

More European Companies Expected to Buy U.S. Defense Contractors

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By Jui Chakravorty Das, Reuters

NEW YORK: The Italian defense contractor Finmeccanica's recent \$4 billion acquisition of DRS Technologies, a U.S. defense company, was a big one for the industry, and it is not likely to be the last.

More European defense contractors looking to gain a presence in the United States, the largest defense market in the world, will very likely be setting their sights on U.S. suppliers. Increasing acquisition activity is also expected within the U.S. defense sector as suppliers consolidate to become one-stop shops for contractors like Boeing, Lockheed Martin and Northrop Grumman.

U.S. defense spending - estimated to exceed \$500 billion in 2009, excluding more than \$100 billion needed for war financing - is not expected to decrease in the next few years, regardless of who wins the country's presidential elections this year. "Four key factors underlie this assessment," said Matthew Smith, a defense economics analyst at Jane's Information Group. "The cost of the military is rising, the political will to reduce spending is nonexistent, the security environment remains challenging and, despite current economic concern, the U.S. can afford it."

With the strength of the euro, this is an opportune moment for European companies to make acquisitions in the United States and try to get a piece of the massive U.S. defense budget. "It's certainly a good time for European companies to get access to U.S. defense programs and the U.S. defense budget," said Rick Phillips, managing director of aerospace and defense at CIT Investment Banking Services. "Not only is the euro high now, but when the dollar strengthens against the euro, the dollar earnings will be higher when reported in euros."

In a disclosure that points to the pent-up demand, DRS said it received a higher offer from an unnamed foreign bidder and an expression of interest by a U.S. defense company before finalizing a deal with Finmeccanica.

Some analysts and bankers said they believed the U.S. company interested in DRS was probably L-3 Communications, which itself is the subject of takeover speculation, with rumors swirling that Raytheon is interested in the company. Les Échos, a French financial newspaper, reported Wednesday that the French defense electronics group Thales was considering a counterbid for DRS. Thales has denied the report, but even so, it is one of the companies expected to make acquisitions in the U.S. market in the near future. EADS, the parent of Airbus, was also expected to counterbid for DRS, but it has said Finmeccanica's offer is "too high," even though it had underscored possible synergies from a DRS takeover and said the company was on its target list.

Analysts say Finmeccanica's offer has raised the prospect that EADS might be sidelined in the lucrative U.S. market, leading many to expect that EADS might start looking at other U.S. companies soon. The company has already said it had a list of potential acquisitions. Other defense suppliers include Vought Aircraft Industries, which is 90 percent owned by private equity firm Carlyle Group; Primus International, owned by the private equity firm Oak Hill Capital Partners; and Moog.

"Higher-multiple companies generally have key proprietary technologies, are in high-growth areas such as UAVs, or have access to key customers in the intelligence arena," Phillips said. UAVs are unmanned air vehicles.

Bill Alderman, president of Alderman & Co., a consulting firm specializing in aerospace and defense, said he expected a lot of mergers and acquisitions, and a few joint ventures, among U.S. defense suppliers. "I think there will be strong M&A activity in the defense supply chain, driven by the evolving requirements of the Department of Defense," Alderman added, referring in particular to a growing need for the maintenance and overhaul of aircraft fleets. "The defense supply-chain provider to the DOD wants to be able to say: 'I can do all of this for you at this price and I guarantee performance.' That would need strong joint venture agreements or acquisitions."