THE BAE-GEC DEAL

How Project Super Bowl won the day

Hugo Dixon and Alexander Nicoll reveal how a combination of war games and a high-pressure auction transformed Europe's defence industry

Manoeuvring (left to right): BAe's Sir Richard Evans, DaimlerChrysler's Jürgen Schrempp, GEC's Lord Simpson and Thomson-CSF's Denis Ranque

The temperature was dropping fast as Sir Richard Evans clambered aboard the British Aerospace executive jet bound for Stuttgart.

It was December 7 last year, and Sir Richard, the burly chairman of BAe, thought he was closing in on a long-held objective: the creation of a pan-European defence company strong enough to compete with the Americans.

His co-passenger was less sure. Lord Simpson, managing director of General Electric Company, knew all about the difficulties in negotiating tie-ups in the defence business. After all, BAe and GEC had been conducting on-off merger talks for 15 years, and had yet to tie the knot.

Now Sir Richard was proposing something altogether more ambitious than the creation of a British defence giant. He was contemplating a three-way deal involving BAe, GEC's Marconi defence division, and Germany's DaimlerChrysler Aerospace (Dasa), headed by the formidable Jürgen Schrempp.

Suddenly, an early winter snowstorm forced Sir Richard's plane to divert to Frankfurt. After a hurried phone conversation, the three industrialists agreed to switch their meeting to Munich.

There, Schrempp made clear he would love to do a deal with GEC; but first he wanted to strike his own terms with BAe. At that moment, Simpson knew a triangular defence arrangement involving the might of British and German industry was not going to work.

Simpson's goal was less grandiose and more immediate. He wanted to sell Marconi to the highest bidder. He was convinced that, in the complicated multi-dimensional game of restructuring Europe's defence industry, the first to move would capture the richest pickings. Those coming late to the party risked being marginalised. He was not going to let Schrempp and Evans conclude their deal first.

So began a high-pressure auction which led finally this week to the creation of the world's third largest defence company: a merger of BAe and Marconi, that left the British government stunned and French and German rivals seething on the sidelines.

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GEC's plan for squeezing the maximum value for Marconi was code-named Project Super Bowl.

Hatched by John Mayo, GEC's cocksure finance director, it was an elaborate plan that was self-consciously named after the American football competition, which involves a series of play-offs to determine which teams make the final round: the Super Bowl.

The image appealed to Mayo's idea of how the global defence industry was going to restructure. But it also reflected his belief that it was vital to keep all the bidders for Marconi on the same timetable. Only then would GEC be able to play one bidder off against another and so leverage up the price.

Furthermore, the 1999 Super Bowl was due to take place in Miami on January 31. In Mayo's mind, this was the deadline by which Marconi's future had to be settled. After all, BAe and Dasa were already in fairly advanced talks. GEC would have to move smartly if it was to seize the initiative.

Mayo took to the task of selling Marconi with glee. A 42-year-old ex-Warburg merchant banker, he revelled in complicated analysis and high-pressure tactics. He had cut his teeth on the demerger of Zeneca, the drugs company, from Imperial Chemical Industries, and went on to become Zeneca's finance director.

Simpson, for his part, had started changing the cautious head office culture inherited from Lord Weinstock, a legendary figure who had run GEC with an iron grip for 33 years.

With Mayo at his side, Simpson's reforms moved into overdrive. Young Turks more in line with Mayo's way of thinking were brought into key posts such as corporate finance director and treasurer.

Mayo also relied on support from two pals from his merchant banking days: Chris Brodie, who is still at Warburg, and Michael Tory, who has since moved to Morgan Stanley. Together, they were the brains behind Project Super Bowl.

At the start of 1998, Simpson was still set on building up Marconi as the core of his new GEC. But he felt frustrated by other parts of the industrial empire inherited from Lord Weinstock – a mish-mash of joint ventures over which GEC did not exercise full control.

For example, Alstom, GEC's power engineering division, was locked in a 50:50 joint venture with France's Alcatel. GPT, its telecommunications arm, was a 60:40 joint venture with Germany's Siemens. Marconi was the only large business Simpson cleanly controlled.

Throughout the first half of 1998, Simpson and Mayo spent much time unravelling these joint enterprises. They spun out Alstom and bought Siemens out of GPT. At the same time, Simpson took the first steps to beef up Marconi. A large joint venture in missiles and electronics was forged with Alenia of Italy. Then Tracor, a Texan defence company, was acquired for $1.4bn in April.

Just weeks before the Tracor deal was announced, the Pentagon dropped what looked like a very large present in GEC's lap. It blocked the merger of Lockheed-Martin and Northrop Grumman, two of the largest US defence companies, on the grounds that the combination could restrict competition.

Yet by waving through the Tracor transaction, the Pentagon was in effect signalling that – whatever its doubts about further consolidation in the US market – it was still in favour of transatlantic consolidation.

There was a second, unspoken, American calculation. After years of talk about consolidation, the leading defence companies in Europe were slowly moving into action. European governments, desperate to reduce the ever-rising costs of military spending, sensed the benefits of a reduction in the number of national champions and the pooling of technology and defence know-how.

The US government was anxious that its own industry was not shut out of any Fortress Europe. So, it was no accident, perhaps, that GEC suddenly discovered that both Lockheed and Northrop were interested in exploring a merger.

Given the huge potential for stripping out duplicated costs, a mega-merger seemed to offer the prospect of greater value-creation than a strategy of building Marconi up piece-meal.

Yet Simpson's radar was picking up the same signals as the Pentagon: European defence consolidation was accelerating. There could be a real chance of doing his own European deal – and the more options he had, the better the terms he could strike.

If two other Europeans linked up first, GEC's options would narrow dramatically. The best option was a rapid-fire auction of Marconi.

What worried Simpson most was Evans. The two had worked closely together when Simpson

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was chief executive of Rover, the automotive group then owned by BAe. Simpson knew Evans was pressing as fast as he could to clinch a merger with Dasa. If that deal went ahead, GEC could be left on the sidelines.

While GEC was pursuing its Super Bowl strategy, BAe was following another game-plan drawn up by a supercomputer – a Cray computer in Stanford, California.

The Cray was owned by Design Insights, a US strategy outfit run by Harry Roundell, a former investment banker with J. P. Morgan. Roundell was an old friend of Richard Lapthorne, BAe's brainy vice-chairman, who along with Evans took the credit for bringing BAe back from the brink of bankruptcy in the early 1990s.

Over dinner in New York, Lapthorne realised Roundell could help him cut through a knotty strategic problem. For several years, Lapthorne and Evans had been pressing for what they called the EADC, or European aerospace and defence company. This would involve merging, in the first instance, BAe, Dasa and France's Aerospatiale. At a later date, other companies like Marconi, France's Thomson-CSF and Alenia of Italy could be invited to the party.

The idea was that a unified European defence industry would be able to compete on equal terms with the fast-consolidating American defence industry. An added bonus was that the three main partners in Airbus, Europe's civil aircraft consortium, would all be merged.

In December 1997, the French, German and British governments all gave their blessing to the creation of EADC. But Lapthorne was still doubtful whether the French and German companies were genuinely prepared to make the difficult compromises necessary to strike a deal.

Roundell had a way of testing Lapthorne's hypothesis: game theory, the mathematical analysis of competitive strategies where choices depend on the actions of others.

First, BAe executives fed Roundell's team with a vast amount of information about the various players in the game. Then Roundell's computer simulated negotiations, generating a million pages of raw data – and a £1m fee.

By March, Roundell's work was complete. His startling conclusion was that even after 10 rounds of negotiation, there was still a stalemate. It simply was not in the interests of Dasa and Aerospatiale to budge enough on key issues – valuation and control. On the other hand, if BAe first did a deal with Marconi, the Cray predicted it could complete its European deal with only four more rounds of negotiation.

BAe presented this conclusion to Misc 5, a UK cabinet committee looking at restructuring of the aerospace industry. But the committee, which brings together representatives from several government departments and Downing Street, was not convinced. In any case, the committee made clear that Tony Blair, the prime minister, was keen for BAe to make a European deal a priority.

Initially, it seemed as if Misc 5 might be right. By July, the Germans, at least, seemed to be moving. John Weston, BAe chief executive, felt he was making progress in his meetings with Manfred Bischoff, Dasa's boss.

The problem with constructing a BAe-Dasa deal was that, although BAe was the bigger company, its shareholding was distributed. Dasa's shares were all held by DaimlerChrysler, the industrial giant created by Schrempp and Robert Eaton, boss of Chrysler, the US carmaker.

Daimler would therefore end up as the largest shareholder of a merged Anglo-German aerospace group. The one tangible concession the Germans were willing to consider was to take some of their stake as non-voting shares.

Negotiations began in earnest. Lapthorne joined BAe's team. Over the next few months, BAe and Dasa executives criss-crossed Europe. Sometimes they met at Dasa headquarters in Munich; sometimes at English country hotels.

A favourite location was Chewton Glen, an award-winning country house hotel in Hampshire, on the edge of the New Forest. In addition to its Michelin-starred restaurant, famous for mushroom dishes, Chewton sports a health spa and is convenient for helicopter landings. Rooms start at £220 a night.

Astonishingly, amid all this frenetic activity, BAe and Dasa found the time to hold talks with another partner: Aerospatiale.

The French were furious about being excluded from the BAe-Dasa arrangement and nervous about an Anglo-German rapprochement on defence, which could challenge the dominant Bonn-Paris political axis in Europe.

Both Evans and Schrempp were insistent that the price of French entry into the defence consolidation game was that the the French government should sell off its large shareholding in Aerospatiale.

In July, Paris had announced plans to reduce its stake to a minority through a merger with the Matra defence division of private-sector Lagardère – but BAe and Dasa made clear they wanted complete privatisation.

Subject to this condition, BAe and Dasa were happy to bring in Aerospatiale, but only once they had completed their bilateral deal.

But while Aerospatiale was getting anxious about an imminent BAe-Dasa deal, the Anglo-German talks were becoming bogged down. The two companies were far apart on valuation. And, although Daimler was prepared to take some non-voting shares, it would still have been by far the biggest shareholder and would have veto powers.

Lapthorne was worried. The deal BAe was being asked to cut amounted to paying a premium price for Dasa – yet it would leave the Germans in control.

A further issue was Manfred Bischoff's position. He would have been chairman of the merged BAe-Dasa, to balance Weston's position as chief executive. The problem was that Bischoff was also planning to stay on DaimlerChrysler's main board. BAe did not see how he could then genuinely represent all shareholders equally.

BAe's other big problem was that Mayo's auction was now in full swing. On December 3, announcing its interim results, GEC said it would make a decision about its Marconi strategy "soon". The idea was to pile the pressure on the bidders to put their best offers on the table.

At best, it was a gamble. Tony Blair viewed a BAe-Dasa link as complementing his own initiative calling for closer defence co-operation in Europe, and an all-British deal risked undercutting Mr Blair. And, by making a public announcement, Simpson and Mayo had put themselves on the line with shareholders.

Nevertheless, GEC's pressure tactics caught Evans's attention. On the day that GEC put out its statement, Evans flew to see Schrempp in Stuttgart and proposed a three-way deal including Marconi. As a sweetener, he improved the terms he was prepared to offer for Dasa.

Although Schrempp liked Evans' financial proposal, he was not so keen on hurrying a three-way deal. But that did not become fully apparent until the crucial, unscheduled meeting in Munich on December 7 attended by Schrempp, Evans and Simpson, which showed the extent to which all three had had separate agendas.

From GEC's viewpoint, Project Super Bowl initially generated serious interest from four companies: BAe; Lockheed and Northrop of the US; and Thomson-CSF of France.

Northrop dropped out fairly rapidly. After the failure of its own merger with Lockheed, it could not risk being left at the altar a second time. The US group insisted on a break-up fee of about $600m in the event that any deal was blocked; Simpson was not prepared to agree.

The next suitor to turn tail was Lockheed. It felt Mayo was using its presence in the auction to leverage up the price. Although views differ on whether Lockheed was ever a serious bidder, all agree that after Lockheed's profit warning on December 23 – when its shares fell 11 per cent – a deal became impossible.

Thomson-CSF, though, had long coveted a deal with Marconi. The two companies were very similar, offering huge potential for cost-cutting.

Yet Denis Ranque, Thomson's new chairman, knew there was no chance of a deal so long as the French government remained his largest shareholder with a 40 per cent stake. He therefore persuaded the government to offer two concessions: that it was willing to see its stake fall below 10 per cent; and that it was ready to see the new merged company be listed in London.

Ranque, however, was not a free agent. Standing behind him pulling the strings was Serge Tchuruk, chairman of Alcatel, the French electronics company. Alcatel has a 16 per cent stake in Thomson, and the socialist-led government in Paris had given Tchuruk an informal mandate to take care of its stake too. The government had also agreed to swap part of its stake in Thomson for one of Alcatel's own strategic investments – perhaps its shareholding in Framatome, the

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nuclear power company.

Tchuruk was determined that Ranque would not overpay, and that limited the value of the offer Thomson was prepared to put on the table to about £5.5bn.

Ranque's hands were also tied in another way. To satisfy French *amour propre*, he had to ensure there was something in the deal to counterbalance the fact that the new company would be British.

Tchuruk's solution was brazenly simple: Alcatel would have the right to propose the company's chief executive. Because the provision would be written into the company's constitution, the right would last forever. For Simpson this was too much to swallow, and the French later backed off.

Fortunately for Simpson, Evans' negotiations with Schrempp were foundering. The mood was tetchy as the two sides meetings squabbled over issues such as value and control.

The BAe camp also suspected Schrempp had other things on his mind, such as his pursuit of an alliance with Nissan, the Japanese car company. A week before Christmas, Schrempp proposed a break in discussions until after the holiday period, and set off for a holiday in South Africa.

Mayo seized the opening created by Schrempp's absence. On December 22, GEC announced it was going to demerge Marconi. Like the announcement on December 3, this was yet another tactic to ratchet up the pressure on the bidders.

For Evans, this was the critical moment when he would have to make up his mind on the strategic merger he had sought for so long. GEC's announcement gave a green light for BAe to make an offer just for Marconi. Previously, the two companies had been considering a BAe-GEC merger, after which GEC's non-defence interests – such as in washing machines and inkjet printers – would be spun out. Now, they would no longer have to go through such a complex process.

The BAe board met to consider its options. Evans knew Schrempp would be left fuming if BAe struck a deal with Marconi. But he was also determined that neither Thomson nor Lockheed should seize this prize, wrap themselves in the Union Jack, and compete against BAe in its home territory. The board decided to put its best foot forward. An offer of £8bn was sent in writing to GEC by Christmas.

Now Simpson and Mayo could go on holiday. Simpson set off to play golf in South Africa. He did not bump into Schrempp. Mayo flew to Orlando, Florida, with his wife and children to spend a week at Disney World.

After Christmas, the BAe and GEC teams worked hard on hammering out the details of their agreement. But even at this late juncture, Simpson and Mayo had not given up on the possibility of securing a better price. So, on January 14, Simpson and Mayo set off to Paris to see if Thomson would raise its bid.

Four days later, Ranque came to London with his final offer. By that time, the BAe deal was virtually signed and sealed. Ranque told Simpson he would only tell him the terms of his own bid if Simpson agreed to various conditions. Simpson countered that he could not accept all the conditions, but asked him whether he could jump the hurdle set by BAe's bid: £8bn. Ranque was stunned. BAe had won the day.

Evans and Simpson now had to break the news to Tony Blair. Publicly, the prime minister welcomed the deal, stressing he wanted BAe to keep pursuing European integration. But privately, ministers and officials were seething that Mayo's tactics might have derailed Blair's European initiative.

That is still the central question. Has the BAe-Marconi merger made the issues of value and control that have bedevilled the restructuring of Europe's defence industry easier or harder to resolve?

The initial hostile reaction from Dasa and Thomson may suggest that Evans' vision of an integrated European aerospace and defence company is lost in a snowstorm. Yet some parties are still interested, notably Lagardère of France. Even the jilted Germans may come round, if only to avoid joining a French-dominated defence entity.

If the Cray computer is right, only four more rounds of negotiation are needed to break the deadlock.

Additional reporting by David Owen in Paris and Christophe Jakubyszyn and Andrew Edgecliffe-Johnson in London.

Countdown to a merger

Dec 9 1997: Blair, Chirac, Jospin and Kohl call on European aerospace and defence companies to unify in the face of competition from US rivals.
Mar 27 98: BAe, Aerospatiale and Dasa respond with report agreeing on principle of merging into a single European aerospace and defence company (EADC).
Jul 22 98: French government announces it will partially privatise Aerospatiale by merging it with Matra defence division of Lagardère.
Jul 24 98: BAe welcomes French move but says still much to do for creation of EADC. BAe/Dasa talks on bilateral merger intensify.
Dec 3 98: GEC says after "intense discussions" with other defence companies, it "expects to make a decision on its future strategic course soon."
Dec 7 98: Schrempp, Evans and Simpson meet in Munich to discuss three-way BAe/Dasa/Marconi merger. But no progress made.
Dec 22 98: GEC says it "has decided to separate its civil businesses from its aerospace and defence activities" – a signal that any suitor for Marconi would not first have to go through a full merger with GEC, to be followed by a de-merger.
Jan 19 99: BAe and GEC announce agreement to merge BAe with Marconi. BAe shareholders will have 63 per cent of new group, GEC shareholders 37 per cent.