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COMMENTARY

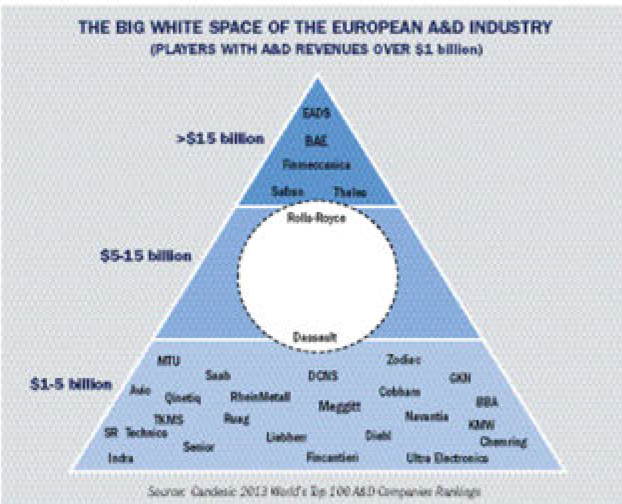
For Europe, Smaller is Better

A&D industry has glaring lack of mid-sized merchant suppliers

The aborted merger of EADS and BAE Systems last year reignited talks about a long-awaited wave of consolidation among prime aerospace and defense (A&D) contractors. After all, Europe still has four major shipbuilders, four missile manufacturers and three combat aircraft primes, while the larger U.S. defense market has essentially two players in each of those categories. The speculations were underpinned by a basic but deeply erroneous assumption: "Bigger is better."

In Europe, the top five industry players—EADS, BAE Systems, Finmeccanica, Safran and Thales—are big enough, with more than $15 billion each in annual A&D revenue. If anything, they are too big for their own sake. What is needed is not further consolidation but rather a reshuffle of their business portfolios so each of these groups is worth more than the sum of its parts. By and large, that is not the case today. Because of a deep-rooted vertical integration and a predatory mindset, each of these companies is a mixed bag of multiple businesses, many of which would be better off on their own or under smaller companies.

Apart from large passenger aircraft manufacturers—Airbus and Boeing—no part of the A&D business requires a company to have more than $10 billion in annual sales to succeed. You do not need to be that big to compete: $4-8 billion in revenue to be an original equipment manufacturer of business aircraft (Gulfstream and Dassault) or regional aircraft (Embraer and Bombardier); $4 billion to be a world leader in tactical missiles (MBDA) or to design nuclear submarines and warships (DCNS). Dassault Aviation may be "just" an 11,000-employee company with $5 billion in sales, yet it profitably makes and sells some of the most advanced combat aircraft and business jets. The company has established a strong market position without any large M&A deal or adventurous build-up.



Source: Candesic 2013 World's Top 100 A&D Companies Rankings

In fact, bigger is often worse. Beyond a certain threshold of size and diversification, dis-economies of scale are bound to appear, typically due to the increased complexity of accommodating different business models and integrating new acquisitions. Some companies have succeeded by managing their businesses as loose portfolios of independent, relatively specialized operations. But even they have limits. L-3 Communications, a U.S. A&D company, thrived under such a model until its portfolio of dozens of loosely managed businesses grew so big that it became unwieldy. L-3's response was to move toward becoming a more traditional, vertical organization. As soon as it changed its model, L-3's performance started deteriorating.

One of the oft-discussed benefits of an EADS-BAE tie-up was that it would have created the world's largest aerospace company, with annual sales approaching $100 billion. However, the weak link in Europe's A&D industry is not at the top, but rather in the middle of the pyramid (see graphic). The predatory behavior of Europe's top players has prevented the emergence of mid-sized merchant suppliers with critical mass in such sectors as defense electronics or aerostructures. As a result, there are essentially no European $5-15 billion A&D suppliers. Sagem was a rapidly growing, $4 billion communications and defense electronics group before Snecma (now Safran) scooped it up in 2005. Since then, all of Sagem's businesses have been disposed of except for Sagem Defense, which has been marginalized. Had it remained independent, Sagem would have been a perfect platform to create a leading defense electronics supplier in Europe. Today, the largest such company is the $1.2 billion Ultra Electronics.

So instead of trying to become bigger, top European players should aim to manage their portfolios more dynamically, making sure all their businesses gain from their ownership, spinning out those that do not and letting them become growth platforms for smaller players. That would be much more beneficial to all their European stakeholders.

Rather than wondering whether we have too many primes in Europe and whether they are big enough, we should worry about how many mid-size suppliers we don't have and create the conditions for such players to emerge. The future of the European A&D industry is at stake. That is why we should dare to say: For Europe, smaller is definitely better.