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CABINET

MINISTERIAL COMMITTEE ON ECONOMIC STRATEGY

SUB-COMMITTEE ON DISPOSAL OF PUBLIC SECTOR ASSETS

DRAKE AND SCULL HOLDINGS LTD (DSH)

Memorandum by the Secretary of State for the Environment

Introduction

1. The previous administration decided in 1976 to provide assistance under Section 8 of the Industry Act 1972 to this company of mechanical and electrical engineering contractors as a rescue operation. It did so to safeguard public sector contracts and to protect the reputation of UK construction firms overseas. Assistance was in the form of a subscription to 598,166 £1 E preference shares (redeemable in tranches between 1983 and 1990), and at the same time the company entered into an agreement with its banks and the Government which gives us a considerable degree of oversight and control over its affairs. In return, the Government may be called upon in certain circumstances to subscribe to further shares until 31 October 1980, when the agreement is due to expire.

2. The company is now trading profitably and began to pay dividends to its shareholders last year. It is anxious to end the support arrangements, partly to increase its commercial freedom, and partly to shed its "lame duck" image. The Chairman therefore made a formal request to the Government last March that the agreement be terminated and our shares placed with institutional investors. Consideration was deferred because of the election.

3. DSH is still showing substantial accumulated losses in the form of negative reserves on its balance sheet. It wishes to effect a capital reconstruction to eliminate these, which would involve the conversion of the preference shares to ordinary shares and a rights issue. So long as the agreement remains in force, the Government's consent to these proposals would be required.

Sale of Shares and Termination of the Agreement

4. The objectives which led the previous administration to support the company have been achieved, and it is now able to stand on its own feet. The Government has already received a return on the investment through the protection of public sector contracts. In addition, sale of the shares is likely to realise a gross capital

gain at present market values of some £225,000 (the precise figure can only be settled the day before sale). My merchant banking advisers (Schroder Wagg) consider that there is no reason to expect that a substantially better price would be realised by postponing sale for a few months. Accordingly I recommend that the shares should be sold and that sale should take place as soon as possible, subject to the negotiation of a satisfactory price, to minimise the risk of premature disclosure of the Government's intentions.

5. It would be inappropriate to retain either our obligations or our powers of control and scrutiny over the company's affairs after disposal of the shares, but it is essential to keep them so long as the Government maintains its present financial interest. The other parties to the agreement, the banks, are willing for it to be terminated. I therefore recommend that, save for one provision, the agreement with the company and the banks should be terminated simultaneously with disposal of the shares. Under one clause of the agreement DSH have undertaken to complete contracts or subcontracts in progress in August 1976 where a UK public sector body was the client in accordance with their terms or with agreed variations of those terms. At least three of those contracts are only due for completion in the next three months, and there are claims outstanding on several others. I therefore propose that this provision of the Agreement should remain in force.

<u>Timing</u>

6. The company had hoped to announce its interim results with the other arrangements on 5 July, but was obliged to postpone any announcement perhaps for a further two weeks. It would be very helpful to the company, and would help to maintain confidence in its relations with the Government at a particularly delicate time, if we were able to take a decision on these matters as soon as possible after 19th July. If the preference shares are to be converted to ordinary, conversion must take place on the 29th day following publication of the interim results, and a considerable amount of preparation will be needed for that to go smoothly. If that date is missed an easy opportunity will not recur for another eight months and the company's reconstruction plans will be similarly delayed.

<u>Sale of Shares to Employees</u>

7. I have given exhausive consideration to giving employees the opportunity to acquire shares, in the light of policy on the disposal of public sector assets. The position is complicated because we are the sole holders of this special class of preference which is not listed on the market, and conversion in due course to ordinary shares is an important part of the company's capital reconstruction proposals. In my view, and in the view of the merchant bank advising us, they are not suitable in their present form for offer to sale to employees, and it would not in any case be practical to synchronise such an offer with placing of the main block of the shares with institutional investors.

8. One course which would guarantee employees an opportunity to acquire shares would be for the Government to withhold a predetermined block from the main disposal operation and offer these subsequently to employees. We are advised that a prospectus on behalf of the Government would be needed for such a sale to employees (covering the history of the company, reasons for the sale, latest accounts and interim results etc,) though the cost of producing a document of this kind would not be prohibitive. This course has however a number of disadvantages. The Government would be retaining a smaller financial stake in the company for an uncertain period after the basic arrangements had been terminated. If the market price of the shares were to vary after the main disposal operation, the Government would be embarrassed by criticisms of bad faith or bad financial judgement. There is also the risk that employees would only take up the offer in part, leaving the Government with a residual shareholding; if this occured the Government would have to sell the shares on the open market as the opportunity arose, which could take a further six to twelve months. However, neither the stake involved (say 5-10% of the Government shareholding) nor the likelihood of a sharp drop in the share price are sufficiently large for this added complication to put at risk the financial viability of the whole operation.

9. There might however be an alternative which would give employees a very good prospect of acquiring shares while avoiding most of the difficulties outlined above. The company, as part of a capital reconstruction scheme prepared simultaneously with their request to end the support arrangements has a rights issue under consideration, which would in part be offered to the Department as shareholder and could in turn be offered to employees. This course of action would involve placing the Government's entire shareholding "ex rights" with the institutional investors in the manner recommended by our merchant bankers, which would however reduce the proceed from the sale to institutional investors by £35,000. This has a number of advantages. The documentation supporting the offer to employees would be similar to that to shareholders. The direct cost to the Government of making the offer would therefore probably be lower. The offer would be underwritten and shares not purchased by employees would not be returned to the Government. It would therefore allow a clear break to be made.

10. It is uncertain however whether this alternative method of offering sale of shares to employees can be brought about in the foreseeable future. Recently the company withdrew its intention to go for a rights issue immediately due to the present state of the market.

There is also an element of risk in the arrangement in that, while it would be a condition of the placing of the shares that the company should announce its intentions about a capital reconstruction and rights issue, the company's proposals would need the subsequent approval of shareholders after our shares had been placed. It is however most unlikely that shareholders would reject the proposals, and the risk could be further reduced by requiring purchasers of the Government's shares to vote in their favour.

11. DSH has some 2,500 UK employees, and some 500 regular employees overseas. The legal requirements of other countries will make it very difficult to offer all overseas employees an opportunity to purchase or subscribe. The transaction is already a complex one to carry out within a tight timetable and, to avoid further complication, I recommend that the offer be confined to UK employees.

12. The company's co-operation will be needed in allocating to all regular UK employees the opportunity to purchase the retained shares or to subscribe to the rights issue. The basis of the allocation might be length of service, salary, or to allow each individual to subscribe to an identical minimum amount. The last method is the simplest and the fairest, and I therefore recommend it. At the price for the shares at present envisaged, if say 2,000 of the employees were eligible and chose to subscribe, each would acquire some 150 shares at a cost of about £50. ~~acquire some 300 shares at a cost of about £100~~. If not all the shares were taken up on this basis, I suggest that the remainder should be made available to employees who have applied for shares in excess of their basic entitlement. Any final remaining balance would then be taken up by institutional investors, or on the open market.

Summary

13. There are therefore three possible ways in which the Government might dispose of its shareholding;

Course (A) Placing the Government's entire shareholding "ex rights" with institutional investors and offering the Government's entitlement of any rights issue, underwritten, to employees; this would reduce the maximum proceeds from the sale by £35,000.

Course (B) Placing the bulk of the Government's shareholding with institutional investors (90% say) and offering the remainder, not underwritten, to employees.

The cost of preparing the required prospectus would be in the region of £30,000; and there would also be a possibility that in the extreme up to £100,000 might be lost were Drake and Scull to cease to trade profitably - but the actual risk must be much less than this.

Course (C) Placing the whole shareholding with institutional investor, with no offer to employees. This would provide the maximum sum realiseable from the sale.

14. Consistent with our general policy on these matters I think on balance we should take as our first line of approach options which will give employees the opportunity to purchase shares. Course (A) in para 13 is clearly the most attractive, but depends on the Company undertaking a rights issue which the Chairman apparently rules out for the forseeable future. I would therefore seek your agreement to pursue Course (B) with the Company and my professional advisers. If however after exploration this solution no longer appears feasable or is likely to result in the Government incurring substantial expense. I would welcome the further discretion to dispose of the complete shareholding to institutional investors ie Course C.

I therefore invite my colleagues to agree that

(1) The Government should proceed to the disposal of its shareholding in Drake and Scull as soon as possible subject to the negotiation of a satisfactory price; and the agreement, subject to (3) below, should be simultaneously terminated.

(2) With respect to employee participation, I should be authorised to pursue with the Company, in consultation with our professional advisers, the sale of a block of shares to employees, but not more than 10% of our holding.

(3) The provision in the agreement regarding performance on public sector contracts in progress in August 1976 should remain in force until those contracts are completed and outstanding claims and final accounts settled.

MH

Department of the Environment
2 Marsham Street
London SW1

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