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INCREASED MILITARY BUDGETS ARE NO GUARANTEE OF A MAJOR PROFITABILITY LEAP FOR EUROPEAN DEFENSE INDUSTRY

The AlixPartners A&D Minute

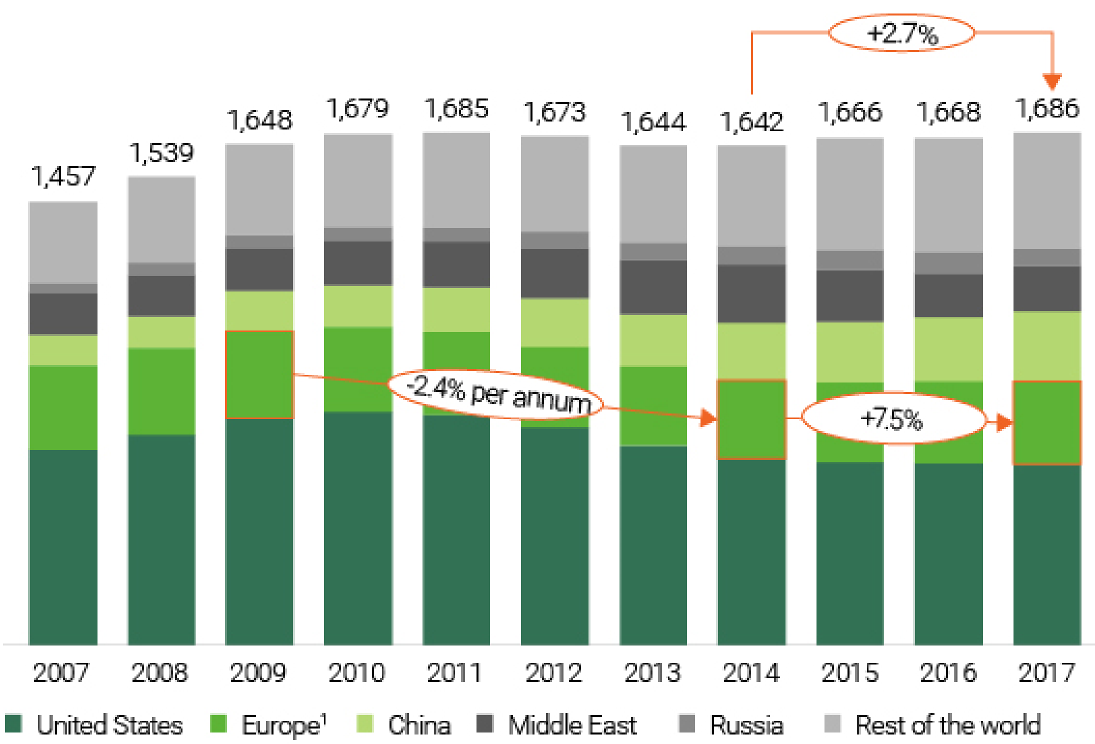
Increasing global defense spending offers opportunities for the European defense industry, yet it finds itself in a quandary about how to capitalize on it. Pressure on pricing, tougher export competitions, and the need to finance development of next-generation systems complicate the path to increased growth.

RISING BUDGETS, BUT LOW INTRA-EUROPEAN EXPORTS

After a trough point in 2014, global defense spending is recovering and continued growth is expected. The uptick is driven in particular by the United States, China, Japan, and Europe, in response to increasing security threats.

While European nations' defense budgets remain much lower than that of the US as a percentage of GDP, they are increasing their military and security spending, with 7.5% growth between 2014 and 2017 (figure 1). But most are still far from the NATO goal that member states put at least 2% of their GDP toward defense.

FIGURE 1: GLOBAL MILITARY EXPENDITURES (CONSTANT 2016 $BILLION)



1. Geographic Europe excluding Russia
Source: SIPRI Military Expenditures Database, AlixPartners analysis

In 2016, European arms exports totaled €191.4 billion, of which only 16% went to European neighbors. The top five destinations for European exports—United Arab Emirates, India, Saudi Arabia, Egypt, Kuwait—accounted for 45% of the total.

THE MULTITUDE OF EUROPEAN WEAPONS SYSTEMS IS A MAJOR HURDLE

The deep fragmentation of the European weapons systems landscape, as compared with that of the United States, remains a major impediment to intra-European arms exports, preventing the industry from capitalizing on the benefits of scale. For example, European armies have 37 different battle tanks and infantry fighting vehicles, whereas the US has just 3.

This problem is further compounded by costly program overruns with the few common platforms developed in Europe. For example, the jointly developed A400M transport plane, NH90 battlefield helicopter, and Tiger attack helicopter have all been plagued by delays, performance problems, and billions of euros' worth of cost overruns. Unless Europe finds a much more efficient way to develop European programs—saying no to multiple country requirements to complete the same missions, implementing leaner program development practices, and leveraging the best skills and technology across Europe instead of political maneuvering—more overruns can be expected.

However, there are success stories, such as the A330 MRTT refueling tanker aircraft, which has secured solid market shares worldwide, and MBDA is now the European missile leader, with 70% market share in domestic markets.

THREE ACTIONS TO CARVE A PATH TO GROWTH

The European defense industry can better position itself for growth by taking three key actions.

1. Reduce the number of European weapons systems.

   Putting a stop to splitting volumes against three or four competing platforms will be a key enabler to future competitiveness. The European Union's Permanent Structured Cooperation (PESCO) framework seeks to reduce the number of major weapons systems used in Europe by as much as 80%—a bold move toward integration.

   This political initiative has recently begun to translate into new programs in air and land systems, as illustrated by the European Future Combat Air System (FCAS) program to be jointly developed and produced by Dassault Aviation and Airbus.

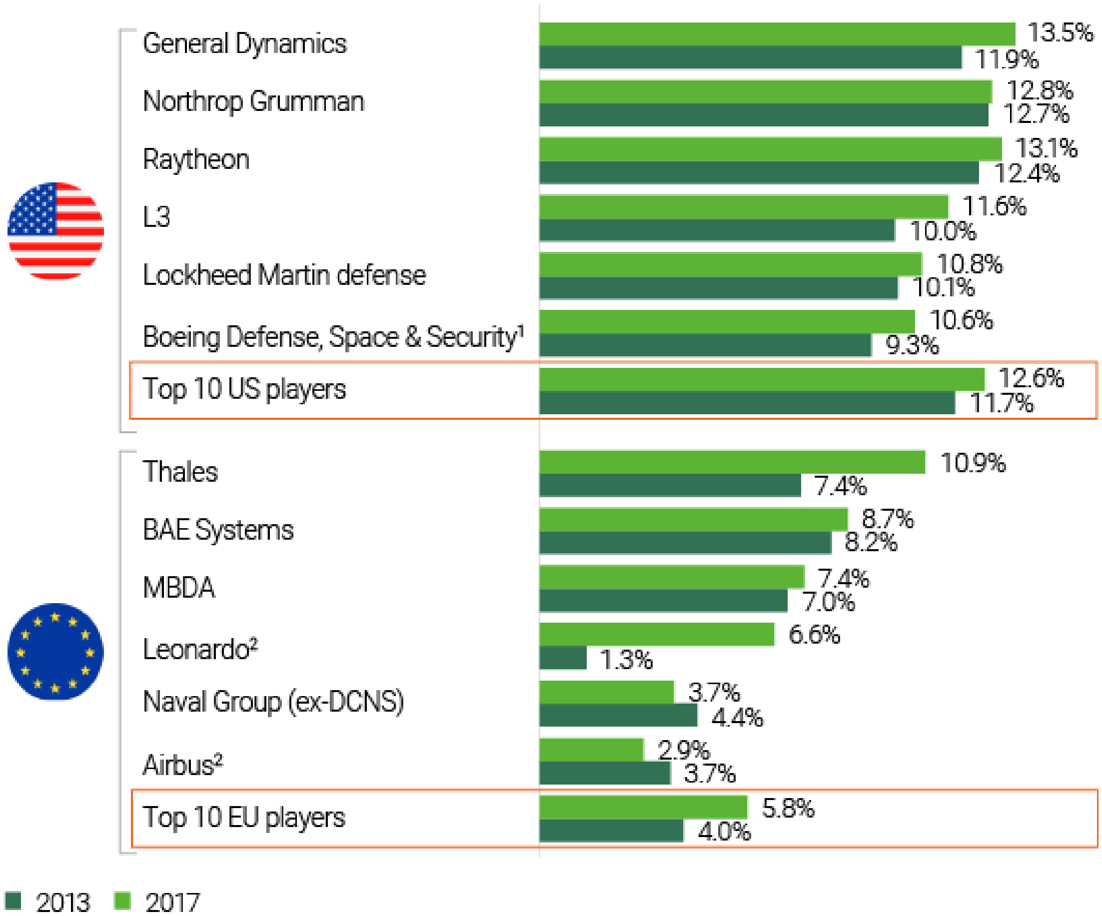
2. Improve program governance and accountability.

   Lessons must be learned from past programs such as the A400M, NH90, and Tiger joint developments—among them, much better governance and accountability, and the need for a unique industrial program lead. Also, better alignment of weapons systems specifications, rather than a compilation of all armed forces requests, is critical. Finally, there must be less political interference—the maneuvering and ensuing disputes involved in the choice of engine for the A400M should not be repeated, for example.

3. Consolidate for a more profitable European defense industry.

   Although leading European defense companies have improved their profitability in recent years, they are still far behind their US peers. European players saw 5.8% EBIT margin in 2017 while US players saw 12.6% (figure 2).

FIGURE 2: 2013 AND 2017 EBIT MARGIN OF MAIN US AND EU DEFENSE PLAYERS (PERCENTAGE OF REVENUES)



1. Operating Profit before tax margin reported instead of EBIT
2. Only defense business as reported in company reports
Source: News Top 100 (top 10 US companies only); company annual reports; AlixPartners analysis

Key levers include design-to-cost for product development, operational excellence in production, and best-in-class sustainment practices, supported by new digital solutions (a joint AlixPartners–MIT study shows that fit-for-future companies are over 15% more profitable than their competitors).

Consolidation of European defense players would trigger scale effect and therefore profitability. Private equity funds play a significant role in accelerating the pace of consolidation, as illustrated by the 2017 sale of Airbus Defense Electronics to KKR.

These three actions will enable European defense companies to better capture opportunities that still remain largely untapped in their native European market and be more successful in export markets.

Now is the time for Europe to step up its game and leverage its fantastic innovation capabilities. The upcoming FCAS aircraft program appears to be the last chance to increase European autonomy and independence on critical defense systems.

FOR A DEEPER DISCUSSION ABOUT THIS TOPIC AND HOW YOU MIGHT PREPARE, CONTACT:

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ABOUT US

For nearly forty years, AlixPartners has helped businesses around the world respond quickly and decisively to their most critical challenges – circumstances as diverse as urgent performance improvement, accelerated transformation, complex restructuring and risk mitigation.

These are the moments when everything is on the line – a sudden shift in the market, an unexpected performance decline, a time-sensitive deal, a fork-in-the-road decision. But it's not what we do that makes a difference, it's how we do it.

Tackling situations when time is of the essence is part of our DNA – so we adopt an action-oriented approach at all times. We work in small, highly qualified teams with specific industry and functional expertise, and we operate at pace, moving quickly from analysis to implementation. We stand shoulder to shoulder with our clients until the job is done, and only measure our success in terms of the results we deliver.

Our approach enables us to help our clients confront and overcome truly future-defining challenges. We partner with you to make the right decisions and take the right actions. And we are right by your side. When it really matters.