PRIME MINISTER   19 November 1986

ROVER GROUP - MEETING WITH GRAHAM DAY ON 20 NOVEMBER

Mr Channon's paper addresses three issues: business plans: funding requirements and the public presentation of whatever decisions are taken.

Business plans

The short term business plan is essentially to sell or give away everything except ARG and Land Rover. The disposal plans we have been aware of for some time and are progressing as well as can be expected. The capital programme for ARG has not yet been quantified. I suspect it will be in the vicinity of £500m to develop the K series engine, to develop the AR8 series motor car and to launch the Sterling in the USA. The proposal to launch Land Rover in the United States makes good sense and should considerably strengthen the Land Rover Group prior to any privatisation.

Range Rover 9 [illegible].

On a very limited acquaintance with the Rover Group I have formed some views on the ARG plans and visited Longbridge last week. I was particularly impressed that the new team are addressing the business from a marketing perspective. Extensive research has already been done on the market for Montego and Rover 200 and this is being followed by the same kind of detailed work on Metro and Maestro. It is therefore by no means a forlorn hope that the ARG company will now start to be market-driven and to build the kind of cars people want rather than trying to push their franchised dealers into selling the cars which are actually being made. Coupled with a new public perception about reliability this initiative could turn ARG into a successful business able to hold its own beside BMW, Ford etc. Modern design and manufacturing techniques should be able to deliver success, given a proper market-driven strategy backed by able management. We have put our money on Graham Day and therefore his ambitions to make the business successful need support.

Funding

The arguments about funding are tangled. It is necessary to separate the alleged funding requirements into two quite different logical types. First, and most urgently, there is the funding needed because Rover Group is a public company with a stock exchange listing and a vociferous albeit tiny minority shareholding. The forecast debt structure of the Group as as the end of December 1986 is:

RG EXTERNAL DEBT IN £m

Truck and Bus	470
Add losses & costs prior to sale (max)	180
	650
Austin Rover Group	500
Land Rover	76
Freight Rover	2
International Companies etc	92
	1320
Less Central Cash Balance (guess)	120
	1200

The argument is being made that the debt associated with Truck and Bus of £650m must be eliminated when those operations are sold by March 1987. It is claimed that the remaining business could not stand the loading of so much debt when there were no assets to set against it. If ARG were not a public company but wholly state-owned one could argue that, because Truck and Bus have been sold, part of the cash drain within the Rover Group is no longer there and therefore external funding is not needed to the same extent as prior to the disposal! In terms of operating cash flow I believe that argument to be valid.

However, a public company has to publish a balance sheet which its directors and auditors are prepared to sign. In Rover's case, the net worth of the company as a whole is reducing every moment and will become zero some time by the middle of next year if nothing is done. Therefore the Directors' argument that it will not be possible to continue trading with such a capital structure must be taken very seriously indeed.

The only real alternative to injecting the £650m would be to remove the minority shareholding, delist the company and collapse its capital structure. One would then have assets directly owned by the state and they could be financed any way we choose. So it is not correct to argue that there is <u>no alternative</u> to injecting £650m. There is, but it has a high political cost. It would be to rationalise the Rover Group into what it really is, a collection of assets with ownership and responsibility in the hands of the state.

Advice from many quarters is that the political cost of taking this course would be too high. However it would go to the root of the problem, rather than addressing the cosmetics that the problem has left us with, namely that Rover's status as a public company currently brings only disadvantage to the Government and the business.

<u>The on-going business</u>

The other purpose for which funding is required and which has nothing to do with balance sheet cosmetics is the capital expenditure required within ARG and the continuing business to put them in solid commercial shape for privatisation. I do not have independent verification of the figures required, but I suspect Graham Day will give you an indicative range. My own estimates are as follows.

CAPITAL EXPENDITURE OVER 3 YEARS	£m
K Series Engine (will use unleaded petrol as required from 1991)	250
AR8 (new replacment from Maestro & 200 series)	180
Revamped Metro for small car market (guess)	35
Modification and Launch of 800 in USA (guess)	35
	500

You could therefore receive the argument tomorrow that £650m is needed within months to satisfy balance sheet requirements, and that a further sum of say £500m is needed in order to progress necessary capital expenditure at ARG. A clever way of putting this would be to argue that, as we need to inject £650m in the near term for balance sheet purposes, let us take only one bite of the cherry and inject a further £500m at the same time to write off the debt within ARG.

I would be very cautious about accepting this argument. As I have said, the £650m is probably necessary unless one were prepared to go through the enormous political battle of removing the minority and then liquidating the company. It is, however, by no means proven that any further injection is needed at the moment, and that is not intended to be scornful or unsupportive of Day's capital programme even if it does total over £500m. So far the omens are positive that the new management is addressing the future properly.

However, once the £650m injection has been made the Rover Group as a whole should be able to carry the level of capital expenditure which Day is talking about, albeit that the actual balance sheet of ARG itself will become increasingly stretched. Once the ARG business plan has demonstrated success, it would be appropriate and necessary to transfer some of the ARG debt elsewhere in order that the subsequent capital structure of ARG would inspire confidence both in the market and in potential partners should as Honda.

Summary Recommendations

(1) Ensure that Day separates the capital restructuring need (£650m before March 1977) from the capital investment programme (£500m).

(2) Recognise the validity of the arguments which stem from the public company structure of Rover Group (publication of audited accounts and maintenance of solvency while trading).

(3) Support the Day management initiatives in the continuing business without conceding any need to fund the capital programme in advance.

GEORGE GUISE

N.B. Since writing the above I have just read Day's note received tonight. As predicted it argues for a further capital injection (£550m not £500m!)

Annex - Observations on the Honda relationship.

Annex on Honda

It is now mainstream opinion in the Rover Group and elsewhere in Government that Honda represents the lifeline for ARG and is a wholly good force. Without having either the background or the inclination to challenge this statement I do observe that it is better when having a business partnership with another independent entity to form a joint venture to do specific things in the market place, rather than for one to hold a minority shareholding in the other.

I do understand the argument that it would make the business appear more viable and could perhaps be a catalyst in enabling its ultimate privatisation. I would prefer however to believe that we could get ARG into such good financial shape that there would be no difficulty privatising it, any more than there was with Jaguar, and that the relationship with Honda would be confined to specific commercial joint ventures for the good of both businesses.

What I fear is that a creeping shareholding by Honda and increasing involvement at board level will ultimately act to the disadvantage of the Austin Rover Group because there is at the end of the day one market place and the Japanese don't really like sharing it with anybody. So while there is every business sense in participating with Honda where they have the technical expertise and ARG has the sales outlets, it would be unfortunate if ARG ever lost the reins so that it could no longer decide how far and how fast it was in its commercial interests to go. With a significant Japanese holding in the ARG company itself that freedom could be lost.

CC PG

ROVER GROUP

The Rover Group plc 22
7-10 Hobart Place
London SW1W 0HH
Telephone: 01-235 4311
Telex: 926880

19 November 1986

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

SECRET

Dear Prime Minister

I am enclosing a background note for the meeting tomorrow evening.

Sincerely

Graham

J. GRAHAM DAY

Encl:

1. INTRODUCTION

These notes have been prepared as background for a meeting with the Prime Minister, the Chancellor of the Exchequer and the Secretary of State for Trade and Industry following on from a previous meeting (28.7.86).

The previous meeting reviewed my early impressions of the Group's businesses and prospects, the indicated early initiatives and the likely year end trading and cash flow positions.

These notes focus on the actions now being taken and planned, consequences arising, including financial, and indicate in some areas possible options.

J. Graham Day
Chairman & Chief Executive
The Rover Group plc
19 November 1986

Copies:

No. 1 - Prime Minister
No. 2 - Chancellor of the Exchequer
No. 3 - Secretary of State, Trade & Industry
No. 4 - Minister of State, Industry
No. 5 - J. Graham Day, Rover Group
No. 6 - P.C.M. Thompson, Rover Group
Nos. 7-14 - Rover Group Board

2. SALE OF MAJORITY INTERESTS IN PRINCIPAL SUPPORT BUSINESSES

Sale of 75 - 80 percent interests in each of Unipart, JRA and Istel, will be substantially complete by year end.

Against initial proceeds estimates of £80 - £90 million, the following is now anticipated:

	On closing	Deferred (Conditions Apply)
	£m	£m
Unipart	30	15
JRA	22	6
Istel	30	-
	----------	----------
	82	21

The Group's interests as the most important customer/user will be protected by the shareholding, a shareholder's agreement and supply/agency contracts.

In the medium to longer term, as the Group's manufacturing subsidiaries are sold, similarly, the retained minority shareholdings will be sold.

3. WAGE SETTLEMENTS 1986

Recent wage settlements, covering approximately 75 percent of the Group's U.K. employees, to date are in line with inflation and well below the national trend.

Subsidiary	Term	Settlement
Austin Rover	2 years	3%/year plus incentives continued for productivity and now linked to quality
Leyland Trucks	1 year	3% + changes in working practices demanded by management
Land Rover & Freight Rover	in negotiation	

4. LEYLAND BUS

Following a competitive bidding procedure in July, 1986 which produced three proposals, an agreement in principle was reached to sell to a management led - finance institutions supported consortium.

Since this, declared changes in British Rail's diesel multiple unit procurement programme and a deterioration in the results of the bus parts business have necessitated revisions to the economics supporting the preferred proposal. Consequently fresh negotiations are under way. The new arrangements being discussed continue to be on financial terms which are less costly than closure.

Chances of success in disposing of the bus business and by year end at this time are considered to be better than even.

At year end, the accumulated debt and restructuring costs requiring to be addressed on disposal are estimated at £130m.

5. LEYLAND TRUCKS

Plans for the disposal of Trucks are developing with the objective being resolution before end March 1987.

Two alternatives are being developed:

1. A joint venture with DAF of Holland, probably including Freight Rover (see item 6), leading to a stock market flotation late 1988/early 1989

2. Sale to Paccar of the U.S. (owners of Foden in England) with likely onward sale of certain elements to third parties, e.g. engine manufacture.

Both alternatives will involve a further contraction of the business. Current indications are that job losses under alternative 2 may be double those of alternative 1. Currently, in order to reduce cash outflow, Trucks is addressing elements of further contraction irrespective of disposal.

5000
7300

The placing by the Ministry of Defence of the "DROPS" and "4 x 4" contracts will have a material impact on Leyland Trucks' value, prospects and employment. It is understood that the MOD might be canvassing EEC suppliers widely.

Trend of military influences the economics for all players

In the event of failure of both disposal alternatives, a fall-back plan of break up, closure of some facilities and, where possible, sale of discrete elements is being developed.

To 31 March, 1987 the accumulated debt and restructuring costs requiring to be addressed on disposal are estimated at £520m.

Heads of Agreement Feb

Down to 9 days

Robert Atkins

6. FREIGHT ROVER

Freight Rover, the commercial vans business, could form part of a solution for Leyland Trucks, failing which its disposal timetable, probably, will be linked to that of Land Rover.

The business remains profitable with positive cash flow.

Work on essential new replacement models for 1989 is continuing as is planning for related facilities expansion at Washwood Heath, Birmingham. For approximately two years during the latter part of these developments and the early period of introducing the new models the company should remain profitable but will experience a negative cash flow.

Preliminary discussions are being held with General Motors concerning the possible supply by Freight Rover of approximately 20,000 units per year from 1989 of the new van designs. This would be incremental to Freight Rover's own requirements and the supply to DAF under the recent contract.

The business, while fundamentally sound, requires to be linked with another related business. In the market place a linkage with Trucks is logical; however, an association with Land Rover is considered workable in order to achieve disposal.

Expand plant on existing site

Anglo/Dutch J.V.
Where new 6?

7. LAND ROVER

While now modestly profitable and with improving cash flow, the business continues to require further development before disposal should be undertaken, particularly if disposal is to be by way of a stock market flotation.

Assuming a successful first year, 1987, for the Range Rover product in the U.S., continuance of the present positive sales trend for Range Rover in the domestic and existing export markets and successful development, now under way, of a new additional product, a stock market flotation may be possible in late 1988-early 1989, failing which prospects are reasonable for a trade sale.

Depending upon which Leyland Trucks solution is adopted, Freight Rover could be included in a Land Rover-Freight Rover disposal. (See 6 above)

2nd line of range rover

FR-FR

8. AUSTIN ROVER

There is no current prospect of returning Austin Rover to the private sector in the short to medium term. In the short term the emphasis is on basics, including cost and capital spend reductions. For the medium term and beyond a number of options are being developed to secure new product funding other than from banks and without Government assurances. Honda remains a critical factor in Austin Rover's future.

Manufacturing Capacity

Austin Rover has at least 25 percent excess car building capacity. Four prospects for utilising some of this capacity and hence contributing to cash and profitability have been identified and are being developed.

1. Honda: In addition to the current contract build of about 11,000 units, a further 70,000 units per year from 1989 is possible.

250,000 out
1 year

8% out
36.4%

① YY.
② Cortina Cross (Rover 200, Triumph)

2. MG Roadster Project: Preliminary merchant bank advice suggests finance for a medium price sports car project may be available by way of venture capital equity. Austin Rover (or the Group) would provide facilities, skills and sales outlets. The Project would be paid a fee per unit plus a share in profits. Volumes would be of the order of 30 - 40,000 units per year.

3. Chrysler: The contract build, initially from kits, of 10,000 to 20,000 mid-size saloons for Europe appears possible.

4. Chrysler - Lotus: The assembly under contract of 7,500 composite body sports cars per year from 1989 for the U.S. market is being discussed.

In the absence of Austin Rover organic growth, adequate incremental contract build or the success of the MG Roadster Project, Cowley South will close in 1989.

Unacceptable

Other Possible External Product Finance Opportunity

ARCONA, the 51% Braman Enterprises - 49% Austin Rover U.S. sales company, is considered to have potential for floating on the New York Stock Exchange in 1988 depending upon the sales success of the Rover 800 in the United States. This company could then finance certain new Austin Rover products including the 800 coupe.

Honda Involvement

Austin Rover continues to be critically reliant upon Honda. There is a present opportunity to formalise in part the Austin Rover - Honda relationship.

The latest indications from Honda show willingness to acquire a shareholding in Austin Rover. The initial and any subsequent levels of shareholding and conditions remain to be determined.

Prior conditions would include a restructured balance sheet for Austin Rover and a contract build agreement (see 1 above). Payment for such initial shareholding, probably, would be by contribution to the capital costs of tooling etc. for Project "YY", the second Austin Rover - Honda joint car development programme, at Longbridge.

1987→1989
Qu: to yield Govt
15% [illegible]
[illegible]

£60m = Capital £200 (£33m in 86)

14½%

Future Profitability

Growth - 20%

20,000

On a stand alone basis Austin Rover should achieve a modest operating profit in 1988 and thereafter to and including 1991.

The elements upon which a return to operating profitability depend include:

- maintenance of a minimum U.K. market share of 14.5%;
- the reduction during 1987 of at least £60 million, on an annual basis, in indirect and fixed costs;
- a further reduction in capital spend of £250 million over the next five years from the level contemplated in the 1986 Plan (£33m has been taken out already in 1986);
- continued growth in existing and new export markets, including North America;
- continued improvement in quality and hence lower levels of warranty costs;
- ability to reduce substantially incentive pricing;
- the maintenance of current competitive unit labour costs.

11%

Finances

The main risk to a stabilisation and turn around of Austin Rover in its present form, or to the implementation of any other option, is whether a minimum U.K. market share of 14.5% can be sustained in the short to medium term. General uncertainty as to Austin Rover's future is real and is impacting adversely on domestic sales. Early and positive action on Rover Group's finances generally is critical to avoidance of progressive Austin Rover market collapse. Additionally, supportive statements by Ministers would assist materially.

Preliminary projections indicate a total erosion of equity during 1987 and, on the existing Austin Rover funding structure, a doubling of borrowing from £500 million to £1 billion over the next five years. In other words, for Austin Rover to be able to service its debt a capital injection of some £550 million, including for restructuring, is required now. This is irrespective of the view that Austin Rover in its present form can be managed so as to trade profitably from 1988 through 1991.

The above ignores possible contributions from Group disposals, whether additional loans may be available, how total loans can be repaid and matters of Directors' entitlement to trade.