P 01620

PRIME MINISTER

This is deliberately a full brief which should relieve you of the need to read the papers in any detail

AT 26/7

E(A)(85)16th MEETING AT 10.30 AM ON MONDAY, 29 JULY
SHORT BROS PLC: STRATEGY, FUNDING AND PROSPECTS FOR PRIVATISATION

FLAG A E(A)(85)51

BACKGROUND

The papers are lengthy (not least the Note by Officials on the 1984 Corporate Plan Update) and this brief seeks to cover the key points you will need to know for the purposes of this discussion.

2. Short Borthers is not a nationalised industry but a Government company wholly owned. The Department of Economic Development (DED) in Northern Ireland holds 90.5 per cent of the issued shares; and the Department of Trade and Industry the rest. The company has three activities:

Aircraft	-	manufacturing small commuter/utility aircraft;
Aerostructure	-	manufacturing parts built on a subcontract basis for major aircraft manufacturers;
Missiles	-	manufacturing Blowpipe, Javeline and Seacat missiles;

During 1984/85 these three activities accounted for some 25, 30 and 45 per cent of gross margins respectively.

3. Shorts is the largest manufacturing employer in Northern Ireland - some 6,700 jobs and about 7 per cent of total manufacturing employment in the province. Its performance in recent years has been*

	1980/81 £m	1981/82 £m	1982/83 £m	1983/84 £m	1984/85 £m
Porfitability					
Turnover	111	122	139	163	199
Profit/(Loss) after tax	(13)	(15)	(7)	(2)	1
Cashflow					
EFR Cumulative	32	65	74	89	95
EFR Annualised	26	33	9	15	6

4. The 1983 Corporate Plan Update directed Shorts to achieve an operating profit of £13 million for the year to March 1985 and an overall profit of £5 million for that period. The cumulative EFL at March 1985 was to be within £87 million. Due mainly to a fall in SD 360 airline sales, these figures were revised in late 1984 to £2.5 million overall profit and EFL of £95 million. The Company has stayed within its revised EFL, but its operating profit is only £1 million.

Proposals

--- 5. In his Memorandum (E(A)(85)51), Mr Hurd proposes:

(a) to note with approval Shorts' decision not to proceed with the development of the SD 360 airliner (to be known as the SD 450); and to seek a revised forward strategy from the Board by Christmas;

(b) to note that the company may bring forward plans for SD 330/360 variants, but only invest in these with his approval;

(c) to set an annual EFL for Shorts in 1985/86 of £16 million and a profit target of £4 million;

(d) to agree new flexibility arrangements for Shorts;

(e) to continue to regard Shorts as a candidate for privatisation once this can be achieved by flotation; and to invite his Department's advisers to carry out more work on this for further consideration in 1986;

(f) to reappoint Sir Philip Foreman as joint Chairman/ Managing Director until 1988 alongside other measures to strengthen management; and

FLAG B

(g) to endorse recommendations (iv)-(vii) in paragraph 79 of the Note by Officials (circulated with the letter of 19 July from Mr Hurd's Private Secretary).

MAIN ISSUES

6. The main issues are:

(a) the 1984 Corporate Plan Update;

(b) Flexibility;

(c) Privatisation;

(d) Management.

The 1984 Corporate Plan Update

7. The 1984 Corporate Plan Update is considered in detail in the Note by Officials, which reflects the views of Touche Ross management consultants and explores the financial consequences of several business options, including withdrawal from each of Short's main activities. The most favourable results flow from Shorts' preferred strategy, as follows:

	1985-86	1986-87	1987-88	1988-89
EFL				
- cumulative (£m)	110	137	132	130
- annual (£m)	15	27	(5)	(2)
Net Profit (£m)	8	10	12	16
Employment	7400	7700	7800	8200

8. The figures for 1985/86 need to be viewed in the light of four features:

(a) Aircraft Development

Shorts have decided not to proceed with the development of a stretch to 44-49 seats of the SD 360 airliner (the SD 450). This has limited commercial potential and the decision will reduce cash expenditure over the Plan period, improving profit in the medium term. But the Board will wish to develop an alternative strategy through the SD 330/360 range and promotion of the Tucano trainer for export. Shorts will also wish to consider whether, for the longer term they should develop a new generation commuter airliner with new technology in collaboration with another industrial partner. Mr Hurd proposes to invite Shorts to present proposals on these options by Christmas so that they can be considered early in 1986.

Shorts are reconsidering how much they should spend on aircraft development in the light of the SD 450 decision. Mr Hurd will not sanction any expenditure until he has had a formal submission; nor will he approve expenditure on the projected SD 330 military variant (a synonym for LMT - Light Military Transport) until the sales prospects to the US Air Force or others look firmer.

(b) Aerostructures

Shorts aim to provide aerostructures for the Boeing 7-7 towards the end of the Plan period. Boeing have recently decided to defer the launch of this aircraft until the early 1990s. Mr Hurd agrees that Shorts should pursue this contract, but believes their financial forecasts should be adjusted accordingly until they secure it.

(c) Missiles

Missiles have been Shorts' most profitable activity. They developed the concept of the high velocity missile, for which the Ministry of Defence (MOD) have placed competitive feasibility studies with Shorts and British Aerospace. Shorts missile business will face a bleak future if they do not secure the development and production contracts, the former of which is to be decided by MOD early in 1986, and their financial forecasts assume they will be successful.

(d) Capital Restructuring

Shorts' forecasts assume capital restructuring on 1 April 1985 to prepare for return to the private sector by injecting £55 million equity and converting £23 million Government loans to equity. This did not happen and the effect is to increase interest payments and reduce profitability.

9. Mr Hurd proposes to adjust Shorts' EFL and profit targets in the absence of capital restructuring and in the light of the SD 450 decision. He recommends an EFL for 1985/86 of £16 million (as against £15 million in the original preferred option) and a profit target of £4 million (as against £8 million). The Note by Officials confirms that the company's business forecasts underlying these EFL and profit targets are realistic. Treasury agree. E(A) should, therefore, agree to the figures Mr Hurd is proposing.

Flexibility

10. Mr Hurd believes it is important to give Shorts greater overall flexibility. Touche Ross agree. Shorts' aircraft sales are unevenly spaced throughout the year - they peak in spring and autumn. The

high value of each aircraft (£3 million) means that minor variations have significant short term cash effects. Shorts contend that if privately owned, they would always have open the possibility of building more "whitetails" (completed aircraft for which a buyer is not identified) to take advantage of a resurgence in demand. In mid 1984 Shorts underestimated demand for the following spring and could have sold more aircraft in February and March 1985 had they been available. They argue that they did this because the risk of an EFL overshoot outweighed the benefits of increased sales.

11. The Note by Officials recommends that flexibility be introduced provided this is consistent with the EFL regime. It suggests a new facility enabling Shorts to draw short term bank borrowings up to a specified maximum, say £2.5 million, for each whitetail genuinely completed and ready for sale. The total facility would be £15 million and allow for up to 6 aircraft. Once each aircraft was sold, Shorts would have to repay the relevant £2.5 million immediately.

12. Mr Hurd therefore recommends such a short-term financing facility up to £15 million . The Treasury accept this in principle, but are likely to argue that £10 million would be enough for Shorts' purposes.

Privatisation

13. Shorts' business prospects remain subject to major uncertainties. In addition to the factors mentioned above, the future profitability of the aircraft side of the business depends on sterling not appreciating much further against the dollar. Samuel Montagu have produced a report on the options for privatising. They conclude there are two routes through a trade sale to a corporate buyer, or through flotation. A trade sale could be undertaken after the company accounts become available in March 1986 and could generate, on optimistic assumptions, net receipts of up to £25 million. It should be possible without injecting £80 million additional share capital (although existing Government loans of £23 million would need to be converted to shares).

It would fall to the purchaser to inject the necessary capital and if he had sufficient financial standing, Government guarantees would not be needed to finance aircraft sales after disposal. But there would be disadvantages. If the buyer wished to rationalise the firm within a larger group, this could reduce employment. Conditions could be written into the contract to prevent this, but this could reduce the prospects of a sale. Shorts also fear a trade sale would mean the loss of their independence in R&D work. Mr Hurd therefore opposes it. He believes it would relegate Shorts to a branch factory, with the risk of wholesale or partial closure in a few years time.

14. Mr Hurd accordingly favours privatisation through flotation, and hopes to combine this with wider share ownership arrangements and an employee share scheme. Before flotation it would be necessary to undertake a capital restructuring of Shorts by writing down the share capital to cover the accumulated deficit of approximately £66 million at March 1985; by capitalising outstanding loans to Government of £23 million; and by injecting new capital of up to £80 million. Shorts would need to have reported profits before tax for two years prior to privatisation; this suggests the earliest possible time for flotation would be the first quarter of 1987. On the basis of profits projected in the latest Corporate Plan, sale proceeds from 1988 flotation could be between £60 and £70 million, implying a cash loss on disposal of £10-20 million. Despite the strengthening of the balance sheet, it is unlikely that the privatised company would be able to support the sales financing required to maintain civil aircraft sales after privatisation. This would require Government guarantees.

15. The Treasury agree with Mr Hurd's preference for privatisation through flotation; and with his recommendation that his Department's advisers do further work so that this can be considered in 1986.
Policy Unit suggest a placement as a compromise.

Management

16. Sir Philip Foreman is currently both Chairman and Managing Director.

Mr Tebbit and Mr Hurd believe he should continue this dual role after his appointment as Chairman expires in March 1986, because of the major contribution his leadership has made to Shorts. Sir John Sparrow has accepted the post of non-executive Deputy Chairman. Sir Philip wishes to strengthen the Board by creating a new post of Deputy Managing Director (to be filled by the current Finance Director) and to recruit a new Finance Director. Mr Hurd agrees and proposes to reappoint Sir Philip in his dual role until March 1988 and, in the intervening period, to test the new Deputy Managing Director and to seek external candidates as Managing Director from 1988.

17. The essence of this complex picture is that the future of Shorts is far from assured in the longer term, whatever the eventual decision about ownership, but there is no reason for early consideration of options for radical retrenchment.

HANDLING

18. You will wish to invite Mr Hurd to present his proposals and the Chief Secretary, Treasury to respond. The Minister of State, Department of Trade and Industry may wish to comment. Other Ministers may also wish to contribute, but the present proposals seem unlikely to be controversial.

CONCLUSIONS

19. You will wish the Sub-Committee to note with approval:

(i) Shorts' decision not to proceed with the development of the SD 360 airliner (SD 450); and the intention of the Secretary of State for Northern Ireland to seek a revised strategy from the Board by Christmas in the light of this decision; and

(ii) that Shorts may bring forward plans for SD 330/360 variants, but that the approval of the Secretary of State for Northern Ireland will be necessary before Shorts undertake any investment in these.

19. You will wish the Sub-Committee to reach conclusions on:

(i) whether the annual EFL for Shorts for 1985/86 should be set at £16 million with a profit target of £4 million, or whether the EFL and profit target should be set at some other figure;

£10 - (ii) the amount of any flexible borrowing facility to allow for unpredictable variations in the timing of aircraft sales;

(iii) whether to continue to regard Shorts as a candidate for privatisation either by flotation or some other method such as trade sale; and whether the Secretary of State for Northern Ireland should commission more work so that this can be considered further in 1986;

(iv) whether to reappoint Sir Philip Foreman as joint Chairman/Managing Director until 1988 alongside other measures to strengthen the management; and

(v) whether to endorse recommendations (iv)-(vii) (concerning exchange rate hedging policy, plans to reduce working capital, to bring production costs more in line with estimates, and to make savings on overheads) set out in Paragraph 79 of the Note by Officials.

J B UNWIN

Cabinet Office
26 July 1985