PISM | POLSKI INSTYTUT SPRAW MIĘDZYNARODOWYCH
THE POLISH INSTITUTE OF INTERNATIONAL AFFAIRS

BULLETIN

No. 90 (423) • September 25, 2012 • © PISM

The EADS-BAE Merger Talks Signal European Ambitions

Wojciech Lorenz, Marcin Terlikowski

The possible merger of the EADS and BAE Systems, both leading European defence companies, could have huge implications for the whole defence sector. The resulting giant would be better positioned to compete with the biggest rivals around the world and would virtually monopolise the European defence market. However, the deal is still far from certain as there are national interests at stake. Although the merger would not affect Poland directly, it would still have serious implications for smaller arms producers in the EU.

The announcement that two major European defence companies, the European Aeronautic Defence and Space Company (EADS) and BAE Systems, are in talks over a possible merger sent shockwaves around the world. Such a new conglomerate would be the world's largest aerospace and defence company—a formidable force in the fight for contracts in a time when military budgets are declining in Europe and competition on the global arms market is increasing.

If successful, the merger will be a prominent step in the process of consolidating the European defence industry. The trans-border consolidation, which started in the early 1990s, transformed the aerospace sector from a multitude of scattered, small-scale manufacturers owned by states, into an oligopoly based on leading players (the German-French-Spanish EADS, British BAE, Italian Finmeccanica and French Dassault) and a network of interlinked companies (e.g., the Swedish Saab-Scania). Along with joint ventures (e.g., MBDA, owned by EADS and BAE). In 2000, when Germany, France and Spain decided to merge their defence manufacturing champions into the EADS, Great Britain was involved in the process, but eventually declined to join and instead to pursue national consolidation, which led to the creation of BAE.

The Economy of the Merger. The merger could be an answer to rapid changes in the defence equipment market which, in a crisis-affected Europe, is dwindling. The real scale of cuts is dramatic: between 2009 and 2011, total EU defence expenditures fell by €17 billion, equal to half of Germany's annual defence budget. In constant 2010 prices, spending dropped to the 2000/2001 level of €204 billion (compared to the United States' €520 billion). So far, investment has not been affected much—it takes time to renegotiate long-term contracts—but upcoming deliveries will surely be limited (e.g., Europeans will buy fewer NH-90 helicopters and F-35 Joint Strike Fighters than originally planned).

The market in other parts of the world is becoming increasingly competitive, as new players such as Brazil, China, India and South Africa challenge traditional market leaders, and the European giants have already felt the consequences of these changes. In 2011 BAE sales have fallen by 14%, and profits have dropped by 7% compared to 2010. Yet it still ranked third globally among defence companies in 2011. At the same time, EADS defence sales declined by 5%, and so was ranked seventh.

By merging, BAE and EADS seek to improve their market position by reducing costs (through more effective use of combined assets, elimination of duplication and seeking economies of scale), broadening their portfolio of products, and limiting dependency on declining sectors.

The EADS and BAE complement each other in different product areas. The EADS, which is the owner of Airbus and Astrium is mainly focused on commercial aircraft and space platforms. Since 75% of its revenue comes from civilian production, its profit increased by 87% in 2011 (compared to 2010). In turn, BAE is focused primarily on defence, with 98% of its output directed to this sector. If consolidated, these firms would create a giant with a balanced portfolio of products, including missiles and precision weapons, rockets and satellites, jet fighters, transport and trainer aircraft, armoured vehicles, radar equipment; ships, command and control networks, and various services.

Such a company would virtually monopolise the European defence equipment market, becoming a major player in the global arms trade arena, and, arguably, would have easy access to the U.S. market (owing to BAE's strong position there; American contracts have generated half of its revenues). Thus, the merger of BAE and the EADS could challenge the strongest U.S. competitors, such as Boeing or Lockheed Martin. Although the EADS' sales (€45.7 billion in 2010) and BAE's sales (€26 billion) will not simply combine, the company resulting from such a merger would surely overtake its American counterparts, which have sales of €48.5 billion and €34.5 billion respectively.

Political Obstacles. However, the merger will be difficult. An important part of the negotiations will refer to the traditional right of governments to block commercial decisions seen as threats to the political or security interests of the state. The British government considers the so called "golden share" in BAE as a guarantee of keeping the national nuclear deterrent supply chain under control (BAE manufactures both the Trident missile and Vanguard-class submarine, in cooperation with the USA). Britain will probably also seek guarantees that sensitive technologies it receives exclusively from U.S. partners under special inter-governmental agreements are not going to be transferred to other countries. Although BAE, too heavily dependent on military sales, could benefit from the merger, there are also voices in Britain that argue the country will practically—even if not formally—leave the EU in the next decade so it should not "Europeanise" crucial assets essential for upholding the "special relationship" with the United States. The French, German and Spanish governments are also unlikely to agree on limiting the political control they currently exert over BAE and EADS (European Commission has been reluctant to accept such solutions in the past). Germany, for example, fears losing the significant influence it has exerted on EADS in favour of France and the UK, as well as potential redundancies following the merger. However, far-fetched guarantees will face scrutiny on the other side of the Atlantic. If the United States were to decide that the European company remained under political control, it may not be willing to open its market to such an organisation. This could undermine BAE's successful business in the USA.

Consequences. The expected benefits from the merger are uncertain, since further consolidation of the European defence industry would outpace defence policy integration in Europe. The EU's Common Security and Defence Policy has lost impetus and cannot provide a political framework underwriting the consolidation (unlike in the 1990s, when the industry coalesced in response to the political aim of having an effective industrial base for a European autonomous defence capability). If the EU's pooling and sharing, or NATO's Smart Defence initiatives, do not become bolder and involve the joint acquisition of capabilities and/or development of new weapons, the economies of scale will not appear. In this case, even a pro-export orientation may not help the new company, as the competition on the African and Asian markets is likely to rise in the future, and the shrinking U.S. market may become even more reluctant to accept non-U.S. companies.

Nevertheless, the competitive power of the new giant formed by the merger could force other players to follow. It has already been suggested that if the merger goes ahead, two French companies controlled by the French government, Safran and Thales (both with broad portfolios of aerospace products), may also merge. The process may also involve land and naval sectors, to date functioning in national frameworks.

More consolidation in the industry will decrease the competitiveness of smaller arms producers, such as those in Poland. Amalgamating the industrial base of the biggest players will virtually sideline the remaining industrial clusters, with few options. One would be to jump on the bandwagon and join the giant (through joint ventures, licensed production etc.), by becoming manufacturers of niche products or components. The second option would be to merge and build a competitive bloc, facing a plethora of financial and technological barriers. A third option (preferred by many EU members to date, including Poland), is to count on non-competitive tenders and offsets, but this is increasingly difficult to pursue as the EU directive on defence procurement seriously limits the freedom of governments to use protectionist tools.

Still, the direct effects of the potential merger on the Polish defence industrial base would be limited. Neither BAE nor the EADS run large operations in Poland. The latter owns PZL Okęcie, which is unlikely to be affected by potential rationalisation following the merger, since it is a valued provider of components for the final assembly of the C-295 transport aircraft, and, further, because it has recently started to function as a service centre for this type of aircraft. The air and missile defence concept "Tarcza Polski" wouldn't be seriously affected either—if it were chosen as the future Air and Missile Defence system for Poland—since it is offered by Bumar and MBDA. BAE itself has even fewer assets in Poland, though it has recently offered a service package for the Polish C-130 Hercules aircraft.