WHAT LIES BENEATH?

WHO OWNS BRITISH DEFENCE CONTRACTORS AND DOES IT MATTER?

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Abstract

This paper presents the findings of research into the distribution of the rewards from capital used in defence production. Much existing research has examined the supply chain in the production of defence goods, but there have been few attempts to look at the ownership of suppliers. First, the paper examines two theoretical issues: why the identity of shareholders in defence contractors should have any economic or political significance, and whether the use of capital in defence industries should in principle be expected to be the same as that in any other industry. It then investigates the identity and ownership of the contractors concerned in 2003-4, using several case studies. It finds that many of the largest suppliers to the UK government are foreign-owned or controlled, and it finds evidence of a surprising degree of American equity participation in major British contractors.

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1. INTRODUCTION

There are several reasons why the ownership of defence contracting companies is of significance. Firstly, many governments, including those of the United Kingdom and the United States, have extended considerably their use of public/private partnerships, private financing arrangements, outsourcing, and other arrangements that amount to various forms of privatization. For the sake, at the very least, of transparency in the dealings of the state with private business it ought to be known who are the ultimate financial beneficiaries, and by how much they benefit. Secondly, there may be reasons of security for wanting to know the identity of owners – would the British government, for example, be content for Chinese or North Korean interests to control a major defence supplier, and will the owners, whoever they are, be reliable sources of finance? Thirdly, there may be reasons of economic governance: are the owners in a position to collude in monopolistic or anti-competitive practices; do they behave towards other stakeholders in an acceptable fashion?

The issue of defence company ownership issue takes on a greater urgency with the recognition of the revolution currently sweeping through the global defence industry, changing fundamentally its character, location, focus and modus operandi (Matthews and Tredinnick, 2001). Following the end of the Cold War in 1989-1990, the industry and the defence sector more generally underwent considerable restructuring and more recent developments have led to it undergoing further rapid transformation (Dunne et al, 2003; Braddon, 2000). The shift in military doctrine and strategy from the demands of the ‘mutually assured destruction’ doctrine of the Cold War years to the evolving ‘rapid reaction’ approach with its associated humanitarian requirements, network-centric warfare developments and ‘homeland security’ issues linked to the terrorist threat have brought and will continue to bring new players and new owners into the defence supply business of the future. Every aspect of the defence sector is being reconfigured from defence budgets, through procurement policies and military objectives and strategy to leading-edge technological developments designed to meet the requirements of the move towards ‘network centric’ warfare (see, for example, Braddon 2004, Hartley, 2003a, 2003b). These changes are certain to result in a further fundamental restructuring of the UK defence industrial base (Hayward, 2005). Major ownership changes have already occurred (Guay and Callum, 2002; Hartley and Sandler, 2003) and, as the revolution spreads further through the supply base of the industry (Dowdall, 2004), further ownership adjustments seem inevitable

2. PROVISION OF CAPITAL TO THE DEFENCE INDUSTRY

There are two main respects in which the provision of capital to a defence contractor might have special characteristics. The first would affect any contractor to the public sector: government generally represents a more favourable credit risk than other customers. Since government is less likely than private businesses to renege on its financial obligations, a private company doing business with it faces a lower risk, and therefore, ceteris paribus, a more attractive risk-adjusted return. This would be as true of a defence contractor as of any other kind. The second is more particularly true of defence, although it could in principle apply also to other fields. Governments need security of supply, sometimes over a long period of time, and they are likely to favour suppliers who can guarantee this.

Once the contract is granted, however, the contractor may have more negotiating power than it would otherwise have because the government is vulnerable to interruption of supply. These two considerations suggest that defence contractors are in a relatively privileged position as business enterprises and helps to explain the long-standing popularity of defence contracts in the business world. This is likely to be reflected in the rates of return available to such businesses, which theory would be adjusted by the markets to reflect a lower risk profile.

The categories of financial capital needed in a defence contracting should be exactly the same as those in any other commercial enterprise. These would naturally include equity share capital, securitised borrowings such as bonds and convertible stocks, some of which may have the status of quasi-equity, and borrowings from financial institutions such as banks. These all represent the liabilities on the balance sheet, and the providers of them are the beneficiaries of returns to capital. There may, of course, be circumstances in which the holders of debt can acquire ownership-like rights, for instance on bankruptcy or liquidation. Normally, however, the ownership rights giving the potential for control over the company will arise from the share capital. Unless the company is in severe financial difficulties or is seeking to raise large amounts of new capital it will be the equity holders, amongst the providers of finance, who will have most power to decide the destiny of the company. Returns to holders of capital come in various forms. These are mainly through dividends and through legal participation in the value of any potential liquidation interest for shareholders, and through interest for debt holders.

Information about shareholding in major corporations is generally more accessible than information about the providers of loan finance. Most major defence contractors are companies having a formal listing on one or more stock exchanges and either they, or some other public authority, often require the disclosure of major equity holdings. This may be done through the annual report and accounts of the company or may result from an announcement to a stock exchange. In some jurisdictions it is possible for members of the public to access a copy of the shareholders' register on payment of a fee. Securitised debt may be held in registered form, but the register may not be available to the public and owners are less easy to identify than shareholders. Bearer bonds are not registered and it is virtually impossible to determine ownership. Bank lending is generally confidential, although large syndicated loans will be in the public arena, and not easy to research.

Most shareholders have the same legal status as one another, but they are likely to differ in many other ways that are of potential interest in this study. The main ways in which they may differ are: size of shareholding (measured as a proportion of total share capital, or of total "free" share capital), time period over which the shares are held, degree of activity or passivity in relation to corporate votes and actions, and their own legal or financial status. With successive shareholder registers at regular time intervals and information about the owners it should be possible in principle to analyse the ownership structure and character of any given company in accordance with the variables listed

The shareholdings that would probably be of most interest in respect of defence-related companies would be those held by governments or other public agencies, large (over perhaps 10%) strategic stakes held by any non-government legal entity, but especially by commercial or industrial groups with multi-national or other defence interests, and foreign shareholders. Other categories could also be of interest in different contexts. Any researcher would be seeking to spot potential covert or overt connections, networks, cartels, or agreements.

BRITAIN'S DEFENCE CONTRACTORS

In the Defence Analytical Services Agency statistics for 2002-2003 (DASA, 2003) 28 organisations are listed in the first three ranks of defence contractors to the UK Ministry of Defence. These categories are first, those receiving contacts of over £500m, second those between £250-500m, and third those between £100-250m of (see Table 1 above). In aggregate these companies account for at least £5.5bn of the UK defence procurement budget out of a total over £6bn annually.

Table 1: 28 Biggest MoD Contractors 2002/03

Over £500 million

- BAe Systems (Operations) Ltd
- BAe Systems Electronics Ltd (both part of BAe Systems PLC, the listed company)
- NETMA (Nato Eurofighter and Tornado Management Agency, multi-national public sector, including MOD)
- QinetiQ Ltd (public/private, some US)

£250m - £500m

- AWE Management Ltd (3 - way BNFL, Lockheed Martin, Serco)
- Defence Science and Technology Laboratory (MOD)
- Devonport Royal Dockyard Ltd (actually run for profit by DML - see separate slide)
- General Dynamics United (USA listed company)
- MBDA UK Ltd (EADS 37.5%, BAe 37.5%, Finmeccanica 25%)
- Rolls Royce PLC (London-listed but at least 50% foreign owned)
- Westland Group PLC (now owned by Finmeccanica of Italy)

£100m - 250m

- ABRO (MOD-controlled vehicle maintenance and engineering trading agency)
- Alenia Marconi (BAe/Finmeccanica jointly owned)
- Annington Receivables Ltd (owned by a company ultimately 51% controlled by Nomura of Japan)
- Babcock Support Services Ltd (part of UK-listed Babcock PLC)
- BAe Systems PLC (the listed holding company)
- BFS Group Ltd (UK company, owners obscure)
- British Telecommunications PLC (the BT)
- DARA (Defence Aviation Repair Agency, controlled by MOD)
- EDS Defence Ltd (subsidiary of USA EDS computer services giant)
- Fleet Support Ltd (50/50 BAe and Vosper Thorneycroft, both UK listed)
- Fujitsu Services Ltd (owned by Japanese Fujitsu Group, itself mainly Japanese owned)
- IBM United Kingdom Holdings Ltd (USA control)Interserve (Defence) Ltd (part of UK listed group)
- Lockheed Martin Corp (guess!)
- Other UK Government Departments (sic in MOD document)
- Royal Ordnance PLC (part of BAe group)
- Serco Group PLC (UK listed company)

We will first explore the ownership issue for UK defence companies by examining a number of these major UK suppliers and identifying what other defence interests, national or international, they influence through ownership linkages.

The UK's largest defence supplier is BAE Systems, a major prime contractor, a systems integrator and by far the dominant player in the UK defence market. BAE Systems' ownership linkages are both extensive and global in nature. The company owns a range of other UK defence suppliers, including all of Royal Ordnance Defence and Alvis; 37.5% of MBDA, the guided weapons supplier; as well as 35% of the Swedish defence contractor, Saab AB; 50% of European Aerosystems, the Anglo-French future aircraft technology research group; 20% of Aeronautical Technologies Company (an Anglo- South African venture); 50% of Italy's defence electronics supplier Alenia Marconi Systems and 25% of New Astrium, the Anglo-French-German satellite company. The significance of its growing global acquisition strategy is explored further below.

The UK's military aero-engine manufacturer, Rolls-Royce plc, owns 100% of the US aero-engine company, Allison and of the German aero-engine organisation, Rolls-Royce GmbH. It also owns 50% of the Anglo-French aero-engine company Rolls-Royce Turbomeca and 33% of the Anglo-German aero-engine company MTU Turbomeca Rolls-Royce (MTR) GmbH. The company also owns all of Reumech, the South African light armoured vehicle manufacturer and is involved in at least two other global co-ownership arrangements with a 50% ownership of the aero-engine maintenance company Rolls-Royce Services Limitada Inc in the Phillipines and 46.8% of IPT SA in Spain.

QinetiQ, established in July 2001, is the world's first leading-edge national defence laboratory to be in the process of transition to the private sector. It derives principally from the former UK Defence Evaluation and Research Agency (DERA) which originally led 'blue skies' testing, research and development for the UK Ministry of Defence and was responsible for a series of major technical developments such as the invention of liquid crystal displays, flat panel speakers, Chobham armour and microwave radar. Interestingly, while still officially UK government controlled (a 57% government shareholding) and formally a public-private partnership moving towards stock market quotation, QinetiQ already owns the US computer software and support company, Westar Aerospace and Defence Group as well as the US engineering and technology development company, Foster-Miller Inc. Such foreign ownership is likely to increase considerably once the company is fully privatised.

The Smiths Group has a significant range of aerospace, threat detection, security and engineering activities related to defence across its 4 divisions. A key player in the UK defence supply market, on the threat detection and security side Smiths also owns ETI Technology Inc., a US-based, privately owned company that specialises in the detection of harmful biological agents and Farran Technology Limited, based in the Republic of Ireland as well as SensIR Technologies LLC, a leading US manufacturer of infrared-based analysers and TRAK Communications Inc., a leader in the design and manufacture of microwave sub-systems, antennas and related components,. On the speciality engineering side of its business, Smiths owns the Chinese-based Tianjin Timing Seals Co Ltd and its associated technology. The aerospace business of Smiths has also been expanded by the acquisition of Integrated Aerospace Inc., a privately owned, California-based supplier of specialist landing gear systems and of the specialist aero-engine component manufacturer, Dynamic Gunver Technologies (DGT) of the US. Cobham plc is another important UK defence supply company that operates in three sectors - aerospace systems, avionics and flight operations & services. Originally founded in 1934 as a British company, through organic growth and acquisitions, the company has become a globally focused group producing a world-class range of niche products and systems for military and civil aviation, marine, homeland security and other related markets. The group owns some 70 companies located across the world. For example, Cobham owns ACR Electronics Inc in the US; Air Precision SA in France; Chelton Applied Composites in Sweden; Drager Aerospace in Germany; Falcon Special Air Services in Malaysia; Mastsystem Int'l Oy in Finland; National Jet Systems Pty Ltd in Australia; Orion in Canada; and also Spectronic Denmark A/S in Denmark.

Similar acquisition strategies by the key players in defence markets outside the UK also impact on the ownership issue. For example, the acquisition of the UK company Racal by Thomson-CSF in 2000 made the French company the second largest defence company operating in the UK and enabled it to use the British operation to access the US market more easily.

Again, the changing ownership process in the defence sector is frequently more far-reaching than it seems on the surface and can exert a significant influence on procurement success in different markets. A good example of this was the takeover of Marconi Electronic Systems by BAE in January 1999. While dealing a severe blow to hopes of European defence industry consolidation designed to match the market power of the US, the move by BAE Systems also gave them control of an American electronics company, Tracor, which GEC Marconi had themselves acquired in 1997. With 10,000 US employees, Tracor became the largest US defence enterprise owned by a European-based company. Both GEC and BAE had to employ a 'proxy' board to run the Tracor company, comprised of US citizens only but felt that this 'inconvenience' was more than compensated for by the access ownership afforded to the lucrative and expanding US market.

Additional ownership changes helped to further strengthen the position of BAE Systems in the US market. In April 2000, BAE gained ownership of Lockheed Martin Control Systems (a flight controls designer and manufacturer) and in July 2000, became owner of Lockheed Martin's Aerospace Electronics business division. Such acquisitions have given BAE Systems an employment 'footprint' in the US of some 25,000, helped secure important contracts with US prime contractors and led to the official recognition in 2003 of BAE Systems as an 'American' company by the Pentagon in the context of its defence procurement strategy.

While accessing the US defence and aerospace market remains a key reason for ownership changes in the industry, the ownership route may not always deliver a beneficial outcome as initially intended. For example, the merger of the German car company Daimler-Benz (the parent company of the German defence/aerospace company Dasa) with the US car company Chrysler in 1998 opened up new market opportunities in the US for Dasa. Initially, considerable success was enjoyed with Dasa selling a significant order of Mercedes armoured vehicles to the US military. However, the formation of the Franco-German EADS company (European Aerospace, Defence and Space company) in 2000 brought the aerospace division of Dasa under EADS control and with it, Dasa experienced the disadvantages of a French connection in the political aftermath of the Iraq war and US antipathy towards French industry.

At the level of the defence industry itself, then, recent restructuring and consolidation have created a complex, interwoven cobweb of trans-national corporate ownership that is both hard to disentangle and effectively conceals where influence and market power may really lie. In reality, however, this ownership maze that lies on the surface of the industry is only part of the picture. Hidden beneath this evolving defence industry infrastructure lies an equally important level of ownership – that of the capital providers to the industry and it is this which we now turn to explore.

CAPITAL PROVIDERS TO THE INDUSTRY

An analysis was undertaken of the shareholder registers the 28 companies listed in Table 1 above to identify the major shareholders. It should be stressed that the shareholder register of a public listed company is constantly changing by its very nature. Shares are traded daily on the stock market and large shifts in the overall profile of ownership can occur quite rapidly. The figures discussed below should therefore be seen as a snapshot in time, as the day before and the day after would have been slightly different. The major shareholders do, however, tend to change much more slowly.

Estimating the approximate balance of ownership from the share registers, showed that only 11 (roughly 39%) of the 28 are wholly British owned or controlled (see Table 2). Four are Anglo-American, four are largely American, three are continental European, and two are Japanese.

Table 2: Major British Defence Contractors: nationality of ownership/control	
British government	5
United Kingdom	8
Anglo-American	5
United States	5
European	3
Japanese	2
Notes: Roundings and estimations used for listed companies. Sources: Company annual reports and websites.	

A well-known and striking feature of the 2002/3 list of contractors is the dominant position of the BAE Systems PLC group (BAES). Two of the four contractors receiving more than £500 million from the MoD are part of the group, the group owns 37.5% of one of the seven contractors in the £250m-£500m band, owns two of the contractors in the £100m-£250m band, and owns 50% of another. By any standards this is a very powerful industrial presence. What the official tables do not reveal is the ownership of BAES itself.

On 17th June 2004 the largest five shareholders each had a small percentage of the shares in issue, totalling only 19.9% (see Table 3). This is not a high degree of concentration for unconnected investors. Three of them were American, and all of these were "passive" investment managers rather than industrial groups investing for reasons of corporate strategy. The largest of them, Brandes, managed $82.7 billion at March 31st 2004 (Annual Report), an amount far in excess of the market capitalisation of BAES. Precise numbers cannot be computed because access was not available to details of very small shareholdings, but of the top 170 shareholders 97 were from outside the UK, with 44 of them American.

Table 3: BAE Systems PLC – Major Shareholders	
Brandes Investment Partners	6.6%
Barclays PLC	4.1%
Legal and General Investment Group	3.2%
Capital Group	3.0%
Franklin Group	3.0%
Notes: 1. The percentages are rounded to one decimal place 2. The figures are minima, as it is possible that some small shareholdings associated with the same shareholders have not been identified on the register. 3. Source: Bloomberg, 17th June 2004	

The overall profile that emerges for BAES is of an international and well-spread share register with no large strategic stakes. This is consonant with the commercial position of the company as a global competitor in major defence markets. In 2004 the main owners of it were American and British portfolio investors. Their investments would take on a greater strategic significance if they became less "passive" and more "active" investors.

Four of the other major defence contractors were investigated: QinetiQ Limited, Rolls Royce PLC, Devonport Royal Dockyard, and Smiths Group PLC. All of them, like BAES, have a strong American presence in their ownership. QinetiQ is an interesting case, as the British Government, which is the majority shareholder, still technically controls it, but it has a major American shareholder, described in the Annual Report of the company as a "strategic partner". This is Carlyle Group, a private equity investment manager with a strong interest in the defence field, a company that could in no way be described as a passive investor. The stated public aim of the management and shareholders of the company is to bring about a public flotation in the relatively near future. It remains to be seen what proportion of the shares after any flotation will be held by overseas interests (See Table 4).

Table 4: QinetiQ – Major Shareholders	
British government	57.0%
Carlyle Group	30.0%
Employees	13.0%
Notes: The percentages are rounded to one decimal place. Source: "Western European Industry Ownership Jigsaw", in Defence Systems Daily, 2005. .	

Rolls Royce is different again. The British government is not a shareholder, and like BAES it is a public listed company, but it has a much more concentrated share register than BAES. Again, American interests are very much in evidence (see Table 5). The five largest shareholders were all non-UK, and together owned at least 38% of the shares. It could be argued that since Franklin Templeton Group holds shares on behalf of funds or clients whose

Table 5: Rolls Royce PLC – Major Shareholders	
Franklin Templeton Group	17.0%
BMW	9.5%
Goldman Sachs	5.3%
Allianz AG	3.4%
Capital Group	3.0%
Notes: The percentages are rounded to one decimal place. Source: Bloomberg, 17th June 2004 .	

assets it manages rather than for its own principal interest, it is of no special strategic significance. A stake as large as 17% might, however, be of great potential interest to an industrial group with defence interests, and Franklin could theoretically sell at any time. Of the top 170 shareholders at least 99 are non-UK, with 49 of them American.

Devonport Royal Dockyard has a special Public/Private Partnerhsip (PPP) operating structure in which the dockyards themselves are still owned by the British Government but the business carried on within it is done by a private sector company, DML. This is controlled by an American oil services giant, Halliburton, who have become a major contractor to the US Department of defence through their support operations in Iraq. There are also two large UK shareholders, albeit in a minority position (see Table 6).

Table 6: Devonport Royal Dockyard – Major Shareholders in DML (managers of yard)

Halliburton Corporation	51.0%
Balfour Beatty PLC	24.5%
Weir Group PLC	24.5%

Source: "Western European Industry Ownership Jigsaw", in Defence Systems Daily, 2005
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The largest single shareholder of Smiths Group PLC is also American, as are 50 of the top 170 shareholders (see Table 7). This shareholder is Capital Group, which was also the fifth largest shareholder in BAES. Two of the other five largest shareholders also had large shareholdings in other contractors to the British Ministry of Defence: Franklin Templeton Group, which was also the largest shareholder in Rolls Royce PLC, and Legal and General, the British financial services group, which was also the third largest shareholder in BAES. Non-UK investors held at least 40% of the share capital and represented 105 of the top 170 shareholders.

Table 7: Smiths Group PLC – Major Shareholders

Capital Group	12.0%
Franklin Templeton Group	7.0%
Legal and General PLC	4.2%
Cater Allen	3.3%
Trimark Investment Man.	2.8%

Notes: The percentages are rounded to one decimal place.
Source: Bloomberg, 17th June 2004
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All the investing companies mentioned as major shareholders in Smiths Group PLC were also found to have extensive interests in many other defence contractors. This may mean nothing more than that the investment policy of these investors current at the time favoured the defence sector, or it may have a wider meaning that is not immediately apparent. Further research and thought is clearly needed.

CONCLUSIONS

Major changes have been taking place in the global defence industrial base as corporations and governments respond to the end of the cold war and the wider effects of business globalisation. British defence contractors has shown the degree to which they have been positioning themselves for optimal strategic advantage in this new world. They have acquired substantial defence-related productive assets in other countries and especially the USA. This analysis of the ownership structure of British companies has shown the degree to which they in turn have developed international shareholder bases, with American investors figuring prominently.

The degree of foreign ownership and the involvement of individual shareholders across the different defence contractors was surprising. It would seem to represent a further stage in a financial and industrial integration of British, American, and to a lesser extent, continental European defence interests. In the case of the UK and the USA it mirrors a close military co-operation in Afghanistan, Iraq, and the "War on Terror". Governments, operating companies and investors (providers of capital) would seem to be involved in the creation of a new trans-national military-industrial complex.

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