SUBJECT cc Master

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10 DOWNING STREET

From the Private Secretary

7 July 1982

bc: Mr. Vereker

BL

The Prime Minister had a word with your Secretary of State yesterday morning about BL. The Chancellor of the Exchequer was also present.

Your Secretary of State said that, after careful consideration by himself and by officials, he had come to the conclusion that the disposal of Land Rover would impose substantial additional costs on the remainder of BL, and that these additional costs would more than offset over the years to 1986 the amount which might come from a Land Rover sale. The analysis, which led him to the conclusion that Land Rover disposal should be set to one side, was set out in a paper circulated by your Secretary of State at the meeting, and attached to this letter.

Your Secretary of State said that he had had a series of discussions with Sir Michael Edwardes and what BL was proposing was a privatisation programme based on a series of collaborative arrangements. In the cars business (Cars and Unipart Group) they were envisaging a minority stake of around 25% from Honda in Austin Rover during 1983/84; in Jaguar a stake of around 25% from BMW also during 1983/84; and the flotation or placement of 40% of Unipart shares in 1984. In the commercial vehicles business (Leyland and Land Rover Group) they were envisaging a stake by Volvo in 1983/84. Your Secretary of State circulated the attached letter from BL dated 2 July (pointing out that the possibilities related to International Harvester at the bottom of page 2 had fallen away, and been replaced by the Volvo proposal mentioned above). What was envisaged was that, following the successful conclusion of these collaborative arrangements, BL would proceed to full privatisation of the Group as a whole via two major groups: the first consisting of Austin Rover and the second of Land Rover with trucks/buses. There would be problems about the allocation of assets and liabilities as between these groups, but these would, no doubt, not be insoluble. The Group would receive the £150 million which had been earlier envisaged, less the cash proceeds from the sale of Unipart. They would commit themselves to this being their last injection of funds from the Government, and they would accept that the Government's guarantee of their credit would lapse at this point. As to Sir Michael Edwardes' successor, your Secretary of State said that he strongly preferred a non-executive Chairman, and was at present thinking that Messrs. Horrocks and Andrews would, under such a Chairman, run

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the businesses. He had it in mind to tie the new Chairman down to a strict time limit, perhaps of 15 months, for the negotiation of the collaborative arrangements.

In discussion, the Prime Minister and the Chancellor of the Exchequer noted that there was a ring of familiarity about these proposals. It was much to be regretted that the sale of Land Rover had not gone ahead in 1979, as the Government had desired. There would be advantage in pushing ahead with this sale now, since early privatisation offered the best prospect for a profitable Land Rover company with an appropriate level of investment. On the other hand, the cash-flow arguments which the Secretary of State had presented were persuasive. On the privatisation plan, there was a good deal of doubt about the practicability of what was envisaged. Would the prospective collaborators actually be prepared to put up any cash? Would they do so once it was made clear to them (and it would be important to make this clear both to the potential collaborators and publicly) that the £150 million less the proceeds of Unipart was the end of Government financial support to the Company? It was hard to resist the conclusion that, once again, the prospect of privatisation was being pushed away - this time, it seemed, to 1984 or later. Finally, there must be considerable doubt about the durability of the present Board's commitment not to seek fresh funding, once the new Chairman was in place. It would be only too easy to argue if, say, one of the elements in the collaboration programme fell away, that a new situation had arisen, and that some fresh funding was required to bring about a successful privatisation.

Summing up the discussion, the Prime Minister said that it would be worth investigating with the Board the prospects for achieving a privatisation programme on the lines which your Secretary of State had set out. It would be essential to secure an unequivocal and durable commitment on the part of the present Board that they would seek no further funds after the £150 million less the proceeds of Unipart. What was required was an earnest of the Board's good faith. Although the present members of the Board would no doubt say that their continued membership of the Board provided such an earnest, the best way forward might be for one of their number to take over the Chairmanship. Sir Austin Bide or Sir Robert Hunt seemed the most likely candidates. Your Secretary of State should explore with the Board the possibility of securing a firm, unequivocal and public commitment on this and on a tightly timetabled privatisation programme. Your Secretary of State should conduct these discussions without commitment, making it plain that, before the Government could reach a conclusion on these matters, he would need first to consult his colleagues.

I am sending a copy of this letter to John Kerr (HM Treasury), John Rhodes (Department of Trade), Barnaby Shaw (Department of Employment), Gerry Spence (CPRS) and David Wright (Cabinet Office). I should be grateful if you and they would give this letter the usual limited circulation.

MS

Jonathan Spencer, Esq.,
Department of Industry.

SECRET

Handed round at Prime Minister's BL Meeting on 6 July 82.

MCS

13

EFFECTS OF AN EARLY PRIVATISATION OF LAND ROVER

1 BL argue that separation of Land Rover will impose substantial additional costs on the remainder of BL. If we wish them to continue with the recovery programme for the remander of BL, therefore, they argue that we shall have not only to provide the £150m for which they have already stated their need, but also recompense their balance sheet for these additional costs to which the proceeds from Land Rover itslef will make only a contribution.

Assessment of BL's Case

2 I told Sir Michael on 27 April (as recorded in my Private Secretary's letter of 6 May) that if the net proceeds of sale fell short of £150m the Government would be prepared to discuss with BL how any financing gap might be filled. I also told him that we had not reached the conclusion we had on the basis of zero or negative net proceeds. If it became clear that would indeed be the outcome, then Ministers would obviously have to look again at the whole question of disposal, or at least of its timing. Since BL's advice is that the net proceeds would indeed be strongly negative in cash terms for the remainder of BL, we clearly have to consider how firmly based their advice is and what account we need to take of it.

3 BL's figures (at Table 1) are founded on merchant bank advice as to the price they might obtain in 1983; on estimates of the costs in loss of synergy between Land Rover and the rest of the company; and for all other matters on the projections in the 1982 Corporate Plan. As regards the first, I am satisfied that the figures (derived from separate but similar advice from Kleinwort Benson and Hill Samuel, which my officials have examined) are realistic estimates. As regards the synergy losses, BL were reluctant initially (for reasons I respect) to put figures on these costs because of their speculative nature. The costs might be less than the indicated range if Land Rover were sold to a non-vehicle UK company who continued to distribute through BL; but against this, the sale proceeds would be much reduced if we restricted the sale to UK companies and excluded the most likely purchasers, foreign vehicle manufacturers. On the other hand, the costs might be much higher if sale of Land Rover were generally perceived as "writing off" the recovery

prospects of the rest of BL. After enquiry I am satisfied however that the estimates provided are not unreasonable at least for the first few years before the scale of the business can be adjusted to the new situation. As to the use of the Corporate Plan projections, it can be argued that more optimistic assumptions would produce better results or alternatively that the figures quoted are all well within the margins of error; I do not think either view is justified, particularly given the scepticism we have normally and wisely brought to our consideration of BL's commercial prospects.

4 , BL's estimates of the cost of separating Land Rover are slightly inflated because of the need they see to restore the debt/equity gearing ratios projected for BL, after the loss of the Land Rover assets and earnings. I do not think this addition is justified; the maintenance of arbitrary debt/equity ratios is to a large extent an academic nicety given the present situation of BL.

5 I do, however, think we have to acknowledge three major categories of cost:

(a) **the** loss of cash flow from Land Rover (£108m up to 1986); on Corporate Plan assumptions, which we believe broadly justified on current judgements, Land Rover cash flow was due to recover sharply, partly through profitability improvement as Land Rover's recent heavy capital investment programme pays off, and partly because the capital programme is itself past its peak and using less cash. It is obviously true that sale of a profitable asset will deprive the seller of the future stream of profits; and the cash flow loss is particularly serious in the years in question for the reasons just stated;

(b) the costs of "loss of synergy" (£50-90m up to 1986); these are basically lost profits hitherto earned by Unipart and by wholly-owned car distribution companies in Europe from Land Rover sales. The higher end of the range allows also for possible loss of sales by the Leyland Group through the weakening of distribution companies in Africa hitherto dependent on Land Rover as well as on Leyland Group volume for viability.

(c) possible higher interest costs (£15m up to 1986) as a result of having to refinance certain medium term loan stocks. BL's Counsel's advice is inconclusive as to whether Land Rover sale would trigger mandatory repayment under the trust deed. (BL also claim on additional £18m interest cost on borrowing to replace the Government equity refused. This item is irrelevant to a calculation of what Government equity is needed to offset the effects of Land Rover sale on the rest of BL and is anyway inconsistent with their claim that they could not borrow on the gearing ratios resulting from the sale and refusal of Government equity.)

These figures are summarised in Table 2.

6 These factors taken together more than offset, over the years to 1986, the amount (£110-145m) which might come from the proceeds of a Land Rover sale (though the phasing of the shortfall is likely to be concentrated in the later years of the period as the sale proceeds come at the start). It thus seems inescapable that, if we want to sustain the rest of BL in line with the Corporate Plan, we should need to provide more to BL in total over this period if Land Rover is sold than if it is not. In this sense, the proceeds are indeed negative, though the 1983 position would be more favourable.

SECRET

TABLE 1

CASH AND EQUITY EFFECT OF LAND ROVER SALE ON REST OF BL: COMPANY'S VIEW

			£'M 1983-1986
1	Government equity sought in 1983-84, as in Corporate Plan*		(150)
2	Proceeds of Land Rover sale		145
3	Adverse effects of Land Rover sale claimed by BL:		
	a) loss of Land Rover cash flow	(108)	
	b) higher interest costs	(33)	
	c) restoration of debt/equity ratios	(41)	(182)
4	Government equity required by BL if Land Rover sold		(187)
5	Add: "loss of synergy" costs		(50)-(90)
6	Government equity required to restore position of BL after Land Rover sale plus "loss of synergy" costs		(237)-(277)

* BL also project net private sector borrowing of approx £100m in this period.

SECRET

TABLE 2

BL: EFFECT OF LAND ROVER SALE ON EXTERNAL CASH REQUIREMENTS

	Adjusted Figures		£'M 1983-1986
1	Proceeds of Land Rover sale †		110-145
2	Allowable Ø adverse effects of Land Rover sale on rest of BL:		
	a) loss of Land Rover cash flow *	(108)	
	b) higher interest costs	(15)-0	
	c) "loss of synergy" costs	(90)-(50)	(213)-(158)
3	Net cash effect		(103)-(13)
4	Government equity sought in 1983-84 as in Corporate Plan		(150)
5	Total Government equity necessary to restore cash position of BL to Corporate Plan base, after sale of Land Rover		(253)-(163)

† This range is that indicated by the Hill Samuel and Kleinwort Benson studies for a 1983 sale.

Ø This item corresponds to lines 3 and 5 of Table 1, except that:

(i) part of the higher interest cost shown in Table 1 relates to the cost of borrowing to replace the projected £150m Government equity (even though BL claim they could not borrow on the resulting gearing ratios): this is inappropriate to a calculation of the Government equity needed to restore the position. The balance (£15m) is the estimated cost (£5m pa) if the medium term loan stocks need to be refinanced at current interest rates. BL's Counsel's advice is inconclusive on whether the trust deed would be triggered by a sale of Land Rover.

(ii) restoration of debt/equity gearing ratios is not allowed for.

* From the Corporate Plan. These may now be slightly on the high side (eg on margins and working capital); but if so the sale proceeds estimates (derived from the Corporate Plan) could also be reduced.

10/8

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2nd July 1982

J. Sterling, Esq.,
Town & City Properties Ltd.,
4 Carlton Gardens,
London SW1.

STRICTLY PERSONAL & CONFIDENTIAL

Dear Jeffrey,

I attach a short note on privatisation and collaboration as agreed at your meeting with Sir Michael on Wednesday.

I must emphasise that there are many complex issues to be discussed both internally here and with the Government before a clear route and timetable for full privatisation could be finalised, and the attached profile should therefore be seen as an illustration of a general approach rather than as a proposal at this stage. As agreed between yourself and Sir Michael, the note is, of course, based on the assumption that the concerns expressed in Sir Michael's letter to the Secretary of State of 25th June are satisfactorily resolved.

Although Sir Michael has seen the note, it has not yet been considered by other Board members - but the Board will have the opportunity to discuss it before they meet the Secretary of State next Tuesday.

Yours sincerely

Roger Holmes

Roger Holmes
Assistant to the Chairman

Registered Office:
35-38 Portman Square, London W1H 0HQ
Registered in England No. 1213133.

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INDICATIVE PROFILE FOR PRIVATISATION

A strategy for full privatisation is being developed for the 1983 Corporate Plan, setting out the options, timetables and financial implications; clearly a pre-requisite of such a strategy is agreement between the Government and the BL Board on the broad objective, e.g. to pursue full privatisation of all BL's businesses as quickly as possible (with early and visible progress to this end) consistent with maintaining the recovery strategy in the Corporate Plan.

As an indication of the general approach which would be adopted in the Plan, the following profile for privatisation is one of the major options to be examined:-

Cars business (Cars and Unipart Groups)

(a) Austin Rover - seek a minority stake of around 25% (or a jointly-owned project company) from Honda during 1983/84 as part of the development of collaboration in the XX project and beyond - this would be unlikely to yield significant cash, but equity participation is already on the table in current discussions with Honda.

(b) Jaguar - seek a minority stake of around 25% (or a jointly-owned project company) from BMW during 1983/84 as part of a major collaborative agreement (already under discussion); failing agreement on this with BMW, aim to float or place 25% of Jaguar shares in 1984 - estimated proceeds £10-15m.

(c) Unipart - the Board has suggested flotation or placement of 40% of the shares in 1984 as a means of partially offsetting Government funding: estimated proceeds £40-60m.

(d) Full privatisation - build on the collaborative deals and completion of the recovery programme to prepare for a full flotation of the Cars/Unipart business as a whole, consisting of majority holdings in the three constituent businesses. If these businesses perform to Plan and external economic factors are reasonably favourable, this may be achievable by 1986/87.

Commercial vehicles business (Leyland and Land Rover Groups)

(a) Explore possible collaboration/disposal of the Leyland and Land Rover Groups (combined) with other manufacturers - separate discussions already under way with International Harvester and the Laird Group.

(b) If none of these discussions are fruitful, seek a minority stake of around 25% in Land Rover by 1984 - estimated proceeds £20-25m.

(c) Proceed in parallel with the recovery of Leyland, so that Leyland and the majority holding in Land Rover can together be floated if not previously sold to another manufacturer. If Leyland recovers in line with Plan, flotation of the combined Leyland/ Land Rover business may be achievable from 1985 onwards.

(d) If Leyland Trucks were to fail to recover and were therefore to have to be closed, dispose of the remainder of Leyland Group and Land Rover as quickly as possible.

Continued

Public Announcement

Statements about privatisation (in principle) could be made publicly just as soon as the succession and organisation issues have been resolved - e.g. in conjunction with the announcement of BL's half-year results in September.

When future funding has also been resolved and the implications of the various routes to privatisation fully discussed, it would then be possible to announce the more specific intention to seek to attract minority stakes into BL's more profitable businesses. Clearly, collaborative agreements would be prejudiced by premature publicity, but in addition to an early announcement of the Leyland/Cummins deal, the current negotiations with Honda and BMW should be concluded within a matter of months and thus enable announcements to be made then about equity participation, if the negotiations have been successful on this issue.

RLH
2.7.82.

Caroline

I've lined up Jill Rutter 87020 DoI. Ind Pol

MCS 2/7

10 DOWNING STREET

1

Prime Minister

Secretary of State for Industry would like a brief word ("10 minutes") about British Leyland – structure and Sir M Edwardes' succession – on Tuesday. We can fit this in.

Agree?

Yes

MCS 1/7

Would you like the Chancellor to be present?

Yes not

MCS 1/7

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