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Are More Mergers Ahead?

BAE-EADS Talks Could Spark More Tie-ups

By DEFENSE NEWS STAFF

For several years, defense contractors on both sides of the Atlantic have been biding their time, building up cash and reviewing possible combinations, awaiting the start of a consolidation wave

that will reshape the global military industrial landscape in the face of sharp spending cuts in Europe and the U.S.

On one side, U.S. companies are waiting for the conclusion of presidential elections and the resolution of the budget battle in Congress that will determine the future of defense spending before making their move.

But on the other side, Europe's not waiting.

The cannon blast that started the consolidation race went off

Sept. 12 when BAE Systems and EADS confirmed talks to unite into a \$96 billion giant that would be the world's leading defense and aerospace titan.

The new company, already nicknamed "BEADS," would be listed on the Frankfurt, London, Madrid and Paris stock exchanges, with EADS holding a 60 percent stake and BAE 40 percent. The combined firm would boast a formidable array of commercial and defense products, including fighter, *See BAE-EADS, Page 8*

Sequestration Might Be Manageable, Experts Say

By JOHN T. BENNETT

Devastating. Catastrophe. Disaster.

That is how Pentagon officials, lawmakers and industry executives have described \$500 billion in automatic military budget cuts set to kick in Jan. 2 unless Congress comes up with a solution.

Yet amid all the dramatic rhetoric about those cuts, several non-partisan Washington think tanks have produced analyses that suggest the process known as sequestration might be manageable.

The Bipartisan Policy Center estimates that even if the sequestration cuts stick, the annual Pentagon budget would dip below \$500 billion for just one year, return to current levels by 2017 and approach \$600 billion by 2020.

And the Center for Strategic and Budgetary Assessments (CSBA) projects the Pentagon likely could avoid canceling any weapon programs, and would not be forced to lay off troops or slash benefits.

The \$500 billion in cuts will be parceled out at \$50 billion annually over 10 years. Yet even if they take place, Washington likely still would spend more on its military than the rest of the world combined, experts said.

The reason, they said, is because the Pentagon's budget has experienced such dramatic growth over the past decade, taking the fiscal 2013 budget down 10 percent would be tantamount to bringing it down to 2006 levels — when there was no hue and cry over an insufficient level of defense spending.

That opinion isn't shared by *See SEQUESTRATION, Page 6*

DoD Conference Expenses Under Scrutiny

By MARCUS WEISGERBER
and ZACHARY FRYER-BIGGS

LAS VEGAS and WASHINGTON — In a mammoth convention hall at a Las Vegas resort and casino that could house nine American football fields, thousands of conference goers peruse exhibits featuring some of the latest advancements in robotic technology.

But of the more than 7,400 attendees at the Unmanned Systems North America 2012 conference of the Association for Unmanned Vehicle Systems International, one demographic was notably absent: the U.S. military. Only a few dozen military officers gave presentations or took part in panel discussions, and only a handful of generals attended.

So why such a small military presence? Stricter government travel restrictions, imposed in the wake of a General Services Administration (GSA) conference spending scandal, are mostly to blame, and the repercussions could shut down some of the most widely attended military events. The restrictions have also launched a debate as to how much value these conferences actually provide.

In June, Deputy Defense Secre-



U.S. ARMY MATERIEL COMMAND

Reduced Presence: Attendees visit the Army Materiel Command's booth at the 2011 AUSA Conference in Washington. The Army will consolidate the 75 booths originally planned for this year's show in October into one.

tary Ashton Carter instructed the services to review DoD or industry conferences that cost more than \$100,000 to attend. That figure includes booth space and other logistical issues, such as airfare, lodging and per diem. The services have since sought waivers to attend some of the larger events.

In response to greater scrutiny on conference and travel spending, as

well as White House and Pentagon spending guidance, the Air Force is scaling back its attendance at the Air Force Association's main conference, which starts this week.

The service is expected to save more than \$280,000 on attendance cost and exhibit booth space, according to a Pentagon memo. Active-duty military and DoD civilians *See CONFERENCES, Page 10*

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Vol. 27, No. 35 \$4.50 (\$7.50 Non-U.S.)

THE VALUE OF EYES IN THE SKY FOR BOOTS ON THE GROUND.

THE VALUE OF PERFORMANCE.

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JOINT STARS

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BAE-EADS

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transport and trainer aircraft; rockets and satellites; missiles and precision weapons; armored vehicles; unmanned systems; radars; command, control and communications gear; networks and cyber capabilities; ship repair and naval products; as well as intelligence and space services units.

The transaction is the brainchild of EADS CEO Tom Enders, who took office in June, to expand his company's defense product line and balance its military-commercial business base, improve access to the U.S. and other key global markets such as India, and use the deal to change the company's governance structure that now allows the French, German and Spanish governments to exert influence on EADS, allowing it to move toward a wholly commercial structure.

For BAE, the deal is a chance to boost its civil activity and balance its civil-defense mix.

The announcement prompted Boeing Chairman and CEO Jim McNerney to quip that EADS was trying to look more like Boeing by better balancing its defense-commercial product mix.

The two companies have until Oct. 10 to announce a deal, and while it's unclear whether it will secure antitrust, financial, security and tax approval from regulators in five governments as well as the EU, companies will have no choice but to review their options.

"All mergers can succeed or fail, and BAE and EADS still need eight months to wrap it up and 18 months to see if it works," one senior retired European executive said. "But other CEOs cannot afford to wait that long to see if it succeeds, and they will all be looking around right now to see how they should react."

Indeed, hours after the two giants confirmed their interest in merging, speculation swirled about who might be next.

And just as an EADS link with BAE would tap the all-important U.S. defense market that remains the world's largest despite spending cuts, U.S. companies are exploring linking with European firms.

"There is a huge amount of change going on in our sector with budget pressure and other issues. There will be a lot of activity over the next five years, but what direction it will take is unclear," one senior British executive said. "Whenever you get a shift like this, it forces people to think. It has the potential to be a game changer in terms of scale and geographic footprint."

Not a Done Deal

But before that happens, the would-be European partners have some high hurdles to surmount.

The British executive added that the deal won't get out of the starting blocks as long as governments can exert influence in the new company, as they do in EADS.

"The important thing to consider is not their shareholding itself, it's about the block voting rights. Before this deal can go ahead, at an absolute minimum those will have to be dissolved, dismantled and cease to exist," he said. "If any shareholder has a share in the new company, all they will have are normal rights and nothing else. Unless the block rights are dismantled, this transaction can-

not proceed."

At issue is how that government shareholding could affect BAE's lucrative North American business, with sales of some \$15 billion annually, including across highly sensitive intelligence and other operations.

Since starting its acquisition of U.S. properties in the 1990s, BAE has operated them independently and under strict security guidelines to protect American technology. While that's customary for all foreign companies that own or operate units in the U.S. that do business with the Pentagon, the British giant benefited from greater access to technology, thanks to the special defense relationship between London and Washington.

"If France and Germany maintain political control over EADS, this will be viewed poorly in the U.S., but I see it as unlikely that France would abandon EADS," the retired

"The important thing to consider is not [EADS'] shareholding itself, it's about the block voting rights. Before this deal can go ahead, at an absolute minimum those will have to be dissolved, dismantled and cease to exist."

Senior British executive

European executive said.

Then there are the regulatory approvals that could prove challenging for the companies. The British, French, German, Spanish and U.S. governments would have to approve the deals, as well as EU regulators.

Steven Grundman, the defense industrial analyst at the Atlantic Council in Washington who oversaw defense mergers and acquisitions at the Pentagon during the Clinton administration, added that while governments should rightly view the new company as a trans-Atlantic industrial bridge, the combination still will face scrutiny on both sides of the Atlantic, including from competition authorities.

"Recall that the European Commission rejected the proposed merger of General Electric and Honeywell on a theory of 'portfolio effects' that took issue not with horizontal overlaps or vertical integration, but the supposed unfair challenge to competitors of the resulting conglomerate's scale and scope," Grundman said.

Antitrust regulators will solicit the views expressed by customer governments — the two companies do compete against one another for business worldwide — as well as take account of competitors who may attempt to argue the combination could materially disadvantage them.

Still, Grundman said he anticipates relatively few traditional antitrust problems on either side of the Atlantic, adding that security issues loom larger for the Pentagon. On the one hand, he said, DoD already supervises industrial security programs at both companies' U.S. businesses. At the same time, the Pentagon is sure to scrutinize closely the changing ownership of BAE's U.S. assets.

Lockheed Martin Chairman and CEO Robert Stevens, however, told a Morgan Stanley investor conference in New York the merger could be a test for the Pentagon's policy of not supporting any more consolidation at prime level.

DoD leaders have said that while they are open to consolidation on a case-by-case basis, they don't want leading firms to unite.

"It might be an early test of whether the unfavorability of consolidation at that tier would in fact be changing or evolving," he said.

Fight or Join

With or without the BAE-EADS merger, the deal pipeline is bulging, but anxiety over sequestration in the U.S. has acted as a brake on mergers and acquisitions.

With U.S. and European defense markets headed into a downturn, large prime contractors are expected to spin off units, offering targets for tier one and two equipment makers and service specialists.

"People are getting ready," a U.S. industry executive said. "They're standing [by], but they're not yet ready to pull the trigger."

In Europe, managers in aeronautics, space and electronics must decide whether to fight or join the planned mega-group.

"Other companies will need to think whether it is better to be integrated into the new behemoth, or to look to other alliances or mergers to get a countervailing strength," said Nick Witney, senior research fellow at the European Council on Foreign Relations think tank.

The proposed EADS-BAE merger is a highly specific, large-scale project, but if a deal is done, it could clear the way for further moves in a fragmented European defense industry hobbled by budget cuts.

"If the BAE-EADS merger goes ahead, it will lead to medium and long-term rationalization in other segments of defense industry in Europe," said Loic Tribot La Spiere, deputy director of think tank Centre d'Etude et Prospective Stratégique.

Thales and Finmeccanica executives are likely watching the deal closely.

"If this initiative goes through, it will lead other big actors Thales and Finmeccanica to question their future," said Jean-Pierre Maulny, deputy director of think tank Institut des Relations Internationales et Stratégiques.

"Thales and Safran will almost certainly merge," the retired European executive predicted.

In France, the deal potentially puts Dassault, maker of the Rafale fighter and Falcon business jet, on the defense sidelines.

"And naturally, this will concern Dassault, the industrial shareholder of Thales, which will see a regrouping of two of its competitors in Eurofighter, and its partner in UAVs, BAE Systems, linking up with the German actor in this sector, EADS Cassidian," Maulny said.

While on the presidential campaign trail, then candidate François Hollande criticized the previous administration for "bowing" before "private and financial interests," a remark widely understood to refer to the 2008 choice of Dassault as industrial shareholder of Thales.

For Witney, the French government appears to be backing EADS in its merger plan, leaving Dassault to deal with the consequences.

"If Dassault takes a hit, it takes a hit," Witney said.

EADS owns 46 percent of Dassault, a stake formerly held by the French state.

In Italy, Finmeccanica reacted positively to the merger plan, rebutting concerns it is threatened by the new company.

Finmeccanica "has established consolidated partnerships with both companies in the industrial, technological and commercial field, which will continue with the combined entity," the company said in a Sept. 13 statement.

"There would be no short-term consequence for Italy, although it would require Finmeccanica to accelerate its focus on its core business," said Michele Nones, head of the security and defense department at the Istituto Affari Internazionali, a Rome think tank partly funded by the Italian Foreign Ministry.

The retired European executive was not convinced.

"Italy could now find it has a minor role, or is excluded completely, from the next big European program, like a UAV," he said. "When it was just the U.K. and France talking about UAVs, Italy could talk to Germany, but that is no longer the case."

"The Italian government can either now ask if Finmeccanica could enter the merger, but it would be the smallest and arrive uninvited, or it could look to France for an alliance or to the U.S. And all are difficult."

One investment banker in London said much of the mergers and acquisitions activity could center on the growth of tier-one and aspiring tier-one companies such as Thales, Cobham and Rheinmetall as they pick up operations being shaken out by the prime contractors, as well as consolidating the supply chain by acquiring niche operators.

Investment bank Espirito Santo said in a market report issued following the BAE announcement of merger talks that "accelerating consolidation bodes positively for defense-centric plays in the U.K. like Chemring, QinetiQ and Ultra Electronics."

Financial crisis is driving the expected mergers and acquisitions flow, as industry battens down the corporate balance sheet.

"We have expected consolidation in defense globally, because of a flattening and reduction in defense spending," said Scott Thompson, U.S. leader of PriceWaterhouseCooper's aerospace and defense practice.

"I don't expect that there will be other consolidation amongst the other global primes," he said. "In that sense, this may be an anomaly. But in terms of consolidation of defense, we absolutely expect that."

The consolidation, however, is not expected this year until there is clarity on sequestration and the level of defense spending.

Mergers and acquisitions in aerospace and defense dried up this year, with about \$5 billion in deals in the first half of the year, after a record 2011, which saw \$43.7 billion in deals, Thompson said.

If suppliers — industry — are able to reorganize, that puts pressure on the customer — government — to be more rational, namely converge requirements and adopt more joint programs, Witney said. But that is another chapter in the defense book. □

Pierre Tran in Paris, **Andrew Chuter** in London, **Tom Kington** in Rome and **Zachary Fryer-Biggs** in Washington contributed to this report.