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SECRET

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PRIME MINISTER

Future of Land Rover Leyland
MISC 126(86)4 and 5

BACKGROUND

The Group has two new papers. MISC 126(86)4 provides further information about the financial performance and prospects of all the BL businesses involved, together with Bedford vans and trucks, and surveys the recent performance of the European commercial vehicle industry and the market prospects for vans and trucks in the UK and Europe. MISC 126(86)5 assesses the alternative proposals received by BL.

Financial Performance and Prospects

2. The first paper shows that the European van and truck industry has faced a difficult five years, and holds out little prospect of major improvements between now and 1990. It also shows how much worse the UK industry has done than its continental competitors, despite the fact that the fall in the UK truck market between 1980 and 1985 was only about 10 per cent, as against 15 per cent in the European truck market. Import penetration of the UK van market increased from 24.5 per cent to 36 per cent over this period, and of the UK truck market from 21 to 37 per cent. The export performance of the UK industry was even worse, with the result overall that UK production of vans has fallen by about 45 per cent since 1979, and that of trucks by about 60 per cent. Meanwhile although the production of Land Rover and Range Rover has remained broadly flat since 1980, their share of the UK market has fallen from 64 per cent to 42 per cent (largely through Japanese competition).

3. The financial picture is equally depressing. Following several

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years of substantial losses, borrowings attributable to trucks and buses amount to £320 million (of which trucks nearly £200-260 million), and those attributable to Land Rover and Freight Rover to a little more than £80 million. On current projections, Leyland Trucks are expected to return to operating profit in 1987, but remain in (relatively small) cash-flow deficit to the end of the decade. In so far as these (or any other vehicle manufacturers) forecasts can be trusted, the outlook is, however, better than that of Bedford; both the manufacturing capacity and the vehicles themselves are of good quality, and Leyland are at least holding their market share in the UK, while Bedford's is falling. Land Rover is forecast to have positive profits and cash-flow throughout the remainder of the decade, but this is before any allowance for the (expensive) establishment of a US marketing operation and may not allow enough for product development in later years. Freight Rover is projected to remain in profit until 1990, but at a declining level.

Alternative Proposals

4. The evaluation of the proposals contains nothing really new. The conditions attaching to the £76 million note offered by GM seem to have been significantly improved. This confirms the commercial superiority of the GM bid. The Schroder/Management buy-out proposals (which exclude Leyland Trucks) would have a high gearing, with equity accounting for only about 30 per cent of the initial balance sheet. Although the business forecast shows a positive cash-flow, which if achieved would make it easier to raise additional equity to finance product development, the Company would not start out from a position of strength. It is not clear how the Lonrho bid (which excludes Trucks and Freight Rover) should be judged; large demands have been made for additional information, which would in any circumstances be difficult to satisfy quickly. Aveling Barford's bid (for Land Rover only) makes little sense, since it seeks to separate Range Rover from Land Rover despite the integrated manufacturing facility. Lancashire Enterprises Limited and the West Midlands Enterprise Board have been given until 14 March to declare their hand; it seems inconceivable that they could prove serious contenders.

5. Not surprisingly, therefore, the BL Board's preliminary preference - they have yet to take a firm decision - remains for the Salton deal. Given the Board's legal duty to act in the best interests of the Company, a Government decision in favour of disposal arrangements at prices totalling less than the £230 million offered by GM would clearly create problems. Furthermore the lower the price at which the businesses are sold, the larger the eventual debt write-off (effectively in favour of Austin Rover) will have to be. This could add to the difficulty of securing EC Commission approval for the write-off under the State Aid Rules (discussed in paragraph 15 and 16 of the paper).

MAIN ISSUES

6. The main issue is how to carry the decision-taking process forward. The Trade and Industry Secretary does not give any indication of the GM response to the suggestion that Land Rover should be separated out from the deal and retained in majority UK ownership. This is crucial. GM seem to have resisted any suggestion that the terms of the deal should be varied. Mr Channon will therefore need to know how far he should press GM to accept an alternative solution for Land Rover: should he insist on this to the point of total breakdown of the GM deal?

7. The choices open to the Government appear to be as follows:

(a) The GM deal as hitherto proposed

This remains the best deal from the standpoint of BL's commercial interest and that of future overall employment in the UK van and truck industry. But it carries with it the political costs of foreign takeover of Land Rover, and the shut-down of the profitable Freight Rover plant in Birmingham.

(b) Management buy-out of Land Rover with GM taking the rest

The proceeds from this would probably be some £100 million less than in the alternative case. It is also uncertain whether GM would accept it. They would almost certainly insist on Freight Rover remaining part of the deal with them, since vans are relatively more important to them than trucks. So although this solution would deal with the political problem of Land Rover, it would still be likely to result in the eventual closure of Freight Rover. These problems would remain if GM participated in an independent Land Rover operation; but in that event there would remain the difficulty of GM and the present management effectively competing for control.

(c) An independent Land Rover/Freight Rover, and no GM deal

It would clearly be preferable for GM to take over Leyland Trucks, whatever the solution for vans. But there must be a risk that refusal to contemplate 100 per cent sale of Land Rover to GM will scupper the whole deal. In that event, Leyland Trucks would either have to be carried on as an independent operation or closed. Meanwhile GM might either close their South Bedfordshire operations with a loss of 7,000 jobs, or at any rate rationalise them and rely more heavily on imported designs and components. If Bedfords were to close, the commercial future of Leyland Trucks might be somewhat improved, but much of the Bedford market share would no doubt be absorbed by increased imports. Leyland Trucks would inevitably face an uncertain future as an independent operation; with a continuing cash-flow deficit, Government-guaranteed borrowings would be likely to rise by £100 million or more over the rest of the decade.

8. The Group will thus have to consider whether the attraction of an independent solution for Land Rover warrants risking the collapse of the remainder of the GM deal if GM refuse to contemplate any variation in the Salton arrangements.

HANDLING

9. You will wish to invite the Secretary of State for Trade and Industry to present the issues to the Group, and to report further on his discussions with GM, and in particular to give his assessment of the likelihood of GM backing off if they were pressed. Thereafter the Chancellor of the Exchequer and the Secretary of State for Employment will wish to comment on the financial and employment aspects of the alternative courses open to the Government. The other members of the Group will all wish to express their views.

10. You will then wish to consider how the issues should be taken forward, and on what timescale. If the conclusion were that the original GM deal is likely after all to be the best bet, it would be desirable to secure the endorsement of the Cabinet for this on 20 March, followed by Parliamentary endorsement before the Easter Recess. If GM were to accept, within the next few days, the separation of Land Rover from the main deal (with or without GM participation in Land Rover), then the same timetable could be followed for the basic decision, although the precise details would no doubt take longer to negotiate. If, however, the conclusion were that the overriding objective is an independent future for Land Rover, even if this resulted in GM's withdrawal, an urgent decision would no longer be needed; the final decision could be taken when all the issues had been thoroughly explored and further talks held with GM and any of the other parties involved. The future of Leyland Trucks could then be reconsidered when the dust had settled.

11. The next step will be for the Trade and Industry Secretary to report back to the Group on his further discussions with GM. If a decision is to be taken, announced and debated in Parliament before the Easter Recess, he will need to report back on Tuesday or Wednesday of next week, 18 or 19 March, prior to consideration by the Cabinet.

CONCLUSIONS

12. You will wish the Group to reach conclusions on:

(i) The guidance to be given to the Secretary of State for Trade and Industry for his further discussions with GM.

(ii) A preliminary view on the likely timetable for final decisions, and

(iii) the lines to be taken in reporting the outcome of the Group's discussion to Cabinet tomorrow, and subsequently in response to further questions in Parliament.

J B UNWIN

12 March 1986
Cabinet Office