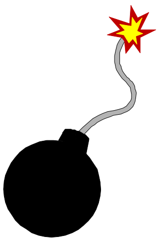
briefing note

MG Rover Group

£500m cash legacy will last until 2003/4, but it's not enough money to pay for both new models and brand building.



- BMW cash legacy of £500m not enough to cover operating losses and the development of the New Medium Car to replace the Rover 45/MG ZS.
- Production volumes not high enough for MG Rover to achieve conventional economies of scale: plant productivity poor; purchasing power poor.
- Survival past 2005 depends on success of the New Medium Car turning cash-flow positive.
- Long term, the New Medium Car is unlikely to make enough money to pay for its own replacement, let alone the development of other models.

MARCH 2001

Executive Summary

MG Rover has a cash legacy of £500m from BMW. They plan to use this to pay for the development of the New Medium Car to replace their out-of-date Rover 45/MG ZS model in 2004. Meanwhile they continue to operate at a loss. Realistically they also need to invest in brand marketing, replace the Rover 25/MG ZR and MG F, and cover their operating losses. The £500m cash will not stretch that far.

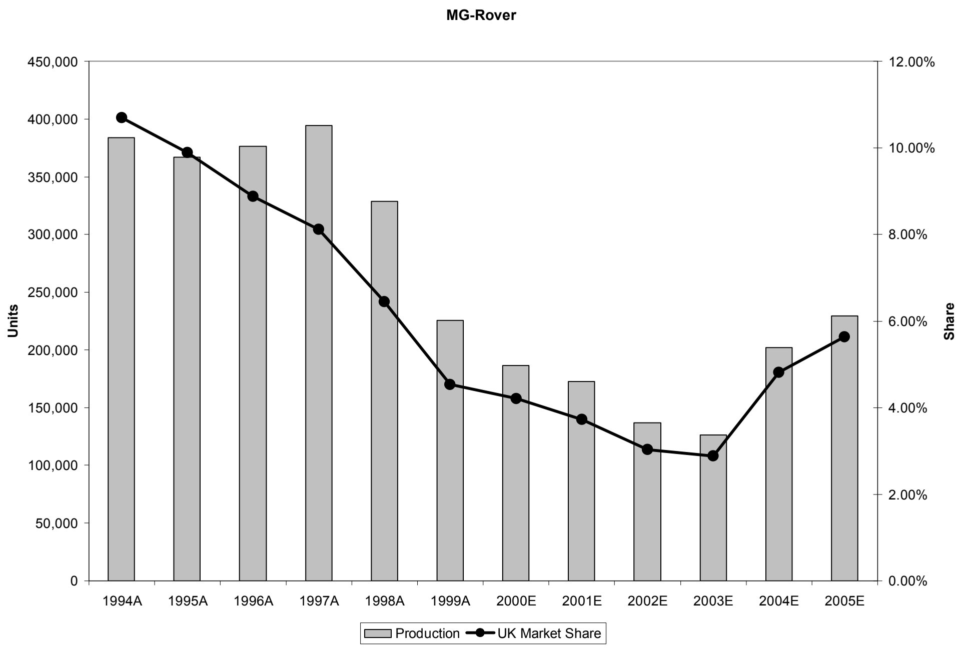
MG Rover will last long enough to launch their New Medium Car. Production volumes at Longbridge will not get high enough to achieve conventional levels of economies of scale and productivity. This means that even if the New Medium Car is a success, it will not generate enough profit to pay for its own successor, nor the investment needed in other models.

Statistical Abstract

	2000	
Vehicle Sales	205,000	units
Vehicle Production	175,000	units
Turnover		
Vehicles	£1,220	million
Parts	£250	million
Total	£1,470	million
Operating Profit	£(300)	million

	2000
Employees	
Production	4,300
R&D	600
Sales & Admin	300
Overseas	300
Total	5,500

Source: Company Data, Financial Times 12/03/01, Own Estimates



Source: Historic Actuals and Own Estimates

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Introduction

The purpose of this briefing note is to provide a summary of the current status of MG Rover and an opinion on its future outlook.

Background

MG Rover Group is an independent unlisted limited company formed during the break-up of the former Rover Group by BMW AG in spring 2000 (BMW bought Rover from BAe in 1994). MG Rover Group is owned by MG Rover Group Holdings, the company formed by the previously named Phoenix Consortium.

In the spring of 2000, BMW sought to fix its loss making Rover Group operations by splitting them up and selling them off. The figure below summarizes what happened to the assets of the former Rover Group.

BMW's Rover Group	Now Owned by:
Land Rover Solihull Assembly Plant Gaydon R&D Centre R&D Staff on Land Rover Projects Gaydon Heritage Museum	Ford
Mini, Triumph, & Riley Cowley Assembly Plant Swindon Pressing Plant Longbridge Engine Plant Consumer Finance Company Overseas Sales Offices	BMW
Rover, MG, Austin, & Morris Longbridge Assembly Plant R&D Staff on Rover Projects	ROVER, MG

Ford got the cream of the Group, in particular the Gaydon site (R&D and Heritage Museum). Gaydon is likely become the UK development heart of its Premier Automotive Group for the Jaguar, Land Rover, and Aston Martin marques.

Far from "ditching" Rover Group, BMW retained significant assets. The Mini, Riley and Triumph marques were kept, and production of the new Mini relocated to the Cowley assembly plant at Oxford. Additionally, BMW is opening a new engine plant at Hams Hall, Birmingham, and a Rolls Royce plant at Goodwood, Chicester.

Longbridge engine plant going back to MG Rover. Swindon pressing plant looking for a buyer.

Because the Longbridge engine plant and Swindon pressing plant also served customers outside Rover Group, BMW kept these plants too. But BMW does not have a long-term interest in these plants. The Longbridge engine plant is likely to be given to MG Rover as part of the "final settlement" of BMW's desire for a clean break from MG Rover. BMW is seeking a purchaser for the Swindon pressing plant and is believed to favour a component maker such as Mayflower. If a purchaser is not found soon, BMW may need to make staff redundant: Swindon's external customers (Land Rover and Honda) are taking operations back in-house and MG Rover business continues to decline. However panels for the new Mini and new Rolls-Royce may be sufficient to secure the medium-term future for the plant.

BMW had planned to sell the assets not wanted by itself or Ford to Alchemy Partners. Alchemy intended to scale down car production at Longbridge from around 250,000 vehicles per year, to around 80,000 MG sports cars. This deal did not go ahead and the Phoenix consortium, headed by previous Rover boss John Towers, bought the MG Rover assets from BMW for the token sum of £10.

The unwanted remains of decades of failure

In reality, MG Rover got the rump of the old Rover Group. Crucially it did not get the Gaydon site, or the consumer finance company, or the overseas sales offices. But it did get a balance sheet free from debt, and a cash "legacy" of £500 million. The cash legacy is roughly what it would have cost BMW to shut-down Longbridge; they reckoned that either Phoenix could do this for them, or at least keep the place running long enough for BMW to make good its escape.

Discussion

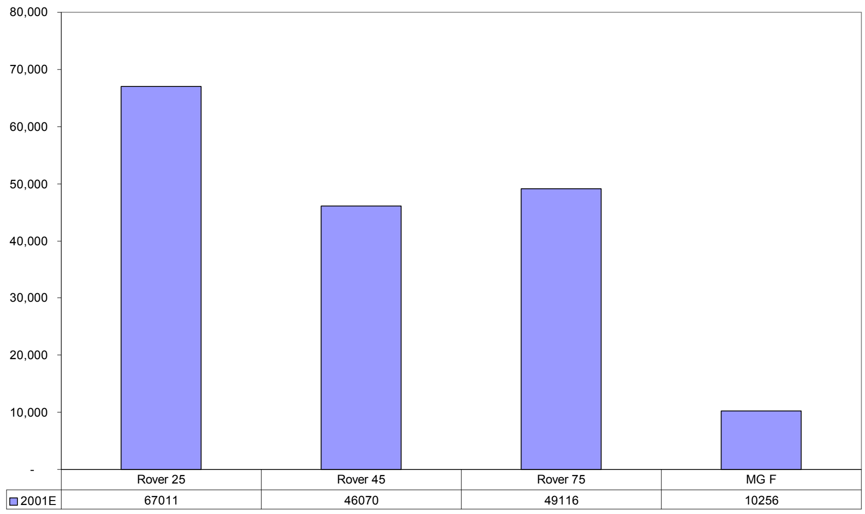
Product and Marketing

To have good sales a car company needs excellent up-to-date cars, a clear image for its brand, and a strong base of customers.

Existing Product

MG Rover makes four products: Rover 25, Rover 45, Rover 75, and MG F. The Rover 25 was launched in 1995 under the name Rover 200. The Rover 45 was launched 1995 under the name Rover 400. The MG F was launched in 1995. The Rover 75 was launched 1999, a brand new car designed by BMW engineers.

MG-Rover Production 2001 estimate



Source: Own estimates

Production for 2001 is estimated at 172,500 units. The chart above shows the split between the four models. MG Rover has just launched sports versions of the Rover 25, 45, and 75 under the MG badge, called MG ZR, MG ZS, and MG ZT respectively. These new MGs are cosmetic derivatives rather than significant new products. Production numbers for the MG ZR, ZS, and ZT models are included in the figures for Rover 25, 45, and 75 respectively.

Good modern engines

MG Rover uses three "series" of engine. The petrol "K Series" engines range in size from 1.4 to 2.5 litres and are produced at Longbridge by the BMW owned Midlands Powertrain plant. K series is acknowledged as a competitive good modern engine. Diesel engines come from two separate series. In the Rover 25 and 45, the engine is the Rover "L Series" 2.0 litre, an average low-tech engine, made by Midlands Powertrain at Longbridge. In the Rover 75, diesel power comes from the "CDT Series" engine, a modern high-tech 2.0 litre unit, supplied by BMW from Germany. All in all, MG Rover's engines should be good enough to last until 2010/15 before they need completely new engines.

Future Product

MG Rover needs the new car to rescue the company (again).

MG Rover's least competitive car is the medium-size Rover 45. The company has, therefore, made it a priority to develop a so-called "New Medium Car" (NMC). By the end of 2001 they will have decided how they will do this. NMC should be ready for sale in 2003/04. But the market segment in which it will be sold is the most competitive. Prices are held low, profit margins are thin, consumers have a wide choice of excellent alternatives, and cars need to be updated/replaced every 4/8 years to remain up-to-date.

If you needed a new car to save a company you wouldn't launch it into the medium size sector. But like so many of its predecessors NMC carries this responsibility. A similar task fell to: Rover 75 (failed - BMW sold-up), Rover

200 (failed - BAe sold before anyone else could realise this), Maestro and Metro (failed - BL/Rover ceased to develop cars and called in Honda).

The Rover 25 is in almost as much need of replacement as the Rover 45. MG Rover does not have either the financial or human resources to replace two cars at the same time. MG Rover is likely, therefore, to try and buy in a car from a competitor and, with minor styling changes, re-badge it as a Rover.

The Rover 75 is new. MG Rover say that the 75 will last for 12 years. That is much too optimistic, even if it receives a facelift. Peugeot tried a similar approach with the 605/607 and will be lucky to sell 30,000 cars a year across Europe. MG Rover hope to sell more than 30,000 cars a year in the UK alone

The summary of MG Rover's current and future product position is that it has four main products, only one of which, the Rover 75, is new and competitive. The New Medium Car is being developed to compete in the most crowded, price sensitive and shortest shelf-life sector of the market. MG Rover is too optimistic about the competitive lifespan of the Rover 75.

Brand and Customers

It's a race between MG Rover and the undertaker as to who gets to its customers first.

Is MG Rover selling Rovers or MGs or both? It does not have enough marketing money to develop and promote both marques. If it moves to being just the MG car company what happens? The MG marque is virtually unheard of outside the UK; it would need an immense and expensive effort to make it known to consumers. In the UK, the MG marque is firmly rooted in the 1950s and 1960s. The MG slogan was "Safety Fast", but it is more likely to be remembered for crudely engineered, damp, drafty, and rusting roadsters. Indeed, when the MG F was launched in 1995, Rover Group was horrified to find that the typical customers for the car were not young professionals, but couples in their 60s hoping to relive the experience of their youth. They were, in fact, typical of Rover customers in general.

Manufacturing

MG Rover is based on the single site of Longbridge, Birmingham. Here it has an assembly plant that welds, paints, and finishes cars. Body panels come from the BMW owned pressing plant in Swindon. Engines come from the BMW owned engine plant on the Longbridge site. MG Rover employs about 4,200 workers in the assembly plant.

The key questions for MG Rover manufacturing operations are:

- Can it achieve a competitive level of productivity (cars made per worker)?
- Can it produce enough cars to spread its fixed costs thinly enough and get low enough prices from its suppliers?

Productivity

A common measure of productivity is the number of cars made per worker each year. This figure is normalised, by adjusting for the scope of assembly operations carried out at a plant. This means that like-for-like comparisons are valid between plants. The table below summarizes the situation measured by the Economist Intelligence Unit in 1998.

Manufacturer	Plant	Country	Total Workforce	Vehicles Produced	Vehicles Per Employee	
				1998	1997	1998
Nissan	Sunderland	UK	4,141	288,838	98	105
Volkswagen	Navarra	Spain	5,258	311,136	70	76
GM	Elsenach	Germany	2,031	174,807	77	76
Toyota	Burnaston	UK	3,224	172,342	58	72
Renault	Doual	France	6,689	385,118	61	68
Renault	Valladolid	Spain	4,965	213,590	59	64
Honda	Swindon	UK	2,691	112,313	62	64
Ford	Dagenham	UK	4,534	250,351	62	61
Fiat	Mirafiori	Italy	7,829	416,000	54	61
Ford	Valencia	Spain	5,841	296,173	57	58
PSA	Vigo	Spain	8,688	338,650	35	52
Volvo/Mitsubisihi	NedCar	Netherlands	6,933	243,000	36	50
GM	Luton	UK	3,533	154,846	39	43
Renault	Sandouville	France	6,600	244,201	36	41
Volkswagen	Emden	Germany	10,729	329,685	28	37
Rover Group	***Longbridge***	***UK***	***13,000***	***281,855***	***34***	***30***

Source: EIU

MG Rover not productive enough.

The Longbridge plant was the least productive in Europe. Since 1998, significant investment was made at the plant by BMW prior to its sale to MG Rover, and the workforce has been reduced. But the number of vehicles produced by the plant has fallen, offsetting some of the improvements gained. The current productivity at the plant is probably in the range of 40 to 50 cars per worker. Is this good enough? No, because checking back at the table we see that:

- GM Luton, 43 cars per worker, will close 2002
- Ford Dagenham, 61 cars per worker, will close 2002
- Volvo/Mitsubishi, 50 cars per worker, Volvo will withdraw from operation; future uncertain
- Nissan, 105 cars per worker, had to fight to retain production of new Micra.

Costs

The table below compares vehicle production at Longbridge with the other major car plants in the UK.

Vehicle Production 2000 Estimates				
MG Rover	*Longbridge*	*Rover 25*	*75,641*	
		Rover 45	*48,932*	
		Rover 75	*45,016*	
		Rover MG	*10,017*	
	Longbridge		*179,606*	
Ford	Dagenham	Ford Fiesta	128,619	Closing
	Coventry	Jaguar S-Type	62,045	
		Jaguar XJ Saloon	18,383	Luxury High Profit
		Jaguar XK8	8,889	
	Coventry Total		89,317	
	Solihull	Land Rover Defender	24,574	
		Land Rover Discovery	56,166	
		Land Rover Freelander	74,192	Luxury High Profit
		Land Rover Range Rover	18,541	
	Solihull Total		173,473	
GM	Ellesmere Port	Vauxhall Astra	171,825	Second model coming
	Luton	Vauxhall Vectra	121,820	Closing
Honda	Swindon	Honda Accord	42,666	
		Honda Civic	24,691	Costs spread world-wide
		Honda CR-V	7,029	
	Swindon		74,386	
Nissan	Sunderland	Nissan Almera	96,810	
		Nissan Micra	128,709	New model coming
		Nissan Primera	92,888	New model coming
	Nissan Total		318,407	Target 450,000
PSA	Ryton	Peugeot 206	195,401	
Toyota	Burnaston	Toyota Avensis	128,149	
		Toyota Corolla	67,134	Costs spread world-wide
	Burnaston		195,283	

Source: Own Estimates

MG Rover makes four cars in one plant, totalling about 180,000 vehicles in 2000, perhaps 220,000 vehicles in a good year. As such its production strategy is “neither here nor there”, in that:

- You can make high price/profit cars in small numbers (Jaguar and Land Rover).
- You can make about 180,000 of one type of car (GM at Ellesmere Port, and PSA at Ryton).
- You can spread the costs globally by making the same car elsewhere in the world (GM, PSA, Nissan, Toyota, Honda).
- You can spread the costs globally by making a sister car with many common parts elsewhere in the world (Jaguar).

Most manufacturers adopt two of the above strategies, or accept that the plant will not make money in the short-term (e.g. Honda, Toyota, Land Rover, who have plans to adopt a second strategic element) or they close the plant (e.g. Ford Dagenham, GM Luton).

Not making enough cars to get lowest prices from suppliers.

For an annual volume of between 180,000 and 220,000 vehicles, MG Rover makes too many models that do not share enough common parts. This means that it can not buy its components in sufficient volume to command the best prices. It also means that it does not spread its fixed costs over enough units to be competitive.

The Longbridge site is home to two manufacturing operations: MG Rover's paint, trim, and assembly plant; and Midland Powertrain's engine manufacturing plant, owned by BMW. The engine plant makes L and K series engines, 80% of productions is for Rover, though K series are supplied to Ford for use in Land Rover vehicles, specialist companies such as Lotus and Westfield for small sports cars. As MG Rover is the main customer for engines from this plant it is assumed that MG Rover will acquire the plant and thereby regain control of its engine supply and the entire Longbridge site. This may prove to be mildly advantageous in the short-term, as the engine is in production its development costs have already been paid for. But long-term, new engine development will prove impossible at only 200,000 units per year. Most manufacturers are looking for about 1,000,000 units per year to cover the cost of developing a new engine.

Research and Development

MG Rover has a £500m cash legacy from BMW. They intend to invest this in the New Medium car for launch in 2003/4, so the £500m represents about 2½ years expenditure. Is this enough?

The table below compares MG Rover with three European competitors.

R&D spending not enough, but more than they can afford

Company	Turnover (millions)	Annual R&D Spend (millions)	Number of Vehicle Models	Spend per Model (millions)	R&D % Turnover
MG Rover	£1,470	£200	4	£50	14%
PSA	£24,575	£947	9	£105	4%
Renault	£23,581	£1,162	11	£106	5%
BMW	£22,361	£1,320	6	£220	6%

Source: Company Data (MG Rover 2000, others 1999), Own Estimates

The table shows that comparable mass-market car makers PSA-Peugeot/Citroen and Renault spend about £100m per model per year. R&D spend amounts to about 4% of their turnover. MG Rover plan to spend half the amount of its competitors, but even this reduced spending will amount to an unaffordable 14% of turnover.

The R&D site went with Land Rover to Ford

In the split-up and sell-off of the Rover Group, BMW sold the Research and Development (R&D) centre at Gaydon to Ford. Gaydon had been responsible for development of Rover and Land Rover vehicles. In the days leading to the transfer of Gaydon to Ford, it is believed that a large number of the best Rover engineers got themselves transferred to Land Rover projects so that their employment contracts would be adopted by Ford. A prospect they preferred to working for MG Rover. That MG Rover did not get the Gaydon R&D centre was, therefore a twofold loss: the facility itself, and the engineers who worked there. MG Rover now conducts R&D from the Longbridge site where facilities are inadequate.

Dealers

Fewer and fewer Rover dealers

The number of MG Rover dealers has been falling over many years because the market share of Rover and its other brands (e.g. Morris, Triumph, Austin, MG) has been collapsed since the 1970s. In the last five years, the share has halved, down 5% points from over 10% to 5%. In the early 1990s, Rover pursued an aggressive programme of firing most of its smaller dealers. In the last few years many of the remaining dealers have seen the writing on the wall and resigned the franchise or take a second franchise from another manufacturer. Now some dealers are simply going bust.

Dealers more optimistic

There has been a recent turn around in dealer attitude to the Rover brand. The period of BMW ownership marked a low point in sentiment. The MG Rover management has inspired optimism in the dealers, false optimism, but optimism none the less: most dealer's idea of foresight stretches to about lunchtime.

Needless to say, any problem effecting MG Rover effects it dealers.

Financial Position

There is no consensus view on MG Rover's financial position. Audited accounts are not yet available. MG Rover is still in dispute with BMW as to the final value of the assets that it bought. The estimates below, are, therefore, based on the small amount of sporadically released data and own estimates based on typical competitor performance.

All figures in millions of Pounds Sterling, except vehicle unit sales in whole units.

		2000E	2001E	2002E	2003E	2004E	2005E
Income	Vehicle Unit Sales	205,000	172,453	136,934	126,395	202,023	229,452
	Revenue	**£ 1,470**	**£ 1,285**	**£ 1,072**	**£ 1,008**	**£ 1,462**	**£ 1,627**
	COGS	**£ 1,198**	**£ 1,061**	**£ 905**	**£ 854**	**£ 1,165**	**£ 1,273**
	R&D	**£ 211**	**£ 161**	**£ 261**	**£ 161**	**£ 261**	**£ 261**
	SG&A	**£ 366**	**£ 180**	**£ 150**	**£ 171**	**£ 196**	**£ 217**
	Operating Margin	**-£ 304**	**-£ 117**	**-£ 245**	**-£ 178**	**-£ 160**	**-£ 125**
	Interest Income	£ 15	£ 13	£ 3	£ 1	£ 1	£ 1
	Interest Expense	£ -	£ -	£ 16	£ 30	£ 46	£ 61
	Net income	***-£ 289***	***-£ 104***	***-£ 258***	***-£ 207***	***-£ 206***	***-£ 185***
Balance	Assets						
	Plant	£ 200	£ 200	£ 250	£ 300	£ 300	£ 300
	Inventory & Receivables	£ 150	£ 128	£ 101	£ 93	£ 149	£ 170
	Cash	£ 500	£ 211	£ 107	£ 20	£ 20	£ 20
	Total Assets	£ 850	£ 539	£ 458	£ 413	£ 469	£ 490
	Liabilities						
	Debt	£ -	£ -	£ 203	£ 373	£ 579	£ 765
	Payables	£ 150	£ 128	£ 101	£ 93	£ 149	£ 170
	Equity	£ 700	£ 700	£ 700	£ 700	£ 700	£ 700
	Retained	£ -	-£ 289	-£ 547	-£ 754	-£ 960	-£ 1,145
	Total Liabilities	£ 850	£ 539	£ 458	£ 413	£ 469	£ 490
Cash	**Free cash flow**	**-£ 289**	**-£ 104**	**-£ 308**	**-£ 257**	**-£ 206**	**-£ 185**

Source: Own Estimates

MG Rover starts with a debt free balance sheet and £500m cash legacy. In this forecast, MG Rover remains debt free until 2002. But as it never makes an operating profit, and continues to invest in R&D; the cash legacy dwindles and is used up. The free cash flow remains negative in all years, i.e. MG Rover is bleeding to death. By 2003/4 the debt & short-term liabilities exceeds the assets. Although the New Medium Car does improve the number of cars that MG Rover sells, the other models are now old and uncompetitive. During 2004 MG Rover is in financial crisis.

Outlook/Timeline

Short term (2001/2002)

Enough cash in bank to keep going

- Development of new medium car based on shortened version of Rover 75.
- Acquire Longbridge engine plant.
- Reduce workforce by natural wastage, perhaps down from 7,000 (including engine plant) to 5,500. Still be more than two times overstaffed versus world-class productivity.
- Declining sales of Rover 25 and 45 models

Medium term (2003/4)

In debt, but launches the New Medium Car

- Much supply is sourced overseas, perhaps in ultra-low cost regions such as India or Russia
- New Medium Car fails to make cost targets and so fails to provide enough profit to fund development of future models.
- Rover does not have enough cash to invest in the marketing launch and brand building for the New Medium Car.
- Sales of Rover 25 very bad, Rover 75 sales now falling.

Medium term (2004/5)

MG Rover in crisis

- It is now clear that new medium car will not make the long-term sales targets and that even if it does it is not profitable enough to fund investment for Rover's future.
- Sales of 25, 75, and MG F are very poor, free additional features to keep the old vehicles selling rob them of any profit potential
- MG Rover's short-term liabilities and debt exceed its assets.

Strategies for MG Rover

MG Rover is a classic case of:

- Fix it,
- Sell it,
- or close it.

Fix-it

They tried to fix it three times already, and could not…

MG Rover management believe that they have a viable company; they are the “fix it” team. Much of the foregoing has addressed the plans that are in place to fix MG Rover, and gives opinion as to the likelihood of success. BMW tried to “fix-it” at Rover for six years, and having destroyed substantial value for BMW shareholders, opted to “sell-it”.

Sell-it

…so they sold it three times…

When BMW despaired of fixing Rover Group it chose to sell it. The Land Rover operation was relatively successful, had value, and was sold as a going concern to Ford Motor Company. BMW kept the completely updated factory at Cowley as the production site for its new Mini. On a short-term basis it also kept the engine plant at Longbridge and pressing plant at Swindon: it is presently active in finding a buyer for these sites. This left the Longbridge assembly plant that no one wanted unless BMW provided it debt free and with a £500m cash legacy.

Given that BMW had to pay to get Longbridge off its hands, could Longbridge be sold again? One year after BMW sold the plant to Phoenix/MG Rover nothing has changed in substance, nothing has happened to change the value of the business. In 2000, BMW could not find an existing car maker to buy Rover. Discussion with corporate financiers reveals that there is still no demand to buy MG Rover. The Longbridge site is well located for the Midlands motorway network and may have value as a business/retail park.

Close-it

…now it can only be closed once.

This remains the most likely outcome at MG Rover and the Longbridge engine plant. In giving MG Rover the cash legacy of £500m, BMW was, in effect, saying, “This is what it would have cost to fire you guys, but if you would rather use the money to try and make a go of it…”. By operating the plant for three or four years, the management have really opted for a salary until 2004 rather than a redundancy payment from BMW in 2000. When MG Rover becomes insolvent and has to close the plant there will not be any money to make redundancy payments. For the workers this will have probably been a better option because they will have got more money from the combination of the £500m cash legacy, the extended operating period, and the debt built up in the final years of operation. The only losers will be the shareholders of any bank that has lent to MG Rover.

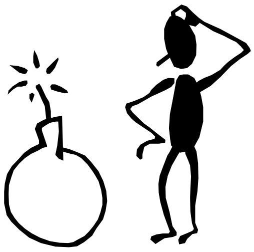
Recommendations

If every car plant in North America were to shut, it would still be possible to make more cars than the world wants to buy. With massive excess capacity only the most efficient car plants will survive. MG Rover will not be one of these, just as Luton and Dagenham did not survive.

This is not a blow to the UK motor industry. If the most efficient plants of Nissan, Honda, or Toyota closed or scaled down it would be a blow. But it is a blow to the people employed by the plants that close, and the people employed by the companies that supply those plants.

Problems at MG Rover are politically significant because the social implications for the people involved combine with a closure of symbol of national virility (the production of cars).

The real story is not at MG Rover, but at Nissan, Honda, Toyota, Jaguar, which although not owned by British companies are successful through the efforts of British workers. These workers are the forgotten people of the motor industry in Britain. They are successful, yet unsung, whereas the employees of MG Rover have failed (many times) and are held high in the sympathies of the Nation.



So it is just a matter of time before MG Rover is in trouble, and just a matter of time before its anguish takes the Nation's attention. But this time it will be death by its own hand, there will be no big bad BMW to blame. What to do?

- Understand and praise the real motor industry in Britain – the Nation needs to feel pride and success about our motor industry.
- Compare success (Nissan, Toyota, & Jaguar) with failure (Luton, Dagenham) and challenge the failure rather than sympathising with it -- We need to understand that MG Rover is a small failure against a background of general success.
- Don't blame anyone for the macro-economic inevitability of MG Rover's demise, the decisions that set it on this course happened in 1994 when BAe sold to BMW -- none of the current managers or workers is to blame.