17.

PRIME MINISTER 25 July 1986

MEETING WITH GRAHAM DAY ON MONDAY

You could start the meeting by congratulating Graham Day on the sale of Unipart and Leyland Bus. Once outstanding purchase orders have been supplied and paid for there will no longer be any continuing Varley Marshall commitment in either of these businesses. The 25% retained by BL in Unipart was inherited from Austin Bide (it was not Charterhouse's proposal), and should not in any way commit the Government to supporting this business in the highly unlikely event that it gets into trouble. (You could also congratulate Day on the smooth removal of Horrocks and Andrews and wish him well with any others).

Graham Day proposes about a 15 minute presentation giving you his personal views of the company and where he wants it to go. You will want to concentrate on Austin Rover (ARG) where the greatest problems are and where most of the money is going. Of the rest of the business, Land Rover is scheduled for privatisation in 2/3 years. Whilst on Leyland Trucks Graham Day should outline the talks he is having with Paccar and DAF. He should also explain more fully the plums he wants to pick out of Bedford if - as regrettably seems probable - this closes, perhaps as early as next month.

Austin Rover

Graham Day has been conducting what he calls an operational audit into ARG to examine the fundamental assumptions on which the strategy is based and to consider alternative policies. Professor Bhattacharyya has usefully assisted him in this exercise (although he has seriously upset Harold Musgrove in the process).

Graham's approach has been the opposite to the traditional BL one. Instead of starting with the financial results they would like to report and then making the assumptions (however unrealistic) necessary to achieve them; Graham is starting from what it is possible for the company to achieve, and the financial figures will fall out at the end of the process. He has not yet reached the financial evaluation but he will need to do so soon.

This is a much more sensible approach. What has been particularly galling about BL in the past is not so much that it has been consuming taxpayers' money, (or Varley Marshall assurances), which seems inevitable even under Day's leadership; but that it has been frittering away excessive amounts of money on projects that never had any chance of making a commercial return.

What we said at the time of the row.

The fundamental problem (with which I think Graham Day agrees) is that ARG's volume base is far too small to recover the costs of developing and marketing the full range of models and components. To be a full line, vertically integrated manufacturer they would need to sell over a million cars per annum rather than the less than half a million they actually achieve. Basically, ARG has a choice: either to significantly reduce its model range and componentry ambitions in line with its resources, or to go for intensive collaboration - almost perforce with Honda. To date ARG has failed to address this strategic issue, instead it has concentrated on defending its perimeter whilst cash, profits and market share have bled away. (Market share this year is only 16.3%, just three quarters of the 21.2% forecast in the 1985 plan, losses are £67m whilst cash outflow is a staggering £173m).

The appendix lists some of the things ARG could do to make their plans more realistic: these add up to more than a

£500m saving on capital and a £50m pa saving in fixed costs. This is not the only possible strategy nor necessarily the best, but what is clearly required is a new coherent strategy that recognises the limitations of ARG's position. What would be totally insufficient is for ARG to respond to this latest financial crisis by merely deferring expenditure plans whilst still sticking to the full line, vertically integrated strategy which has always been at the root of its successive financial problems.

Honda

In all of this the impact of Honda cannot be neglected. ARG are already seriously dependent upon Honda for the Rover 200 range and the newly launched Rover 800, with the AR8 (Maestro replacement), perhaps half their volume will be Honda-dependent.

Honda itself is only the number three manufacturer in Japan and its main ambition is to develop in Europe as it has already in the States (where it has established a leading position amongst foreign companies). ARG has to find a strategy that prevents Honda from using it as a convenient, (and very cheap), stepping stone into Europe, only to drop it dead when Honda is established.

There is no simple solution to this problem, perhaps the best is to aim for some long term marketing agreement whereby ARG only develops a partial model range but supplements it by building Honda derivatives and marketing them under an ARG badge. Within Europe, Honda would be expected to operate a reciprocal policy so as to maintain a mutual inter-dependence. ARG could try to reinforce this relationship through sub-contract manufacture for Honda. Alternatively ARG could lease Honda the surplus Cowley South factory on terms that link back to the overall marketing and strategy agreements.

A Honda equity stake could be a useful additional hook. But anything short of outright ownership is unlikely to be as important as securing the mutually inter-dependent business relationship discussed above.

Conclusions

You could aim to achieve the following conclusions from the meeting:

1. Government would be prepared to look at BL's future funding requirements with a reasonably open mind provided (a) ARG now produce a credible plan, (which means one substantially different from past ARG plans and that addresses the true underlying problem) and (b) that having made financial forecasts ARG stick to them,

2. That Graham Day should bring forward two or three different plans with varying degrees of Honda involvement in order that the Government can decide which route is politically most attractive.

Peter Warry

PETER WARRY

APPENDIX

POSSIBLE CHANGES TO ARG PLAN

1. - Drop the AR6 (Metro replacement) and merely reskin the existing Metro (as Ford did with the Cortina) - saving £120m.

2. - Change the AR8 (Maestro/Rover 200 replacement) from a collaboration with Honda to a straight British-build arrangements as for the Triumph Acclaim. (The Acclaim - now known as the Rover 213 - has the best quality of all ARG cars).

3. - Drop the AR9 (notch-back derivative of the AR8) saving £50m.

4. - Drop the AR10 (Montego replacement) save £125m.

5. - Drop the 'K' series engine and purchase the Honda 1.3 engine instead, saving £150m. (Ford have privately indicated to Graham Day that they might wish to buy the 'K' series, if this happened it would substantially increase 'K' series volumes and perhaps convert it into a viable project. You will, however, remember that one of the arguments used last year was that no self-respecting manufacturer would ever consider buying a main-line engine from a competitor!)

6. - Drop the V6 engine and continue purchasing from Honda, saving £50m.

7. - Drop the S series engine, saving £40m.

8. - Consolidate the Drews Lane and Common Lane, Birmingham factories into Longbridge and move out of the Cowley South factory. Fixed cost saving £50m per annum. In fact, ARG could probably also get out of Cowley North but this should not be pressed.

CCBG

Prime Minister!

Agree to see Mr Day?

[initials] 13/6.

Yes [initials]

PRIME MINISTER

Now that Graham Day has been with BL for 6 weeks or so, Paul and I suggest that you would both benefit and think it worthwhile to spare a few minutes over a drink to discuss with him the situation as he has found it. I am glad to say that I have managed to keep very closely in touch with him and that - with no disrespect to Sir Austin Bide - the relationship with the Company has changed very much indeed.

I know that you continue to have major worries about the future of privatisation. I know too that Graham would value a discussion. For both of these reasons I think an informal chat would be most worthwhile.

Peter

PETER MORRISON

CR

Could you arrange 3/4 hour please, by the end of the month if possible, plus Mr Channon (if he's available) or Mr Thomson?

[initials] 16/6.

Mr Hargrave

17.30 on Thursday 3 July.

CR

BF

999-49 JO6AHI

ROVER GROUP

Prime Minister

cc BU
3/9

DRN
28/7

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28 July 1986

Rt. Hon. Margaret Thatcher, MP,
Prime Minister,
10 Downing Street,
LONDON SW1.

SECRET & PERSONAL

Dear Prime Minister

I have prepared a background note for this afternoon's meeting. I am enclosing a copy which you may wish to read before then.

Yours sincerely

J. Graham Day

J. GRAHAM DAY

SECRET AND PERSONAL

INTRODUCTION

These notes have been prepared for a meeting on 28 July 1986 with the Prime Minister, the Secretary of State for Trade and Industry and the Minister of State for Industry. The views expressed are mine and have not been considered by The Rover Group Board.

No specific approvals are sought from this meeting. Should the intentions generally be acceptable, they will be reflected in the 1986 Group Corporate Plan. Specific approvals will be sought either in advance or through the Corporate Plan.

J. Graham Day
Chairman & Chief Executive
The Rover Group plc
28 July 1986

Copies: 5 only
No. 1 - Prime Minister
No. 2 - Secretary of State
No. 3 - Minister of State
No. 4 - J. Graham Day
No. 5 - P.C.M. Thompson (The Rover Group)

SECRET AND PERSONAL

OBJECTIVES

The perceived views of the majority shareholder, the interests of all shareholders and the financial, commercial and political realities, in the absence of a specific mandate, require a comprehensive plan for the Group directed towards:

- stemming the losses and cash outflows, then reversing them;

- reducing, then eliminating, the requirement for Government funding and guarantees; and

- progressively putting the respective businesses on a basis which enables them to be returned to the private sector.

THE GROUP OVERALL

The Group has not managed its businesses for some time. There has been a marked lack of strategic thinking. In consequence, the Group has been reactive rather than proactive.

Losses are rising, cash is being consumed at an alarming rate and projected capital requirements are beyond the Group's present ability and likely Government and bankers' willingness to fund.

The Group as presently constituted is fundamentally unprofitable and never can become financially self-sustaining.

Six key actions are indicated.

1. The prompt disposal of two of the major loss making and cash consuming subsidiaries, Bus and Truck.

2. Sale in 1986 of majority interests in the larger supporting businesses such as Unipart, Istel and JRA Australia in order to raise cash, perhaps £80/£90m.

3. A significant cut back in capital spend and a review of capital spend timetables.

4. A reduction in fixed costs particularly in Austin Rover and to a lesser extent in Land Rover (including Freight Rover).

5. Further rationalisation of facilities.

6. A definitive plan for the Austin Rover business.

A number of these actions is in hand and planning is underway on the balance.

The medium term result will be two manufacturing businesses, Austin Rover and Land Rover (including Freight Rover), with support from relatively minor subsidiaries and companies in which minority shareholdings are held. It is not possible at this time to say definitively whether together or separately these businesses could be both profitable and financially self-sustaining. However, the possibilities are very much greater than for the existing structure.

In two to three years the plan is to sell the Land Rover business. Austin Rover would be the subject of a progressive reduction in Group shareholding leading potentially to full disposal in, say, three to five years.

An agreed and progressively implemented financial reconstruction is essential, particularly in connection with disposals. With Group plans directed towards the phased elimination of direct Government involvement through shareholding and finance, such financial reconstruction has the advantage of finality.

ROVER GROUP - PROFIT/(LOSS)

	1985 Actual			1986 Latest Forecast		
	PBIT	Interest	Total	PBIT	Interest	Total
£m	(39.5)	(70.8)	(110.3)	(120)	(100)	(220)

ROVER GROUP - CASH FLOW

	1985 Actual	1986 Latest Forecast
£m	(187.0)	(300)*

* 1. Assumes all PBT losses go through to cash
2. Gains/losses on disposals not included.

ROVER GROUP - YEAR END BORROWING

	1985 Actual	1986 Latest Estimate
£m	637	912

LEYLAND TRUCKS

Improvements between 1983 and 1985 have reversed during 1986. No return to profit and positive cash flow is foreseeable as presently structured.

The facilities are good, the management competent and domestic market share is up.

Major overcapacity for a shrunken European market and a collapse of traditional export markets, e.g. Africa, mean that underutilisation remains a costly problem, despite extensive rationalisation of facilities that has occurred.

The only solution to the Trucks problem is disposal. Two possibilities are being developed.

Should GM announce its intention to withdraw from truck manufacture in the U.K. an opportunity to secure some market gains, including military, may be possible. This would have a positive impact on Trucks in any scenario. The disposal of Trucks may not produce a sale consideration which is positive and, in any event, will result in existing debt having to be addressed; however, the result will be a final one.

LEYLAND TRUCKS - PROFIT(LOSS)

(Including 67% of Leyland Parts)

	1985 Actual			1986 Latest Forecast		
	PBIT	Interest	Total	PBIT	Interest	Total
£m	(28.0)	(32.9)	(60.9)	(45)	(40)	(85)

LEYLAND TRUCKS - CASH FLOW

(Including 67% of Leyland Parts)

	1985 Actual	1986 Latest Forecast
£m	(20.2)	(78)

AUSTIN ROVER

Austin Rover has lost its way again. Domestic market share is falling, losses are rising, capital spending intentions are large and cash is a major concern. Productivity has improved but quality and reliability have lagged behind.

The business operates on a tactical level with no overall strategy. Austin Rover has a narrow manufacturing focus and, partly in consequence, a very inadequate marketing and commercial capability.

The management includes persons possessing considerable specific skills but too many without the breadth required for senior general management. This feature, together with a divisive corporate culture and organisation and the past lack of direction from BL, have been major contributing factors in ARG's many problems.

A major strategic planning exercise is in hand at Group level and actions are being formulated including major fixed costs reduction, planned capital spend reductions, e.g. cancellation of the V6 and 'S' series engines programmes, and rationalisation of facilities.

There is a critical but beneficial reliance, through a series of contracts, on the Honda Motor Company. The future of Austin Rover may well depend upon securing a transition from the present association to one where Honda has a clear interest in Austin Rover's corporate well being. This can be achieved in part through Honda taking a shareholding in Austin Rover. In present circumstances commercial reality suggests a total disposal to Honda now, or for that matter to another manufacturer. At least, as a move towards securing the Honda relationship and paving the way for disposal, Honda should be encouraged to take an initial significant minority shareholding.

AUSTIN ROVER - PROFIT/(LOSS)

	1985 Actual			1986 Latest Forecast		
	PBIT	Interest	Total	PBIT	Interest	Total
£m	(9.2)	(35.1)	(44.3)	(90)	(55)	(145)

AUSTIN ROVER - CASH FLOW

	1985 Actual	1986 Latest Forecast
£m	(67.0)	(162)

LAND ROVER UK

Land Rover UK is the Group's holding company for the Land Rover, Freight Rover (light commercial vans) and related parts businesses.

While inter company sourcing, e.g. pressings, engines and gear boxes, has been developed, there is no natural synergy between the units. Together they are now modestly profitable with positive cash flow. In the absence of any fresh compelling reason to separate them, the intention is to continue the present association which offers a position which will best assist disposal. You earlier felt that it would be better to disentangle them.

LAND ROVER

The business has traded at a marginal profit over the past two years but with negative cash flow due to site and facilities rationalisation. Break even after interest and positive cash flow are forecast for 1986.

The management is effective, particularly in delivering an agreed plan. There is a need to introduce more flexibility, particularly to contend with volatile markets.

Land Rover sales volumes have been declining steadily while Range Rover sales are expanding. Prospects for the company are uncertain and are tied very much to future Range Rover sales in North America. The company must have new models to replace current old and aging products. The business does not generate enough cash for capital investment in facilities and model replacement.

FREIGHT ROVER

This company is a mini miracle within the Group. It operates the worst plant and builds basically poor and obsolete light commercial vans which it sells successfully in an infinite variety of configurations in a highly competitive market.

Profitable trading and positive cash flow have been achieved in 1984 and 1985 and are forecast for 1986.

In aggregate Freight Rover has the best management of any Group manufacturing subsidiary.

The threats, and they are immediate, are market related. New product and plant are needed for which capital is urgently required.

Freight Rover's continued success is a key factor in preparing Land Rover UK for disposal in 24 - 36 months.

LAND ROVER UK - PROFIT/(LOSS)

	1985 Actual			1986 Latest Forecast		
	PBIT	Interest	Total	PBIT	Interest	Total
£m	10.2	(6.9)	3.3	17	(11)	6

LAND ROVER UK - CASH FLOW

	1985 Actual	1986 Latest Forecast
£m	(28.0)	7