

THE EUROPEAN DEFENCE INDUSTRY'S FUTURE: HOW EUROPEAN?



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SUMMARY

The contraction of domestic markets, with cuts and delays in military expenditure in both the EUMS and the USA represents the main constraint for the defence industry in Europe. On the demand side, the global framework of budget diminution underlines a clear trend towards pooling of capacities. On the supply side the rationale is to maintain production capabilities and revenue. There is a quest for better opportunities in non-EU markets, along with the continuing issue of bolstering EU-wide exports. Meanwhile, the Commission attempts to shape the current landscape of the European defence industry via a number of directives. Yet, defence industries are not only pure “suppliers”. The fact that some states are shareholders of defence companies reflects the complex legacy of this sector, a mix of the sovereign state concept of production together with the protection of workers and specific constituencies. The latter is a key issue in industry governance, as revealed by Germany’s refusal of the BAE-EADS merger.

This Policy Paper is part of a series entitled “[How can Europeans be taken seriously with lower hard security capacities?](#)” which also includes contributions by Ronja Kempin (SWP, Berlin), Daniel Keohane (Fride, Brussels), Jan Techau (Carnegie Europe, Brussels) and Nick Witney (ECFR, London).

It is a contribution to the project “[Think Global – Act European \(TGAE\). Thinking strategically about the EU’s external action](#)” directed by *Notre Europe – Jacques Delors Institute* and involving 16 European think tanks:

Carnegie Europe, CCEIA, CER, CEPS, demosEUROPA, ECFR, EGMONT, EPC, Real Instituto Elcano, Eliamep, Europeum, FRIDE, IAI, Notre Europe – Jacques Delors Institute, SIEPS, SWP.

Four other series of Policy Papers deal with key challenges on EU neighbourhood, strategic resources, migrations and economic policy. The final report presenting the key recommendations of the think tanks will be published in March 2013, under the direction of Elvire Fabry (*Notre Europe – Jacques Delors Institute, Paris*).

Introduction

The recent EADS-BAE merger project attracted much attention, launching some speculative scenarios about the future of Europe's defence industry.

The contraction of domestic markets, with cuts and delays in military expenditure in both EU Member States and the US, represents the main constraint for the industry. It weakens the position of companies which, in a somewhat typically post-monopolistic fashion, traditionally rely on national-domestic markets. Shrinking margins and investment capabilities make it increasingly difficult to maintain the logic of nationally-based production for a national market. If cutting-edge technological capabilities are to be maintained – keeping in mind that technical capabilities are synonymous with strategic assets – a critical mass of investment must be reached.

This issue of critical mass is a factor that favours further consolidation in the European sector. It was also a driving force behind the BAE-EADS merger, a project that offered significant industrial advantages.

Another way to compensate for the weakening of domestic markets is to increase exports, exploiting the potentialities of emerging markets (growing economic areas with strong needs in terms of defence technology such as the Middle East, Asia and South America). Yet here again, size plays a role, and competition between European companies is common. Rafale/Eurofighter rivalry is an emblematic example in that respect.

Let's recall the main developments on the demand side. In the global framework of budget cuts, there is a clear trend toward pooling of capacities. Both the EU and NATO (via its smart defence initiative) propose pooling and sharing as a solution to cope with the problem of maintaining capabilities.

In that respect, the 2011 Libyan intervention illustrates what is working and what is not. France and the UK undoubtedly played a central role, showing European leadership and taking political responsibility for the mission – a rather new phenomenon. Key capabilities, however, were provided by the US, while the non-participation of Germany in the mission created problems, including a lack of availability of AWACS aircraft. Two problematic aspects can be identified: a technical gap (between intelligence and telecommunications technologies) due to which Europeans still rely on the US, and a problem with coalition resources if one or several partners chooses not to participate in a context of shared capabilities.

1. What Future do Stakeholders Foresee for the Industry?

“THERE IS A QUEST FOR BETTER OPPORTUNITIES IN NON-EU MARKETS”

On the supply side, from an industrial, prime contractor “business” point of view, the rationale is to maintain production capabilities and revenue. A decrease in “domestic” demand can create pressure to subcontract, something which can potentially destroy technical know-how and capabilities if companies are pushed out of the market by shrinking revenues. The issue of exports is also a parameter in this framework. There is a quest for better opportunities in non-EU markets, but there is also the issue of EU-wide exports, with the Commission acting through its defence directives (on defence equipment transfers and defence procurement) with the aim of fostering a more open defence market in Europe. The defence directives represent an interesting tool for this market, a process which is slowly taking place among EU Member States and should start to produce effects in 2013.

There is a strong push for efficiency and value for money, implying a higher level of competition and strategies aimed at specialisation, which could force some companies to exit the market. Another important factor is the

business mix between defence and civilian applications, both from a blurred, dual-use technological point of view and a market point of view (where it can be beneficial to take advantage of the different market cycles in the defence and civilian industries).

Furthermore, defence industries are not only pure “suppliers”. The fact that the French, Italian and Spanish states are shareholders in defence companies reflects the complex legacy of this sector, a mix of the sovereign state model of production together with the protection of workers and specific constituencies.

This is a key issue in industry governance, as shown by the German refusal of the BAE-EADS merger, partly due to a need to defend national production capabilities.

On the demand side, European departments of defence express a rather clear need: to maintain continuity and security of supply, to maintain and develop cutting-edge technologies at a better price, to get better value for money, and to mediate between monopolistic, nationally-embedded production and a more “open”, competitive EU market. This is a generic and rather theoretical statement which shall be complemented by an analysis of ongoing procurement in several sectors. What scenarios exist for Future Air Systems, taking into consideration the current Rafale/Typhoon/Gripen/F 35 production, and numerous UAV and UCAV programmes? Is the helicopter rationalised through a duo in Europe (Eurocopter/AgustaWestland)? What about transport aircraft (Airbus Military / US production)? Is it realistic to rationalise the armoured vehicle sector and should a joint programme be launched to set up a cooperation framework? Can cooperation in vessel construction be reinforced? What about submarines? Is further consolidation needed for defence electronics? In space, paths diverge: pooling occurs in the case of some programmes, while other technologies, such as intelligence, are developed on a national basis. All these issues involve separate scenarios.

**“ THE EADS-BAE
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Specific attention should certainly be paid to future capabilities, such as the future of air support. Recently, Claude-France Arnould, Chief Executive of the European Defence Agency, warned Europeans of the urgent need for concerted action for Future Air Systems (FAS). Ideally, Europe should avoid repeating the mistakes made with the last generation of planes (Rafale versus Eurofighter), meaning that rationalisation should be pursued in the field of combat aircraft.

A BAE-EADS merger could have illustrated a new paradigm of mergers and acquisitions after the first wave of the 1990s. The idea of merging the two companies was a potential response to several of the constraints described above and would have put the new company in a leading position for all future programmes. The creation of the world’s leading aerospace company would have been a sign of supremacy even if it engendered monopolistic effects within the European market. The rationale behind an EADS-BAE merger rested on the success of the EADS model and the relative failure of the BAE model, based on a specialisation in defence that has been penalised by the cyclical reduction of defence budgets.

2. After the “No-Go” of the EADS-BAE Merger, What Could Be the Next Move on the Supply Side?

The failure of the two groups to merge certainly decreases the pressure on other European players (Thales, Dassault, Finmeccanica, Saab, Safran) who were expressing concerns about potential side effects, fearing they would become too small to compete. All the big players in Europe currently maintain strong businesses but the EADS-BAE merger project warned all concerned of the need for rationalisation. Existing companies will go on. The arrival of a non-European company on the European scene is possible. BAE, which already does half its business in the US, could find a “natural” alliance with a US company. Among the top US defence

companies, however, no one seems really interested in wedding the jilted bride: Boeing could be the perfect match (complementarity between the civilian and defence portfolio) but seems more focused on developing civilian activities; Lockheed Martin is concentrated on its F-35 programme; Raytheon has expressed doubts about such a merger; Northrop Grumman is in a restructuring phase with apparently no resources to absorb such a company; General Dynamics could face some competition issues with BAE and has recently expressed a commitment to maintaining its balanced civilian/defence portfolio. Second-tier consolidation with players such as Rockwell Collins, L-3 Communications, SAIC, ITT Exelis and Harris Corp seems more likely to happen, but would be more of a “US market” operation than a European one.

First-tier European players (EADS, BAE, Thales, Safran, Finmeccanica, Saab, Dassault Aviation) will pursue their rationalisation strategy but at a slower speed. Reductions in defence revenue will have a different impact on these companies. BAE is on the front lines and must react to this changing context, while EADS, with 75% of its revenue coming from civilian activities, seems safe for the time being. This is also the case for Finmeccanica despite a recent poor economic performance which pushed it to sell non-strategic assets such as transport to compensate losses.

EADS can remain a pole of attraction and development for a more globalised European industry. The BAE-EADS merger attempt has left a mark, producing effects in terms of re-thinking the perimeter of the company. This work won't go to waste and it remains in the nature of EADS to expand.

The question of defence electronics also arises. Thales and Finmeccanica have held lengthy negotiations about merging these activities and talks are apparently open again. At least some type of cooperation framework could be established.

“ POLITICAL AND STRATEGIC CONSTRUCTIONS ARE, HOWEVER, OFTEN NOT REALISTIC FROM A BUSINESS

Two opportunities were missed as a result of the BAE-EADS merger collapse: the rationalisation of MBDA (the missile production company shared between BAE, EADS and Finmeccanica) and the rationalisation of Eurofighter combat aircraft production (shared between BAE, EADS and Finmeccanica).

OR INDUSTRIAL POINT OF VIEW” We can observe two types of logic in this merger game: a political logic and a business logic, which although not mutually exclusive, can help to describe future scenarios.

On the political side, one key issue is certainly the evolution of the French and the Italian positions. These two countries still have a mainly state-oriented defence model, with the state acting both as an industrial stakeholder and a customer. A shift within French and Italian companies to include a system of golden shares and strict laws to protect national security interests would foster the evolution of the sector. During the BAE-EADS merger talks, the French government showed some flexibility, accepting to transform its shares in a new group. This is an important indicator for future rationalisation in the sector. Now that the BAE-EADS deal has fallen through, some in Paris are launching the idea of a reinforced French solution in the form of a Thales-EADS merger, for example. Another option could be the creation of a French national aerospace champion by merging Dassault Aviation, Thales, Safran and possibly Zodiac (this “grand policy” was rejected by Zodiac when Safran launched a takeover of the company). Furthermore, Dassault seems to be less protected by the Hollande Presidency than the former government. The failure of the BAE-EADS deal might also accelerate changes for EADS shareholders. Lagardère has declared its intention to exit EADS in 2013, leaving a stake that could be bought by the French state. On the German side, Daimler too will probably exit EADS; the German state should take over this stake. Furthermore, the Emirate of Qatar has expressed an interest in investing in EADS. This “Middle East paradigm” can also be observed in the key role played by Saudi Arabia (until now as a customer) for BAE.

Such political and strategic constructions are, however, often not realistic from a business or industrial point of view. The EADS-BAE merger was very logical in a business sense as it would have allowed the rationalisation

of MBDA and Eurofighter activities. If we look at other scenarios, Dassault, 46.3% of which is owned by EADS, produces a rival jet, the Rafale, for which Thales is a key partner in electronics and avionics. Industrially speaking, a merger between Dassault and Thales is therefore plausible. If we take into consideration the future of Cassidian, the defence division of EADS, and keeping in mind the need to rationalise MBDA and the Eurofighter programmes, the alternative partner to BAE is Finmeccanica: Eurofighter avionics are produced by its Selex subsidiary and the Eurofighter is built by Alenia Aermacchi, Finmeccanica's military aircraft division. An alternative alliance with Finmeccanica could achieve EADS goals and put BAE in a corner.

This scenario does not, however, seem to be the main alternative. The "Italian" solution is often considered a fantasy from a French point of view; even on the Italian side, the expressed interest for a Finmeccanica (Selex)/Thales union illustrates a strategic vision more than a real industrial one. Following the same logic, though, a rationalisation between BAE and Finmeccanica could be pursued (based on MBDA and Eurofighter and the presence of Finmeccanica in the UK), even if this scenario is never mentioned by analysts.

Again, the French position is a central issue, as is Dassault Aviation. The Rafale worked well during the Libyan campaign, but remains a considerable investment for one country which has, furthermore, divided Europe. All things considered, it is fair to say that this rift, if it continues, is a threat to the future generation of air systems. The NEURON programme has already set up a cooperative framework between Dassault and BAE. The EADS-BAE merger would have brought EADS back into the game of future UCAVs.

The fact that Germany caused the EADS-BAE merger to fall through could influence the future of Cassidian, and indicates the country's unwillingness, given its rather pacifist constituency, to support a shift by EADS toward military production. Certainly, within Cassidian, MBDA will keep its integrity. Also, the development of a service-based/security business in emerging countries apparently has potential, but the Eurofighter, largely based in Germany, could lose ground.

The BAE-EADS merger is an interesting scenario which has sparked debate on the reorganisation of Europe's industrial defence sector. The defence industry is, however, not limited to aerospace.

Other sectors are also affected by rationalisation efforts. As far as land production is concerned, there is a high level of fragmentation on the supply side. Rheinmetall and Krauss Maffei Wegmann are the heavyweights in this sector in Europe. Renault Trucks Defence (RTD), a subsidiary of the AB Volvo group, recently took control of Panhard and Acmat and could be interested in further acquisitions. Nexter is certainly the French chip in this panorama, as it is fully owned by the state.

On the naval side, the BAE/EADS merger would also have strengthened BAE vessel production capabilities. Here again, the European sector is shared by multiple competitors like DCNS, TKM, Finmeccanica and Navantia. Mergers between these different actors have been suggested but until now, none have occurred. It seems reasonable to imagine at least one merger taking place at some point in order to better compete on a global scale. Nevertheless, these companies are still nationally based and nationally managed, and will try to maximise this position as long as possible.

3. Recommendations

The EU directives on defence and security procurement and transfers of defence-related products are crucial to the development of market efficiency in Europe. Their implementation within Member States is often slow, and this agenda has to remain a priority.

In areas where there is a high level of market dispersion, joint programmes with common requirements should be undertaken to promote industrial cooperation and rationalisation in Europe.

Supply chains are a key issue. Mapping the defence and security supply chain has somehow proven impossible. Nevertheless, efforts to strengthen the supply chain shall be pursued.

Governments have a key role to play and should consider shareholding in big groups as a dynamic tool rather than a matter of static sovereignty.

Lastly, the distinction between "civilian", "security" and "defence" technologies is a catalyst for flexibility in the context of the European Commission's research programme. "Security research" has already opened the way for military forces to use "civilian" dual-use technologies. This could be further developed in order to ensure that the EU can finance the "civilian" and "dual-use" component of "military" systems development, for example.

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