

BAE/EADS Merger is a Mistake

Written by Harvey M. Sapolsky

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HARVEY M. SAPOLSKY, SEP 27 2012

Corporations sometimes seem to suffer from Attention Deficit Disorder. Their senior managements just can't stop messing with their structure, lines of business, industry focus, etc. They see a shiny object there or new management fad here, and they are on to it. BAE Systems which only recently seemed to have survived well a difficult transition from being the British defense champion to an American defense giant, a move that brought it out of the desert of defense spending and into the Land of Plenty, is now trying to tie up with Airbus' parent, EADS, to create the world's largest aerospace company, one dominated by its airliner franchise. Apparently, they believe that there are synergies to be gained from being in the airliner business as well as defense, although, they recently were and divested that connection just a few years back.

It is a complicated tie-up because EADS has substantial government ownership and most of the combined firm's defense business will be in the US which places special restrictions on the access to classified information by foreign owners of its domestic based suppliers. Mergers of this scale always draw the attention of governments, including the EU's executive, because of their potential antitrust implications. But defense is a strange business to begin with—governments are not only the regulators and sometimes owners, but also the only buyers. Try buying a modern fighter aircraft on your Master Card. Moreover, in the case of BAE and EADS, European governments (France, Germany and the UK) have veto power over aspects of the business as partial owners and or have legacy interests that are protected.

But it is the US government's actions that will count the most. The US imposes restrictions, described as Special Security Arrangements, on foreign owned companies doing serious US defense business, most often requiring a separate American management team and limitations on the information access of the foreign owners and managers. BAE has prospered under these conditions and now has nearly 40,000 US based employees and the US government as its biggest customer by far. EADS has been less successful in penetrating the US market, doing at most a tenth of BAE's business. BAE is more welcomed in the US defense market, no doubt, because it is British and thus the beneficiary of long standing military trust that exists between the nations. For all practical purposes, BAE System is considered a US/UK defense firm. It holds major shares of the US armored vehicle, artillery, and sensor business, and is one of Lockheed Martin's senior partners on the mammoth F-35 Joint Strike Fighter project. This is guaranteed work in that the US military is dependent upon parts of BAE for vital segments of its equipment.

It is likely, of course, that if the merger goes ahead a new Special Security Arrangement for the US located facilities can be negotiated. There are always retired US generals or admirals who can be persuaded to join a well compensated review board that screens out the EADS/BAE combined company executives from sensitive US information. That is not the hard part. What will be difficult to shake is the belief that the combination is no longer a British company that moved to US, but rather a French/German company moving back to Europe. At risk is the stake BAE built in the US as a top level contractor. Viewed as an extension of Airbus, it will no longer be in the circle of trust to quote a movie or two.

Another problem will be the inability to find much synergy in the combination of the airliner and defenses businesses. The development costs of military equipment from aircraft to sensors are borne by governments. In contrast, airliner development risks the business. International trade rules restrict government subsidies. Most of the funds have to be internal or air line shared. Soon the airliner competition will increase as developing nations, especially China, enter

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the business. Even the boom/bust cycles of the airliner and the defense businesses aren't always in counterbalance. There have been times when both have been down together. The airliner business is likely to be more of a drain for talent and money for the stogy old, and now declining, defense business than its savior. BAE saw a shinny object in Europe and will likely fall into the Atlantic reaching for it.

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Read more from Harvey M. Sapolsky in his e-IR blog: [The High Ground: Observing International Security](#)

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