DISCORD: Chancellor Angela Merkel has turned her back on a European aerospace merger; now Germany seeks to defend its interests in Airbus. **REUTERS/JAN BAUER/POOL**

How politics, pride and resentment killed the EADS-BAE merger and now threaten a new crisis in European aerospace

Flying solo

BY NOAH BARKIN AND TIM HEPHER

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On a cloudy day in southwest France last month a frail 91-year-old Frenchman in a white shirt and white tie took the stage in front of 1,000 Airbus workers and VIPs and delivered a subtle warning.

Known as the "Father of Airbus", co-founder Roger Beteille reminded his audience, gathered in a vast new plane factory in Toulouse, how an industry once "devoted to destruction" had become a symbol of European unity in the decades after World War Two.

Only by "working hard together, hand in hand", Beteille said, had the European firm's employees realised their dream to create "the largest and best airliner manufacturer in the world".

The meaning of the revered engineer's message to Europe's feuding politicians and industry barons

NOSE OUT OF JOINT: The first mainly carbon-fibre Airbus comes together on a Toulouse assembly line. A row over jobs is driving partners on the $15 billion project apart. **REUTERS/JEAN-PHILIPPE ARLES**

was plain: cooperate with each other or lose what you have built.

Just two weeks before the ceremony - to mark the start of production of the new Airbus A350 jet - talks between France, Germany and Britain to create a European aerospace and defence giant bigger than Boeing had collapsed in acrimony. Chancellor Angela Merkel, Europe's most powerful leader, had refused to back the $45 billion merger between Airbus parent EADS and British defence group BAE Systems, effectively dooming the deal.

Top officials in the German government deflected blame, alleging discord between Paris and London over the size of the French government's stake in the combined group.

But two confidential sets of demands sent by the German government before and during the talks and described to Reuters, as well as conversations with senior officials in Germany and France, confirm that the roots of the failure lay far deeper.

The mega-deal fell apart because of Berlin's growing resentment of what it saw as its loss of influence within EADS, wariness about France - sometime rival, sometime partner - and suspicion about the motives of the firm's German CEO Tom Enders.

"We already have an imbalance on technology within EADS, to the benefit of the French. We didn't want to make this situation even worse by hooking up with BAE," a senior German official said.

For Enders, who in the months before the BAE talks had come under acute pressure from Berlin to move prized Airbus research work to Germany from France, the proposed deal with BAE was a last-ditch attempt to free EADS from the yoke of government influence.

The deal's failure is likely to bring the opposite result. Germany, emboldened by its growing stature in Europe, looks set to push ever more aggressively for jobs, technological know-how and management influence - as the French did to detrimental effect in the early years of the firm.

Insiders say this could have disastrous consequences for the company. Some fear it will also tarnish ties between Berlin and Paris at a time when Merkel and French President Francois Hollande must find common ground to solve the crippling euro zone debt crisis.

"The fight that is happening now over Airbus is a grave threat," said an industry veteran with close ties to EADS. "Going back to a situation where you have to argue at the board over every industrial decision would be a disaster. That could really kill the company."

In the aftermath of the deal's collapse, deep-seated tensions between Paris and Berlin have been exposed. The two are already squabbling over Merkel's plans to centralise control over European budgets. Germany is also increasingly sceptical about Hollande's readiness to reform the French welfare state.

Enders declined to be interviewed for this story. The German government, Airbus and EADS also declined comment.

POWERFUL SYMBOL

EADS was formed in 2000 through a merger of France's Aerospatiale-Matra and Germany's Dasa, together with Spanish aerospace assets.

The deal, unveiled by French Prime Minister Lionel Jospin and German Chancellor Gerhard Schroeder in the border city of Strasbourg, was hailed as a breakthrough for the fragmented European aerospace and defence sector.

It gave Toulouse-based Airbus, the hugely successful civil jet-making joint venture between France, Germany, Britain and Spain, a dominant parent. And it was a powerful symbol, just a year after the birth of the euro, of Europe's potential for industrial cooperation.

Its first decade brought major successes: Airbus outsold arch-rival Boeing and launched the double-decker A380 superjumbo, the world's largest passenger plane.

But the company was also dogged by infighting, as executives like Noel Forgeard, backed by President Jacques Chirac, pushed for French domination and an end to the awkward dual Franco-German management structure.

It wasn't until Enders was put at the top of Airbus and Louis Gallois became CEO of parent EADS in 2007 that the healing between the Germans and French could begin. By June this year, when Enders took the top EADS post, the days of national strife finally seemed at an end.

Behind the scenes, however, German politicians led by Peter Hintze, a theologian and close party ally of Merkel, were deeply unhappy. Merkel's aerospace tsar believed the balance of power within Airbus had been tilting toward France for some time.

First, the main A380 factory had been placed in Toulouse. Then the planemaker's next-generation jet, the A350, was to be built there in a plant named after Beteille. This would give French workers many more jobs in the $15 billion project - up to 42 percent of the total work when top suppliers were included.

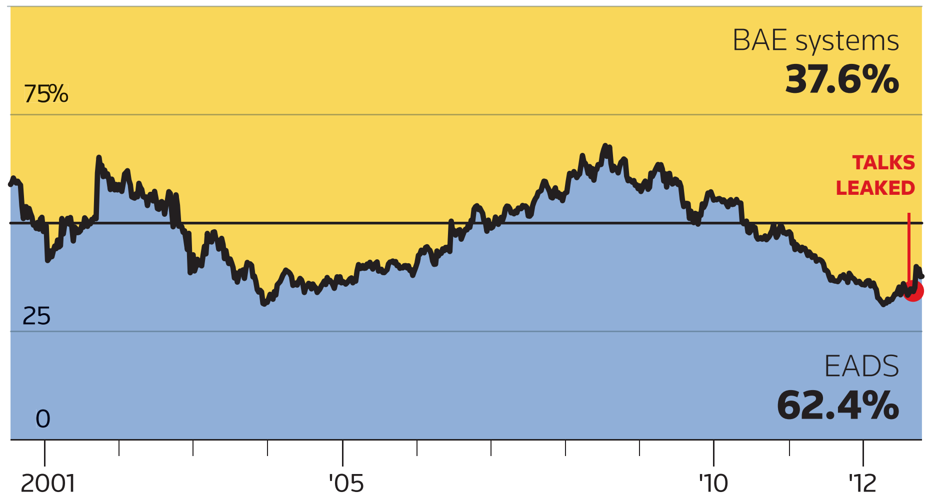
In return, Germany negotiated the right to build a successor to the best-selling A320 exclusively in Hamburg. But as struggling airlines looked for fuel savings, Airbus decided instead on a quick, modest revamp of the existing A320 with new engines. The so-called A320neo, to be built in both Toulouse and Hamburg, proved a huge success and boosted EADS stock. But in Berlin the triumph was bitter.

LIST OF DEMANDS

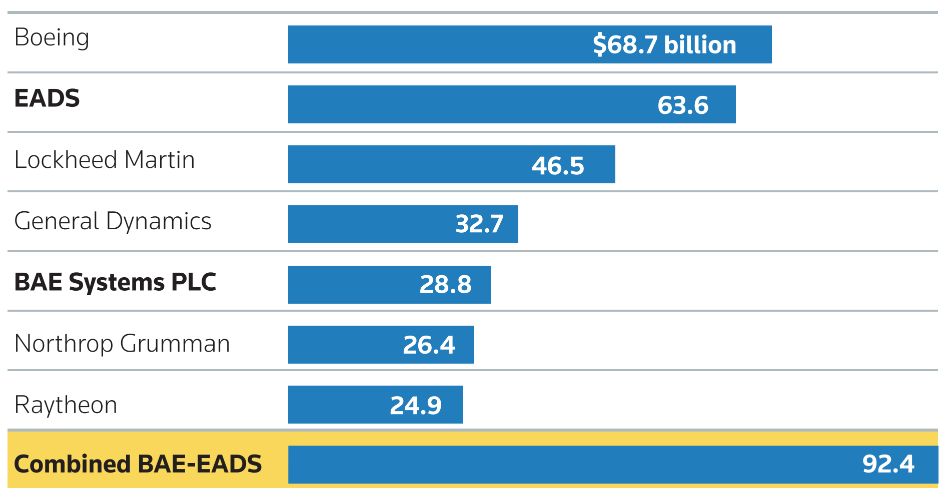
In November last year, Merkel's government decided that it would purchase a 7.5 percent stake in EADS held by Daimler.

Size matters

Relative size based on market cap in euros



Aerospace companies 2011 sales



For years, the carmaker had held a 22.5 percent share in the aerospace group to counter-balance 15 percent held by the French government and 7.5 percent owned by French media firm Lagardere. But Daimler was eager to reduce its holding, seen as peripheral to its main auto business, and asked for Berlin's help.

After failing to convince German firms to take a look at EADS, the government agreed to buy the stake itself. With that came a new determination in Berlin to rebalance power within the company in its favour.

In late February, months before Enders began merger talks with BAE, Hintze wrote to him with a list of demands that threw Berlin's newfound assertiveness into stark relief.

In the letter, according to people familiar with its contents, Merkel's ally noted that an imbalance had developed within Airbus to the disadvantage of the German plants.

"This development is unacceptable to the German federal government," wrote Hintze. "What is required, therefore, is a reversal of the trend, and a restoration of the Franco-German balance, particularly in research and development."

For Germany, this was a not just a battle for jobs, but for know-how and control.

Among Hintze's demands was the relocation of one of aviation's crown jewels, Airbus "Flight Physics", from Toulouse to Bremen. The work carried out by scientists in the department – located in "M-01", an iconic design office shaped like an upside-down pyramid - dates back to Concorde. Its recruitment ads seek experts in disciplines like aeroelastics, the science of how flags fly and wings flutter.

Hintze also insisted that a German be appointed to the prestigious chief engineering post, and that the group responsible for plane "structure" be relocated east of the Rhine. Hamburg, he declared, must have full control over the A320's successor.

> "Toulouse is a high-tech aerospace cluster, the largest and most competent in Europe. You don't simply decree that it all has to move to Germany.
>
> **FrancoisHeisbourg**
> Foundation for Strategic Research, Paris

The icing on the cake was Hintze's request for a one-for-one "balancing" of French and German Airbus staff from the top down through the first five levels of hierarchy. Horrified EADS executives said this would reverse a half-decade drive to rid the company of national rivalries.

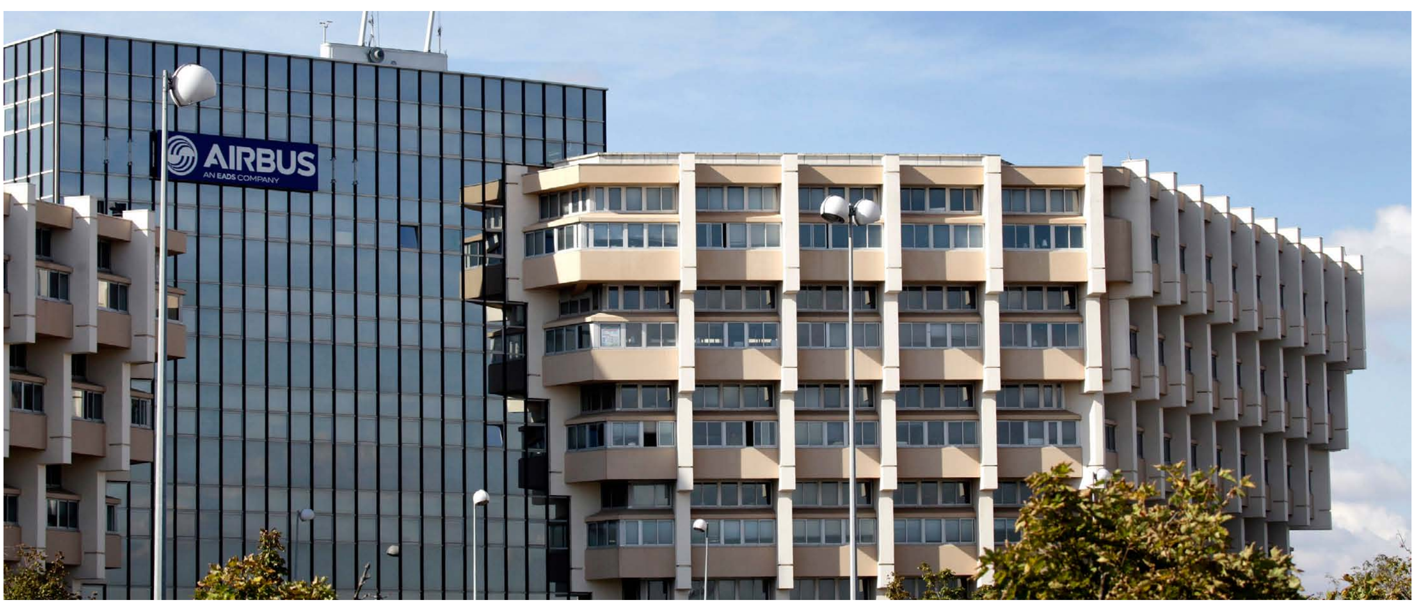
Enders fired back a toughly worded rejection of Hintze's demands with the backing of the company's board, a person familiar with the matter said.

"The division of labour should be dictated by economics, not politics," Francois Heisbourg, special adviser at the Paris-based Foundation for Strategic Research and a former aerospace executive, told Reuters last month.

"Toulouse is a high-tech aerospace cluster, the largest and most competent in Europe. You don't simply decree that it all has to move to Germany."

It was against this tense backdrop that Enders took the reins of EADS and began serious merger planning in June.

One of his first acts was to move the company's headquarters to Toulouse, ending the



JOBS IN TOULOUSE: The Airbus design office is at the centre of rivalries over high-tech jobs. Physicists in the Toulouse building study how flags fly, and wings flutter. **REUTERS/JEAN-PHILIPPE ARLES**

WORKSHARE ROW: German government aerospace coordinator Peter Hintze, seen in the cockpit of an unfinished A321 in Hamburg in 2007, wants more Airbus skills and jobs based in the port city.
REUTERS/CHRISTIAN CHARISIUS

awkward split between Paris and Munich that had existed for more than a decade.

The step was symbolic - a sign to investors that EADS had overcome national divisions and was operating like a normal company. Apart from his L-shaped office, strewn with souvenirs of Airbus's global market conquests, the spartan white premises where Enders set up shop remain mostly empty.

But in Berlin it was seen by many as confirmation that France was bent on taking de facto control of EADS, aided and abetted by a CEO who was placing the company above national loyalties.

Also gnawing at the Germans was the fact they had been outmanoeuvred by France in previous cross-border endeavours.

Back in 1999, the merger of Hoechst and Rhone-Poulenc to form Franco-German drugs giant Aventis was hailed as a model of European cooperation. Underlining the point, some of the firm's top managers were the children of French and German officers who had fought during World War Two.

Just five years later, the French government worked to help a smaller domestic firm, Sanofi-Synthelabo, take over Aventis, as the shocked Germans looked on.

In 2011, after years of shifting former Hoechst jobs from Germany to France, the company dropped all pretence, ditching the dual name Sanofi-Aventis in favour of Sanofi, which it called "simpler and easier to pronounce". A Franco-German project was now officially French.

This was not the only example. Over the years, Germany had watched in dismay as France intervened with industrial firms like Areva and Alstom. Officials in Berlin vowed it would not happen again.

RADIO SILENCE

On July 25, 45 years to the day after France, Germany and Britain authorized Beteille to start planning "the airbus", Enders won the support of the EADS board to pursue the idea of an audacious merger with BAE Systems of the UK.

The would-be deal was never given more than a 50 percent chance of success,

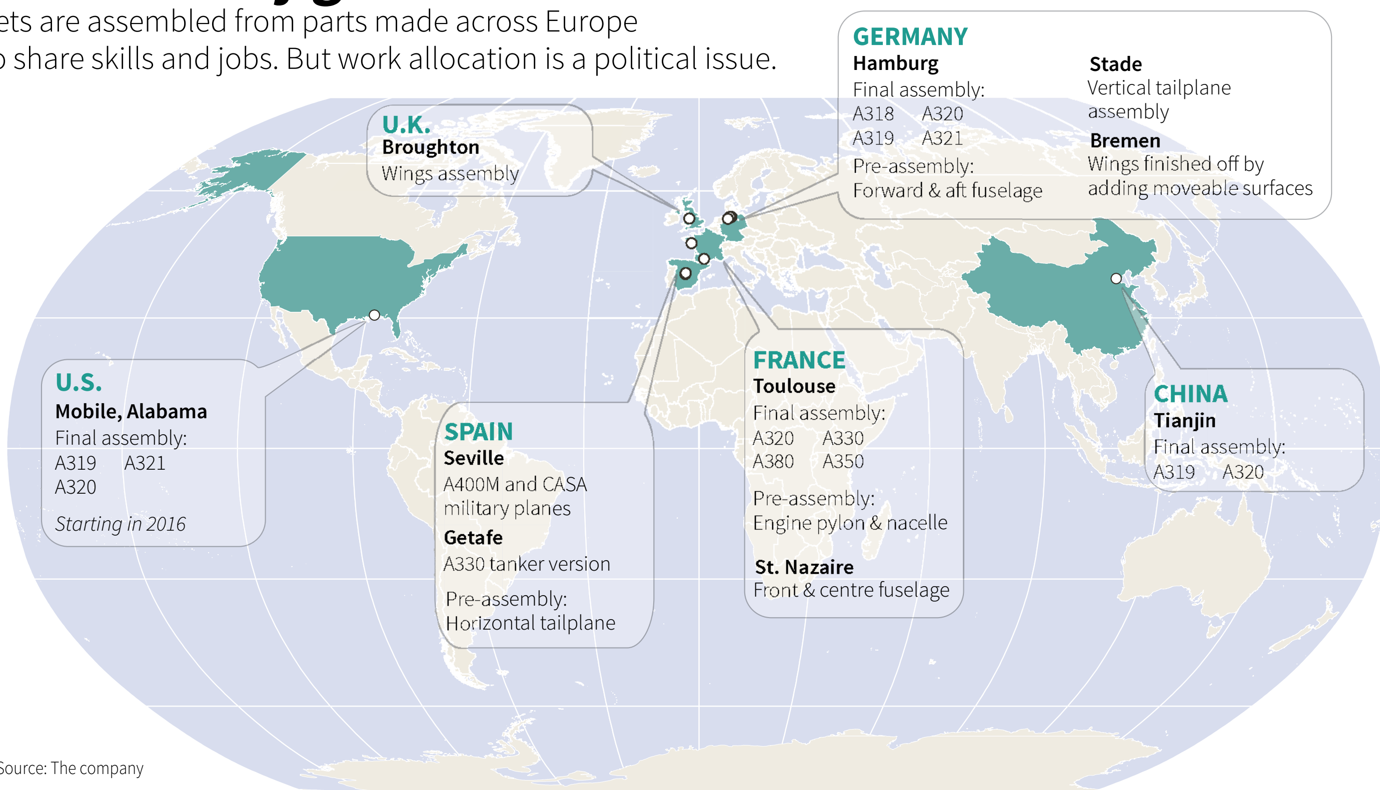
Germany's EADS-BAE Checklist

At the end of September, during merger talks between EADS and BAE Systems, Germany put its list of demands to France. Negotiators have told Reuters EADS accepted all the points except the last, a proposal to switch the headquarters from Toulouse, France, to the outskirts of Munich.

- Ringfence submarine sonar maker Atlas Elektronik and the radar sensor/infrared activities of EADS Cassidian in a new German defence company
- Up to two directors of this new company must be approved by the German government and must also be on the main board
- Hamburg must be sole "Centre of Competence" for single-aisle A320-style jets, including R&D
- Balance between German, French, UK representatives on the EADS executive committee and board
- No adverse employment impact for Germany
- Qualified majority voting for strategic decisions including location of the HQ and investments or disposals
- Group HQ to be in Ottobrunn, outside Munich. Must include the CEO and Strategy/Finance/HR/International departments

The Airbus jigsaw

Jets are assembled from parts made across Europe to share skills and jobs. But work allocation is a political issue.



Source: The company

according to people on both sides. But political hurdles were thought to be highest in France or Britain - two long-term, fiercely patriotic rivals - or in the United States, where BAE's status as a privileged foreign contractor might be questioned. Few expected Germany to object.

The merger would create an integrated aerospace and defence firm bigger than Boeing, and an undisputed European champion with a strong presence in the lucrative U.S. market to boot.

Enders believed the ambitious nature of the deal alone would help overcome any government opposition. By giving Germany, France and Britain a "golden share" that allowed them to block future takeovers, he also hoped they would agree to pare back their day-to-day involvement in the firm - a dream that was dashed when the French insisted on retaining their stake in EADS.

But the Germans, suspicious of Enders, wary of French motives and already seething over waning influence within EADS, smelled a rat.

Hintze was against the deal from the start and wasn't shy about letting his bosses know. The 62-year-old Protestant pastor from a small town on the Rhine river had got to know Merkel - herself the daughter of a Lutheran clergyman - in the years after German reunification. Their ties ran deep. He was among the first people she named to her team after becoming minister for youth and family under Chancellor Helmut Kohl in 1991. Seven years later she succeeded Hintze as general secretary of the Christian Democratic Union (CDU).

While the French and British quickly appointed senior officials to oversee the talks and formulate a list of "red line" demands, Berlin stayed silent.

In late August, Enders was due to accompany Merkel on a trip to China - the perfect opportunity to talk the deal through in person. But the thrill-seeking 53-year-old, a former paratrooper who studied at UCLA in California, tore ligaments in his arm in a hang-gliding accident and had to cancel at the last minute.

"Tom is good on strategy but not so good on psychology," said a former colleague. "One very important mistake was to miss the trip with Merkel."

Two weeks later, during the Berlin air show, Bloomberg News reported that merger talks were underway, forcing EADS into a mad one-month scramble to convince governments to back the deal.

Berlin finally delivered its own list of seven conditions at the end of September.

Obtained by Reuters, it picked up where Hintze's demands from late-February had left off. It called for key EADS radar assets and Atlas Elektronik, an affiliated maker of submarine sonars, to be ringfenced inside a new German company, two of whose directors must be government-approved; it demanded balance between French, British and Germans on the board and executive committee; no job losses for Germany; special voting rules for strategic decisions; a German group headquarters and, crucially, full research-and-development control over all single-aisle jets - the cash cow of Airbus.

Enders wanted the deal badly and agreed to all points but one: the German demand that he shift the operational command centre of the combined firm from the freshly painted EADS headquarters in Toulouse to Ottobrunn, outside Munich.

Still, Berlin would not budge. In the weeks that followed, Merkel became convinced that if she let the deal go through, the new company would run roughshod over German interests. She sealed the deal's fate in a call to French President Hollande on the morning of Oct. 9.

The unborn giant was buried with no name - "Airbus" had been rejected by BAE - and unpublished plans to save 850 million euros were placed back in the drawer. In a final call, say witnesses, Enders told BAE counterpart Ian King, "Let's stay friends".

BATTLE ROYALE

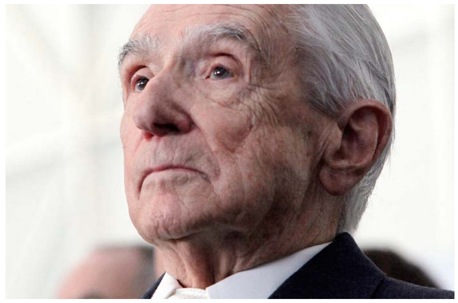
Almost a month later, EADS has moved to contain any damage from its summer dalliance with BAE, touting business as usual.

But the tremors sent by the failed deal will be felt in Toulouse, Paris and Berlin for some time.

The relationship between Enders and the German government, already strained by earlier feuds over a costly bailout for the delayed Airbus A400M army plane, will be hard to repair.

The EADS chief is unlikely to ease off his drive to rid the company of state pressure. Meanwhile, Germany is pressing to buy even more shares.

In a paper sent to members of the German parliament's budget committee last month, the economy ministry urged lawmakers to free up 2.65 billion euros to take Germany's stake in EADS up to 15 percent - on par with France.



APPEAL FOR UNITY: The "Father of Airbus," Roger Beteille, 91, issued a coded warning to Europe's squabbling politicians in October 2012. **REUTERS/JEAN-PHILIPPE ARLES**

This could set the stage for a battle over seats and influence on the EADS board. Already, Berlin is threatening to withhold hundreds of millions of euros in loans for the A350. A shareholder pact designed to balance French and German interests within the group poses a legal minefield and could be another source of tension.

"I don't know how the firm is going to be able to manage given the tensions between the various shareholders," said Heisbourg of the Foundation for Strategic Research. "The Germans have made quite clear that they are prepared to exercise their shareholder rights quite aggressively."

Some in the industry believe Germany's goal is to push Enders out to make room for someone more focused on German interests, though aides to Merkel vigorously deny this. Others say the bigger risk is that Enders becomes fed up and chooses to leave himself.

Regardless, many in the industry say that a return to the uneasy status quo that existed before the BAE deal was floated will be next to impossible.

With the dream of a European defence giant dashed, the French could take another look at consolidating their own fragmented sector, which includes combat-to-business jetmaker Dassault, and Thales, Europe's leading defence electronics group.

Keen for a bigger slice of the massive U.S. defence budget, EADS management may feel compelled to look outside Europe for deals, although politics could get in the way again.

"I don't think we've seen the end of this. We may have only seen the first stage," said Alexandra Ashbourne-Walmsley, who runs a defence consultancy in London.

Most worrying of all, say European industry sources, is the spectre of a political fight over the crown jewels of Airbus that stokes dormant national rivalries and scares off investors. With no major new projects on the horizon soon, the opportunities for redistributing jobs are limited for now. But that seems unlikely to keep the Germans at bay.

By blocking the BAE deal, Berlin sent a signal to its partners. It may be open to closer European cooperation, but only on its own terms.

That has implications not just for the bold planemaking project launched by Beteille and others in the decades after World War Two, but also for the crisis-hit bloc as a whole.

Additional reporting by Andreas Rinke, Gernot Heller, Jason Neely, Christiaan Hetzner, Arno Schuetze, Sophie Sassard, Cyril Altmeyer, Emmanuel Jarry, Jean-Michel Belot, Andrea Shalal-Esa, Alwyn Scott; Editing by Sophie Walker and Simon Robinson

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