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PRIME MINISTER

ROVER GROUP

To Channon, the Chancellor, and you.

We are meeting next Tuesday to review progress and to discuss some points outstanding from our recent discussions with Graham Day and with colleagues.

Leyland Bus

2 RG report that all major issues on Bus have now been settled with the Management Buy-Out. The prospects for concluding a deal soon look promising.

Commercial Vehicles

3 My Statement on 2 December was well received and there is growing recognition of the severe difficulties facing Leyland Trucks. We must keep the initiative and move forward as rapidly as possible.

(i) **DAF**

RG are continuing their intensive discussions with DAF on the agreed timetable with a view to reaching Heads of Agreement by end-January.

You will recall that Nigel Lawson expressed concern about the structure of any deal and in particular the prospects for an early placement of the proposed Leyland minority interest. A note by officials is attached at Annex ~~A~~ C.

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The key point is that Graham Day fully shares the Government's objective of making as clean a break as possible from the tucks business and I am confident that he will drive a hard bargain within the constraints of his overall negotiating hand. I have no doubt at all that he will work hard to keep the minority stake small and to avoid any obligation by Rover Group to contribute to any future cash calls by the new joint company. I strongly believe we should leave Graham Day to strike the best deal he can with DAF. We shall be free to take our own view when we have his recommendation.

(ii) Paccar

A team from Paccar is currently in the UK and will be staying a week or two until they have completed a thorough appraisal of the Leyland Trucks business and facilities. This is encouraging because it should enable Graham Day in early January to have a good appreciation of Paccar's attitude.

TIMETABLE

4 My objective remains to be in a position to make a Parliamentary Statement on the disposal of Bus and Trucks in mid-February and achieve the write-off of debt and restructuring costs within this financial year. A note on the main risks to this timetable - and proposals for dealing with these - is at Annex A.

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5 Assuming the commercial negotiations keep to schedule, the major uncertainty is in securing EC approval for the aid. We have moved quickly here and I am encouraged by my own contacts with Commissioner Sutherland that the sensitivity of the issues is well understood in Brussels and that he will do his utmost to smooth our path. As expected the Commission will almost certainly open a procedure on Trucks - I hope within the next week or so - but will accelerate their procedures so that a decision is reached in March.

PREMATURE DISCLOSURE

6 We are taking every precaution to avoid leaks of the substance of our proposals - both here and in Brussels - but we must recognise there is a high risk of this happening before we are ready to announce our decisions in mid-February. The fact of our notification to the Commission - and the implied admission that we are already to contemplate some debt write-off - are the most likely details to become public and, as guidance from Brussels suggests these might leak over this weekend, I have proposed, subject to your and Nigel Lawson's agreement, to announce this through an arranged Question on 15 December. Timing of the formal notification to the Commission of the more politically sensitive data - the level of equity injection proposed and the redundancy/rationalisation consequences of any deal - requires careful thought. It may be possible to take matters forward informally with the Commission and delay official notification until late January and this would reduce the risks appreciably. However, there is also the possibility that details will leak from industry circles and I have asked officials to consider with Treasury and the

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Policy Unit how best we might deal with this. Our plans will need to take account of the speculation that is bound to be generated by the Public Expenditure White Paper in mid-January which will have to make some reference to the possibility of aid to the Rover Group.

ARG/HONDA

7 We have agreed that Graham Day should have authority to explore with Honda the possibility of their taking a stake of up to 20 per cent in Austin Rover. It is too soon to judge whether - or how soon - this can be accomplished, and therefore whether this could form part of my February Statement. In the meantime there is one issue we need to resolve.

8 You will recall that Honda have asked for an assurance from the Government that in the event of ARG being taken over by a third party Honda would be welcome to develop their own assembly operation at Swindon. Honda would like this assurance before they commit to a Design and Development Agreement with ARG on the replacement Maestro/Rover 200 (AR8). Annex ~~C~~ B sets out the pros and cons of our giving that assurance now rather than when Honda are ready to agree to a shareholding in ARG or at least are committed to a manufacturing agreement. This question involves a tactical judgement on when such an assurance would have maximum leverage. Graham Day is emphatic that the advantage lies in

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giving the assurance now and, bearing in mind the importance we attach to the fundamental objective of strengthening the relationship with Honda, I think we should not overrule his judgement.

9 I am copying this minute to Nigel Lawson.

Timothy Walker

pp PAUL CHANNON

12 December 1986

Approved by the Secretary of State and signed in his absence

DEPARTMENT OF TRADE & INDUSTRY

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ANNEX A

SECRET
COMMERCIAL IN CONFIDENCE

PROVISION OF CAPITAL INJECTION TO ROVER GROUP RELATING TO LEYLAND BUS AND LEYLAND TRUCKS

CONTINGENCY PLANS

Note by Officials

Following the meeting on 20 November between the Prime Minister, the Chancellor of the Exchequer, the Secretary of State for Trade and Industry, and the Chairman of The Rover Group, officials were asked to prepare a note on the steps required to make the capital injection. This note, prepared by DTI officials in consultation with HM Treasury officials and the No 10 Policy Unit, considers contingency plans in case the disposal of Bus or Trucks is not completed as expected, or European Commission approval for the equity injection is delayed.

Commercial Negotiations on Bus

2 We now understand that all major points of principle have been agreed with the Management Buy Out (MBO). However if, contrary to RG's expectations, the current negotiations with the MBO were to collapse, Rover Group would either seek an alternative buyer (most probably Lairds) or, failing that, close the business. The choice of an alternative buyer could delay Heads of Agreement by about two months, so that a deal might be agreed just after Trucks. A closure decision could be announced more quickly.

3 Sale to Lairds or closure would cause no greater difficulty over the European aspects than the existing proposals, since the degree of rationalisation would be increased.

Commercial Negotiations on Trucks

4 RG aim to reach Heads of Agreement on Trucks by end-January. Progress on the Trucks negotiations is important because of the need to supply detailed information about the consequences of the chosen option, in confidence, to the

Competition Directorate of the Commission during late January and early February.

5 Mr Day has said that he would wish to implement a radical restructuring plan for Trucks if talks with both DAF and PACCAR broke down. The level of rationalisation under this plan is likely to be at least as great as under either sale option and the negotiating position with the Commission should not be weakened.

European Aspects

6 The major risk to the timetable is failure by the European Commission to give formal approval for the equity injection by 1 April 1987. The likelihood of this risk will be easier to gauge in mid-January.

7 A brief formal notification was tabled on 8 December. However, to enable accelerated consideration of this notification, by mid-January the Competition Directorate, DGIV, will need to be given formally, in strict confidence, the proposed level of aid and, in as firm detail as possible, the proposed counterpart on Trucks (as well as Bus). In order to be able to provide this information to the Commission, negotiations will need to have reached, or be close to, Heads of Agreement by end-January. Alternatively, if neither deal is possible, a commitment to implement Rover Group's internal rationalisation option may need to be given to the Commission.

8 Payment of an aid not authorised by the Commission would be contrary to the Treaty of Rome and could result in legal action before the European Court of Justice with the Commission seeking repayment of the aid. The Court has shown a tendency to side with the Commission in such arguments.

9 Provision by the Government of a commercial rate loan to Rover Group in advance of Commission approval for an equity injection would be an aid. However if by February authorisation of the equity injection within this financial year appeared unlikely, the use of a commercial loan (under Section 3(2)b of the 1980 Industry Act) might, with the Commission's connivance, enable us to meet our deadline without the Commission losing face. If we were forced to resort to the use of such a device we should need to make quite clear to the Commission that the loan would

subsequently be converted into equity and that this conversion would take place immediately their formal approval of the notification had been given.

10 A decision on whether the debt write off is made by an equity injection or through a commercial loan for conversion into equity must be made in early February because of the need to be explicit in the estimates.

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12 December 1986

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ANNEX B

SECRET
COMMERCIAL IN CONFIDENCE

HONDA - SWINDON

The meeting of Ministers on 27 November to discuss Rover Group matters requested that Treasury and DTI should set out the facts and tactical implications involved in Honda's request to be given an assurance now, that HMG would not oppose the development of their Swindon site into a full manufacturing facility in the event of Austin Rover (ARG) being taken over by a third party. The following note has been prepared by DTI officials in consultation with Treasury.

2 Honda have no car manufacturing facilities in Europe but have purchased a very large site at Swindon, at present used for pre-delivery inspection of cars produced for them by Austin Rover, and also for some parts assembly/pressing. It is planned that part of the site will be used for a plant for assembly and machining of the medium size engine Honda propose to supply for the next ARG/Honda collaborative car (AR8). There would still be ample space to accommodate a full car manufacturing plant for Honda's European production.

3 The AR8 car is due to be launched in 1989 to replace the Maestro and Rover 200. The estimated capital cost to ARG is £185m spread over 1987 - 1991. (Honda would bear the corresponding capital costs of producing AR8 in Japan). Mr Day sees AR8 as an essential plank in Austin Rover's future model strategy and an important element in consolidating the Honda relationship, which Ministers have agreed is the way forward for ARG. It is commercially vital because the Austin Maestro is not selling well in its sector whilst the joint production agreement on, and Honda component supply for, Rover 200 is currently scheduled to end in 1989. With AR8 likely to account for upwards of 150,000 vehicles from that year (in excess of 30 per cent of anticipated total output) it will give vital loading to ARG facilities with a competitive vehicle. Any delay would leave ARG increasingly exposed to newer more up to date models from their competitors especially in export markets. RG assure us that the timetable is tight; any delay beyond a few weeks in the signature of the Design and Development agreement now scheduled for 18 December would be unacceptable.

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4 There are no formal central Government powers to oppose development at Swindon. Any further planning permission required would be likely to be a formality for the local authority. However a Japanese company will not embark on a major overseas investment project unless privately certain that it was not acting against the wishes of the host government. Despite the absence of formal powers to oppose the development it is clear therefore that the question of the Swindon assurance is a negotiating card whose timing merits consideration.

5 It is questionable whether in domestic political terms it would ever be defensible to take a stance that prevented creation of employment and exports, even if there were strong pressure from the existing UK vehicle manufacturers and other EC Member States to exclude Honda from the UK. That being so Rover Group believe that the assurance Honda seek should be given now as a quid pro quo for the certainty of early signature of the AR8 D and D agreement and to avoid any risk of reopening in Honda's mind fundamental doubt about whether the Government has a positive attitude to their presence in the UK. RG believe that Honda were seriously unsettled by the opening of the talks with Ford earlier this year and wish to establish as soon as possible that they could still look to a future in the UK as their route into Europe if those talks were to be revived at some point in the future.

6 There are three options open to Ministers:

(i) to accept RG's argument and give an assurance now, albeit one which would set out that any Honda operation at Swindon would have to conform to established UK policy on local content;

(ii) to hold back the assurance until the negotiation of the AR8 manufacturing agreement (six months away);

(iii) to hold back the assurance so that it was considered as part of a wider package of any conditions Honda seek in the context of negotiations about a minority shareholding (in the first quarter of 1987).

7 Option (i) carries the least risk of unsettling the Honda relationship at a critical time and is what Mr Day believes was agreed at Ministerial meeting on 20 November.

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On the other hand the Design and Development Agreement already contains an escape clause for either company in the event of a substantial third party shareholding in ARG or Honda being taken, and it is arguable whether any further assurance should be given in this context.

8 Option (ii) could involve considerable delay to the AR8 programme with serious commercial consequences for Austin Rover, but might strengthen the negotiating position on the fine detail of local content and balance of investment in AR8. However it could be argued that it would still be premature to give the assurance Honda seek since AR8 is only a 4 year model life programme. The objective should be to withhold such an assurance until Honda could be locked into a very long term commitment to ARG as their route into Europe.

9 Option (iii) would carry a similar risk of delay to AR8 as option (ii) but the negotiating card would be reserved for use only in the context, perhaps most appropriately, of strategic negotiations on a very long term relationship. If Honda do not in the event prove willing to take an early decision in principle on a shareholding, the negotiating card might still be played to help achieve a fallback in which Honda entered into a long term framework of strategic collaboration with ARG, albeit without a shareholding to cement it.

10 Ministers will need to consider whether they wish to overrule the firm view of Mr Day and his colleagues that option (i) is the right option to follow if he is to move quickly to consolidate the Honda relationship in a constructive climate.

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ANNEX C

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FINANCIAL STRUCTURE OF A ROVER GROUP/DAF JOINT TRUCKS COMPANY

Note by Officials

Following the Prime Minister's meeting on 27 November about the Rover Group (RG), officials were asked to prepare a note on the initial debt of any joint RG/DAF trucks company; and on the possibility of placing Rover Group's shareholding in such a joint company with institutions, in advance of the main flotation.

Comparative Trading Performance of Leyland Trucks and DAF

2 DAF Trucks itself trades profitably and is able to service its debt while undertaking substantial capital expenditure. In 1985, a year in which DAF undertook some £30m capital expenditure, Profit before Interest and Tax was around £25m and Profit Before Tax was £4.4m. This compares to Leyland Trucks Loss Before Interest and Tax of £26m and Loss Before Tax of £60m in the same year, with capital expenditure of £21m. While DAF Trucks' trading performance is very much better than that of Leyland Trucks, DAF remains highly geared. It makes only modest trading profits of which 80 per cent are absorbed in interest costs and it is not therefore financially strong. As a result a combined company would not be financially robust.

Must Leyland Trucks be sold Debt Free?

3 No detailed discussions have yet taken place on the financial structure of any combined DAF/Leyland Trucks company and it is therefore too early to take a final view. However, given the marked contrast in the trading performance of the two companies, Mr Day does not believe it would be possible to take any of the Leyland Trucks debt into the joint company. Even when restructured the Leyland Trucks part of the joint company would still be cash negative for the first two to three years of operation. Mr Day believes that the complete write-off of Leyland Trucks debt underpins all the negotiations with DAF. He believes that this point was made clear in his meeting with the Prime Minister on 20 November.

It was.

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4 Barings advise that, if the combined company is to be financially independent, it is not unreasonable for DAF to be very reluctant to take Leyland Trucks except on a debt-free basis.

Structure of the Proposed Joint Company

5 RG fully share the Government's concern to obtain as clean a break as possible from the Trucks business. In particular they wish to retain as small an equity stake as possible for as short a time as possible in any joint company. Ministers may wish to emphasise to Mr Day the importance the Government attaches to these broad objectives in pursuing detailed negotiations with DAF on the balance struck between the RG and DAF equity stakes in any joint company and the amount of debt DAF is allowed to bring into the joint company. In particular Ministers may wish to ask Mr Day to explore with DAF the possibility of DAF (and its shareholders) converting some part of the DAF debts to equity prior to any merger. This would reduce further the gearing of the combined company and thereby improve its financial prospects.

6 With these broad objectives in view, Ministers may also wish to emphasise to Mr Day that the new company must be expected to stand on its own feet financially and that, unless it is unavoidable for the conclusion of an agreement, there can be no commitment to the provision of further capital from either RG or HMG to the joint company.

Prospects for Early Placement of RG's Minority Holding In a Joint Trucks Company

7 At his meeting with the Prime Minister on 20 November Mr Day mentioned the possibility that DAF might agree to placement with institutions of RG's minority shareholding in any joint company, in advance of the main flotation planned for late 1988 or 1989. Rover Group's view is that it is likely to prove difficult to obtain DAF's agreement to unilateral early placement of the RG shareholding. In any case, investors may be reluctant to invest in a company facing very substantial initial uncertainties in a difficult industrial sector. Nevertheless, RG recognise that early placement of their minority holding would be desirable, and are examining further with their merchant bank advisers, Lazards, and with DAF the possibilities of an early placement.

8 Barings view is that until the new venture is seen to be on a reasonably firm footing it would be difficult to place RG's minority shareholding. Depending on the progress of the business, they believe that the earliest date for sale or placement of the minority shareholding would be early 1988.

Freight Rover

9 Freight Rover (FR) will be considered as a separate issue in the discussions between Rover Group and DAF. The debt in FR was £2.9 million at end-September, and is unlikely to be a major issue, in negotiations. (More significant may prove to be the need to fund investment in new products for FR.)

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