

A merger too far?

GRAHAM WARWICK/WASHINGTON DC

LOCKHEED MARTIN and Northrop Grumman shocked the industry in July 1996 with news of their merger agreement. Now it is the turn of the US Departments of Defense and Justice to shock, with their last-gasp opposition to the merger plan.

Just weeks ago, as shareholders voted to approve the merger, company officials were predicting that the deal would gain anti-trust approval, with only the minor adjustments that have marked previous defence industry consolidations. Now they have given an emergency team 30 days to draw up a proposal addressing the Government's competition concerns, while preserving at least some of the merger's original attractions.

What went wrong? All the parties concerned judiciously decline any public discussion of the areas in question, but informed speculation centres on the defence electronics businesses, and particularly the effect of the merger on competition in the electronic warfare and airborne radar sectors.

If true, then the companies could rightly question whether the Government has changed the ground rules – fewer than three months ago it approved the combination of the country's only air-to-air missile manufacturers with the merger of Raytheon and Hughes.

Reports, described as accurate by company insiders, say that Lockheed Martin and Northrop Grumman expected to have to divest businesses worth less than \$500 million as the price for approval. Instead, the Department of Justice (DoJ) wants divestitures exceeding \$1 billion. Perhaps coincidentally, this equates to Northrop Grumman's combined airborne radar and electronic countermeasures sales last year.

Spin-offs on such a large scale, from the \$9.1 billion overall merger, could jeopardise the principal attraction of the deal. Lockheed Martin had promised annual sav-

Does US Government opposition to a Lockheed Martin-Northrop Grumman merger end defence industry consolidation?

ings of \$1 billion on top of the \$2.6 billion it is on course to achieve as a result of its previous mergers.

It was the companies themselves which broke the surprise news that the DoJ was "fundamentally opposed" to the proposed merger. The DoJ says only that its goal is to "...ensure competition and innovation and to protect taxpayers". The DoD says it has "...serious concerns about the competitive effects of the transaction". All the parties emphasise that talks continue and that the merger has yet to be formally blocked – a move which both companies say they would "vigorously oppose". This has been taken to mean that they would be prepared to go to court to argue their case, if necessary.

There is an irony about the dispute. In February, Lockheed Martin chief executive Vance

Coffman told a European audience that the US Government had encouraged the consolidation process that created his company and fostered its bid for Northrop Grumman. The Government, he said "...not only accepted consolidation of the industry, but encouraged the process.

"The US Government had an obvious financial incentive in encouraging the consolidation process...to the extent the DoD benefits from savings achieved through consolidation, so do US taxpayers," he said. It was these savings which Lockheed Martin and Northrop Grumman hoped would justify approval of their merger. Successive defence secretaries have urged companies to consolidate, and the so-called "last supper", when the DoD laid out possible consolidation options in the early 1990s, is largely attributed with sparking the merger frenzy.

The central question is why this latest deal is being contested when others were not. The answer may lie in the vertical integration that would result from the combination. Lockheed's 1995 merger with Martin Marietta and 1996 acquisition of Loral were approved with only minor adjustments, but created a defence giant with unparalleled breadth and depth. Even before the Northrop Grumman merger was announced, Lockheed Martin had been forced to state publicly that it would be a "mer-

chant" contractor – buying from and selling to its competitors without impediment.

The degree of vertical integration which would result from the merger becomes clear when looking at the elements required to build a next generation combat aircraft. A merged Lockheed Martin/Northrop Grumman would be able to provide from its own resources the airframe, flight controls, radar and infra-red sensors, electronic warfare suite, and even the cockpit displays. Boeing, in contrast, would have to turn to outside sources, principally Raytheon, for almost everything other than the airframe.

What would become of Northrop Grumman if the merger is blocked or made unpalatable to Lockheed Martin? The company was determined to remain independent, and embarked on a strategy of building up its defence electronics business, until it lost the bid for Hughes. This prompted it to accept the merger offer, and its plans have been in limbo since then. Back on the street as an independent company, now significantly smaller than third-placed Raytheon, Northrop Grumman would have to identify acquisition opportunities quickly or find itself again a take-over target. Boeing could conceivably be interested in a bid to achieve the degree of vertical integration already exhibited by Lockheed Martin, but the sheer scale of the resulting company (approaching \$60 billion annual sales) could raise anti-trust objections. An approach by Raytheon would almost certainly cause competition concerns and a bid from an overseas company, such as the UK's acquisition-minded GEC, is certain to spark foreign ownership fears within the US Congress.

Life without Lockheed Martin looks difficult for Northrop Grumman. The question is: how much are the companies willing to give up to realise at least some of the benefits promised to their shareholders and their customers? □



Vertical integration with Northrop Grumman would give Lockheed Martin the edge on future fighters