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EADS Plan for BAE Merger Fails to Cheer Investors

By Robert Wall and Andrea Rothman - Sep 13, 2012

European Aeronautic, Defence & Space Co. (EAD) and BAE Systems Plc (BA/) declined on concern their proposed merger would struggle to deliver cost savings and penetrate the key U.S. defense market.

Airbus SAS parent EADS slumped 10 percent in Paris, while BAE fell 7.3 percent in London. EADS, which has twice the revenue of BAE, would control 60 percent of the new entity and the U.K. company the rest, they said yesterday.

The enlarged group would have a market value of about $45 billion and sales nudging $100 billion, with assets spanning civil jets, warplanes and nuclear submarines. Hindering integration is a complex shareholder structure that includes governments keen to protect their national assets, with plans for a single European aerospace business having failed once before more than a decade ago amid political infighting.

"It's a tough deal to complete politically, and there's not much to commend it," said Mark Slater, the chief investment officer of Slater Investments Ltd., which owns BAE shares. "It's one of those bigger-is-better stories from management, but I'm not sure it's good news for shareholders. I am skeptical that it will happen."

BAE slumped 26.5 pence to 337.1 pence, reversing an 11 percent surge yesterday after the companies confirmed that they are in talks. Today's drop clipped BAE's market value to about 10.9 billion pounds ($17.6 billion). EADS dropped 2.86 euros to 25.15 euros in Paris, for a value of 20.8 billion euros ($27 billion).

Reviving Aspirations

A merger would revive plans to create an equal to Boeing Co. (BA) and balance civil and defense sales in an era of shrinking budgets. The deal would add Toulouse, France-based EADS's revenue of about 49 billion euros last year to BAE's 17.7 billion pounds. That compares with $68.7 billion at Chicago- based Boeing and $46.5 billion at Bethesda, Maryland-based Lockheed Martin Corp. (LMT), the market leader.

The companies didn't say who would lead the enlarged group or where it would be based. EADS Chief Executive Officer Tom Enders, who took over in June, has been revamping senior management positions and switched the leader of the Cassidian defense business this month. The 53-year-old German previously ran the Airbus unit.

Government Shareholders

Among EADS's biggest shareholders is the French government, which owns 15 percent. German carmaker Daimler AG (DAI) controls 22.5 percent, of which 7.5 percent is owned by German federal states and some banks. The Spanish government owns 5.4 percent. The German defense ministry said it has been informed of the talks and has been asked by the companies to support a merger.

Should the deal go through, the enlarged group would issue special shares in BAE and EADS to each of the French, German and U.K. governments "to replace the existing U.K. government share in BAE Systems and the stakeholder concert party arrangements in EADS," the companies said yesterday

Enders has been critical of government shareholders in EADS, saying their increasing influence constitutes political meddling. The U.K.'s so-called golden share in BAE gives it veto power over any strategic moves. The two companies will need to ensure the French government's role in the future company entity is no stronger than the U.K.'s to avoid political blow-back.

'Complicated'

Britain is working with the companies "to ensure the public interest is properly protected," Steve Field, a spokesman for Prime Minister David Cameron, told reporters in London today.

"The proposal is immensely complicated," said Peter Luff, a U.K. lawmaker who was defense equipment minister until two weeks ago. "My gut feeling is this is a good thing. Europe has been too divided for too long.

BAE, led by CEO Ian King, was the U.S. government's ninth- largest contractor in fiscal 2011, with $7.3 billion in direct, or prime, contracts, while EADS was its 100th, with $684 million in contracts, according to a Bloomberg Government study ranking the top 200 contractors.

The two companies employ about 45,000 workers in the U.S., 90 percent of them at BAE, and operate under special security agreements with the government. BAE supplies the U.S. military with combat vehicles and artillery such as the Bradley fighting vehicle, the self-propelled Paladin howitzer and naval guns.

'Very Sensitive'

EADS makes UH-72 Lakota light-utility helicopters for the U.S. Army. The company in 2011 lost a bid to Boeing to develop a refueling tanker based on an Airbus plane for the Air Force as part of an estimated $35 billion program.

Given the "highly secure" nature of the defense business involved, BAE and EADS plan to ring-fence certain activities, particularly relating to the U.S., the world's biggest defense market, they said.

"The Pentagon is very sensitive about what foreign entities buy defense assets," said Edward Stacey, aerospace and defense analyst at Espirito Santo Investment Bank in London. "It is still unclear how the deal would be structured to address any U.S. concerns."

A U.S. regulatory review would last at least three months, perhaps six, said Steven Grundman, principal of Grundman Advisory and ex-Pentagon deputy under-secretary for industrial affairs. Included would be antitrust considerations, a foreign investment review and a technology control review, he said.

Keeping Faith

Boeing CEO Jim McNerney said yesterday that a combination of EADS and BAE wouldn't "threaten us fundamentally."

"I have a pretty deep and abiding faith in our company's strength," he told reporters at the Council on Foreign Relations office in Washington. "It does reflect a global consolidation that is beginning to happen."

BAE was created in 1999 when British Aerospace Plc, which had been exploring a merger with Daimler's Dasa unit in Germany, opted instead for an all-U.K. combination with the Marconi Electronic Systems unit of GEC in 1999.

That prompted Dasa first to acquire Construcciones Aeronauticas SA of Spain and then to combine with France's Aerospatiale Matra SA to form EADS. The sequence of events gave EADS control of 80 percent of airliner manufacturer Airbus, which BAE exited in 2006, while allowing the U.K. company to dominate the European defense sector.

BAE's market value peaked at about 18 billion pounds in October 2007, when it was worth more than EADS. BAE has since suffered as Britain seeks to eliminate a 38 billion-pound defense shortfall, while governments across Europe have cut commitments for Eurofighter combat jets and armored-vehicle sales have fallen following the end of the war in Iraq and a wind-down of troop numbers in Afghanistan.

Still, the deal may prove a tough sell to investors, who enjoy a higher dividend at BAE than at EADS and have a cleaner portfolio, said Nick Cunningham, managing director at Agency Partners, a London-based research firm.

"The proposal is that they'll end up owning a company that's half European civil aerospace, with a much lower yield," he said. "It's just not what they signed up for."

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