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BAE investors face further political turmoil as White House battle hots up

Richard Blackden - 10/12/2012

SHAREHOLDERS and board directors at BAE should set their alarms for 2am on Wednesday morning. Where the future of their defence company is concerned, the second US presidential debate in Kentucky could ultimately be rather telling.

Last week's first televised showdown drew 67m viewers and saw Mitt Romney, the gaffe-prone Republican challenger, deliver a performance that was as close to presidential as he has so far come. President Barack Obama, in turn, was bereft of ideas and offered the strong impression he would rather be somewhere else.

Romney's polished performance dodged questions, but, more than a week later, the former governor of Massachusetts is leading in three national opinion polls. The performance has left the election poised on a knife edge, but it has also left Britain's leading defence company in its own form of limbo.

For however much BAE chief executive Ian King insists it is business as usual after the collapse of his company's planned £30bn merger with EADS, that is a hard sell. BAE has spent the past month spelling out the commercial logic of being part of a bigger group, and who does big better than the Americans? The US is the only country from which a bid for all or part of BAE would now be politically acceptable. And such an American bid is, on balance, more likely if the Republicans reclaim The White House on November 6.

This is a function of the candidates' respective plans, say analysts. In February, Obama laid out a plan to shrink the US military budget by \$487bn (£303bn) over the next decade. The cuts may be modest - after all, military spending has, according to the **Cato Institute**, grown from the late 1990s by about 80pc to \$520bn this year - but they're in contrast to Romney's plans as he proposes increasing spending.

The 65-year old has pledged to allocate a minimum of 4pc of US gross domestic product a year to defence. Although that is a lower ratio than under Ronald Reagan, it is more than Obama intends. As with much of the Republican's policy pledges, there are few specifics. But, for now, it is the bigger picture that matters.

Under a Romney presidency, the largest buyer of weapons in the world is going

to roll up with a wallet full of freshly minted dollar bills. That would make most defence businesses, including a major US contractor such as BAE, much more enticing for would-be suitors.

"Right now, the main objection to doing mergers is that valuations are too high versus future prospects," says Lauren Thompson, a defence consultant at the Lexington Institute in Virginia.

America's largest defence companies have said little over the past month as BAE and EADS frantically sought to make the European politics of their tie-up work.

In a rare public comment, Jim McNerney, the boss of Boeing, said the combination of the companies would not pose a "fundamental threat". But there is little doubt that BAE has businesses US rivals would be happy to prise from its grasp.

Joe Lissenden, a director at IHS Jane's, a defence research firm, says five or six companies would be interested in BAE's electronics warfare business that employs 12,000 people in America and makes hardware including surveillance equipment. BAE's intelligence and cyber warfare division, based in Virginia, could also tempt buyers as the US shifts more of its dollars towards combating the threat from terrorists.

It's enough to get BAE shareholders dreaming of a juicy bid arrowing across the Atlantic, but as with most things political, of course it's not that simple. What Romney and Obama plan to do might turn out to be altogether different from what the economic situation allows. For starters, there's the small matter of a \$500bn cut to the Pentagon's budget, scheduled in for January.

The reduction is part of the 'fiscal cliff' - shorthand for a series of tax rises and spending cuts due to take effect in 2013 because politicians in Washington spent the past three years failing to agree on a grown-up plan to cut the country's debt.

Congress will almost certainly avoid sending the economy over the cliff, but how the defence budget will shake out in any agreement is anyone's guess. BAE warned yesterday that the situation "clouds" its outlook in the US. Any potential American bidder won't leave the starting blocks until the clouds clear.

And even if Romney wins, there is no guarantee he will be able to bolster the Pentagon's budget. With the US out of Iraq and withdrawing from Afghanistan, Chris Preble, a defence expert at Cato, expects military spending to fall whoever is victorious. "If I were a betting person, I would anticipate that US military spending goes down," he says.

It may be that King persuades BAE investors that the best course is for the company to remain independent, and it may be that a US bid never emerges. But

it is clear that, following the collapse of the EADS deal, shareholders' focus will shift across the Atlantic. That means tuning into US politics at a time of bitter division. Next week's debate is a good place to start.

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