

European interview
n°99
24th March 2020

Military naval industry: the urgent need for European consolidation

• **After almost six years at the head of Europe's leading military shipbuilding company, you are launching a vibrant call for a European consolidation of the sector's shipyards. Is there real urgency to do this?**

Absolutely. The strong international growth currently experienced by the naval defence industry can be explained in particular by the return of the « power States », which massively support their defence assets. This has led to two major developments in our sector:

- Growth in these countries' acquisition budgets, generating an increase in the market shares that we can seek outside Europe and a potential revival of activity for the European industry;
- But especially, the arrival and rapid development of new competitors in the shipbuilding market. At the beginning of the 2000s, Europeans still had a virtual monopoly on the export market. For the last fifteen years, Chinese and Russian shipyards have experienced very strong growth, followed by players from Turkey, South Korea, India, etc.

In view of this dual challenge, European manufacturers very often find themselves opposed into fratricidal competitions, destroying value on European and export markets and making the competitive pressure even more aggressive. This necessarily leads to strong pressure on profit margins and risky outbidding on technology transfers. In this context, a status quo ultimately threatens the preservation of skills and the performance of the European industrial base and jeopardizes our individual and collective sovereignty.

This is even more worrying that European naval defence companies are the only ones to be heavily dependent on exports, given the small volumes of their domestic

market compared with the «power States». Exports account for about half of their turnover and are essential to maintain skills and keep their industrial production at an acceptable cost.

Industrial cooperation in Europe is therefore essential to maintain critical mass to face the new entrants supported by these «power states». However, the naval shipbuilding industry, with more than a dozen shipyards, is still one of the few defence sectors in Europe that has not undergone any major consolidation in the recent decades.

If we do not react quickly, there is, unfortunately, a good chance that the fate of the military shipbuilding companies in Europe will resemble the railway sector's one: in the beginning there were four, one French, one German, one Spanish and one Italian. Now, only the French and the German remain, but with difficulties and lagging behind their Asian competitors.

• **Who are the European shipyards' most powerful (threatening) competitors?**

Our most dangerous competitors are mainly developing in Asia, predominantly China and South Korea. Russia is also a serious threat. The competition created by emerging players gets even more formidable as their industrial capacities rapidly increase in quality and quantity.

The Chinese government, in particular, has undertaken a major effort to renew and modernize the Chinese army, as the former carries a significant share of the burden. CSSC-CSIC, the sole Chinese leader, is now the world forerunner with more than €10 billion turnover in the naval defence sector. Because of the robustness and size of their domestic market, we are now meeting our Chinese competitors all over the world: Argentina,

Military naval industry: the urgent need for European consolidation

Brazil, Peru, Poland, Greece, Algeria, Egypt, United Arab Emirates (UAE), Saudi Arabia, Pakistan, Indonesia, Malaysia, Thailand, West and East Africa, etc.

Of course, the CSSC-CSIC conglomerate still has to further move upmarket to meet the Chinese government's ambition to modernize their fleet and expand on the high seas, but their development does attract European equipment manufacturers who are thus contributing to the technological maturity of their products. China launches a new submarine every three months, and a new frigate every month: you'd have to be naive to think that they won't improve their product range very quickly!

• What is the relevant size of a company or of companies in your sector in competition with major groups from third countries?

To give an order of magnitude, over the past decade, two Chinese manufacturers (CSSC-CSIC, which have since merged) have built 136 warships. Lockheed Martin and General Dynamics, in the United States, have built 78, OSK in Russia 68, HHI and DSME in South Korea, which recently announced their merger, 40. By comparison, over the same period, in Europe, 12 different players have built 80-armed vessels.

• How should the European market be consolidated and is it enough to enable a European naval industry to rise to international competition?

Consolidation among Europeans requires a combination of elements:

- bilateral or even multilateral cooperation built by States, with a convergence of their long-term strategic interests and an intergovernmental will to share strategic interdependence;
- joint industrial programmes, including programmes that are jointly captured for export;
- a competitive context that does not preclude discussions for consolidation;
- and, finally, progressive horizontal integration, taking into account the stakes of national sovereignty, i.e. a more flexible form than in the case of a merger: complementarity, industrial synergies and similar industrial models are the sine qua non conditions

to reach the necessary critical size and survive in international competition.

• Is export essential to the balance of a European group? And to maintain technological skills?

When national flows are insufficient, exports and cooperation are indispensable, not only to maintain skills but also to preserve industrial performance. It means guaranteeing our sovereignty at an acceptable cost by partially compensating for the off-peak periods in national orders, by diminishing development costs and by supplying engineering offices, building sites and workshops whose fixed costs are very high. Given the weakness of national defence budgets in Europe, no European country can alone maintain such a broad industrial and technological base with its domestic market, involving as many specialities as those needed for the construction of first-class naval vessels.

It is, for example, totally illusory to think that we are able to maintain our skills in France when national programme cycles, particularly for submarines, have periods of almost 7 years with no development activity to support these skills. These «gaps in activity» inevitably lead to a loss of know-how. The subsequent development of new capabilities requires major investments and creates significant risks in terms of costs and timeframes. In addition, the competitiveness of the programmes is largely linked with the full workload of the industrial base.

Europeans are thus the only global players who have to export more than half of their production, so it is vital for them to seek out between 40 and 60% of their workload from exports. The Naval Group site in Lorient, for example, has built 29 surface vessels in 30 years, 13 of which were for export.

• Does Europe master the key technologies in your sector?

Yes, Europe masters them, but in a heterogeneous manner, because the landscape of the European naval defence sector is complex and fragmented, with each player having a specific positioning (equipment, systems, construction, maintenance, MCO, etc.). I would like to

point out here that the naval defence industry has been built up over the centuries to reflect a political will for power and sovereignty, and therefore reflects the tradition and geographical specificities of each one. As a consequence, the level of national ambition and equipment requirements differs significantly from one country to another: a ship is built to carry out a mission, for example the French Navy has to be able to go anywhere, on all seas, on all oceans, while the German Navy mainly sails in the Baltic Sea, the North Sea and the North Atlantic. This is due to differences in ship architecture, operational capabilities, on-board systems and uses and, as a result, to differences in technological investment.

Constant investment in its nuclear deterrence policy gives to France an exceptional position in Europe: we have the capacity to design, produce and maintain our defence equipment and systems at a very high level, thus enabling our navy to enjoy technological superiority, in full independence and sovereignty.

However, in the face of increasingly diverse and aggressive competition, we must also stay one step ahead in terms of innovation. This is true for the entire French and European defence industrial and technological base (DITB). The arrival of breakthrough technologies, digital technology and new uses of artificial intelligence are revolutionising the field of possibilities. Only by taking into account the acceleration of technological cycles will we be able to offer our navies faster than other and at the right price, products with very high technological level and high capacity for incremental evolution.

We know that innovation is expensive, but do we really have a choice? Here again, European investment capacity remains limited and exports are a necessary complement. But let's be realistic: faced with new demands made by our international customers, who increasingly assert technical and industrial sovereignty (local establishment, technology transfer), internationalisation is not an alternative to European consolidation, but a complement!

• **Are European yards competitive compared to their competitors?**

As I was saying, the arrival of new competitors, massively supported by their States, and the clear shift of the

centre of gravity towards Asia are eroding the relative position of the historic European champions, causing them to slip several places on the world scale in less than a decade. The twofold movement of intensification and diversification of competitive pressure inevitably increases the fragility of the European players, who are smaller and more dispersed than the world leaders.

This situation will worsen as Chinese and Russian players accelerate their international development; this even applies to American players if there were to be a slowdown in domestic demand in the United States.

In this context, the consolidation of the European industry is imperative to preserve market positions and competitiveness, but also to seize new opportunities. The first players to move closer together will enjoy a decisive industrial and commercial advantage.

• **You have turned the DCNS Group around and transformed it into the NAVAL GROUP. You have turned a former arsenal, which once had a virtual public monopoly, into a profitable and very high-tech company that exports and sells its products all over the world? What lesson have you learned from this?**

Driving change to transform a company, especially one as steeped in history as Naval Group, requires transparency, pedagogy, humility and... nerve! I believe that we must not be afraid to throw our energy back into the industry and to trust, trust the talents of our employees. When I joined Naval Group in 2014, the first thing I did was to go out into the field and meet everyone. Once I had identified the problems, and even if it wasn't often good news, I made a point of sharing it internally and playing the card of transparency, so that all employees were aware of the scale and urgency of the transformation we had to carry out.

We have gradually regained control of all industrial sites and programmes. We have thus regained control of our costs and lead times, and have therefore been able to support this industrial turnaround with financial reorganization. In this way, we have restored our competitiveness, making the company robust.

This robustness is of course very important, both to cope

Military naval industry: the urgent need for European consolidation

with the ups and downs of the business, which is a highly technological one in which significant «setbacks» can occur, and to invest in preparing for the future. It is also this solidity that inspires customer confidence. We are a very long-term partner, our agreement with Australia, for example, commits us for fifty years!

Once this competitiveness had been restored, proving the robustness of our industrial policy, we were able to expand internationally. I have just mentioned Australia. The programme of 12 submarines, the largest in Australia's history, but also probably the largest export programme in French history, was also a very audacious gamble. But I have confidence in the excellent know-how of our staff, and the State, whose support was crucial, obviously had confidence in us as well.

All of this has obviously contributed to a change in the Group's image, and the change of name has had a definite impact: it reflects the transformation of the company over the last five years, which has become international, at the forefront of innovation, financially sound and now a driving force in the European consolidation of the naval defence industry.

• You have just concluded a partnership with Fincantieri and created Naviris, a joint venture with the Italian champion. What do you expect from it and is it a prelude to other groupings? Is the door open to others?

With Naviris, we have created the first structuring European alliance in naval defence. This alliance is the natural evolution of the historic partnership between two European leaders. With more than twenty years of cooperation, Fincantieri and Naval Group already have many joint successes to their credit, such as the Horizon air defence frigate programme in the 1990s or the FREMM multi-mission frigate programme, which began in 2005.

This joint company, owned 50/50 by our two groups, has been fully operational since 13 January this year. Its head office in Genoa will manage all the actions decided jointly and its subsidiary in Ollioules, the Common Naval Engineering Laboratory (CNEL), will enable it to carry out its work as a systems integrator.

With Naviris, we aim to create value in various key areas. It will allow us to jointly develop R&D projects, five of which were already the subject of an offer last summer and are due to be notified very shortly.

It will also develop bids for bi-national programmes, such as the mid-life refit of the HORIZON frigates, and for export contracts, with the common objective of securing ten to twenty additional ships within ten years. Tenders will be for surface vessels ranging from 2,000 to 8,000 tonnes. We have already jointly proposed the European Patrol Corvette (EPC) project to our two navies and to the European Commission, and this project is now part of the permanent structured cooperation (PESCO). It will involve the French Navy replacing surveillance frigates from 2030 onwards.

Lastly, synergies will be possible in the area of procurement, since the pooling of requirements will help us to achieve economies of scale.

We are only at the beginning of the story and I hope, of course, that this will continue, that other partners will join us. The door is, of course, open. Greece and Spain have already expressed their interest in participating in the EPC project.

• You have a long personal experience of cooperative programmes, having been the Director of the London Joint Project Office responsible for the Horizon frigate programme, which the United Kingdom abandoned, leaving Italy and France to continue it. In these types of joint programmes, what should be avoided and what rules must be followed if they are to be successful?

Above all, there must be State impetus, a shared will to bring long-term interests together. This is not simple because of the differences, already mentioned, in strategic culture and operational ambition. Restricting the number of actors involved therefore facilitates the convergence of objectives and specifications, which must be defined upstream of the programme in order to avoid delays or additional costs linked to the number of variants.

Cooperative programmes are indeed complex mechanisms, which have all too often suffered significant delays. As

we have seen with Horizon, FREMM or other projects, technical specifications can change during the course of the programme and States have sometimes found themselves unable to keep up with the volume of orders because of a lack of budgetary guarantee. These difficulties, which are not specific to the naval field and which are also faced by land or air programmes, lead to costly negotiations and the staggering of deliveries.

Then, whether we are talking about international or European cooperation, it is necessary to entrust the project management to a single contracting agency such as OCCAR (Organisation for Joint Armament Cooperation) or a pilot nation, so as to ensure the harmonisation of the technical specifications and coordination of the partners' schedules, and then of the execution of the programme. OCCAR has two decades of experience in the management of cooperative programmes.

Finally, it is imperative for each State to have a long-term vision and plan to integrate the funding dedicated to these programmes into its successive budget programmes, at the risk of having to revise the initial targets downwards. The objectives of a co-operative programme are not only to reduce acquisition costs through shared development costs, but also to create a serial effect on production and a shared DTIB.

• **Do competition rules, both national and European, allow the creation of the European champions that you are calling for?**

European competition rules do not allow the creation of European champions in the current state of affairs, as

evidenced by the Alstom-Siemens case, in which the European Commission opposed the merger of the rail giants in February 2019, and the acquisition of STX (Chantiers de l'Atlantique) by Fincantieri, which has been pending since the European Commission opened an investigation in December 2018.

European merger control law is based on competition rules established 20 years ago to avoid monopoly situations within the European Union. At that time, competition in many industrial sectors was only intra-European. Today's markets are no longer the same: over the last 15 years the Asian states have developed a strong and competitive shipbuilding industry, which enjoys far less stringent rules than those of the European Union in terms of competition, mergers and State aid. In this new international industrial competition, European companies and those of States such as China or the United States are not fighting with the same weapons.

I therefore believe that it is necessary to rethink the rules used by the European Union to analyse competition so that European industrialists be able to move towards greater integration and achieve the critical size necessary to withstand competition from outside Europe. Large European industrial groups would also enable entire value, supplier and small business chains to be driven across the European continent. The European industrial ambition is at stake.

Hervé GUILLOU

Chief-Executive-Officer NAVAL GROUP

See all of our publications on our site:
www.robert-schuman.eu

Publishing director : Pascale JOANNIN

THE ROBERT SCHUMAN FOUNDATION, created in 1991 and acknowledged by State decree in 1992, is the main French research centre on Europe. It develops research on the European Union and its policies and promotes the content of these in France, Europe and abroad. It encourages, enriches and stimulates European debate thanks to its research, publications and the organization of conferences. The Foundation is presided over by Mr. Jean-Dominique Giuliani.