

Parking Tanks on Whose Lawn ? A Review of Defence Sector Acquisition Activities

by Dr Jeffrey Bradford

Dr Bradford is Manager, Group Business Development at Babcock International and formerly was a consultant with Arthur D. Little specializing in corporate strategy within the aerospace and defence sector. In this article, he looks at the recent history of mergers and acquisitions and the way in which it might develop in the future.

To the casual observer the purpose of an article focused on acquisition activity could well appear to be of marginal interest in comparison to the contributions concerning the more immediate trends in the fields of operational experience, doctrine and defence technology.

However, it could be suggested, for those in the armed services, staffs supporting defence management in the bureaucracy and those taking political decisions, that ownership of the means of defence capability research, development and production is an issue which is increasing in relevance.

The impact of defence programmes on the fortunes of an ever-consolidating defence industrial base can be witnessed in the 'winner takes all' situations that are emerging, most notably in the case of Lockheed Martin and Boeing efforts to secure the Joint Strike Fighter (JSF) programme. Furthermore, the recent bid to acquire a majority stake in the only remaining UK armoured fighting vehicle manufacturer, Alvis, illustrates the challenge for the European defence industry and national governments, concerning efforts to control the structure and pace of consolidation within national defence industrial bases in a global commercial environment.

The objectives of this article are threefold: firstly, to provide definitions and an

overview of merger and acquisition (M&A) activity; secondly, to indicate why this activity is relevant to the defence and aerospace sector and the value inherent in defence M&A; and lastly, to probe the key drivers of acquisition by defence & aerospace companies.

The origins of this article lie in original research conducted into the likely synergies of M&A deals within the sector during the 1990s in order to provide a forecast which supported a Scandinavian defence company in successful development of a merger strategy.

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The research had as its object the development of a negotiation strategy for a Scandinavian defence group that wanted to merge its business under the best possible terms. This project was regarded as a success by virtue of the fact that during execution of the strategy, not only did the company merge with its preferred partner, but in addition it achieved a value in excess of 40 per cent above net asset value.¹

Definitions

Although the acronym 'M&A' is used to describe commercial consolidation of the means of defence capability production, there are some useful nuances in the terminology used. Whilst a merger is seen in more benign terms as a marriage between consenting equals (often roughly equal in terms of their market capitalisation), an acquisition is seen as an

aggressive take over of a non-consenting enterprise (often smaller in terms of market capitalisation²).

However, whilst bearing these definitions in mind, it is important to be cognizant of what is underpinning the public proclamations of those companies involved in consolidation activity. Corporate diplomacy often uses the friendly term of 'merger' to prevent ruffling the feathers of customers, the stock market and suppliers – not to mention the surviving personnel of the acquired enterprise.

M&A is regarded, in most typical commercial sectors, as a means by which an enterprise can grow faster, become increasingly commanding within a market sector or enter new business areas. In the aerospace and defence market more than 130 acquisitions occurred between 1987 and 2000 worth in excess of \$120 billion.³

In geographical terms, some 60 per cent occurred within the US, reflecting the push by the Department of Defense to encourage consolidation, coupled with the commercial culture and access to finance to enable the transactions. The next most significant market for activity in the same period was the UK (16), followed by France (10) and Germany (8). These four markets accounted in the time period for over 85 per cent of M&A activity.

However, in terms of value of transaction, acquisition activity in the US far outweighed any other country with the exception of the British Aerospace / Marconi Electronic Systems deal. The US in the mid- to late-1990s saw a series of titanic deals leading to the highly concentrated market today including

Northrop/Grumman (\$2.1bn), Lockheed/Martin Marietta (\$ 7.3bn), Raytheon/E Systems (\$2.0bn) and Boeing/MacDonnell Douglas (\$15.7bn).

The Relevance of M&A to the Defence and Aerospace Sector

The consolidation of the US defence industrial base after the end of the Cold War provides some pointers as to the speed with which an industry can restructure within the boundaries of one country. A Washington-based think-tank conducted a study that noted, 'in 1993, there were 21 companies doing major defence aerospace work - today there are five: Boeing, Raytheon, Litton, Lockheed Martin and Northrop Grumman'. Subsequent events in early 2004 reduced the figure to four following Litton's acquisition by Northrop Grumman.⁴

The speed of restructuring carries with it risks of creating a monopolistic, competitive situation downstream. The push towards building a few systems integration players in the defence field carries risks. As noted by a senior CSIS policy panel on the mid-1990s restructuring in the US noted that, 'a conventional anti-trust approach to consolidating and restructuring the defence base was, and remains, incompatible with the realities of the defence marketplace'.⁵

What was the value for the US Government from this consolidation activity? The wave of restructuring in the mid-1990s resulted in some half a million job losses and probably contributed to the Clinton election victory of 1992. In terms of research and technology (R&D), it could be suggested that, whilst consolidation may have a short term negative impact on R&D expenditure, in the longer term fewer sources of research translate into fewer innovations. In one such study, the impact of industry consolidation on alliance formation and R&D expenditure in the US market suggested that R&D expenditure fell by one quarter as a direct consequence.⁶

In terms of the ability of the customer to

pursue competitive acquisition policies, the implications of unfettered commercial consolidation are to reduce choice and create ever greater dependency on fewer suppliers. To consider the US case, the JSF programme could effectively create a monopoly supplier of manned combat aircraft. Lockheed Martin production of JSF and the F-22 programme would give the company an unrivalled position once existing manufacturing lines are closed in competitor companies.

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In the international market, the EuroFighter and low cost Russian designs, with the two US led programmes, will form the manned aerial combat procurement environment through to the middle of the twenty-first century – a clear case of industrial activity shaping future force structures and capabilities.

This commercial effect can be seen in additional market segments beyond aerospace. The US Government continues to give contracts for nuclear attack submarines to reduce the risk of the industrial capability to design and manufacture such equipment being lost irrevocably. The land systems arena, at least in the US, has been pared down via specialisation – with the remaining players focused on either main battle tanks (General Dynamics) or infantry fighting vehicles (United Defense).

The recent attempt by General Dynamics to seek control of Alvis in the UK would seem

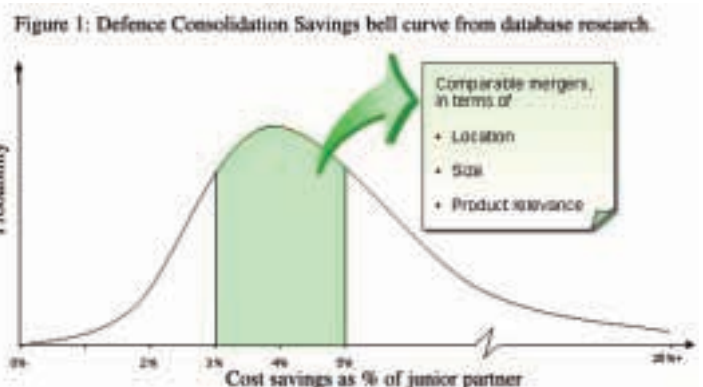
predominantly driven by the need to access both the revenues associated with the FRES programme, but also by the need to acquire experience of design of such platforms to enhance their commercial position in the US – which is, without doubt, currently the fastest growing market for defence equipment.⁷

To summarise, it could be suggested that for the companies in the defence sector there are distinct commercial advantages in terms of building controlling positions for particular platforms or technologies. One possible difference for the defence sector to other commercial fields, is the long lead time associated with defence programmes – an increasing trend – which is resulting in more gladiatorial-style commercial activity. The JSF programme is an illustration of the threat which, arguably, Europe can no longer ignore through means of collaboration.

The Drivers

The database that was developed to support the Scandinavian activity in the late 1990s had, as its objective, identification of synergies that could reasonably be expected to be generated through M&A. Consideration of over a hundred cases of defence-specific merger activity yielded two principal conclusions:

- Some 20 per cent of the M&A cases considered, which occurred within the borders of one country, could yield savings (as a percentage of total sales) between 3 per cent and 24 per cent.
- Some 10 per cent of the M&A cases



considered, which occurred across national borders, yielded savings (as a percentage of total sales) between 3 per cent and 5 per cent.

The disparity between domestic and cross-border merger can be accounted for by a series of factors. In the case of domestic merger, quite radical reviews of headquarters requirements, production and research facilities can be made. Cross-border merger may well require central functions in both countries – for political if not commercial reasons. The Thales ‘multi-domestic’ market strategy can be seen in this light, with acquisitions such as Racal conducted within a framework of a semi-independent UK operation. Whilst consolidation of support functions would have obvious commercial advantages in other commercial sectors, the political imperatives of the defence industry militate against this option being available in practice.

Other synergies pertain to rationalising product lines and reducing the labour force employed. Cross-border merger, especially transatlantic merger, makes realising labour synergies harder, due to more stringent employee protection in the European Union.

Summary

This article has considered the nature of M&A, considered its application to the defence and aerospace industry and looked at the ramifications for customer and commercial players. Lastly, through analysis of previous activity, some idea as to the scope of potential synergies (and the factors driving them) has been ascertained.

As a pointer to the immediate future, we have witnessed a scramble in the US market, because of the long term revenue streams from next generation aircraft carrier and submarine construction,⁸ to acquire shipbuilding capability resulting in six independent shipyards being acquired by two defence players, each purchasing three. Internationally, General Dynamics’ strategy of building a network of small acquisitions, which taken together provide

a substantial regional presence, represents a stealthier *modus operandi* when compared to Thales ‘multi-domestic’ market model.

For the UK, several industrial capabilities are reaching a point of becoming terminally subcritical – leaving the principal customer with the choice of acting to protect the industry or letting market forces determine UK access to a particular capability in future. The fact that the potential sale of BAE Systems Naval Ships division will not include sale of its nuclear submarine facilities to an overseas buyer indicates continued government interest in shaping the defence industry.

European players are likely to be watching the situation anxiously as the UK has one of the largest procurement programmes across Europe – and foreign buyers or acquirers of significant shareholdings will look to them next. EU merger policy exempts the defence industry from its provisions and the creation of EADS, by politically combining German and French companies appears a defensive measure to create sufficient financial scale to shape, rather than be shaped by, commercial forces.

It could be suggested that, for all governments, the key policy issues are control of the generation and deployment of intellectual property, linked to the value of the activity. For example, UK concern over BAE Systems’ talks with potential overseas owners of its naval shipbuilding capability is limited to the more complex, higher-value nuclear submarine activity. The US decision to intervene in the early 1990s attempt by a French company to acquire LTV was based on preventing access to the intellectual property invested in stealth technology – which LTV supplied to the B-2 bomber programme.

Geography also plays a part in government interest in defence sector acquisition activity. For many countries, the labour-intensive, industrial age defence construction capabilities for ships,

armoured fighting vehicles etc. tend to be in areas where this activity once thrived, but where commercial forces have caused the collapse of non-government related activity. Therefore risks associated with cuts in the level of employment or total closure will impact disproportionately on the communities and will magnify the effect of political action. In Europe the industrial heartland where many of these companies are based, tend to be left of centre politically and thus have enhanced political leverage to protect their regional interests.

To conclude, whilst cost savings from M&A can be clearly seen, there are several political factors which will influence the extent to which the acquirer can find commercial advantage. Such activity is therefore likely to be limited to niche companies’ technologies and/or lower value activities which fall below the political radar scope and/or the concerns of the national defence ministry.

NOTES

- 1 Net Asset Value or NAV is defined in the context of a company as the book value of its entire assets minus liabilities (source: www.investopedia.com)
- 2 Where market capitalisation refers to the total value of all shares currently in circulation.
- 3 Research conducted by the author
- 4 Linster BG, Slate S & Waller R L, Consolidation of the US Defence Industrial Base: Impact on Research Expenditures, Acquisition Review Quarterly, Spring 2002, page 143. Note: Since its publication, Litton was successfully acquired by Northrop Grumman in a \$5.1 billion transaction completed in April 2001
- 5 Defence Restructuring and the Future of the US Defence Industrial Base, CSIS, Washington.
- 6 Op. Cit. Linster, Slate & Waller 2002, page 148
- 7 FRES or Future Rapid Effects System is a UK land systems acquisition programme with the potential to replace existing tanks and infantry fighting vehicles
- 8 Northrop Grumman acquired Litton, Ingalls and Avondale. NASSCO, Electric Boat and Bath Iron Works were purchased by General Dynamics. For more details see O’Rourke Navy Shipbuilding: Background and Issues, Congressional Research Service 2002, ISBN 1-59033-558-9