STATE OWNERSHIP IN THE EUROPEAN DEFENSE INDUSTRY: CHANGE OR CONTINUITY?

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Europe's modern-day industrial base has its origins in the European nation-states, which took early interest in, and eventual control of, its destiny. Yet, the passing of kings and sovereigns, the end of large continental wars, and the dismantling of cross-border trade barriers have done little to transform state attitudes toward what the French still refer to as "pouvoirs régaliens." According to an Avascent analysis of Europe's top defense companies, state participation remains remarkably high across most of the continent. A close examination of all European companies generating more than €400 million in defense sales in 2011 reveals a remarkable statistic: governments owned some 20% of a combined value of €84 billion.

Unlike other European industries, such as energy, telecommunications, postal systems, and transportation – long considered within the direct purview of national governments prior to their privatization in the 1980s and 1990s – defense has undergone a much slower, uneven transformation over the past thirty years. The gradual decline in public ownership of European defense companies, which occurred mostly in the decade following the end of the Cold War, came to a sudden halt in the last decade.

Underlying conditions, however, point to a possible new wave of privatization, driven largely by the severe fiscal pressures and intensifying global competition facing European governments and industry, respectively. In this light, the recently aborted merger between EADS and BAE Systems would seem to have been only slightly premature. At the very least, it contributed to last December's Franco-German agreement on a new ownership structure for EADS that keeps the combined state holding to less than 30% of the total, with France and Germany each holding 12% and Spain around 4%.

Governments across Europe appear now more willing to reconsider their hold on assets that are losing value rapidly or offer little prospect for high future returns. This includes not only debt-ridden countries such as Greece, Italy and Spain, but also countries less affected by the recent financial crisis. (Poland, for one, expects its largest defense group, Bumar, to be ready to go public within the next three years.) It is Avascent's expectation that privatization, alongside industry consolidation and restructuring, will continue and may even briefly accelerate in the coming years, resulting in a dramatically changed defense industrial base in Europe.

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THE STATE'S PERSISTENT INFLUENCE

In a quarter of Europe's top defense companies, the state is the sole or predominant stakeholder, with majority voting rights and thus control over key strategic decisions. Another 15% of the sampled companies has a government ownership share in excess of 25%. State ownership is absent or negligible in only 19 of the 32 analyzed companies. These companies are almost exclusively headquartered in the UK, Germany or Sweden – three countries where state ownership of defense companies has long become obsolete (EADS Germany constituting a special case given the ownership structure of its larger European parent). The three exceptions in this group of 19 companies – France's Dassault, Italy's Iveco, and Spain's Indra – are hardly representative of their respective national defense industries, since in all cases defense accounts for less than 30% of total revenue.

TOP EUROPEAN DEFENSE COMPANIES (2011)

	AVASCENT	Defense Revenue (2011)					State Ownership	
		€M	% Total	AIR	LAND	SEA	Direct	Total
1	BAE Systems	21,498	97%				0%	0%
2	EADS	12,526	25%				28%	28%
3	Finmeccanica	9,525	55%				30%	30%
4	Thales	6,819	52%				27%	30%
5	Rolls-Royce	3,518	27%				0%	0%
6	DCNS	2,493	95%				65%	74%
7	Safran	2,362	20%				30%	30%
8	Saab Group	2,186	84%				0%	0%
9	Rheinmetall	2,141	48%				0%	0%
10	Babcock International Group	2,068	62%	*exclusively services*			0%	0%
11	Serco Group	1,606	30%	*exclusively services*			0%	0%
12	Cobham	1,389	65%				<3%	<3%
13	ThyssenKrupp (TKMS)	1,493	3%				0%	0%
14	Navantia	1,199	95%				100%	100%
15	QinetiQ	1,135	67%	*predominantly services*			0%	0%
16	Kongsberg Gruppen	1,071	55%				50%	50%
17	Krauss-Maffei Wegmann	936	100%				0%	0%
18	Dassault Aviation	890	27%				0%	13%
19	Nexter	851	100%				100%	100%
20	GKN	803	11%				0%	0%
21	Iveco *(part of Fiat Industrial)*	765	8%				<3%	<3%
22	Diehl Group	752	26%				0%	0%
23	RUAG	750	52%				100%	100%
24	Bumar	728	100%				100%	100%
25	Chemring	724	97%				<3%	<3%
26	Ultra Electronics	674	80%				0%	0%
27	Meggitt	674	40%				0%	0%
28	Fincantieri	596	25%				99%	99%
29	Patria	557	90%				73%	81%
30	MTU Aero Engines	446	15%				0%	0%
31	Nammo	406	100%				50%	90%
32	Indra Sistemas	403	15%				<3%	<3%

Source: Avascent EDIB Database (covers all of Europe excluding Russia)

LEGEND

Share of state ownership (as of Dec 2012) >50% >25% ≥10% <10%

Predominant or exclusive defense focus — Smaller/non-core part of defense business

NOTES:

1. **Revenues:** Calculated figures reflect companies' fiscal year 2011 and exclude non-military security, civil and commercial work. Shares are in relation to parent company total revenue (only for Iveco is the holding company used as a basis due to the disproportionately large size of the parent industrial conglomerate). Subsidiaries and joint ventures are already reflected in cited revenues.
2. **State ownership:** All figures are as of 31 December 2012. "Direct" ownership refers to shares owned directly by a state-owned entity; total ownership also includes indirect stakes held via third-company holdings. Indirect ownership is thus higher than direct ownership in some cases: Dassault (46% owned by EADS), Thales (27% French state, 26% Dassault), DCNS (65% French state, 35% Thales), Patria (73% Finnish state, 27% EADS), and Nammo (50% Norwegian state, 50% Patria). EADS figures reflect the December 2012 agreement by the company's Board of Directors and core shareholders, which remains subject to a formal shareholder vote in 2013.
3. **Domain categories:** Domains encompass platforms, subsystems, and domain-related products, such as missiles, ammunition, radars, etc. Domain classifications are ill-suited to services companies, as not all outsourcing is attributable to a single military branch.

State ownership is common across all of Europe's defense sectors, notwithstanding differences in their respective structure and portfolio composition. The aerospace sector has undergone the greatest consolidation over the years. However, this has led to neither the withdrawal of the state (as still evident among key players such as EADS, Finmeccanica, Thales, and Safran) nor the creation of optimal defense portfolios (BAE is probably unique in having built strong businesses across a diversified portfolio, although even Europe's largest defense player is not immune to a possible future industrial restructuring on either side of the Atlantic).

Within the naval domain, specialization is more frequent and state control more complete. Of the five largest military shipyards in Europe, only one has extensive revenue outside defense (Navantia) and only two are free of direct state involvement (BAE and ThyssenKrupp Marine Systems). Similar problems of overcapacity and extensive state ownership prevail in the land systems sector, with some variations across vehicle, weapon systems, and ammunition providers.

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Traditional divisions between North and South or West and East are notably absent, further demonstrating that state industrial participation is not limited to specific regions or industry clusters within Europe. This is not to say that French and Norwegian attitudes toward state ownership are alike or that Poland and Switzerland share the same motivations for maintaining majority stakes in their respective industries. Economics and history contribute to the development of distinct national policies. Seen at an aggregate European level, however, such policies appear increasingly out of touch with broader European developments and global market trends.

THE NEED FOR CHANGE

If governments once seemed indispensable for the promotion and continued health of national champions, this has long ceased to be true in Europe. Modest or declining domestic defense budgets, rising costs of technologically complex weapon systems procured in ever smaller quantities, and growing international competition are challenges shared by all national industries. Even the usual arguments about the need to protect local jobs and technological know-how fall flat against the evidence. Several of the firms analyzed by Avascent have been steadily declining in revenue and some may soon be unable to sustain even their existing industrial footprint and manufacturing capability. Technological innovation is equally under threat both from declining national R&D budgets and, indirectly, from companies' subscale operations, which makes them less competitive in international markets and limits their ability to generate sufficient export proceeds that can be invested back into the business.

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Companies with more diversified portfolios, such as ThyssenKrupp, GKN or MTU, can occasionally rely on their commercial activities to fund part of the investment and ongoing operations of their military business. But unless the company is privately owned, as is still the case with Germany's family-run Krauss-Maffei Wegmann and Diehl Group and, to a certain extent, France's Dassault, shareholder pressure will ultimately force management to divest or significantly restructure chronic underperformers within their portfolio. Most private companies, when faced with significant core market erosion or changing competition, sooner or later reach the realization that they need to consolidate, liquidate, or exit select markets altogether.

State-owned companies are typically left with fewer, less palatable options. Their access to capital markets is limited. Governments often block management decisions to implement much-needed restructuring of the business. Prospective partners are reluctant to engage in serious merger discussions and often turn elsewhere, leaving their state-owned counterparts increasingly ill-equipped to compete going forward.

Indeed, probably the most serious handicap state ownership presents for today's European defense companies is the artificial suppression of the industry's much-needed consolidation and restructuring. French companies, in particular, are at a distinct disadvantage as attested by various stillborn cross-border merger discussions involving French state-owned firms over the years – GIAT (now Nexter) and Vickers (now part of BAE),[1] GIAT/Nexter and Rheinmetall, DCNS and ThyssenKrupp Marine Systems (TKMS), to name a few. Industry fragmentation also persists at the national level; the examples of Iveco Defence Vehicles (part of Fiat Industrial) and Oto Melara (part of Finmeccanica) in Italy or of Nexter and Renault Trucks Defense (part of Volvo Group) in France come to mind.[2]

Just as private enterprise has proven to be a responsible steward of other critical infrastructure assets, so should most sectors of national defense be allowed to operate without undue state interference.

To be sure, governments still have a role to play in promoting innovation and regulating competition, as well as in preventing potentially harmful foreign investor influence through special voting rights and "golden shares." But just as private enterprise has proven to be a responsible steward of other critical infrastructure assets, so should most sectors of national defense be allowed to operate without undue state interference. Recent developments and official statements suggest European governments are starting to heed industry's calls for reform. Embracing such a goal would serve both national and European interests.

[1] Failed merger talks between Vickers Defence Systems Ltd and GIAT in the late 1990s led to the eventual acquisition of Vickers first by Rolls Royce in 1999, then Alvis in 2002 (which by then had already acquired Swedish armored vehicle manufacturer Hagglunds and the armored vehicle business of GKN) and finally by BAE Systems in 2004, when the latter bought Alvis and folded the Alvis and Vickers brands under its new Land Systems business.

[2] Through its acquisition of privately held French firm Panhard in late 2012, Volvo Group grew its military vehicle business by nearly a third, but at some €330 million in 2011 pro-forma revenues, the combined Renault Trucks Defense (RTD) and Panhard portfolio offers no match to that of their much larger European competitors. This latest merger was largely the result of previously aborted talks between RTD and Nexter.

The European Defense Industrial Base Forum *is an Avascent initiative to explore and debate issues critical to the performance and long-term viability of Europe's defense establishment. Designed to engage and inform representatives from both the private and public sectors, including the financial community and academic institutions, this forum seeks to provide senior executives and decision-makers with objective, nonpartisan analyses to support strategic action across Europe's diverse defense technology and industrial base. Comments, questions, and requests to receive future updates may be sent to europe@avascent.com.*

ABOUT THE AUTHOR

Dr. Christina Balis leads Avascent's European operations. Based in Paris, she supports corporate and financial clients operating in or looking to expand to Europe and adjacent geographies. She has experience providing strategicadvisory services, assessing market opportunities, and supporting merger and acquisition activities across a diverse set of defense, civil government, and commercial markets.

Dr. Balis worked for a number of years as a consultant with Avascent before transitioning to industry. Prior to rejoining Avascent in late 2011, she was vice president for strategy and corporate development at Serco Inc., the US subsidiary of international service company Serco Group plc. Previously, she was a fellow in the Europe Program of the Center for Strategic and International Studies (CSIS) in Washington, DC. She holds a joint B.A. in European Business Administration from the ESB Business School (Reutlingen, Germany) and Middlesex University (London, UK) and a M.A. and a Ph.D. in International Relations from the Johns Hopkins School of Advanced International Studies (Bologna, Italy, and Washington, DC).

ABOUT AVASCENT

With offices in Paris and Washington, DC, Avascent (www.avascent.com) is the leading strategy and management consulting firm serving clients operating in government-driven markets. Working with corporate leaders and financial investors, Avascent delivers sophisticated, fact-based solutions in the areas of strategic growth, value capture, and merger and acquisition support. With deep sector expertise, analytically rigorous consulting methodologies, and a uniquely flexible service model, Avascent provides clients with the insights and advice they need to succeed in complex market environments.

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