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Poland Looks to Ride Rising Tide of Transatlantic Defence Market Mergers

The aerospace and defence industries are on the brink of a major shake-up. The aircraft producers will have to meet booming demand for civilian planes, while defence companies face slashed military budgets and different military priorities. Both sectors of the industry will need a serious restructuring to adapt to the changing market, with consolidations and take-overs constituting a major trend. Their consequences will be felt in Central and Eastern Europe, with Poland, as the biggest defence market in the region, at the forefront.

Introduction

The aerospace and defence industries on both sides of the Atlantic have been doing surprisingly well in a time of global economic downturn. In 2011 the top 100 A&D companies set a record with $677 billion in revenues—5% higher than 2010.[1] In the first half of 2012, overall revenues in the combined A&D sector continued to grow.[2] However this general picture may be misleading as serious challenges to the U.S. and European defence parts of the sector are just behind the corner.

With an era of belt tightening far from over, competition among defence companies is likely to increase while defence expenditures will continue to decline. The UK plans to save

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[1] PricewaterhouseCooper, "Aerospace and Defence. 2011 year in review and 2012 forecast," http://kc3.pwc.es/local/es/kc3/publicaciones.nsf/V1/3BA80418709B058BC12579F700550B1B/$FILE/PwC_AD_2011_year%20in%20review.pdf.

[2] Deloitte, "Defence Continues to Shrink as Commercial Aerospace Is Taking Off," http://www.deloitte.com/assets/Dcom-UnitedStates/Local%20Assets/Documents/AD/us_ad_DefenseContinuesToShrink_09242012.pdf.

£10 billion over the next four years, Germany will cut defence spending by €10 billion in the same period, while Spain is unable to pay a €27 billion arms purchases bill.[3] Procurement projects have been cut or cancelled in numerous countries. The market's biggest tremors come from the United States, responsible for 40% of the world's overall defence expenditures. The Pentagon has started to introduce spending cuts that may amount to $487 billion over the next 10 years, and faces additional automatic cuts of $492 billion beginning in January if Congress failed to agree a deficit reduction bill. Even if there is a compromise it may involve additional cuts in the defence budget. The overall trend in the defence sector is at best flat and at worst downwards, and this will have serious implications for defence companies both in America and Europe.

Not only must the defence industry prepare for reduced military budgets, but it also needs to ready itself for a different strategic environment. The end of the war in Iraq and the withdrawal from Afghanistan by 2014 will change the needs of the militaries in many nations, reducing demand for many types of equipment, especially land vehicles. A number of countries will seek capabilities that would be effective in combating terrorism, weapons of mass destruction, and cyber threats. Intelligence, surveillance and reconnaissance technologies such as drones (Unmanned Aerial Vehicles) have become a priority. The American strategic shift to the Asia Pacific region is likely to increase the demand for naval and air forces as well as for upgrading existing equipment. At the same time governments may be less willing to invest in development of new systems or to offer long term financial guarantees for traditional weapons projects, as has been the case in the past. Instead they may prefer to buy off the shelf products, which will force the manufacturers to search for new forms of funding research and development (R&D), which is the most costly part of product development.

This creates an uncertainty on the market. The economic condition of the defence industry in such an environment will depend both on its competitiveness and on companies' ability to adjust. Some manufacturers have already tried to improve their performance by exploring new markets and cutting costs. There have also been clear signals that companies are waiting for the right moment and opportunity to embark on mergers and acquisitions. While for some this can represent an additional means of improving performance, for others it may prove the only recipe for survival.

Commercial vs. Military

Aerospace and defence markets are often presented as one entity. Both manufacture complex products that can be used for commercial or military purposes. Both are heavily regulated as governments try to maintain safety of supplies for their armies and want to protect their national industrial base which is able to develop cutting edge technologies, guarantees security of supplies and provides thousands of jobs. Nevertheless,

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3 M. Gonzales, "Plan Drawn Up to Cut Military by 20 000," El Pais, 17 July 2012, http://elpais.com/elpais/2012/07/17/inenglish/1342525776_142934.html.

both sectors often operate in different economic realities. While the defence sector has recently been under pressure due to military budget cuts, the commercial aerospace sector is booming. After very weak growth in 2009 there has been a rebound in demand for air travel, and orders for aircraft from the major companies such as Boeing and Airbus have increased to record levels. Market forecasts for both manufacturers expect that passenger and cargo air traffic volume will grow steadily and around 30,000 planes will be produced in the next 20 years.[4] The aerospace sector has already proved it can forecast the changing demands of the market accurately. Just as the airlines' profitability was being hit by rising fuel costs, aircraft manufacturers were ready to offer more fuel efficient planes such as the B-787 Dreamliner, the 737 MAX from Boeing and the A320neo from Airbus. Demand has been so high that aircraft producers have a backlog of orders for 4,000 jets and will need to increase their production by 40%.

Prospects for the defence markets are gloomier. Global defence spending, estimated at $1738 billion in 2011, is the same as it was in 2010, after more than a decade of continuous growth.[5] It has been brought to a halt mainly by spending cuts in the U.S. and Europe, where governments are struggling with huge budget deficits. However, India and Brazil also contributed to the slowdown as both countries, responsible for a substantial increase in defence expenditures in recent years, decided to introduce saving measures as well. This slowdown has already affected defence contractors. Defence companies from the top 20 in the global aerospace and defence sector suffered a $1.3 billion (1%) decline in revenues in the first half of 2012, after a 3.3% decline in 2011.[6]

The pressures on the defence companies differ from country to country. Some national companies dependent on governmental orders will suffer more from cancelled programmes and less procurement. On the other hand, numerous countries plan to increase their spending on research and development, which can open new possibilities for the sector. Almost all top 40 global R&D spenders, even crisis-ridden Italy, Ireland and Portugal, planned to increase their expenditures in 2012.[7] Yet once again, despite an overall growth in R&D investments, it is the commercial sector that seems to be a priority. In the U.S.—by far the biggest R&D spender with 31% of overall world expenditures—research and development sponsored by the Department of Defense is falling, while industrial R&D is growing. Hence the major players in the market have been readying themselves for a battle for resources that are not only shrinking but shifting.

[4] Airbus, "Global Market Forecast 2011–2030," June 2011, www.airbus.com/company/market/forecast; Boeing, "Current Market Outlook 2011–2030," 2011, www.boeing.com/commercial/cmo.
[5] SIPRI, press release, 17 April 2012, http://www.sipri.org/media/pressreleases/17-april-2012-world-military-spending-levels-out-after-13-years-of-increases-says-sipri.
[6] Deloitte, *op. cit.*
[7] Battelle and R&D Magazine, "2012 Global R&D Funding Forecast," December 2011, http://battelle.org/docs/default-document-library/2012_global_forecast.pdf?sfvrsn=2.

Merge or Die

The global aerospace and defence industries remain highly concentrated. Together, they can be viewed as a pyramid shape, with the biggest players, so called tier 1 producers, at the pinnacle, and a vast number of suppliers, known as tier 2 and tier 3 companies, in the middle and at the bottom. From the top 100 producers in the civil aerospace and defence (A&D) sector, 46 come from the U.S. and 34 from Europe.[8] The leaders have remained unchallenged for years, with Boeing (the U.S.), EADS (France, Germany and Spain), Lockheed Martin (the U.S.), General Dynamics (the U.S.), BAE Systems (the UK), Northrop Grumman (the U.S.), Raytheon (the U.S.), United Technologies (the U.S.), Finmeccanica (Italy) and General Electric (the U.S.) leading in the ranking. Just outside the top ten are two French companies, Safran and Thales.

This dominance of U.S. and European companies, also reflected in the rankings of the top 100 defence producers, is the result of the decades long consolidation of aerospace and defence sectors on both sides of the Atlantic triggered by the post-Cold War budget cuts in 1990. In Europe, trans-border consolidation 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, the British BAE, the Italian Finmeccanica and the French Dassault), and a network of interlinked companies (for example, the Swedish Saab-Scania), along with joint ventures (such as MBDA, owned by EADS and BAE). Through mergers and acquisitions, companies have tried to benefit from access to new markets and economies of scale, i.e. increased and broadened production at lower labour costs. The process of consolidations has again begun to accelerate in recent years.[9] However, most of the mergers and acquisitions have been taking place among smaller and mid-sized companies, with the top 20 virtually unaffected. The only exception has been the acquisition of Goodrich, an aerospace company, by United Technologies Corp. in 2012—the first such merger within the top 20 A&D companies for more than a decade.

With uncertainty casting a shadow on the defence market, companies have already tried to increase their competitiveness by reducing labour costs and increasing exports in growth markets in the Middle East and South East Asia. However, both strategies have serious limitations. The sector has already suffered from talent drain, and further redundancies of skilled workers could have a negative effect on the companies, limiting their chances of adapting to new demands. Cuts among tier 2 and tier 3 producers would make them even less reliable partners for tier 1 manufacturers, who will demand timely supplies in order to compete on an increasingly challenging market. Outsourcing of some production segments may also prove difficult, due to pressure to retain the industrial base in home

[8] Candesic, "The World's Top 100 Aerospace and Defence Companies, September 2012," http://candesic.com/wp-content/uploads/2012/09/Candesic-Top-100-AD-report-Sept-2012.pdf.

[9] Deloitte Corporate Finance LLC, "2012 Mergers and Acquisitions: Outlook for the US Aerospace and Defense Industry," https://www.deloitte.com/assets/Dcom-UnitedStates-CorporateFinance/Local%20Assets/Documents/us_dcf_2012_ma_outlook_for_us_aerospace_defense_industry_041312.pdf.

countries. It will also be a challenge to improve revenues from export, due to increased competition on outside markets and in-country barriers.

Thus one of the top drivers of revenue growth may become mergers, joint ventures and acquisitions. Three quarters of the CEOs in the U.S. defence sector believe that their companies will be involved in a merger or an acquisition over the next two years.[10] However, the U.S. Department of Defense has repeatedly indicated that it would not approve mergers among the leading U.S. prime contractors.[11] According to the U.S. government, the current number of big players assures the proper balance between the need for fair competition and having an industry that is capable of providing reliable equipment, technology and services crucial for both national security and economic advantage over the rest of the world.

A Failed Merger: BAE and the EADS

Plans to merge BAE Systems and the EADS, which leaked in September 2012 against this backdrop, electrified the industry because it would have led to the creation of the world's largest aerospace and defence company. Such a giant would not only virtually monopolise the European market but could substantially increase its competitive power in challenging the biggest U.S. competitors, such as Boeing or Lockheed Martin.[12]

The commercial logic behind the merger was strong, as both players complement each other in different product areas and different markets. The EADS, owner of Airbus and Astrium, focused mainly on commercial aircraft and space platforms, and could have decreased its dependence on Airbus sales and improved its profit margin, which was lower than average in this sector. It could have also capitalised on BAE's extensive business links in the United States, where the British company is one of top five contractors for Pentagon. For BAE the merger was an opportunity to gain access to civilian markets and decrease its over-dependence on defence sector, which generated 98% of the company's revenues.

The plans for merger failed, as political obstacles proved impossible to overcome.[13] Britain, which has the right to block any change in control of the company through the government's so called golden share, was ready to support the merger and cap political control over the resulting combined firm, provided it received assurances that the new company would continue to secure defence programmes vital for British national interests. However, France and Germany, which each have a 22.5% holding in the EADS, could not agree on the stakes that they should be allowed to keep in the company. Reportedly,

[10] KPMG Industry Outlook Survey, 2012, http://www.kpmg.com/US/en/IssuesAndInsights/ArticlesPublications/Documents/2012-aerospace-defense-outlook-survey.pdfhttp://www.kpmg.com/US/en/IssuesAndInsights/ArticlesPublications/Documents/2012-aerospace-defense-outlook-survey.pdf.

[11] Bloomberg, "Pentagon Will Back Defense Mergers Outside Top Five Companies, Carter Says," 9 February 2011, www.bloomberg.com.

[12] W. Lorenz, M. Terlikowski, "The EADS-BAE Merger Talks Signal Growing European Ambitions," *PISM Bulletin,* no. 90 (423), 25 September 2012.

[13] Reuters, "Back to Drawing Board after Berlin Halts BAE, EADS Deal," 10 October 2012, http://www.reuters.com/article/2012/10/10/us-eads-bae-idUSBRE89903E20121010.

German chancellor Angela Merkel derailed the deal, fearing that jobs and production locations in Germany—where elections are due next year—would be moved to the UK and France. Plans for the merger have been put on hold but the appetite for far reaching consolidation in the sector remains. The EADS North America chief executive Sean O'Keefe said that his company will continue to hunt for takeovers, especially on the American market, although on a scale smaller than the planned BAE deal.[14]

European Integration Opens the Way for Further Consolidation

The failed merger of the EADS and BAE indicates the deficiencies of the European defence market, which remains heavily fragmented with countries jealously protecting their interests. Hence, the industry is unable to take full advantage of the European defence spending of €194 billion[15] ($248 billion) which is the equivalent of 15% of the world's overall defence expenditure. In Europe, less than one fifth of procurement is spent in collaborations in which at least two countries take part.[16] While over the past ten years the value of procurement in the U.S. has grown, in EU NATO member countries it has stagnated. Still, there are prospects for a more open and competitive market leading to increased cross-country cooperation.

Although a common market was a driving force of European integration, governments preferred to maintain control over arms production and the arms trade in order to secure the needs of their armies, which they deemed an important symbol of sovereignty. This has been reflected in the Rome Treaty (now art 346 of the Lisbon Treaty), which states that defence production and procurement is exempted from the principles of the common market. During the last decade, however, the EU has pressed for deeper harmonisation and integration of the defence market, seen as an indispensable factor for the EU's ability to build a common military identity and strengthen its position on international arena. Such a market would provide European armies with state of the art technology and equipment, improve effectiveness of military expenditure in the EU, and strengthen European industry's power to compete on international markets. In 2004, the European Defence Agency (EDA) was established to coordinate defence cooperation and production among Member States. Groups of countries managed to agree a number of multi-national projects such as the Eurofighter plane, the NH90 helicopter, the Tiger helicopter, and the A400M transport aircraft, which helped to build transnational industrial capacities and a strong network of transfers in technology, research and development, and

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[14] Reuters, "EADS keeps sights firmly on expansion in U.S," 10 October 2012, http://www.reuters.com/article/2012/10/10/us-eads-bae-usa-idUSBRE8990W620121010.

[15] European Defence Agency, 25 January 2012, http://www.eda.europa.eu/info-hub/news/12-01-25/EU_and_US_government_Defence_spending.

[16] European Commission, "Defence Industry. Comprehensive sectoral analysis of emerging competences and economic activities in the European Union," 2009, http://ec.europa.eu/restructuringandjobs.

production.[17] The EU has further tried to break down barriers on the defence market, by introducing Directive 2009/43/EC in 2009, which alleviates control on transfers of military equipment between Member States, and Directive 2009/81/EC, on procurement of arms, munitions and war material. The latter, so called defence directive, aims to encourage cross-border procurement and prevent countries from granting contracts to national companies if national security interests did not provide sufficient justification to do so. In September, the European Commission asked the European Court of Justice to fine Poland, the Netherlands, Luxembourg and Slovenia for not implementing the directive on a national level, which indicates that the EU is increasing its scrutiny in pursuit of a level playing field for competition.[18]

Prospects for the Future

After a decade of continuously rising revenues, the aerospace and defence sector is bracing itself for major shake-up, with a new wave of mergers likely on both sides of the Atlantic.

Changes in the aerospace part of the sector will be driven primarily by increasing demand for the aircraft and orders which have already been received. Both of the major manufacturers, Airbus and Boeing, which between them produced 1,000 planes in 2011, need to enhance their production capacity by 40% to if they are to meet the backlog of 4,000 planes. Both companies have encouraged their suppliers to consolidate and create an efficient supply chain that is more efficient and reliable, and will avoid delays that plagued the sector in the past. As companies rely on a chain of 1,500 suppliers, there is much room for mergers and acquisitions. The biggest pressure for consolidation will be exerted on the suppliers specialising in one set of products, such as fuselages or wings, as they are unable to increase revenues from additional services or different areas of production. Should some crucial supply companies face bankruptcy, both major aircraft manufacturers could decide to buy or finance them.[19]

Changes in the defence industry will be driven by dwindling military budgets and, possibly with the exception of the NATO Missile Defence System, by the lack of new large military projects that boosted the sector in the past. The end of the war in Iraq, the pending NATO withdrawal from Afghanistan, the American strategic shift towards Asia-Pacific, and the overall transformation of armies into more flexible, deployable forces will lead to a fast decline in demand for land vehicles. The defence companies will have to resort to three

[17] For more, see: SIPRI report, A.J.K. Bailes, S. Depauw, "The EU Defence Market. Balancing Effectiveness with Responsibility," 15 September 2011, http://www.sipri.org/research/armaments/transfers/publications/other_publ/other%20publications/conference-report-eu-defence-market-flemish-peace-institute.

[18] European Commission, press release, 27 September 2012, http://europa.eu/rapid/press-release_IP-12-1020_en.htm?locale=en.

[19] A. Parker, J. Shotter, "Airbus and Boeing Push Supply Mergers," *Financial Times*, 8 July 2012, http://www.ft.com/intl/cms/s/0/2b66574a-c73b-11e1-849e-00144feabdc0.html#axzz2BS7n9sOy.

main strategies of cost cutting, increased export and mergers and alliances if they are to survive.

A number of manufacturers have already started to spin off segments of their production that are less profitable, and are attempting to offset declining revenues with cost cutting. They also try to compete on the growing markets in Asia and the Middle East. Mergers and consolidations are likely to follow, with hostile takeovers becoming more frequent. Bigger players will look for mergers with smaller firms that have technologies, systems and products that can be easily integrated, especially in the areas of intelligence, surveillance, reconnaissance and cyber security.

Defence producers will also move into adjacent markets, by trying to increase revenues from the refurbishment of old equipment, civil production, new services, and market niches. They will attempt to exploit financing available on the civilian market for developing new dual use products and technologies.

After the election victory of Barack Obama in America, and with the House of Representatives once again in hands of Republicans, the uncertainty regarding future cuts in military expenditure remains high. Should additional savings be introduced, industry executives in the U.S. predict that a new wave of consolidation among smaller companies in the U.S. will follow.

The past two years have already seen an increase of foreign acquisitions of American A&D companies, with Canadian and European companies at the forefront.[20] This indicates that European firms are attempting to balance shrinking opportunities in Europe with investments in the U.S. market, despite the tough rules discouraging foreign companies from operating there. It is fair to assume that this will be a two way trend. Although U.S. companies already have a strong position in the European market, they may try to benefit from new EU regulations increasing the competitiveness in the defence sector.

Future consolidation will, however, be limited to mid-sized and smaller companies. Irrespective of attempts to liberalise and open the defence market, governments seem determined to maintain control over the national leaders, by discouraging mergers. The arguments that companies are crucial for national security have been supplemented by fears of job losses that could be set off by deep restructuring at the top of the sector.

Consequences for Poland—National Interests at Stake

With serious cuts in military expenditures in the U.S. and the EU, defence companies may explore new opportunities in Central and Eastern Europe. EU regulations easing rules of procurement will provide an additional incentive for this. Since Poland, Bulgaria, the Czech Republic, Romania and Slovakia are to increase defence procurement

[20] Deloitte Corporate Finance LLC., *op. cit.*

spending, at least until 2016, these markets will become prospective territory for multi-national defence companies.[21]

In this group, Poland is likely to be a major target for foreign offensives, since it the biggest defence spender in the region.[22] It allocates 1.95% of its GDP on military expenditures, which in 2012 amounted to PLN 29.5 billion ($9.1 billion). It is also running an ambitious programme of modernisation of its armed forces, and plans to invest billions in air and missile defence capabilities, drones, helicopters, navy and heavy armour. Foreign companies will try to benefit from those programmes, taking advantage not only of the EU defence directive, which is due to be implemented, but also of the recent signed Polish-American Reciprocal Defence Procurement Memorandum of Understanding, prohibiting favouring national defence companies. Since the Polish government plans the partial privatisation of the defence sector in 2013[23] (retaining majority shares in the strategic companies), foreign companies will receive an additional opportunity to improve their access to the market. Altogether, this creates both opportunities and serious risks for the Polish defence sector and Polish national interests.

Poland has based its security on three pillars: NATO, the EU, and bilateral relations with the U.S. It modernises its armed forces to create a credible deterrent, but also to prove to its allies that it is a reliable partner. It also tries to increase its strategic importance for the U.S. by strengthening military and economic cooperation. At the same time, it wants to preserve the national defence sector, which could become a driver of the economy, creating thousands of jobs and generating new technologies and original products, which could give added value to the country. So far this has not been the case. Polish companies, which have relied on the support of the state, and on state contracts, have often been unable to offer competitive products on time and within budget.

To secure Polish national interests the government will need to find the proper balance between political, military and economic benefits from the opening of the defence sector to foreign investors. This balance can be defined as the need for acquiring state of the art military equipment, building stronger relations with allies, and retaining the competitive national sector, protected to the degree that it can benefit from national, multi-year contracts.

In the short and mid-term perspective, the Polish defence industry, comprising 100 companies with a quarter of these consolidated under the umbrella of the Bumar Group—the biggest defence consortium in the region with an estimated minimal value of PLN 1.2 billion ($370 million)—is likely to find itself under immense pressure from foreign

[21] I.H.S. Janes, "Regional Focus-Europe," 11 June 2012, http://www.ihs.com/events/exhibitions/eurosatory-2012/news/jun-11/english/Regional-Focus-Europe.aspx.

[22] Poland allocates 1.95% GDP to defence. In 2012, this amounted to PLN 29.5 billion PLN ($9 billion). For more, see: Ministry of National Defence, http://www.mon.gov.pl/pliki/File/budzet/basic_information2012.pdf.

[23] Polish Ministry of Treasury, "Privatisation Plan for the Years 2012-2013," March 2012, http://bip.msp.gov.pl/download.php?s=1&id=49190.

competition. Smaller, uncompetitive manufacturers may be pushed off the market. Others may lose part of their revenues from national procurements. Estimates made by Bumar suggest that implementation of the EU "defence directive" may lead to a 22% drop in revenues for the company. The additional competition from the U.S. companies may lead to an even bigger decrease in revenues.

In the long term perspective, defence companies, strengthened with foreign capital and know-how, could improve their competitiveness and positions on both the domestic and international markets. This would require the kind of careful strategy already employed by the bigger, foreign players, including a shift to new areas of production (including the civilian market), further consolidation, and increased foreign exports supported by the government. Companies such as Bumar and its subsidiaries may take advantage of the unique products and technologies they offer such as radars, optics and telecommunication systems, which are on the priority lists of many countries. They can also increase their chances to compete for future contracts in areas where the Polish sector has the necessary technology, such as drones.

However, it may be a challenge for the Polish industry to take advantage of other big national programmes, such as air and missile defence system or modernisation of heavy armour and navy. According to EU law, the Polish government will have to prove that it acts in the national security interest every time it wants to grant a contract without a tender, which in practice may be limited to a handful of the most ambitious procurements. Even if such protectionism is approved by the EU it will be at loggerheads with the recently signed Memorandum of Understanding with the United States. Since it may be contestable whether a country may treat EU and U.S. companies differently, Poland may be forced to either give free access to procurements to all players, or cite national security concerns for the benefit of national companies. In the former case, Polish firms are likely to lose the competition edge and the country will have limited economic benefits from the programmes, though there may possibly be some political benefits. In the latter case, the Polish sector may become the main beneficiary but the armed forces would not necessarily receive the best available equipment and the agreement with the U.S. would be undermined.

To avoid such a dilemma, Polish defence companies will have to create joint ventures with those foreign partners best positioned to win the battle for the most ambitious contracts and ready to transfer technology to Poland. This could allow the defence sector to avoid the fate of the aerospace industry, which has been taken over by foreign companies and as a part of the global supply chain provides components for the biggest manufacturers, with 80% of its exports going to the U.S. Although it helped the aviation industry to survive and saved thousands of jobs, Poland received no added value from the development of unique national products and technologies.