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Prime Minister

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Told Caroline
Yes
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For discussion at Wednesday's
meeting. Mr Jenkin asks if Sir P
Carey may attend. Agree?

MLS 16/4

BL'S FUTURE STRUCTURE

We are meeting on 21 April to discuss the BL Board's proposals on future structure. Your Private Secretary's letter of 22 March set out your comments and questions on my minute of 16 March. I have also seen the Chancellor's letter of 6 April. I apologise for the length of this minute but the issues are complex.

BL's requirements for public funds

2 It is clear to me that in the context of the Government's overall economic strategy the key issue we must consider is BL's likely claim on the PSBR beyond the present year. Broadly, I believe that the company is on course to contain its call in 1981-82 and 1982-83, taken together, to the £990m announced by Keith Joseph in January 1981. (I cannot exclude the possibility that up to £100m or so might slip forward out of 1982-83 into 1983-84, just as that amount has slipped from 1981-82 to 1982-83, because of the timing of redundancy payments, capital expenditure payments and working capital: but I would see such deferment as a benefit to be welcomed, not something to be penalised). But there remain the high risks we have previously perceived. On the Cars side, a sudden collapse in the UK car price level to match continental prices could have quite serious effects; on the Leyland Group side, the future of the truck business will continue doubtful, until it is seen whether the drastic surgery currently in hand, (and which led to the strike which BL faced out successfully) leads to the recovery which similar surgery on the Cars side seems likely to produce.



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3 Beyond 1982-83, however, BL have always maintained that they will need additional equity of £150m, to be drawn in 1983-84. We have never said "yes" or "no" to this request, which has been explicitly left on the table. (I deal below with the question you raise about the assurances offered by the present Board to live within this £150m).

4 However, given the likely public expenditure constraints over the next two years, I think we must now tell BL that this £150m will not be available from the Exchequer and that they must do what any normal private sector company struggling for survival and recovery would do - realise saleable assets to finance the rest of the business. I have therefore come to the view - without further consultation with Sir Michael Edwardes who does not yet know of this proposal- that BL should be told we will not provide the full £150m, and that they must realise Land Rover by the end of 1983 to find the finance for the rest of the business. Depending on the net receipts from the sale of Land Rover, we would want to consider what steps should be taken if further finance turns out to be needed.

Sale of Land Rover

5 In favouring early realisation of Land Rover, we would have to reconcile conflicting objectives - speed of sale; maximisation of proceeds; a wide spread of shareholding; reduction of vulnerability of Land Rover itself to disruption spreading from the other businesses; assurance of continuity of supply for defence purposes; assurance of continuity of manufacture in the UK. My own priorities between these would be to maximise sales proceeds, to ensure continuity of manufacture in the UK and so to protect defence interests.

6 Against this background I have considered the various possible methods of privatisation. Main options are:



- (a) Flotation: I note the Chancellor's preference for this, and I understand the advantages in terms of wide spread of shareholding and (probably) continuity of UK manufacture. However I suspect that Land Rover has too narrow a market base to find a secure future as a free-standing quoted company. It has, effectively, only one rather narrow product range; and its overseas markets, though widely spread geographically, are largely in unstable parts of the world. [Land Rover exports 80% of its output]. It may therefore appear too vulnerable to stand alone and so prove unattractive to investors. As to timing and proceeds, a flotation could not take place immediately and would yield a lower price. I agree with the consultants' view that given the need to complete separation of financial services, establish a track record (Land Rover has been a self-accounting unit from 1 January 1982) and prepare a prospectus, a flotation could only just be contemplated 18 months from now.
- (b) Sale to a conglomerate [e.g Lonrho]: this could probably be done quickly at a fair price but there would be a risk of an embarrassing re-sale at a premium, and assurances that production would stay in the UK would be of doubtful value.
- (c) Sale to an engineering or defence company (e.g Vickers, GKN): this might provide a viable industrial context for Land Rover, but without testing the market I cannot know whether any suitable company would have the funds or want to expand its vehicle interests.



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- (d) Sale to another vehicle manufacturer: this is much the most likely form of outright sale, and could probably be achieved fairly quickly; but a fair price could only be achieved at the right time which is not this year. The world vehicle industry (Japanese possibly excepted) is short of ready cash. We should need to consider the wider implications (for example political and defence considerations) of selling Land Rover to a foreign company; and we should be exposed to the risk that manufacture would be shifted progressively overseas, so that the sale would be more the disposal of the design and marque than the transfer of ownership of an ongoing UK business. We should be vulnerable if this were seen publicly as a major risk, since it would raise questions about our motives in selling the company.

7 I am unable to estimate proceeds very precisely, but as a guide I would expect BL to realise very approximately £150m from a sale of Land Rover to another company at the right time (i.e. not under immediate duress), and significantly less for a flotation. However, the disposal of such a large part of BL's assets would be likely to trigger the premature repayment of up to about £75m worth of loan stocks and related borrowing, which might then have to be refinanced. This could be done, but as BL's asset base would be narrower, it would probably be at the expense of other loans which the company planned to negotiate.

8 I conclude that BL should be asked to sell Land Rover (but not Freight Rover, the light commercial van operation which is really part of the Truck operations); that the sale should be to another company, preferably but not essentially a UK owned one; that transfer of ownership should take place before the end of



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1983; that BL or its successor companies should be allowed to retain the proceeds subject to approval of the 1983 Corporate Plan due this autumn; and that continuity of the UK as the centre of manufacturing and R&D operations should be a covenant requirement in such a sale. We should be in no doubt that this last point will be very difficult to guarantee, as we found with Peugeot's assurances when Linwood was closed; but it is essential that reasonable assurance should be secured that Land Rover will stay in the UK and continue to base its operations here.

9 In taking this decision, we should be fully aware of the difficulties it will raise. First, it will lead to accusations that we are dismembering BL as a preliminary to closure; there is at least a significant risk of major industrial action in other parts of BL which could lead to closure of volume cars operations. Second, there are undoubtedly (as the consultants confirmed) important inter-dependencies between Land Rover and the Leyland Group, whose rupture unless handled carefully could be particularly serious for the recovery prospects of the Leyland Group. For instance, Land Rovers and Leyland trucks are assembled in the same assembly plants in most of the English speaking territories in Black Africa: the six most important of these markets account for nearly 20% of Leyland Vehicles' exports, and 10% of Land Rover's exports (25% of their kit exports). Given time, these links can be reconstituted on a contractual arms-length basis where appropriate, and damage to the Leyland Group minimised. Third, there will be an adverse morale effect in the less successful parts of BL if the "jewels in the crown" are removed, and this will reflect on performance.

10 Finally, I have little doubt that this proposal will be fiercely resisted by the BL Board (especially as we have not yet been told the first results of the feasibility study they have been conducting with Hill Samuel). But our stance must be that



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it is the only way BL can have further funds after the £990m. We should also present it to the BL Board as a condition of accepting the Board's view on structure, which I discuss below. Nevertheless we must accept the probability of a major row with the BL Board, which is likely to become public very quickly and which could well lead to threatened resignations of some or all of the Board.

Future structure

11 Against this background, the question arises whether it is nevertheless right to proceed with the Board's proposal, which I have advocated, to split the company into two.

12 I believe the logic of that split is largely unaffected by sale of Land Rover. The management burden of the remaining volume businesses will continue to be very large for a single Board; and the synergy between Cars and Leyland Group is minor. It is possible that the timing of Land Rover sale, in relation to implementation of the two-way split, would present problems; but I propose that we should tell BL that, subject to their own views on this point, we should be willing to accept the two company plan.

13 You suggested that if Sir Michael Edwardes is not staying on it is his successor who should have the main say in any changes in the structure of the company which are to take place. I question this. It must be for the Government as owner to decide on the structure of the company and then to appoint the Board or Boards to manage that structure. I do not see how this could be left to a new Chairman to recommend.



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New Boards

14 You asked what plan the Department has for ensuring that the strength of the Boards and the managements of the two new companies would be adequate for the tasks facing them; and the Chancellor has expressed doubts about the adequacy of the two potential Chief Executives. Sir Michael Edwardes has proposed that Mr Ray Horrocks should be the Chief Executive of the new Cars company, with Sir Austin Bide as part time Chairman; and that Mr David Andrews should be Chief Executive of the new Commercial Vehicles company with another of the non-executive members as part time Chairman (possibly Sir Robert Hunt, who is due to retire from Dowty in about 18 months' time, but I have not, of course, consulted him). I consider that the ability and personal qualities of these members of the present Board were under-estimated by the consultants; and that in particular, Mr Horrocks and Sir Austin Bide, who now has a good deal of time available from his duties at Glaxo, would make a very good team on the Cars' side and complement each other well. We also have a very high regard for the abilities of Mr Andrews. If Sir Robert Hunt were unwilling to serve, or if we felt him not ideal for the job, an alternative non-executive member could be put on the BL Board within the next few months in preparation for taking the Chairmanship of the Commercial Vehicles company. I have not yet formed a view as to whether it would be sensible to accept Sir Michael Edwardes' offer to serve on the two new Boards for up to two years. It might also be necessary to find some additional non-executive members to strengthen the new Boards.

15 Sir Michael is confident that most of the management team he has built up at BL would remain to serve the new companies; but he warns that if the present Board's advice on structure is over-ruled, this would not be the case; that Messrs Horrocks and



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Andrews might not agree to continue (the latter particularly if Land Rover were sold against the commercial view of the Board) and that other senior executives would follow; it would clearly be a very serious matter indeed if we had to find not only a complete new Board but were also faced with a need to reconstruct the top executive management of the company in circumstances of crisis.

Limitations on Government funding

16 You asked about the implications of the BL Board's absolute commitment to the limitations on Government funding envisaged in the 1981 and 1982 Corporate Plan; and the Chancellor commented on the possibility that splitting BL into two would reduce the disciplines on management to contain financial requirements.

17 The BL Board has offered an undertaking to ask for no more public funds beyond the £150m. As explained above, I envisage telling BL that they cannot have the £150m, but must instead realise Land Rover, keeping the proceeds subject to our accepting the 1983 Corporate Plan due in the autumn. I envisage that the Board would be asked for a corresponding undertaking that they would ask for no further funds beyond the £990m plus retention of Land Rover proceeds.

18 As to whether such an undertaking (if offered) from the present Board could be considered binding on the Boards of the two separate successor companies, I believe it would to the extent that they would consist almost entirely of the members of the present Board. As to what would happen if, later on, the need for additional funding became inescapable, there would be the following options:



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- (i) the Board or Boards might consider increasing their private sector borrowing, as you envisage, e.g by way of a new medium term loan with the Government's implicit guarantee under the existing assurances. But this would adversely affect BL's debt equity ratio, and the banks would, on past experience, be reluctant to advance further loans on a poor gearing ratio without a formal Government guarantee. The company might increase its short term borrowings by way of overdraft, but would probably only do this to meet a temporary deterioration;
- (ii) the Board would be more likely to review the Plan of whichever business was causing the trouble. This might lead to additional closures and redundancies, or some other remedial action; or to a decision to liquidate the business concerned;
- (iii) the Board could, despite its commitment, seek additional money from the Government; or, more likely, present the Government with the option of closure or more money. This would leave us with a difficult choice; in order to avert a major closure close to an election, we could feel obliged to put up extra finance.

19 I do not think it is realistic to exclude any particular course in advance - we do not know what situation might arise, and at what time. But that enhances the importance of the commitment the Board is now offering. I do not agree with the Chancellor's view that the assurances of the present Board are of little value.

I do!
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20 As to the Chancellor's point, (that splitting the company would erode financial discipline), I think the reverse of what he suggests may be the case: Boards responsible for smaller companies should be able to keep them under tighter financial control, and thus restrain the need for external finance, to a greater extent than a unitary Board.

Jaguar

21 Finally, you asked whether the accounts of Jaguar could be made up as for a separate unit. At present Jaguar Cars is a distinct commercial operation within the BL Cars Group, but it does not own its assets. It can assess its profit and cash position, but it does not have a separate capital structure. It would of course be possible to draw up full accounts, but as it does not have a separate accounting function, it would take until the end of this year. I do not think it would be wise to take an initiative with BL over the sale of Jaguar at this stage. Jaguar made a trading loss of about £25m in 1981 and is forecast to trade at no better than break even in 1982. Substantial cash outflow is likely to continue for the next two years because of a major programme of capital investment in a new engine and new model for Jaguar which will be launched in 1984. Moreover, many BL volume car dealers depend on Jaguar sales for their profitability, and sale of the business to another company would undermine the dealer network and destroy confidence in the recovery of the Cars business as a whole. Meanwhile, high level talks are taking place between BL and BMW about collaboration on a smaller version of the Jaguar which would replace BMW's present "5 series" model. BMW have expressed interest in taking a minority stake in Jaguar. If these talks come to fruition in the next few months, BMW would contribute to the future capital requirements of BL Cars, and this might lead to an even closer link between the two companies.

how much
money
would
they
put in



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22 I am sending copies of this minute to the Chancellor of the Exchequer, the Secretary of State for Trade, the Secretary of State for Employment, Sir Robert Armstrong and Mr Sparrow; and in view of the defence implications of selling Land Rover, I am also sending a copy to the Secretary of State for Defence together with copies of my minute of 16 March, your Private Secretary's letter of 22 March, and the Chancellor's letter of 6 April.

*CV**for*

P J

16 April 1982

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