

# ROLLS-ROYCE LIMITED



Chairman's Office

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March 26 1984

The Rt Hon Margaret Thatcher MP  
Prime Minister  
10 Downing Street  
London SW1

*2.5 m  
leave financing for  
his 70% —*

*Dear Prime Minister,*

Following the announcement in February that formal approval had been given by HMG to the five-nation V2500 project, I have been in discussion with the Secretary of State for Trade & Industry on the level of launch aid to be provided by Rolls-Royce. The most recent offer falls well short of the Company's requirements, and is only about half of the proportion of launch costs which normally has been funded by HMG in the past for viable civil aviation projects.

Since I took over as Chairman of Rolls-Royce twelve months ago, my priority has been to establish a realistic plan under which the Company could return to sustainable profitability, and thus be able to offer at least a 50% shareholding to the private sector within four years. This was a key objective put to me by HMG when I accepted nomination for the Chairmanship of the Company in the summer of 1982, and one which I readily accepted.

The actions since taken to achieve this major objective include:

- (i) reduction of the investment risk and sharing of costs in civil aero engine projects by entering into collaborative deals with United Technologies (and Japanese, German and Italian associates) on the V2500 project, and with General Electric on their CF6-80 engine and Rolls-Royce's -535E4;
- (ii) agreement in principle with GEC on a joint company to exploit gas turbines for industrial power generation;
- (iii) discussion and thus far agreement with European collaborators on the new European fighter and engine and on helicopter engine developments;
- (iv) continued reductions in Rolls-Royce's manpower;
- (v) cuts in expenditure on research and development, in part made possible by (ii) above;

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- (vi) further modernisation of the Company's facilities, notably on new manufacturing methods;
- (vii) establishment of a new management structure which more clearly identifies responsibility for profitability and cost control below the level of Chairman/Chief Executive.

These policies should result in the following financial prospects, excluding launch aid for the V2500:

	£ million (out-turn money)			
	1984	1985	1986	1987
Turnover	1,403	1,651	1,900	2,300
Profit/(Loss) after tax	(8)	(3)	104	228
Cash generated/(required)	(12)	(14)	53	119
Shareholders funds				
HMG equity	508	508	508	508
Reserves	(216)	(219)	(115)	113
	<u>292</u>	<u>289</u>	<u>393</u>	<u>621</u>
	<u><u>382</u></u>	<u><u>396</u></u>	<u><u>343</u></u>	<u><u>224</u></u>
Borrowings (net)	382	396	343	224
Gearing*	131%	137%	87%	36%

\*Borrowings ÷ shareholders funds

Whilst these figures show a progressive improvement, they nevertheless show that until 1987 the equity investment by HMG is diluted by losses carried forward from earlier years, and the gearing ratio is commercially unsatisfactory. Inevitably, the latter years are much less certain and I am bound to say that it is quite unlikely that better results can be achieved. In particular, 1987 has many more downside risks than upside potential. Furthermore, there are significant hazards which apply to all the figures:

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- (i) the results would worsen if the pound strengthens against the dollar, eg \$1.60 : £ in 1987 instead of the assumed \$1.50 : £ would lower cash and profit by some £40 million;
- (ii) they depend significantly on budgetary decisions on purchases by MoD representing annually approximately £500 million of turnover and £40 million on profit/cash;
- (iii) turnover, profit and cash would be substantially less if the assumed recovery in Civil business is further delayed, and if major overseas military programmes (eg Pegasus for the AV8B in the USA) totalling £200 million a year in 1984 and 1985, and rising to £400 million thereafter, are not confirmed.

My judgement is that the Company will need to achieve financial results - profit, positive reserves and gearing - even better than shown in the years 1984-1986 for a convincing prospectus to be written which would return us to the private sector. The provision of launch aid for the V2500 on the following scale significantly improves the prospects of achieving that objective:

	£ million (out-turn money)					
	1984	1985	1986	1987	1988/89	
Requested V2500 support	10	30	50	20	25	£135 million
	10	30	20			

This represents 50% of the estimated UK share of total launch costs expressed in out-turn money, a level which I consider is fully justified in the following circumstances:

- (a) availability of approximately 50% support for the V2500 was always assumed when, with HMG's encouragement, the collaborative arrangements were negotiated in 1982/83, and there was no indication until much more recently that this was in doubt;
- (b) contribution by HMG of approximately 50% of launch costs for viable projects (and the V2500 is generally accepted to be a good project) has been HMG's position for over 20 years;
- (c) an HMG contribution of that proportion (and of a substantially larger amount) has been provided to British Aerospace on the A320; and Westland have had much the same sum for their helicopter projects;
- (d) such aid is accepted internationally, and is the most substantial way in which HMG can support this high technology industry against its competitors, all with their respective large Government assistance: no other form of finance has the same favourable effect on the profit and loss account;

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- (e) the Company is not seeking launch aid for its other new Civil projects, eg the Tay, the deal with GE.

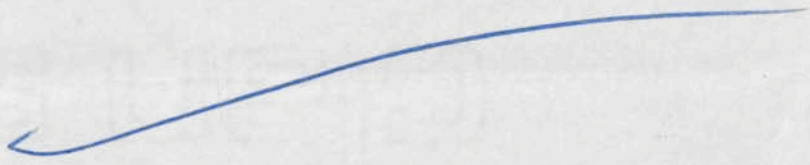
I understand from the Secretary of State that so far HMG is prepared to provide the amounts assumed above for 1984 and 1985, plus up to £20 million for 1986. This amounts to £60 million which is less than a quarter of the estimated total launch costs.

I saw no alternative with so much at stake on the two Civil collaboration deals, but to accept announcement of HMG's public support in principle on the V2500, with the details of aid to be negotiated later. I believe strongly that if the Government does not provide funding for a bigger proportion of V2500 launch costs, with recovery by levy providing a 5% real rate of return to HMG, the Company cannot meet the policy objectives which have been set of privatisation in the lifetime of this Parliament and will be penalised for the efforts it is making to improve profit and cash.

I have already discussed these issues with the Secretary of State, to whom I am copying this letter, and I do hope now to have the opportunity of discussing this situation with you.

Yours sincerely

Bill Duncan



27 FEB 1984



Roms Royce



File SLH  
GR?  
cc BY

10 DOWNING STREET

*From the Private Secretary*

27 March 1984

Thank you for your letter of 26 March which I have put before the Prime Minister. I will be in touch again when she has had an opportunity to consider it.

ANDREW TURNBULL

Sir William Duncan CBE