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policy brief

How should Europe respond to sovereign investors in its defence sector?

By Clara Marina O'Donnell

★ A small number of sovereign investors, sometimes originating from countries with non-democratic governments, are buying shares in Europe's aerospace and defence sector. Such investors can provide useful capital. But they could also leak sensitive information or interrupt the supply of military equipment to European armed forces.

★ Some EU governments have responded by calling for tougher controls on foreign investment in their defence industries. But other member-states have become less averse to state-owned enterprises and sovereign wealth funds in the aftermath of the global financial crisis.

★ EU countries should not reject sovereign investments in their aerospace and defence industries in principle. Instead, governments should rely on investigative committees to assess the risks of sovereign and other foreign investments. And in the long term, EU member-states should co-ordinate their efforts to monitor, and if necessary block, bids by foreign investors.

The global economic crisis has transformed the debate in Europe about sovereign wealth funds (SWFs) and state-owned enterprises (SOEs). Until recently, European governments and public opinion mainly worried that SWFs or SOEs were vehicles that could allow undemocratic states to gain control of valuable financial and industrial assets in the West. The US, Germany and Australia tightened their controls over foreign investments. France set up its own SWF with an explicit mandate to protect domestic enterprises against unwanted takeovers from abroad. As the global financial crisis unfolded in 2008, however, some European governments started to see sovereign investors in a more positive light, welcoming them as a source of badly-needed capital. At the height of the crisis, some SWFs bought billion-dollar stakes in the likes of UBS, Barclays and Credit Suisse. In 2010, the Greek government was encouraging Chinese SWFs to buy government bonds to alleviate its economic troubles.

Sovereign funds, for their part, incurred heavy losses during the financial crisis, which encouraged many to revisit their investment strategies. After focusing on western banks, some groups started to diversify their assets and invest in anything from farmland to manufacturing companies. Such diversification strategies could conceivably lead to a stronger interest in European aerospace and defence firms. That industry is less cyclical than other sectors of the economy and can provide substantial financial returns – although forthcoming cuts in defence budgets across Europe are likely to make some defence manufacturers less attractive investments. Sovereign funds could also be interested in European aerospace companies because of the possibilities for accessing advanced technology through joint ventures with such firms. Governments that own SWFs are increasingly keen to use their funds to develop their national industries and diversify their economies.

Small but controversial players

Groups with ties to governments from the Gulf, the former Soviet Union and emerging Asia have become increasingly important global investors. To date, however, sovereign investments in aerospace and defence are still relatively rare. Of the $3 trillion in

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assets managed by SWFs globally, it is estimated that only 1 per cent is invested in defence companies.[1] Some sovereign investors have held small stakes in the European aerospace and defence industry for many years, including the Government of Singapore Investment Corporation. The Norwegian Government Pension Fund also used to own stocks in various defence companies, but its strict ethical code has forced it to sell several of these holdings.

1 Based on reported transactions in 1995-June 2009 collected by Dealogic, quoted in Steffen Kern, 'Staatsfonds - Staatlich investitionen in der finanzkrise', Deutsche Bank presentation, July 2009.

In recent years, some sovereign investors have become increasingly active in the sector. Gulf-based groups in particular have acquired stakes in small aerospace firms, and invested in some of Europe's largest groups. In 2006, Dubai International Capital (DIC) bought Doncaster, a British company which supplies aircraft components amongst other things. The same year, Mubadala, a sovereign investor from Abu Dhabi, bought around 30 per cent of Piaggio Aereo, an Italian civil aircraft manufacturing company. And a consortium of SWFs from Dubai and Abu Dhabi took over the German firm SR Technics, one of the world's leading independent aircraft maintenance providers.

Several sovereign investors have acquired significant stakes in Europe's largest aerospace company, EADS. In 2007 DIC became one of the largest direct shareholders when it bought just over 3 per cent of EADS, while the Qatar Investment Authority (QIA) expressed a desire to acquire a 10 per cent stake. DIC and QIA have also been significant investors in EADS' French and German institutional shareholders – Lagardère and Daimler.[2] In 2006, a Russian bank, VTB, bought over 5 per cent of EADS, and people close to the Kremlin publicly expressed an interest in doubling that share. This controversial investment triggered calls in Berlin for stronger protection against foreign investment.

2 When the European aerospace giant was formed in 2000 by a merger of French and German companies, the respective governments agreed that the firm would have a core shareholder from each country in order to maintain a certain amount of control over the company.

In recent years, several Gulf and Russian groups have also developed joint ventures with large European aerospace and defence manufacturers, although mainly within the civilian field. Mubadala has partnerships with EADS, Finmeccanica and Rolls Royce. EADS and Rolls Royce have joint ventures with the Russian defence firm Irkut, while Finmeccanica co-operates with Russian groups such as Oboronprom Corporation in building helicopters, jet planes and in the railway sector. The Italian company also has various partnerships with government-owned groups in Libya.

Threats and opportunities

The defence industry delivers the military capabilities that states rely on for their national security. In the 1980s and 1990s, when most European defence firms were fully state-owned, governments did not need to worry about the risks involved in foreign ownership. Since then, privatisation, stock market listings and market liberalisation have increased the competitiveness of the European defence industry, but also left defence companies vulnerable to unsolicited foreign investments, sovereign or otherwise.

SWFs and SOEs can be useful sources of capital for defence companies, especially now that fiscal pressures are forcing governments across Europe to cut defence budgets. Through joint ventures, sovereign investors can also facilitate the access of European companies to their home markets and to their lower-cost labour force.

However, sovereign investors (like other investors) could leak information about sensitive military equipment produced by a defence company. SWFs and SOEs could also threaten the security of supply of a nation's armed forces: for example, if a sovereign investor bought a French defence firm which produced encrypted radios for the French army, it could stop producing the radios for political reasons. In addition (as other private owners might do), the sovereign investor could stop selling radios because it did not think them commercially viable. Or the firm could be forced to interrupt supplies to the French army because it was overwhelmed by multiple orders from other customers.

The risks that a sovereign investment could pose largely depend on its size and the intentions of the investor. If SWFs or SOEs hold only limited stakes, their broader strategic considerations are less relevant. Consequently, in both Europe and the US, investors in defence companies do not have to disclose their purchases below a certain threshold.

If a sovereign fund acquired a blocking minority, sought a seat on a company's board, or bought a defence manufacturer outright, it could potentially influence the firm's strategy and access sensitive information. So far, governments have only allowed sovereign groups to make sizeable investments in civil aerospace firms that do not produce sensitive equipment, such as Piaggio Aero and Doncaster. Whether European states would accept such participation in their leading defence firms largely depends on whether they considered the investor's home government an ally. Some European governments might agree to board members from certain well-trusted and transparent SWFs, for example from Singapore or Norway. After all, Thales and Finmeccanica are still partly owned by the French and Italian governments, respectively. Yet both companies are important defence suppliers to the British ministry of defence. Sovereign funds from Russia or China are likely to be less welcome. EADS publicly informed Moscow that VTB could not expect any involvement on its board.

Even cases where SWFs and SOEs formally remain passive investors could be risky. A company's value can drop if a shareholder suddenly sells significant stakes. Sovereign funds might threaten withdrawal in an attempt to influence the management's behaviour. How much exposure to an individual investor creates vulnerability is open to debate. The UK does not allow any foreign shareholder to own more than 15 per cent in BAE and Rolls Royce. But 15 per cent can already give an investor the ability to influence the share price.

In addition, sovereign investments could make it harder for European defence companies to supply some foreign markets. Even if a European manufacturer, and its host government, judge that an investor is safe, other countries may take a different view. The US government is even more concerned than European states to protect information relating to sensitive military equipment. The Pentagon may be less willing to buy from a European company that has ownership ties with Russia, China or other countries which the US considers as potential threats. According to defence experts, such concerns contributed to EADS' protests against VTB's drive to increase its stake in the company. EADS was (and still is) competing for a contract to supply the US airforce with aerial refuelling tankers, and it feared that ties with a Russian bank would hurt its bid.

No need to worry

About 90 per cent of Europe's defence industrial base is located in six countries: Britain, France, Germany, Italy, Spain and Sweden. EU governments have broadly excluded the defence sector from the rules and obligations which apply to other areas of the single market. As a result, the extent of state ownership and the attitude towards foreign investment vary widely from country to country. The UK and Sweden are the most open to foreign ownership. The British government began selling its defence companies in the 1980s as part of a wider effort to privatise nationalised industries. The state believes that national ownership in defence is not necessary, so long as the investment, skills and technology remain on home soil. Today most UK defence manufacturers are publicly listed companies and around 25 per cent of the defence industrial base is foreign-owned. [3]

[3] *Defence Industrial Strategy, UK Ministry of Defence, 2005.*

Sweden started privatising its defence industry in the 1990s, and nowadays the government has no equity in its former companies. Foreign groups have acquired several large Swedish defence manufacturers. The British defence giant BAE owns Bofors and Hagglunds, and the German shipbuilder HDW has bought Kockums. The rest of the industry has extensive foreign participation. Until recently BAE owned up to 20 per cent in Saab AB.

France lies at the other end of the spectrum. Since the 1990s, the government has partly privatised some firms in order to allow them more freedom of action and to promote European consolidation. But the French authorities believe that certain strategic assets should be owned by the state. Until recently, Paris had full control of DCNS, the naval shipyard; it still entirely owns Nexter and SNPE; and it holds stakes of approximately 30 per cent in Thales and Safran. As mentioned above, the French government has also worked closely with Berlin to create a tightly balanced shareholding agreement within EADS, which gives equal weight to the French and German institutional shareholders, Lagardère and Daimler.

In Spain and Italy, the state also remains an important shareholder in most large defence companies, although both countries have been more open to outside investors than France. The Italian government owns over 30 per cent of Finmeccanica, a group which controls about 80 per cent of the Italian defence industry, and over 90 per cent of Fincantieri. The Spanish government fully owns Navantia and it held 99 per cent of CASA until the firm became part of EADS (in which Spain has a stake of approximately 5 per cent).

The Italian government allowed Mubadala to become a significant investor in Piaggio Aereo, and allowed a European private equity firm, Cinven, to acquire Avio, an aerospace engine manufacturer. Spain sold one of its large defence firms, Santa Barbara, to an American company, General Dynamics. And when Madrid privatised the defence firm Indra in 1999, it allowed foreign investors to buy 35 per cent of the shares for sale (with the remaining 65 per cent being reserved for Spanish investors).

Most European governments maintain some control over privatised defence firms. Many have golden shares which confer them special rights, such as blocking power over strategic decisions or potential new shareholders. The UK notably holds golden shares in BAE and Rolls Royce. In addition both companies' terms of association require the chairmen and certain board members to be UK nationals. France's golden share in Thales gives the state the right to oppose any outside investor acquiring more than 10 per cent of shares. The government also has an observer on the firm's board of directors. Madrid kept a golden share in Indra for seven years after its privatisation, while Rome has golden shares in various companies, including Finmeccanica and Fincantieri. The state also must authorise investments of over 3 per cent in Finmeccanica.

In addition, European governments have introduced laws giving them the power to investigate and block foreign investments which they consider detrimental to national security. Ministerial committees frequently request guarantees from new owners to ensure that supplies to their armed forces are maintained and that sensitive information remains secure. Very few proposed investments have been formally blocked. In large part, this is because prospective investors informally enquire whether a bid would be acceptable before launching a formal bid.

Compared to other European countries with large defence industries, Germany introduced rules to regulate foreign investment relatively recently. German defence companies have traditionally been owned by large families or financed through close shareholdings amongst the big German industrial groups and banks. But as German manufacturers started to raise funds on the international financial markets by selling equity stakes to foreign investors, German authorities became increasingly nervous about their vulnerability to foreign takeover. In 2004, after the American firm One Equity Partners controversially acquired the German shipbuilding company HDW, the government passed a law which allows it to block foreign investments in defence companies. After VTB's investments in EADS, the government also considered introducing golden shares in the European aerospace group.

The various national regulations in place across Europe provide sufficient protection against the potential risks posed by foreign investments, including from sovereign groups. In addition, in the unlikely event that an unwelcome investor managed to take control of a defence company, the state could make it impossible for the firm to operate. For example, a government could refuse to grant export licences to the company or to buy the military equipment it produced. European states have often discouraged acquisitions within their defence industries by other European defence manufacturers – mostly to the benefit of their national producers. In light of such a cautious attitude, it is highly unlikely that a hostile investor from Russia or the Middle East would succeed where companies based in neighbouring EU countries had failed. So, while remaining vigilant, governments and defence firms should be open to sovereign investments in principle.

An EU investigative committee

Several European countries actually maintain excessive controls on foreign investment and some of the legal requirements in place across Europe are too rigid – be it overall limits on foreign shareholdings or the need for board members to be national citizens. To avoid unnecessarily restricting the possibilities for benign foreign investments, European governments should eliminate some of their rules and rely primarily on ministerial committees to oversee foreign bids.

Ministerial committees provide a degree of flexibility. By examining requests on a case by case basis, they have the ability to block only the risky investments. But governments must ensure the investigative process is transparent and robust. The outcome should not be undermined by public pressure, as occurred when Dubai World attempted to invest in US ports. In 2006 the US Committee on Foreign Investments considered it was safe for the Emirate company to take over the management of several American ports. But the public backlash was so fierce that Dubai World withdrew its bid.

In the long term, EU member-states should co-ordinate their rules on foreign investment in the defence industry. Currently, there is little transparency amongst European countries. Yet foreign investments – sovereign or otherwise – have the potential to adversely affect a fellow member-state's security of supply. For example, the German army might rely on radios produced by a company in Sweden. Deployed German troops could be put at risk if new owners of a Swedish defence firm decided to stop producing such equipment.

For years, EU countries have talked about better integrating their defence markets, acknowledging that their fragmented national industrial bases are too small to sustain. So far, governments have been slow to deliver on that objective. But as the cost of defence equipment spirals and defence budgets continue to shrink, the pressure on member-states to open their defence markets will grow. If pan-European supply chains develop, member-states will become increasingly reliant on defence companies based in other EU countries to provide them with components or finished military equipment. A co-ordinated system across the EU to monitor foreign investment, with a common investigative committee, would increase transparency and make life simpler for investors. It would also help to give EU member-states stronger guarantees on their security of supply.

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