

Recent headlines reveal a potential merger between London listed defense contractor BAE Systems and the Franco-German defense combine EADS. What does this mean for the political and defence consumer - not to mention investors ? Dr Jeffrey Bradford, Director of Research for the U K Defence Forum, considers the issue

For the mainland European politician a combination offers the prospect of a European champion in the defence sector. The arguments about efficiencies and ultimately cost-savings to national governments of common procurement are likely some way away - if indeed ever. Obtaining synergies outside of combining back-office functions such as accounting, HR etc. would involve closing production lines which has a geographic and political complication. The decision to continue separate management post merger implies inefficiency from a business and investment standpoint.

BAE Systems however has an interesting strategic culture. In the 1990s it hankered desperately for an American suitor and was ultimately dashed by MacDonnell Douglas's acquisition by Boeing. Acquiring United Defense from the Carlyle Group gained exposure to land systems in the united States which has served the business well and established a toehold in the mindset of the Pentagon. Let's also not forget the BAE sale of its Airbus stake in recent years - not exactly the strategic move of a business keen to enmesh itself with European partners...

How willing is BAE really to put at stake its access to the US in return for 'becoming part' of Europe ?

Perhaps the reality is that this courtship of EADS is a smoke screen for a BAE push for a transatlantic partner. Given the USA will remain the worlds largest defence spender at the highest levels of technology is going to make the suits at Lockheed Martin, Boeing, General Dynamics and Northrop Grumman think seriously about cementing a tie-up before Europe becoming a more closed market.

The synergies of English language, military interchange between the principal nations and overseas exports markets such as Saudi Arabia offers a more compelling logic for a tie-up between a North American and British defence contractor surely ?

Taking a look at yesterday's market capitalization figures for the top US defense contractors plus BAE Systems and EADS shows the logic for them to get together. "BEADS" would, depending on the dilution effects of linking up will put them neck and neck with Lockheed Martin (LMT) and in second place behind Boeing.

Given BAE Systems management are serious enough about EADS to put themselves in play, announcing their intent to the stock markets, one of the cultural reasons behind BAE's move could be that they see it as better to retain autonomy in Europe than risk being the junior partner

in a Transatlantic merger scenario.

Amongst US players Northrop Grumman would offer the best option for a merger of near equals and the product mix would be interesting for the combination, though perhaps lower on the value chain than Northrop would like. GD and LMT offer the biggest logic given General Dynamics Land Systems operations versus Lockheed Martin's F-35 Lightning II ("JSF") programs.

Looking more broadly the completion of this combine could ultimately reflect the defence industrial drift between the USA and Europe - with Europe reluctant to invest in research and development and the USA having pushed a high level of sustained defence spending.

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you can imagine the stark choices faced in the Boardroom of BAE Systems with regard to the corporations prospects for independence.

The UK defence budget can be seen, regardless of the methods of monetary measurement, to be in a state of decline versus the rate of defence inflation (ie. the ever increasing expense of state-of-the-art procurements) probably since the end of the Cold War.

This is not intended as reflecting upon any particular party. The Peace dividend associated with the fall of the Berlin Wall and Gulf War of 1990-91 set in train an ideological position that defence was out of control.

As the post cold war period has unfolded the Ministry of Defence, through repeated difficulties in managing defence acquisition, left itself open to repeated charges from Administrations of both sides of the political spectrum to be not managing public funds properly. This in term led to expedition political reorganizations which only served to confuse military and civil service managers, resulting in more problems, more reviews and thus the spiral into chaos. All at a time when the tempo of actual operations is the highest in a generation.

The impact of new accounting methods at the ministry of defence coupled with the challenge of getting politicians to buy into new procurements has led to lower numbers and higher unit costs - which for a prime contractor is not going to offer the long production lines which are rewarding commercially vis-à-vis the risks of construction.

The Astute SSN program me is a good example. Repeated delays led to suppliers, fearful of the only nuclear submarine programme in town being cancelled, rapidly increased the charge for their components - leading to an increased unit cost which the Prime could not realistically hold down.

The new aircraft carrier programme, which in a more sensible world would probably have been rescoped or cancelled by now in favor of more frigates, will have absorbed political interest in what is on the whole a relatively low-tech manufacturing exercise compared to a fighter jet and leave little stomach for even the essential need to replace the frigate fleet.

Little wonder that BAE executives, having tried the Middle Eastern export route (Al Yamammah - USA now pushing hard on their own with Saudi Arabia), exiting civil aviation (divested their Airbus interest), then the US acquisition route (as Iraq and Afghanistan wind down the bonanza in land systems work is slowing) are now left throwing the dice as their market capitalisation dwindles and either getting a US player to commit or else harnessing themselves for protection to a European combine.

This article is based on posts which first appeared on Dr Bradford's [National Security Analyst](#) blog, which develop further ideas