87

	1986	1987	1988	1989	1990	1991	1992
TOTAL DEBT £M							
Austin Rover Group	552.0	163.0	314.1	357.1	326.1	363.1	434.1
Land Rover Group	5.8	9.6	35.9	19.5	13.3	3.4	25.7
LRL International Holdings	67.2	70.1	59.8	59.3	58.8	58.2	57.6
BLMC Engineering	(228.1)	(99.1)	(38.7)	-	-	-	-
Istel (Prior to Disposal)	(0.7)	-	-	-	-	-	-
Other	79.3	337.1	392.4	451.4	528.0	609.9	693.3
Assoc Companies	-	(0.6)	(1.5)	(2.5)	(93.4)	(94.2)	(95.0)
Consolidation	38.6	(3.5)	(2.4)	(2.8)	(3.1)	(8.2)	(10.3)
Contingency	-	18.7	5.0	5.0	5.0	5.0	5.0
Rover Group	962.0	495.3	764.6	887.0	834.7	937.2	1110.4
WHOLESALES 000							
Austin Rover Group	437.9	477.1	494.7	508.0	528.9	519.2	507.8
Land Rover Group	38.5	40.5	44.3	43.2	44.9	49.5	49.1
LRL International Holdings	1.5	0.1	-	-	-	-	-
Disposed Companies	31.8	-	-	-	-	-	-
Consolidation	(16.1)	(9.5)	(14.0)	(13.0)	(12.2)	(14.5)	(14.9)
Rover Group	493.6	508.2	525.0	538.2	561.6	554.2	542.0
MANPOWER 000							
Austin Rover Group	38.8	34.6	35.1	32.8	32.8	28.9	28.2
Land Rover Group	8.1	8.5	8.2	7.8	7.9	8.0	7.9
LRL International Holdings	3.5	-	-	-	-	-	-
Istel (Prior to Disposal)	1.4	-	-	-	-	-	-
Other	0.7	0.6	0.3	0.3	0.3	0.3	0.3
Disposed Companies	17.0	-	-	-	-	-	-
Rover Group	69.5	43.7	43.6	40.9	41.0	37.2	36.4

Addressee Only

1988 CORPORATE PLAN

AUSTIN ROVER GROUP

SUMMARY OF PERFORMANCE

1987 has seen a marked improvement in Austin Rover Group's trading performance; following the sharp increase in operating losses during 1986, the out-turn for 1987 is now expected to show at least break-even.

This improvement reflects higher volumes, including the first full year of Rover 800 sales, reduced levels of retail sales incentives and real reductions in fixed costs. The profit from exports has been secured by means of forward exchange contracts and options, fixing the favourable exchange rates of earlier
in 1987.

A relatively modest further improvement in profitability is projected for 1988 to £19 million, reflecting further volume increases including the effect of Rover 800 fastback launch, significant further efficiency improvements across the company and the first full year effect of the 3 year pensions holiday. These factors are gradually offset, however, by the more stringent sterling exchange rate assumptions adopted for the Plan based on £1 = US $1.70 and significant deterioration in all European rates.

Subsequent years show further efficiency improvements together with the benefits of controlling incurred economics: operating profit increases from £29 million in 1989 to £69 million by 1991.

The results forecast for the final year of the Plan benefit from an improved mix of sales with Mini run-out and the introduction of R17 and R18, pushing Rover 800 further up-market into the executive and luxury car sectors. As a consequence, there is a strong improvement in operating profit to £129 million thereby generating a return (before interest) on assets employed of nearly 15 per cent.

Compared with the 1987 Plan, the latest projection shows a marginal improvement of £6 million in operating profit over the period 1987 to 1991, with 1989 being worse than the previous Plan through increased activity on new products and facilities in order to satisfy marketing, quality and efficiency objectives.

This improvement is despite the much more severe exchange rate assumptions which have caused on average £(50) million per annum deterioration compared with the 1987 Plan. Favourable factors are the continuing effects of pricing ahead of inflation in 1987 in the domestic market, and the effects of the pensions holiday - worth c. £25 million per annum over three years.

Pricing action ahead of inflation has been assumed in North America to offset a weaker dollar thereby retaining at worst a marginal break-even position for this business.

Cash outflow over the period 1986 to 1991 is contained at £(600) million compared with £(579) million in the 1987 Plan. This is despite additional capital expenditure of £65 million now identified to support new investment in 3 year corrosion protection, paint plants and presses. The cashflow figures are, however, not directly comparable due to the different level of re-capitalisation assumed in the 1987 Plan (£310m over 1987 to 1991 compared with £500m in 1987 in this year's Plan).

The Product Plan now includes a clearer definition of the R17/18 and R9 programmes which were not formulated in detail when the 1987 Plan was prepared, but there remains unallocated product expenditure of £119 million for the years 1991 and 1992 against new models to be introduced in the mid 1990's.

Working capital requirements show a progressive improvement up until 1990 and reflect introduction of the Minimal Inventory Concept (Just-in-Time).

The 1988 Plan shows a much lower borrowings profile as a result of the transfer of £500 million borrowings to Rover Group backdated to 1 January 1987. As a consequence of the reduction in interest charges, net earnings become positive by 1990, when there is also a net cash inflow. Borrowings increase thereafter with the commencement of heavy capital investment to support the new products of the mid 1990's.

After adjusting for capital approvals received post 1987 Plan, different levels of capitalisation, and higher 1986 losses, the underlying borrowings are within the profile laid down in last year's Plan.

AUSTIN ROVER GROUP

SUMMARY OF PERFORMANCE

		1986	Fcast 1987	1988	1989	1990	1991	1992
Revenue	£M	2116.0	2583.0	2736.0	2965.0	3385.0	3480.0	3630.0
UK Exports	£M	359.0	720.0	721.0	806.0	866.0	901.0	955.0
Operating Profit	**£M**	**(162.4)**	**-**	**19.0**	**29.0**	**74.0**	**69.0**	**129.0**
Assoc. Co. Income		-	-	-	-	-	-	-
Exceptional Items	£M	(96.3)	-	-	-	-	-	-
PBIT	£M	(258.7)	-	19.0	29.0	74.0	69.0	129.0
Profit Before Tax	£M	(316.6)	(28.0)	(21.0)	(27.0)	13.0	8.0	63.0
Retained Earnings	£M	(317.4)	(30.5)	(24.0)	(31.0)	9.0	4.0	59.0
Cashflow In/(Out)	**£M**	**(285.9)**	**(113.8)**	**(151.1)**	**(43.0)**	**31.0**	**(37.0)**	**(71.0)**
Capital Expenditure	£M	99.9	95.0	272.1	184.0	130.0	177.0	245.0
Year End Assets	£M	556.6	639.9	767.0	779.0	757.0	798.0	928.0
Year End Total Debt	**£M**	**552.0**	**163.0**	**314.1**	**357.1**	**326.1**	**363.1**	**434.1**
Sales volumes	000	437.9	477.1	494.7	508.0	528.9	519.2	507.8
UK Exports	000	114.8	148.3	160.5	162.8	162.3	159.6	155.6
Production	000	412.2	468.0	483.6	493.1	509.5	502.9	491.3
Manpower	000	38.8	34.6	35.1	32.8	32.8	28.9	28.2
PBIT/Sales	%	(12.2)	-	0.7	1.0	2.2	2.0	3.6
PBIT/Average Assets	%	(45.0)	-	2.7	3.8	9.6	8.9	14.9
Return on Shareholder's Funds	%	-	-	-	-	2.1	0.9	11.9
Debt: Equity Ratio		99: 1	25: 75	41: 59	46: 54	43: 57	46: 54	47: 53
Contribution/Sales	%	25.6	25.4	24.5	24.2	23.0	22.8	23.8
Incurred Fixed Costs/Sales	%	27.4	20.8	19.6	19.2	16.1	15.9	15.9

1988 CORPORATE PLAN 09-12-87

AUSTIN ROVER GROUP

EARNINGS AND BALANCE SHEET

	1986	Fcast 1987	1988	1989	1990	1991	1992
EARNINGS £M							
Revenue	2116.0	2583.0	2736.0	2965.0	3385.0	3480.0	3630.0
Contribution	542.0	656.6	669.0	719.0	780.0	795.0	863.0
Fixed Costs							
- Incurred	(579.4)	(536.5)	(537.0)	(570.0)	(546.0)	(554.0)	(578.0)
- Depreciation	(99.0)	(113.0)	(116.0)	(126.0)	(156.0)	(148.0)	(132.0)
- Other	(8.0)	(9.0)	(12.0)	(12.0)	(12.0)	(12.0)	(12.0)
Total Fixed Costs	(686.4)	(658.5)	(665.0)	(708.0)	(714.0)	(714.0)	(722.0)
Sundry Income/(Expense)	(18.0)	1.9	15.0	18.0	8.0	(12.0)	(12.0)
Operating Profit	**(162.4)**	**-**	**19.0**	**29.0**	**74.0**	**69.0**	**129.0**
Exceptional Items	(96.3)	-	-	-	-	-	-
PBIT	(258.7)	-	19.0	29.0	74.0	69.0	129.0
Interest	(57.9)	(28.0)	(40.0)	(56.0)	(61.0)	(61.0)	(66.0)
Translation	-	(1.6)	-	-	-	-	-
Extraordinary Items	1.1	-	-	-	-	-	-
Other	(1.9)	(0.9)	(3.0)	(4.0)	(4.0)	(4.0)	(4.0)
Net movement in Reserves	(317.4)	(30.5)	(24.0)	(31.0)	9.0	4.0	59.0
BALANCE SHEET £M							
Capital Assets	527.9	514.4	671.0	729.0	703.0	732.0	845.0
Operating Assets	98.5	160.5	116.0	70.0	64.0	66.0	83.0
Restructuring Provisions	(69.8)	(35.0)	(20.0)	(20.0)	(10.0)	-	-
Assets Employed	**556.6**	**639.9**	**767.0**	**779.0**	**757.0**	**798.0**	**928.0**
Funded by:-							
Opening Shareholders Funds	294.5	4.6	476.9	452.9	421.9	430.9	434.9
Equity Injection	27.5	502.8	-	-	-	-	-
-Retained Earnings	(317.4)	(30.5)	(24.0)	(31.0)	9.0	4.0	59.0
Closing Shareholders Funds	4.6	476.9	452.9	421.9	430.9	434.9	493.9
Borrowings/(Cash)	**412.9**	**63.0**	**248.1**	**318.1**	**306.1**	**353.1**	**434.1**
Leasing/other	139.1	100.0	66.0	39.0	20.0	10.0	-
Minority Interest	-	-	-	-	-	-	-
Total Funding	556.6	639.9	767.0	779.0	757.0	798.0	928.0

1988 CORPORATE PLAN 09-12-87

AUSTIN ROVER GROUP

CASH FLOW

	1986	Fcast 1987	1988	1989	1990	1991	1992
SOURCE OF FUNDS £M							
Operating Profit	(162.4)	-	19.0	29.0	74.0	69.0	129.0
Interest	(57.9)	(28.0)	(40.0)	(56.0)	(61.0)	(61.0)	(66.0)
Depreciation	99.0	113.0	116.0	126.0	156.0	148.0	132.0
Translation	-	(1.6)	-	-	-	-	-
Total Sources	(121.3)	83.4	95.0	99.0	169.0	156.0	195.0
APPLICATION OF FUNDS £M							
Net Capital Expenditure	(99.9)	(95.0)	(272.1)	(184.0)	(130.0)	(177.0)	(245.0)
Working Capital	(44.7)	(62.2)	44.5	46.0	6.0	(2.0)	(17.0)
Tax and Other	(9.0)	(5.2)	(3.5)	(4.0)	(4.0)	(4.0)	(4.0)
Restructuring	(11.0)	(34.8)	(15.0)	-	(10.0)	(10.0)	-
Total Applications	(164.6)	(197.2)	(246.1)	(142.0)	(138.0)	(193.0)	(266.0)
Cash Flow In/(Out)	**(285.9)**	**(113.8)**	**(151.1)**	**(43.0)**	**31.0**	**(37.0)**	**(71.0)**
Memo: Analysed as:							
Trading	(117.1)	44.0	176.0	197.0	232.0	211.0	240.0
Net Capital Expenditure	(99.9)	(95.0)	(272.1)	(184.0)	(130.0)	(177.0)	(245.0)
Operational Cashflow	(217.0)	(51.0)	(96.1)	13.0	102.0	34.0	(5.0)
Interest	(57.9)	(28.0)	(40.0)	(56.0)	(61.0)	(61.0)	(66.0)
Restructuring	(11.0)	(34.8)	(15.0)	-	(10.0)	(10.0)	-
Debt Transfers	-	-	-	-	-	-	-
Funded by:-							
Equity	(27.5)	(502.8)	-	-	-	-	-
Borrowings	**(274.3)**	**329.7**	**(185.1)**	**(70.0)**	**12.0**	**(47.0)**	**(81.0)**
Other funding	15.9	39.1	34.0	27.0	19.0	10.0	10.0
Divestment Proceeds	-	20.2	-	-	-	-	-
Movement in Funds	(285.9)	(113.8)	(151.1)	(43.0)	31.0	(37.0)	(71.0)

Addressee Only

1988 CORPORATE PLAN

LAND ROVER GROUP

SUMMARY OF PERFORMANCE

The Plan Operating Profit for the Group rises from £3m in 1986 to £43m by 1991 - an improvement of £30m over the previous Plan for the same period. Profitability increases most significantly in 1990 and 1991 following the launch of Jay; the reduction in PBIT in 1992 reflects the drop in Range Rover volumes and margins prior to the launch of Discovery.

The benefit of the pension contribution holiday, included in the above figures, is £20m in profit and cash flow. This will contribute towards funding product development and capital expenditure on new models.

Whilst profits over the Plan period are reduced by over £5m due to the loss of the Freight Rover parts business, the improvement in parts availability being achieved and planned to be achieved are fundamental to supporting the vehicle sales growth.

Sales Revenue throughout the plan period increases from £445m in 1986 to £776m by 1992, with wholesales rising from 38,500 units to 49,100 units over the same period. The most significant increase being Range Rover sales in Europe reflecting the successful extension of the product range with the introduction of the diesel derivative.

The launch of Range Rover in North America is the most significant individual market growth sector; this, combined with the introduction into the personal transport sector with Jay, are the major reasons for the projected increases.

Cumulative cash flow over the six years from 1987 to 1992 is projected to be restricted to a £20m outflow, which will be a considerable achievement given the launch of 2 new models in the Plan period. Actions to improve profits and to achieve large reductions in working capital have been and continue to be implemented to fund the capital expenditure during the Plan period.

The Swiss Army contract amounting to some 2,400 units over 1989-1992 is now being treated as an opportunity.

Assets Employed increase from £130m in 1986 to £316m by 1992, return on assets peaking at 17.2% in 1991. The level of off-balance sheet funding contained in this plan reduces from c. £50m in 1987 to c. £25m as the practice of discounting bills drawn on ARG European sales companies is discontinued.

Borrowing Levels are significantly lower than in the 1987 Plan due to higher profits, the pension holiday, and the fact that the holding company - Land Rover UK Limited - has cash balances arising from the disposal of the Freight Rover business which have been retained within the group.

Production volumes increase in 1987 and 1988 following the implementation of the 4/5 shift pattern which has increased single shift capacity by 25%.

Contribution as a percentage of sales revenue reduces throughout the Plan period. A number of factors influence this trend, the most significant being:

- the adverse movement of exchange rates over 1987 on nearly all currencies but particularly on the US Dollar;
- the decision to improve the function and refinement on Range Rover by fitting the Borg Warner chain-driven transfer box in lieu of the cheaper in-house manufactured LT230 transfer box;
- the weakening of the average margin with the significant volume of Jay and the decline of the more profitable Range Rover in the later years.

Fixed cost increases largely reflect the incremental spend on Product Engineering at Land Rover Limited which rises from £15m in 1986 to £29m in 1988. This increased level of spend continues throughout the Plan period.

Warranty performance and labour productivity both show steady improvements as the result of both improved quality, increased attention to detail, appropriate capital expenditure and well-designed incentive schemes. Warranty performance is particularly difficult to forecast as heightened customer expectations and increased complexity of vehicles combine with a market switch to more critical customers, for example from the Middle East to North America.

Range Rover of North America operating profit shows a steady improvement throughout the plan period, the start up losses for 1986/7 being recovered by 1990 and profits peaking at £3.2m in 1991. Cumulative profit for the years 1986 to 1991 is a £2.5m improvement over the 1987 Plan for the same period.

Rover Zambia's figures are not consolidated in the group results, the company being treated as a trade investment.

1988 CORPORATE PLAN 09-12-87

LAND ROVER GROUP

SUMMARY OF PERFORMANCE

		1986	Fcast 1987	1988	1989	1990	1991	1992
Revenue	£M	445.5	533.6	583.7	620.4	672.4	757.0	776.0
UK Exports	£M	259.5	327.9	375.9	387.8	412.2	458.5	462.9
Operating Profit	**£M**	**3.3**	**22.9**	**27.0**	**29.7**	**34.0**	**42.8**	**33.3**
Assoc. Co. Income		-	-	-	-	-	-	-
Exceptional Items	£M	(10.1)	-	-	-	-	-	-
PBIT	£M	(6.8)	22.9	27.0	29.7	34.0	42.8	33.3
Profit Before Tax	£M	(16.3)	21.1	21.5	24.8	29.8	39.4	29.6
Retained Earnings	£M	(16.7)	21.1	21.5	24.8	29.8	39.4	29.0
Cashflow In/(Out)	**£M**	**44.5**	**(3.8)**	**(26.3)**	**16.4**	**6.2**	**9.9**	**(22.3)**
Capital Expenditure	£M	7.1	15.1	33.8	27.2	43.8	46.8	71.9
Year End Assets	£M	130.1	154.9	202.7	211.1	234.7	264.2	315.5
Year End Total Debt	**£M**	**5.8**	**9.6**	**35.9**	**19.5**	**13.3**	**3.4**	**25.7**
Sales volumes	000	38.5	40.5	44.3	43.2	44.9	49.5	49.1
UK Exports	000	21.9	27.9	30.2	28.8	29.7	32.5	31.7
Production	000	35.5	40.7	44.4	43.3	44.9	49.5	49.1
Manpower	000	8.1	8.5	8.2	7.8	7.9	8.0	7.9
PBIT/Sales	%	(1.5)	4.3	4.6	4.8	5.1	5.7	4.3
PBIT/Average Assets	%	(4.2)	16.1	15.1	14.4	15.3	17.2	11.5
Return on Shareholder's Funds	%	-	14.5	12.9	12.9	13.5	15.1	10.0
Debt: Equity Ratio		4: 96	6: 94	18: 82	9: 91	6: 94	1: 99	8: 92
Contribution/Sales	%	28.8	30.4	28.4	27.9	27.2	27.0	26.7
Incurred Fixed Costs/Sales	%	21.8	21.6	21.1	20.5	19.6	18.4	19.3

1988 CORPORATE PLAN

09-12-87

LAND ROVER GROUP

EARNINGS AND BALANCE SHEET

	1986	Fcast 1987	1988	1989	1990	1991	1992
EARNINGS £M							
Revenue	445.5	533.6	583.7	620.4	672.4	757.0	776.0
Contribution	128.2	162.0	165.8	173.1	183.2	204.2	207.5
Fixed Costs							
- Incurred	(97.0)	(115.3)	(122.9)	(127.0)	(131.5)	(139.5)	(149.5)
- Depreciation	(17.4)	(17.9)	(20.0)	(21.3)	(21.9)	(22.0)	(25.0)
- Other	(10.0)	(7.6)	(3.0)	(2.4)	(1.1)	(0.8)	(0.7)
Total Fixed Costs	(124.4)	(140.8)	(145.9)	(150.7)	(154.5)	(162.3)	(175.2)
Sundry Income/(Expense)	(0.5)	1.7	7.1	7.3	5.3	0.9	1.0
Operating Profit	**3.3**	**22.9**	**27.0**	**29.7**	**34.0**	**42.8**	**33.3**
Assoc. Co. Income	-	-	-	-	-	-	-
Exceptional Items	(10.1)	-	-	-	-	-	-
PBIT	(6.8)	22.9	27.0	29.7	34.0	42.8	33.3
Interest	(9.5)	(1.8)	(5.5)	(4.9)	(4.2)	(3.4)	(3.7)
Translation	(0.4)	-	-	-	-	-	-
Extraordinary Items	-	-	-	-	-	-	-
Other	-	-	-	-	-	-	(0.6)
Net movement in Reserves	(16.7)	21.1	21.5	24.8	29.8	39.4	29.0
BALANCE SHEET £M							
Capital Assets	98.2	98.2	112.0	117.9	139.8	164.6	211.5
Operating Assets	32.0	56.7	90.7	93.2	94.9	99.6	104.0
Restructuring Provisions	(0.1)	-	-	-	-	-	-
Assets Employed	**130.1**	**154.9**	**202.7**	**211.1**	**234.7**	**264.2**	**315.5**
Funded by:-							
Opening Shareholders Funds	140.9	124.2	145.3	166.8	191.6	221.4	260.8
Equity Injection	-	-	-	-	-	-	-
-Retained Earnings	(16.7)	21.1	21.5	24.8	29.8	39.4	29.0
Closing Shareholders Funds	124.2	145.3	166.8	191.6	221.4	260.8	289.8
Borrowings/(Cash)	**(3.4)**	**3.5**	**32.2**	**16.7**	**11.4**	**1.6**	**24.2**
Leasing/other	9.2	6.1	3.7	2.8	1.9	1.8	1.5
Minority Interest	0.1	-	-	-	-	-	-
Total Funding	130.1	154.9	202.7	211.1	234.7	264.2	315.5

LAND ROVER GROUP

CASH FLOW

	1986	Fcast 1987	1988	1989	1990	1991	1992
SOURCE OF FUNDS £M							
Operating Profit	3.3	22.9	27.0	29.7	34.0	42.8	33.3
Interest	(9.5)	(1.8)	(5.5)	(4.9)	(4.2)	(3.4)	(3.7)
Depreciation	17.4	17.9	20.0	21.3	21.9	22.0	25.0
Translation	(0.4)	-	-	-	-	-	-
Total Sources	10.8	39.0	41.5	46.1	51.7	61.4	54.6
APPLICATION OF FUNDS £M							
Net Capital Expenditure	(7.1)	(15.1)	(33.8)	(27.2)	(43.8)	(46.8)	(71.9)
Working Capital	44.5	(24.7)	(34.0)	(2.5)	(1.7)	(4.7)	(4.4)
Tax and Other	1.0	(2.9)	-	-	-	-	(0.6)
Restructuring	(4.7)	(0.1)	-	-	-	-	-
Total Applications	33.7	(42.8)	(67.8)	(29.7)	(45.5)	(51.5)	(76.9)
Cash Flow In/(Out)	**44.5**	**(3.8)**	**(26.3)**	**16.4**	**6.2**	**9.9**	**(22.3)**
Memo: Analysed as:							
Trading	65.8	13.2	13.0	48.5	54.2	60.1	53.3
Net Capital Expenditure	(7.1)	(15.1)	(33.8)	(27.2)	(43.8)	(46.8)	(71.9)
Operational Cashflow	58.7	(1.9)	(20.8)	21.3	10.4	13.3	(18.6)
Interest	(9.5)	(1.8)	(5.5)	(4.9)	(4.2)	(3.4)	(3.7)
Restructuring	(4.7)	(0.1)	-	-	-	-	-
Debt Transfers	-	-	-	-	-	-	-
Funded by:-							
Equity	-	-	-	-	-	-	-
Borrowings	**38.3**	**(6.9)**	**(28.7)**	**15.5**	**5.3**	**9.8**	**(22.6)**
Other funding	6.2	3.1	2.4	0.9	0.9	0.1	0.3
Movement in Funds	44.5	(3.8)	(26.3)	16.4	6.2	9.9	(22.3)

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1988 CORPORATE PLAN

LAND ROVER GROUP

ANALYSIS BY PRODUCT COMPANY

	1986	Fcast 1987 (10+2)	1988	1989	1990	1991	1992
Sales revenue £M							
Land Rover Limited	398.9	475.9	513.0	542.3	590.2	665.8	683.2
LR Parts & Equipment	65.0	76.5	68.5	70.2	71.0	76.3	80.8
Range Rover N America	-	49.5	71.9	89.4	103.1	115.6	115.5
Rover Zambia	-	-	-	-	-	-	-
Land Rover Santana	-	-	-	-	-	-	-
LR Consolidation	(18.9)	(68.3)	(69.7)	(81.5)	(91.9)	(100.7)	(103.5)
Land Rover Group	445.0	533.6	583.7	620.4	672.4	757.0	776.0
Operating Profit £M							
Land Rover Limited	4.8	22.1	25.0	26.2	30.3	37.9	28.9
LR Parts & Equipment	0.7	1.6	1.5	1.7	1.6	2.1	2.2
Range Rover N America	(2.4)	(0.3)	0.9	2.2	2.4	3.2	2.2
Rover Zambia	-	-	-	-	-	-	-
Land Rover Santana	0.8	1.3	-	-	-	-	-
LR Consolidation	(0.6)	(1.8)	(0.4)	(0.4)	(0.3)	(0.4)	-
Land Rover Group	3.3	22.9	27.0	29.7	34.0	42.8	33.3
Assets Employed £M							
Land Rover Limited	111.2	128.1	171.6	178.7	201.4	230.9	280.9
LR Parts & Equipment	16.6	18.5	18.4	19.0	19.7	20.4	21.6
Range Rover N America	0.1	4.2	8.7	9.7	10.1	9.6	9.6
Rover Zambia	-	-	-	-	-	-	-
Land Rover Santana	3.2	6.0	6.0	6.0	6.0	6.0	6.0
LR Consolidation	(1.0)	(1.9)	(2.0)	(2.3)	(2.5)	(2.7)	(2.6)
Land Rover Group	130.1	154.9	202.7	211.1	234.7	264.2	315.5
Total Debt £M							
Land Rover Limited	25.9	21.0	45.5	32.2	29.9	26.5	53.1
LR Parts & Equipment	(2.2)	(1.7)	(3.0)	(4.2)	(5.3)	(7.1)	(8.5)
Range Rover N America	(0.7)	2.0	6.0	5.3	3.8	0.5	(0.8)
Rover Zambia	-	-	-	-	-	-	-
Land Rover Santana	-	1.5	1.5	1.5	1.5	1.5	1.5
LR Consolidation	(17.2)	(13.2)	(14.1)	(15.3)	(16.6)	(18.0)	(19.6)
Land Rover Group	5.8	9.6	35.9	19.5	13.3	3.4	25.7

Note: 1987 onwards, share of Land Rover Santana profit taken at PBT level.

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PRIME MINISTER

ROVER GROUP PRIVATISATION

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

Privatisation

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

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

RG's 1988 Corporate Plan

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

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

4. I am copying this minute to Nigel Lawson.

DY

30 November 1987

DEPARTMENT OF TRADE AND INDUSTRY

SECRET

ROVER GROUP PRIVATISATION
MEETING ON 1 DECEMBER

A. POINTS FOR DISCUSSION BETWEEN MINISTERS

1. End January Objective

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

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

2. Placement

- prospects remain doubtful before the end of the decade;

- but need to hear Day's views;

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

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

3. Trade Sale of AR

VW

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

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

- need to decide whether VW should be pursued further;

Ford

- Ministers and RG believe Ford are interested;

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

- need to decide whether Ford should be pursued further;

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- past Parliamentary statements do not rule out this option;

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

Land Rover

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

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

- could be protected by a golden share;

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

4. Graham Day's Position

- keeping Day on side is absolutely critical;

- he appears to be focussing on placement option;

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

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

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B. POINTS FOR DISCUSSION WITH GRAHAM DAY

1. Current State of RG Business

- end year results anticipated?;
- market prospects for 1988?

2. Day's Thinking on Placement

- welcome sight of Schroders (RG's advisors) views before next meeting in January;
- important that Honda's position should be precisely defined in Day's planned meeting in Tokyo on 22 January;
- seek agreement on financial performance targets which would need to be met. Officials and HMG's advisors to agree with RG and their advisors before next meeting in January.

3. Day's Thinking on Trade Sale Possibilities

VW

- interest without Land Rover?;
- speed at which VW could negotiate a deal?

Ford

- interest?;
- speed at which Ford could negotiate a deal?;
- need for advisors to reach agreement on a negotiating timetable for a trade sale.

4. RG 1988 Corporate Plan

- delivery date to Government?;
- broad thrust of Plan?;
- inter-relation to prospects for a placement?

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12

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PS/ *Secretary of State for Trade and Industry*

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27 November 1987

D Norgrove Esq
Private Secretary to the Prime Minister
10 Downing Street
LONDON
SW1

Prime Minister

Relevant to your meeting with Graham Day on Tuesday. Further papers will follow on Monday. DRW 27/11.

Dear David

ROVER GROUP PRIVATISATION

I am enclosing a note by officials on how competition scrutiny procedures relating to a trade sale of Austin Rover might be accelerated. My Secretary of State's conclusion is that, while competition aspects are important they would not be an insuperable obstacle if a trade sale were considered right on industrial, commercial and political grounds.

I am also sending a copy of this letter and enclosure to Alex Allan (HM Treasury).

Yours

Jeremy Godfrey

JEREMY GODFREY
Private Secretary

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ROVER GROUP PRIVATISATION

COMPETITION CONSIDERATIONS

1 This note sets out how domestic and EC competition policy might bear upon a trade sale of Austin Rover (AR) either to Ford or VW.

2 In the UK, AR currently hold 15.8% of the car market; Ford 27.4% and VW 6.1%. In the European market AR hold 3.5% of the car market, Ford 11.7% and VW 14.7%.

3 Sale to either bidder would require scrutiny under the Fair Trading Act. Sale to Ford or VW might provoke a request to the Competition Directorate of the Commission DGIV for scrutiny under Article 85 or 86 of the Treaty of Rome, relating to restriction of competition or abuse of a dominant position in a substantial part of the Common Market.

UK Competition Procedures

4 Informal soundings of the Office of Fair Trading (OFT) indicate that it would be possible for the Secretary of State for Trade and Industry (SoS) to secure preliminary confidential advice from the Director General (DGFT) on whether or not on the facts then available to him he would be inclined to recommend for or against a reference to the Monopolies and Mergers Commission (MMC). Preliminary advice from the DGFT could be sought on the basis of information provided by DTI and RG. More authoritative confidential advice might be possible in the course of the

suggested three week accelerated commercial negotiation period, if the bidders could then be approached by OFT. Preliminary advice would clearly be helpful in enabling Ministers to decide whether a commercially and politically acceptable offer resulted from the negotiations. However, the DGFT could not give definitive advice to the SoS, prior to public announcement of a deal, in view of his obligation to be willing to hear the views of third parties, such as competitors, component suppliers, Unipart and AR dealers, before reaching a final view.

5 In framing a Parliamentary announcement on a deal, the SoS would be able to indicate that he had consulted the DGFT, who had offered initial advice on the basis of the evidence then available to him. The SoS could indicate that he believed there were very strong commercial, industrial and political arguments to support the deal, but on competition policy considerations he would wish to await the outcome of the normal procedures. Whatever the disposition of the DGFT's initial advice, the DGFT and the SoS could be open to legal challenge if the OFT did not then allow representations from third parties, normally over three weeks, before offering considered final advice to the SoS. The SoS could also be open to challenge if he did not wait for the advice of the DGFT before making his decision under the Fair Trading Act.

6 Following receipt of the DGFT's final advice, it would be open to the SoS to decide whether or not to accept any recommendation for a reference. It would be very unusual but not unprecedented for the SoS to overturn the DGFT's advice (only 9

cases since 1979 out of over 2000 qualifying mergers). A reference would be likely to take three months to complete.

EC Competition Procedures

7 If the announcement of a deal on AR provoked complaints to DGIV from competitors about the creation of a company with a dominant position in the UK market, the Commission could open a procedure under Article 85 or 86 of the Treaty of Rome. The prospect of complaints on competition grounds to DGIV would undoubtedly be heightened by the unavoidable need for HMG to make a major state aid application to DGIV at the same time, to meet debt and restructuring costs. A procedure under Article 85 or 86 could run in parallel with a scrutiny of state aid provisions under Article 93. If there were an MMC reference in the UK, Commission officials would be likely to await the outcome before deciding whether to undertake more than preliminary inquiries. In consequence an MMC reference could have the effect of delaying procedures in Brussels, but in any event scrutiny of the deal under Article 85 or 86 could take a number of months to complete.

Speeding Up Procedures

8 Reasonably authoritative (but not final) confidential advice could be provided by DGFT to SoS within an accelerated timescale for commercial negotiations, to help Ministers reach a view on whether an acceptable deal was on offer which could be announced with conviction.

9 Following a Parliamentary statement, it would not be possible for OFT to decline to hear the views of third parties without a high risk of an application for judicial review against the DGFT or the SoS. But hearing third party views might be constrained to two weeks which would run in parallel with unavoidable pressure in the House for full debate on the implications of the deal.

10 If the DGFT subsequently recommended for a reference, and the SoS accepted that advice, debate and uncertainty would be extended for a further three months at least. Such an extended period of uncertainty would have a serious effect on AR's business. It is likely that UK market share would drop sharply, dealers might defect, trade creditors might press and the banks might ask for the Varley-Marshall assurances to be translated into guarantees. The argument that AR could not reasonably withstand such a period of uncertainty could be pressed with OFT. If, nevertheless, the DGFT recommended in favour of a reference, but the SoS decided to overturn that advice, he might wish to state publicly the need to avoid the collapse of the company owing to extended uncertainty. However, this would seriously undermine the SoS's normal competition policy of treating sceptically claims of imminent collapse (as in BA/BCal). Moreover, such a statement could provoke the situation it is designed to avoid, if the EC Commission subsequently stepped in, thus prolonging the uncertainty.

11 A decision to overturn the DGFT's advice might be viewed as weakening the integrity of mergers policy, and as inconsistent with the SoS's published objectives. An application for judicial review cannot be ruled out; but provided that it could be demonstrated that the SoS's decision was not unreasonable, and the normal procedures had been followed, such a challenge would be unlikely to succeed.

12 The extent and pace of EC Commission scrutiny of the competition issues would depend in part on how far domestic scrutiny procedures were seen to be applied thoroughly, and in part on the strength of any complaints advanced to the Commission. Given the sensitivities of both the state aid and competition considerations surrounding a trade sale of AR, Ministers might wish to consider a confidential sounding of Commissioner Sutherland at an early stage in the context of state aids if trade sale options are to be pursued.

Vehicles Division

DTI

27 November 1987

SECRET AND PERSONAL

SUBJECT
CC MASTER

File

10 DOWNING STREET

LONDON SW1A 2AA

2 November 1987

From the Private Secretary

ROVER GROUP PRIVATISATION

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

In a short discussion before Day arrived, your Secretary of State said it was clear that flotation would not be feasible in this Parliament. It might be possible to achieve placement with institutions in 1989. However his preference would be for a trade sale to Ford or VW by means of a limited tender. The House would need to be informed, and outside shareholders dealt with. The support of management would be needed. The Chancellor of the Exchequer said he hoped an early decision could be taken so that debt could be written off in this financial year. The possibilities of a sale to both Ford and VW should be investigated, but it would be essential to exclude Land Rover/Range Rover. The House should be informed at an early stage.

Graham Day then joined the meeting. He reported that in every respect the company had met or bettered the figures laid down in the corporate plan. The company was now trading profitably and by the end of the year all of the peripheral business would have been sold or closed. The inventory of vehicles had been halved and inventory control had been improved. £60 million of unnecessary costs had been slashed out of the business; costs could be further reduced but this would require the use of a scalpel. Cash flow continued negative before interest and would probably not turn positive until 1989. The business was not marvellous but it was much improved. He shared the Prime Minister's belief that Rover Group should be privatised before the next election. It was possible that sale by means of a placement might be achieved in the life of this Parliament. However the privatised company would not be able to carry the burden of past debt. If that were written off and the company were to receive the proceeds of the placement in order to provide finance for working capital, it could probably then be self-sustaining. The Varley

Marshall assurances would of course be withdrawn once the placement had been made.

The Prime Minister stated her firm view that Land Rover must remain a British company. It was noted that a placement with British institutions might allow Land Rover to be sold with ARG, though a golden share would be required to prevent Land Rover then being sold on to a foreign shareholder. Agreeing with the Prime Minister that there would be no future for ARG unless it retained a tie with a larger company, Day said the only possible partner in a placement would be Honda, which might take some 20 per cent of the equity, the level at which the company would not need to be consolidated into the Honda accounts. This would tie Honda into the Rover Group. His own position was also relevant: City institutions (not merchant banks) which he had consulted had said his presence with the company would be essential to a successful placement. Day said he did not wish to face that decision unless he had to. He had told Honda (Mr Koomay - phonetic) that he would be holding discussions with the Government about privatisation. Day had said that if there were a concrete proposal he would put this to Honda in late January or early February. It was clear that with certain trade sales the relationship with Honda would be severed. In answer to questions, Day argued that Honda might not wish to start green field factories in Europe as they had in America.

The Prime Minister expressed scepticism about whether Honda would be willing to take a minority stake, noting that in any case they would be slow to take a decision and it was important for the Government that a decision should be reached this year or next. The Chancellor pointed to Day's use of the words "possible" in referring to whether the placement could be made in this Parliament, and to the potential political difficulties if a Japanese company were seen to be controlling Rover Group. Day stated his belief that the possibilities for a tie up with Honda should be known in the first quarter of next year. Whether Rover Group would be sufficiently profitable for placement would be known by the third quarter.

The meeting then considered the possibilities for a trade sale.

On VW, Day pointed to its two tier board structure, with union members sitting on the supervisory board. When VW had bought Seat the discussions had been carried out in a public manner and union representatives had sought assurances that jobs would not be exported to Spain. Discussions between Rover Group and VW would also become public after a certain point and if there were still minority shareholders the Stock Exchange would need to be informed. It would be essential for discussions, once started, to be successfully completed, in order to avoid major damage to the business. Day had himself held two meetings with Carl Hahn of VW and a further meeting had been held at the level immediately below with three participants on each side. It could truly be said that

there had been no negotiations. VW were interested in buying both ARG and Land Rover, though Day could not swear that VW would not be interested in buying the car business alone. The importance of employees being able to take shares in VW was noted.

Day said he had held no discussions as yet with Ford. Ford management had made clear their continued interest in buying ARG but had also indicated that it would be for the Government to say if and when they were prepared to enter discussions. The initiative would have to come from Government. One possibility would be quickly to agree in principle and then to appoint an arbitrator to settle the terms and conditions. The Prime Minister did not however believe that this would be acceptable to the House. Day said that other things being equal he would prefer VW to Ford, since with VW the business would retain an individual identity. (Later however he suggested that Ford might wish to retain the Rover marque.) On the other hand it should be possible to reach agreement more quickly with Ford than with VW. It was noted that a sale to Ford would almost certainly be referred to the Monopolies and Mergers Commission. The Secretary of State for Trade and Industry undertook to consider how long such a reference might take and how far it could be speeded up.

After further discussion the Prime Minister invited Day to speak urgently to VW to establish whether they would be interested in buying Rover Group without Land Rover. He should as quickly as possible complete his studies of the placement option and of the various possibilities for a trade sale including, as he had suggested, Fiat and PSA. She would wish to see him again for a preliminary talk before Christmas with a view to a further more definitive discussion by the end of January. The Government would consider whether and when it would be right to buy out the minority shareholders. This would be necessary if there were to be a trade sale, but not if there were to be a placement. The Prime Minister stressed finally that the Government would not be prepared to finance continuing substantial capital expenditure for new models. Rover Group's borrowing had to be contained.

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

David Norgrove

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

SECRET

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MR NORGROVE

30 October 1987

ROVER

1. Professor Kumar Bhattacharyya of Warwick University telephoned me this morning. He is thoroughly familiar with Rover Group and has high-level contacts at Honda. One of the latter phoned him early this morning with the information that someone at Rover is promoting the idea of Honda taking a 20% stake in a new company formed by merging ARG and Land Rover without any debt, with the balance bought out by management over time. Bhattacharyya was aware, presumably through Rover contacts, that Day is soon to see the Prime Minister to discuss trade sales. His purpose in phoning me was to warn that management may be already trying to frustrate this through a lock-out arrangement with Honda, which would allow them to continue operating the business while a buy-out was negotiated. I do not know how reliable his sources of information are, but he has told me that he intends sending a letter to the Prime Minister about this forthwith.

   He also made the general point that sales of parts of the business which leave HMG with residual holdings such as 40% in Leyland Trucks, 25% of ISTEL and of Unipart could come back to haunt us. If any of these businesses became bankrupt, creditors would come straight to HMG for support. The point was not about legal obligations but political embarrassment.

2. I saw David Young this morning and described my fears about the failure of a trade sale. If there are any chinks of suspicion about Day's motivation in Young's mind he certainly did not expose them to me. He emphasised that Day was now thoroughly in support of a trade sale and pushing hard to achieve one. The possibility that Day's courtiers might not be so inclined appears not to have occurred to

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him. In any case, he does support the idea that the Prime Minister should make it clear that if the trade sale fails, Rover must present an alternative to its huge capital programme. Young also told me that Day had told him privately that, if a trade sale does collapse, once it has become public, the only alternative would be to close the business.

GEORGE GUISE

PRIME MINISTER

THE ROVER GROUP

Your primary objective at the meeting with Graham Day will be to explore with him the possibility of a trade sale with VW and make it clear that if there is a possibility of a politically acceptable sale, you will be determined for it to go ahead. This should I suggest be the main emphasis in the first part of the meeting.

If a trade sale emerges as a realistic possibility, George Guise's concerns about the Rover Group's plans should be put to Mr. Day to make it clear that life will not be comfortable whatever else happens. This will be a stick which will help to ensure that those around Day will have less interest in frustrating a trade sale.

If a trade sale does not look a realistic possibility, the concerns about the capital programme become ever more important and you will want to be that much tougher.

The further note by George Guise below records a discussion with Professor Bhattacharyya, who has now written to you, letter also below.

I have spoken to George Guise about Bhattacharrya's conclusion that a consortium buy-out would be preferable to a trade sale. George is very surprised because he felt that Bhattacharyya would be reaching the opposite conclusion.

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DAVID NORGROVE

30 October 1987.

The National Archives

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PRIME MINISTER

29 October 1987

ROVER GROUP

It is most unfortunate that we have no financial projections for the existing business if it continues in Graham Day's hands beyond the end of the decade. The 1988 plan is not ready although Day may have some indicative figures if you press him on Monday. I understand that the directors are still arguing about capital expenditure. I have obtained most unofficially outline ARG and Land Rover figures as attached in Annex A. They have not been 'blessed' by the RG Board. Neither have the overall consequences in terms of Varley Marshall guarantees or overall cash exposure been quantified. My own simple calculations of these figures, as set out, may therefore look very different after Rover headquarters has been at them.

to follow if poss

Nevertheless, the overall philosophy can be gauged and it is no surprise. It is all spend, spend, spend, with little hope of economic return for ages, perhaps ever! The Treasury critique of Land Rover's Jay development programme (Annex B) is an excellent example of the basic economic questions which RG leave unanswered when they come to the DTI for more money. Furthermore, the 1987 plan showed Rover's determination to develop and build a small car replacement for the Metro in the 1990s, even though it believes that the market will not be profitable. It is this kind of thinking which underlies much of the predicted cash drain over the next years.

The main problem in dealing with Rover is that when challenged, they simply proceed by assertion, not argument. If asked for lower capital expenditure proposals they reply that there is no alternative to their scheme, other than the company's collapse. When asked at the time of the last plan about the alternatives to Honda collaboration, I was told

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that, without Honda, the company is finished! When you asked Graham Day why Rover Group could not buy in engines instead of developing new ones, he replied that every one would have to be either paid for in advance or given a forward purchase commitment which would incur greater costs than developing and building its own engines.

I recently proposed to DTI officials a low volume, high quality alternative strategy focussing upon the traditional Rover marque and asked for it to be costed. The building of small cars would cease after the present Metro falls foul of EEC exhaust regulations in the early 1990s; the AR8 would be developed as planned and, of present ARG models, only the 800 series would continue. Land Rover would contribute only the successful Range Rover model with all other production, including the new J, being terminated. These three continuing models would all be constructed at one, or maximum two, sites under a single management organisation with one chief executive. There would be no central London Head Office full of planners and advisers, no West London building full of clerks and accountants, and certainly no plethora of management committees and boards across the Midlands. There would be a concentrated three-model business with a minimal management and administrative support system on site.

The officials were horror struck and I was told, in no uncertain terms, that if we start asking Rover questions like that we will lose Graham Day. I do not know whether that statement is correct or over timid. But I do know that when the shareholder relinquishes the basic right to discuss fundamental strategic issues with management, financial anarchy and the abandonment of business realism soon follows. I have seen it before: my previous company allowed its assets in Australia and America to be abandoned to management with appalling financial consequences and wholesale board replacement as the only ultimate answer.

I do not say that Graham Day is encouraging the Rover business to develop thus. Indeed, he began by fighting a valiant battle against the very forces which I describe. What is disturbing is that he is surrounded in London with courtiers and advisers, who would not readily find jobs elsewhere, and tries to operate the business through the remote control of subsidiary boards and committees. He is infrequently seen at the operating sites although he endures a taxing burden of foreign travel. When we see him on Monday he will have just returned from the Tokyo Motor Show.

I have dwelt on the above matters in order to illustrate my fears about what may happen if we continue owning the business in anticipation of self-regeneration and economic recovery. Far better to achieve a politically and financially acceptable trade sale if at all possible. As negotiator, Graham may be experiencing a conflict of interest which he he hasn't even realised; his advisers are bound to prefer retention of the business because it is most unlikely that Volkswagen or Ford would want to keep them. By contrast, some of his line managers are superb: any owner would wish to retain the excellent Andy Barr, responsible for production at Longbridge.

Under these circumstances it may not be easy for Day to distinguish between real negotiating obstacles and initial stances. For example, it is said that Hahn at Volkswagen would only take ARG if he were also sold Land Rover. Although he would obviously like to take both, ARG alone offers so much to a company like Volkswagen, in terms of manufacturing sites and dealer networks, that it would be improbable for them to have no underlying interest in ARG alone.

Conclusion and Recommendation

Despite impressive marketing achievements this year, the bad

old ways are probably still endemic at Rover. Graham is a charismatic leader and it may be this very quality which, through driving him into continued defence of his management, is subconsciously sucking him into their own thinking pattern, namely that the answer to every problem is to spend. The remote control aspects of his management style are worrying as indeed are the advisory core which form his windows on the business. There is a separation between shareholder, in the form of DTI officials, and management which is growing into a 'Graham knows best' reflex.

He sees his appointment as carrying your personal endorsement for his every action. This indicates the appropriate channel through which he will genuinely accept direction. I therefore recommend that on Monday you leave him in no doubt on the following matters:

1. HMG does not wish to own a car manufacturer at the end of this term.

2. A rapidly executed trade sale is a possibility and HMG is in a better position to weather the political storms than in January 1986.

3. There nonetheless remain some political constraints against, for example, Land Rover going to Volkswagen.

4. Regardless of whether he can achieve a trade sale, you will expect to see a radically different plan from last year based upon the earliest cash profits coupled with minimum capital expenditure and overhead.

David Young's list of ten questions is a good discussion framework, but it does not raise the possibility of an alternative lower cost business strategy instead of a trade sale.

GEORGE GUISE

~~copy no 1 of 4~~
ANNEX A

VEHICLES DIVISION
DEPARTMENT OF TRADE AND INDUSTRY
ASHDOWN HOUSE
123 VICTORIA STREET
LONDON SW1E 6RB

Telephone (Direct dialling) 01 - 212) 0993
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SECRET - NAMED DISTRIBUTION ONLY

G Guise Esq
Policy Unit
10 Downing Street
LONDON SW1

29 October 1987

Dear George

1988 CORPORATE PLAN - AUSTIN ROVER FIGURES

You asked about figures for RG from the 1988 Corporate Plan. As I explained on the telephone there still appears to be considerable debate going on between the central RG Corporate staff and AR over the Plan; on the LR side you have of course seen the latest draft which we understand is unlikely to differ signficantly from the final version. For these reasons we considered it unhelpful to annex these tentative figures to the paper prepared for the Prime Minister's meeting on 2 November, preferring to rest on the 1987 Corporate Plan, although we do of course recognise that those figures are not an up to date reflection of RG thinking.

For AR we have had sight on a personal basis of some of the figures coming forward from the operating company. With the very important proviso that these may well change significantly in the debate at Corporate Staff level it may be helpful if I set out under some key headings what the comparison of the new Plan with the old shows.

PBIT

	1987	1988	1989	1990	1991
1987 AR CORPORATE PLAN	-30	20	45	75	75
DRAFT 1988 AR PLAN	0	20	40	75	100

Broadly a better operating performance with a slightly higher assumed market share (reaching 15.5% by the end of the Plan) offsets adverse external factors, notably the effect on translation of export earnings of weaker dollar and continental currency rates against sterling.

PBT/Net Earnings lines are not available on a comparable basis to the 1987 Plan which assumed a partial internal recapitalisation of AR.

CB4ABG

Gross Capital Expenditure

Here it is necessary to look first at how the gross capital expenditure profile had already moved on before work started on the new Plan; this was the result largely of the rephasing of capital expenditure on K Series and AR8 known in April when those projects were formally approved by Ministers. We agreed with RG and Treasury that the appropriate adjustment (which actually slightly reduces the total) was:-

	1987	1988	1989	1990	1991
1987 CORPORATE PLAN	131.7	178.3	169.8	172.9	202
ADJUSTED COMPARATOR	103.0	256.3	174.3	123.1	193.7

Against this the gross capex line now proposed by AR in the draft 1988 Plan is:-

	112	262	229	195	127

On AR's proposals the five-year total would thus be increased by some £70-80m. We understand the major influence here is investment in new press and paint facilities; this would enable AR to offer improved corrosion protection based on the galvanised steel processes which are increasingly the norm for the up-market manufacturers. Within the new spend profile there is also greater definition from the allotment of previously unallocated spend to individual projects eg a new R8 derivative to replace Montego.

Cashflow pre-interest

Because of the internal recapitalisation distortions it is only possible to compare like with like at the pre-interest level.

	1987	1988	1989	1990	1991
1987 CORPORATE PLAN	-62.3	-56.0	19.0	50.0	24.0
DRAFT 1988 AR PLAN	-42	-130	-33	+33	+128

Here the main influence is the additional capital expenditure in the early plan period. The five year total 1987-1991 shows little change.

Consolidation

As yet we have not seen any consolidated RG figures. Until these are available it is not possible inter alia to estimate the profile of Varley-Marshall-Joseph liability. Based on what we do know of the new Plan I would however be surprised if the projections were markedly outside the range £1.5-1.7bn derived from the 1987 Plan; one must note in this context however that range did assume separate LR disposal at the beginning of 1989.

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I hope the above gives you some flavour of what the new AR Plan is likely to contain but I would stress the provisional nature of these figures. There are elements which we know must be revised to take account of the latest exchanges with Honda, leaving aside the further scrutiny to be applied by David Hankinson's team.

I am copying this letter to Helen Roberts at the Treasury.

Yours sincerely

Catherine Bell

MRS C E D BELL

999-80 CB4ABG

15/009

ANNEX B.

TREASURY COMMENTS ON LR PLAN - MARKED FOR SPEED READING

LAND ROVER: 1988 CORPORATE PLAN

1. The corporate plan is a valuable document in that it provides much of the background information on products, markets and competitors which has been missing from some of Rover Group's recent investment submissions (Jay, R6). Motor car companies are complex organisations whose business investments tend to be large, long-term and relatively complicated. If we are to have a reasoned and independent input to the decisions to approve them, then we must have the necesary detailed information. So in that respect, the corporate plan is certainly a step in the right direction.

2. The problem, however, is that the more one sees of the workings of the company, the less one is convinced by the merits of its strategy. In particular, there are mjaor doubts about both the wisdom and the likely success of Jay. In recent discussions about the Jay project, it has been suggested that it is not the job of civil servants to second-guess companies' commercial investment decisions. But Land Rover's strategy is so dependent on Jay's success that any serious discussion of that strategy, as embodied in the corporate plan, will effectively be one about Jay. More pertinenetly, if Jay fails, then we are likely to be talking about public funding of some sort. It might therefore be worth setting out the objections to Land Rover's strategy in some detail.

Land Rover's Current Position

3. The Land Rover Group is a relatively minor division of a small to medium-sized volume (if that is not a contradiction in terms) car manufacturer. It is smaller than all bar two of the world's major 4x4 producers (table on page 3.1, figures for Ford and GM in table 1.14) and even these two are likely to overtake it at some point in the future. It is also distinctive in a number of other ways.

- Ignoring Land Rover Santana (which is a marginal activity intended to become more so) it is virtually the only manufacturer which does not have either existing or proposed production links with one of its competitors (3.10 - 3.12). For Land Rover, collaboration means components only (2.1 - 2.2).

- it is the only one of the major manufacturers which neither is owned by a large multinational company nor has access to substantial financial resources.

Conventional wisdom holds that a motor vehicle manufacturer in today's environment which does not have these two characteristics is unlikely to survive in the long-term. Yet despite these twin handicaps, Land Rover has survived; indeed, its financial health is better than for some time. The company is forecasting, after years of losses, combined operating profits for the two years 1987 and 1988 (i.e. pre-Jay) of £46.4 million and after tax profits of £30.3 million.

4. There are two reasons for this. First, the production volume figures on page 3.1 disguise the fact that the world 4x4 market is in fact divided into three parts; the traditional utility sector, the personal transport sector, and the luxury car sector. Although there is some overlap between the sectors (between the first two in Third World countires, for instance), for the most part they are separate and distinct (3.5 - 3.7). The utility sector, mainly farmers and armies, is in long-term decline relative to the other two and offers little or no growth potential; nevertheless it is relatively stable, has a small number of competing firms and, given that volumes are at (historically) rock bottom levels already, has a limited downside. The personal transport sector has been, and is expcted to continue to be, fast growing. But it is also where the greatest competition lies, is volatile (Toyota's production was down 30% last year, after a rise of 18% the year before) and in the long-term may be prey to changes in fashion (cf the convertible car). The luxury car sector is also competitive. But products in this area are also able, to a certain extent, to generate their own demand by portraying themselves as "unique" in some sense; the challenge of course then becomes to maintain that uniqueness.

5. By dint of good fortune, Land Rover has itself firmly established in the first and third sectors, the "niche" parts of the market, and so has to date managed to avoid the bruising competition of the second. Volumes in these sectors are not large enough to attract a Japanese or U.S competitor to any great extent, and although growth prospects are unexciting at best, Land Rover can expect to pick up a fair proportion of any demand. The evidence in the corporate plan (3.17) shows that the company is currently more than holding its own. In the utility sector, the introduction of a turbocharged diesel engine has improved the sales performance of the Land Rover in Europe, and the military version has maintained its lead over the main competitor product from Mercedes. In the luxury car sector, Range Rover's launch in North America and success in other markets such as Spain have helped sales of Range Rovers to record levels.

6. The other reason behind Land Rover's survival is the changes which have recently taken place within the group itself. The key element here was the 1985 rationalisation plan which consolidated the previous 14 manufacturing sites onto 1 at Solihull. Productivity has risen markedly, though not at the expense of quality. Vehicles per employee are expected to rise from 4.7 per annum in 1986 to 6.4 in 1991, a rise of 36% (1.28), while faults per unit fall on all models (1.25). The introduction in the 1987 wage agreement of a quality bonus will presumably be a contributory factor.

7. Overall, then, Land Rover today finds itself in a not unfavourable position. It has well-known products which sell into stable and relatively uncompetitve markets. Growth prospects are not good, but neither are they bad; nor are the competitive pressures likely to worsen substantially. Its low business risks offset the high financial risks attached to being a part of the Rover Group. Moreover, the company is currently profitable and self-sustaining.

Objectives

8. Now, consider what the company would like to be. Land Rover's corporate objectives (page 1.1) can be paraphrased as follows:

- become the leading 4-wheel drive manufacturer
- worldwide
- on its own (ie. through all the stages of production from design to final sale, and thereafter)
- using its own resources.

Clearly, this is a very different position from the one it has now. Either the objectives have to be modified, or a strategy introduced which will lead to a radical change in its corporate make-up.

Alternative Strategies

a) Play Safe

9. Curbing some of the company's ambitions would result in Land Rover's staying pretty much as it is now. It would concentrate on the two sectors it knows well, and resign itself to being a "niche" player. Volume growth

would either be small or negligible (depending on the success of Range Rover), but there would be steady profitability. Any improvement in the company's financial performance would be gradual, through increases in productivity and small design and technology developments. New product launches would be rare, but there would be ample time and resources, financial human and technological, to ensure that the introduction of the replacement for Range Rover in the 1990's (the "Discovery" programme) was managed successfully.

10. Such a strategy would not be an unreasonable one for a company in Land Rover's position. Cautious certainly; but realistic, and mindful of the company's size and financial strength relative to its competitors. It would also dovetail neatly with the plans for Rover Group as a whole, Land Rover's low business risks offsetting to some extent the much greater problems of the car division. For a group with limited managerial and financial resources, this is important; Land Rover would provide a small but useful income stream without a corresponding drain on senior Rover management time.

b) **Radical Change**

11. Land Rover, however, have ignored the safe option, and instead gone for the opposite course; big objectives requiring big change. The corporate plan doesn't put it like that of course. Jay is portrayed as merely filling a product gap, broadening the product range and building on the firm foundations of Land Rover and Range Rover to take advantage of what will be the growth sector of the market. The realty is more complex; commitment to Jay implies much more.

12. First, it means abandoning the utility sector and its profits. In the plan, it is anticipated that production of the basic Land Rover will be gradually run down so that it is eventually sold in its military version only. But such a managed reduction in commitment looks unrealistic. Once it is common knowledge that Land Rover have to all intents and purposes given up on the model, it would not take much for potential customers (or dealers, particularly those in countries not supplied with Jay replacements) to start becoming worried about reliability and after sales service. Add in a judicious bit of undercutting from Mercedes on a series of key military contracts, and Land Rover's demand disappears. The planned holding operation turns into a competitive rout.

13. Secondly, commitment to Jay also implies commitment to any future successors. One of the great benefits of the utility sector is the relatively long product-life of its inhabitants. Although there have been modifications

and improvements during the last 40 years, the 1988 Land Rover looks pretty much like it did in 1948. But the personal transport sector demands constant model development, and, if the car market provides a precedent, at ever decreasing intervals. All of Land Rover's competitors are currently working on model replacements; outside companies, such as the South Koreans, are thinking of joining in. Can Land Rover design, manufacture, and sell successfully completely new products every x years? Prospects do not look promising; remember that Jay, which is meant to provide the initial market breakthrough, is itself not a wholly new product. Furthermore, the company suffers from a major constraint which would hamper such a go-it-alone strategy.

- It is vulnerable to technological change. Despite "the rate of product change and technology development (being) higher than at any time in the past", Land Rover believe "it would not be economic to participate in pure research or application of leading technologies of a speculative nature" (3.13). It will always therefore be reliant on other people's technology, and yet;

- It lacks flexibility. A "Flexible Manufacturing System" is "currently beyond (its) financial and resource capabilities" (3.15), component contracts are "long-term in duration and cannot be changed in the short-term" (3.20).

14. Thirdly, commitment to Jay will automatically lead to greatly increased competition, for which Land Rover lacks the necessary financial resources (the combination of Jay and Discovery is already putting a strain on the company). As well as the pressures of new entrants to the personal transport sector such as the South Koreans, established firms are casting their eyes towards Europe, "a prime target" (3.2). Jeep/Chrysler have "a stated intention of increasing European market penetration" (3.3); Toyota pick-ups will be introduced by VW in Germany from 1988 onwards and Mitsubishi 4x4 vans built in Spain (3.10). Could Jay survive (say) a concerted 5-year marketing blitz by Jeep/Chrysler which used the American company's existing links with Renault?

15. Fourthly, implementing Jay may well cause problems in the market sector where Range Rover is positioned. Land Rover are already worried that Jay will be viewed as a down-market Range Rover. Such a reaction would be a defeat for the "segmented marketing approach" advocated by the company itself (3.4). More seriously, problems with Jay will lead to problems with Discovery. There will be competing demands from the two new model programmes for resources (and

not just financial ones), a competition which Discovery is almost bound to lose. As in chess, the one that starts first always has the advantage. The planned launch of Discovery has already been put back a year since the 1987 corporate plan; and the Jay programme hasn't yet reached the difficult stages.

Risk V. Reward

16. There is nothing inherently wrong with having a high-risk strategy. But the real problem with Land Rover's is that the expected rewards in no way compensate for the added risks. The company expects to make operating profits in 1991 (the first full year of Jay) of £45.1 million, as against £27.7 million in 1988. Allowing for inflation and the opportunity cost of the use of funds in the Jay project, it probably represents at most a £10 million increase. That is surely not sufficient reward for the risk of exposure to worldwide competition, loss of markets, or even the failure of Jay itself.

17. In short, the case for the high-risk strategy has not been adequately demonstrated. Corporate history is littered with examples of companies that have rejected the (admittedly boring) alternative of no growth, stick-to-what-we-know-best and have ended up in a mess. Too often, it has been because the managers themselves cannot accept the reduced horizons which the strategy involves. They will admit that the alternative is high-risk, but then shrug their sholders and say "we have no choice" (as Land Rover have done). What they often mean is that they don't choose to evaluate all the available options because they have already made up their minds what it is they want to do. Rational debate is bypassed.

18. Under normal circumstances such a cavalier attitude wouldn't matter. If companies want to do silly things, then that's up to them and their shareholders. But if Jay fails, then the buck will pass to the Government. Current policy dictates that Land Rover should stay as part of the Rover Group; yet Rover just doesn't have the financial reserves to both support an ailing subsidiary and turn round the car division. As best we would be looking at a distress sale, at worst some form of capital injection. Either would be difficult to resist, given Ministers' endorsement of the original plans.

Alternatives

19. It might have been easier to take the Jay strategy seriously if Land Rover had provided some evidence that they had looked at ways of offloading some of the risks. But there is none. Alternative options to full go-it-alone development to Jay were not even considered as they were held to be

too expensive. This approach ignores any concept of risk/reward trade-off; moreover, it flies in the face of developments elsewhere in the industry, where collaboration is becoming the norm. It is particularly disappointing, as there would appear at first sight to be two extremely good candidates for collaboration.

20. First, Land Rover already has a potential collaborative partner in Suzuki through its shareholding in Land Rover Santana. The corporate plan shows clearly (2.46 - 2.47) that the balance of power in the joint venture has shifted towards Suzuki, and that although this has increased the value of Land Rover's shareholding, the long-term benefit to Land Rover of the arrangement looks, on present forecasts, limited. For Suzuki, however, "Land Rover Santana is an important strategic investment"; sooner or later the company will use it for an assault on the European market (including Jay). Suzuki already has links with GM in North America, and might well prefer to have an active partner in Europe, not a 17% fellow shareholder in a joint venture which sells hardly any of that shareholder's products. If L-R doesn't want to get dumped time, it should try and cement the relationship now. Sourcing/rebadging Suzuki models from Spain is one option, collaboration elsewhere in the world (eg launching Jay in America) another.

21. Secondly, although Land Rover view the Jeep/Chrysler takeover as a competitive threat, it might also represent an opportunity. After years of being tied down by its links with loss-making companies, Jeep now has a parent which will be able to provide it with the financial reesources it needs. The company already does well in America, and rightly sees Europe as a potential growth area for its products. But Chrysler is presumably wary, after its experiences with cars, of reestablishing manufacturing facilities in Europe, so any expansion will have to come through a third party. Renault has been mentioned as a candidate, but Land Rover might be a better fit. It is weak in North America, where Jeep is strong; the converse is true in Europe (and the rest of the world?). And Jeep is mainly in the personal transport sector, Land Rover in the others. What about selling or making under licence personal transport Jeeps (the new YJ range) in Europe in return for Range Rovers in the US.? in a few years'

22. Both of these options would be controversial, and there may be good arguments for rejecting them. But it would be wrong for Land Rover not to consider them. A bold strategy (and that is what Land Rover are proposing) calls feor bold moves; yet so far, all Land Rover have come up with is a half-baked product which they would have us believe they can introduce into a competitive market at premium pricing.

Summary

23. Jay is a high-risk strategy which produces scant reward. It is unimaginative and in some areas (eg pricing) little more than wishful thinking. If it fails, it is likely to cost the Government in both time and money. Given that we can't improve the rewards, shouldn't we try to limit the risks?

24. It may well be that since Jay has already been approved by both the Rover Group Board and (tacitly) by Ministers, there is no point reopening the issue. But Land Rover have themselves done just that (a corporate plan is after all a strategy document), so we shouldn't feel embarrassed about running through the arguments with the company one more time. The view that Jay is the wrong strategy for Land Rover is contradicted by the company itself. However, that doesn't mean that the rationale behind Jay is clear cut; nor does it remove the obligation both to review the strategy itself, and to continue to justify the rejection of alternative ones, as Jay develops.

"Let's roll up our sleeves and get to it, gentlemen—we have to spend billions and billions and billions!"

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PRIME MINISTER

ROVER GROUP PRIVATISATION

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

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

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

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

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

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

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

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

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

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

D Y

29 October 1987

DEPARTMENT OF TRADE AND INDUSTRY

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MEETING ON 2 NOVEMBER

QUESTIONS TO BE PUT TO GRAHAM DAY

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

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

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

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

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

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

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

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

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

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

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ROVER GROUP PRIVATISATION

Note by the Department of Trade and Industry

CONTENTS

Preamble

A. PRIVATISATION OPTIONS:

(i) Placement/Flotation

(ii) Trade sale of Austin Rover: (a) Motivation of Potential Purchasers

(b) Company Structure after a trade sale

(c) Honda

(d) Rationalisation of Model strategy

(e) Effect on Manufacturing

(f) Component Sourcing

(g) Research + Development

(h) Effect on Dealerships

(j) Effect on Current RG management

(k) Competition Aspects

(iii) Land Rover

B. FINANCIAL COSTS TO GOVERNMENT OF A TRADE SALE

C. EC ASPECTS

D. DOMESTIC PRESENTATION

E. TIMING AND HANDLING OF NEGOTIATIONS WITH A TRADE PURCHASER

F. CONCLUSIONS

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ROVER GROUP PRIVATISATION

Note by the Department of Trade & Industry

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

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

A. PRIVATISATION OPTIONS

(i) ROVER GROUP : PROSPECTS OF PLACEMENT/FLOTATION

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

greater economies of scale. Financial projections for RG and the two operating companies over the period of the 1987 Plan are at Annex 1.

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

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

(ii) TRADE SALE OPTIONS FOR AR

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

(a) Motivation

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

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

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

(b) New company structure

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

One question which has arisen in VW's exchanges with RG is that of a retained Government shareholding in any businesses sold to them. VW apparently expect such a stake (say 10-20%) to be retained, conditioned as they are by the terms of the SEAT deal and by their own partly state-owned share structure. It is not known how much importance they attach to the idea, but they may favour keeping HMG involved as an insurance policy against future difficulties. However from HMG's perspective it appears that any presentational advantages in a retained stake as evidence of retained UK participation would be outweighed by the difficulty for the Government of standing back if the company subsequently

encountered difficulties; similar advantages without that risk might be achieved by listing some VW shares on the London Stock Exchange.

(c) Relationship with Honda

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

In the context of last year's Ford talks, the question of whether Ford (who were keen to continue the collaboration) or RG or HMG should talk to Honda and when, became a very contentious issue. RG believed Honda wished to negotiate early withdrawal from all

the collaborative links. If a slow and detailed negotiating framework is followed it would be possible to explore both the intentions of AR's bidder on collaboration with Honda, and the latter's response. If on the other hand a much quicker timetable is adopted, the bidder(s) would probably just have to make their own assessment of the likely Honda reaction. While the exclusion of Honda from any competition for AR might give rise to some later criticism from them, HMG would be able to argue that they had had ample opportunity over the years to show a real interest in taking a stake but had always stood back; in the most recent exchange with RG, Honda said again they were not interested in taking AR over.

(d) Model Rationalisation

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

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

Detailed study would be required to establish the real degree and the effects of a conflict/compatibility across models taking account also of model replacement timescales and respective company strengths. Short term it would be

possible for both Ford and VW to maintain existing manufacturing and marketing arrangements for all AR models. Over time these are bound to be dove-tailed into an overall model strategy which would be likely to lead to commonality in major components - engines and transmissions in particular whilst preserving some outward differentiation between models e.g. as with the Rover 800/Honda Legend.

(e) Manufacturing

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

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

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

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

(f) Component Sourcing

The consequences for the UK components industry of any sale of RG businesses are likely to prove a major topic of

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

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

Given the above balance of interests, UK suppliers are likely to regard any deal with VW with suspicion. The German vehicle assembly industry has proved a particularly difficult nut to crack because of the domestic loyalties of German management and engineers (who have a major say in relationships with suppliers) and the influence of trade unions on Supervisory Boards. It is instructive in this context that General Motors (who at Corporate level were

determined to reduce dependence on German sources of supply) decided in 1986 to transfer their European headquarters from Germany to Switzerland so as to break the stranglehold German personnel exercised over procurement and general operational decisions. The reasons for this move will not have been lost on informed industry observers. Ford, who have traditionally achieved a very high level of local components in the vehicles built in the UK, have not been confronted with this problem on an equivalent scale.

(g) Research and Development

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

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

encourage automotive engineers and manufacturing automation specialists) and on RG's financial support for their suppliers' R&D.

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

(h) Effects on Dealerships

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

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

The extent of any rationalisation is however likely to depend on the relative efficiency as well as geographical position of individual dealerships. When Leyland DAF was created

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

(j) Effects for Management

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

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

(k) Competition

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

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

(iii) LAND ROVER

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

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

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

B. FINANCIAL IMPLICATIONS FOR GOVERNMENT OF A DISPOSAL OF RG

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

These calculations are assumed to apply to acquisition by VW or Ford.

As regards the phasing of payments by HMG, new money for RG has predominantly taken the form of HMG subscribing for new equity in the company using powers under Section 3 of the Industry Act 1980, a course which is only possible while HMG holds the controlling interest. If this route were used again it might be necessary to put in all the new funding up front in advance of completion of a deal. This approach would also enable state aid considerations to be taken forward in a single application. Alternatively, it might be possible to phase any public expenditure costs over more than

one financial year. Phasing would be least difficult from the EC point of view in respect of those elements of costs which are likely to be incurred over a period i.e. rationalisation/ redundancy costs (£180-£300m) and future capital expenditure if any were conceded. This is because the timing of the Government payment could be linked to restructuring. Phasing of the repayment of RG borrowings (ca £600m) might also be technically feasible if the group's assets were to be transferred to the buyer, leaving the debts with RG. EC clearance for the procedure might however be more problematic. It is not possible to be more specific about the profile of expenditure until there have been further discussions at a commercial level.

C. EC CONSIDERATIONS

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

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

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

D. DOMESTIC PRESENTATION OF A TRADE SALE

In view of the risks of premature disclosure of even preliminary exchanges, Ministers may wish to consider now some of the difficult presentational issues resulting from a trade sale. Early press speculation about talks with potential suitors could be met by reference to exploring opportunities for collaboration. But well informed and substantiated questioning in the House or in the press could precipitate the need for rapid negotiations and

early decisions. Mr Day strongly believes that AR would not stand another prolonged political debate about its future: creditor confidence could collapse, crystallising the Government's obligations under the Varley Marshall assurances, currently £1.5bn.

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

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

In the case of LR, there could be many credible British bidders. JC Bamford, Lonhro, Aveling Barford and a management buy out all expressed strong interest in spring 1986, following the disclosure of the GM talks. Although Jaguar have said they are not interested at present, public debate on LR's future might draw

them back. Other British interests could also come forward. Although LR is not as strong and successful a company as is popularly perceived, pressure to keep LR British could again prove strong. Ministers may therefore wish to reflect on whether they would wish to exclude LR from a sale of AR. Allowing separate competing bids for LR could prove a more popular course, though excluding respectable foreign bidders (such as BMW who have expressed interest) could prove a problem.

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

E. THE TIMESCALE FOR DECISIONS ON PRIVATISATION OPTIONS

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

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

In considering Mr Day's views, Ministers will wish to reflect, however, on the possibility of alternative approaches to exploring the opportunities for a trade sale. Experience of previous RG privatisation initiatives suggests that there is a high risk of premature disclosure if large numbers of operational staff are involved in negotiations over several months. And negotiating with a single bidder weakens the Government's hand in forcing the

best financial deal for the taxpayer. DTI's merchant bank advisors, Barings, believe that it would be possible to work to a much shorter timetable whereby HMG might invite confidential bids from VW and or Ford on the basis of certain key conditions which the Government would wish to see met. The bidders would be asked to supply within a matter of days an indication of the financial terms on which they would proceed; a deal would then be clinched with the preferred bidder in a matter of 2-3 weeks, with minimal involvement of operational staff in working at product plans and future strategy.

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

F CONCLUSIONS

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

QUESTIONS FOR MINISTERIAL CONSIDERATION NOW

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

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

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

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

QUESTIONS TO BE CLARIFIED WITH VW

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

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

(ii) Do VW want a 100% stake?

(iii) Do VW expect to maintain Honda collaboration?

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

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ANNEX 1

LAND ROVER FINANCIAL PROJECTIONS

£m

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

NOTES

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

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

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

FINANCIAL BACKGROUND

ANNEX 1

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

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

ANNEX 2

BACKGROUND NOTE ON VW Annex 3

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

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

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

Products and markets: VW has been traditionally strong in the medium-sized sector, where its Golf represents a third of output. There is little overlap of models in VW's range, but the Golf and

several others are nearing the end of normal model lifespan in the industry. Table B shows Worldwide 1986 production by model.

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

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

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

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

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

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

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

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

VW/AUDI/SEAT

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

Source:

Banque Paribas Capital Markets

Notes:

1987 figures: estimated

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

TABLE A

Table B

PINNACLE

WORLDWIDE VW PRODUCTION BY MODEL

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

Table C

VW: FINANCIAL RECORD

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

Notes

1 Forecast

2 £1 = DM3 approx (October 1987)

UK REGISTRATIONS (PASSENGER CARS)

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

Source:

SMMT: Monthly Vehicle Market Reports

Automotive Industry Data: 1986 Data Year book

ANNEX 4

PH

EEC Registrations (PASSENGER CARS)

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

Source:

Automotive Industry Data: 1986 Data Yearbook

Motorstat ORS 12 months 1986

EEC figure includes Ceuta, Melilla and Canary Islands

ANNEX 5

DISPOSAL COST ESTIMATES ANNEX 6

Gross cost of disposal excluding any capital expenditure contribution:-

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

Net Cost:-

Gross Cost	950m		1095m
Less consideration received	-250m (g)		-50m (g)
Net Cost	£$^{3}/_{4}$bn	-	£1bn

By comparison a very approximate calculation carried out in June of the cost of a complete break-up of RG suggested that the bill to HMG could be as high as £2bn, though the amount would depend crucially on the levels of redundancy payments offered. There is no reason at this stage to believe that one or other trade sale option would be significantly more or less costly to HMG. Nor,

given the limited synergy between AR and LR, is there any particular evidence that the total bill would be very different for separate deals for the two operating companies.

Notes on Cost Calculation

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

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

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

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

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

(f) £1495m " " " " of £400m conceded.

(g) Consideration determined as follows:-

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

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MARKET SENSITIVE

RG MINORITY

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

PURPOSE

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

BACKGROUND

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

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

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

MECHANISMS FOR REMOVING THE MINORITY

Scheme of Arrangement (Section 425 of Companies Act)

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

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

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

Alternatives to an immediate S of A?

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

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

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

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

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

11 Demerger of Land Rover

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

ARGUMENT

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

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

CONCLUSIONS

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

1) a Scheme of Arrangement now:

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

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

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

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

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

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ANNEX 1

ROVER GROUP FINANCIAL PROJECTIONS

£m

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

NOTES

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

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

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

DL1ABB

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ANNEX 1

AUSTIN ROVER FINANCIAL PROJECTIONS

£m

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

NOTES

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

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

10 DOWNING STREET

Tessa

So:

(i) could you arrange a meeting please with

✓ Graham Day
✓ ~~Sir~~ Lord Young
✓ Ch/Ex

for before the wider meeting on Rover Group? I think I should do the talking to Graham Day.

(ii) The wider meeting should be

✓ Lord Pres
✓ Young
✓ Ch/Ex
✓ Ridley
✓ Lord Priv Seal
✓ Chief Whip

PTO.

Can you tell DTI
who is running to Lotus
meetings?

DKS.

6

1

PRIME MINISTER

ROVER GROUP

I am arranging a meeting on Rover Group for around the end of the month, with:

Lord President
Secretary of State for Trade and Industry
Chancellor of the Exchequer
Lord Privy Seal

Mr. Ridley was involved in the past in the inner group on Rover, and he would also be a useful member again. John Wakeham was a member when he was Chief Whip. This was partly because of his knowledge of backbench opinion, but also for his personal background. Do you wish to involve David Waddington? Yes

Two points emerged at your meeting on Monday which make the possibility of a sale to VW much more feasible, first that Graham Day was perhaps more amenable now to a trade sale, and secondly that VW are less likely to insist on buying Land Rover with Austin Rover.

Both of these assessments were given by Lord Young on the basis of contacts with Graham Day. I wonder whether you would find it helpful to hear Graham Day's views direct. Lord Young would like this much less than his predecessors. But would you like to see Graham Day before your next meeting with colleagues?

Yes - with DH present

DGN

David Norgrove
8 October 1987

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SUBJECT

CC MASTER

10 DOWNING STREET

LONDON SW1A 2AA

From the Private Secretary

5 October 1987

Dear Tim,

ROVER GROUP: PRIVATISATION

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

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

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

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

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

Yours,

David.

DAVID NORGROVE

Tim Walker, Esq.,
Department of Trade and Industry

PRIME MINISTER

ROVER GROUP

This meeting has suddenly broadened in scope to cover not only the question of buying out minority shareholders but the whole future of the Rover Group. Briefly, the position is as follows. Lord Young favours a trade sale and would like to open up discussions with Ford or Volkswagen. Graham Day is to see VW on 5 October for a "fact finding" meeting and Lord Young is seeing the Chairman of Ford on 13 October which would give him an opportunity to take soundings. Graham Day on the other hand is against a trade sale and favours a flotation, though he recognises that this is probably not achieveable during the life of this Parliament.

Lord Young urges the need for an early decision.

Clearly, as ever, the continuing interest from Ford and the fresh interest from Volkswagen present a considerable opportunity. The essential question however is whether the coming of a new Parliament changes the situation enough that the difficulties, some familiar, some new, can now be overridden, among them:

- the risk of leaks, political difficulties, damage to the Company and eventual failure;

- the threat to suppliers arising from a takeover by Ford;

- the likely chauvinistic reaction to a sale of Range Rover to VW (though I believe that the weaknesses of Range Rover are now better recognised than they were in the past);

- the resistance by Graham Day to a trade sale;

- the tasks already facing the Government this year.

David Young fears that VW and Ford may lose interest unless their offers are taken seriously now. But there is no evidence for this.

The options are:

(i) reject a trade sale altogether;

(ii) allow one approach to proceed but not the other;

(iii) make it clear to both VW and Ford that the Government is not interested at present but has not ruled out a trade sale later in the Parliament;

Against this background the buying out of the minority stake becomes a far less significant issue. In any event I suggest you should not seek to decide this on Monday. But if you decide to rule out the trade sale for the present it may now be more feasible to proceed to buy out the minority stake. If so you might make it a proviso that the Government undertakes to make available to the public and to the House of Commons all the information which it and the company have at present made available by virtue of the public quotation.

In view of the unexpected importance of this meeting I have invited the Lord President and the Lord Privy Seal in addition to the Chancellor. (Mr. Ridley is away.)

PAB

D. R. Norgrove
2 October 1987

PMMAHX

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PRIME MINISTER 2 October 1987

RG - PRIVATISATION/MINORITY

I suspect that Young and Day have totally opposite motives which, paradoxically, lead them both to recommend an early buy-out of the minority. Day wishes to demonstrate that he can revive a corpse into a successful British publically floated company with himself as Chairman. Young, who recently remarked that the Conservatives were not re-elected to build motor cars, is eager to offload Rover into private ownership fast.

Both motives are laudable but we have to ensure that they do not erupt into damaging, and possibly public, conflict. Day wishes to extract the minority because of the administrative complications which they pose. Young wishes to do so in order to remove a potential weapon from the directors if they are opposed to some future action which he might favour such as a trade sale. Barings advise that the minority can be eliminated via a scheme of arrangement provided Government is willing to overpay and spend up to £17m.

Public Flotation or Placement

Current performance at ARG is better than plan with a year to date market share to end August of 15.2%. In August market share fell to 14.5 but ARG predict a recovery in September. They are currently selling all they can produce under the new regime of quality emphasis but are not gaining share in a rising market. In the half year to June 1987 losses fell to £42m for RG as a whole, of which £20m was incurred by ARG, and Day has indicated that he expects to break-even at the operating level this financial year. His clear desire is to manage the business for the next couple of years in order to build a track record leading to privatisation via majority share placement around 1990. A

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full public flotation would be sometime later. It must be said that such a strategy contains much pious hope with the overwhelming probability that the Government would continue owning this business right throughout the present term and well into the next.

A Trade Sale

The radical alternative is to go for a trade sale soon which is clearly Young's preference. Day is deeply inimical to any further truck with Ford, but has agreed to examine possibilities with Volkswagen who have initially indicated that Land Rover must be included with ARG. I have no indication of the financial terms but they would probably include a substantial dowry, probably in the form of debt retirement as we did for DAF. Total borrowings will be £620m at the end of the year scheduled to increase to £900m over the following 12 months owing to capital expenditure commitments.

The Elimination of the Minority Shareholding (0.2%)

On Monday Young will seek agreement to start the process for buying out the minority at a total cost of some £17m. If all went well this might be achieved by Christmas. He will argue that the removal of the minority is an essential step towards any form of early privatisation. Furthermore, this would be better done quickly, when affairs are quiet at Rover, than as a necessary but politically high profile part of some more complicated future plan.

This argument has merit but not sufficient to overcome the objection that we will be putting Rover Group into the spotlight at a time when its future strategy has not been clearly formulated and when there is much other hay on the Government's fork. I believe that the Chancellor will also argue against unncessarily exposing a flank.

Young's meeting with Ford

The other matter on which Young may seek a steer is how to respond to any strong enthusiasm from Ford's Chairman with whom he is to dine in mid-October - such an invitation is a normal courtesy to a new Secretary of State. All my signals are that Day will not face his management with the prospect of a sale to Ford unless so instructed. When we discussed Ford in June there was the possibility of Jaguar's prior acquistion of the Land Rover business which might have made the Ford pill politically easier. Therefore, until we have seen the outcome of Day's discussions with Volkswagen, and had an opportunity to evaluate his options for the business, any contact between the Secretary of State and the Ford Chairman should be kept formal and low key.

Recommendation

Despite the argument that the elimination of the minority is a necessary step towards privatisation, it is premature to agree it before we have heard Day's proposals in some detail, probably towards the end of October.

Day will see Volkswagen on 5 October and thereafter put together a package evaluating his preferred options for Rover. At that point he will seek a meeting with yourself at which he will make a strong plea to be left alone to build the business. That is the time to support or oppose his proposals.

GEORGE GUISE

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PRIME MINISTER

ROVER GROUP : PRIVATISATION

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

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

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

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

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COMMERCIAL IN CONFIDENCE

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

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

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

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

D Y

2 October 1987

DEPARTMENT OF TRADE AND INDUSTRY JF5CEE

999-49

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Copy No 6 of 8

TO: PS/Secretary of State

cc PS/Mr Clarke
PS/Sir B Hayes
Mr Luff
Mr Williams
Mrs Bell
Mr Bowen

FROM: Michael Cochlin
Hd/V
Room 341
Ashdown House
212-6093

1 October 1987

ROVER GROUP : PRIVATISATION

Following the meeting with Graham Day yesterday, I attach a draft minute which the Secretary of State might send to the Prime Minister.

MICHAEL COCHLIN

999-80

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PRIME MINISTER

ROVER GROUP : PRIVATISATION

We are to meet on Monday to discuss the position of the minority shareholders but it might be useful then to take stock of the general RG privatisation issue on which I have had a preliminary discussion with Graham Day.

2. He sees two broad options for the Group, either a trade sale or placement with institutions followed by eventual full flotation. He wants a political steer on the direction he should take.

TRADE SALE

3. Until now Ford have been considered the only likely contenders but Volkswagen (VW) have very recently expressed serious interest in acquisition of the whole Group. ~~- including Land Rover~~?

4. Ford understandably are cautious but they have hinted that - if we were to take the initiative - they might be ready to revive the earlier talks on a take-over of Austin Rover. They have not previously regarded Land Rover as a necessary part of any deal; equally, if it were on offer, I am confident they would be interested. I have the opportunity to take soundings when I meet Ford's US Chairman, Donald Petersen, on 13 October.

5. VW want both Austin Rover and Land Rover and, according to Graham Day, would not want ~~one~~ AR without ~~the other~~ LR. VW is a public company in which the State and Federal Governments each have a 20% stake though the latter have announced their intention to dispose of their holding within the next few months. Three-quarters of VW output is in Germany but, within Europe, they have an assembly plant in Belgium and control the Spanish company SEAT. On motivation,

Graham Day believes that acquisition of RG with its market share would enhance VW's position as a world player in a fast-changing industry and provide them with efficient UK manufacturing facilities, lessening their dependence on high-cost German operations. RG are to hold a "fact-finding" meeting with VW on 5 October which might disclose more of their thinking.

FLOTATION

6. On the assumption that RG's business and financial performance continues to improve, Graham Day hopes it would be possible to arrange placement of the majority of shares with institutions (with employee participation) perhaps in 1989/90. Government might have to retain a stake, say 25-30%, but would no longer have contingent liabilities under the Varley Marshall assurances. If all went well, full flotation might follow a year or two later.

7. In the meantime, no initiative would be taken to open talks with Ford or VW nor should a separate solution be explored for Land Rover the retention of which Mr Day argues would materially help placement/ flotation prospects. However he does accept that if over the next 18 months or so RG performance was blown off-course (against previously agreed bench-marks) then the privatisation strategy would be reviewed. The hope of course would be that potential trade purchasers would then still be around.

8. Graham Day's own distinct preference would be for a placement/ flotation. He would like the next year to work up detailed proposals during which he hopes the businesses would continue to improve. He recognises this would require an act of faith by the Government but points to his considerable achievements on privatisation since he was appointed. However, if the Government want a trade sale, he would choose VW rather than Ford. He believes this would be more acceptable to AR management who would expect to have a greater measure

of independence with the German company than with a US multinational. He also suspects that the degree of closure/rationalisation involved would be more painful with Ford than VW who have no existing manufacturing capacity in the UK. Finally he would argue strongly that, under either trade sale option, the deal would have to be negotiated quickly and secretly and announced as a fait accompli. He warns that the business is simply not strong enough to withstand a prolonged negotiation amidst political and public controversy. For the same reason, he would advise against a competition between Ford and VW which he feels would increase the possibility of a leak.

NEXT STEPS

9. We need to decide quickly how we wish to proceed. I am personally sceptical about the prospects of a flotation. Graham Day admits that this is probably not achievable during the life of this Parliament; nor does he have any considered merchant banking advice to suggest that a placement is a realistic possibility within that timescale. The fact is that while Austin Rover might be around break-even at the trading level at end-1987, no new models which might help lift performance are scheduled until 1989. The same is true of Land Rover. Assuming things do not go badly wrong, the likelihood is that progress until then will be steady but unspectacular, hardly likely to excite the City. If we choose to go down the flotation route, we must I think therefore do so on the basis that no progress on privatisation might be possible until the mid-1990s.

10. The trade sale route, if available, offers the only sure prospect of a swift return of RG to the private sector and I think it would be unwise to assume that the opportunities presented by VW/Ford will be available indefinitely. If rebuffed, there is a risk they will lose interest. Delay could also prove expensive. As with a placement/ flotation, a pre-requisite for a trade sale would be Government action to write-off historial debt and RG borrowings are forecast to rise from around £620m (end 1987 forecast) to around £900m by the end of next year

11. At this point it is difficult to judge the relative merits and risks of the VW and Ford options. Ford have an excellent track-record on UK R&D, investment, manufacturing and support for the components industry. This would be a significant reassurance for the industry here and the informed public. VW have no such track-record although (for what they are worth) they might of course be willing to give suitable assurances about their intentions. Against this VW has the advantage (unlike Ford) that it is apparently willing to float its shares on the London Stock Exchange as well as providing for employee participation. This could be helpful presentationally. Second, the European Commission, whose approval would be required not only for debt write-off but also for any Government aid towards restructuring, might also look with more favour on a deal between two European companies than one involving a US multinational. Third, because of the history and AR management attitudes on Ford, Graham Day leans towards negotiation with VW and his co-operation will be important in clinching any deal. All this simply underlines that, should we decide to go for a trade sale, we shall need to think very carefully about which horse to back.

12. Within all this there is the problem of Land Rover whose sale was the focus of particular controversy last year. A deal with Ford on Austin Rover would leave us free to seek a separate solution for Land Rover though John Egan has told me that, for the foreseeable future, Jaguar are not interested and other attractive British candidates may be hard to find. In the case of VW, we would need to establish how determined they are that Land Rover should form part of any sale and then judge what presentational problems this might pose for us.

13. Finally we shall need to consider the position of Honda. There would be no complication under the flotation option. In respect of a trade sale, Ford were keen last year to maintain Austin Rover's links with Honda and VW have taken the same line. Whether Honda

would be ready to co-operate with either remains to be seen but I suspect they would be ready to behave sensibly and not to frustrate our privatisation objectives. My predecessor gave Honda an assurance that, should ownership of Austin Rover change, Honda would be free to develop their own manufacturing operation at their Swindon site. This freedom would I believe be more than enough to ensure a co-operative approach from Honda. Any problems would therefore likely to be transitional.

14. I am copying this minute to Nigel Lawson.

PART 13 ends:-

DRN TO PM 30.9.V7

PART 14 begins:-

INTERNAL DTI MINUTE 1.10.V7

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