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MINISTERIAL COMMITTEE ON ECONOMIC STRATEGY

SUB-COMMITTEE ON DISPOSAL OF PUBLIC SECTOR ASSETS

FINANCING OF BRITISH AIRWAYS - SHARE ISSUE

Memorandum by the Secretary of State for Trade

1 On taking up my appointment at the Department of Trade I commissioned a study of the financing of the British Airways Board and the possibility of a minority shareholding by the private sector. Though British Airways did not feature in our election programme, this course would accord with our general policies and could bring substantial relief of up to £1 billion to the Public Sector Borrowing Requirement (PSBR) over a number of years. I believe that it could help in developing a successful commercial organisation and involving the employees, through giving them a special opportunity to buy shares in British Airways.

2 I have now come to the view that we can and should move fairly quickly in this matter. Accordingly I am now circulating copies of the completed study and I set out my proposals below.

Method

3 The study concludes that the method to be adopted should involve legislation enabling the assets and liabilities of the British Airways Board to be transferred to a new company, British Airways Limited. The Board itself would be dissolved, though I am advised that special provisions might be necessary with regard to its assets and liabilities overseas.

4 Initially all the shares would be held by the Department of Trade. Subsequently a public issue could be made either of these shares or of further shares created by the company, or both, with preferential treatment for employees of British Airways. I agree with this approach and, since this question of method is fully discussed in the enclosed study, I need not comment on it in detail here.

Control

5 The study identifies as a crucial question the extent to which we would be prepared to disengage from intervention in the airline's affairs, and whether we should wish to reserve to ourselves any special rights other than those which the Department would have as a major shareholder. I have myself no doubt that we should aim to disengage

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as fully as possible, and we should make clear our intention to adopt the same attitude to the new company as towards British Petroleum. At the same time, I am having an itemised examination carried out of our existing powers of control over the British Airways Board to see whether there are any of these which, exceptionally, we should retain for security reasons or on other grounds.

Future finance

6 We should, in my view, be in a position to make further equity investments in the company in the future, if only to enable us to take up any rights issues. The study raises the further question whether we should also have power to make further loan finance available to the airline in the future. I am not ready to make a firm proposal on this. I believe that the airline should have no difficulty in financing its aircraft purchases, but we have so far had no concrete discussions of the future arrangements with British Airways themselves. In any event I should not want the retention of a purely permissive power of this kind, possibly for a limited period of years, to prevent the new company from being treated as a private sector body.

Disposal of assets

7 If we are to market the shares I do not see any grounds for requiring the British Airways Board to dispose of assets such as investments in hotels which are, I believe, a fairly common feature among airline enterprises. We can in any event achieve our objectives without doing so. Both the previous chairman, Sir Frank McFadzean, and the present chairman, Mr Ross Stainton, have urged that, to reduce the risk of opposition to our plan, it should not involve dismemberment of the airline or disposal of profitable parts of it. They have also urged that, partly as an assurance against any break-up of the airline, which is likely to be the main fear of the Unions, the Government should retain a majority shareholding. I feel that we should attach weight to this advice. It seems to me that the public presentation of our policy should from the outset make it clear that we have no intention of dismembering the airline and that our proposals will be to its commercial advantage and the benefit of the workforce. Otherwise we should increase the possibility of industrial disruption which would be damaging to the airline and could frustrate a successful share issue.

Implications for the PSBR

8 The statistical conventions governing what comes within public expenditure and the PSBR are, I understand, being looked at again by the Treasury, in conjunction with the Central Statistical Office. I do not think that our decisions about the national interest in these matters should be determined by statistical conventions. However, it appears that, even on the existing conventions, my proposals could bring substantial relief to the PSBR.

9 What matters for PSBR purposes is, I understand, the status of the borrower as a public sector body or a private sector body. British Petroleum has been treated throughout as a private sector body, irrespective of whether the Government has had a majority or a minority shareholding, because the Government has stood back from

the management of the company. In the same way, I porpose that we should stand back from the management of British Airways Limited. I hope therefore that Treasury Ministers will be able to confirm that any sale of government-owned shares in British Airways Limited, which might involve £100-200 million, will count to reduce the public expenditure figures; but also, and more important, that the company's subsequent borrowings will fall outside the PSBR. Over a five-year period the amount which, on this approach, we should transfer out of the PSBR would be of the order of £1 billion.

Timetable

10 The study suggests 1981 as a possible target date for a share issue. However, Hill Samuel have advised that an earlier date could be feasible and, provided that British Airways have a good financial performance in the current financial year, I should like to preserve the option of a share issue in 1980. In order to keep this option open, we should need legislation in the current Parliamentary session. I have asked for a place for a Civil Aviation Bill in the current session and I propose that we should expand the Bill by a few clauses in order to provide us with the necessary powers to bring British Airways within the framework of the Companies Acts. This would still be a perfectly manageable Bill but, before we become committed to this course, I have asked my advisers to carry out a rapid check in the next week to ensure that there are no insuperable snags. I have no reason at present to assume any major technical difficulty.

11 Subject to this safeguard, and to the decisions reached on my proposals, I envisage that it may be prudent to make a policy announcement on this matter before the summer recess primarily in order to avoid damaging and inaccurate leaks about our intentions. In view of the timetable which I have in mind, this would go beyond the kind of holding statement suggested in the study.

Licensing policy

12 The airline will continue to be subject to licensing by the Civil Aviation Authority, and British Airways have stressed that, as a prerequisite to the course of action discussed in this paper, we will need to have made a statementon future licensing policy such as to remove any doubts about the future of British Airways in this country's civil aviation capability. It is true that we need to resolve the problem created by the Court of Appeal's judgement in the Laker case which invalidated the previous Guidance to the CAA, and I will bring forward proposals in good time. But I do not propose to be rushed into a commitment in this complex matter and will want to look carefully at all the options, including the possibility of amending the legislation so as to dispense with Ministerial Guidance. Meanwhile I propose that my announcement should make it clear that we are not thinking in terms of an arbitrary reallocation of routes away from British Airways. This should go at least some way towards meeting their concern.

Conclusions

13 I therefore seek the agreement of colleagues that -

(a) legislation should be introduced this session to enable the assets and liabilities of the British Airways Board to be transferred to a new company;

(b) we should keep open the option of a public issue of shares in the new company, with a preference for employees of the airline, in 1980, but otherwise we should aim at a share issue in 1981;

(c) we should disengage to the maximum from intervention in the airline's affairs;

(d) the Treasury should be invited to confirm that, on this basis, a sale of the company's shares by the Department of Trade would count as a reduction in public expenditure, and that subsequent borrowings by the airline would be outside the PSBR;

(e) we should give the airline and the investing public appropriate assurances against any dismemberment of the airline or disposal of profitable parts of it or disruption to its route structure.

(f) I should make a statement of our intentions before the summer recess.

J N

Department of Trade
1 Victoria Street
SW1

29 June 1979

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FINANCING OF BRITISH AIRWAYS

Department of Trade

June 1979

FINANCING OF BRITISH AIRWAYS

INTRODUCTION AND GENERAL APPRAISAL

The enclosed study on the future financing of British Airways, including the possibility of a minority private sector shareholding, has been prepared at the request of the Secretary of State for Trade, on the basis that the work should be carried out with a high degree of confidentiality. The method of work adopted has been as follows -

(a) The legal and administrative aspects have been examined, different options have been framed for producing the required capital structure, and available financial data have been assembled, within the Department of Trade.

(b) The financial data and a list of questions on the market aspects, have been given to Sir Robert Clark, Chairman of Hill Samuel & Co, and discussed with him. The list of questions, and Sir Robert Clark's written comments in a letter of 13 June, which is essential reading, are annexed to the study.

(c) The subject has been discussed informally with the Chairman and Chief Executive of British Airways, but nothing has been put to them in writing, and their preferred public position for the time being has been that they have received no proposal from the Government on an equity participation.

British Airways have embarked on a major programme of fleet replacement and expansion, requiring a substantial increase in capital financing from both internal and external sources. Although the airline's profit record in recent years has for the most part been mediocre, it is improving and, if the projected further improvement is secured, there should be scope for a substantial degree of equity financing, whether to meet new capital requirements or to refinance previous loans. The share values would reflect the airline's profit record and prospects, not the asset valuation.

The nature of a statutory corporation such as British Airways does not allow of an ordinary shareholding, and the creation of a new company, to take over the assets and liabilities of the British Airways Board, would be necessary to make financing by this method possible. Although the British Airways Board could themselves achieve this effect under existing legislation, by setting up a new company in which initially the Board held all the shares, neither the Government nor the Board would be able on this basis to divest themselves of their existing powers and obligations; the operating company could not function in a truly commercial manner under this regime, and a successful equity participation could not be achieved.

The preferred method, therefore, is to pass legislation under which all the assets and liabilities would be transferred to a free-standing company; the Department of Trade would initially hold all the shares. The British Airways Board would be dissolved.

A crucial question will be the extent to which the Government is prepared to disengage from intervention in the affairs of the proposed company and to legislate accordingly. Specifically, decisions would be needed whether the Government should reserve to itself any special rights other than those which it would have as a major shareholder. Though some reserved rights might be justified on grounds of national security, retention of such powers as a right of approval of the airline's investment and borrowing, or the ability to give policy directions, would militate against the commercial functioning of the company and would be prejudicial, possibly fatal, to the success of a share issue.

Decisions will also be needed on the question of retaining powers for the Government to put further finance into the company, if necessary, for at least an initial period.

The top management of British Airways, while privately seeing advantage in a plan on these lines, as providing an additional discipline on industrial and commercial performance, would attach importance to the following points -

(i) There should be no dismemberment of the airline or disposal of profitable parts of it.

(ii) The Government should retain the majority of the share capital.

(iii) The airline's route structure should not be adversely affected by the devd opment of the Government's civil aviation policy on licensing and competition.

It will be necessary for the success of the operation to find an agreed accommodation between this last condition and the degree of competition for which the Government's civil aviation policy will be expected to provide.

Hill Samuel have not been asked at this stage to give specific advice on such matters as asset values and issue prices, which would have to be worked out much nearer the time. However, to put a rough order of magnitude on the contribution which equity financing might make towards the capital requirements of British Airways in the next few years, it might be in the range of a hundred to a couple of hundred million pounds in one or more tranches, subject to the timing and to the airline's performance.

It is envisaged that employees of British Airways would be given a degree of preference in the allocation of shares. Neither Hill Samuel nor the top management of British Airways see this as making an important contribution to the climate of industrial relations, and the latter attach much more importance to the points mentioned above, but they see employee shareholdings as a possibly useful supplement to the package.

In view of the need for legislation, and for British Airways to establish a good earnings record, the earliest practicable opportunity for a share issue is likely to be 1981.

The following is a possible order of events which, however, could be subject to variation in detail -

(a) Government statement on civil aviation policy.

(b) Clear the ground by implementing the previous Government's intentions to write off part of the public dividend capital of British Airways and by seeking to reduce the amount of outstanding guaranteed debt.

(c) Statement of policy on equity participation.

(d) Synchronised explanation of this policy by British Airways to the trade unions.

(e) Legislation to give effect to the new policy, with provision to fix by Order the appointed day for the transfer of assets and liabilities to the new company.

(f) Work out details of the transfer, including capital structure and starting debt of the new company, and name the appointed day.

(g) Employ merchant bank to advise on details of the proposed share issue.

If an approach on these lines is agreed, the question of making a holding statement at some suitable opportunity in the near future should be considered. This could be to the effect that the Government are considering the possibility of a future change in the capital structure of British Airways, not involving disposal of any part of the airline, so as to enable part of its future capital requirements to be met by a minority private shareholding, including shareholdings by employees of the airline; the Government do not propose any immediate steps in this matter, but they expect in due course to make a further statement, and at that stage there will be full discussion with the British Airways Board and, through them, with representatives of the airline's employees.

The British Airways management attach importance to the conduct of consultations with their Unions being in their own hands. Ministers may nevertheless wish to consider whether at some point they should find an opportunity to explain their intentions to Union leaders at first hand.

L P

19 June 1979

Financing of British Airways

Scope of the Paper

1. This paper considers the future financial requirements of the British Airways Board (British Airways) and ways of meeting them, including the possibility of a minority private sector shareholding, but excluding fragmentation of the business and disposal of the more profitable parts.

Objectives

2. Civil aviation is a growth industry but increasingly competitive and possibly vulnerable to the oil situation. A major objective in terms of civil aviation policy is to enable British airlines to operate and compete successfully.

3. In terms of overall economic policy, it is a major Government objective to reduce public expenditure and taxation and to contain the public sector borrowing requirement.

4. The objectives of a minority private sector shareholding would be some or all of the following, not in order of priority:-

(a) to help finance future capital requirements;

(b) to recover past government investment in British Airways;

(c) to enable employees of British Airways to subscribe for shares in the airline, thus giving them an added incentive to work for its success;

(d) to facilitate reduced government intervention in the management of the airline on a more fully commercial basis.

Existing Structure

5. British Airways is a statutory corporation governed by the British Airways Board Act 1977 and the Civil Aviation Act 1978. This legislation sets out, among other things, the Board's functions and powers, and the duties and powers of the Secretary of State, covering for instance appointment of Board members, provision of

government finance and the right to give directions on various matters.

6. British Airways is not a company subject to the Companies Acts. It does not have shares or shareholders.

7. Its existing capital has been provided from the National Loans Fund, from market borrowings with Treasury guarantee, from trading surpluses put to reserve, and from Public Dividend Capital (PDC) provided from Department of Trade Votes.

8. PDC is not share capital, and can be described as an equity investment only by a very loose analogy. It could equally well be described as conditional grant, or alternatively as a loan on variable terms.

9. The previous administration announced on 22 February 1979 that £160 million of the PDC previously issued to British Airways would be written off, as part of revised financial arrangements relating to the Concorde aircraft operated by British Airways. The report of the working party on which this decision was based was made public. Legislation has still to be passed to give effect to the write-off.

10. The following is a simplified presentation of the capital financing of British Airways as at 31 March 1978, not allowing for this write-off of PDC.

		£ million
		830
<u>Net assets financed by</u>:		
Public dividend capital	300	
Reserves	135	
Issues from National Loans Fund	60	
Overseas borrowing and bank loans	160	
Leasing finance	80	
Deferred taxation	95	
		830

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Future Capital Requirements

11. The estimated future capital requirements of British Airways, of which purchase of aircraft and spares accounts for roughly three quarters, and the Board's present proposals for financing them, are summarised below, together with the corresponding figures for some previous years by way of comparison. All the figures are at actual or forecast out-turn prices:-

	£ million					
	Total capital requirements	Internal resources	PDC	Net NLF Borrowing	Other net borrowing	Leasing (net)
1972-3	101.5	95.1	60.0	(35.9)	(17.7)	-
73-4	105.0	124.1	11.3	(35.9)	5.5	-
74-5	125.5	88.2	80.0	(35.9)	(6.8)	-
75-6	130.8	60.6	63.7	28.1	(21.6)	-
76-7	177.5	160.3	10.0	(24.6)	15.7	16.1
77-8	195.3	108.0	10.0	(23.0)	28.2	72.1
78-9	221.8	150.2	10.0	(14.5)	29.9	46.2
1979-80	347.7	175.8	10.0	(6.0)	177.5	(9.6)
80-81	464.8	237.3	10.0	(6.0)	233.4	(9.9)
81-82	462.4	298.6	10.0	(5.9)	170.1	(10.4)
82-83	542.6	343.1	10.0	(5.9)	206.3	(10.9)
83-84	595.1	378.9	10.0	(5.9)	223.4	(11.3)

( ) = NET REPAYMENTS

More detailed presentation of these figures is available.

12. The presentation in paragraph 11 is designed to show the trend in the airline's total capital requirements and how far they rely on internal and external financing respectively. The figures reflect a major fleet replacement programme and, in spite of a high degree of self-financing, a large increase in borrowing is projected. None of the borrowing is shown specifically as leasing finance, but in practice opportunities for leasing on favourable terms will be taken as they arise. The projections assume a continued injection of £10 million of PDC a year, but clearly there could be room for a substantially higher proportion of equity financing.

13. The element of internal resources provided by profits was small or negative from 1972-73 to 1975-76, but has been £35 million and £32 million respectively in the next two years, including an adjustment of £15 million to prior years taxation in 1977-78. The profit figure has been projected to rise to £85 million in 1978-79 and progressively to about £190 million in 1983-84. Forecasts of dramatic future improvements over the past are always suspect, but British Airways say that their financial performance for 1978-79 is broadly in line with the previous forecast.

14. The future inflation rate assumed in the projections, though not explicitly stated, is 7 or 8 per cent a year. This now looks optimistic for the period immediately ahead.

15. The projections assume that there is no physical limitation on the operations of British Airways through shortage of fuel (as distinct from higher prices) or a failure to provide an adequate airport capability in this country. Their plan aims at a progressive improvement in productivity with higher real wages per head. They do not regard the share of world traffic at which they are aiming as over-ambitious or, on these assumptions, unrealistic.

Possible New Structures

16. In principle a new form of statutory corporation security could probably be devised, to be issued by British Airways, differing from a fixed interest security in giving the holder a right to participate in some way in the corporation's net earnings, on a basis which would have to be defined for the purpose. However, so long as these were securities of the corporation itself, they would not be shares such as are issued by a company.

17. The possibility of a quasi-equity of this kind (termed Option C for the purpose of this exercise) has been looked at briefly, as at any rate a possible means of giving employees a sort of

financial bonus, but Hill Samuel do not consider the idea worth exploring further even for an issue to employees. A quasi-equity could not be made attractive to the investor unless new obligations were placed on the airline, and the rights and duties of the Secretary of State were altered, so as to give the shareholder a reasonable assurance of an equity-type return on his investment. Quite complex legislation would be needed for this, and it is preferable to think in terms of a change in structure, whether or not involving legislation, so as to create a company in which investors could have an ordinary shareholding. This could be done in one of two ways.

British Airways Limited (Option A)

18. The preferred method would be to transfer all the assets and liabilities of British Airways to a new company, British Airways Limited. It would be given an initial capitalisation reflecting its existing indebtedness, PDC and reserves, with an appropriate debt/equity ratio. All the issued equity would initially be owned by the Department of Trade. The company would have power to issue further securities.

19. So long as it retained shares, the Department would have the usual shareholder's rights. In addition, any existing rights or powers of the government which it wished to retain, or any new rights or powers which it wished to have, could be secured either by provisions in the new legislation or by the Memorandum of Agreement and Articles of Association of the new company. The question of these reserved rights is one of the most important matters for decision if the "British Airways Limited" option is adopted.

20. The following are some of the relevant powers conferred on the government by the 1977 and 1978 Acts:-

To appoint the Chairman and members of the Board

To determine their remuneration

To give general directions to the Board on matters affecting the national interest

To give directions on the organisation for carrying out the Board's activities

To give directions for the discontinuation of particular activities or the disposal of shares of property

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To make loans to the Board from the National Loans Fund

To make payments to the Board out of Votes, ie. PDC, and to determine the dividend on it

To approve other borrowing by the Board within limits specified in the Acts

To guarantee borrowings by the Board

To approve plans for capital expenditure and leasing of equipment

To set financial targets for the Board

In time of war or emergency, to require the whole of part of the undertaking to be placed at the Government's disposal

21. The objective of creating a more fully commercial enterprise, attractive to the investing public, suggests the abandonment of at least the larger part of these powers. Nevertheless, given that the enterprise had been built up with the assistance of public funds and government guarantees, some of these items, such as the remuneration of Board members, would be sensitive. The Board members of the nationalised industries which retained their present status would no doubt have an interest in this point.

22. The key point in Sir Robert Clark's advice on this matter is that, though he sees no difficulty in one or two of the reserved powers mentioned, "when it comes to other matters such as the specific approval of capital expenditure plans, the setting of financial targets, the approval of specific borrowings, the giving of directions on national interest matters and on the organisation and activities of the company generally I think that the specific retention of specific powers for the Government would have a material and in most cases, fatal, effect on the marketability of a minority interest on the Stock Exchange."

23. The government would presumably take powers to provide further equity capital, at the least to enable it to take up any rights issues. In addition, it would have to decide whether to retain powers to make loans to the company. This would provide potential of financial backing for what would still be by far the largest component in the country's civil aviation capability. It might make it the more attractive to the private equity investor, provided that the power did not also involve eg. a continued right of control of investment. But the government would be open to

criticism if it provided continued financial backing without retaining safeguards of this kind. It could also be criticised for using the public purse to help create profits for the private investor.

24. Sir Robert Clark's advice on this point is that "the ability to make loans to the new company from the National Loans Fund would not necessarily be objectionable provided it was up to the Board of Directors of the company as to whether those loans were drawn on any particular terms and no element of compulsion was involved." The informal view of the British Airways management is that, while they would welcome a continued right of recourse to financial backing from the government, they recognise that they could not have it without strings and might have to do without it as part of the change of regime.

25. The chairman and the chief executive of British Airways, in common with the previous chairman, attach importance to three points, either from the management point of view or from the industrial relations standpoint or both:-

(i) There should be no dismemberment of the airline or disposal of profitable parts of the business.

(ii) The share issue should put only a minority holding in private hands. Although this in itself could have the effect of a "BP solution", and it could be argued that a further move to a majority private sector shareholding would not make a radical difference, the latter course would be more likely to be seen as "denationalisation" and attract a hostile reaction. Moreover, retention of a majority holding by the government would give a greater degree of assurance that the business would not be dismembered.

(iii) The airline should be assured that it would not lose existing routes or forego possible further routes. (On this see also paragraphs 31-34 on Civil Aviation Policy).

26. Subject to these points, privately they would see advantage in the change as providing an extra discipline in support of their efforts to improve the airline's industrial and commercial performance.

A British Airways Subsidiary (Option B)

27. Another approach would be for the British Airways Board to set up an undertaking, as it has power to do under Section 2 of the

1977 Act, in the form of a company subject to the provisions of the Companies Act, to provide all the services and carry out all the operations of the airline; all the shares would initially be held by the British Airways Board. Under Section 4 of the Act the Secretary of State could issue directions, by means of a statutory instrument, requiring the Board to dispose of part of the shares, provided that this course did not impede or prevent the proper discharge of the Board's duties.

28. There is, on the face of the matter, nothing in the legislation to prevent such a course, and it should be possible so to arrange matters that the proceeds of the disposal were paid over to the Government. If a specific plan of action on these lines were to be contemplated, it would be desirable to get a firm legal opinion on the plan.

29. Sir Robert Clark has commented as follows:-

"So far as the marketability of a minority interest is concerned there are in my view no practical differences between option A, a new company, and option B, a subsidiary of the existing statutory corporation. The key factor would be the extent to which the Government would reserve powers to use its influence and I deal with these in a separate section below.".

30. However, under this method, neither the Department of Trade nor the Board would divest itself of any of its powers and obligations under the existing legislation. The subsidiary would therefore have to be set up in such a way that the Secretary of State and the Board remained able to discharge these functions. A statement of policy could be made about the commercial basis on which the company was to operate, but this could not override the provisions of the existing legislation. The Department of Trade and, informally, the British Airways management consider that, notwithstanding the convenience of avoiding the need for new legislation, this course would not provide the basis for a successful equity issue.

Civil Aviation Policy

31. The airlines and the public will need to know the government's intentions as regards civil aviation policy, in the sense of the allocation of routes and the extent to which competition is allowed or restricted. These matters are regulated by the Civil Aviation Authority but, whereas a licence from the CAA is sufficient to enable an airline to fly on a domestic route, international routes also require the negotiation of an agreement between the governments

of the countries concerned.

32. In February 1976 the government issued a White Paper on Future Civil Aviation Policy (Cmnd 6400) which included guidance to be observed by the CAA in its licensing activities. The White Paper set out the respective spheres of interest to be enjoyed by British Airways on the one hand and British Caledonian Airways on the other.

33. The decision of the Court of Appeal in the Laker case (Laker Airways v. Department of Trade 1977 1 ALL ER 182) undermined the legal basis of the Guidance; and other developments in civil aviation since 1976 make it desirable to reconsider the existing Guidance. One line of thought is that the existing pattern of long-haul services, where in general British operators compete with foreign operators rather than with each other, should be accepted as the starting point for any new guidance; and that the various airline networks should be allowed to evolve in response to changing commercial circumstances. This would mean in effect asking the CAA, in considering applications for licences, to take account of the effect on existing services provided by British operators without attempting to impart any geographical bias. It is not yet clear whether guidance to this effect can be given effectively without an amendment of the Civil Aviation Act 1971.

34. There is no reason why a change in the status of British Airways or the method of financing it should in itself affect the aspects of civil aviation policy discussed above. If the Government approves either this or some other line of approach, a statement of policy would presumably be made independently and in advance of any specific proposal for a share issue, and would form part of the background against which the share issue subsequently took place. As has been said, the attitude of the British Airways management towards the share issue, and in their view the attitude of their employees, would be considerably influenced by the place accorded to the airline in the government's future civil aviation policy.

Employee Shareholdings

35. It is envisaged that employees of British Airways would be given an opportunity to subscribe for shares in the airline. Page six of Sir Robert Clark's letter sets out his comments on the degree of preference which could be accorded to employees. Detailed arrangements on this and other aspects of a share issue would have to be worked out nearer the time.

36. Both Sir Robert Clark and the British Airways management have reservations about the importance of employee shareholdings from the industrial relations point of view. British Airways attach much more importance to the points listed in paragraph 25 above. However, they would see preferential treatment of employee applicants for shareholdings as a possibly useful supplement to the package.

Implications for Public Expenditure and the PSBR

37. All borrowings by public sector bodies, whether from the National Loans Fund or the market, are counted in the Public Sector Borrowing Requirement (PSBR), and the classification of public sector bodies depends on the nature of the public sector's control over them. Under present statistical conventions, the creation of a new company to carry out the operations of British Airways, and its financing by share issues, would not reduce the public expenditure figures or the PSBR so long as the company was effectively controlled by the government. However, even if the government held a large proportion of the shares, it is understood that the company need not be treated as a public sector body for these purposes, so long as the government stood aside from control over its management as it has done in the case of British Petroleum.

Implications for British Caledonian

38. The remit for this study included a request to consider the implications for British Caledonian Airways, the "second force" in British civil aviation, if British Airways become a company with a degree of private equity finance. It is not expected that the entry of British Airways into the equity market would adversely affect British Caledonian's ability to raise finance. British Caledonian might see some improvement in the respective competitive positions of the two airlines if British Airways no longer had government financial backing. But it must be assumed that their expectation of routes under the government's civil aviation policy would be a much more important matter for them, just as it will be of great importance to British Airways from the opposite standpoint.

Timing

39. Sir Robert Clark suggests that, from the point of view of issuing a prospectus, the first possible opportunity for a share issue might be in December 1979, and the next opportunity might be

in June 1980. However, he recognises that the need for legislation could affect the timetable, and he also comments that an achieved level of profits would have an advantage over a forecast of profits.

40. The firm view of British Airways themselves is that they should have two clear financial years beyond 1978-79 in which to achieve a good profits record, and also in which to concentrate on their development programme itself rather than on a new capital structure and method of finance. On this basis the earliest date for a share issue would be in 1981, and the necessary legislation would have to have been passed not later than the 1980-81 session. This seems a more feasible timetable.

June 1979

Questions on the Market Aspects

Option A is a free-standing company. (Legislation required.)
Option B is a subsidiary. (Possibly no legislation.)
Option C is a quasi-equity in the existing organisation.

What would be the marketability under Options A and B respectively of a minority share issue (i) in the existing capital and (ii) to raise new capital? Would (i) have to precede (ii)?

How far would marketability under Option A be affected by (a) retention of government safeguards (b) continued power to provide Government finance?

What assurances on government policy would be needed?

What would be the pre-conditions for a successful issue other than those already covered?

What would be an appropriate timetable?

What would be the basis of the issue price? Profit forecasts? Would the net assets figure have any relevance?

Can you put any rough orders of magnitude on the sums?

What preference could be given to employees subscribing for shares eg. as regards amounts and prices?

Could employees get free shares?

Any other comments on employee participation?

Is Option C a starter for issue either to the general public or to employees?

Would there be any effects on the position of other existing companies in the industry?

Any other comments?

SIR ROBERT CLARK
CHAIRMAN

HILL SAMUEL & CO. LIMITED
100, WOOD STREET,
LONDON, EC2P 2AJ
01-628 8011

13 June 1979.

Sir Leo Pliatzky, KCB,
Permanent Secretary,
Department of Trade,
1 Victoria Street,
London SW1H OET.

My dear Leo,

As promised at our meeting last Monday I am writing to confirm the view I gave in answer to the specific questions you put to us about the project we discussed. So far as possible I have dealt with the various matters in this letter in the order in which they appeared on the sheet of paper you handed to us.

1. The various options.

First of all I do not believe that option C is a starter even for an issue to employees. The difficulty arises because before a quasi equity in the existing organisation could be issued to a third party it would be necessary to provide some substitute to the legal background for such participation contained in the Companies Acts. It would I suppose be possible to pass an Act the provisions of which converted the existing statutory corporation into a Companies Act corporation but this would seem to have no advantage over option A.

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So far as the marketability of a minority interest is concerned there are in my view no practical differences between option A, a new company, and option B, a subsidiary of the existing statutory corporation. The key factor would be the extent to which the Government would reserve powers to use its influence and I deal with these in a separate section below.

2. New shares or existing shares

Provided the financial structure of the company is stable so far as can be foreseen at the time of the issue there would be no difference in marketability between an offering of new shares and an offering of existing shares or a mixture of the one and the other. There is therefore no need for an offering of existing shares to precede an issue of new capital or vice versa.

3. Effect of retention of special powers to the Government.

I see no difficulty with one or two of the retained powers which you mentioned. For example an obligation to place the undertaking at the Government's disposal in time of War or emergency would I think be regarded as perfectly reasonable; the ability to make loans to the new company from the National Loans Fund would not necessarily be objectionable provided it was up to the Board of Directors of the company as to whether those loans were drawn on any particular terms and no element of compulsion was involved. The initial Board would be appointed by Government; thereafter nominations would be proposed by the Board but, with its majority shareholding, individual names would have to be approved by Government. I believe it is essential that if the general public are to become shareholders, the corporation must be conducted as nearly as possible as a private sector public quoted company.

However when it comes to other matters such as the specific approval of capital expenditure plans, the setting of financial targets, the approval of specific borrowings, the giving of directions on national interest matters and on the organisation and activities of the company generally

I think that the specific retention of specific powers for the Government would have a material and in most cases, fatal, effect on the marketability of a minority interest on the Stock Exchange. However voting control will give control of such matters as overall borrowing powers and the provision of new capital.

In practice there would naturally be a whole host of matters on which the Government as majority shareholder would expect to be consulted and on which its views would naturally be taken into account by the Board of the company. However relations between the majority shareholder and the company would have to operate in the normal way, i.e. the only remedy which the majority shareholder has in the event of a disagreement between it and the Board of the company is the removal of that Board by operation of the majority shareholder's voting power. Clearly that is not a very practical remedy.

4. Necessary assurances on Government policy.

The only other assurances required would be that the Government policy would permit the creation of a commercial environment in which the new company, like its competitors in the industry, stood a reasonable commercial prospect of success.

5. Timetable.

It is a Stock Exchange requirement that the audited figures contained in the Prospectus contain accounts made up to a date no earlier than six months prior to the date the Prospectus is published. Furthermore, although it is sometimes done I do not think it is desirable to include in a Prospectus published in the first half of a company's financial year a forecast of profits for the full financial year then current; such a forecast which would be likely to be made before the first quarter of the new financial year had ended, generally exposes the Directors of the company and other sponsors of the issue to an unacceptable degree. Although it would be normal to set out in some detail the assumptions on which any forecast is based, the reputation of all involved suffers if the forecast is not achieved and, additionally, the shares are "blighted" in the market and normally take some time to recover.

It follows from this that there are two alternative timings normally available for a company wishing to go public. The first moment is early in a financial year and just as soon as the audited accounts for the previous financial year are available. In this case although it is necessary to make some general comments about trading in the new financial year it would not be normal to make a forecast for the reasons I have explained. The second moment is in the second half of a company's financial year once audited accounts for the first six months of that financial year are available. In the case of this timing it would be normal to make a forecast of profits for the full year. The risks attendant on such a forecast are somewhat reduced since the first six months' results are known and management accounts have also given some indications of the likely results for the first few months of the second half.

The overriding necessity, if the public are to be shareholders, is the satisfactory state of the corporation at the time of issue. There must be :

(i) an adequate record of profits over say the preceding three years (any exceptions being explainable) and a confidence, whether express or implied under the terms of the preceding paragraph, that this is a continuance of a trend,

(ii) an adequacy of financial resources, in the absence of unforeseen circumstances, for say two years, and

(iii) a balance sheet and profit record which demonstrates an ability to raise further equity or loan capital.

Applying this to the case under consideration in the light of the anticipated profits contained on your schedule, it seems to me that the first possible opportunity would be in say December 1979 in which case the Prospectus would contain audited accounts for the half-year ended 30 September, 1979 and a forecast for the full year ending 31 March, 1980. The next opportunity would be in say June of 1980, in which case the Prospectus would contain audited accounts for the year ending 31 March, 1980 but no forecast of profits for 1980/81.

Presumably whether legislation is required will have some effect on timing as will any desire by HMG to obtain the highest possible value for any shares sold. In this context the price/earnings ratio applicable to a forecast of profits would be marginally lower than that applicable to an achieved level of profits.

6. The basis of the issue price

The issue price would be based on the forecast or achieved profit figure for the latest year contained in the Prospectus. Net assets would only have marginal relevance.

I find it somewhat difficult to put even approximate orders of magnitude on the sums involved. The price achieved would depend upon general Stock Market conditions at the time and in particular how the particular industry was then regarded by investors. I base the following opinion upon the figures which you gave us and these will obviously need review in great detail if you proceed. However, were the operation being done in current conditions the price/earnings ratio which could be expected to be achieved as a multiple of fully taxed profits would be of the order of between five and seven times. Applying these ratios to the forecasts contained in your schedule (which we understand are after deducting only the relatively tiny amounts of taxation actually estimated to be payable) gives a value for the whole of the corporation of between approximately £300 million (based on a five times multiple of fully taxed 1979/80 profits) and approximately £475 million (based on a seven times multiple of fully taxed 1980/81 profits).

7. Employee preference

Normal Stock Exchange practice is to permit up to ten per cent of the number of shares offered to the public to be allotted to employees on a preferential basis as to allotment but not as to price. I see no reason why in the case of an issue of this size and where there are a very large number of employees the Stock Exchange should not give favourable consideration to increasing the proportion of the issue which could be allotted preferentially to them.

Giving employees preference on price is a taxation matter. Certainly free shares issued to employees, except those issued under currently permitted Share Incentive Schemes would result in the employee being taxed at his highest marginal income tax rate on the market value of the shares received.

It is however sometimes possible to argue that the market value of the shares in a company prior to the public flotation is in fact lower than the value ultimately attributed to them in the Offer for Sale. The amount by which the value is lower when unquoted depends on how long before the quotation that value is established and the degree of uncertainty which can be attributed to the likelihood of flotation at the time. It would I think be possible to allow employees to buy shares say three months before the Offer for Sale took place at a discount of 15 or 20 per cent on the then likely Offer for Sale price; however this might be difficult if for any reason the operation did not in the event go ahead and any arrangement whereby the employee had the right to sell the shares back again might vitiate any tax benefit.

My only general comment on employee participation is that I doubt whether, in a large organisation, it gives the employees sufficient sense of sharing in profits to change the industrial relations climate. In my experience there is not vast enthusiasm in these instances from the general body of the work force and, where shares are acquired, unhappiness arises should they fall below the issue price. This is a rather superficially expressed view of something which would merit detailed consideration.

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8. Other pre-conditions for a successful issue.

It would be crucially important to be able to demonstrate, and for the sponsors of the issue to be satisfied, that the company could be expected to finance itself adequately for a foreseeable period following the issue. From the indications of capital requirements you gave me it seems that, provided taxation is not payable at a higher rate than estimated and provided profits of the orders of magnitude forecast are achieved, debt/equity ratio does not rise above the 1 - 1.2 level. I think investors would regard these as reasonable.

I have assumed, which I believe to be broadly correct, that dividends payable following a public quotation would not be materially different from figures contained in your forecasts.

I have one general comment on financing: that is that the new company may have some difficulty in obtaining borrowings on an unguaranteed basis so long as there are Government-guaranteed borrowings in existence. It may therefore be necessary for its guaranteed borrowings at the point of flotation to be transferred to HMG and converted into NLF borrowing, if that is structurally possible. For this reason it may be desirable in the period up to quotation for NLF borrowing to be increased and for outside borrowing under HMG's guarantee to be decreased so as to reduce the problem to a minimum when the operation takes place.

I hope that I have not dealt with the matters at too great length or in too much, or too little detail. If you or Gavin Dick have any further questions I would be delighted to call upon you and try and answer them or to help in any other way I can.

Yours ever

JB.