

Comment & Analysis

ENGINEERING

Rising star: an acquisitive Finmeccanica thrusts into Europe's defence dogfight



Industry big guns: Finmeccanica has moved to the centre of the debate over the future of Europe's defence sector after acquisitions including the takeover of AgustaWestland, maker of the Apache AH Mk1 helicopter (above)

Bloomberg News

The sharply refocused Italian company will be a force to be reckoned with in the industry's consolidation and is winning important deals in the US. Peter Spiegel reports

Beneath the snow-capped Italian Alps, on the edge of Turin's construction-choked international airport, is a factory just larger than a football pitch where Italy's share of the four-nation Eurofighter programme is assembled.

Because Italy is buying only 121 of the planned 620 fighters – Germany, Britain and Spain have committed to take the rest – the work allocated to Italy represents just 19.5 per cent of the value of the total aircraft: the jet's left wing, which moves from station to station down one side of the factory, and its rear fuselage, which is assembled across the floor.

Despite the exacting detail in the multinational contract that ensures no country does more than its fair share, Finmeccanica, the Rome-based aerospace and defence group, has managed not only to secure the airframe opera-

tions in Turin. As a result of aggressive corporate moves, it also now provides nearly two-thirds of the aircraft's advanced electronic content, its most valuable and complex part.

How did a conglomerate that, until last year, was largely considered an also-ran in defence and aerospace suddenly become the largest supplier of the most sophisticated parts of Europe's premier military programme? The answer reveals one of the most remarkable reversals of fortune in the recent history of the European defence sector, one that signals a shift in who builds and sells the continent's largest and most important weapons.

Through a series of bold and sometimes costly restructurings and acquisitions – particularly in the UK, where over the past nine months it has spent more than £1.6bn (\$2.9bn, €2.4bn) to become, by some measures, the second largest defence group in the country – Finmeccanica has thrust itself into the centre of what many expect to be the second large-scale consolidation the European sector has seen in a decade.

"It's like the end of a very big chess game," says a senior executive at a rival defence company. "There are not so many pieces left – so, if you move one or two big pieces, all the rest are concerned. Now Finmeccanica is part of this game."

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was an unfocused industrial conglomerate owned by the Italian state and, to all intents and purposes, bankrupt, with €6bn in debt and huge losses. Its future had become the stuff of bitter, high-level rows that led eventually to the resignation of Fabiano Fabiani, Finmeccanica's long-time chairman and one of the last of Italy's old-guard, state-sector industrial barons. To save itself, the company planned a radical shake-up.

First, it would go public, injecting market-driven incentives into the business for the first time. "I worked for corporate Finmeccanica on a junior level eight or nine years ago," recalls Giovanni Soccodato, the company's head of strategy. "I just came back and I found a different culture, a different kind of attitude. Now, I see people going around and looking at the share price."



Second, the company would focus on its defence and aerospace business, which at the time accounted for just 43 per cent of revenues, and begin shedding its non-core assets. That resulted in, for instance, the \$2.1bn sale of Eltag Bailey, one of the world's leading process automation companies, to ABB, the Swiss-Swedish engineering group.

Finally, in order to break away from its reliance on the Italian government, it would seek partnerships and joint ventures with other European defence groups, attempting to increase its stature and international reach. "It was very difficult for an Italian-based entity with the market size that we had to demonstrate that we could play this game at a global level or even an international European level," says Alberto de Benedictis, who had just become the group's head of strategic finance at the time, overseeing the divestiture of more than 60 subsidiaries.

The decision to go for joint ventures rather than look for acquisitions was borne of necessity. According to one company executive, the group's heavy debt meant that it could contribute assets but not cash to any deal. So, slowly and haltingly, Finmeccanica began to tie its best assets to those of Europe's top-tier defence and aerospace companies.

Its Agusta helicopter group was lashed on to the UK's Westland in a 50-50 venture with GKN, the British manufacturing group. Its missile operations were thrown in with those of BAE Systems of the UK and France's Matra Défense to form a European missile house called MBDA. Those deals followed what was arguably its most important move apart from flotation: a merger of its defence electronics business with that of GEC Marconi, Britain's leader in the sector.

Although the defence industry is known for its big, flashy "platforms" - fighters, submarines, tanks - the sub-systems and electronics inside that make the thousands of tonnes of metal move and shoot include some of the industry's most sophisticated technologies. Those - radars, seekers, command and control systems - require the world's best engineers and, as a result of their complexity, command a big chunk of the defence world's research budgets and some of the industry's most impressive margins.

The link-up between Finmeccanica's Alenia subsidiary and Marconi, which became known as Alenia Marconi Systems, vaulted the Italian group into the big league of defence electronics. To represent the Italian half of the company, Finmeccanica chose the new star in its defence business, Pier Francesco

Guarguaglini.

Mr Guarguaglini, 68, now Finmeccanica's chief executive, is an electrical engineer from Tuscany who worked first at Finmeccanica's Selenia and Galileo subsidiaries, in radar and defence electronics. By the time the 1997 crisis struck, he had become head of Finmeccanica's defence business and began pushing hard to internationalise the group, understanding that weak Italian defence spending and the rapidly consolidating industry ran the risk of leaving the company behind. "It was quite impossible for us to be considered at the same level as the other companies, and we needed to be at that level," he recalls over breakfast in the rooftop solarium of Finmeccanica's headquarters, overlooking the towers and cupolas of the Rome skyline. "I was sure Finmeccanica needed to be more present in international markets."

But the bureaucratic infighting that had engulfed the group in the late 1990s soon claimed Mr Guarguaglini himself. Although he had the same strategic vision as Alberto Lina, the then chief executive, the two men's styles clashed. When an opening to run Italy's troubled state-owned Fincantieri opened up, the government decided to solve the clash by making Mr Guarguaglini the cruise ship builder's chief executive. Mr Lina spent the next three years working to rationalise Finmeccanica, including a 2000 rights offering that took the government out of direct management of the company. Under Mr Lina, the first signs of a turnaround began to emerge as well. But the group still depended on joint ventures and Mr Guarguaglini, who had very publicly succeeded in turning around Fincantieri, was called back by the Finmeccanica board in April 2002 to replace Mr Lina.

"I found the same thing as when I left," Mr Guarguaglini says. Executives estimated that nearly 40 per cent of its defence and aerospace assets were tied up in joint ventures. He began unwinding them. Three months into the job, he approached Amedeo Caporaletti, the chairman of AgustaWestland, and told him the first target would be the helicopter group.

The reason behind the move, says Mr Guarguaglini, was the same as the motivation behind the reorganisation a decade earlier: only through increasing its size, and controlling its own destiny, could Finmeccanica become a global player. "When you have joint ownership of a lot of assets, the market discounts the value of those assets, because you don't have full control," he says. "Of all the European players - BAE, EADS and Thales - we were the

one with the most aerospace and defence assets tied up, which wasn't a strategy we could live on."

Fortuitously, Finmeccanica's partners were making a similar judgment about their joint ventures. The difference from 1997, however, was that the group now had cash to play with. Thanks to a comparatively strong financial performance and the large rights issue, Finmeccanica had cut its debts. The Italian government had meanwhile given the group a valuable currency: a 21 per cent stake in ST Microelectronics, the Franco-Italian semiconductor group.

GKN was finding AgustaWestland difficult to manage and Finmeccanica bought GKN's stake for £1.1bn, selling most of its holding in STM to pay for the deal.

At the same time, Finmeccanica was in the middle of protracted negotiations with BAE, which had taken over the British side of the AMS joint venture, about the future of their partnerships: BAE was increasingly looking across the Atlantic for its future. Not only did the two sides agree to unwind AMS, with each reclaiming their old assets, but in January BAE decided to unload nearly its entire UK-based avionics division to Finmeccanica for £648m, a move that surprised industry watchers and vaulted the Italians into their leading role in the Eurofighter programme.

The three transactions - taking over AgustaWestland, reclaiming its AMS assets and acquiring BAE's avionics - also thrust Finmeccanica into the middle of the debate over the future of Europe's defence industry, which is being driven by two big changes: BAE's decision over the past year to abandon large swathes of its European operations to buy Pentagon contractors in the US, and an increasing likelihood that the French government will back a break-up of Thales, Europe's largest defence electronics group.

BAE's expected next exit is the sale of Atlas Elektronik, its German-based naval systems group in which Mr Guarguaglini has expressed interest. In addition, Denis Ranque, Thales chief executive, opened talks with Mr Guarguaglini this year about a tie-up

between their two companies, a move industry insiders viewed as an effort to fend off predator EADS (see below).

Mr Guarguaglini remains interested in a possible deal with Thales but, as he awaits political infighting to play itself out in Paris, he insists his top priority is to make sure his latest prized acquisitions (for which some in

the industry believe he overpaid) are successfully brought into Finmeccanica's embrace. "My first objective is to be sure what we acquired will be completely integrated into the Finmeccanica network," he says.

Mr Guarguaglini has quickly seen some promising returns, particularly in the market all European defence groups covet: the US. In January, the Pentagon surprised industry officials by selecting AgustaWestland's US-101 over arch-rival Sikorsky to be the new presidential helicopter, a contract that will eventually include 23 aircraft at \$6.1bn. Company executives think Finmeccanica's newly strengthened position in the UK will help it win additional deals from the Pentagon, including a fleet of search-and-rescue helicopters being sought by the US air force and a handful of small cargo aircraft for the US army.

But Finmeccanica's new high profile has also brought some unwanted attention, particularly from arch-rival EADS, which finds Finmeccanica its prime competitor in a raft of areas, from helicopters in the UK (EADS had hoped to sell its Eurocopters to Britain's Ministry of Defence but Agusta landed strategic agreement with the ministry) to cargo aircraft in the US (the two are vying for the army's contract) to a hand in Thales's future.

In addition, in June the European Union widened its investigation into whether the Italian government gave Finmeccanica as much as €3.2bn in illegal interest-free loans, a charge Silvio Berlusconi, Italian prime minister, vigorously denies.

More centrally, critics have raised questions about its strategy in the UK,

which has become its most important growth market. For example - unlike Thales, the most successful foreign player in the UK, or EADS, which has recently made important inroads into Britain - Finmeccanica has chosen not to name a Briton as head of its local activities, instead appointing Mr de Benedictis as head of US and UK operations. "I'm the Brit in London," he jokes in idiomatic, American-accented English, the product of two decades of schooling and work in the US. One top UK-based executive at a rival group says of the Roman competitors: "They actually produce really good engineering and engineered products... But they are a product of the Italian interplay of industry and state, which is very different from our environment."

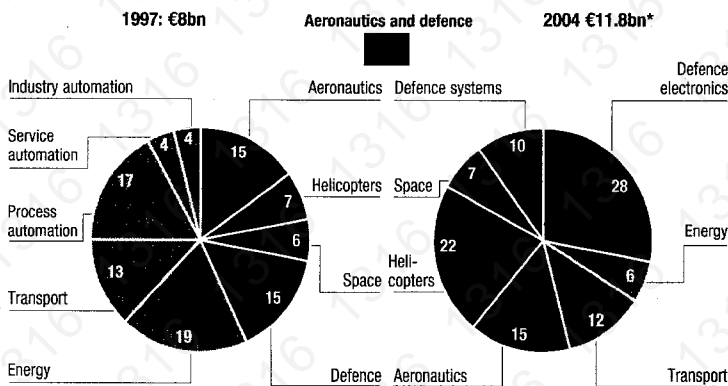
Mr Guarguaglini insists he is sensitive to that perception, adding that he intends to move British executives into Finmeccanica's senior management in order to start a "cultural shift" inside the group. "It is clear that we must give the right consideration to the British people... because for us the British market is very important," he says. "The British MoD is sometimes more important than the Italian MoD."

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Finmeccanica: revenues by activity

Per cent



Source: company

* Pro-forma



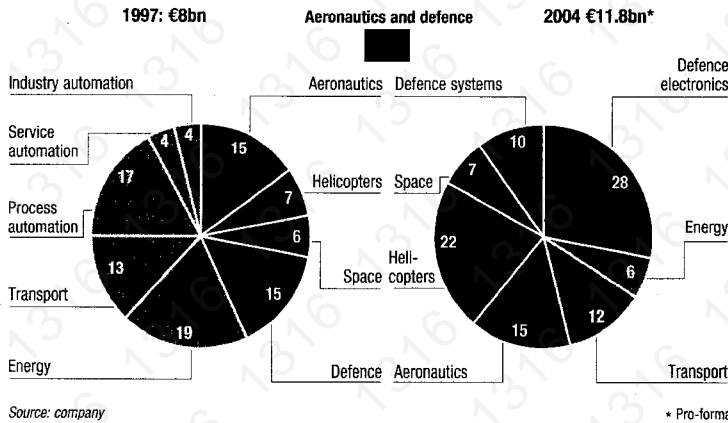
Quick returns: Pier Francesco Guarguaglini

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