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**MERGERS FAILURE IN THE EUROPEAN DEFENCE TECHNOLOGICAL AND  
INDUSTRIAL BASE. THE CASE OF EADS / BAE SYSTEMS**

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# MERGERS FAILURE IN THE EUROPEAN DEFENCE TECHNOLOGICAL AND INDUSTRIAL BASE. THE CASE OF EADS / BAE SYSTEMS

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**Summary:** This paper deals with the project of a merger between BAE systems and EADS, announced in September 2012 and finally cancelled one month later. It investigates the rationale of the merger project and the reasons that explain its collapse. Our first aim is to assess the importance - usually put forward in the literature - of the pre-merger phase in the success or the failure of a merger project. Our second aim is to put forward the specificities of mergers when defence firms are involved. Using a single case study methodology, we show that the economic rationality of the project was based on industrial complementarities, economic synergies and personal motives. We then investigate the many political divergences, specific to the defence industry, that emerged during the pre merger phase. Finally, considering the economic and political stakes, we suggest the merger project appeared as too big to succeed.

**Key words:** Merger, EADS, BAE Systems, Defence, European Defence Technological and Industrial Base (EDTIB)

**JEL Codes:** L10 (Industrial Organization – general), L64 (industry Studies – Armaments), G.34 (Corporate Finance and Governance : Mergers, acquisition, restructuring)

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## TABLE

<b>INTRODUCTION</b>	<b>4</b>
<b>1. CONCEPTUAL BACKGROUND</b>	<b>4</b>
1.1. Mergers' motives and success factors: the importance of the pre-merger phase	4
1.2. The consolidation of the European Defence Technological and Industrial base	6
<b>2. METHODOLOGY</b>	<b>10</b>
2.1. A single case study methodology	10
2.2. Data	10
2.3. Context	10
<b>3. RESULTS</b>	<b>12</b>
3.1. Strategic complementarities supporting the merger project	12
3.2. Economic synergies and personal motives supporting the merger project	14
3.3. Political divergence during the pre merger phase	18
<b>CONCLUSION</b>	<b>20</b>
<b>REFERENCES</b>	<b>21</b>

## **INTRODUCTION**

Last 12 September 2012, BAE Systems and EADS announced their intention to combine their businesses through a dual listed company (DLC) structure. Contrary to full-mergers, the deal would enable each company to operate as one single entity operating collectively and sharing equally in economic and financial risks, while preserving autonomy regarding taxes, legal identity and national sovereignty issues. After four weeks of intense negotiation involving representatives of the two companies' government stakeholders, the decision was made to abandon the project. Yet, the realisation of the project would have given birth to a European aerospace and defence giant comparable in size to Boeing in the United States.

The cancellation of the merger project opens up a number of questions related to the construction of the European Defence Policy (EDP) and the consolidation of the European Defence Technological and Industrial Base (EDTIB). Adopting a case study methodology, our aims in this paper are to investigate the rationale of the merger between EADS and BAE Systems, and to put forward the main reasons for its collapse. In particular, we contend that the industrial complementarities and economic synergies which would have followed the merger did not provide stakeholders with enough reasons to overcome political obstacles. While the two companies did work on full commercial details of the merger (e.g., legal structure, governance, deal structure, management and logistics of business combinations), they failed to anticipate on the political divergence the project did reveal. Both public and private stakeholders stayed unsatisfied, despite real technological and industrial opportunities.

The paper begins by exploring the literature on merger and acquisition within Defence industries. This section defines the concept of a merger, identifies the specificities of the EDTIB and analyses the recent trends characterising its evolution. The case study methodology, data collected and context of the merger project are then presented. The next section presents the main results of the case study. The latter can be summarised as follows. First, it is argued that the experience and industrial background shared by the two companies' executive officers reinforced the historical trend towards consolidation. The merger concept was thus aligned with the previous development of each firm's strategy and particular history. Second, we provide evidence that the merger was rooted on strong commercial positions and industrial complementarities. From an economic and industrial perspective, the combination of companies' resources would have reinforced competitive advantage in the aerospace and defence sectors. Third, it is contended that the two companies underestimated the negative impact on the project of European governments' political divergence regarding the construction of the European defence policy. Basically, the European political context was unfavourable to deepening, in this way, the consolidation of the EDTIB. The conclusion draws on the main implications of the case study results, and discusses the limits and future developments of that research.

## **1. CONCEPTUAL BACKGROUND**

### **1.1. Mergers' motives and success factors: the importance of the pre-merger phase**

The project of merging EADS and BAE Systems provides a vivid example of 'merger of equals' involving companies of comparable size which "come together and take the best of each company to form a completely new organization" (Epstein 2005, p. 38). However, the EADS/BAE Systems merger concept differs from full-mergers as it would have taken the

form of a dual-listed company (DLC). Such corporate structure enables two firms to pool all of their operational businesses through a legal equalisation agreement while keeping their separate stock-market listings and conserving their own legal identity. The specificity of the EADS/BAE Systems' merger project is reinforced by the fact that each company is itself the outcome of a vast consolidation process occurring in Europe during the nineties. EADS emerged in 2000 as the outcome of a transnational merger between French, German and Spanish aerospace companies (i.e., Aérospatiale-Matra, Daimler-Chrysler Aerospace AG and Construcciones Aeronauticas SA). Similarly, BAE Systems was created in 1999 when British Aerospace (BAe) merged with Marconi Electronic Systems (MES), the defence corporate division of General Electric Company. As Guay (2005, p. 24) explained, "BAE is the result of the consolidation of much of the UK's national defense infrastructure into one company, without any major cross-border ties. EADS, on the other hand, was formed via a "merger of mergers" thereby producing a company that would be in a stronger position to negotiate transnational ventures". The mega-merger between EADS and BAE Systems would have resulted in the creation of a multinational aerospace and defence corporation made up with two giant companies tied up to harness market-oriented and technological synergies (i.e., merger of equals) but, at the same time, preserving the advantages of autonomy and decentralisation (i.e., DLC).

Regarding the rationale for mergers and acquisitions, scholars acknowledged that managers usually have multiple motives in a merger. Brouthers et al. (1998, p. 348) identified 17 different motives for mergers which the authors classified into three categories: economic, personal and strategic motives. Economic motives revolve around a managerial vision which considers mergers as the best way to build and further develop long-term competitive advantage. Economic motives include "increasing profits, achieving economies of scale, risk spreading, cost reductions (...) or responding to market failures" (Brouthers et al. 1998, p. 348). Together with economic motives, Brouthers et al. (1998, p. 348) indicated that "mergers occur because managers see a personal benefit", including "increased prestige through increased sales and firm growth, or increased remuneration through increased sales or profitability". Strategic motives "such as synergy, global expansion, pursuing market power, acquisition of new resources" (Brouthers et al. 1998, p. 348) may finally encourage merger projects. Regarding the merger concept involving EADS and BAE Systems, it is clear that the strategic vision proposed by companies' Chief Executive Officers (CEO) articulated various economic and strategic motives. The official announcement of the project cancellation indicated that CEOs believed that "the merger was based on a sound industrial logic and represented an opportunity to create a combination from two strong and successful companies (...) the merger would have produced a combined business that would have been a greater force for competition and growth across both the commercial aerospace and defence sectors"<sup>3</sup>. One should therefore consider that merging EADS and BAE Systems would have resulted in greater economic performance.

Although the prominent reason of a merger is to enhance economic performance of the firms, "it is important that the entire rationale is not centered on cost-cutting and elimination of redundancies" (Epstein 2005, p. 39). It is expected that mergers involving companies such as EADS and BAE Systems shall provide each firm with additional advantages, including larger geographic coverage, market diversification, improved operations through better knowledge management, and additional capabilities in services to both institutional and non institutional customers. Would the EADS/BAE Systems' merger has realised its full promises if it had

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<sup>3</sup> Source:[http://www.eads.com/eads/int/en/news/press.20121010\\_eads\\_bae\\_announcement.html](http://www.eads.com/eads/int/en/news/press.20121010_eads_bae_announcement.html)

been accepted? This question will remain unanswered. However, scholars suggested a number of factors which contribute to improve our understanding of the (potential) success or failure of such operations. Investigating mega-mergers occurring in the Pharmaceutical industry in the nineties, Schmidt and Rühli (2002, p. 223) indicated that prior strategy process is critical. In particular, the authors suggested that “it is important that the merger/strategy is aligned with previous development in the merging firms” (Schmidt and Rühli 2002, p. 223). In the same vein, Epstein (2005, p. 39) contended that “companies must evaluate whether the entities are proper choices as merger partners and the right fit to fulfil the strategic vision”. The pre-merger phase is thus essential. This phase requires that the partnering firms are capable of accomplishing three tasks considered by Epstein (2005) as key factors of merger success: negotiating the deal structure, establishing a due diligence team and coordinating communication before the merger is publicly announced (Epstein 2005, pp. 39-40). Since the merger project between EADS and BAE Systems had been cancelled, it is important to pay particular attention to the pre-merger period. Investigating the industrial and political context characterising the pre-merger phase shall therefore improve our understanding of the reasons why the merger was announced and finally cancelled. This involves considering the specificities of mergers occurring in the defence industry, in particular regarding the political factors that might facilitate or impede the development of such highly strategic projects, in particular during the initial phase. It also leads to go deeper into the history of its each company’s collaborations and partnerships, focusing particularly on the period of consolidation of the European Defence Technological and Industrial Base (EDTIB) occurring in the nineties, and which resulted in the creation of EADS and BAE Systems companies

## **1.2. The consolidation of the European Defence Technological and Industrial base**

The concept of Defence Industrial Base is usually defined as the set of scientific technological and industrial activities that contribute to the development of equipments related to the Defense (Dunne, 1995). This concept was developed in the 1990s. It updated the one of military-industrial complex. As a matter of fact, the military-industrial complex (developed during the Cold War and popularized by President Dwight Eisenhower in 1961) was focused on the national base (and notably in the US context) and mainly included the activities in charge of the satisfaction of strategic needs. On the contrary and even if there are many debates surrounding the definition of both concepts (see Dunne and Sköns, 2011, Bellais, 2000), the DIB adopts a rather open and “free market” approach, through the integration of all the enterprises that have a competitive advantage to supply the systems and components that will be used in a defence purpose.

This evolution in the concepts is linked to several changes in the environment of Defence and Security in the post Cold War context. The first one was the decreasing role of States both on the supply (privatization of former state-owned companies, notably in Europe) and on the demand (reduction of defence budgets) sides. The second important change is related to the increased complexity of military technology, which implied the development of links between the defence and the “non defence” industries. Currently many authors consider that it is no more possible to consider the future of defence industries within the framework of national boundaries (Bellais, 2011, Masson, 2011). This can be explained by the increased cost of programs and by the impact of the economic crisis that began at the end of the 2000s on military expenditures. Despite the fact that military expenditures are often considered according to their stabilizing effect, the current budgetary crisis of many States in Europe (and also in the US) has and may have in the near future a negative impact on the military expenditures and thus on the results of companies. To maintain their activity in this context,

European enterprises need to rationalize their activity or access to larger markets than national ones (Masson, 2011). Associated to competition considerations (notably toward the US), this is an important incentive for the development of a European Defence Technological and Industrial Base.

The creation of the European Defence Technological and Industrial Base is indeed at the centre of the current European defence industrial policy. This policy has three components (Hartley, 2011, p.95): the focus on collaborative defence equipment programmes such as Eurofighter Typhoon and Airbus A400M Airlifter; the 2005 initiative to create a Single European Defence Equipment Market (EDEM) and the 2007 initiative to maintain a “strong” and “truly” European Defence Technological and Industrial Base<sup>4</sup>. In 2007, the Steering Board of the European Defence Agency (EDA) presented its view of the future of the EDTB, which is based on six main points: three relate to the political and economic reasons justifying the maintaining of a strong EDTIB (point 1 to 3), and three relate to the vision of this EDTIB in the future (point 4 to 6). They are summed up in table 1.

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<sup>4</sup> The three pillars of this policy are managed by the following institutions: the Organisation for Joint Armaments Cooperation (OCCAR), The European Commission (EDEM) and the European Defence Agency (EDA).

Table 1: Reasons for maintaining the EDTIB and vision of its future

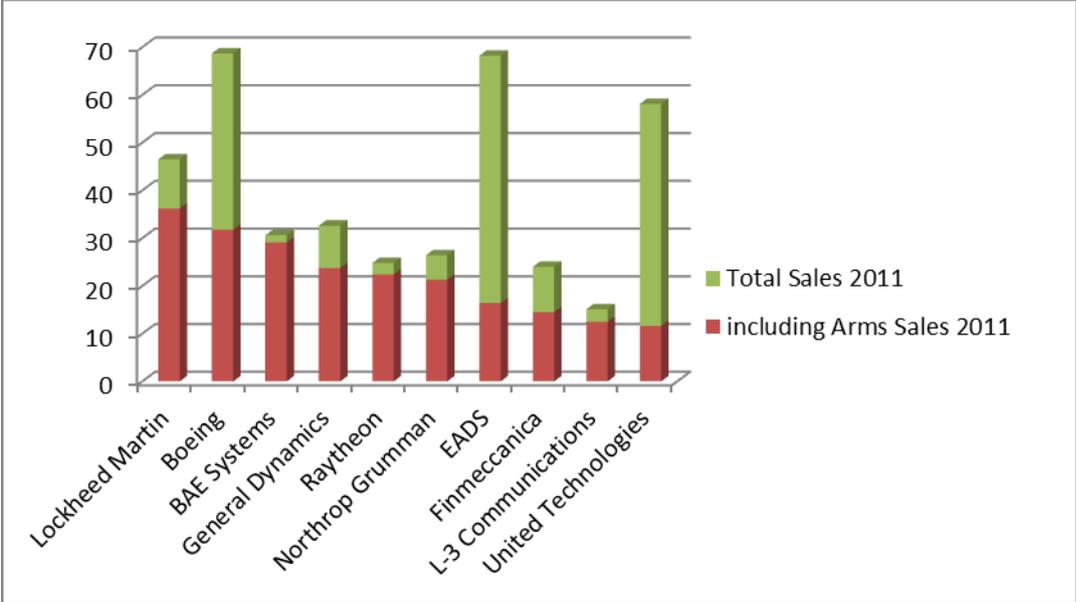
1 – Political and economic importance of the EDTIB	<ul style="list-style-type: none"> <li>- Supply of the equipment and systems required by the Armed Forces</li> <li>- Provide the world leading technology they need</li> <li>- Guarantee that the Armed Forces operate with appropriate independence</li> <li>- Source of jobs, exports and technological advance</li> </ul>
2- An EDTIB which is the result of past investments	<ul style="list-style-type: none"> <li>- A widely capable and in many sectors world-leading DTIB</li> <li>- But decline in the investments and in levels of defence expenditure</li> <li>- Growing costs and complexity of defence systems and more intense competition in overseas markets</li> </ul>
3- An Adequate EDTIB is no longer sustainable on a strictly national basis	<ul style="list-style-type: none"> <li>- Necessity to develop a “truly” European DTIB; as something more than a sum of its national parts</li> <li>- Necessity to achieve consolidation on both side of the market in Europe: aligning and combining the various needs in shared equipment requirements; and meeting them from an increasingly integrated EDTIB</li> </ul>
4- ‘Three Cs’ vision	<p>EDTIB needs to be</p> <ul style="list-style-type: none"> <li>- <i>Capability driven</i> (meeting the real operational requirements of the Armed Forces of the future; sustaining the necessary levels of European and national operational sovereignty)</li> <li>- <i>Competent</i> (rapid exploitation of the best technologies)</li> <li>- <i>Competitive</i> (within and outside Europe)</li> </ul>
5- A more integrated, less duplicative and more interdependent EDTIB	<ul style="list-style-type: none"> <li>- Increased specialisation at all levels of the supply chain</li> <li>- Emergence, from a market driven process, of Centres of excellence</li> <li>- Appropriate regional distribution (through public policy)</li> <li>- Closer integration with the wider, non-defence European technological and industrial base</li> <li>- Less European dependence on non-European sources for key defence technologies.</li> </ul>
6 - An EDTIB which is not a fortress	<ul style="list-style-type: none"> <li>- Imports from, or cooperation with, overseas defence industries are not excluded</li> <li>- But more cooperation between Europeans is needed in order to access the US defence market and to establish balanced technology exchanges across the Atlantic</li> </ul>

Source:based on EDA, A Strategy for the European Defence Technological and Industrial Base, 14/5/2007

To build such an EDTIB, EDA’s document (EDA 2007) defines a strategy (as its title suggests), based on governments which are asked to act as “regulators, customers and investors” (EDA, 2007, p.2). Several key actions for governments are suggested including the clarification of priorities, the consolidation of demand, the increase in investments, the insurance of the security of supply and the increase in competition and cooperation (EDA, 2007, pp. 2-4). One major point is to increase cooperation between firms, which may imply or lead to the re-structuring of the industry. According to Hartley (2011, p.95), the main role of the EDTIB is “to address the inefficiencies in EU defence markets”: “Compared with the US Defence industry, European inefficiencies result from small national markets, duplication of costly R&D and short production runs with European firms failing to exploit economies of scale and learning”. Due to the reduced defence spending following the end of the Cold War, several mergers and acquisitions have already been achieved, resulting in new names emerging in the top European arms firms, namely BAE Systems, EADS and Thales. But, as pointed out by Hartley (2011, p. 98), “Compared with the top US arms firms, there remain further opportunities for re-structuring to create larger European firms capable of competing with the top US companies”.

As a matter of fact, the aerospace sector of the EDTIB<sup>5</sup> has two main characteristics (European Communities, 2009; Hartley, 2011, p.100): the importance of collaborative programmes which are a distinctive feature of the European defence industrial policy (but which are mostly confined in the aerospace sector); the existence of too many small firms which leads to excess capacity and reduces the ability to achieve scale and scope economies. Only BAE Systems is of a similar size of the top US military aerospace firms; This firm is the top European aerospace firm. It is multi-product arm in both EU and the US. EADS is the sector top European second company (graph 1). Engine companies and suppliers are, according to Hartley (2011), the first actors concerned with the restructuring opportunities and needs. However, we may also consider that the merger project between BAE Systems and EADS participates in the European defence industry (and notably in the aerospace sector) restructuring.

Graph 1 : Top ten global defence companies 2011 (US\$ m.) (Source: Sipri Yearbook, 2012)



<sup>5</sup> The EDTIB is made of several sectors which are the air, land, sea and defence electronics sectors. We mainly focus on the air (aerospace) sector.

## **2. METHODOLOGY**

### **2.1. A single case study methodology**

We adopted a single case study methodology (Yin, 2009) focusing on the project of merging EADS and BAE Systems. The rationale for this methodological choice may be explained by two reasons. Firstly, single case studies are usually used when the case is extreme, unique or has something to reveal. The project of merging EADS and BAE Systems is undoubtedly unique and extreme since the two main actors in the European Defence market would have given birth to a giant in the global defence industry. The specific characteristics of defence industry should also reveal specific elements on the role of political interests in such a merger. Secondly, the case study methodology is useful to study contemporary events and single case study are often used when the case is special and gives the possibility to test and established theory. As regards our case, the literature review (part 1) stressed the importance of the pre-merger phase. Our aim is thus to confront this established theory with the reality of what happened in the EADS-BAE Systems project of merger. Since the project has been abandoned, the pre-merger planning phase and the historical roots of the merger project appear essential. Therefore, two periods, revealing the real life context of our case, receive specific attention. The first period corresponds to the last 14 years, from 1998 to 2012, during which BAE Systems and EADS followed their own strategic path. Our objective is to better appreciate why and how the two companies came to the conclusion that merging was the best option to sustain competitive advantage in the aerospace and defence industry. The second period corresponds to the five weeks that goes from the day the merger project had been publicly announced (September, 12<sup>th</sup>) to the day of its official cancellation (October 15<sup>th</sup>). This period corresponds to the negotiation phase during which stakeholders communicate their intentions. That period ended up with the cancellation final decision.

### **2.2. Data**

Our interest in studying how was the project of a merger between and BAE systems and EADS built and why it finally failed results from previous work achieved in the field of defence industry and on the analysis of industrial firms strategies in the current economic context (Laperche, Picard, 2012). These previous researches give us a useful background to this case study analysis. Moreover, We collected a variety of secondary data so as to document the case. In particular, official reports (notably annual reports) published by the companies provided us with critical information about their global strategy and its evolution. Based on them, detailed observations of complementarities between the companies were done. In addition, newspaper articles covering the merger project enabled us to rebuild the chronology of the events during the five weeks the project had been rendered public. We used business press and press specialized in defence (e.g. *Defense News*), analysed interviews and press releases, particularly to put forward the various political stakes involved in the merger project. Finally, we used a number of research articles related to each company's strategy and to the evolution of the EDTIB. This data collection strategy helped us to triangulate the information.

### **2.3. Context**

BAE Systems emerged in the late nineties as the final outcome of massive mergers and acquisitions of UK aircraft manufacturing, defence electronics and shipbuilding which began in the early sixties with the creation of the British Aircraft Corporation (BAC) and continued

on with the establishment of the British Aerospace Company (BAe) in the late seventies<sup>6</sup>. The final step was achieved in 1999 when General Electric Company (GEC) found a common agreement with BAe for the selling of its defence corporate unit (Marconi Electronic Systems, MES). The new organisation was renamed BAE Systems (Guay 2055, p.24), now representing the third largest defence and security corporation in the world (behind Lockheed-Martin Company and Boeing) and the first one in Europe (graph 1).

The same year, a similar consolidation process occurred in France when Aérospatiale joined with Matra (Lagardère group) to give birth to a major aerospace and defence company named Aérospatiale-Matra. Interestingly, one year before the decision was made to create BAE Systems, the project of merging British Aerospace (BAe) with Germany's aerospace champion, Daimler-Chrysler Aerospace AG (DASA), was widely anticipated by analysts. Alike BAE Systems, DASA resulted from the massive consolidation of the German aerospace and defence industry. Daimler-Benz established Deutsche Aerospace (DASA) in the late eighties as one of its four corporate divisions by integrating five companies: Messerschmitt-Boelkow-Blohm (MBB), Dornier, Motoren und Turbinen Union (MTU), Telefunken Systemtechnik (TST) and Deutsche Airbus. In 1995, Deutsche Aerospace became Daimler-Benz Aerospace (DASA), representing 80 percent of German industrial capabilities in aerospace. After merging with Chrysler Corporation, the aerospace division was renamed Daimler-Chrysler Aerospace AG: DASA<sup>7</sup>.

Despite advanced negotiations between BAe and DASA CEOs, the project of merging the two companies was abandoned when it became clear that General Electric Company (GEC) was about to sell Marconi Electronic Systems (MES). British Aerospace (BAe) CEO Richard Evans decided to purchase Marconi so as to establish a 100 percent UK company benefiting from strong competitive advantage within the US defence market. The cancellation of the merger project between BAe and DASA had a direct impact on the creation of EADS. Indeed, DASA CEO Jürgen Schrempp, disappointed by the failing merger with BAe, chose to merge his company with Aérospatiale-Matra and CASA (Construcciones Aeronauticas SA). The result was the creation of a pan-European aerospace and defence corporation named European Aeronautic Defence and Space Company (EADS). EADS now comprises four companies: Airbus (commercial and military aircraft products and services), Eurocopter (civil and military helicopter products and services), Astrium (space solutions and services) and Cassidian (defence and security platforms and services). These companies cover the full spectrum of aerospace, defence and security businesses.

The consolidation of the European defence industry took a surprising turn last 12<sup>th</sup> September 2012, when BAE Systems and EADS announced their intention to merge their businesses by creating a dual listed company structure. The two companies had agreed on the principal terms of the merger, subject to the approval of their respective Boards, which included commercial and strategic aspects (*The commercial terms of the merger; The strategy for the combined business; The cost saving and revenue benefits of the combination and associated implementation plan*) governance aspects (*The legal structure of the merger; Governance arrangements which would enable the combined business to operate in a normal commercial manner; A unified management and Board structure*) as well as the shareholder policy (*Near-*

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<sup>6</sup> British Aerospace resulted from various mergers and acquisitions occurring in 1977 and involving the British Aircraft Corporation (BAC), the Hawker Siddeley group and Scottish Aviation. BAC itself resulted from massive consolidation occurring in the sixties when the TSR-2 programme was developed (see, Barbaroux 2011 for additional information of the TSR-2 project and its consequences on UK aerospace and defence industry).

<sup>7</sup> <http://www.globalsecurity.org/military/world/europe/de-dasa.htm>

*term dividend policy*). However, less than one month after the announcement of a possible combination of their businesses, BAE Systems and EADS announced on October, 10<sup>th</sup> 2012 (deadline under current UK regulations) that they decided to terminate their discussions. The termination of the discussion was decided due to impossibility to reconcile “*the interests of the parties’ government stakeholders*” with “*each other*” or with “*the objectives that BAE Systems and EADS established for the merger*”. As a matter of fact, the support of the parties’ stakeholders, notably on the *transaction structure*, was a basic condition of success. However, “*Discussions with the relevant governments had not reached a point where both companies could fully disclose the benefits and detailed business case for this merger*”. And this is the reason why the enterprises decided to “*terminate the discussions to focus on delivering their respective strategies*”. This was the last episode in date of the ongoing process of consolidation of the European defence technological and industrial base.

### **3. RESULTS**

Results are threefold. First, we observe that the merger project is grounded on strong strategic complementarities between the two companies. Second we suggest that while the merger project have been motivated by the search of economic synergies, it also have been supported by personal motives shared by key individual members of companies’ executive board involved in the project Third, we find that political divergence made the merger project more complicated. In other words, failures to anticipate on political consequences of the merger might have contributed to its final cancellation

#### **3.1. Strategic complementarities supporting the merger project**

At the beginning of the 2000’s, BAE Systems and EADS businesses were tightly connected. BAE Systems initially owned 20% share of Airbus and 25% share of Astrium, the civil aircraft manufacturing and space divisions of EADS respectively. The two companies, associated with Alenia Aeronautica (Finmeccanica), also collaborated on the Eurofighter-Typhoon programme. Finally, EADS and BAE Systems’ decision to merge EADS missile business and Alenia Marconi Systems (BAE/Finmeccanica) gave birth to MBDA, the second world largest missiles and missile systems company, jointly owned by EADS (37,5% share), BAE Systems (37,5% share) and Finmeccanica (20% share).

Whereas BAE Systems and EADS benefited from strategic proximity and complementarities inherited from history, BAE Systems began to change its global strategy, adopting a transatlantic vision consisting in specializing in defence platforms and services. The objective was to reinforce BAE Systems’ positions within the US defence market and, to some extent, within the Middle-East. In 1999, when BAe acquired Marconi, US markets represented only 17 percent of BAE Systems global sales. Twelve years later, the company realised 39 percent of its global sales in the US. To implement the new vision, BAE Systems began to sell its 25% share in Astrium to EADS in 2003. The next year, BAE Systems bought Alvis plc, a UK consolidated armoured vehicle manufacturer. The new entity was renamed BAE Systems Land Systems (Weapons & Vehicles), now part of BAE Systems Land & Armament operating group. Two years later, in 2006, BAE Systems sold its 20% shares in Airbus to EADS. The transaction brought an additional cash - flow to finance the acquisitions of United Defense Inc (2005) and Armor Holdings (2007), two major land systems contractors for the Pentagon. While maintaining its participation in the Eurofighter Typhoon programme (a cooperation between EADS DASA, BAE and Finmeccanica), BAE Systems disengaged from

the Gripen programme (developed through a joint venture between Saab Military Aircraft and BAE Systems) in 2004<sup>8</sup> and sold its avionics business in 2005. At the same time, BAE Systems confirmed its participation to the Joint Strike Fighter (JSF-35) US-led international joint programme. Ten years after its inception, BAE Systems became a major player in the US and global defence markets, declaring in 2010 that its vision was to be “the premier defence and security company” (BAE Annual Report 2010, p. 14). However, decreasing military expenditures in Europe and the US made BAE Systems more vulnerable. 47% of BAE Systems’ sales come from US defence and government markets. In 2011, therefore, the vision changed. The company aimed at becoming “the premier global defence, *aerospace* and security company” (BAE Annual Report 2011, p. 6; *italics added*). BAE Systems’ strategic actions for 2012 now focus on developing aerospace, cyber-intelligence and security solutions, electronic systems and services to customers. These actions are expected to provide BAE Systems with additional sources of revenues to compensate for the anticipated Defence budget reductions. In particular, the company has a “highly sustainable Services business, which is an area for growth as customers’ operations and maintenance budgets come under pressure” (BAE Annual Report 2011, p. 62). While the company continues to “align the cost base to the reduced activity in the Land & Armaments business” and complete “a number of strategic business disposals” (BAE Annual Report 2011, p. 13), some analysts began to think that BAE Systems’ disengagement from Airbus and, to some extent, Astrium was a mistake. BAE Systems is now looking for ways to move again towards aerospace civil markets to compensate for anticipated reductions of government military expenditures.

At the same time, EADS struggled with the development of its defence-related businesses. One major strategic goal of the company had been to balance its sources of revenues between civil and defence-related activities so as to compete with Boeing Company Inc for global, civilian and defence-oriented, leadership. Yet, in 2011, the transnational European company remained highly dependent upon (very volatile) civil aircraft markets. Airbus represented up to 67 percent of EADS total revenues, while Cassidian, its defence and security business corporate unit, only weighted for 11.5 percent. One major reason of the relative stagnation of the defence and security source of revenues is the company huge difficulties in penetrating the US defence market. After a very aggressive battle against Boeing, EADS North America, teamed up with Northrop Grumman, had lost the huge contract for the modernisation of the US Air Force tankers fleet. This contract would have provided EADS with additional credibility regarding its position as a major contractor for the Pentagon. It would have ensured long-term revenues and enabled EADS to achieve the delicate balance between civil and defence-oriented sources of revenues. EADS also considered that it should improve its services to customer solutions so as to capture additional sources of revenues. It is widely accepted that the most sustainable sources of revenues come from services to customers rather than platforms’ sales. In this connection, EADS strategic vision for 2012 insisted on that point. The chief strategy and marketing officer explained that EADS plans to increase its “services share to 25% in 2020” (EADS Annual Report 2011, p. 24, Laperche, Picard, 2012) essentially through targeted mergers and acquisitions. As a consequence, it appeared very rational for EADS to associate with BAE Systems so as to benefit from the UK company defence positions, notably within the US, and high-level capabilities regarding services to governmental and non governmental customers. On the other side, BAE Systems would gain from merging with EADS since it would access to important markets for its aeronautics and electronics operating groups.

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<sup>8</sup> BAE Systems sold the remaining part of its stake in Saab in June 2011.

At first glance, combining BAE Systems and EADS resources would provide the new entity with additional capabilities to support each company's strategic vision and overcome their particular weaknesses. One should expect that the European leader in civil aerospace manufacturing associating with the European leader in defence and security products and services would generate a giant firm with world-level capabilities within both civil and defence-related manufacturing and service activities. Beyond strategic fit considerations, we need to go deeper into the economic complementarities that companies' CEOs had been expecting from the merger between EADS and BAE Systems.

### **3.2. Economic synergies and personal motives supporting the merger project**

Investigating BAE Systems and EADS companies' Annual Reports in 2011 provides useful insights on the economic motives underlying the merger project. Building on a comparative analysis of each firm's economic performance and business development strategy, we suggest that the alignment of each company's economic motives is likely to justify the merger.

When comparing the economic situation of BAE Systems and EADS at the time the announcement of the merger project was made, we observe that the two companies did not exhibit similar performance. While EADS benefited from a seven percent growth of its global sales in 2011, BAE Systems suffered from a thirteen percent decrease of the same indicator. BAE Systems' poor results came from a twenty percent sales' reduction in the Land & Armaments (L&A) business. The Platforms & Services (P&S) business group operating in the US which comprises the L&A business, represents thirty percent of BAE total sales. Basically, the group has been directly affected by defence spending reductions in BAE Systems largest markets, the US and UK. Besides global reductions of defence budgets, the cancellation and further restructuring of the US Army's Future Combat Systems (FCS) programme had had a dramatic impact on BAE Systems' Land & Armaments business. Considered as "the largest and most ambitious planned acquisition programme in the US Army's history" (RAND 2012), the FCS programme represented a major source of sustainable revenue that shaped the BAE Systems' strategic vision emerging in the mid 2000's. The decision made by BAE Systems to acquire United Defense Inc. and Armor Holdings, thus becoming a major prime ground combat systems contractor in the US defence market, was fundamentally motivated by the opportunities offered by the FCS programme. The latter indeed "called for fielding not just one system but an entire suite of systems, all organized into a brigade structure that was envisioned to operate under an entirely new (...) doctrine while integrated by a wireless network" (RAND 2012). Therefore, the variety of US Armys' ground combat systems was to be renewed and BAE Systems wanted to be considered as a major prime contractor in the FCS programme. Unfortunately, cost escalations, technological immaturity and timeline extensions led to the cancellation of the programme in the late 2000's. Consequently, a number of critical systems offered by BAE had to be transferred to other US Army's acquisition programmes through spin-outs, or simply abandoned<sup>9</sup>. This trend towards reduction of defence-oriented sources of revenue was reinforced by two other BAE Systems' business groups exhibiting declining sales in 2011: the Electronic Systems (ES) group which comprises the US- and UK-based electronics activities for both civil and military customers, and the Platforms & Services (P&S UK) group representing the UK-based air and maritime activities. These groups have been heavily dependent upon reduction in military spending. Their participation in important but poorly

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<sup>9</sup> The Bradley and Paladin Integrated management, the Joint Light Tactical Vehicle (JLTV) or the CAIMAN Multi Terrain Vehicle (MTV) programmes, while remaining in the Land & Armaments group's portfolio, suffered from the FCS programme restructurings.

managed fighter aircraft (e.g., the US-led Joint Strike Fighter and the Eurofighter-Typhoon) and maritime acquisition programmes (e.g. Type-45 destroyer and Queen Elizabeth aircraft carrier programmes) made them more vulnerable to defence acquisition programmes restructuring occurring in the US and UK (GAO 2010; NAO 2012).

Although defence-oriented businesses followed decreasing sales paths, BAE Systems' civilian businesses exhibited moderate but increasing sales in 2011. In particular, the Electronic Systems and Cyber-Intelligence business groups' civilian activities (e.g., communication & control, ISR, commercial aircraft avionics, propulsion, cyber-security solutions, and geospatial software applications and supports) continued to grow. These activities have been benefiting from the development of civilian aircraft and space systems markets in the late 2000's. Interestingly, EADS played a leading role in these markets through its Airbus, Eurocopter and Astrium divisions. As an illustration, the variety of Airbus civilian and military programmes offer (e.g., A320neo, A380, A330 and the future A350XWB; A330 MRTT, CN 235, C295 and the A400M) enables the company to compete with the world leading company, Boeing, on both the 100 seating and more passengers commercial market segment and, to some extent, the light and medium-sized military transport segment. The Airbus division exhibited a ten percent growth and, together with Airbus military, weighed for sixty-seven percent of EADS total sales. EADS aerospace divisions therefore represent major outlets for BAE Systems' civilian solutions and services. In this context, it appears reasonable to expect that merging EADS and BAE Systems would improve companies' market shares and create future opportunities for vertical and horizontal diversification, at least within the aerospace industry.

Regarding EADS, its major ambition is to be capable of competing with Boeing on both civil aircraft and defence and security markets. Cassidian, the company's global security solutions and systems division, did not develop enough to make EADS become a leading player in traditional defence industry. Global leaders like Lockheed Martin, BAE Systems, Northrop Grumman, Boeing, General Dynamics and Raytheon are capable of delivering the full-range of products and services for air, land and naval forces, as well as advanced electronics, security, information technology solutions and support services. To compete with these global defence suppliers, in particular Boeing, would make the project of merging EADS with BAE Systems sound congenial. As the second largest defence company in the world, equivalent in sales and revenue to Boeing's defence and security total sales (33 Bn\$ *versus* 30.9Bn\$ in 2011), BAE Systems would have brought to EADS critical assets and capabilities enabling it to compete with US giant defence companies.

Another important economic motive for merging EADS and BAE Systems is related to the geographic synergies that each firm would have benefited within key markets. BAE Systems defence and security businesses are well implanted in North America, Saudi Arabia, UK, India and Australia. Besides Europe, EADS key markets are located in the Middle-East, North America and China. The combination of EADS and BAE Systems' businesses would have generated an extension of the firms' geographical scope and a spectacular increase in their market shares through a diversification of both civil and defence-related activities. The resulting entity would have reinforced companies' competitive positions in Europe, North America and the Middle-East, but also supported the development of market shares within emerging countries (Brazil, Russia, India, China, Malaysia ...) where economic growth is expected to be high.

Finally, we suggest that personal motives might have supported the project of merging the two companies. Interestingly, the individual decision-makers who strongly sponsored the merger project were all coming from defence-oriented companies that formerly merged to create BAE Systems and EADS in the late 1990's. Investigating the professional career of key individuals involved in the merger project before being appointed strategic positions within EADS and BAE Systems' executive board, indicates that most of them occupied important posts in Aérospatiale Matra, BAe and DASA, three companies that played a central role in the European defence industry consolidation process. In particular, Guy Griffiths (BAE Systems Group Managing Director of international operations), Fabrice Brégier (Airbus Chief Executive Officer), Marwan Lahoud (EADS Chief Strategy & Marketing Officer) and Alan Garwood (BAE Systems' Group Business Development Director) held important positions in Aérospatiale Matra (so-called "Largardère boys") and MBDA during the 1990's and the early 2000's. Thomas Enders (EADS Chief Executive Officer), Ian King (BAE Systems Chief Executive Officer) and Bernhard Gerwert (Cassidian Chief Executive Officer) took on various posts at DASA and BAe during the same period, two companies which were very close to merge before BAE Systems and EADS were created. Building on the foregoing, we suggest that the decision made to merge EADS and BAE Systems might have been shaped by the cultural background and professional profile of key individuals involved in the project.

Table 3 summarises BAE Systems and EADS respective economic forces and weaknesses and strategic perspectives discussed in the last two sections.

Table 2. BAE Systems and EADS respective forces, weaknesses and perspectives (Source: Annual Reports 2011)

	<b>EADS</b>	<b>BAE</b>
<b>FORCES</b>	<p>World leader for commercial aircraft manufacturing (AIRBUS + ATR)</p> <p>Account for 33% of the total world civil and parapublic helicopter fleet</p>	<p>World leader for defence systems and services covering the full-spectrum of defence platforms (Land, Maritime, Air, Electronic &amp; C4ISR systems)</p> <p>Strong capabilities in commercial aircraft avionics, cyber &amp; intelligence technology (government other than military expenditure)</p> <p>Major/prime contractor in the US, Saudi Arabia, India and Australia</p>
<b>WEAKNESSES</b>	<p>Euro / dollar dependence for financial performance</p> <p>Dependent on civilian / commercial aviation and aircraft manufacturing markets and commands</p> <p>Services to customer to be further developed</p> <p>Defence markets positions to be further developed (&lt; 20% of global sales)</p> <p>Emerging markets' penetration to be developed (India,)</p> <p>Only 12% of global sales in North America</p>	<p>Dependent on defence markets evolution</p> <p>Dependent on US defence and government markets (47% of the group sales)</p> <p>Weak penetration of selected emerging and traditional markets (Brazil, France, Germany, Russia)</p>
<b>PERSPECTIVES</b>	<p>Long term growth in air traffic (supported by emerging countries)</p> <p>Helicopter recovery</p> <p>European government pooling defence resources</p>	<p>World military expenditure is slowing since 2010</p> <p>43% of global military spending are US ... and the US budget is stabilising</p> <p>Emerging countries (China, Russia, Brazil and India) support aerospace growth perspectives</p>

### 3.3. Political divergence during the pre merger phase

Building on the foregoing, we may consider that the project of merger aligned with the three C's vision of the European Defence Technological and Industrial Base (see table 1). More *capabilities*, *competence* and *competitiveness* may as a matter of fact be considered as the expected results of the mega-merger project. However, many political divergences appeared during the pre-merger phase. According to several analysts, "too many governments [were] involved : the US and the British in the case of BAE as its major customers and the German, French and Spanish Governments in the case of EADS, who between them effectively hold 50 percent of the corporation's shares"<sup>10</sup>. Most of the divergences appeared within and between European governments.

UK wanted to impose to the other States thresholds equity in the new company. At the time of the project, BAE systems was a fully publicly quoted company, although the British government did have a special share in the operation<sup>11</sup>. On the contrary, EADS was controlled by a shareholder's pact linking Sogead (22,35%) (French media Company Lagardère and the French State holding company Sogepa) the automaker Daimler (22,35%) and the SEPI (5.45%) (Spanish State Holding Company). The parties envisaged issuing special shares in BAE Systems and EADS to each of the French, German and UK governments to replace the existing UK government share in BAE and the stakeholder concert party arrangements in EADS, which would allow each to block any entity from holding more than 15 percent of the merged firm. As a matter of fact, according to the UK, if the other States (and notably the French and the German States) still had important shares, this would have implied a too strong political influence on the management of the new company. Close to the deadline, deadlocks appeared in the negotiation: Germany intended to hold a 9-percent stake in the new company, the same as France, but Britain feared France would later buy the shares held by French conglomerate Lagardère, which was known as willing to sell its 7.5-percent stake in EADS in the medium-term<sup>12</sup>. Defence Minister Philip Hammond warned on Oct. 7 2012 that Britain could use its "golden share" to block a planned merger: "It is not, I think, necessary to have no French or German interest in the company. It is necessary to reduce that stake below the level at which it can control or direct the way the company acts." he told BBC Radio<sup>13</sup>.

France asked for guarantees on three points: the protection of its assets linked to nuclear deterrence, the guarantee that MBDA would continue to arm the Rafale and not only the Eurofighter (majority owned by EADS and BAE Systems), and the guarantee that EADS will still own 46% of the Share of Dassault. France feared for the future of its "national champions" like Dassault but also DCNS, Safran and Thales. "Let's not forget that EADS is a Dassault shareholder, which in turn is a shareholder of Thales and DCNS," the French shipbuilder, French defence consultant Bruno L.G. Carré declared to *Defense news*. The restructuring ensuing from the merger would have been difficult to negotiate<sup>14</sup>. Moreover, Lagardère, which held a direct 7.5 percent stake in EADS through the Sogead holding company (which also held the French state's 15 percent stake in the European aerospace group) considered on October 1 2012 the conditions of the merger between EADS and BAE

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<sup>10</sup> Looking the American Giants in the eye, by Michael Clarke, *Telegraph* 13/09/12.

<sup>11</sup> Special share. The main Shareholders of BAE are Blackrock (5,16 %), Invesco (5,08 %), Axa S.A (5,00 %), Franklin Resources (4,92 %), Legal & General Group (3,99 %) et Barclays (3,98 %).

<sup>12</sup> EADS/BAE Merger Talks Reportedly Deadlocked, *Defense News*, 5/10/12.

<sup>13</sup> U.K. Warns It Could Veto EADS-BAE Merger, *Defense News*, 7/10/12.

<sup>14</sup> L'Usine Nouvelle, Comment EADS a plombé sa fusion avec BAE Systems, *L'usine Nouvelle*, 23/10/12 and BAE-EADS Deal Faces Questions From Investors, *Defense news*, 24/09/12.

to be unsatisfactory: “This project, despite the industrial and strategic potential, has not so far shown that it would create value for EADS”, the company said. Several investor analysts considered that the deal that would give EADS shareholders a 60 percent stake in the merged company, with BAE obtaining the remaining 40 percent was unfair, with some explaining that it was too advantageous for EADS and others for BAE systems<sup>15</sup>.

Germany has been considered, notably by EADS’ CEO, as the main responsible for the failure of the project: “I’m ready to admit that we never expected to face such opposition against the deal, in particular not in Berlin. We saw the combination with BAE Systems as the logical, long-overdue step in the European integration of our industry.” wrote Tom Enders in a letter sent to his staff after the failure of the project<sup>16</sup>. Germany was not a direct shareholder of EADS and wanted to become a shareholder and to obtain a stake in the future company. As a matter of fact, Germany claimed to host the headquarters of the company in order to avoid the formation of a duopoly where France would have had the decision power in term of civil aviation and England the decision power in the defence part of the activity. Germany also wanted greater representation in the new firm, such as for example the number of German administrators. Moreover, Germany (like other European countries) also feared for jobs since Tom Enders announced (before the announcement of the project of merger) his willingness to transfer the headquarters of EADS in Toulouse. Cassidian, the Defence branch of EADS employs 12000 persons in Germany and the merger would have led to unavoidable job cuts<sup>17</sup>.

Budgetary reasons may also have complicated the negotiations in the context of crisis in Europe. Added to impacts of restructuring ensuing from mergers (job cuts in particular), the “mere” building of the new company would have implied public investments, notably in Germany and in Spain. How to finance the obtaining of shares in the new entity when budgetary constraints are high, whatever the economic position of the country? It is likely that this issue has been in the heads during the negotiations.

Some concerns also emerged regarding conflicting interests between Europe and the US. Considering the important position of BAE Systems on the American market, several problems would have emerged. The governance of the new company would have been made difficult by the American regulations (International traffic in Arms regulations, ITAR) that already imply a partitioning of BAE’s activities (with BAE Systems Inc being an American unit operating in the US and separated from the rest of the corporation’s activities) (Masson, 2012, p.13). Regarding commercial aspects, if France or Germany encroached upon the “commercial dividends” ensuing from the special relation existing between the UK and the US, this would have been a negative point for BAE Systems and its shareholders<sup>18</sup>.

Finally, some important issues were related to the diffusion of critical technologies. On the one hand, “US and Britain worr[ie]d that placing sensitive Defence contracts with such a conglomerate might lead to leaking of critical technologies to other European States, in whom we don’t have full confidence, and thence to third parties in whom we have none at all”, declared M. Clarke, Director General of the Royal United Services Institute to the Telegraph

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<sup>15</sup> BAE-EADS Deal Faces Questions From Investors, *Defense news*, 24/09/12 ; French Firm Lagardère Calls for Review of Planned EADS-BAE Merger, *Defense news*, 1/10/12 ; BAE’s biggest Shareholder questions logic of EADS merger, 8/10/12.

<sup>16</sup> Enders: EADS To Review Strategy; Cooperation With BAE Possible, *Defense News*, 9/10/12.

<sup>17</sup> EADS-BAE et les égoïsmes nationaux, *L’Usine Nouvelle* 10-10-2012 ; Comment EADS a plombé sa fusion avec BAE systems, *L’Usine Nouvelle* 23/10/12.

<sup>18</sup> EADS-BAE, La fusion sous la menace des exigences politiques, *L’Usine Nouvelle*, 17/09/12

(note 8). According to Masson (2012,p.15), the American may have considered this operation as a “European Trojan horse”. This situation could have destabilized the activities of BAE Systems Inc and increased the entry barriers for EADS on the American market.

On the other hand however, one could consider that the American market would have benefited from the European defence technology that would have been diffused through the new entity. Considering the American and European Defence strategy, Uzunidis and Bailly (2005) argued that the American policy was innovation-oriented (Schumpeterian policy) while the European one was market-oriented (Smithian policy). According to the authors, The Schumpeterian American innovation defence policy is based on strong state investments but also on the development of networks so as to access to new (dual or not) technologies developed elsewhere. They give several examples of the growing implications of American companies in European ones or in European programs. It is likely that the merger between EADS and BAE systems would have also increased the stock into which the American Defence could have taped.

To sum up, the conflicting positions of the two companies’ shareholders and stakeholders and their inability to find a common agreement on the conditions of the merger resulted in its collapse.

## **CONCLUSION**

Our case study analysis gives another evidence of the importance of the pre-merger phase, already stressed in the literature on mergers’ success or failure. The industrial complementarities, economic synergies, and the social proximity of the managers were indeed strong explanatory factors in the emergence of the project of a merger between EADS and BAE systems. Moreover, this paper underlines the specificity of mergers in the defence sector and shows the interweaving of political and economic decisions. The political reason may outweigh the overall economic rationality, as shown by our analysis of the failure of the merger project. Despite a favourable context for the consolidation of the EDTIB based on the implementation of the three C’s vision implying necessary restructuring and mergers, all the project’s stakeholders were forced to “accept” the failure. In fact, our research shows that the project was too big (in terms of economic and political stakes) to succeed. In addition to contributing to the literature on mergers, and more specifically in the defence sector, this paper may thus have practical impacts on the concrete management of such industrial projects and on the definition of future paths for the industrial Defence policy in Europe.

This paper has focused on the analysis of a particular moment in the life of the two companies. Several issues however remain to be further analysed, notably regarding the implications of the failure on the current and future strategies of the two companies, which will constitute further steps in our research. Since the end of 2012, EADS has tried to build a new governance so that to become a “normal” company, where operations will be managed without any interference from specific shareholders and notably government intervention<sup>19</sup>. According to some analysts, this new governance (where State holdings falls from 49 to below 30 percent: France 12%, Germany 12% and Spain 4%) is likely to accelerate mergers, acquisition and joint venture deals for the European aerospace and defence company, notably in high technology companies and in services for aeronautics. Even a military cooperation

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<sup>19</sup> [http://www.eads.com/eads/int/en/news/press.20121205\\_eads\\_governance.html](http://www.eads.com/eads/int/en/news/press.20121205_eads_governance.html)

with BAE systems may be possible<sup>20</sup>. In other words, does the failure of the merger project open up a new period for the company strategy, more independent from European states? As regards BAE systems, the stakes are related to the military expenditures. According to the 2012 Sipri Yearbook, world military expenditure did not increase in 2011, for the first time since 1998. Since Arms sales represent 95% of the total sales of the company in 2011, the failure of the merger with EADS increases the necessity for BAE systems whether to diversify its activities or to study possible new cooperations<sup>21</sup>.

Of course, the failure may also have consequences on the evolution of the EDTIB and more globally on the European defence policy, already weakened by the Euro crisis. In a recent study, Brattberg and Varga (2012) present possible scenario for the European security which concerns both political orientations and industrial strategies. The four scenarios include a continuation of the current policies mainly focused on national issues, a disintegration path, the construction of a multispeed Europe and an enhanced defence integration. The study of the consequences of the failure of the merger on the future of the European Defence Technological and Industrial base (toward more or less integration) will therefore constitute another further step of this research.

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<sup>20</sup> "New EADS Rules should speed mergers, other deals", *Defense news*, 8/12/12 ; "EADS To Review Strategy; Cooperation With BAE Possible", *Defense News*, 9/10/12

<sup>21</sup> According to Joseph Schneider, president of the consulting firm JSA Partners, the project of merger was a "Trojan horse proposed deal designed to put big company mergers on the table and then enable BAE to merge with a U.S. company like Northrop Grumman or General Dynamics", BAE-EADS Deal Faces Questions From Investors, *Defense news*, 24/09/12.

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