Merger of Rolls and BAE could be a real high-flyer

Chris Blackhurst

THE Government has got itself into a pickle over Rolls-Royce. Five profits warnings in less than two years have forced Downing Street to consider the future of the engine-maker. Of particular concern, apparently, is "that Rolls-Royce's management has no substantial experience of defending against hostile takeovers".

When I read this in the FT, attributed to sources familiar with the plans, I did a double-take. The Government has a "golden share" in Rolls-Royce that prevents the company from selling 25% or more of its net assets or 25% or more of the strategically sensitive nuclear division without its permission. In addition, a foreign investor cannot hold more than 15% of the group.

These clauses were inserted into the company's constitution when it was privatised in 1987. A hostile foreign bid is highly unlikely, so that narrows down the scenarios to an aggressive UK move.

Only one fellow engineer – BAE Systems – is capable of mounting such an attack. Or a strike could come from a finance house, from private equity, possibly a consortium with a view to breaking up Rolls and selling off the parts.

It's curious the Government should zone in on the management's lack of hostile takeover expertise. Such has been the lack of hostile M&A in recent years that I'm struggling to think of anyone who would tick this box. My cynical suspicion is that this is polite code for "we don't rate Rolls-Royce management highly, not in the situation the company now finds itself". Who they're really talking about is Ian Davis, the ex-McKinsey consultant now Rolls chairman, and former ARM chief Warren East, parachuted in as chief executive earlier this year.

Davis lacks experience in this field, at this level. East left ARM in 2013 and had picked up a nice portfolio of part-time appointments. It's difficult to imagine him relishing the full-on workload that now confronts him. The pressure on both men is intense, especially with activist shareholder ValueAct stoking the flames. They strengthened the board with the appointment as a non-executive director of Sir Kevin Smith, formerly of GKN and BAE, and today cut two senior bosses in a revamp of its structure.

Team effort: the Red Arrows' Hawk jets are built by BAE and powered by Rolls-Royce

Even so, officials would be forgiven for looking across at another defence contractor and wishing its chairman was at Rolls-Royce. BAE chairman Sir Roger Carr loves the public cut and thrust, can glide smoothly along the corridors of power, and knows which doors to open and palms to press. He is also a chairman who has been on the wrong end of a hostile takeover. He lost that fight, at Cadbury's, but no one is more versed in the art of media and political persuasion than Carr.

He has enjoyed a good dust-up ever since his days at Williams Holdings, Centrica and Mitchells & Butlers, and as president of the CBI. He has become vice-chairman of the BBC Trust just as the broadcaster's future is under renewed scrutiny. I would not be shocked if quiet words have already been exchanged between Carr and the ministers and mandarins. Given the extensive nature of Smith's CV, it is inconceivable the two don't know each other.

A marriage between Rolls-Royce and BAE looks increasingly like a neat solution to a gaping problem. The two companies co-operate extensively on military aircraft and the Trident nuclear submarine programme, and will again on the mooted next generation of Successor submarines. It would create a giant UK defence business, one capable of taking on overseas all-comers.

The downside would be that the sole UK contractor would be able to play the MoD for all its worth. But BAE and Rolls separately can – no other UK company does what they do, making planes and submarines in BAE's case and adding the engines in Rolls'.

A BAE joined with Rolls-Royce would not have to be so in the thrall of foreign defence procurers, notably Saudi Arabia. And it would have a civil aero-engine division to fall back upon. Downing Street should do what it gives the impression of itching to do, and steer Rolls-Royce towards BAE.

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Let's raise interest rates to lay foundations for return to house-price sanity

AS we contemplate a new year, the Government exhibits no sign of being able to tackle just about the biggest domestic issue it faces: the housing crisis.

The latest to lend his view is my pal and fellow Fulham FC devotee, Gerard Lyons. The ex-Standard Chartered chief economist, now economics adviser to Boris, says we should move away from our obsession of owning a home.

"A country can't get rich by selling property to one another or to foreigners. What's disappointing is that we have an economy where people think the only way to save for their pension is to buy property," he adds. "I can't stand the phrase getting on the property ladder. It's completely wrong for the country."

Hear, hear. Prices, in London certainly, have to come down. That may happen, given the level of building now and planned for the near future. Supply at the top end will outstrip demand. You only have to look at the towers and cranes at Vauxhall to guess where the bubble will burst. While that may inject some sense into a market that has gone crazy, it won't be enough. It may drive away the speculative foreign buyers but we will still need a great deal of convincing of an alternative income source.

The recent boom has taken place in a period of low interest rates. Rich people have been able to borrow, in order to buy, at minimal cost. The only way I can foresee some sort of order being restored is by raising interest rates. They've been so tiny as to drive savers away from cash and into income-yielding property: buy-to-let, despite the Government's best endeavours, continues to boom.

The pendulum needs to swing in favour of savers. For too long, they've endured negligible returns – forcing many to alternative income streams such as buy-to-let. Increasing rates would take the heat out of the buy-to-let market, and the overall housing market.

While it would also make borrowing costlier and would hit first-time buyers, hopefully that would be more than matched by the fall in prices.

Something has to give – and apart from Government intervention on a grand scale (a cap on land values, say) – it's difficult to see where the process can begin. Raised interest rates, together with the Government delivering on its promised housebuilding programme, could see the tide begin to turn.