CONFIDENTIAL

FCE 8H

bcc: Bob Young.

cc: HMT, NIO, D/En, SO, WO, DoE, LPSO, CDLO, D/Emp, MAFF, CSO, HMT, D/Trans, CO

10 DOWNING STREET

From the Private Secretary

14 May, 1984

Dear Callum,

BL Corporate Plan

The Prime Minister has seen your Secretary of State's minute of 9 May and the Report of the Official Group on British Leyland attached to it. On Austin-Rover, she welcomes the proposal to scrutinise the capital expenditure programme and expects this to be rigorous to ensure that expenditure is strictly necessary and not merely "nice to have". She has suggested that substantial economies in capital expenditure could be made through more collaboration on engines and gear-boxes and through more outsourcing. In examining the programme, she believes it would be helpful to set an objective of securing economies which will improve net cash flow by around £200 million over the period 1984/87. She has noted your Secretary of State's suggestion that BL should bring forward proposals for accelerating the prospects for privatisation. She wonders whether this really needs to wait for the 1985 Corporate Plan, i.e. another year, and suggests that proposals be brought forward in six months, based on a target for privatisation in 1987.

On Unipart, she has noted that further collective discussion will be required but she has expressed no view on the issues involved.

On Land Rover, she welcomes the proposal that BL be asked to prepare a study of the steps that would be needed to turn Land Rover into a separately saleable entity. She has suggested that a time limit of three months be set for this work.

Following discussions with your Secretary of State and the Secretary of State for Scotland, it has been agreed that the outstanding questions on Leyland Trucks will be raised at E(A) on Wednesday, 16 May.

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I am copying this letter to Private Secretaires to members of E(A) and to Richard Hatfield (Cabinet Office).

Yours sincerely

Andrew Turnbull

ANDREW TURNBULL

M. C. McCarthy, Esq.,
Department of Trade and Industry

cc No

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COMMERCIAL IN CONFIDENCE

PRIME MINISTER

BL 1984 CORPORATE PLAN

We have already discussed Jaguar privatisation and Leyland Trucks in E(A). For the timing reasons set out in my minute of 1 May to you, we need now to settle our policy on outstanding points arising from the BL Corporate Plan, including Leyland Trucks and Bathgate; discuss our decisions with the Board; and announce the outcome, by the third week of May. Otherwise our intention - now firm, following further advice from Kleinwort Benson - to float Jaguar on 24 July will be at rapidly increasing risk.

2 The principal outstanding issues concern the Austin Rover

... Group, Land Rover and Unipart. The attached Report from the Official Group on BL represents unanimous official advice on them from the interested Departments (DTI, HM Treasury,

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Employment, Scottish Office and No 10 Policy Unit). I hope we may be able to reach agreement on all outstanding points except Unipart (which I feel merits collective discussion, which can take place at a later date) by correspondence. On this basis I would hope to be able to proceed to an announcement of our overall approval of the Plan late next week.

BACKGROUND

3 We need to consider the 1984 plan against this year's achievements. The overall picture for 1983 is that BL broke even at the trading level - for the first time since 1978 - with a PBIT of £4.1m, in line with the forecast in the 1983 Plan. The overall cash outflow was contained to £91m, £267m better than the 1983 Plan figure. But underlying these improvements are sharply diverging performances within the Group, with Austin Rover and Jaguar doing substantially better than foreseen, and Land Rover and Leyland Vehicles doing worse. The radical improvements at Longbridge therefore conceal to some extent the worsening position at Land Rover and Leyland Vehicles.

4 A similar pattern is seen in the development of the 1984

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Plan: car operations are expected to improve faster than previously foreseen (I note in particular officials' assessment (paragraph 2.7) of Austin Rover's improved productivity; Austin Rover's performance in productivity, and commercially and financially, represents a considerable success for our economic policies, for which we ought perhaps to take more credit in public than we have done). On the other hand expectations for commercial vehicle operations have been adjusted downwards markedly. We have already considered within E(A) remedial and risk-limiting actions in respect of the main parts of Leyland Vehicles, and I am discussing these decisions with the Board.

AUSTIN ROVER

5 Austin Rover is progressing broadly on the lines established as a result of decisions on previous Corporate Plans. Most of the very substantial capital expenditure necessary for the model programme can be financed internally, but a part of the finance necessary for this expanding business is planned to be raised by further borrowing, against the Varley-Marshall assurances (effectively on Government credit). This model programme could not be pruned without serious damage to market sector

coverage and hence market share forecasts. However, I propose that the capital expenditure programme - in which individual capital projects over £25m each require separate Government approval - should be kept under careful review to see if it can be reduced, for instance by increased collaboration.

6 The long term solution to this unsatisfactory situation can only be privatisation. The Board assess the prospects for this in the Plan period as "fragile", but obviously they will be improved somewhat if the recent improvement in Austin Rover's commercial results and reputation continue. The company's collaborative strategy is closely linked to some of the possibilities for privatisation. I therefore recommend that the Board should be asked to bring forward proposals in its 1985 Corporate Plan, for improving as far as possible privatisation prospects earlier than now foreseen. These should take account of the development of the company's collaborative strategy.

UNIPART PRIVATISATION

7 This raises several difficult issues. First while a bird in the hand is certainly worth two in th bush, I should

remind colleagues that our ultimate objective of returning ARG to the private sector will be made more difficult by disposal of Unipart. Officials refer (para 5.6 of the attached report) to widespread continuing scepticism about the desirability of separating Unipart from the BL product companies, which is contrary to normal practice in the car industry. Obviously the separation and privatisation of Unipart represents a balance between the commercial interests of BL as a whole and our privatisation policy, but I am confident the Board would have told us if the path being followed was impractical or seriously damaging, and they have not done so. I, therefore, do not regard either of these points as overriding objections to our proposal to separate and privatise Unipart.

8 A further awkward decision arises: very recently, in line with one of the possible ways forward mapped out by the Board in the Plan, the Board have recommended an acquisition for cash (about £20m), as a preliminary to privatisation, of Edmunds Walker (EW), the component distribution arm of AE plc. The Board believe the acquisition would create a commercially stronger combined entity, which it will be easier to privatise. Their main reasons are that:

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- Unipart's perceived over-dependence on its contract with Austin Rover in particular will be lessened;

- EW's distribution system and administration can profitably be rationalised with Unipart's;

- Unipart will acquire access to non-franchised garages, who do an important proportion (over a third and growing) of the servicing of BL and other cars but to whom they have currently no distribution channel.

9 I have considered other options. We might tell BL that acquisition before privatisation is ruled out altogether, or that they should try to employ a less direct method of acquisition (such as those described in para 5.9 of the official report). But BL have already considered, and rejected chiefly on grounds of delay and greater expense, other methods of financing the acquisition, such as disposing of shares representing a minority of Unipart. The unanimous advice of the official group favours acquisition of EW for cash, provided BL commit themselves to the privatisation of Unipart by mid-1985. A public commitment

on these lines would be essential if we were to agree to this acquisition.

10 It seems to me that, while the Board may somewhat overstate the case, the acquisition of EW would help Unipart privatisation forward significantly. If we decide to opt for early privatisation, this is risky and does not fit well with industrial considerations; and given the congestion of the markets we cannot float Unipart in its present form this year. If we go forward on the basis of the industrial case advocated by the Board, the components business would need to be run on an entirely commercial basis, and the officials' recommendation has much to be said for it. If we did opt for this course, I would make it clear to BL that I could not support them if they engaged in a contest with another company to acquire EW; and that any monopolies aspect would have to be considered on the merits of the case. I cannot exclude the possibility that I might receive advice from the Director General of Fair Trading that a merger between Unipart and EW should be referred to the Monopolies and Mergers Commission.

11 Stripped of inessentials the choice before us is straightforward but difficult. Do we seize the earliest and

simplest opportunity to achieve privatisation as a political objective, or do we accept the industrial and commercial case for privatisation by the route proposed by the Board and endorsed by our officials? As I have said, I believe this decision is sufficiently controversial to merit further collective consideration, but I would welcome any initial reactions colleagues may have.

LAND ROVER

12 Our decision on 4 April to separate Leyland Bus within Leyland Vehicles Ltd, as a prelude to privatisation, needs to be complemented by a decision on privatisation policy towards the other UK part of the Land Rover-Leyland Group, Land Rover UK Ltd (Land Rover and Freight Rover). I endorse the official recommendation (para 6.8 of their report) that the Board should be asked (in parallel with the work on Leyland Bus) to prepare a study of the steps that would be needed to turn Land Rover into a separately saleable entity, as a basis for a full review of the privatisation options within Land Rover-Leyland.

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LEYLAND TRUCKS

13 Before the Corporate Plan decisions can be announced, we need to complete our consideration of the future of the Bathgate plant of Leyland Trucks. I explained in my minute of 1 May why a decision cannot be put off very much longer without unacceptable risks to Jaguar privatisation. I therefore ask the Committee now to endorse the recommendation at para 12 (i) of E(A)(84)19. The timing and mechanics of the announcement will need to be settled with BL and I will let you know what is proposed.

FUTURE FINANCIAL REGIME

14 You may also wish to note that the Report proposes controlling BL's borrowings in the years ahead, taking into account the fact that the company's borrowing is in effect against the Government's credit. This will reproduce the capital constraints which are imposed on commercial businesses by the market as well as providing the opportunity for limiting, as well as reducing, the Government's exposure under the Varley-Marshall assurances. We shall be pursuing this separately and promptly with BL.

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CONCLUSIONS

15 Decisions on the points in paragraphs 5-13, with those we have taken in E(A) on 15 February and 4 April, will open the way to our approving the major items in the BL 1984 Corporate Plan, except for the specific proposals on Unipart. I propose that the other lesser issues should be agreed on the basis of the report from the Official Group on BL. After discussion with the Board, we will circulate to those concerned a draft of a Parliamentary statement covering these points on which decisions need to be announced at this stage. I am pursuing the outstanding minor points on Jaguar privatisation on the basis of the arrangements set out in your summing up at E(A) on 4 April, but these points do not need to be cleared in detail before the Corporate Plan decisions and the principles of Jaguar privatisation can be announced.

16 I recommend:

i the proposals on Austin Rover capital expenditure and privatisation policy in paras 5 and 6;

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ii that decisions on the precise method of privatising Unipart (paras 9-11) should be deferred for collective consideration at a later date;

iii steps towards Land Rover privatisation as in para 12;

iv completion of our consideration of Leyland Trucks as in para 13; and

v that subject to the specific decisions on the various points we should approve the 1984 Corporate Plan on the basis set out in para 15 above.

16 In view of the timetable pressures I should be glad of any reactions from colleagues by 15 May. This timetable is imposed on us by the demands of the Jaguar flotation.

JH2AHW

17 I am sending copies of this minute, with attachments, to other members of E(A) and to Sir Robert Armstrong.

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9 May 1984

Department of Trade and Industry

JH2AHW

BL'S 1984 CORPORATE PLAN

FINAL REPORT BY THE OFFICIAL GROUP ON BL

I INTRODUCTION

1.1 We have reported separately on the BL Board's proposals for the privatisation of Jaguar and on the options for Leyland Trucks. In this report we consider, first, the performance of the various subsidiaries (excepting Leyland Vehicles) in 1983; second, the financial projections over the Plan period for BL as a whole, and their implications; and third, the business prospects and privatisation strategy for Austin Rover Group Holdings, Unipart and Land Rover. Our conclusions and recommendations are drawn together in a final section.

II SUMMARY OF PERFORMANCE IN 1983

2.1. Overall, BL has achieved its objective of breaking even before interest and tax in 1983, recording a trading profit of £4.1 million, in line with the forecast of £4m in the 1983 Corporate Plan. However, this overall result conceals a widely diverging performance within the Group, with Austin Rover Group Holdings (ARGH) and Jaguar performing significantly better than Plan and Land Rover, Leyland Vehicles and to a lesser extent Land Rover-Leyland International Holdings (LRLIH) falling well short of their Plan projections:-

1983 Profit/(loss) before interest and tax (£m)

	ARGH	Unipart	Jaguar	Land Rover	LVL	LRLIH	Total[1]
Actual	2.0	17.0	55.0	(14.0)	(70.0)	18.0	4.1
1983 Plan forecast	(64.0)	20.0	10.0	17.0	(12.0)	31.5	4.0
Actual better/(Worse) than Plan	66.0	(3.0)	45.0	(31.0)	(58.0)	(13.5)	0.1

2.2. BL overall contained its cash outflow in 1983 to £(91)m, £267m better than Plan. This improvement can be attributed largely to ARGH (£111m better than Plan) and Jaguar (£98m better than Plan):-

Cashflow in/(out) (£m)

	ARGH	Unipart	Jaguar	Land Rover	LVL	LRLIH	Total
Actual	(95)	11	56	(9)	(69)	(1)	(91)
1983 Plan forecast	(206)	12	(42)	(14)	(50)	7	(358)
Actual better/(Worse) than Plan	111	(1)	98	5	(19)	(8)	267

[1] Throughout, "BL total" includes certain central services and consolidation adjustments and may not equal the sum of the individual results shown.

Austin Rover Group Holdings (ARGH)

2.3. In a year in which the total industry volume (TIV) soared to 1.79m units, 15.5% up on 1982 and an all-time record, ARGH improved its market share from 17.24% in 1982 to 18.01% in 1983. The market share fell short of the company's Corporate Plan target of 18.5% for the year as a whole, but because of the higher than expected TIV UK sales totalled 323,000 units as against 287,000 units in the Plan (and as against 268,000 in 1982). One reason for the shortfall of market share was that supply of Maestros was limited by the capacity of the production lines at a time when demand was very strong: with work on the parallel LM11 line and some associated common facilities now complete this should be less of a problem in 1984. In volume terms sales of Maestro (at 65,000 units) were very close to the target figure of 67,000 despite the fact that some 8,000 vehicles were lost as a result of the four-week "washing-up" strike at Cowley in April. A second reason for the market share shortfall was that demand for older models, particularly Ital and Ambassador (itself fairly recent, but a facelift of the older and unsuccessful Princess), fell away more rapidly than expected. This led ARGH to decide to discontinue the Ambassador from the end of 1983 rather than end-1984 as originally intended. Production of the Ital had always been intended to cease at the end of 1983.

2.4. In contrast to the higher than expected UK sales volumes, ARGH's export volumes were disappointing, and overall ARGH's sales totalled 458,000 units as against a forecast of 475,000 in the Plan (a 3.5% shortfall). Sales revenues overall were £1,799m as against a Plan forecast of £1,829m (a 1.6% shortfall).

2.5. The main reasons for ARGH's very much better than expected trading profit were:-

a) higher than expected UK sales, which after allowing for the changed sales mix increased PBIT by some £35m; and

b) better than expected cost performance, which accounted for a further improvement of £35m.

Other factors which affected the PBIT performance included greater than expected list price increases (PBIT up £7.5m - but this effect is more than offset by the level of discounting), more favourable than expected exchange rates (up £2.3m) and better overhead coverage (up £7.4m), offset by worse than expected export volume and mix (down £12.2m) and greater than expected marketing costs (PBIT down £18.5m). This last factor reflects the intense competition which existed in the UK car market throughout 1983, leading to the offer of substantial discounts on list prices, and which shows signs of persisting into 1984.

2.6. ARGH's loss before tax of £(18.2)m was £103.8m better than the Plan forecast of £(122)m, and this was the main contributing factor to the much better than expected cashflow (£(95)m as against a forecast of £(206)m). Working capital (increased by £56m as against £47m in the Plan) and capital expenditure (at £126m as against £129m) were broadly on target.

2.7. Productivity in ARGH rose by some 20% during 1983 and is now running at over 12 cars/man/year. (In some months during 1983 productivity of over 14 cars/man/year has been achieved - well ahead of current French performance and at or above the European average: an outstanding achievement considering BL's record in the 1970's.)

Unipart

2.8. Unipart improved its trading profit from £14.3m in 1982 to £17.0m in 1982, despite an only marginal increase in sales revenue from £339m (of which £253m was in the UK) to £342m (£256m in the UK). This increase in sales revenue, though small, exceeded expectations (in fact a decrease of £10m had been foreseen) and has been achieved with a smaller workforce (4,600) than was forecast in the Plan (5,000). Given the strong growth in the UK car market during 1983, which should to some extent have fed through to Unipart's sales revenues, the increase in revenue is perhaps somewhat disappointing. However, as with other parts manufacturers Unipart depends for a significant proportion of its revenue, and for an even larger proportion of its profits, on the aftermarket, which can be expected to lag the new car market for obvious reasons. As forecast in the 1983 Plan, export sales revenues increased only marginally on the disappointing 1982 level during the year, reflecting in particular the continuing economic difficulties in major Middle Eastern and African markets.

Jaguar

2.9. Jaguar's sales volumes increased from 21,400 units in 1982 to 28,500 units in 1983 (2,500 units more than forecast in the 1983 Plan). Within the overall increase in sales revenue from £327m in 1982 to £490m in 1983 (Plan forecast £356m), domestic sales revenue increased by 25% from £152m to £191m and export sales revenue by 70% from £175m to £298m, reflecting in large part the continued strength of the US dollar.

2.10. Jaguar's trading profit of £55m exceeded the 1983 Plan forecast by £45m. The main reason for this variance was the stronger than expected US dollar, which averaged \$1.52 = £1 over the year as against the Plan forecast of \$2.05 = £1. Even if Jaguar's sales volumes in the USA had only achieved Plan forecasts, rather than exceeding them as they did, the exchange rate effect would have increased the company's profits by some £28m.

2.11. Productivity at Jaguar continued to improve during 1983: it averaged about 3.4 cars/man/year over the year (broadly in line with the 1983 Plan forecast), as against 2.96 cars/man/year in 1982.

Land Rover (UK) Ltd

2.12. Land Rover continued to suffer during 1983 from depressed conditions in its main overseas markets. Sales revenues, at £369m, were only 81% of the Plan forecast of £453m. Export sales volumes of Land Rovers totalled only 19,100 units, just over 50% of the 1983 Plan forecast of 37,800 units and nearly 40% below the export volumes achieved in 1982.

The main reason for this decline in export sales does not appear to be any shortcoming in Land Rover's products - the new One Ten was launched in March and has been favourably received both at home and abroad - but that many of Land Rover's most important markets in Africa and the Middle East continue to suffer from economic difficulties and a lack of foreign exchange. Land Rover has tried to compensate for this by attempting to export more to Europe, but European margins are much smaller and profitability is therefore reduced. ?

2.13. Within Land Rover UK, Freight Rover recorded a small trading profit of £0.2m in 1983, £1m better than expected and a substantial improvement on the 1982 trading loss of £(2.3)m. Sales volumes, at 15,800 units, comfortably exceeded the 1983 Plan forecast of 13,400 units, and the Sherpa K2 achieved a 22.3% share of the PV2 (panel van up to 2.5 tons) market as against 16.6% in 1982 and a 1983 Plan forecast of 19.5%. The new, wide-bodied Sherpa MT210 was introduced late in the year, in only a limited number of variants at first, and has so far made little impact on the market.

Land Rover - Leyland International Holdings (LRLIH)

2.14. LRLIH is a newly formed subsidiary of Land Rover-Leyland and includes all the group's overseas subsidiaries. The two largest subsidiaries are Ashok Leyland in India and Leyland South Africa: there are also a number of other assembly plants, mostly in Africa. There is frequently a local minority holding in LRLIH subsidiaries.

2.15 LRLIH's trading profit of £18m fell £(13.5)m short of the 1983 budget figure of £31.5m (1983 Plan forecasts are not available because of organisational changes within Land Rover-Leyland). This shortfall against budget can largely be attributed to two companies within LRLIH:

a) Ashok Leyland, in India, has suffered because of the depressed Indian trading conditions resulting from severe credit restrictions and the monsoon failures and drought, which seriously affected agriculture, the main economic stimulant to market growth.

b) Leyland South Africa has been seriously affected by the recession in the South African economy. This was reflected in the extremely competitive trading conditions in the commercial vehicle market, with the TIV some 25% below 1982 levels and margins under severe pressure. Full year BL unit sales were 85% of budget at 5,800, although sub-contract assembly units were 64% above budget at 8,000.

III THE FINANCIAL PROSPECTS FOR BL AS A WHOLE

3.1 This discussion of BL's overall forecast results relates to the company as it is presently constituted, including Jaguar, so as to allow comparison with the 1983 Plan. However, in setting financial objectives for 1984 and later it will be necessary to take account of the effect on these forecasts of the various privatisation actions foreseen, most immediately the sale of Jaguar.

3.2 The 1983 Corporate Plan showed BL returning to profit before tax in 1984 and achieving a cumulative profit before tax of £644m in the period 1984-87. In the 1984 Plan the return to profit before tax is deferred to 1985 and the cumulative profit in the period 1984-87 is reduced to £304m. This overall deterioration obscures movements in opposite directions within Cars Operations and Land Rover-Leyland. The 1984 Plan for Cars Operations shows a distinct improvement over the 1983 Plan, with a pre-tax profit first achieved in 1984 rather than 1985 and with cumulative pre-tax profits over the period 1984-87 rising from £68m in the 1983 Plan to £348m. However, this improvement is more than offset by the deterioration in the forecast results for Land Rover-Leyland, where the return to pre-tax profit has been deferred from 1984 to 1986, and a 1984-87 cumulative pre-tax profit of £576m in the 1983 Plan has turned into a cumulative loss of £(39)m.

3.3 The profit forecasts can be broken down by operating company as follows:

FORECAST PROFIT/(LOSS) - £M

	1984	1985	1986	1987	1988	Total 1984-88
Trading profits						
ARGH	18	46	56	89	105	314
Jaguar	51	26	66	85	100	328
Unipart	19	22	25	28	31	125
Land Rover	3	31	49	50	52	185
Leyland Vehicles Ltd (LVL)	(42)	(17)	3	14	36	(6)
LRLIH	6	20	27	36	42	131
Other companies/ consolidation	(3)	(1)	(1)	-	1	(4)
Total BL trading profit	52	127	225	302	367	1073
Interest charges	(88)	(101)	(107)	(106)	(106)	(508)
Total BL profit after interest and before tax	(36)	26	118	196	261	(565)

Over the period 1984-87, the differences in profit forecasts between the 1984 Plan and the 1983 Plan can be broken down as follows:

1984 PLAN PROFIT FORECASTS BETTER/(WORSE) THAN 1983 PLAN (£M)

	1984	1985	1986	1987	Total 1984-87
Trading profits					
Cars Operations	59	18	36	68	181
Land Rover-Leyland	(149)	(151)	(129)	(118)	(547)
Other companies/consolidation	1	3	2	-	6
Interest charges	29	21	5	(10)	45
Total BL profit before tax	(60)	(109)	(86)	(60)	(315)

3.4 Although cashflow over the Plan period is also worse than in the 1983 Plan, the deterioration is less marked than for profit: over the period 1984-87, a cash outflow of £(191)m is forecast, £(109)m worse than the 1983 forecast. The cashflow forecasts, broken down by operating company are as follows:

FORECAST OPERATING CASHFLOW IN/(OUT)[1] (£M)

	1984	1985	1986	1987	1988	Total 1984-88
ARGH	(84)	(31)	7	30	28	(51)
Jaguar	5	7	5	9	20	46
Unipart	28	12	17	20	22	100
Land Rover	(16)	8	55	41	37	125
Leyland	(31)	(20)	(5)	18	27	(11)
LRLIH	1	1	5	(5)	(5)	(3)
Other companies/consolidation	8	24	14	6	12	63
Interest charges	(88)	(101)	(107)	(106)	(106)	(508)
Asset reduction on Ashok deconsolidation[2]	83	-	-	-	-	83
BL TOTAL	(95)	(100)	(9)	13	35	(156)

Note:

1. ie excluding interest charges/receipts (which in the BL accounts are somewhat arbitrarily allocated between operating companies but which are shown here as a separate item).

Note:
2. During 1984 BL's holding in Ashok Leyland (India) will fall below 50% in consequence of the issue to Indian shareholders of a convertible debenture. The deconsolidation of Ashok from BL's accounts generates an apparent cash inflow of £83m in 1984; but because this does not represent a movement of funds it is separately identified above.

As for profits, the cashflow forecasts for Cars Operations in the 1984 Plan are better than those in the 1983 Plan, but this improvement is more than outweighed by the deterioration in the forecasts for Land Rover-Leyland.

1984 PLAN CASHFLOW FORECASTS BETTER/(WORSE) THAN 1983 PLAN (£M)

	1984	1985	1986	1987	Total 1984-87
Cars Operations	46	26	(5)	39	106
Land Rover-Leyland[1]	(80)	(135)	(72)	(51)	(338)
Other companies/ consolidation	30	(3)	8	5	40
Ashok deconsolidation	83	-	-	-	83
BL TOTAL	79	(112)	(69)	(7)	(109)

Note:
1. Excluding the effect of Ashok deconsolidation.

BL ECONOMIC ASSUMPTIONS

3.5 BL's economic assumptions were discussed with Treasury Economists last year. However, partly due to subsequent developments eg the Budget, there are some differences between BL and Treasury forecasts. The Treasury now regard BL's forecasts of GDP, manufacturing output and consumer spending as on the pessimistic side. Their inflation, earnings and interest rate forecasts are also pessimistic. On exchange rates the Treasury are forecasting that sterling will be weaker against the US dollar but stronger against European currencies than BL.

3.6 If domestic prospects are better than BL assume this should have a favourable impact on the Corporate Plan. On the other hand if sterling is stronger than BL expect compared to European currencies this will have adverse effects on BL's competitive position in both domestic and overseas markets. The overall effect of the differences is difficult to judge with more bullish domestic prospects tending to be offset by an adverse exchange rate effect.

CONCLUSIONS

3.7 For the first time in many years BL does not expect to need any injections of Government equity over the Plan period. Instead its activities will be financed from profits, the proceeds of privatisation, and borrowing. However, BL's borrowings will be against the surety of the Varley-Marshall assurances and cannot be regarded as a purely commercial source of funds. We believe that there will be a need in the years ahead for some means of controlling BL's borrowings so as to simulate in some way the capital constraints imposed on commercial businesses by the market.

3.8 The Memorandum of Understanding between the Government and BL envisages that the Government will establish short-term financial objectives, as well as long-term strategic objectives, for the company. It has been the practice so far to set objectives based on the limitation of losses and on the restriction of drawdown of Government equity. Neither of these concepts is any longer relevant to BL, and the financial objectives for 1985 and later years will have to be on a different basis than in previous years. One suitable form of objective may be the establishment of a target rate of return on assets. But we also recommend that the objectives should take into account the fact that the company's borrowing is in effect against the Government's credit. Apart from achieving the objective set out in paragraph 3.7, this would also provide the opportunity for limiting, and in due course reducing, the Government's exposure under the Varley-Marshall assurances.

IV AUSTIN ROVER GROUP HOLDINGS (ARGH)

Business plans

4.1 The 1983 Corporate Plan for ARGH included a product strategy based on at least five different models on three distinct vehicle platforms. In the 1984 Plan the strategy has been developed and simplified so as to increase the market coverage while reducing the number of vehicle platforms to two. The strategy now aims at the development by the late 1980s of two distinct vehicle families: one family would cover the small and lower medium sectors, while the second would cover the upper medium and executive sectors. Within each family the models would share essentially the same basic structure, although short wheelbase (swb) models would have a fillet cut out of the middle; and variations between models would largely be achieved by means of panel modifications. The objective is to arrive by the end of the 1980s at the following model line up:

Small/lower medium family

swb	AR6 (Metro replacement)
Long Wheelbase (lwb)	AR5 (booted, Acclaim replacement)
	AR7 (hatchback, Maestro replacement).

Upper medium/executive family

swb	AR17 (booted, Montego replacement)
	AR16 (hatchback, Ambassador replacement).
lwb	XX (booted and hatchback, Rover replacement).

These models would give ARGH coverage of nearly all the important market sectors, as the following table shows:

Sector	Sector share of total market	4-door variants		5-door variants		3-door variants		Other
		Share of sector*	ARGH model	Share of sector*	ARGH model	Share of sector*	ARGH model	ARGH model
Small	25.1%	-	-	10%	AR6	90%	AR6	-
Lower medium	33.4%	20%	AR5	40%	AR7	25%	AR7	-
Upper medium	27.0%	45%	AR17	35%	AR16	-	-	AR17 estate
Executive	7.5%	50%	XX	25%	XX	-	-	XX Coupe

* estimate

4.2 The upper medium/executive family is to be derived downwards from the XX, which is itself due for introduction in 1985. The small/lower medium family is to be designed upwards from the AR6, which is planned for introduction in 1988. The launch dates currently forseen for the models are as follows:

Small/lower medium family

AR6	Mid-1988
AR5	Mid-1989
AR7	Early 1991.

Upper medium/executive family

XX	Late 1985
AR16	Late 1987
AR17	Early 1989.

In the interim, there will be changes to existing models to enhance their marketability. Among major developments, a Metro facelift and five-door derivative will be launched in 1984, as will an Acclaim facelift; and a Maestro facelift will be introduced in 1987.

4.3 The increased market coverage provided by this model strategy is expected to lead to an increase in market share from 18.0% in 1984 to 23.5% by the end of the decade, slightly better than foreseen in the 1983 Corporate Plan:

ARGH UK Market Share (%)

	1984	1985	1986	1987	1988	1989	1990	1991
1984 Plan	20.0	22.0	23.2	23.4	23.4	23.5	23.5	23.5
Better/(worse) than 1983 Plan	(0.4)	(0.4)	0.8	1.0	N/A	N/A	N/A	N/A

ARGH are also forecasting generally higher market sizes than previously over the Plan period, with the result that forecast UK sales volumes exceed those foreseen in the 1983 Plan.

UK Sales Volumes (000 units)

	1983	1984	1985	1986	1987	1988
1984 Plan	320	350	381	376	398	412
Better/(worse) than 1983 Plan	33	13	34	18	40	N/A

4.4 ARGH are also planning to devote major efforts to exporting:

Export volumes (000)

1983	1984	1985	1986	1987	1988
112	110	153	170	161	173

Most of this export growth is expected to be in sales to Continental Europe, although the XX is also to be sold in the USA. Within Europe, ARGH will be concentrating on France, Italy and Germany, which account for 70% of Europe's volume potential and where margins tend to be higher than in smaller markets where there are no indigenous vehicle manufacturers. The Maestro, Montego, XX, Acclaim facelift and 5-door Metro are all expected to contribute to this export growth - the last particularly in France and Italy, where the Metro has already achieved some success and 5-door small cars are particularly popular. ARGH admit that an increase in exports to these countries on the scale envisaged is a substantial task: the company's image suffered abroad during the 1970s at least as much as it did in the UK, and the recent improvement of image in the UK has not yet been reflected abroad. Nonetheless, ARGH feel that as they re-establish a reputation for quality and reliability the export volumes projected are achievable. In support of the export effort ARGH are rationalising and developing their dealer networks in Europe; and an extensive rally and motor sport programme is envisaged to help overcome the company's image problem.

4.5 Manpower in ARGH is forecast to rise slightly in 1984 and 1985 and then to decline slightly for the remainder of the Plan period. Productivity is expected to continue the strong improving trend of recent years, although at a slightly slower pace than foreseen in the 1983 Plan:-

	1981	1982	1983	1984	1985	1986	1987	1988
Manpower (000)	51	41.5	41.9	42.4	43.2	42.2	41.7	41.2
Productivity (Cars/man/year)	8.0	9.5	12.0	12.6	14.3	14.6	15.3	16.2
Productivity higher/(lower) than in 1983 Plan	-	-	(0.1)	(1.4)	0.1	(0.5)	(0.3)	N/A.

Capital expenditure over the Plan period is expected to be rather higher than foreseen in the 1983 Plan:-

Capital expenditure (£m)	1982	1983	1984	1985	1986	1987	1988	1984-87 total
1984 Plan	92	112	173	167	181	216	242	737
1983 Plan	109	129	152	138	113	197	N/A	600
1984 Plan higher/(lower) than 1983 Plan	(17)	(17)	21	29	68	19	N/A	137

In the early years, the major part of this increase in capital expenditure can be attributed to increased levels of non-product expenditure, that is to say, cost-saving projects designed to improve efficiency across the product range but not associated with any one model launch. This increased capital expenditure is expected to be offset, mostly by improved profits, so that the cash outflow over the Plan period is expected to be slightly less than in the 1983 Plan:

	1982	1983	1984	1985	1986	1987	1988	1984-87 total
Profit/(loss) before tax (£m)								
1984 Plan	(129)	(26)	(20)	5	8	34	46	27
1983 Plan	(169)	(122)	(68)	(46)	(21)	(8)	N/A	(143)
1984 Plan better/(worse) than 1983 Plan	35	96	48	51	29	42	N/A	170
Cashflow in/(out) (£m)								
1984 Plan	(150)	(92)	(123)	(72)	(41)	(25)	(31)	(261)
1983 Plan	(293)	(206)	(132)	(78)	(18)	(55)	N/A	(283)
1984 Plan better/(worse) than 1983 Plan	143	114	9	6	(23)	30	N/A	22

Risks

4.6 ARGH's recovery plan depends heavily on an increase in market share from 18.0% in 1983 to 23.2% by 1986. The first stage of this increase depends on an increase in the market share of Maestro (from a running rate of 4.4% in 1983 to 5.5% in 1984, falling back to 4.8% thereafter) and the capture of a substantial portion of the market by Montego (5.4% by 1985); subsequent growth in the Plan period depends on the XX, which is forecast to capture around 2.5% of the market (nearly twice as much as the Rover, which it is replacing). These are demanding targets, against the background of fierce competition from Vauxhall and Ford. However, Maestro has achieved a 5.25% market share in the first three months of 1984, while Metro is once again outselling its target (of 6.2%) with a market share of 8.0%. If this pace can be maintained there seems to us to be a reasonable chance that ARGH's targets will be achieved. If they are missed, however, the effect on ARGH's profitability would be serious: BL estimate that a 5% volume shortfall in ARGH's UK sales over the Plan period would reduce the company's trading profit by some £25m in 1984 rising to £38m in 1988.

4.7 Of the other risks over which ARGH has some influence, if not control, the main one seems to be the risk of prolonged industrial unrest. Although there may be difficulties over the pay negotiations in the Autumn - the first for two years - we believe this risk to be lower than in previous years. The rapid resolution of a recent dispute at Longbridge, superficially similar (in the triviality of its cause) may be an indicator of improving employee relations. The remaining risks to ARGH's recovery are largely outside ARGH's control: the level of economic activity (and its effect on TIV) and the exchange rate (particularly against other European currencies) are perhaps the most important. As noted in paragraphs 3.5-3.6 above, we believe ARGH's domestic forecasts to be a little pessimistic and their exchange rate forecasts a little optimistic. We cannot at this stage judge the effect on ARGH's profits if Treasury, rather than BL, expectations are realised.

4.8 There might also be a risk to ARGH if UK car prices had to be held down in response to EC action to narrow the price differential between the UK and Continental Europe. In fact, ARGH's forecasts imply a narrowing of the differential over the Plan period, partly because of an ARGH policy of matching Continental inflation but pricing slightly below UK inflation, and partly because of the assumptions made about the exchange rate of sterling against European currencies. The exchange rate changes which are expected to contribute to this narrowing of differentials would in any event have some beneficial effects on UK producers as against Continental producers; and Japanese pricing pressure would be reduced. If differentials were to be artificially reduced further than is expected, ARGH's belief is that volume car manufacturers, few of whom are making very substantial profits, would in practice tend to level prices up rather than down; and that the effect of a reduced differential would therefore be minimal. Whilst this may be over-optimistic, it is certainly possible that any reductions in UK prices would be partly offset by increases in Continental prices, so increasing ARGH's export earnings and compensating in part for reduced domestic revenue. It is also relevant that a reduction in the differential would make the UK a less attractive market for foreign manufacturers, and could therefore provide ARGH with an opportunity to increase market share.

Conclusion

4.9 ARGH is continuing broadly on the path set out in previous Plans, and its projected results - which are rather better than was foreseen last year - appear to be reasonably achievable. Our major doubt concerns ARGH's ability to fund from its own resources or from borrowing on its own credit (rather than against the Varley-Marshall assurances) the substantial capital expenditure foreseen throughout and beyond the Plan period. We have asked ARGH whether it would be possible to reduce the number of planned models or take other steps to reduce the capital investment required. We have been told that the achievement of the market share forecasts in the Plan depends on achieving the market sector coverage illustrated in paragraph 4.1 above. ARGH believe that if anything there is insufficient capital expenditure planned for engine and gearbox development. We recognise the force of ARGH's arguments, but believe nonetheless that the company's capital expenditure programme should be kept under careful review in order to see whether there is any possibility of reducing it, for instance, by increased collaboration. Individual capital projects which fall for the Government's approval - that is, those costing over £25m - should be appraised against this background. We believe that a revised financial objective of the kind recommended above (in paragraph 3.8) will in fact encourage BL to take a similarly critical view of investment projects.

Privatisation

4.10 The results in the Corporate Plan do not suggest that privatisation of ARGH as it stands is very likely within the Plan period: the Board themselves assess the possibility as "fragile". We have therefore explored with BL whether it would be possible to proceed towards privatisation by establishing joint companies with collaborative partners (assuming the partners to be willing, on which we have no evidence one way or the other) to produce collaborative models, starting with the XX. Their view is that this would not be a feasible course of action. They have pointed out that, following the rationalisation programmes of recent years, ARGH's operations are highly integrated, so that many facilities are common to several models and could not be allocated to individual models and transferred to joint companies of the kind proposed. Examples include the panel press shop at Swindon, the foundry at Longbridge and the paint shops at Cowley and Longbridge. Almost the only tangible assets which could be transferred to such joint companies would be the final assembly line. Even this would require an arbitrary division of factory space and overheads between ARGH and the joint companies, and it does not appear practicable. It might be possible to form joint companies to handle sales and marketing of collaborative models: but this would deprive ARGH of a sizeable part of its profits and would not be commercially acceptable.

4.11 We have also asked BL whether there is any prospect of a collaborative partner investing equity in ARGH itself. They have told us they do not see this as likely within the next few years, during which period the business is not expected to be profitable enough to attract equity funds from anyone, whether collaborative partners or not. Nor is it yet clear that ARGH's collaborative future lies exclusively with one company (Honda); for instance, engine collaboration might well be with some other company, and future model collaboration might be with more than one company. The best privatisation strategy, they argue, is to continue to improve the company's profitability to a level at which it could hope to raise capital on ordinary commercial terms. Collaboration, to which they are fully committed in appropriate cases, is seen as a means to this end rather than as a means of securing direct equity participation by a collaborative partner.

Recommendation

4.12 We accept the force of BL's arguments on this subject. Nonetheless, we recommend that the Board should be asked, in its 1985 Corporate Plan, to bring forward proposals, taking account of the development of the company's collaborative strategy to improve so far as possible the prospect of privatising ARGH at an earlier stage than is now foreseen.

V UNIPART

Business plans

5.1 Unipart's profits are forecast to grow slightly less quickly than was foreseen in the 1983 Corporate Plan:

Profit before tax (£m)

	1982	1983	1984	1985	1986	1987	1988	Total 1984-87
1984 Plan	3	17	18	24	28	33	39	103
1983 Plan	6	16	21	26	30	34	N/A	111
1984 Plan better/ (worse) than 1983 Plan	(3)	1	(3)	(2)	(2)	(1)	N/A	(8)

All three main divisions of Unipart contribute to this increase in profits; Unipart International, the aftermarket distribution operation; Unipart Contract Services, offering a replacement parts warehousing, control and distribution service to vehicle manufacturers (initially all BL product companies, but with the intention of diversifying); and SU Butec, the parts manufacturing division:

Profit before tax by division (£m)

	1983	1984	1985	1986	1987	1988
Unipart International	6.0	7.1	8.7	10.8	12.6	14.3
Unipart Contract Services	8.0	11.0	13.0	15.0	17.0	21.0
SU Butec	1.9	2.0	3.2	3.7	4.7	5.3

5.2 Partly in order to achieve the above results against the background of a BL vehicle parc which has been in decline for several years and can only be expected to recover gradually, and partly in order to prepare the company better for privatisation, all three divisions are taking steps to reduce their dependence on BL companies (and in particular on ARGH). Thus:

a. Unipart International is concentrating its attention on the "all-makes" aftermarket.

b. Unipart Contract Services will initially be handling only BL companies' replacement parts business, but is hoping to offer similar services to other vehicle companies in the future. In the longer term the company intends to diversify beyond vehicle parts: potential markets where the company's particular skills could be profitably applied are said to include consumer durables, electronic machinery and leisure equipment.

c. SU Butec, apart from developing its "all-makes" range of aftermarket parts, intends to seek contracts to supply other vehicle manufacturers with equipment.

5.3 Over the Plan period, Unipart International is seeking to increase its turnover of "all-makes" parts from £107m (in 1983) to £135m (in 1988), an increase of 26%. This may not be easily achievable in a market which is expected to remain broadly static, as longer service intervals and greater reliability counterbalance the expected increase in the size of the vehicle parc. Unipart Contract Services, being dependent initially on BL parts, is vulnerable to the risk that demand may be lower than expected if the BL product companies' sales targets are missed. On the other hand, the forecasts for Contract Services make no allowance for revenue from the planned diversification. We think it unlikely that any other vehicle company will allow Unipart, closely linked to BL as it is bound to be for some years, to handle its replacement parts business; but the chances of diversifying outside the vehicle sector may be more promising. SU Butec too assumes increased turnover (from £72m in 1983 to £100m in 1988) in a broadly static market. About half of this expected increase can be attributed to inflation: in volume terms, the main areas of growth are expected to be in non-BL original equipment sales, up by some 150% by 1988 (though still by then constituting less than 20% of SU Butec's business).

Conclusions

5.4 Over Unipart as a whole, there hangs the major handicap of a static market resulting from larger service intervals and improved reliability, into which all divisions must make further inroads if they are to achieve their Plan. This depends above all on being price competitive and improving the cost effectiveness of manufacturing, storage and distribution systems. This is clearly well understood by Unipart, as is illustrated by the use of modern manufacturing techniques within SU Butec and of computerised warehousing in Contract Services; and, given the company's recent record, we believe the forecasts contained in the Plan to be reasonably achievable.

Privatisation

5.5 The Board's preferred strategy for Unipart privatisation is based on a perception that the company as it is presently constituted, with a very heavy dependence on BL and particularly on ARGH would be viewed by the market as unattractive and that a correspondingly poor price would be obtained. The Plan suggests that it would be possible to overcome this disadvantage by widening Unipart's distribution (and possibly product) base before privatisation by merger with other component companies. The two companies which have been identified are Edmunds Walker (EW) a distribution subsidiary of Associated Engineering (AE), and Quinton Hazell, a manufacturing and distribution subsidiary of Burmah Oil. EW's turnover is about one-sixth, and Quinton Hazell's one-third, of that of Unipart. Since submitting the Plan, Sir Austin Bide has written to the Secretary of State for Trade and Industry (copy at Annex A) formally seeking agreement to the acquisition of EW for up to £20m cash as the first stage in this process.

5.6 Discussion in the Group has revealed deep and widely held concerns (though not a unanimous view) that the proposed separation of Unipart from the rest of BL may not be to the advantage of either Unipart or the remaining companies within BL. If Unipart is separated from BL, ARGH will (so far as we can establish) be the only volume car manufacturer in the world without full ownership and control of its parts distributor. This prospect is viewed with considerable scepticism throughout the motor industry. There is a strong possibility that over time the product companies will gradually rebuild their own parts organisations and that Unipart will eventually be left only its non-BL business. Nonetheless, apart from Jaguar, Unipart presents the only prospect of early privatisation (as promised by BL in 1982) of a substantial business, and we have appraised the Board's proposals on that basis.

5.7 The vehicle parts aftermarket in which Unipart operates is divided into a number of sectors:

a. Franchise workshops are operated by dealers franchised by the vehicle manufacturers and carry out repairs on the franchising manufacturer's vehicles only. (For repairs under warranty it is a condition that franchise workshops are used). They are supplied by the manufacturer's parts distributor - for BL companies, Unipart Contract Services. Franchise workshops account for about 33% of all sales of parts for incorporation in BL vehicles.

b. The independent motor trade includes independent garages, not franchised as dealers, carrying out repairs on any make of vehicle. The stocks held by these garages are fairly small, and they are supplied by factors who purchase and warehouse a wide range of parts, some of them "all-makes" parts. Unipart is not significantly represented in this sector, which accounts for about 38% of all parts sales.

c. The DIY retail trade comprises High Street shops selling a wide range of components, many of them "all-makes" parts, to individual motorists. Unipart is represented in this sector by Unipart International. DIY sales account for about 12% of all parts sales.

d. Fleet operators often do their own repairs, and account for some 9% of parts sales.

e. Free-fit and specialist centres offer quick replacement or repair of specific items (eg exhausts, tyres), often using "all-makes" parts. This sector, in which Unipart is represented by Unipart International, accounts for about 7% of parts sales.

The proposed acquisition of EW, whose outlets are mostly in the independent motor trade, is intended to enhance Unipart's coverage of the market. The acquisition would increase very substantially the effective market available to Unipart Contract Services, and would provide additional outlets for the "all-makes" parts manufactured by SU Butec or procured by Unipart International. At the same time costs would be controlled by rationalising the Unipart and EW warehousing, distribution and administrative networks.

5.8 We are not entirely convinced that the dependence of Unipart on ARGH, substantial though it undoubtedly is, would be quite as unappealing to the market as BL believe. The Board themselves point out that the contracts concluded between ARGH and Unipart would not be terminable until 1988, and only after two years' notice, which would give Unipart plenty of time to take corrective action; and the contracts could only be terminated at some considerable cost to ARGH, who would have to find some other way of distributing spare parts (probably by re-establishing their own distribution network). It would, in our view, probably be possible to privatise Unipart as it is, although the perceived dependence on ARGH might depress the proceeds. But we are convinced that the proposed acquisition of EW, by providing Unipart with a more diversified distribution base, would considerably enhance Unipart's attractiveness, provided of course that Unipart management can demonstrate their ability to turn EW round into profit and that the prospects for a successful privatisation would be better after a merger than before.

5.9 The question then arises how a merger should be effected. There seem to be three main options, although variants could be devised. The simplest option, in commercial terms, would be a straightforward acquisition by Unipart for cash. The Board have expressed a strong preference for this course. Second, it might be possible to arrange that no cash changed hands but that each parent company took shares in the merged company proportionate to the respective value of the companies merged. A third option would involve a third party, possibly a consortium of institutions, who might purchase the "target" company and then arrange a cashless merger with Unipart along the lines of the second option. In both the second and the third options, we would expect the non-BL party holding shares in the merged company to seek to realise its investment at the time of privatisation. The Board's view is that these options would be unnecessarily complex and almost certainly more expensive than acquisition for cash.

5.10 The question whether any or all of these options is acceptable as a precursor to privatisation is essentially a political one. The first option, acquisition for cash, could be seen by some as "back-door nationalisation", and it would certainly be seen as an unconventional precursor to privatisation. In our view, however, given the commercial justification, it would be acceptable if it was accompanied by a clear undertaking by the Board (and possibly a public statement) that the merged entity would be privatised by, say, mid-1985, barring a major downturn in the market in the meantime.

5.11 The second and third options, although considerably more complex and commercially less attractive (to BL and the other parties) than the first, appear on their face to be more consistent with the overall privatisation policy. There is, however, a serious drawback. The putative external shareholder will, even if there is a guaranteed redemption of his investment by privatisation, wish to be compensated for the risk he bears in the meantime, probably be taking a larger than proportionate share in the merged company. Thus the proceeds to BL on privatisation would be reduced when privatisation took place, probably by more than the cash BL would otherwise have paid for EW in the event of a cash acquisition. If, for any reason, privatisation were deferred and BL were obliged to buy out the external shareholder, it is by the same token likely that the cost to BL would be greater than the cost of a straightforward acquisition now. We believe it is for these reasons that the Board has dismissed these options as being "complex, time-consuming to implement and expensive" (see Annex A).

5.12 To summarise, the Board have identified two major options for the privatisation of Unipart. The first is privatisation of the company as it stands. The second involves the prior acquisition of EW and the subsequent privatisation of the merged entity. We believe that the acquisition proposed under this second option would be a useful step towards privatisation, and we recommend that the BL Board should be authorised to negotiate a simple purchase for cash of EW, so long as a suitably binding commitment on the subsequent privatisation of Unipart can be agreed. We have not been able to take a view on whether the proposed price of about £20m is reasonable (although it is not obviously unreasonable, given EW's net assets of £22.4m) but this is not a matter on which a view need be taken in advance of the Board's opening negotiations.

5.13 There are two other important questions which will need to be addressed in due course. One is whether privatisation should be by flotation on the stock market or by sale to a single buyer. Our initial view is that there is little chance of a UK company in the component industry making an acceptable offer for Unipart, two-thirds of whose turnover comes from distribution. This area of the business has been relatively unprofitable for some time, and some companies (eg AE) have publicly stated their intention of concentrating on manufacturing and if possible withdrawing from distribution. Similarly, the GKN bid for AE last year was aimed primarily at AE's manufacturing operations. Outside the component industry it is difficult to see who would find Unipart's business complementary to their own (and Burmah's publicly stated intention of disposing of QH may be a pointer to the likely attitude of non-vehicle companies to the component industry). However, one possibility which the Board have discarded, because they thought that it would be unacceptable to the Government, would be a sale to one of the large American component companies. The American vehicle industry does not demonstrate the same close dependence of particular distributors on particular vehicle manufacturers, so that there are a number of large independent distributors. Some of these might be interested in acquiring Unipart. This would avoid the disadvantage to BL of selling Unipart to the distribution arm of one of their domestic competitors; on the other hand, it would put the BL companies in the perhaps unattractive position of having their parts distribution network controlled from the USA. It could also lead to further import penetration of the UK car parts market. Against this background we believe that it would in all likelihood be necessary to privatise by way of flotation; but that the possibility and implications of finding a single buyer, whether British or foreign, should be investigated further.

5.14 The second major question will be whether BL should retain a minority stake in the privatised Unipart. The Corporate Plan suggests that BL may propose retaining a stake of around 40%. The reservations which we express above (in paragraph 5.6) about the implications of separating Unipart from the rest of BL will clearly be relevant when the time comes to consider this question. On the other hand, Ministers' decision against a residual BL holding in Jaguar suggests that they will wish to consider carefully whether the benefits, both to BL and to Unipart, of a retained minority shareholding might equally well be secured by means of appropriate contractual arrangements. No decision is needed on this point at this stage, but it does need to be raised with the Board as a matter to which Ministers will wish to pay attention.

Recommendations

5.15 We recommend:

a. that the Board should be given approval to proceed with negotiations for the purchase of EW from Associated Engineering, subject to the negotiation of a suitable binding commitment to proceed with Unipart privatisation by mid-1985 and subject also to final confirmation that the price is reasonable;

b. that the Board should be invited to bring forward as soon as possible detailed proposals as to how privatisation by mid-1985 might best be achieved, such proposals to take account not only of the relative merits of flotation and sale to a single party but also to the justification for the currently proposed retention by BL of a minority stake in Unipart.

VI LAND ROVER (UK) LIMITED (LR)

Business plans

6.1 The forecasts for LR in the 1984 Plan display a marked deterioration on those in the 1983 Plan:

Profit/(loss) before interest and tax* (£m)

	1982	1983	1984	1985	1986	1987	1988	Total 1984-87
1984 Plan	(2)	(14)	3	31	49	50	52	133
1983 Plan	3	17	30	48	63	64	N/A	205
1984 Plan better/(worse) than 1983 Plan	(5)	(31)	(27)	(17)	(14)	(14)	N/A	(72)

*1983 Plan figures for profit before tax are not available on a comparable basis.

This deterioration is primarily due to a further reduction in the level of expected export volumes of Land Rovers and Range Rovers:

Export volumes (000)

	1982	1983	1984	1985	1986	1987	1988
Range Rover							
Plan	10.4	9.5	11.1	11.8	12.8	13.0	13.4
Better/(worse) than 1983 Plan	(0.3)	(1.8)	(2.5)	(7.2)	(7.6)	(8.3)	N/A
Land Rover							
Plan	31.0	20.7	26.1	31.0	33.3	35.9	36.3
Better/(worse) than 1983 Plan	(0.7)	(17.1)	(15.7)	(13.6)	(13.4)	(11.0)	N/A

6.2 The reduced level of exports foreseen for Range Rover is almost entirely accounted for by the decision not to attempt to enter the North American market, at least for the time being. This reflects two main factors. First, their most recent market survey indicates a demand for about 3000 Range Rovers annually in North America, less than half the level projected in the 1983 Plan. At this level of sales the cost of adapting vehicles to US legislative requirements is prohibitive. Second, developments in the UK and other markets have been such that LR's engineering priorities have been changed: all available engineering resources are now being concentrated on developing the "Ninety" (see below) and other, less immediately necessary, projects have been deferred.

6.3 The reduced levels of Land Rover exports in the Plan are accounted for by two main factors. First, many of Land Rover's traditional markets, especially in Africa and the Middle East, are suffering severe economic problems and have cut back sharply on imports; and sales in these markets are expected to recover only slowly. In Nigeria, for instance, imports of Land Rovers (in the form of kits for local assembly) fell from 5,700 units in 1981 to 500 in 1982 and 300 in 1983, and are expected to rise to only 2000 units over the Plan period. To some extent this reduction in expectations is offset by the prospect of a local assembly operation in Algeria, which could lead to exports of over 2000 units per year by 1986. Second, the past few years have seen increased Japanese competition in the four-wheel drive (4 x 4) market world-wide. Many of the Japanese vehicles have been less robust than Land Rovers, and correspondingly cheaper: but they have been suitable for a number of less demanding applications for which Land Rovers have until recently been unrivalled. Some Japanese manufacturers are now also moving into the heavy duty sector which LR occupies, and this has led LR to review its product strategy.

6.4 LR's product strategy review is not yet complete: but its conclusions so far can be summed up as follows:

(a) The growth to date in the 4 x 4 market has been essentially product-led, with growth stimulated by the introduction of new, often fairly light and relatively inexpensive, models. LR is not represented in the sectors showing most rapid growth.

(b) There has also been some growth in the slightly up-market versions of some heavy duty vehicles - eg long wheelbase station wagons. In these sectors LR was suffering because of the excessively utilitarian appearance of its models.

(c) LR see little prospect of success, operating from a UK cost base and with the financial, engineering and management resources available to LR, in developing a model to compete head-on in the "new", lighter (and high volume) sectors. This would be an expensive project and would divert attention from developing the areas in which LR's strengths lie - eg durability, versatility and whole life costs in tough conditions.

(d) Nonetheless, LR do intend to assemble a light 4 x 4 vehicle, under licence from Suzuki, at their Santana plant in Spain, partly to fill empty capacity and partly as a test of its capabilities in this area. (Initial indications are that the Spanish Government will require a high level of local content in this vehicle. If not, the project could threaten the UK's local content policy on Japanese investment in the motor industry, and this development will have to be closely watched.

The review of product strategy is expected to be completed shortly; but some product actions have already been decided upon. Most importantly, LR has decided to concentrate engineering resources on the proposed "Ninety", a smaller (90" wheelbase) version of the One Ten (110" wheelbase) model introduced in 1983. The Ninety is to be introduced in mid-1984, and will replace the existing 88" wheelbase model, which LR believe is less able to compete in the growing leisure market (a belief which is borne out by a decline in sales of the 88"). The plan to develop the Ninety replaces a less ambitious plan to transfer some characteristics from the One Ten to the existing 88" model. At a more detailed level, LR will be increasing the specification of some heavy-duty models to meet the failing identified at (b) above.

6.5 LR have also reacted vigorously to the reduced export prospects by announcing an unexpectedly radical rationalisation of their facilities. At present production is spread over nine different sites, eight in the West Midlands and one at Pengam, Cardiff. Over the next two years, eight of these plants are to be closed and production is to be centered on the main plant at Solihull. There will be about 1600 redundancies. The rationalisation is expected to reduce the breakeven production level to 40,500 units annually. (Sales of Range Rovers and Land Rovers together in 1983 totalled 41,300 units). The rationalisation plan was announced, after consultation with the Government, in November 1983 and appears to have been accepted by the workforce.

Risks

6.6 The major risk is that export markets will not recover to the extent foreseen. Only a slow increase is foreseen for Range Rover exports: but Land Rover exports are expected to increase by 26% in 1984 and a further 19% in 1985. There must be some doubt whether such a rapid recovery can be achieved, especially if LR continues to be isolated from the light 4 x 4 sector which has shown strongest growth in recent years. On the other hand, the forecasts are still only for a recovery to a level somewhat below what has been achieved fairly recently.

Land Rover exports (000 units)

1979	1980	1981	1982	1983	1984	1985	1986	1987	1988
33.4	38.1	35.6	31.0	20.7	26.1	31.0	33.3	35.9	36.3

Similarly, even in those African markets where, by virtue of their local assembly facilities, LR are in an entrenched position, sales are forecast to increase to levels lower than have been seen quite recently:

African exports by market (000 units)

	1980	1981	1982	1983	1984	1985	1986	1987	1988
Nigeria	2.6	5.7	0.5	0.3	0.4	2.0	2.0	2.0	2.5
South Africa	1.2	1.8	0.8	0.3	0.7	1.1	1.2	1.2	1.2
Zimbabwe	-	0.1	0.4	0.4	0.5	0.5	0.5	0.5	0.5
Algeria	-	-	-	-	-	0.3	2.1	2.2	2.2
Other	3.6	3.2	1.3	0.7	0.7	1.3	1.4	1.5	1.5
TOTAL	7.4	10.8	3.0	1.7	2.3	5.2	7.2	7.9	7.9

It is difficult to assess accurately the risk that these forecasts will be missed; but, at least in the early years, it must be substantial. (It may be relevant to note that Leyland Trucks, who depend on many of the same markets, are forecasting a rather slower recovery of export volume in 1984 and 1985, especially in Africa).

6.7 In the longer term, we are concerned at the prospect that LR's product base may become too narrowly based to compete effectively in the market against an ever-growing Japanese threat. We acknowledge the force of LR's argument that they should concentrate on their strengths and not attempt to compete in areas where they have no expertise and where the LR reputation is not established. This strategy may well be the right one: but on the other hand it bears a disturbing resemblance to the strategy once pursued by the British motorcycle industry in the face of Japanese competition. The outcome of the current review of product strategy will clearly be crucial to LR's future.

Conclusions

6.8 The environment in which LR operate has continued to deteriorate. Economic difficulties continue to beset LR's traditional markets, and the company's export projections must be considered risky. We are concerned at the prospect of an undue narrowing of LR's market coverage, although on this we await the outcome of the current review of product strategy. Against this background we consider that there are clear risks to the achievement of the Plan. Although the new management in Land Rover have acted with considerable conviction in developing and implementing a rationalisation plan which matches fixed costs more closely to expected sales volumes, it is too soon to tell whether a similarly thorough approach will be applied to the other problems facing the business. We recommend that it should be a condition of approving the Plan that LR supply, at the latest in the 1985 Plan, a detailed review of their product and market strategy. Such a review will need to take into account the scope for collaboration with other vehicle manufacturers, and it will be highly relevant to the review of the scope for privatisation which we propose in paragraph 6.11 below.

Privatisation

6.9 As in the 1983 Corporate Plan, the Board's preferred strategy is to privatise Land Rover-Leyland as a single entity. However, because of deterioration within both Land Rover and Leyland Vehicles, the forecast performance of the Group is now considerably worse than in the 1983 Plan. The Group is not now expected to return to profit before tax until 1986, and on the Board's own assessment (which we accept) the projected performance of the Group would be unlikely to warrant privatisation before 1987 or 1988. It does not seem acceptable to us that the preferred strategy should involve such a lengthy delay before privatisation is achieved unless all the alternatives have been thoroughly explored and found to be unacceptable.

6.10 We have therefore asked BL for an appraisal of the options for privatising Land Rover on its own. In reply they have pointed out that the deterioration in Land Rover's prospects means that it is unlikely that privatisation could in any event take place before 1986. More broadly, they have argued that to sell off Land Rover separately would undermine Leyland Trucks and accelerate its decline (frustrating the decision Ministers have taken to reject the closure option for Leyland Trucks), and could also damage Land Rover. There are two important links between Land Rover and Leyland Trucks: Freight Rover's and Leyland Trucks' UK distribution networks are closely linked and require continued joint franchising to remain viable; while Freight Rover needs continued close links with Land Rover because of the increasing level of component commonality. Similarly, both Land Rover and Leyland Trucks depend for a considerable proportion of their exports on the overseas assembly plants owned by Land Rover-Leyland International Holdings (LRLIH), which in turn require volume from both companies in order to be viable. If Land Rover were sold to another vehicle manufacturer, which BL see as the most likely prospect, they think it unlikely that either link would survive. It is conceivable, they argue, that such a purchaser would also purchase LRLIH because of the protected position that company enjoys in a number of markets: but if so, it would be in an attempt to gain entry to the market for its own trucks, not Leyland's. Similarly, they argue that a purchaser of Land Rover would distribute Freight Rover through its own distributors to the probably fatal detriment of Leyland Trucks.

Recommendation

6.11 These are powerful arguments, reflecting strongly held views within BL. But we are not convinced that they are, as BL claim, sufficiently strong to lead to the conclusion that Land Rover-Leyland should be kept together with a view to privatisation in 1987 or later. We recommend therefore that the Board should be asked to prepare, within a specified timescale, a study of the steps that would be needed to turn Land Rover, with or without LRLIH, into a separately sellable entity, with an indication of the timescale in which they could be accomplished. The study should take into account the possibility of proceeding towards privatisation by collaboration and/or merger with another company with capacities complementary to those of LR, particularly in the light 4 x 4 sector. The study should also include a full analysis of the effects of separate privatisation of Land Rover on Leyland Vehicles. Such a study would provide the basis for a full review of the privatisation options within Land Rover-Leyland.

VII SUMMARY OF RECOMMENDATIONS

Financial objectives for BL as a whole

7.1 We recommend that BL's financial objectives for 1985 and subsequent years should take account of the fact that the company's borrowing is in effect against the Government's credit, both so as to simulate the capital constraints imposed on commercial businesses by the market and so as to provide the opportunity for limiting, and in due course reducing, the Government's exposure under the Varley-Marshall assurances. (Paragraph 3.8).

Austin Rover Group Holdings Ltd (ARGH)

7.2 We recommend that the Board should be asked, in its 1985 Corporate Plan, to bring forward proposals, taking account of the company's collaborative strategy, to improve so far as possible the prospect of privatising ARGH at an earlier stage than is now foreseen. (Paragraph 4.12).

Unipart

7.3 We recommend:

a. that the Board should be given approval to proceed with negotiations for the purchase of Edmunds Walker from Associated Engineering, subject to the negotiation of a suitable binding commitment to proceed with Unipart privatisation by mid-1985 and subject also to final confirmation that the price is reasonable; and

b. that the Board should be invited to bring forward as soon as possible detailed proposals as to how privatisation by mid-1985 might best be achieved, such proposals to take account not only of the relative merits of flotation and sale to a single party but also to the justification for the currently proposed retention by BL of a minority stake in Unipart. (Paragraph 5.14).

Land Rover (UK) Ltd

7.4 We recommend that Land Rover should be asked to supply, at the latest in the 1985 Plan, a detailed review of their product and market strategy. Such a review will need to take into account the scope for collaboration with other vehicle manufacturers, and it will be highly relevant to the review of the scope for privatisation which we recommend below. (Paragraph 6.8).

7.5 We also recommend that the Board should be asked to prepare within a specified timescale a study of the steps that would be needed to turn Land Rover, with or without LRLIH, into a separately sellable entity, with an indication of the timescale in which they could be accomplished. The study should take into account the possibility of proceeding towards privatisation by collaboration and/or merger with another company with capacities complementary to those of LR, particularly in the light 4 x 4 sector. The study should also include a full analysis of the effects of separate privatisation of Land Rover on Leyland Vehicles. Such a study would provide the basis for a full review of the privatisation options within Land Rover-Leyland. (Paragraph 6.11).