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PERSONAL AND CONFIDENTIAL
COMMERCIAL IN CONFIDENCE

MINISTRY OF DEFENCE
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MO 10/4E

11th June 1986

Dear David,

ROYAL ORDNANCE: FLOTATION

As a result of their discussion this afternoon, Ministers sought further advice on two issues. I have written separately about the position on the order for the 7th Challenger Regiment. I now attach a note setting out possible alternative courses if flotation does not proceed.

I am sending copies of this letter and attachment to the Private Secretaries to the Lord President, the Chancellor of the Duchy of Lancaster, the Chancellor of the Exchequer, the Secretary of State for Trade and Industry, the Financial Secretary and the Secretary of the Cabinet.

Yours

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ROYAL ORDNANCE - ALTERNATIVES TO FLOTATION

The Government has made clear that its preferred course is to achieve privatisation by a public offer for sale of the shares of Royal Ordnance plc, though sales of assets or subsidiaries to third parties have not been excluded. It has indicated that flotation is planned for mid-1986 and it is generally known that a date in July is planned.

2. The immediate alternative to flotation is that the Government would have to face directly all the substantial problems of RO. There is no doubt that the operation needs to be slimmed down and made more competitive so that it can succeed in export markets. Some 4,000 redundancies are planned by the Company. Lord Trefgarne's minute spelt out in paragraph 8 the essential need to get the business into the private sector. Those arguments remain totally valid.

3. If, however, we were left with the Company on our hands, we would need to address several possibilities:

a. Keep RO intact and float later

The integrated nature of RO's business, with a heavy interdependence between Divisions, makes it sensible to sell the Company as a whole. But without the Challenger order, Leeds would face closure in 1988 and this would rule out a flotation of the present Company for several years. Even with the order, a delay in flotation now would bring the demise of Leeds too close to the date of sale, quite apart from the risk of other unforeseen obstacles arising.

b. Detach Leeds and float later

The mechanics of separating Leeds (and perhaps the sister factory at Nottingham) would be complicated but it might be feasible to sell them both to Vickers, who has exposed an interest, within about 6 months. Thereafter, the remaining Company would have to regroup and then develop a track record suitable for a flotation. This would, at best, take a couple of years, provided that the management have the necessary motivation and drive to get on with the restructuring and competitive improvements as referred to above. This would not be easy within the public sector.

c. Sell the whole Company to a private buyer

An early attempt to achieve this was unsuccessful. Both Lord Weinstock and Lord Hanson have been involved at different times, though we were probably then thinking of a higher price. There might be scope for exploring with either, or someone else, again but we cannot hold out much hope of success. There are certainly no current bidders.

d. Sell off in bits

This would have to become an option for examination. It would carry the risk that the attractive parts of the business would be sold, leaving HMG with an unsaleable rump. There might be options for some sort of contractorisation but that is unlikely to bring the same commercial drive as a true privatisation. The only possible 'trade sale' that is on the table is the Vickers' interest in Leeds and Nottingham. At an earlier stage, IMI expressed an interest in buying the Summerfield factory which they manage on an agency basis: this was developed into a joint interest with MEC (a subsidiary of ICI) in acquiring Powfoot, Radway Green and Westcott as well but terms were not discussed and Ministers decided not to pursue the idea.

Under any of these options that retain the Company in the public sector, the Government would face the continuing need to subsidise the Company in one form or another. Without the drive to improve its competitiveness we will see none of the improvements we hope for in the prices we pay for their products and at the same time there will inevitably be pressure to place more non-competitive contracts with them. Moreover, its external financing will continue to score as public expenditure. This is bound to lead us to impose the very constraints from which the management have to be free if they are to get on with the job of slimming the Company down and rationalising its facilities and products.