CC B/KP 21

PRIME MINISTER 30 October 1986

ROVER GROUP

The sale of Unipart is now effectively settled, my old company, Self-Changing Gears, has been sold and ISTEL looks likely to go before the end of the financial year. The management buy-out for Buses might yet be pulled off but if it can't be sold, then it must be closed. Negotiations for Leyland Trucks with Paccar and (much better) DAF are proceeding satisfactorily but won't reach a conclusion this side of Christmas. Land Rover is sidelined for the time being, but without tough management action now it will face major problems by 1990. This leaves two major issues, the future of Austin Rover (ARG) and the funding of the Rover Group.

THE FUTURE OF AUSTIN ROVER

Until this year's collapse Austin Rover's market share had held constant since 1979 at roughly 18%. This had been achieved off the back of new model introductions expanding ARG's effective model range, the management momentum following the Edwardes era, increasing dealer incentivisation, and some fiddling of the numbers.

1986 has been the year of reckoning. There have been no new model introductions to expand ARG's effective coverage (Rover 800 only replaced the reasonably successful Rover SD1). The management lost its way and become overtly political. Dealer incentives reached such high levels as to be almost counter productive. And the fiddling of the numbers (and Varley Marshall borrowings) finally came home to roost.

Over this period ARG's strategy has veered between emulating Ford and ad hoc arrangements with Honda. But ARG cannot hope to remain as a full line car manufacturer selling only 450,000 cars per year when its competitors have the economies of scale of selling twice that number and more. And whilst Honda has been beneficial to ARG in the short term, without more permanent arrangements, Honda will desert ARG once it is properly established in the European market leaving ARG comprehensively in the lurch.

Time is running out: ARG needs to switch to an unambiguous and achievable strategy. There would appear to be two basic options.

> Either concentrate on specific segments and niches in the car market and cut fixed costs by reducing the level of vertical integration.
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> Or work towards full integration with Honda's European activities.

Concentrating on a more restricted market segment is not without its risks. ARG is currently strongest at the bottom end of the market, where it will find it most difficult to compete in the future. It has a rather worse image at the top end, where a 'Roverisation' strategy would be most natural. Nevertheless, such a strategy could work with careful planning but it might take 10 years to come through. A corollory to this would be reducing the vertical integration of the company and buying in more engines and gearboxes. This would substantially reduce both the capital costs and the risks of staying in business.

Integration with Honda is the best strategy if it can be achieved. Honda is only the No 3 company in Japan: its strategy is to make its main sales overseas. It already sells more cars in the US (where it is now the No 1 importer) than in Japan, and it is targetting to sell a million cars in the US by 1990. Its European strategy is evidently to imitate its US one, using ARG as a stepping stone towards that goal.

What sort of deal with Honda?

A Honda shareholding in ARG is not a guarantee of a sustained long term relationship. A shareholding would be helpful, but the investment would be relatively small and once spent could easily be abandoned if it proved uneconomic. A shareholding in just part of ARG (eg the Cowley plant) would be even less binding.

Much more important is creating a mutual inter-dependence between Honda'a operations and ARG's such that neither can walk away without seriously damaging their own interests. Honda wish to use ARG's facilities at Cowley for producing their own cars and the new AR8 collaboration car. If the plant is sold to Honda then ARG makes a short term gain but has little continuing leverage. On the other hand, if the plant were just leased with Honda giving undertakings not to establish manufacture elsewhere and to continue their relationship with ARG, then the inter-dependence would be established. This would be reinforced if, for example, cars from the Cowley site had to go to one of ARG's facilities for paint treatment. A similar arrangement could be achieved for the manufacture of a new Honda engine at one of the satellite Longbridge facilities.

The principal objective for ARG must be to secure a full range of cars without having to design and build them all itself. The ideal would be for ARG to market some Honda cars under the ARG badge and for Honda to sell ARG cars under its badge. (Honda already sell their own cars under three different marques). If Honda and ARG are able to divide the products between them in this manner then they may also be able to split the European market - one taking France, say, and the other taking Italy.

Honda will, of course, be reluctant to agree to any deal that diminishes its ability to milk ARG and then walk away. But even with the deal outlined above, Honda would still gain a relatively cheap and trouble free entry into Europe. Honda have already shown that they are keen to get a foothold in Europe, but they are currently fully occupied sorting out the US, and will not wish to commit large managerial or financial resources to Europe at this stage.

The current sterling/yen exchange rate makes the UK a very favourable place for Japanese investment. Honda resources are currently stretched (this year's profit is likely to be little better than break even). Honda have already significantly invested at their Swindon site and they will need the Government's cooperation on local content etc to make a successful go of their operations. ARG represents Honda's ideal solution.

Conclusion

It is essential that no more ad hoc deals are done with Honda. Mutual inter-dependence is ARG's only guarantee, and the only way it can avoid having to duplicate the investment in new models whilst still safeguarding its future. It is also good politics.

A proper strategy for Honda must be developed, not just for the immediate deal but for the overall game plan. We have a strong negotiating hand and we should not under play it.

ROVER GROUP FINANCES

BL's borrowings stand at some £880m, way in excess of the £680m limit the old management committed to last year.

There is little that Graham Day can do about the history, and indeed even with good management, he is still likely to need more money before he can get the company on an even keel. **Having connived with the illusion that BL was self-supporting, I do not believe that the Government can suddenly pull the Varley Marshall rug from under them, nor would it actually make industrial sense to do so. Provided Graham Day produces a sensible plan he is entitled to expect our support.**

However this is easier said than done. Borrowings have now reached such a level that BL is in breach of both the terms of its debenture loans and of its Articles of Association. The debentures are to be repaid albeit out of incremental Varley Marshall borrowings. The Articles constraint can only be resolved by changing it at an Extraordinary General Meeting. Because this is unavoidable, it would be much better to hold the EGM soon whilst the bad news from the old management is still fresh in peoples minds. Waiting until next year risks 'BL bankruptcy' headlines just when the company may be beginning to pick itself up off the floor.

The more difficult problem relates to the European Commission. Strictly speaking the Varley Marshall assurances are a state aid and should have been approved by the Commission. So far the EC have not noticed them, but they will become increasingly difficult to hide as the losses mount and debts have to be written off on the sale of subsidiaries. If the EC do get onto it, then they could stop any extension of the Varley Marshall assurances and may even attempt to block their continuation.

This has several ramifications. Firstly, it may make it much more difficult to give Graham Day the extra funds he needs. Secondly, on the sale of major assets such as Buses or Trucks (but curiously not Unipart) the directors have to send a circular to all shareholders, inter alia, stating the adequacy of the working capital. This would be difficult to give without the promise of continuing Government support which the EC might block. Thirdly, the banks are arguing that the size of Rover's borrowings means they need something more concrete than Varley Marshall which clearly cannot be given. (But the banks are probably bluffing - they would hate the Rover Group to take its overdraft elsewhere!)

This quagmire is, of course, the result of the whole glorious pretence that BL were free of Government support. It is the responsibility of the previous management and those that supported them. But it is also all history and the need is to find a way out of the mess.

I don't think any of the problems are insuperable. Provided Graham Day comes up with a realistic plan then the Government ought to back him. This means promising to inject money to pay off the residual debts of the subsidiary companies once they are sold. If this can be agreed, then both sides will need to be flexible in finding the best way to give effect to the decision so as to ensure it can be muddled past the Commission and have the right political presentation.

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