

The EU defence industry suffers from significant overcapacity. The euro-zone crisis, and the budget cuts it has triggered, is making this situation increasingly unsustainable – from both an industrial and financial perspective.

# After austerity: futures for Europe's defence industry

Consolidation and restructuring are thus necessary. However, the consolidation of the EU defence industry is likely to occur across simultaneous and parallel tracks, mostly encompassing a mix of Europe, NATO, extra-EU, and purely national solutions.

In October 2012, the merger between BAE Systems (GB) and EADS (France, Germany and Spain), two of the biggest defence contractors in the world, failed. Despite this setback, further consolidation within the European defence industry is likely to occur in the near future. Because of the eurozone crisis, in recent years EU countries have significantly curtailed their public expenditure, defence included. This has important implications for the structure of the European defence industrial base. Specifically,

defence companies are dependent on public defence expenditure. When defence spending declines, industrial overcapacity results. This, in turn, calls for restructuring and consolidation. Inevitably, EU countries will have to go down this road. However, given their ongoing concerns regarding sovereignty, technology and jobs, there are good reasons to think that they will promote the consolidation of their defence industry through a mix of Europe, NATO, extra-EU and purely national solutions.

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## Understanding the game

Three main factors help understand how the European defence industry may consolidate in the years ahead.

First, governments have a strong interest in maintaining their defence manufacturing capabilities, given the extensive economic and political benefits this activity grants.

Second, this situation endows them with significant powers *vis-à-vis* their defence companies which, in turn, means that their preferences shape defence economics: it is up to governments to decide whether defence expenditure has to prioritise jobs or technology, for example.

Finally, countries export military equipment for political, industrial and economic reasons. However, when exporting becomes an industrial necessity (e.g., national budgets are insufficient), their national defence companies may increasingly come under the influence of foreign governments. This may cause political, economic or industrial tensions.

## The European champions league

Europe possesses the second most capable and advanced defence industry in the world after the US. However, its defence industrial base is fragmented both across countries and business sectors. The consolidation of the late 1990s and early 2000s brought about the formation of a few European 'champions' mostly working on aerospace projects and with strong national features. Thus, alongside US giants Lockheed Martin, Boeing, General Dynamics, and Northrop Grumman, European conglomerates of comparable size have emerged: BAE Systems, EADS, Finmeccanica (Italy) and Thales (France).

Then there are specific, more or less independent, weapons manufacturers, like Dassault (France) and Saab (Sweden) in fixed-wing aircrafts; Navantia (Spain), TKMS (Germany and Sweden), DCNS (France), Royal Schelde (Netherlands) and Fincantieri (Italy) in defence shipbuilding; Iveco (Italy), Nexter and Renault Trucks-Panhard (France), Krauss-Maffei-Wegemann and Rheinmetall MAN (Germany), Patria (Finland), and General Dynamics Land Systems (Austria, Switzerland, Spain, Britain and Germany) in land-armaments; Diehl BGT (Germany), Saab-Bofors Dynamics (Sweden) and Kongsberg Defence and Aerospace (Norway) in missiles; Atlas Elektronik (Germany), Indra (Spain) and Safran (France) in systems integration and defence electronics. Finally, there are engine makers like Rolls-Royce (GB), Safran, MTU (Germany) and Avio (Italy).

## After BEADS

During the first part of 2012, EADS and BAE Systems planned their merger: BEADS. BAE Systems needed to address the global downturn of the defence business, especially in the US. EADS was interested in gaining the competences it currently lacks (mostly in defence electronics), in expanding on the American market and in rationalising part of its business (mainly the *Eurofighter* programme, of which BAE Systems and Finmeccanica are also part). Their plan received wide media attention, prompting many hopes for a further integration of the European defence industry. However, in the end, it failed.

At close investigation, the factors mentioned above help understand why the two companies parted

## Structure of the main European prime contractors

Company	Reference country and main markets	Ownership structure	Business areas
BAE Systems	US/UK, Saudi Arabia, Australia	Public company, British government's golden share.	Systems integration, defence electronics, fixed-wing aircrafts, defence shipbuilding and land-armaments.
EADS	France, Germany and Spain	Public company, with national shareholders.	Systems integration (Cassidian), fixed-wing aircrafts (Airbus military), helicopters (Eurocopter), and space (Astrium).
Finmeccanica	Italy, US, UK	Public company, with Italian government owning a controlling stake.	Systems integration, defence electronics (Selex ES), fixed-wing aircrafts (Alenia Aermacchi), space (Telespazio and Thales Alenia Space), helicopters (Agusta-Westland), and land-armaments (Oto Melara).
Thales	France, UK, Australia, Netherlands	Public company, with the French government owning a controlling stake.	Systems integration, defence electronics, space (Thales Alenia Space) and missiles.
MBDA	France, UK, Italy, Germany and Spain	BAE Systems and EADS at 37.5%, Finmeccanica at 25%.	Missiles and missile systems.

ways. To start with, the final decision fell upon governments that had contrasting views about the industrial and employment consequences of the deal, let alone its political implications. Moreover, foreign customers indirectly played a considerable role: both British politicians and BAE Systems shareholders feared the creation of BEADS could trigger some resistance within the Pentagon and thus potentially compromise BAE Systems' privileged position on the American market. In the end, this also contributed to the collapse of the operation.

Given the downsizing of defence budgets in the EU, there are good reasons to expect further consolidation to occur, perhaps taking various forms. In this way, EU countries can tackle their existing industrial overcapacity while at the same time maintaining their prerogatives with respect to jobs, technology and sovereignty.

or France) would be required to give up part of its defence industrial base. However, this is unlikely to happen, especially in light of the importance and prospects of the two companies' core area of business, defence electronics.

- A merger between Finmeccanica and either BAE Systems or EADS would provide a partial rationalisation of the European aircraft manufacturing industry along the lines of the *Eurofighter* programme. However, by merging with Finmeccanica, BAE Systems would not address its core problem, namely its exposure to foreign defence markets in general, and to the American one specifically. Rather, this situation would be exacerbated as the new company would end up operating in three shrinking defence markets: Italy, the UK and the US.
- Over a decade ago, EADS and Alenia-Aermacchi (a Finmeccanica company) were supposed to merge, but then the plan failed when the Italian government left the A400M programme. In theory, if



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### Selective affinities

An inevitable part of the consolidation process of the European defence industry will likely occur *within* Europe. The creation of EADS, Astrium or MBDA a decade ago pointed in this direction, and so did the (failed) BEADS deal. Currently, there are two main options for the creation of a more integrated European defence industry: either consolidation of some prime contractors or consolidation of existing Tier-I manufacturers.

As there are only 4 prime contractors within the EU, the merger options at this level are inherently limited. Recently, besides BEADS, the possibility of a merger between Thales and Finmeccanica was floated, eventually incorporating also Dassault and Safran. Other analysts speculated about a possible merger between Finmeccanica and either EADS or BAE Systems. Finally, in the past there were also rumours about a possible merger between Thales and EADS: those, however, have not yet resurfaced.

All these options have merits and drawbacks.

- An alliance between Thales and Finmeccanica would strengthen the two companies' existing partnerships, but it would also pose a number of challenges. Notably, the issue of who controls the company would inevitably raise political dilemmas, and so would the consolidation of their industrial capabilities. For the merger to create value, one of the two companies (and thus Italy

pursued again, this option would allow EADS to expand in the US and address one of its current weaknesses, the lack of strong competences in subsystems and sensors (where Finmeccanica is a world leader). Conversely, Finmeccanica could profit from a financially stable partner, from its further diversification into complementary civilian markets (thanks to Airbus), and from a likely expansion of its subsystems and sensors business around the world (through EADS).

- Finally, a merger between Thales and EADS could produce analogous results, with the sole exception of expansion in the US market. However, such a deal would raise tricky questions about the future role of Dassault, the French aircraft-manufacturer, owned at 46.32% by EADS and owning 26% of Thales, not to mention political controversies as happened with BEADS.

Alternatively, the promotion of a more integrated European defence industry could occur on a sector-by-sector basis, with the merger of the leading companies in each business area.

- In the missile industry, most consolidation has already occurred around MBDA, although the company could still acquire some of the remaining capabilities like those of Safran and Thales in France and of Diehl BGT in Germany.
- In the naval industry, so far the only significant transnational merger occurred with Germany's TKMS acquiring the Swedish Kockums AB. While



existing bilateral or trilateral cooperation programmes could offer some opportunities for further transnational restructuring, it is unlikely that this option will be explored. European defence shipbuilding companies are strong competitors in export markets: thus, without strong political support, they may find that this solution has little to recommend it. However, such political support is difficult to secure because of the labour-intensive nature of the industry.

- Slightly more consolidation has occurred in the land-armaments industry, thanks to BAE Systems and General Dynamics Land Systems (GDLS). However, not only is further consolidation possible, but demand still remains very fragmented: for example, Europe has currently 4 main battle tanks (the US has 1) and 16 armoured fighting vehicles (3 in the US), while there is just one main cooperative programme within the EU, the German-Dutch Boxer MRAP.

## Beyond Europe

**NATO.** Since most EU members are also in NATO, transatlantic industrial reorganisation is another logical option for addressing defence overcapacity in Europe. No merger at the prime contractors' level has ever occurred across the Atlantic. However, in the past many speculated about BAE Systems merging with either Boeing or Northrop Grumman. Such voices resurfaced in recent months and especially after the BEADS deal collapsed (also involving Finmeccanica).

Self-evidently, such options present many political and industrial problems. For this very reason, prime contractors across the Atlantic could pursue targeted acquisitions of Tier-I or -II suppliers in the other continent: this would exploit the comparative advantages of the parties involved, promote competition in single domestic markets, further integrate the transatlantic armaments market and, last but not least, trigger less political opposition than mergers at prime contractors' level.

For both Finmeccanica and BAE Systems, given their established US activities, this option would be significantly easier. Symmetrically, US companies could also pursue this strategy, although the decrease in EU defence budgets may reduce its appeal. Otherwise, specialised arms manufacturers could try to expand their own business on the other side of the Atlantic, as happened recently with Fincantieri, the leading Italian-shipbuilding company that acquired Manitowoc Marine Group in 2007, or over a decade ago when GDLS acquired several land-armaments companies throughout Europe.

**Extra-European partnerships.** European companies could either try to increase their exports or attempt to buy companies in the fastest growing defence markets around the globe: India, Brazil, Australia, Nigeria, Indonesia, Turkey. However, legal and political impediments to the acquisition of foreign defence companies, on the one hand, and strong competition for export in the global defence

market, on the other, make both options difficult. As a result, armaments cooperation may emerge as a more effective solution: partnering with foreign local suppliers, and granting them industrial returns in order to win contracts abroad. Yet, this is not devoid of problems either as it fails to address properly defence overcapacity in Europe and indeed it risks increasing it even further worldwide.

Finally, non-European countries with surpluses in their trade balance (e.g. Qatar, UAE and Saudi Arabia) could employ some of their financial resources to enter the ownership structure of some European defence companies. But this, too, is potentially fraught with political problems.

**Home-made solutions.** Last but not least, domestic restructuring represents an additional option. In the late 1990s, this solution gave rise to national champions like Thales, Finmeccanica, BAE Systems, and Rheinmetall MAN, among others. European countries could pursue it further in some areas through a mix of horizontal and vertical consolidations at both factory and company level.

- For example, TKMS radically restructured German shipbuilding yards in 2009, while in 2011 Finmeccanica decided to re-organise its Italian and UK-based defence electronics activities into a single business structure: Selex ES. Other countries could follow suit.
- Second, European countries could promote the merger of companies working in similar areas. In 2008, BAE Systems pursued this strategy with the acquisition of the VT Group (shipbuilding). In land armaments, MAN and Rheinmetall merged their military vehicle units in 2010 and Panhard and Renault Trucks merged in August 2012. Many such similar deals are still possible. In France, for example, the merger between Safran and Thales (or at least of some of their activities) is a recurrent theme.
- Third, further vertical integration could occur. This would reduce duplication of functions along the supply chain and also competition in export. For example, both in France and Italy there has been conjecture that Thales and Finmeccanica might pursue further vertical integration: Thales acquiring Nexter (land-armaments) and DCNS (shipbuilding), and eventually also merging with Dassault and Safran.

## Conclusions

The various options for the likely future wave of consolidation in the European defence industry are neither mutually exclusive nor necessarily all bound to materialise. We might witness a combination of them depending on political considerations and genuine market pressures. However, consolidation in the defence business is unlikely to be definitive or to deliver its full potential. There is in fact good reason to think that countries will try to preserve their prerogatives – for both commercial and political reasons.