

After the demise of 'BEADS', what now for consolidation?

After the failure of the EADS-BAE Systems merger, many predictions for the future are having to be rewritten. **John Dowdy** looks at the potential ramifications of this

With the collapse of the EADS-BAE Systems merger on 10 October, those who, once again, argued that the deal would see a new round of consolidation in the defence industry in its wake will have been temporarily silenced.

Despite the merits of an EADS-BAE merger, or indeed whether it re-emerges in whole or in part, large-scale consolidation across the defence industry is unlikely. We are much more likely to see portfolio rationalisation, internal restructuring, vertical integration, and spinoffs, at least from the US primes, and indeed from many parts of the supply chain.

The reasons are simple. The US Department of Defense (DoD) is showing no signs of demurring from the view expressed by Deputy Secretary of Defense Ashton Carter early last year, when he said that the Pentagon did not want to see mergers of the biggest players in the sector, as occurred during the last consolidation wave in the 1990s. He singled out the prime weapon system contractors. In most segments the aerospace and defence industry is already highly consolidated.

In 1991, on the eve of the last round of consolidation, there were 16 prime contractors in the United States. Back then, the top 10 global defence companies

represented less than 40% of the combined revenue of the top 100 globally. By 2000, the number of primes had shrunk to six, and the top 10 companies had grown to control 60% of the market. They have largely maintained that share since.

Such was the extent of industry consolidation that only 19 of the companies in 1991's top 100 list are still present today.

The pressure on industry is too real to not result in some restructuring of the sector

The US may still have six major league defence primes, but in many segments it only has two or three viable suppliers remaining. With all of the big primes competing in multiple segments, there are very few large mergers and acquisitions (M&A) transactions that would not run into state or regulatory objections on the grounds of decreased competition in one or more segments.

Although Carter left the door open for consolidation in the supply chain, many segments in the upper tiers, such as engines, avionics, and aircraft systems, are already highly concentrated. There are exceptions, such as

aerostructures, where there is room for further consolidation, but the opportunities for mega-mergers are few and far between.

The stated intent of the EADS-BAE merger was based less on segment-level consolidation and more on the desire to create a balanced commercial aerospace and defence portfolio, thereby providing a more stable platform in aggregate than a pure commercial or defence player could achieve on its own.

Boeing, the biggest remaining commercial player, is already a mixed commercial/defence entity. There is a much stronger case to be made for further consolidation in Europe, yet the

prospects for pure European consolidation are more troubled, despite the underlying logic. The EADS-BAE Systems discussions clearly demonstrated the complexities inherent in any European cross-border transaction.

There are clearly still a few companies out there that are potential M&A candidates and we will no doubt see some movement, especially once the sequestration-related uncertainty has abated, but it is difficult to imagine anything like the wave of consolidation that occurred at the end of the Cold War, when 16 US primes shrunk to the current six.

If a new wave of consolidation

is unlikely in the US, then what should we expect to see? The pressure on industry performance is too real to not result in some restructuring of the sector.

While the industry grew, the rising tide lifted the performance of all players. All of the competitors in a segment had access to new business, order books were healthy, and there was little differentiation in performance. Now that the market has levelled off, and in some instances declined, less-efficient providers are already suffering. It is in a downturn that differences in competitiveness really begin to show.

Many companies have portfolios that were built up over the last 20 years with little or no portfolio rationalisation. As a result, they contain a mix of some very good businesses and others that are challenged. Without a mega-merger to remove unproductive capacity from the system, companies are going to have to do this themselves, either by selling less attractive businesses, substantially restructuring them, or spinning them out.

We have begun to see some of this already, with Northrop Grumman spinning off its ship-building business in March of last year to form Huntington Ingalls Industries, and SAIC announcing its intention to split into two separate companies.

We can expect to see a lot more of this type of portfolio rationalisation and restructuring. Even so, the news that has dominated the defence sector over the past weeks was not the firing of the starting gun on a new round of mega-mergers. The restructuring of the industry will look very different this time. ■

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