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From the Minister of State
for Industry and Information Technology

GEOFFREY PATTIE MP

John Moore Esq MP
Financial Secretary to the
Treasury
HM Treasury
Parliament Street
LONDON
SW1

5 December 1984

Dear Financial Secretary,

BRITISH AEROSPACE

When we spoke in the House on the evening of 26 November about the possible disposal of the Government's remaining shares in British Aerospace, we agreed to consider the matter further in the light of advice which was expected from Lazards. This has now been received in the form of a short paper, a copy of which is enclosed. *will request if required.*

The paper considers the two options of disposing immediately of 23.3 per cent of the Government's shares by means of a placing, or alternatively, selling the Government's entire holding by March 1985 by means of a public offer. The pros and cons of these options are clearly set out on pages 8 and 9 of the paper. While I entirely understand the reasons which have lead you to ask us to consider sale of our entire holding, my own view, with which I know that Norman Tebbit agrees, is that the placing option is to be preferred.

It seems to me that, in essence, we face a choice here between a bird in hand and two in the bush. Lazards are confident that the placing option could be carried through swiftly and with minimum of risk in the next few weeks, while the market for equities will almost certainly still be strong as the institutions look for alternative ways of investing funds they had earmarked for British Telecom.

To aim to sell our entire holding, on the other hand, would mean that we were exposed to a number of hazards. Firstly, we would need to negotiate with the company on the creation of a Golden Share and this would give them the opportunity to try to secure some quid pro quo, either related to the disposal of our shares or on other business. The negotiations would have to be concluded quickly, since the Golden Share arrangements would need

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to be ratified by an EGM, for which a minimum of 2 weeks' notice would have to be given. The calling of the EGM would be a clear signal of our intention and it would almost certainly be necessary to make a Parliamentary statement at that stage, particularly as repeated assurances were given before the first British Aerospace offer for sale that the Government had no intention of ever reducing its shareholding below 25 per cent. We could not rule out the possibility of some unhelpful GEC intervention once our decision to sell all our shares became known. Finally, we cannot accurately foresee now what general market conditions might be by February or March but the possibility obviously exists that they will have become less favourable. While I understand your reasons for seeking to dispose of the Government's shares quickly, I strongly believe that the balance of advantage lies with a placing now.

I am copying this to the Prime Minister.

James ...

Nat ...

for GEOFFREY PATTIE

*approved by the Minister
+ signed in his absence*

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Annex A

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MAPA/CW

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28th November, 1984.

Sir Brian Hayes, KCB,
Joint Permanent Secretary,
Department of Trade and Industry,
1 Victoria Street,
London SW1.

Dear Brian,

As promised I have pleasure in enclosing a paper setting out our views on the various City related aspects of the matters we discussed on Monday afternoon. I have had the benefit of discussing the paper with Ian Fraser.

If you have any comments or queries, I should be most happy to discuss them with you.

*Yours sincerely,
Marcus.*

Marcus Agius

C.c. Mr. Roy Croft
Mr. John Michell

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BRITISH AEROSPACE

INTRODUCTION

This paper considers the disposal of all or part of HMG's residual 48.4 per cent. holding in British Aerospace ("BAe"). In particular it assesses the key features of, on the one hand, an immediate placing of 23.3 per cent. of the Company's shares (to be followed at some indeterminate future date by a disposal of the remaining 25.1 per cent.), and, on the other hand, an offer for sale of the entire Government's holding before the end of the current financial year.

PREAMBLE

When shares in BAe were first offered to the public in 1981 provisions were made to ensure, inter alia, that the Company could not fall under foreign control without HMG's consent. These provisions are enshrined in the Company's Articles of Association and could, therefore, be removed by shareholders passing a special resolution at an Extraordinary General Meeting. Accordingly, without having to rely exclusively on the provisions of the Industry Act, HMG must retain at least a 25.1 per cent. investment in the Company in order to preserve the status quo and this sets a limit on the number of shares which HMG could dispose of by way of an immediate placing. Given time, however, the protection currently provided by the Articles of Association could be achieved by other means, for example a "Golden Share", in which case HMG would be free to dispose of the entirety of its holding

This paper represents the views of Lazard Brothers alone. It has not been possible to have conversations with:-

- (a) BAe, to determine its current trading circumstances, its views on the proposals, or its attitude to the issue of a Golden Share;
- (b) the Company's stockbrokers, to learn their views on the current state of the market in BAe shares;
- (c) GEC, to find out whether they are still interested in making an offer for BAe; and
- (d) the Government Broker, to ascertain the state of the new issue queue between now and 5th April, 1985.

Any or all of the above information could have a material effect on the views expressed below.

In all of the following, the attitudes of both BAe and GEC will be crucial.

1. BAe

As is often the way, the fact that BAe has been the object of takeover interest appears to have led to a fundamental reappraisal of the Company by the stock market. Before the announcement of Thorn EMI's interest in BAe, the Company's share price stood at around 250p per share. Since then the price has risen to around 400p before falling back to its current level of around 370p. While there is doubtless some element of takeover anticipation remaining in the share price, the underlying security nevertheless has been re-rated. This fact will serve to HMG's benefit if they seek to dispose of their remaining shares. It would also serve to benefit BAe itself should it wish to have a rights issue. It would, however, be difficult for the Company to have a rights issue in the present circumstances because the market would expect that HMG would not be taking up its rights. Indeed, a rights issue would more easily be effected once the disposal of the Government's shares has taken place. For this reason it might be supposed that BAe would co-operate with the Government in making the necessary arrangements to facilitate the sale of its shares. Such an attitude, however, remains to be tested in practice.

2. GEC

Ideally, public clarification of GEC's attitude to BAe would precede the sale of HMG's shares. It is assumed for the purposes of this paper, however, that no such clarification is forthcoming. In its absence, two risks remain for HMG. First, news of HMG's intention to sell its shares will be disappointing to the market and this will affect HMG either by way of increasing the placing discount or lowering the price at which an offer for sale could be effected. Secondly, it is possible that GEC could embarrass the Government by stating, after the announcement of HMG's intentions, that it would have offered more for the relevant shares by way of a direct sale. Both of these risks appear unavoidable in the absence of co-operation from GEC, but the latter is of lesser consequence in a placing, as compared with an offer for sale, because the exercise will have been completed before GEC will have had time to intervene.

AN IMMEDIATE PLACING

(i) Timing

A placing of existing shares can be a very straightforward matter. It is not necessary to book a place in the Government Broker's "queue" and, at its simplest, the operation merely involves an instruction by the vendors to sell up to a certain number of shares at a predetermined price. No elaborate documentation is required - in particular no prospectus is needed - and the sale can be completed very swiftly, typically during the course of a single morning. Lazard Brothers arranged that HMG's aggregate holding of 25 per cent. of British Sugar Corporation was sold in this way in 1981.

Applications for the British Telecom offer for sale close today, 28th November, 1984, and dealings in the new shares will commence on Monday, 3rd December, 1984. The initial "success" of the flotation probably will have been determined by the end of next week, or by the middle of the following week. The precise timing of the British Airways flotation is not known, but is believed to be planned for mid-February, 1985. Accordingly, there may be a "window" during which a placing of 23.3 per cent. of BAE's shares could be made extending, apart from the Christmas break, from the week beginning 10th December, 1984 to the week ending 18th January, 1985.

Notwithstanding the size of the British Telecom flotation, a placing of the order of £150 million is large by City standards and should not lightly be attempted in uncertain stock market conditions. It appears, however, that the marketing of British Telecom has been so successful that that issue will be substantially over-subscribed. (Indeed, it seems unlikely that the recent vendor placing of £180 million worth of shares in Dee Corporation - the biggest of its kind so far completed - would have been attempted had the success of the British Telecom issue not already been in prospect.) If the issue is over-subscribed then, given the stated objectives of favouring the small individual shareholder at the expense of the large institutions, professional investors will have their applications severely cut back. Accordingly, a good part of the heavy institutional liquidity which has been built up in anticipation of the British Telecom flotation will be available for investment. No doubt some of this liquidity will be used to "top up" holdings of British Telecom by way of purchases in the market from other shareholders. Sufficient should remain, however, to sustain the buoyancy of the stock market in general and so enhance the prospects for a successful placing of BAE shares. In addition the stock market is currently standing close to its all time high and indications are that interest rates on both sides of the Atlantic are likely to continue falling.

Because the practicalities of a placing are so straightforward, the operation could be effected within, say, three days of HMG giving its consent. Although, as already stated, it is not necessary to reserve a specific date with the Government Broker, it would be wise to share HMG's intentions with him first in order to ensure that the placing is not attempted at a time when there is another significant call on the stock market. Subject to the Government Broker's diary, therefore, and the completion of preliminaries, the placing could be attempted on any business day up to Wednesday, 19th December. Thereafter the market will effectively be moribund over the Christmas break until, in effect, Thursday, 3rd January. The placing should preferably be carried out before Christmas in order to take advantage of the momentum generated by the British Telecom issue and the current high level of the stock market and perhaps ideally should take place in the week commencing 10th December by which time the precise allocations under the British Telecom issue will be known. It might also be possible for the placing to be carried out during the first two weeks of January after which time the operation would fall under the shadow of the prospective offer for sale of British Airways.

(ii) Underwriting

A placing of shares can be effected either on a "best endeavours" or on an underwritten basis. Under the former alternative the vendor has no certainty of selling any or all of his shares at the predetermined price. Under the latter alternative underwriters in effect guarantee to buy any shares which the stock market will not take. In the British Sugar example cited above (which was done on a best endeavours basis), although the shares involved also represented around a quarter of that company's issued equity, the sum raised was much smaller being some £44 million. In particular the shares were being sold at a time where a further offer for the company was a strong probability - and indeed that is what came to pass. One part of the shares placed was acquired by British Sugar's suitor and another was used to satisfy a substantial "short position" in the stock market. In those circumstances the placing went smoothly. In the current BAe situation, however, not only is the sum of money involved very much larger but the very act of selling by HMG might well be interpreted by the stock market to mean that the chances of BAe being taken over by GEC are less than had previously been thought. The possibility of the Government's residual stake being sold in the future would also overhang the placing. In these circumstances our recommendation is that HMG should give careful consideration to having the placing underwritten. Not only does the very fact of underwriting normally tend to facilitate the operation but failure - that is to say not being able to sell all of the shares offered in a best endeavours placing - would materially compromise the future disposal of HMG's remaining shares as well as the Company's own ability to raise new money by way of a rights issue.

(iii) Placing Discount

In order to facilitate the placing, the shares would need to be offered to the market at a discount to the prevailing share price. Typically, placing discounts range between 4 and 10 per cent. Without having had the benefit of discussions with the Company's brokers, it seems likely that the discount for the proposed placing would be in the range 8-10 per cent. for the following reasons:-

- (a) the amount of money involved is large in absolute terms;
- (b) it will be presumed that the remainder of the Government's shares will eventually be sold (notwithstanding that this would not be for at least 12 months);
- (c) the likelihood of an imminent bid by GEC will appear to have receded; and
- (d) the placees will not receive their shares in renounceable form (as with an issue of new shares): accordingly they will have to pay 1 per cent. stamp duty and suffer relatively poorer liquidity.

At the current share price of 370p, 23.3 per cent. of BAe's equity is valued in the stock market at approximately £172.5 million and, assuming an 8-10 per cent. discount, an immediate placing would realise for the Government £155.2 million - £158.6 million.

(iv) Practicalities

The practicalities associated with a placing are few:-

- (a) BAe would need to be informed of the Government's intentions;
- (b) broker(s) would need to be appointed, the natural choice being BAe's own brokers since they know best the precise market in the Company's shares;
- (c) a meeting would need to take place to brief the brokers as to the Company's general trading circumstances;
- (d) a press announcement would need to be agreed specifying the Government's reasons for selling its shares and giving an undertaking that no further sales by the Government would take place for at least 12 months; and
- (e) a short Placing Agreement between HMG and the underwriters would need to be prepared if the placing is to be underwritten.

(v) Costs

The costs associated with the exercise would be a fee to the brokers (to be negotiated but normally up to one quarter of one per cent. of the value of the shares placed), a small put-through commission to the brokers (say one sixty-fourth of one per cent.), an underwriting commission if that alternative is adopted (of three-eighths of one per cent.) and an advisory fee.

AN OFFER FOR SALE

(i) Timing

It is assumed that it would not be possible or desirable for the Government to place with professional institutions the entirety of its 48.4 per cent. holding in BAe. Rather, the method used would be an offer for sale. This involves the publication of an abbreviated prospectus describing BAe. (Such a document was used in similar operations in recent years for both BP and Cable & Wireless.) Investors, both professional and private, would be invited to purchase the shares on offer at a predetermined price by submitting applications within 5 days of the prospectus being advertised in the national press. For the reasons described above, however, it is assumed an offer for sale would not take place until the existing protection against overseas control afforded by BAe's Articles of Association had been replaced by a Golden Share arrangement. This obviously requires the full co-operation of the company insofar as the precise terms of the Golden Share would need to be negotiated beforehand and insofar as the enabling resolution would need to be recommended to shareholders by the Board. At the moment the precise reaction of the company to such a proposal can only be a matter for conjecture. The terms having been negotiated, however, the Golden Share arrangements can be brought about by means of a Special Resolution at an Extraordinary General Meeting of shareholders at which HMG could vote. It seems unlikely that all of this could be achieved prior to the British Airways flotation next February. If the BAe shares are to be realised by the end of the current financial year, therefore, the offer for sale presumably would need to take place in March, 1985. It is understood that the Government Broker's queue is already filling up for that period and, therefore, early selection of a date is desirable if this option is to be followed.

(ii) Price

The announcement of the creation of a Golden Share in BAe will effectively serve notice on the stock market of the HMG's intention to dispose of its shares. Indeed, there may well be merit in HMG making plain its intention in due course to dispose of its BAe shares. This is likely to have a depressing effect on price for two reasons. First, the sale will overhang the market and secondly, once again, it will be assumed that HMG would not plan such a sale if it had reason to believe that an offer for the Company from GEC was a realistic prospect in the short term. What effect this would have on price is impossible to determine this far in advance but does not seem improbable other things being equal, for the resultant fall in the share price to be of the order of 5 per cent. On the other hand, once the immediate shock has dissipated, past experience suggests that there could be a relative firming of the share price in the run up to the offer for sale. In addition the actual price at which the offer for sale could be effected would be at a relatively narrow discount to the then prevailing market price, say of the order of 3-5 per cent., if the shares are offered on a fixed price basis. In certain market conditions, it may be more advantageous to offer the shares by way of tender.

(iii) Practicalities

So far as practicalities are concerned, the following would need to be organised:-

- (a) fix the date of issue with the Government Broker;
- (b) negotiate a Golden Share arrangement with the Company;
- (c) call and hold an Extraordinary General Meeting of BAe shareholders;
- (d) prepare an abbreviated prospectus and application forms - this should include an estimate of BAe's results for the year to 31st December, 1984 together with a forecast of the final dividend for that period;
- (e) advertise the prospectus in the national press;
- (f) prepare an underwriting agreement;
- (g) incorporate provisions in the offer for sale arrangements to prevent, say, GEC attempting to acquire a disproportionate amount of the shares on offer;
- (h) choose between a fixed price or tender offer depending on market conditions at the time; and
- (i) if desired, incorporate provisions for BAe employees to apply for shares on a favourable basis.

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(iv) Costs

So far as costs are concerned, ad valorem commissions would be chargeable, made up as to three-eighths of one per cent. underwriting commission plus an advisory fee, one and one-quarter per cent. sub-underwriting commission and up to one-quarter per cent. overriding commission to the brokers. In addition there would be costs involved in advertising, printing and postage as well as fees for the accountants involved in preparing the Company's profit estimates.

SUMMARY

The arguments for and against an immediate placing of part of HMG's holding in BAe and an offer for sale of all of it appear to be as follows:-

1. Placing

Pros

1. Quick, easy and relatively cheap;
2. Takes advantage of known favourable market circumstances both as to liquidity and level;
3. Sudden impact takes some advantage of the takeover speculation in BAe's share price;
4. Denies GEC the opportunity of intervening;
5. Hedges HMG's position should GEC bid within the next 12 months; and
6. Requires relatively little co-operation from the BAe management.

Cons

1. Remaining shares cannot be sold for 12 months;
2. Shares are placed with professional investors rather than private individuals; and
3. Further sales prejudiced if best endeavours placing "fails".

2. Offer for Sale

Pros

1. Disposes of all the shares; and
2. Achieves wide spread of shareholders (including employees if desired).

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Cons

1. Market conditions post British Telecom and post British Airways cannot be forecast now and may not be so favourable.
2. Announcement of proposal to introduce a Golden Share might interfere with the British Airways flotation.
3. Anticipation of offer by the stock market would affect the price at which the operation is effected.
4. More expensive than a placing.

MAPA/CW
28th November, 1984



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