PRIME MINISTER

BL: Austin Rover Review
(E(A)(85)28 and 29)

BACKGROUND

The recovery of BL had been proceeding with moderate success until 1984, at least on volume car production, although the heavy vehicles part of the business experienced increasing difficulty. Last year, however, the position deteriorated, mainly as a result of the Austin Rover Group's (ARG) sales and profits falling short of planned levels. The 1985 Corporate Plan showed a deterioration in projected cash flow, resulting in an increase in borrowings covered by the Varley-Marshall assurances of £243 million over the 5 year period to 1989 (and an overall increase in the Government's gross exposure, because of increased creditor levels, of £630 million). Since the 1985 Plan was prepared there have been two major developments affecting ARG in particular: the EC agreement on new and tighter emissions standards to be applied from 1989, and the prospect of further collaboration with Honda involving joint development of a replacement for the Maestro and assembly by ARG of certain Honda mid-range models. An outline 1986 plan has been prepared by BL taking these developments into account.

2. BL are meanwhile going ahead with preparations for the privatisation of Unipart before the end of this year; detailed proposals are expected to be put to Ministers within the next few weeks. The future of the remaining businesses (Land-Rover, Freight Rover, Leyland Trucks and Buses, etc) will be for consideration in the light of the results of the discussions now in progress with GM on the rationalisation of the commercial vehicle sector.

3. You held two discussions with the Secretary of State for Trade and Industry early in April, at which you expressed great disappointment about the deterioration in BL's prospects, the postponement of the Unipart privatisation, and the prospective increase in the Government's Varley-Marshall exposure. You asked for an urgent examination of possible means to reduce the ARG capital budget by £250 million over the Plan period and to BL's borrowings on a downward path; meanwhile no commitment could be entered into on collaboration with Honda.

MAIN ISSUES

4. The main issues before the Sub-Committee are:

i. whether there is a viable alternative to the outline ARG 1986 Plan which would bring ARG into a more satisfactory financial position and reduce the Government's financial exposure;

ii. depending on the answer to i., whether to approve the outline ARG Plan including the collaboration with Honda;

iii. what sort of limit to place on BL's borrowing, with a view to containing any increase in the Government's financial exposure.

Alterhative strategies

5. Until the recent set-back there had been some prospect that ARG's business might develop to the point where it would be ripe for privatisation towards the end of this decade. The prospect of this having receded, the implications of three alternative strategies which would reduce capital expenditure by £250 million over the Plan period, and so slim down ARG's operations, have been explored: not replacing the Metro; buying in engines and gearboxes, and in particular the engine for the Metro replacement; and restricting ARG's presence in the medium car range to a single model. ARG, the Department of Trade and Industry, and Baring Brothers have all concluded that none

of the options is preferable to the outline ARG Plan. The comparative figures are shown in the table in paragraph 5 of Mr Tebbit's paper.

6. On the question of the Metro replacement, differences of view are possible about the rate at which demand would fall away and the timing of the end of production; but ARG have had their greatest success with cars of this size, and there would be little prospect of maintaining a viable company (manufacturing operation, dealer network etc) if ARG withdrew from this sector. The financial projections show that the result would be a rapid movement into large losses, and a very large cash outflow within the Plan period. In other words there would be a very high risk that cutting back in this way on capital expenditure would precipitate the crystallisation of a large part of the Varley-Marshall liabilities.

7. It is perhaps somewhat more difficult to reach a firm judgment on the option requiring the buying in of engines and gearboxes. In principle savings might be made by ARG if they could find a collaborator on a small car engine meeting the new EC emissions standards; but there is no candidate in sight, and no precedent for large volume buying in of petrol engines. Nor is there an existing engine meeting those requirements around which ARG could design a new car, and ARG would be at an enormous market disadvantage if they had to wait for another manufacturer to develop such an engine before they could begin work on a Metro replacement. Finally, even if an engine could be bought in, ARG would be in a relatively weak bargaining position in approaching another manufacturer with whose cars ARG would be competing.

Policy Unit disputes these points.

8. Restricting the medium car range is the option least fully explored, in that ARG have assumed that the Honda collaboration would not go ahead, and that the car to be produced would be a compromise between the Maestro and Montego replacements. Other assumptions might be made, e.g. that the car would be

produced in collaboration with Honda; but the implications of either the strategy assumed by ARG,or any possible alternatives,for market coverage, dealer network etc. would certainly be adverse, and Honda's readiness to cooperate would be far from certain.

The Honda collaboration

9. This option involves

i. a collaborative programme to develop and manufacture successor to the Maestro and Rover 200, which would use both ARG and Honda engines;

ii. ARG to produce the Honda Ballade as sub-contractor, and perhaps subsequently other Honda models;

iii. Honda to establish an engines plant at Swindon to supply engines for the collaborative car, the Ballade and the Rover 213.

The alternative for Honda would be to establish a green field assembly plant à la Nissan. So far as ARG are concerned, the collaboration would reduce the cost of developing the Maestro replacement, and should help to inculcate throughout the Group Honda's higher quality standards, so contributing towards the improvement in the reputation of ARG's products which is essential for eventual successful privatisation. ARG would have to make some limited investment at Longbridge to produce the Ballade, but the pay off period would be short. Altogether it does not appear that ARG have anything to lose from the proposed collaboration, even if it did not lead to a continuing close relationship between the two companies in the 1990s; and having Honda use ARG's excess capacity at Longbridge would avoid the creation of yet further excess car manufacturing capacity in the UK.

Baring Brothers Report

9. It does not appear that Barings have any strong engineering expertise; and they have not had time to make exhaustive independent studies of the consequences for ARG of pursuing possible alternative strategies. Their report, circulated with Mr Tebbit's paper, should probably be seen, therefore, as a quick review by independent observers of the facts of ARG's situation; they approached these facts with fresh eyes, and without previous commitments, and saw no reason to dissent from the conclusions reached by ARG and Department of Trade and Industry officials. They do have considerable experience of the Japanese scene, and their judgment on Honda's approach to the situation should carry some weight.

The underlying choice

10. The position would be more satisfactory if the deterioration in ARG's prospects, and the extra burden of meeting the EC emissions requirements, could be offset by bringing forward the privatisation of some other part of BL, or otherwise scaling down the company's operations so as to reduce the Government's financial exposure. However, with the successful privatisation of Jaguar, and the forthcoming privatisation of Unipart, and with discussions continuing with GM on Land Rover and heavy vehicles, it does not appear practicable to find any further satisfactory half way house between continuing to support ARG at broadly its present level of operations, and running it down in a way which would precipitate early closure and result in the crystallisation of the Government's liabilities. It must be very doubtful whether Honda would be ready to commit themselves to a collaboration for the medium term with ARG, if the UK Government's approach was perceived to be one of restricting very tightly that company's access to the resources it needed to survive in the market. Although ARG's performance has been disappointing, it has to be acknowledged that the car market has been and remains very difficult, with a number of other European manufacturers doing very considerably worse than BL. Moreover, although ARG have not found a viable method of reducing capital expenditure by £250 million, £45 million extra to meet EC emissions standards, and £25 million to provide for the assembly of Honda cars has been absorbed

in a revised projection £28 million lower than in the 1985 Plan.

BL borrowing and the Government's exposure

11. Consideration was given to the possibility of reducing the Government's exposure by prescribing a declining borrowing limit within which BL would have to live, and leaving the company to adjust the scale of its business to fit in with such a limit. However, given the apparent impossibility of reconciling the Government's desires with the company's situation, this did not appear to provide a way forward. Nor, for reasons explained in paragraph 4.2 of E(A)(85)29, would putting limits on total Varley-Marshall exposure (i.e. including creditors) rather than on borrowings be a satisfactory form of control. Mr Tebbit therefore proposes to impose a borrowing limit akin to a nationalised industry EFL, which would be set at the level projected for the end of 1985. This would require BL to husband their financial resources carefully, and to economise on working capital, since it would keep maximum borrowings £67 million lower than the level projected in the 1986 outline Plan for 1986 and 1987. Trends in borrowing, and in other short-term financial flows will in any event need to continue to be maintained very closely; and the limit will need to be reviewed in the light of privatisations and decisions yet to be taken on the future of the commercial vehicle business.

Other Issues

12. Mr Tebbit in paragraph 17 of his paper proposes endorsement of the other, less major, recommendations in the official report. This refers to paragraph 5.2.3-17 of E(A)(85)29; the recommendations generally call for full coverage in the 1986 Corporate Plan of the options for investment, model development and rationalisation open to BL in respect of Land Rover, Freight Rover, Leyland Trucks and Leyland Bus. Specific decisions are not required at this stage, and indeed cannot be taken until BL have done the further work specified, and conclusions have been reached in the current discussions with GM.

HANDLING

13. You will wish to invite the Secretary of State for Trade and Industry to introduce his paper. The Chancellor of the Exchequer and the Secretary of State for Employment will wish to comment on the financial and employment aspects of the issues before the Sub-Committee. Other Ministers are likely to want to comment on the wider economic and political aspects of the future of BL/ARG.

CONCLUSIONS

14. You will wish to reach conclusions on

i. whether a viable option can be found for scaling down ARG's investment programme, so reducing both the company's level of activity and the Government's financial exposure;

ii. if no such option can be found, whether to endorse the proposed Honda collaboration and the 1986 ARG Outline Plan;

iii. whether to impose a limit on BL's borrowings of £680 million, subject to review in the light of privatisations and other developments;

iv. the need for further discussion, as soon as possible, of BL's proposals for the Unipart privatisation and the future of the Land-Rover-Leyland businesses.

JW

(or P L GREGSON
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