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CABINET

Ministerial Committee on Economic Strategy

INMOS: Finance and Factory Location

Memorandum by the Secretary of State for Industry

This paper records discussion on the future of this company in the Sub Committee on Economic Affairs, and invites the Committee to decide on the provision of a further £25 million to the company, and on the siting of its first production plant. The issues are set out in the paper which the Sub Committee considered, together with a letter from the Secretary of State for Wales dated 5 March which are attached at Annexes A and B. The Sub Committee were able to meet Sir Arthur Knight (Chairman of the National Enterprise Board) (NEB) and Mr Iann Barron, the Chairman of INMOS.

2 Some Ministers had reservations about the scale of investment required. They felt that a small new company would not be able to raise private finance, and with public money available would have no incentive to invest efficiently or control its costs. They thought that NEB should set up monitoring arrangements. With this condition, the Sub Committee recommend unanimously that the Government should provide the second tranche of £25 million which the previous Government promised as part of the original agreement with INMOS. They felt strongly that they should not attempt to over-rule a commercial judgement of the NEB on a matter like this. They considered, however, that this was a high-risk investment, of a kind which was only justified as an insurance premium. They made it clear to Sir Arthur Knight and Mr Barron that the Government was not prepared to put up funding beyond £50 million (a condition which the Prime Minister asked should be made). They noted, however, that if the project was unsuccessful, the Government's maximum exposure (which it is impossible to estimate accurately) could be as high as £100 million, in the extreme case in which none of the products proved successful and none of the productive assets could be re-sold, so that the Government had to honour the NEB guarantees of loans raised on the market and meet creditors' claims and the usual redundancy costs. They also noted that,

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in the event of success, the three entrepreneurs behind INMOS, and their dozen or so senior lieutenants, whose personal investment at present is relatively small, (though significant for the individuals concerned), stood to realise very large gains indeed.

3 The Sub Committee were unable to agree on the siting of the first production plant. Mr Barron agreed that the company had originally been prepared to separate the technology centre (already in temporary quarters at Bristol) from the first production plant, although it had never committed itself to a site in an assisted area. The site at Bristol had been chosen for the technology centre in order to attract the highly-qualified research staff who are needed to design and develop the 'chips' and the manufacturing process. The company is now convinced that it would add an unacceptably high additional level of risk to separate the research site from the production site. Mr Barron claimed that he could not guarantee the success of the project if this were done. Sir Arthur Knight told us that the NEB were convinced by the argument for a common site. Mr Barron said he did not think the company could succeed if the technology centre were moved from its present temporary quarters at Bristol, and that some of the 60 staff that have already been recruited might leave.

4 The Secretary of State for Wales, supported by the Parliamentary Under Secretary, Scottish Office, felt very strongly that the company should not be allowed to go back on its earlier intention to site the manufacturing facilities in a development area. They felt the decision was of great importance for the future of regional policy. They could not understand why the company refused the additional finance which could be made available through regional development grants. They believed that provision of the manufacturing plant in a development area could make an important contribution to job creation in places seriously affected by industrial change, and would be politically most important. They pointed out that PA management consultants had identified attractive sites near Cardiff and elsewhere. They did not think they could defend a decision to site these facilities in a prosperous area like Bristol. They therefore asked that the issues should be brought before the main Committee. The other Members of the Sub Committee, however, were convinced by the arguments of the National Enterprise Board and the company, and consider that the plant should be sited at Bristol. They considered that it would be inconsistent with the Government's decision to back the company, not to accept its advice on this issue. They believed that this would make a risky investment even riskier.

5 The Committee is therefore invited:

(i) to confirm the Sub Committee's advice that a further £25 million should be made available to INMOS, subject to strict monitoring by the NEB;

(ii) to decide whether Industrial Development Certificates should be granted to the company for the construction of its first manufacturing plant at Bristol, or whether

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the company should be required as a condition of further finance to site this plant in an assisted area.

K J

14 March 1980

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Ashdown House
123 Victoria Street

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At its meeting on 11 July 1979 (E(EA) (79) 7th meeting), the Committee endorsed proposals by the Secretary of State for Industry on the future role of the NEB, including support for growth technology companies, of which Inmos is the biggest. In his statement to the House on 19 July the Secretary of State made it clear that any provision of further funds for Inmos, beyond the £25m already then committed, would be subject to detailed review. The NEB have now sought approval for the investment of a further £25m to enable Inmos to proceed with the establishment of its production plants, the first of which Inmos wishes to site at Bristol. Colleagues have asked that we should consider the issue collectively and this paper sets out my recommendations.

2 The original Inmos proposal envisaged a total equity investment by the NEB of £50m. This was accepted by our predecessors but initial approval was given only to the first tranche of £25m because the NEB thought it desirable to have a review of the company's progress at this half-way stage. The NEB's investment in Inmos now stands at £14.6m. A further £14.4m is due to be called during 1980 (of which £10.4m is already committed under the first £25m tranche) with the remainder falling in 1981. Thus the amount we are now being asked for is what was originally envisaged.

3 The purpose of the half-way review was to check that the company was on course and the management demonstrating the competence and skills that had been expected. Subject to satisfaction on these points it was not envisaged by the NEB or Inmos that there would be a fundamental re-appraisal of the merits of the venture, but I am advised that the contract between them would permit the NEB to withdraw without specific penalty if it thought it right to do so (for whatever reason).

4 The NEB are satisfied that the company is on course, and they have high confidence in the management. My own advisers do not dissent. But these are matters of commercial judgement for

which the NEB has sole responsibility. The venture falls within the framework of our policy towards the NEB and we have approved PES provisions which are adequate for its funding. I have, however, in consultation with the NEB and Inmos, looked carefully at the risks to which we are exposed in going ahead.

5 First there is the risk of absolute failure of the venture. It has always been risky, and it still is, but I am advised that the prospects are appreciably better than they were originally: this is because the market has grown more quickly than was expected, without any increase in the number of competitors or ground gained by them.

6 But risks of failing to capture a profitable share of the market either because of design, production, quality or delivery factors have to be considered. Inmos is an NEB subsidiary, so if it collapsed the NEB would meet all its obligations in liquidation. Although it is impossible to be sure what these might be, Inmos estimate that after full realisation of all their assets the net cost to public funds would be £10m if failure occurred before end 1980; £20m if it were before end 1981; and £15m if it were before end 1982. These are the critical years for the company's growth. By end 1984, however, there would be a small surplus for the shareholders. Thus the maximum exposure to catastrophic loss is put by Inmos at £20m. My own judgement is that these estimates are over-optimistic, being based on unrealistic assumptions about asset realisation values.

7 Then there is the risk of the Government finding itself on an expenditure escalator. The current projected cash flow to 1984 indicates a maximum cash requirement of £91.5m in 1983, with a slightly lower requirement in 1982 and 1984. This implies bank borrowing and leasing finance of up to £41.5m. There is no reason to think that this will not be available from a consortium led by Citibank. (They are well aware that in lending to Inmos they would effectively have gilt-edged security). The cash flow makes provision for an uncommitted reserve against contingencies, amounting to about £9m in the three years of peak cash flow, which has been added to the forecasts at the request of the NEB. (The risks of operating failure covered in paragraph 6 takes this borrowing into account).

8 It was never intended, nor do the NEB now believe, that additional private equity investment could be attracted at this early stage. However, when the NEB investment is complete, and Inmos has demonstrated its capabilities, it might be possible to attract private investment, though the prospects are slight before 1983. Beyond 1984 the NEB believe that any further equity financing could readily be secured from the private sector, coupled with the disposal of all or part of the NEB's holding. On this basis the NEB confidently believe their equity involvement can be limited to £50m. Again, it is necessary to question these assumptions because of the high risk nature of the project. There has to be a risk that the project will slip in time scale, or e.g. product technology as not to be attractive to private capital. The Government would

once again be caught in a "jam tomorrow" situation. We therefore must make it absolutely clear that the £50m is the limit of public money input unaccompanied by private investment.

Location

9 Inmos has announced its decision that its first UK factory (1080 employees) should be located in Bristol next to the technology centre (currently employing 60 to rise to 450). This is a contentious matter because there seems to have been some misunderstanding about whether the factory would be in an assisted area. Inmos have now come to believe that it is essential that the factory and the technology centre should be as close as possible because of the need for production and research staff to maintain close contacts during the critically important early stage of production. But Inmos have firmly declared that their second UK factory will be sited in an assisted area - probably in 2-3 years.

10 The Inmos proposal would require an IDC for Bristol. The tighter criteria for selective financial assistance which we have introduced recognise that there would be cases where particularly attractive projects would justify substantial financial inducements to locate in an assisted area. If the Inmos project fully satisfied the criteria, it could receive up to £9m at Cardiff, and nearly £11m at Washington (Tyne and Wear) the two sites which were short-listed. In both these cases an ECSC or an EIB loan of up to £12m would be available, with £1m interest rebate at Cardiff (a steel closure area). The Inmos Board are aware of these potential benefits but do not think they warrant the risk entailed in separating the production staff from their research colleagues. The NEB endorse this view.

Conclusion

11 The first question for consideration is whether, in principle, to authorise the second £25m for Inmos. I have made clear my doubts about certain of the assumptions and estimates made by the company and endorsed by the NEB. Nonetheless they believe that their judgements are as well founded as is possible in this uncertain area and, indeed, that the company's prospects have improved rather than diminished over the past 12 months. I am impressed too that the NEB, whose expenditure we have severely limited, recommend continuing the project and giving it priority. We have appointed the new Board and it is their task, within the resources provided, to make the commercial judgements, and I have little doubt that should we refuse this first, and single largest, case in the advanced technology area they would have no option but to resign. The project remains at the frontier of its technology, but the quality of the team is widely accepted and their motivation is secured by the large entrepreneurial interest they were given by our predecessors. I do not feel that those doubts which I have, and which I believe colleagues will share, justify challenging the combined Inmos/NEB view on the technical/commercial prospects, despite my personal reservations on some of the figures. I therefore firmly conclude that we should accept the NEB's recommendation to continue within the overall £50m.

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12 I have to decide whether to grant an IDC or not. There is conflict between the needs of the regions for good jobs and the company's commercial judgement. I recognise the doubts which have been expressed by some colleagues about the location and the political sensitivity of this decision. I am therefore prepared formally to ask Inmos why they cannot build the factory in South Wales, the nearest Assisted Area. If they reply, as I expect, that only a shared site will give the necessary intimate linkage between the design and production teams I would then give an IDC for the Inmos factory at Bristol. I would justify this on the grounds that it is even more important for the country as a whole and its Assisted Areas that Inmos succeed there, than its first factory be in an Assisted Area.

Recommendation

13 With these considerations in mind I seek the Committee's agreement that:

- i) we should accept the NEB recommendation that they should provide the second £25m of equity for Inmos; and
- ii) subject to a formal enquiry as proposed in paragraph 12 about Inmos' decision to locate their first production unit at Bristol, we should be prepared not to intervene, and an IDC should be issued;

I am very conscious of the extent to which the success of the venture depends upon its swift progress and I hope that it will be possible for the Committee to reach a quick decision.

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The Rt Hon Nicholas Edwards MP

ANNEX B

WELSH OFFICE
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WHITEHALL LONDON SW1A 2ER
Tel. 01-233 3000 (Switchboard)
01-233 6106 (Direct Line)
From The Secretary of State for Wales

5 March 1980

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Dear Keith

The proposal that is being put to E(EA) to grant an IDC for the Inmos factory at Bristol, subject only to a formal enquiry about their choice of site, raises issues of great importance.

Colleagues should understand that what is at stake is the credibility of our Regional Policy. A decision to grant an IDC in this case for a Government financed factory will be seen as signalling the abandonment of IDC control. It is hard to believe that if an IDC is granted in this case one could ever be refused again. That is something that would cause grave concern throughout the assisted areas. The interpretation that IDC control is being abandoned will be reinforced by the fact that former Ministers have stated and will continue to state that an IDC for the research centre was only given on the understanding that the manufacturing units would be established in the regions.

The issue has a greater political significance even than that. The decision will be taken and announced at a time of industrial tension when the Nationalised Industries are being asked to undertake large scale demanning, when unemployment is rising and when there are understandable and widely held fears of a return to the thirties. I do not believe that it will be in Wales alone that the decision would be seen as an abandonment by Government of any serious attempt to attract new and more diverse industry to the area when jobs are being lost.

Certainly in Wales such a decision would have the most serious impact on the attitude of those who see their jobs at risk, and on the political reputation of the Government.

/In my view

The Rt Hon Sir Keith Joseph Bt MP
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In my view the commercial argument for permitting the development to take place at Bristol would have to be extraordinarily persuasive for the Government to grant an IDC in these circumstances. The arguments that have been presented by Inmos and the NEB do not seem in the least persuasive.

The evidence is very strong that when Inmos applied for an IDC for the technology centre the NEB gave a firm commitment to our predecessors that the production units - all four that Inmos had in mind at the time - would be located in the assisted areas. Eric Varley, Alan Williams and Gerald Kaufman, in their letter in the Times on 29 February, made it plain that the IDC for the technology centre was approved on that basis. There was no suggestion from Inmos at the time that they dissented from that arrangement - indeed that it was crucial for the first production unit to be cheek-by-jowl with the technology centre. On the contrary, representatives of Inmos explained to officials in my Department and to local authority officials in South Wales the positive advantages of separation. Our predecessors made public statements on this matter but so far as I am aware there was no suggestion from Inmos that there were any doubts about the matter.

If Inmos knew all along that it was essential for the first production unit to be located alongside the technology centre then they must have deliberately misled the NEB and our predecessors. If on the other hand it is only now that they have concluded that separation would prejudice the whole project it must raise doubts about their competence. Nothing in the papers I have seen suggests that the arguments for a reversal of the previous attitude are compelling. It is surprising to discover that the IDC application approved by our predecessors 15 months ago - with Inmos pleading great urgency - has apparently still not been acted upon. This reinforces my suspicion that the intention all along has been to secure the first production unit for Bristol, and that Inmos were less than frank - to put it mildly - with Government about their proposals. They were similarly less than frank with the very large number of local authorities in the assisted areas who responded - at considerable public expense - to the invitation to submit sites for consideration.

In submitting their present application there is, in my view, a clear onus on Inmos to demonstrate beyond doubt that they have assessed all possible locations in the assisted areas and found none to be suitable. The absolute minimum requirement, I would have thought, is for Inmos to report in detail on the short-listed assisted area sites. Until they do so I do not see how it can possibly be suggested that the application has been sufficiently substantiated.

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I understand that Inmos have claimed that only Bristol offers an assurance of attracting the key personnel who are critical for the success of the project. The evidence put forward in support of this is, in my view, very shaky indeed. It really is absurd to suggest that Cardiff, and a host of other assisted area locations throughout the country, are not attractive to professional people. It is not the view taken by Ferranti for example who are going ahead with a high technology project at Cwmbran.

So far as I am concerned I am in no way persuaded that the site on offer to Inmos in Cardiff - which is already in public ownership and on which a start can be made immediately - is not eminently suitable for the first production unit. It is alongside an interchange on the M4 (giving all-the-way motorway access to Heathrow and Bristol); it is environmentally superb (as has been conceded by the consultants acting for Inmos); it is shared only with the important new Radio Chemical Centre development (who have had no difficulty whatsoever in recruiting key personnel); it is within walking distance of an attractive high-class residential area on the outskirts of the city; it is within 10 minutes by road of the city centre and the University; and within easy reach of a national park and areas of outstanding beauty. The alleged bias against Cardiff - and South Wales generally, as a good place to live and work in is totally at variance with the experience of scores of firms who have moved into the area.

The Memorandum suggest that Inmos should simply be asked why they cannot build the factory in South Wales, and that if they say in reply that the technology centre and production should be together - which will be their automatic response anyway - they will get the IDC. I cannot conceive of a more pathetically weak test to be applied to an issue of such importance. Indeed, if Inmos themselves had been asked to think up a test I doubt whether they would have produced such a weak one.

I take the view, therefore, that whilst Inmos and the NEB may have made out a case for the additional funds, they should be released only on condition that the first production unit is located in an assisted area.

If they choose a location in an assisted area outside Wales I could not object, but I think they will accept that if the development is to take place in an assisted area the Cardiff site is eminently suitable. Frankly the suggestion that the project would succeed

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in Bristol but would fail in Cardiff is incredible. If that is the justification advanced it has serious implications for the future industrial development not just of South Wales but of the Regions generally. If we as a Government endorse such a view we will make infinitely more difficult the industrial recovery of such areas because it will be that much more difficult to direct high technology investment, foreign and domestic, into the regions.

/ I am copying this to the Prime Minister to other members of E(EA) and to Sir Robert Armstrong.

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