

# Mergers in Era of Strategic Shifts

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BLOMSTEIN has kicked-off a series of briefings on current legal topics in the defence sector. In our last briefing, we discussed our take on how to get direct awards. Today, we focus on the recent merger clearance of the German Federal Cartel Office (*FCO*) for the acquisition of ESG Elektroniksystem- und Logistik-GmbH by Hensoldt Holding Germany GmbH. This merger clearance underscores a pivotal moment in defence industry consolidation. The merger is set against a backdrop of geopolitical shifts and heightened defence investment. ESG's expertise as a system integrator focused on the development, integration, and support of third-party electronic systems complements Hensoldt, a leading manufacturer of defence electronics, including radars and optoelectronic systems. This briefing explores the antitrust law implications and the unique characteristics of the defence market, particularly in the context of the current geopolitical climate marked by the urgency of strengthening defence capabilities through innovation and investment and the rapid digitalization of the battlefield.

## Merger Control

In reviewing a proposed merger, a competition authority's primary concern is assessing whether the deal could negatively impact competition in any relevant product market, and thus ultimately consumers, by leading to higher prices, diminished quantity, quality, or service, or by stifling innovation. Such adverse outcomes are likely where the merger significantly consolidates market power, enabling price increases or declines in quality or innovation. Should a competition authority anticipate that the merger would either create or bolster market power, it can block the merger or request corrective measures. Where the authority has no competition concerns it will not oppose the merger but issue a clearance decision – as the FCO did for the Hensoldt / ESG merger.

## Understanding the Defence Market's Complexity

Evaluating mergers within the defence sector presents unique challenges due to the industry's distinct characteristics: The market is heavily regulated. It often features a single buyer (typically the national defence department), and procurement processes are different from those in most industries. The defence market involves complex, heterogeneous products. All these characteristics may be implicated in an analysis of a defence industry merger. The intricate nature of products and services, from weapons systems to surveillance technology, and the critical role of national security frame the context within which mergers are assessed.

## The Merger Analysis Framework

- **Market Definition and Analysis:** A granular approach is required to define relevant markets, which could range from tangible products like tank ammunition to intangible efforts such as the development of new weapons systems. The specific "missions" the weapon systems are designed for often determine the parameters of the relevant market, recognizing that products designed for different applications (e.g., tactical vs. strategic) rarely compete directly.
- **Identification of Market Participants:** Beyond current market players, this includes potential entrants who could disrupt the status quo. The assessment leverages a wide array of information sources to map out the competitive landscape accurately, including internal company records, and industry analyses. In the defence sector, this may include inputs from the Defence Department, which usually has in-depth knowledge about the products manufactured by companies, their technical capabilities, and available alternative options.
- **Evaluation of Competitive Dynamics:** The analysis extends to understanding how a merger might influence competition on several fronts: pricing, innovation, and the availability of products and services. Particularly in a sector, like the defence industry, where technological advancements rapidly change the competitive landscape, historical market shares might not provide a complete and accurate picture of competitive conditions. Thus, a forward-looking perspective, considering potential technological shifts, the intricacies of the procurement process, and market entry barriers, is crucial.
- **Special Considerations for Defence Mergers:** Defence industry mergers also involve additional layers of scrutiny due to their potential impact on national security. Merger control law provide for a "security exception" allows for a merger that might otherwise raise competition concerns to be justified on grounds of public security. While the exception provides for some flexibility in merger approvals, the primary analysis still centers on ensuring that the merger does not detrimentally affect market competition and innovation. Competition authorities must balance the imperative of maintaining robust competitive markets with the strategic needs of national defence, ensuring that mergers do not compromise the ability to deliver advanced, cost-effective solutions to defence challenges.

## **What Else to Consider: Government Contracts and State Aid**

A considerable risk-factor for mergers and acquisitions in the Defence industry that must also be taken into consideration is European public procurement law. Changes to the legal entity that holds a defence contract bear the risk that this specific contract must be re-tendered provided the change qualifies as a *modification* of the contract under EU public procurement law. In addition, if the target company is (presumed to be) a recipient of State aid, for example for research and development, a change of control harbours the risk for the acquirer to become liable for repaying the aid (e.g. where State

aid has been granted unlawfully to the target or where the conditions for granting the aid are no longer met). It is therefore essential to make government contracts and State aid assessments an integral part of the due diligence process.

## **Navigating Future Defence Mergers**

As geopolitical tensions and technological innovation continue to reshape the competitive landscape, antitrust authorities are faced with the challenge of playing an increasingly nuanced role. A keen understanding of the sector's unique challenges will be invaluable in guiding future merger analyses. BLOMSTEIN will continue to monitor developments closely and keep you informed. If you have any questions, please do not hesitate to contact BLOMSTEIN's [defence team](#).

Stay tuned: Our next defence briefing coming up on 13 March will provide an introduction to CBAM, the forthcoming obligation to accurately report emissions data in the EU. It poses a significant challenge for the Defence & Security industry, as the industry's reliance on highly specialized components and materials made from iron, steel or aluminium, which are often procured from a global network of suppliers, complicates the collection of reliable emissions data.