

Anticipated acquisition by Chemring Group plc of the air countermeasures and pyrotechnics business and certain assets of Wallop Defence Systems Limited

Decision on relevant merger situation and substantial lessening of competition

ME/6523/15

The CMA's decision on reference under section 33(1) of the Enterprise Act 2002 given on 29 March 2016. Full text of the decision published on 3 May 2016.

Please note that [X] indicates figures or text which have been deleted or replaced in ranges at the request of the parties for reasons of commercial confidentiality.

SUMMARY

1. Chemring Group plc (**Chemring**) has agreed to acquire the air countermeasures and pyrotechnics business and certain assets (the **Air Countermeasures Business**) of Wallop Defence Systems Limited (**Wallop**) (the **Merger**). Chemring and Wallop are together referred to as the **Parties**.
2. The Competition and Markets Authority (**CMA**) believes that it is or may be the case that Chemring and the Air Countermeasures Business will cease to be distinct as a result of the Merger, that the share of supply test is met and that, accordingly, arrangements are in progress or in contemplation which, if carried into effect, will result in the creation of a relevant merger situation.
3. The Parties overlap in the supply of air countermeasures in the United Kingdom (the **UK**) and have a combined share of supply of magnesium, teflon and viton (**MTV**) flares of 100%, with an increment arising from the Merger of 40%.
4. The Parties submitted that the correct counterfactual for the assessment of the Merger is that, absent the transaction: (i) Wallop would have exited the market; (ii) there were no less anti-competitive purchasers available; and (iii) if

Wallop had exited the market, its sales of air countermeasures to UK customers would all have diverted to Chemring.

5. The CMA notes that Wallop has been loss-making since 2011 and that it was heavily dependent on intra-group loans from its US parent company, Esterline Technologies Corporation (**Esterline**), in order to remain solvent. Given Wallop's position within a profitable corporate group, the CMA believes that Wallop would have continued to be viable as long as its parent company continued to provide financial support. As such, the CMA does not believe that Wallop's exit due to financial failure was inevitable. Whilst taking into account Wallop's financial position, the CMA therefore considered whether, in the absence of the Merger, Wallop would have inevitably exited due to strategic reasons.
6. Taking a cautious approach, the CMA has reviewed many contemporaneous documents, on the basis of which the CMA found that that Esterline was fully committed to either selling Wallop or winding it up. The evidence shows that Esterline had taken decisive action to close the Wallop site irrespective of whether the Merger proceeded. Therefore, the CMA believes that there is no realistic prospect that Esterline would have continued to operate the Air Countermeasures Business.
7. The CMA went on to consider whether there was any alternative purchaser to Chemring which would have led to a less anticompetitive outcome. Esterline had explored its sales options, first for the entire Wallop business and then for just the Air Countermeasures Business. Chemring was the only prospective purchaser to make an offer for the Air Countermeasures Business. The CMA took a cautious approach to Esterline's submissions on how extensively it marketed the sale of the Air Countermeasures Business. The CMA found that ultimately an extensive marketing process had been undertaken with financial and trade buyers and that there were a restricted set of buyers for the business due to restrictions on non-UK domiciled firms supplying and exporting air countermeasures from the UK. On the basis of this evidence, the CMA believes there was no realistic prospect of a less anticompetitive buyer than Chemring buying the Air Countermeasures Business.
8. The CMA also believes that if, in the absence of the Merger, Wallop were to exit the market, all of its sales would divert to Chemring.
9. The CMA therefore believes that, in the absence of the Merger, Wallop's Air Countermeasures Business would inevitably have exited the market, with no replacement of the competitive constraint currently exerted on Chemring by this business.

10. Relative to this counterfactual, the CMA believes that the Merger will not give rise to a realistic prospect of a substantial lessening of competition (**SLC**).
11. The Merger will therefore **not be referred** under section 33(1) of the Enterprise Act 2002 (the **Act**).

ASSESSMENT

Parties

12. Chemring specialises in the manufacture of high technology products for the aerospace, defence and security markets, focusing on three strategic product segments: (i) countermeasures (air and naval); (ii) sensors and electronics; and (iii) energetic systems. The group turnover of Chemring in its financial year to 31 October 2014 was approximately £[~~xxx~~] worldwide and £[~~xxx~~] in the UK.
13. Wallop is a subsidiary of Esterline, a defence industry company incorporated in the USA. Wallop specialises in the supply of air and naval countermeasures for the defence industry in the UK and abroad. The turnover of Wallop in its financial year to 31 October 2014 was approximately £[~~xxx~~] worldwide and £[~~xxx~~] in the UK.

Transaction

14. The Transaction involves the acquisition by Chemring Countermeasures Ltd, a wholly-owned subsidiary of Chemring, of the Air Countermeasures Business of Wallop. The total consideration payable under the Asset Purchase Agreement (**APA**) for the Air Countermeasures Business of Wallop is [~~xxx~~].

Jurisdiction

15. As a result of the Merger, Chemring and the Air Countermeasures Business, both of which are enterprises, will cease to be distinct. The Parties overlap in the supply of MTV flares in the UK, with a combined share of supply of 100%, with an increment arising from the Merger of 40%. Accordingly, the CMA believes that the share of supply test in section 23 of the Enterprise Act 2002 (the **Act**) is met.
16. The CMA therefore believes that it is or may be the case that arrangements are in progress or in contemplation which, if carried into effect, will result in the creation of a relevant merger situation.

17. The initial period for consideration of the Merger under section 34ZA(3) of the Act started on 11 February 2016 and the statutory 40 working day deadline for a decision is therefore 8 April 2016.

Counterfactual

18. The CMA assesses a merger's impact relative to the situation which would prevail absent the merger (ie the counterfactual). For anticipated mergers, the CMA generally adopts the prevailing conditions of competition as the counterfactual against which to assess the impact of the merger. However, the CMA will assess the merger against an alternative counterfactual where, based on the evidence available to it, it believes that, in the absence of the merger, the prospect of the prevailing conditions continuing is not realistic, or there is a realistic prospect of a counterfactual that is more competitive than these conditions.¹
19. The Parties submitted that the correct counterfactual for the assessment of the Merger is that, absent the transaction: (i) Wallop would have exited the market; (ii) there were no less anti-competitive purchasers available; and (iii) if Wallop had exited the market, its sales of air countermeasures to UK customers would all have diverted to Chemring. The Parties submitted that there were a limited number of companies which could have bought the Air Countermeasures Business, or otherwise replaced Wallop's sales to its UK customers, due to national security restrictions.
20. As set out in the CMA's Merger Assessment Guidelines, for the CMA to accept an exiting firm scenario it would need to believe that the following conditions were met:
- (a) on the basis of compelling evidence that it is inevitable that the Air Countermeasures Business would exit the market (limb 1);
 - (b) that there is no substantially less anti-competitive purchaser for the business or its assets (limb 2); and
 - (c) the Merger does not represent a substantially less competitive outcome compared with what would have happened to the sales of the business in the event of its exit (limb 3).²

¹ *Merger Assessment Guidelines* (OFT1254/CC2), September 2010, from paragraph 4.3.5. The *Merger Assessment Guidelines* have been adopted by the CMA (see *Mergers: Guidance on the CMA's jurisdiction and procedure* (CMA2), January 2014, Annex D).

² *Merger Assessment Guidelines*, see paragraph 4.3.10.

21. The CMA has considered each of these limbs as set out below.

Limb 1 – would the target business inevitably exit the market absent the transaction?

22. In reaching a view on whether Wallop, and in particular the Air Countermeasures Business, would, in the absence of the Merger, inevitably exit the market, the CMA has considered Wallop's financial performance and a range of other factors, including Esterline's Board decisions and announcements, its interactions with customers, its management actions and its discussions with potential purchasers.

Financial performance

23. In assessing whether a firm's exit is inevitable, the CMA considers first whether the firm is unable to meet its financial obligations in the near future and whether it is unable to restructure itself successfully.³ In undertaking this assessment, the CMA examines both the firm's profitability over time and its balance sheet to determine the profile of its assets and liabilities. The CMA also considers the action management has taken to address the firm's position by reviewing contemporaneous documents such as board minutes, management accounts and strategic plans, and considers what further action might be taken.

Wallop's views

24. Wallop submitted that it was failing financially, saying that Wallop's poor financial performance historically, and limited ability to compete for future business, meant that it would inevitably have exited the market.

25. Wallop submitted that a number of factors had contributed to its negative profitability:

- Wallop said that in 2006 and 2008, respectively, it suffered two serious accidents, one of which resulted in the death of a member of staff. Following these accidents, Wallop had to invest significantly in health and safety, incurring high overhead costs in order to make it compliant with Health and Safety Executive (**HSE**) requirements and legislation, such as the Explosives Act 2014.

³ [Merger Assessment Guidelines](#), paragraph 4.3.14.

- Wallop said that, from 2010 onwards, there had been a dramatic decline in the global demand for countermeasures, which had resulted in falling profits for many businesses in the sector. Wallop submitted that there was no reason to expect demand to increase in the foreseeable future.
- Wallop said that it had invested for several years in its new spectral flares product. However, the development cost for this product had increased as specifications had continuously changed and demand for the product had been significantly curtailed as the Ministry of Defence (**MoD**), with which it had developed the product, had indicated that it would not be possible for Wallop to sell this product outside of the UK.
- Wallop said that it had tried to restructure its business to reduce its overhead costs, in particular by reducing its staff numbers, cutting its research and development (**R&D**) and replacing its existing ‘50 year old, inefficient, low capacity and fragile’ facilities.⁴ While the staff cuts and R&D cuts had mitigated its losses, Wallop said that it had not been able to identify a feasible alternative to its existing production site and, as a result, its maintenance and compliance costs had continued to increase.⁵
- Wallop said that it had entered into nine loss-making contracts between FY 12 and FY 16 as it had systematically underestimated the costs of fulfilling these contracts and had repeatedly bid aggressively against competitors in order to deliver strong revenue figures. One of these nine contracts was with [REDACTED] for the supply of MTV flares. Wallop submitted that the contract made a gross margin loss of £[REDACTED]. At the end of FY 14, Wallop made a £[REDACTED] provision for the loss on the whole contract.⁶ Wallop explained that the loss on the [REDACTED] contract was due to erroneous assumptions and oversights when the business plan was prepared.⁷ For example, it was assumed that the [REDACTED] product (40% of the contract by value) would be sub-contracted to Zeveta in the Czech Republic, which would save costs, but Zeveta was subsequently unable to manufacture the product to the required specification and Wallop had to manufacture the product itself at much greater cost.

26. Wallop submitted that, from 2011 to 2015, it reported operational losses in each year, with losses averaging about £4 million per year.⁸ Wallop’s total operating losses over this period amounted to £20.4 million. Wallop said that,

⁴ Response to first RFI, page 8.

⁵ Response to first RFI, page 8.

⁶ [REDACTED] contract breakdown, Annex 44.

⁷ [REDACTED]

⁸ Operational losses reported by Wallop: £(4.5) million in FY 11; £(4.0) million in FY 12; £(1.5) million in FY 13; £(5.8) million in FY 14; and £(4.5) million in FY 15.

in the absence of a sale or exit, it expected that these losses would continue for the foreseeable future.⁹

27. Wallop submitted that it was only financially viable due to its inter-company loans from Esterline. As at 29 February 2016, Wallop's loan book liability was £21.7 million, having risen every year for the last seven years.

Review of Wallop's profitability

28. The CMA examined Wallop's profitability. Table 1 outlines Wallop's financial performance between FY 11 and FY 14, using information from its audited statutory financial statements.

Table 1: Summary of Wallop's profit and loss accounts

	FY 14	FY 13	FY 12	FY 11
	£'000	£'000	£'000	£'000
Sales	15,567	14,936	11,624	16,699
Gross profits	(2,741)	1,551	(188)	1,978
Operational profit/(loss)*	(6,608)	(1,504)	(3,902)	(4,498)
EBITDA**	(5,233)	190	(1,777)	(2,955)
<i>Add back exceptional restructuring one off costs</i>	-	-	705	1,643
Adjusted EBITDA	(5,233)	190	(1,072)	(1,312)

Source: Wallop's financial statements FY 14, FY 13, FY 12 & FY 11

* Operational profit/(loss) is taken directly from the statutory accounts. Wallop has designated operational profit/(loss) as Earnings before Interest and Tax (EBIT).

** Depreciation and amortisation of fixed assets and losses on disposal of fixed assets totalled £1.38m in FY 14, £1.69m in FY 13; £2.13m in FY 12; £1.54m in FY 11; and £0.67m in FY 10.

29. To assess Wallop's financial performance, the CMA derived Wallop's Earnings before Interest, Tax, Depreciation and Amortisation (**EBITDA**), by adding back depreciation and amortisation costs into Wallop's 'operational losses' (**EBIT**). As set out in Table 1, Wallop had negative EBITDA in three out of the four years in the period.
30. The CMA then added back other costs which it believed were not reflective of Wallop's current and ongoing operational performance, ie its restructuring costs from 2011 and 2012. In these years, there had been a number of redundancies which had resulted in one-off costs. The Parties noted that, in

⁹ Paragraph 51 of the merger notice.

the absence of these costs, Wallop's losses would have been much worse in subsequent years. However, for the purposes of the CMA's assessment, it is the profitability of the underlying business, after all possible restructuring, which is of interest. The CMA note that, when all of Wallop's one-off restructuring costs are added back into its results, the business is still shown as being loss-making with negative adjusted EBITDA in three of the four years, and only a small profit in FY 2013, as shown in Table 1.

31. The CMA considered whether Wallop's R&D costs should also be added back to the adjusted EBITDA on the basis that these costs might reflect an investment for the future and therefore might not be reflective of Wallop's current underlying trading performance. However, Wallop submitted that, given the nature of its business, it was dependent on continuous R&D in order to maintain its competitive position. The CMA notes that Wallop's accounting policy, which is to expense its R&D costs rather than to capitalise them, supports this view. Wallop said that little of its total R&D cost related to new product origination and that the majority related either to the development of existing products to meet current customer demands or to process engineering developments to improve the safety of Wallop's production processes in line with HSE and statutory requirements. Wallop submitted that countermeasures with old designs rapidly become obsolete and, without constant investment in R&D, it would have been forced very quickly to exit the market. Wallop said that, for this reason, although it had cut back on its R&D expenditure significantly following the 2011 restructuring, the remaining level of expenditure was not discretionary and, rather, was essential to maintain the company with any prospect of returning it to profitability. Wallop said that, for these reasons, it was not appropriate to add back these costs into its financial data.
32. The CMA considered the nature of Wallop's R&D expenditure and the kinds of projects described by the Parties. The CMA was satisfied that most of the R&D spent by Wallop was not on discretionary investments for longer term future returns but on shorter term operational developments. On this basis, the CMA accepted that these costs should not be added back to Wallop's EBITDA when seeking to present the underlying profitability of the business.
33. In the absence of cash-flow statements, the CMA believes that the adjusted EBITDA figures shown in Table 1 provide a rough proxy for Wallop's operational cash-flows and underlying profitability.
34. At the time of the CMA's investigation, Wallop's statutory financial statements for FY 15 had not yet been prepared. Therefore, for this period, the CMA examined Wallop's monthly management accounts. In this period, Wallop's

financial year was the 11 months to September 2015.¹⁰ Making the same adjustment as above (ie adding back exceptional, one-off expenditure), Wallop made an adjusted EBITDA loss of £2.1 million in the period, as shown in Table 2.¹¹

Table 2: September 2015 management accounts (11 months)

	Air counter measures	Naval Rockets	Pyrotechnics	Services	Chaff & Naval	Other Misc ¹²	Total
Sales	5,628	280	841	1,030	556	-	8,335
Gross profits	331	139	450	421	243	(1,196)	388
EBITDA*	-	-	-	-	-	-	(3,407)
Add back exceptional fixed asset disposal/impairment	-	-	-	-	-	-	1,261
Adjusted EBITDA	-	-	-	-	-	-	(2,146)

* The September 2015 management accounts did not include any charges for depreciation or amortisation.

35. The CMA also considered the financial performance of Wallop's air countermeasures division separately using Wallop's divisional management accounts. In September 2015, this division showed a gross profit for the 11 month financial year of £331k, as shown in Table 2. However, Wallop submitted that it was not appropriate to judge the viability of a business on the basis of gross profit as this ignored the significant overheads and engineering expenses which are necessarily incurred. The CMA accepts that the figure reported as the gross profit of the air countermeasures division provides limited insight into the underlying profitability of the Air Countermeasures Business, due to it excluding many essential costs.

36. The CMA also reviewed forecasts prepared by Wallop management to see what they indicated about the future profitability of Wallop and, in particular, the Air Countermeasures Business. However, the CMA found that Wallop had failed to match any of its forecasts for several years, such that little weight could be placed on these forecasts.¹³

¹⁰ The 2015 fiscal year was an 11-month reporting period in order to realign the year end to September.

¹¹ Note that the Management Accounts are not prepared on the same basis as Wallop's statutory financial statements, therefore, caution should be exercised when making a comparison.

¹² This category relates to operational variances that are not attributable to a single product or product category.

¹³ In FY 14, Wallop prepared forecasts indicating a return to profit in FY 17. These forecasts were presented to the Esterline Board in May 2014 and August 2014. However, Wallop told the CMA that these forecasts were 'very

Review of Wallop's balance sheet

37. The CMA has examined Wallop's balance sheet using figures from Wallop's audited statutory accounts for the period FY 11 to FY14,¹⁴ as shown in Table 3.¹⁵

Table 3: Profile of Wallop's assets and liabilities for the period between FY 11 and FY 14

	FY 14	FY 13	FY 12	FY 11
	£'000	£'000	£'000	£'000
Fixed assets	14,152	15,894	17,011	18,382
Current assets	8,896	11,314	9,015	6,843
Creditors: falling due within one year	22,671	19,278	16,498	11,625
Amounts owed to group undertakings	17,443	15,102	12,076	6,737
Other creditors	5,228	4,176	4,422	4,888
Net assets	377	7,930	9,528	12,882
% Amount of group undertakings/total liabilities	76.9%	78.3%	73.2%	58.0%

Source: Wallop's financial statements FY 14, FY 13, FY 12, & FY 11.

38. Table 3 shows that Wallop's net assets have fallen each year since FY 11, consistent with its long-term negative financial trading performance. Table 3 also shows that, at 31 October 2014, Wallop had a total net current liability of £13.8 million. In particular, Wallop's inter-company loan has increased each year in the period. Table 3 also shows that Wallop's net fixed assets have declined each year in the period, indicating that its depreciation of tangible assets and amortisation of intangible assets have exceeded new amounts capitalised, suggesting that investment has been below historic levels.

optimistic'. It also submitted that it had previously prepared forecasts which anticipated the business returning to profitability in FY 12 and FY 14, and that these forecasts had never been realised. The Chief Financial Officer (CFO) of Esterline told the CMA that the forecasts which Wallop management had provided to the Esterline Board had proved thoroughly unreliable for several years and no reliance was placed on them by Esterline. He said that this was evidenced by the fact the Esterline Board decided to sell or wind-up Wallop at the meeting when Wallop's FY 14 forecasts were presented. Given Wallop's history of presenting forecasts which have not been borne out in reality, the CMA attached very little weight to them.

¹⁴ Wallop's year end was near the end of October in FY 11 to FY 14, though the exact date varied from year to year.

¹⁵ The CMA was unable to assess Wallop's balance sheet for FY 15 as the final statutory accounts had not yet been prepared and the management accounts do not include the company's balance sheet.

39. The CMA noted that, over recent years, Wallop had been sustained financially by its growing inter-company loan from its parent company. The CMA therefore considered the extent to which Wallop was dependent on this financial support and, if this were the case, whether that support would continue such that Wallop could continue to meet its liabilities.
40. Wallop submitted that it had been dependent on Esterline’s financial support since 2009, with the funds made available being used to fill working capital deficits, ie making payroll payments and payments to suppliers.¹⁶ On 29 February 2016, the total debt outstanding to Esterline was £21.7 million. Wallop said that, without the on-going financial support of its parent company, it would have been unable to meet its financial obligations and would have been insolvent many years before. As evidence of the level of its debt and liabilities, Wallop submitted its ‘Accounts Payable’ as reported in December 2015, as shown in Table 4.¹⁷

Table 4: Wallop’s debt and liabilities, December 2015

FY 15	£'000
Creditors: falling due within one year	28,411
Amounts owed to group undertakings	21,801
Other creditors	6,610

Source: Wallop.

41. Wallop submitted that, not including the Esterline loan, in December 2015 Wallop was approximately £6.6 million in debt to third parties, with no prospect of these debts reducing except through Esterline’s financial support.
42. Wallop submitted that, in addition, its business currently needed an immediate £1.5 million capital investment in order for it to become compliant with the Explosives Regulations 2014. It continued that, moreover, if it were to continue trading, it would have to increase its annual expenditure on safety compliance costs in order to satisfy increasing operational control demands from HSE. Wallop said that, in FY 2015, it had set a Health and Safety budget of £919,000, but had only spent £545,000 in light of the impending closure of

¹⁶ Wallop submission, 1 March.

¹⁷ This includes creditors, where invoices have been received, and accruals, where costs have been incurred but have not yet been invoiced.

the business. Wallop said that, were the business to continue, the remaining costs would need to be incurred.

43. Notwithstanding the parlous state of the Wallop business, the CMA noted that Esterline had continued to provide Wallop with a Letter of Support, allowing Wallop's auditors to prepare its financial statements on a 'going concern' basis. However, Esterline told the CMA that it would not have wanted Wallop to fail in an unmanaged way given Esterline's corporate responsibilities and reputation and given its ongoing relationships with many of Wallop's customers for other products (eg the MoD). For these reasons, the CMA considers that the Letter of Support indicates that Wallop would be able to meet its financial obligations in the near future, but does not indicate any long term intention on Esterline's part to support this business, other than to allow an orderly exit.

Restructuring

44. Given Wallop's long-term loss-making performance, the CMA considered whether Wallop, and in particular its Air Countermeasures Business, could have returned to profitability as a result of restructuring.
45. Wallop submitted that it had attempted repeatedly to restructure the business. Wallop said that, in 2011, it had brought in a new Managing Director with the explicit purpose of restructuring the business to make it sustainable in the context of reduced global demand for its products. In 2011, Wallop estimated that its sales would decline between 15% and 30% and, as a result of its high cost base, it believed there was a real prospect that it would return to being loss making. In benchmarking itself against its closest competitor (Chemring), Wallop estimated that its cost of sales was 73% higher. In order to reduce its cost base, Wallop's new management proposed that it would:
- reduce headcount by 54, which would deliver an annual saving of £1.9 million;
 - undertake a full review of its production overheads, including energy costs, the procurement of spare parts, waste disposal expenditure and the use of outside contractors and consultants; and
 - reduce R&D expenditure significantly to focus on essential issues.
46. Wallop submitted that, recognising these measures to be insufficient, in 2012 it attempted to restructure the business further, in particular by again reducing staff numbers.

47. Wallop's financial results evidence the impact of these restructuring measures in 2011 and 2012.¹⁸ Wallop's salary costs and R&D costs were significantly reduced. However, these savings occurred at the same time as a decline in sales. As a result, although the measures reduced Wallop's losses from what they would have been, the business still did not manage to operate profitably.
48. Wallop submitted that further reductions in staff numbers were not possible as Wallop was required to maintain the safe environment required by statute and the HSE, and the 2012 reduction in workforce had reduced the resources to the absolute minimum safe level.
49. Wallop submitted that it had investigated new methods of production, including the introduction of a new MTV manufacturing facility. However, the new plant failed to reach the required levels of safety and Wallop was forced to rely on its existing, inefficient and cost-ineffective facility. Wallop submitted that it had also explored relocating parts of its MTV production to its parent company's site in Arkansas.¹⁹ However, these attempts proved 'futile' as the production processes were fundamentally different and US regulations (ITAR) would have impeded the sale of Wallop's products on the international market.²⁰
50. With respect to air countermeasures, Wallop told the CMA that, over recent years, it had continued to work with the MoD to develop dual spectral and multi-shot flare products, for which it had initially anticipated high sales. However, Wallop said that, although these products had been well received by the MoD, its sales expectations had declined significantly as the MoD had indicated that Wallop would not be permitted to sell these products to customers outside the UK.

CMA views on Wallop's financial performance

51. The CMA notes that Wallop has been loss-making since 2011 and successive attempts by management to restructure the business have been unsuccessful in turning the business around. Based on the evidence provided, the CMA recognises that Wallop was reliant on its parent company for financial support and in order to remain solvent. However, the CMA's guidance states that in the context of a firm exiting for reasons of financial failure, consideration is given to whether the firm is unable to meet its financial obligations in the near

¹⁸ Wallop's overheads in 2010 were £10.95 million; in 2011 this reduced to £10.29 million; in 2012 this reduced to £8.14 million (as a result of the 2011 restructuring); and in 2013 this reduced to £7.73 million in 2013 (due to the 2011 and 2012 restructuring activities).

¹⁹ Wallop's response dated 26 January 2015, page 8.

²⁰ Wallop submitted that if its technology or data had been shared between UK and the US, Wallop's products would have become subject to the ITAR regulatory regime. According to Wallop, ITAR tainted products are unpopular on the international markets because of the complex US regulations and severity of penalties for breach thereby significantly reducing their marketability.

future.²¹ Given Wallop's position within a profitable corporate group, the CMA believes that Wallop would have continued to be viable as long as Esterline continued to provide financial support and, therefore, the CMA has not found, in spite of an extensive analysis of Wallop's accounts, that it would have exited for financial reasons alone. The CMA therefore, whilst taking into account the parlous financial situation of Wallop and its dependence on intra-group loans, turned to consider whether, in the round, the business would have ultimately exited for strategic reasons.

Board decisions

52. The CMA considered a number of documents and announcements made by Wallop's parent company Esterline.
53. Wallop submitted that these documents demonstrated Esterline's firm intention, absent the Merger, to wind-up Wallop, including the Air Countermeasures Business. Wallop submitted that it had been 'trading at a significant loss' and that the company did not demonstrate a potential return to profitability or to providing a compelling contribution to the Esterline business relative to its ongoing required investment.²² Wallop said that, accordingly, management's recommended plan of action was to pursue a sales process and, if that failed, to wind-up the business. The Parties submitted that this would have inevitably resulted in all of Wallop's air countermeasures products and technology exiting the market.²³
54. Wallop submitted that the principle strategic reason for Esterline's acquisition of Wallop in 2006 was that Wallop had the ability to manufacture spectral flares, a product which, at that point, Esterline was unable to manufacture.²⁴ These flares were seen as attractive as they were one of the 'few profit-making countermeasures' on the market.²⁵ However, three months after Esterline acquired Wallop, there was an explosion involving spectral flares at the UK facility, which resulted in the death of a member of staff.²⁶ As a result, the HSE issued a 'Prohibition Notice', which had the effect of stopping Wallop's manufacture of spectral flares.²⁷ Wallop submitted that it therefore had to focus on the manufacture of 'non-profit making countermeasures (such as MTV flares and chaff)'. Wallop added that a further on-site explosion occurred in December 2008, which resulted in more site closures and further

²¹ [Merger Assessment Guidelines](#) (OFT1254/CC2), September 2010, paragraph 4.3.14.

²² Submission dated 5 February 2016, page 2.

²³ Merger Notice, Para 22b), page 9.

²⁴ Response to RFI, 26 January 2016, page 1.

²⁵ *Ibid.*

²⁶ Para 49 of the Merger Notice.

²⁷ Response to RFI, 26 January 2016, page 1.

substantial safety costs.²⁸ Wallop said that, despite considerable investment, it had not been able to navigate successfully into producing the more profitable products which had made the business attractive.²⁹

55. Wallop submitted that the combination of the two accidents alongside the effect of the worldwide downturn in defence spending placed Wallop in an 'unsustainable financial situation',³⁰ and that, since 2011, Wallop has consistently operated at a significant loss. In 2011, recognising the challenges faced by the business, the Esterline Board decided to bring in new management with the aim of turning the business around.
56. In November 2013, Esterline appointed a new group CEO, who immediately initiated a strategic review of Esterline's entire portfolio. The Esterline Board decided that Esterline should shape its portfolio to its core strategic objectives.³¹ Therefore, from the beginning of 2014, Esterline began the process of analysing its operations and businesses to determine whether they were viable, or whether they should be divested or closed. As part of this review, [REDACTED] entities were considered, including Wallop. The [REDACTED] entities /were grouped into four categories, reflecting the Board's view of their prospects. Wallop was categorised as [REDACTED], the lowest category, which Esterline told the CMA meant that it had decisively failed. Wallop was deemed to be in a 'very poor financial state',³² with no prospect of recovery. Esterline told the CMA that this categorisation and financial assessment did not change at any point during the review process. Esterline said that, against the backdrop of a declining market, it had concluded that the UK (and wider) market was simply not in a position to sustain two large defence countermeasure companies.
57. In February 2014, [REDACTED], initial discussions took place between Esterline and Chemring [REDACTED].
58. In April 2014, Esterline [REDACTED], Edwards Advisory was retained to explore possible sale options for Wallop.
59. On 6 May 2014, Esterline management presented a formal proposal to its Board that Wallop (and three other businesses) should be designated as 'discontinued operations'. In the presentation, Wallop was identified as a candidate for 'pruning'. It was also stated that Wallop was not a strategic fit for Esterline.

²⁸ Para 49 of the Merger Notice.

²⁹ Response to RFI, 26 January 2016, page 1.

³⁰ Para 49 of the Merger Notice.

³¹ Response to second RFI, 5 February 2016, page 2.

³² Response to second RFI, 5 February 2016, page 2.

60. On 17 July 2014, Wallop management presented its 'FRQ-3' forecasts to Esterline management. Wallop forecasted that it would have net losses of \$7 million in FY 14 and \$11.6 million in FY 15. In the presentation, Wallop set out some strategic options for the business, which included selling it to one of Chemring, [REDACTED] or [REDACTED]. It also presented an option to exit MTV flares and air chaff completely, which it submitted would remove 'most of the overhead' and significantly reduce its health and safety risks and HSE compliance costs. In the presentation, Wallop considered the consequences of exiting, noting the losses it would incur on the [REDACTED], and the future gross margins it would lose on outstanding quotes for business worth around \$[REDACTED].
61. On 20 August 2014, another presentation was made to the Esterline Board, in which the proposal to designate Wallop as a 'discontinued operation' was discussed. Included in the presentation was the draft wording for the '10-Q footnote', which relates to US regulations for listed companies on publicly announcing a decision to discontinue a business. The draft wording stated that: 'our board of directors decided to sell certain non-core business units including...Wallop Defence Systems'. No decision was taken by the Board at that meeting but responsibility to approve the plan to sell Wallop was delegated to the Audit Committee.
62. On 3 September 2014, the Audit Committee agreed that Wallop, and the other entities which had been categorised as [REDACTED], were to be designated as "discontinued operations". This decision was made public in September 2014. The announcement was included in Esterline's Q3 quarterly SEC filing, which stated: '[Esterline has]... approved a plan to sell certain non-core business units following an evaluation of its businesses'.³³
63. The Parties submitted that, as a consequence of filing this statement and designating Wallop as a 'discontinued operation', Esterline was required to: (i) recast any previous Esterline group financial statements for continuing operations, removing references to the business to be discontinued; and (ii) either effect the disposal within 12 months of being declared 'discontinued' or have at that stage an active ongoing sales process for the business.
64. Esterline recognised that it is legally possible to bring a business designated as a discontinued operation back into its continuing operations. However, Esterline submitted that this was very rare. Esterline said that this only ever occurred where the discontinued operation was a material business for the parent, which was seeking strategic alternatives to a sale or exit. Esterline

³³ SEC filing: www.sec.gov/Archives/edgar/data

stressed that, in the case of Wallop, there was no possibility that this business would ever have been restored as a continuing operation. The CFO of Esterline told the CMA that it was inconceivable that, having made the SEC announcement, Esterline would have gone back to the financial markets to say that it was continuing with Wallop within its group. Esterline stated that, having made this announcement, there were only two possible outcomes for Wallop: either a sale of the business or to wind the business up.

65. Edwards Advisory told the CMA that, when Wallop was publicly declared a 'discontinued operation', this effectively placed Wallop on the market, advertising the business to any interested purchaser.

Interactions with customers

MoD

66. In May 2014, Chemring and Esterline approached the MoD to discuss their potential global joint venture. The CMA notes that much of the presentation to the MoD summarises the preliminary discussions held between Chemring and Esterline about combining and rationalising their countermeasures businesses. In its presentation to the MoD, Esterline set out in detail its view that the countermeasures market was not able to support two commercial businesses in the UK. It presented a number of options including how best it could exit from Wallop.³⁴
67. On 15 October 2014, following the SEC filing, Esterline's CFO sent a letter to the MoD stating that Esterline was 'exploring a sale of the Company [Wallop] to a third party...[and] should no suitable buyer be found, Esterline may need to consider the winding-up of the Company'. Wallop submitted that, in communicating this to its principal customer, Esterline was signalling a clear intent to exit the business.
68. On 29 October 2014, Esterline, Wallop and Edwards Advisory met with the MoD. The primary purpose of the meeting was to inform the MoD that Wallop had been listed as a discontinued operation and to discuss the impact this would have on the countermeasures market. Esterline was also subject to certain obligations under the Deed of Undertaking it had signed with the MoD when it had acquired Wallop, and was bound to inform the MoD, as a significant customer and development partner, of the possible closure/sale of

³⁴ Esterline presentation to the MoD of 29 October 2014, Annex 6 of Wallop's response to the CMA's second request for information of 5-2-16.

the business. An email from Edwards Advisory to Wallop and Esterline in advance of the meeting set out a draft agenda, including:

- ‘Gain MoD support for a possible sale of Wallop to Chemring
- Ensure the MoD understand that the only alternative is a site closure’.³³

69. The Parties submitted that, in line with this agenda, it was made absolutely clear to the MoD that, if a sale were not secured, Esterline’s ‘Plan B’ would be to close the Wallop facility in an orderly manner.³⁵
70. The MoD told the CMA that it had been informed of the Esterline position on Wallop. The MoD said that discussion had focused on the fact that having failed to find a buyer for Wallop, coupled with the losses made by Wallop, Esterline had concluded that it had no other option than to close Wallop.³⁶

Refusal of the [REDACTED] contract

71. In March and April 2015, Wallop won two contracts to supply MTV flares and chaff to the [REDACTED].³⁷ However, in a letter dated 1 July 2015 sent by Esterline to the [REDACTED] it was explained that it had become clear that it had not been possible for Esterline to sell the Wallop business via a share sale, and that Esterline was now planning to sell the business via an asset sale. The intellectual property, contracts and associated assets would be transferred to the buyer, while the legal entity (Wallop) would remain in Esterline’s ownership as a dormant company with no manufacturing capability. The significance of this change was that the two awarded contracts, as drafted, could not be transferred to a new owner under a business and asset transaction. Therefore, Esterline explained to the [REDACTED] that this would leave Esterline with the associated contract obligations with no means by which to fulfil them.³⁸ Esterline said that, under these new circumstances, it would not be able to accept the two contracts.
72. Wallop submitted email correspondence between Esterline and Wallop management in June 2015 which discussed a draft letter to notify the [REDACTED] that Esterline would refuse to accept the awarded contracts. Within the email discussions, Esterline said that there would be no liability for damages if the contract was not signed but that Esterline (and Wallop) would ‘lose

³⁵ Wallop agenda and post meeting notes for the meeting with the MoD in October 2014.

³⁶ MoD’s unclassified response to CMA’s customer questionnaire.

³⁷ Confirmation of Wallop being awarded the [REDACTED] contract arrived via e-mail on 10 March 2015, and Wallop was notified of being awarded the [REDACTED] chaff contract via e-mail on 28 April 2015.

³⁸ Esterline suggested a slight rewording of the contract, re-issuing the contract in the new owner’s name (when known) or, if the [REDACTED] chose to issue a fresh tender request, inviting Esterline’s US business to bid.

reputation'.³⁹ Wallop's Managing Director indicated that he would try to limit any reputational damage and would send the letter at the end of the week.

73. Esterline submitted that its decision to refuse the [X] contracts, with the consequent reputational damage this caused between Esterline and a significant international customer, indicated Esterline's commitment to exit the Wallop business, either through a sale or by winding it down.
74. Wallop submitted that it had also been invited to bid for new contracts from [X] but, in June 2015, it had declined. This occurred at a time when the deal with Chemring had collapsed and there was no transaction to sell either Wallop or the Air Countermeasures Business in contemplation. Nevertheless, Esterline senior management wrote that 'CHG [Chemring] is gone and not coming back', and that 'we are at the decision point of not accepting anything (including [X]),... and closing down, otherwise we are going to bleed cash and profits indefinitely'.⁴⁰
75. Esterline submitted that, in declining the [X] contracts and refusing to quote for business with other customers, it had effectively excluded the possibility of Wallop trading profitably in FY 16 and for some time beyond.⁴¹ Esterline said that these actions clearly demonstrated its commitment to either sell the Wallop business or close it.

Plans to close down the Wallop site and the Wallop business

76. Wallop and Esterline submitted a number of internal documents to demonstrate its plans to close down the Wallop business in the absence of a sale. A summary of these documents is set out in chronological order below.
 - Following listing Wallop as a discontinued operation in September 2014, Esterline's senior management discussed in email correspondence (21 - 22 October 2014) the possible timeframe for the closure of Wallop, in particular if a sale of the business were not achieved. Management estimated that it would take around 14 months, but an aggressive target would be about a year.⁴²

³⁹ Email between [X] of Esterline and [X] of Wallop – 24 June 2015.

⁴⁰ Email between [X] of Esterline and [X] of Esterline -1 June 2015.

⁴¹ The CMA notes that if Esterline had signed the contract, it would have had to keep its UK site open in order to service it.

⁴² 'At the last Platform President's meeting when [X] was talking about the Disc Ops companies, he mentioned that he thought it was reasonable that we could take one to two years to sell these companies. If it looked like it would take longer then we would have to address that with the Street as to what we would do next. Is that an accurate recollection? I ask as one of the concerns of the UK MoD that I will need to address next week with them is "what if no one will buy Wallop". I'd like to say that while we would eventually phase out the company in an organized way to minimize impact to customers, I would also like to say that it would not necessarily be a

- In April 2015, Wallop began to engage Hampshire Environmental Services (**HES**) in relation to the demolition of certain buildings on the Wallop site.⁴³ Wallop submitted that these plans to close down the Wallop site began once it became clear that there was no purchaser interested in acquiring the land and buildings. However, until May 2015, there remained the prospect of selling the entire Wallop business to Chemring [REDACTED], as such, these initial demobilisation activities were taken while the Merger was in contemplation.
- In May 2015, [REDACTED].⁴⁴[REDACTED]. In particular:
 - Esterline continued to gain quotes for demolition works to clear the Wallop site.⁴⁵
 - Wallop management prepared a draft redundancy proposal. In it Wallop stated that there was no future for production on the Wallop site and the business was being closed down.⁴⁶ The proposal outlined a process of phased redundancies which were designed to ensure an orderly closure and to mitigate any health and safety and environmental issues. The draft redundancy proposal stated:

...a plant closure budget of between £2.5m to £3m was discussed and agreed. This number is inclusive of employee redundancy, plant decommissioning, site clearance and site closure. The employee related costs equated to c£1.5m to £2m of that original budget and reflect the need to retain the employees until completion of key contracts ([REDACTED]), which will avoid future penalties from those customers inclusive of bank guarantees and liquidated damages.

Wallop provided to the CMA a breakdown of the full winding up costs, which were estimated to be around £2.5 million.

- In July 2015, Esterline re-engaged Chemring in discussions in relation to a purchase of the Air Countermeasures Business, at which point the transaction was again in contemplation. The APA for this transaction was signed in November 2015. Between July and November Esterline took a

matter of months if our existing deal falls apart for some reason. How long would we likely keep Wallop going in Disc Ops? Would we move quickly to close it down or could it be a year or more?’

⁴³ Email chain between [REDACTED] of HES and [REDACTED], Environment and Facilities Manager for Wallop – 16 April 2015 to 18 May 2015.

⁴⁴ Email from [REDACTED] of Chemring to [REDACTED] of Edwards Advisory – 15 May 2015.

⁴⁵ Email from [REDACTED] of HWM Group to [REDACTED] Environment and Facilities Manager for Wallop – 25 June 2015.

⁴⁶ The draft redundancy plan was prepared in June 2015.

number of further steps to wind-up the Wallop business, which it stated would have been irrational if it had any intention of continuing operating Wallop as a going concern in the absence of the deal with Chemring being agreed. In particular:

- In August 2015 senior management at Esterline and Wallop discussed two possible options regarding the removal of buildings on the north site. It set out the timescales for the proposed works, indicating that the likely announcement would be in late September 2015.⁴⁷
- In October 2015 Wallop received approval from Esterline for redundancy benefits for Wallop employees.⁴⁸ The total redundancy budget was set at £[REDACTED].

77. The CMA believes that this contemporaneous evidence indicates that, in the absence of a sale of the Air Countermeasures Business, Esterline had the clear committed intention of closing it down.

Evidence from potential purchasers

78. Edwards Advisory told the CMA that, following the SEC filing, it had marketed the Wallop business to many potential trade buyers and several potential financial buyers. Further details of the sales process are set out below as part of the CMA's consideration of limb 2.

79. With regard to the initial sales process for the entire Wallop business, Edwards Advisory said that, although several potential trade buyers and financial buyers showed initial interest, they all withdrew, often citing the health and safety liabilities relating to the Wallop site as being their principal concern. One financial party offered to acquire the entire Wallop business but required a payment from Esterline of £8 million to take on the liabilities associated with the site. Given that this cost was significantly in excess of Wallop's own estimates of the cost to wind up the site, this bid was not considered acceptable.

80. The CMA believes that the lack of interest from third parties in purchasing the Wallop business, and in particular the reasons these parties provided to explain their concerns, indicates the parlous state of the business and the significant liabilities associated with it, especially in relation to its land and buildings.

⁴⁷ Email of 13 August 2015 from [REDACTED] to [REDACTED], MD of Wallop Defence Systems.

⁴⁸ Approval memo from [REDACTED] and [REDACTED] of Esterline for redundancy benefits for Wallop employees dated 12 October 2015.

CMA conclusion on limb 1

81. In reviewing mergers at Phase 1, the CMA is required to assess whether the merger creates a realistic prospect of an SLC. The 'is or may be the case' standard in the CMA's SLC test also has implications for its approach to the counterfactual. The CMA considers the effect of the merger compared with the most competitive counterfactual providing always that it considers that situation to be a realistic prospect. In practice, the CMA generally adopts the prevailing conditions of competition (or the pre-merger situation in the case of completed mergers) as the counterfactual against which to assess the impact of the merger. However, the CMA will assess the merger against an alternative counterfactual where, based on the evidence available to it, it considers that the prospect of prevailing conditions continuing is not realistic.⁴⁹ In this case, the CMA has considered whether Wallop and its Air Countermeasures Business would inevitably exit the market in the absence of the Merger.
82. The exiting firm scenario is most commonly considered when one of the firms is said to be failing financially.⁵⁰ As set out in paragraph 51, the CMA recognises that Wallop was reliant on its parent company for financial support and in order to remain solvent. Nonetheless, the CMA believes that Wallop would have continued to be viable as long as its parent, Esterline, continued to provide financial support and, as such, the CMA has not found, in spite of an extensive analysis of Wallop's accounts, that it would have exited for financial reasons alone. However, exit may also be for other reasons, for example because the selling firm's corporate strategy has changed.⁵¹ Accordingly, whilst taking into the parlous financial situation of Wallop, the CMA went on to carefully consider whether it had compelling evidence that Esterline would have chosen to wind-up Wallop for strategic reasons.
83. The CMA believes that Esterline's decision to sell or close Wallop was taken in September 2014. This decision followed Esterline's strategic review of its businesses and was made in light of Wallop's ongoing financial losses, its increasing indebtedness, and its failure to successfully restructure. Viewed together, Esterline's SEC filing and its discussions with key customers, including the MoD, amounted to a public commitment either to sell Wallop or close it down. This intent was confirmed in its decision not to accept two large contracts from the [X] and not to bid for possible new contracts. The parlous

⁴⁹ [Merger Assessment Guidelines](#) (OFT1254/CC2), September 2010, paragraph 4.3.5.

⁵⁰ *Ibid*, paragraph 4.3.9.

⁵¹ *Ibid*.

state of the business is also confirmed by the comments made about it by parties to which it was marketed.

84. The plans for closing down the Wallop site began [✂]. However, importantly, more general plans to close down the business began from May 2015 when the deal with Chemring fell apart and there was no transaction in contemplation. Esterline's actions in this period indicated its clear intention to close the business in the absence of a sale.
85. The CMA has considered the available evidence carefully and reviewed extensive contemporaneous documents which indicate that Esterline was committed to selling Wallop and, in the absence of a sale, would wind it up.
86. For all the reasons set out above, the CMA believes that there is no realistic prospect that the business would have continued in operation absent the Merger. Rather, the CMA believes that, absent the Merger, Wallop would have exited the market.

Limb 2 - no substantially less anti-competitive purchaser for the division or its assets

87. Even if the CMA believes that the firm would have exited, there may be other buyers whose acquisition of the firm as a going concern, or of its assets, would produce a better outcome for competition than the merger under consideration.
88. When considering the prospects for an alternative buyer for the firm or assets, the CMA will look at available evidence supporting any claims that the merger under consideration was the only possible merger. The CMA will take into account the prospects of alternative offers above the liquidation value.⁵²

Sales process

89. Edwards Advisory told the CMA that it started preparing marketing materials to sell Wallop as a going concern in July 2014, and formally commenced the sales process after Wallop had been publically listed as a 'discontinued operation' in the SEC filing of September 2014. Edwards Advisory told the CMA that, when Wallop was publicly declared a 'discontinued operation', this effectively gave everyone in the industry notice of the fact that Wallop was for sale.

⁵² Ibid, paragraphs 4.3.16 – 4.3.17.

90. Edwards Advisory contacted many potential trade purchasers, including Chemring, [REDACTED], gauging their possible interest in the business. In parallel, Edwards Advisory also had discussions with many potential private equity and financial buyers, including [REDACTED].
91. Aside from Chemring, the only other offer received for the entire Wallop business was from a financial buyer which required a payment from Esterline of £8.3 million to take on the liabilities associated with the site. Given this cost was significantly in excess of Wallop's own estimates of the cost to wind-up the site (the liquidation cost for Wallop was estimated at £2.5 million) this bid was not considered acceptable. Every other possible purchaser (trade or financial) declined to make an offer for Wallop. Edwards Advisory said that, although several potential trade buyers and financial investment companies showed initial interest, they all withdrew, often citing the health and safety liabilities relating to the Wallop site as being their principal concern.
92. Edwards Advisory and Esterline engaged in extensive discussions and diligence meetings with Chemring about the sale of Wallop. However, in January 2015, [REDACTED]. Further discussions and diligence then took place. However, in May 2015, Chemring then stated that it was no longer interested in the acquisition at all and the transaction terminated.
93. Following the collapse of negotiations with Chemring, the sales process was paused for three months between May 2015 and July 2015 whilst Esterline considered alternative options for Wallop. In this period, Esterline continued to take decisive action to close down the site in anticipation either of a sale process resuming on the basis of it excluding the land and buildings or of the business being wound up (see limb 1 above).
94. In July 2015, Edwards Advisory and Esterline began considering an asset sale of the business, with a possible breaking up of the assets as between air and naval countermeasures. At this time, Edwards Advisory and Esterline had a number of calls to discuss which buyers to approach taking into account third parties' reasons for declining interest in the whole business and their existing facilities. Esterline told the CMA that any prospective buyer of the Air Countermeasures Business would need a facility⁵³ to which it could move the relevant operational activities and assets, and that this would exclude all financial buyers. Esterline said that Wallop's air countermeasures assets require the most specialised, dangerous and regulated manufacturing processes, and it would not have been possible to move the assets and operations into an unregulated facility and, therefore, the only possible

⁵³ See paragraphs 102 and 103.

purchaser of the Air Countermeasures Business would be an existing player in the industry, namely: [REDACTED] or Chemring.

95. Esterline submitted that Magellan does not have a site capable of producing MTV flares and therefore it was not in a position to even consider an asset sale/transfer of the Air Countermeasures Business. On this basis, Esterline did not approach [REDACTED] about an asset sale.
96. In July 2015, Esterline approached both Chemring and [REDACTED] but, at this time, it chose not to approach [REDACTED] because it had only been interested in a purchase that provided them with a UK production facility ([REDACTED] had declared it was not interested in Wallop's land and buildings after declining to make an offer for Wallop as a going concern). Nevertheless, Esterline told the CMA that, in October 2015, [REDACTED], an officer of Esterline, approached a Vice President of [REDACTED] informally at the US Army trade show in Washington DC⁵⁴ about an asset purchase once it became clear that the naval and air countermeasures assets would be split. Esterline told the CMA that [REDACTED] Vice President had confirmed that [REDACTED] was not interested in an asset purchase of the Air Countermeasures Business only. The officer of [REDACTED] responsible for communicating with the CMA could not exclude the possibility that these discussions happened but was not able to confirm this.⁵⁵
97. [REDACTED] only expressed interest in Wallop's naval countermeasures division. [REDACTED] told the CMA that while, in principle, it would have been interested in the opportunity to purchase the Air Countermeasures Business, it did not express an interest due to:
 - restrictions concerning access to the UK market (see below); and
 - the level of investment required to meet safety and environmental regulations for the manufacture of air countermeasures.
98. Chemring [REDACTED],⁵⁶[REDACTED] the APA was signed in November 2015.
99. On the basis of this evidence, Esterline submitted that there was no alternative purchaser to Chemring for the Air Countermeasures Business. Further to this evidence on the sales process, Esterline also provided evidence on export restrictions which it submitted supported its view that

⁵⁴ Esterline said that Edwards Advisory had contacted [REDACTED] about the possibility of purchasing Wallop's assets, and [REDACTED] of Esterline had a conversation with the Vice President of [REDACTED] at the US Army Trade Show in Washington DC in October 2015 – Response to CMA's questions of 18 February 2016.

⁵⁵ [REDACTED] response of 23 March 2016.

⁵⁶ Email of 2 September between [REDACTED], Edwards Advisory and [REDACTED].

Chemring was the only viable purchaser for the Air Countermeasures Business.

Export restrictions on the sale of air countermeasure assets outside of the UK

100. The MoD told the CMA that the products which Wallop had developed in partnership with it were generated as a result of Wallop's access to highly classified material. Therefore, Wallop's products which met the UK's defence requirement specifications were subject to export limitations.⁵⁷ This also applied to "export" variants of air countermeasures.
101. The MoD also said that, given the sensitive nature of the products supplied by Wallop, and to preserve national security, MoD consent was required for the sale of Wallop and/or any sale of the Air Countermeasures Business.
102. The MoD said that [REDACTED]. Moreover, it said that it would not grant an export license for Wallop's recent air countermeasures technological developments as these had been based on classified MoD material. For these reasons, the CMA believes that any acquirer of the Air Countermeasures Business would have to set up a site in the UK in order both to sell to the MoD and to benefit from Wallop's recent technological developments.⁵⁸
103. The MoD gave Edwards Advisory consent to approach entities outside the UK when it was anticipated that Wallop would be sold as a going concern. This was on the basis that Wallop's facilities and site would have been part of the transaction, thereby ensuring that the products would continue to be manufactured in the UK by a UK domiciled company. To the extent the purchaser was a non-UK company, a firewall, similar to that in place between Wallop and Esterline, could have been erected to prevent the sharing of classified UK data between the parent and subsidiary.
104. However, with respect to the asset sale of the Air Countermeasures Business, the CMA believes that any purchaser would have been required to either have existing land and buildings in the UK to which it could transfer the assets or have been willing to invest in a new site in the UK which met HSE requirements. Esterline submitted that, for these reasons, the only realistic purchaser of the Air Countermeasures Business was Chemring, which was already domiciled in the UK and had the appropriate, authorised facilities.

⁵⁷ Mainly reflecting the level of performance sensitivity/technology inherent in the particular product. For example [REDACTED], has been designated non-exportable by the MoD.

⁵⁸ The MoD confirmed that those Wallop products which are currently exported abroad, and which are of an earlier generation of countermeasure, also required approval from the MoD.

105. In these circumstances, the CMA believes that this is strong evidence that there was no alternative purchaser to Chemring for the Air Countermeasures Business because other than Wallop it was the only other UK domiciled and approved supplier of air countermeasures who could readily utilise the assets of the Air Countermeasures Business.

Conclusion on Limb 2

106. The CMA notes that Edwards Advisory had utilised the responses from the initial marketing round, for the entire company, to inform whom it should contact with regard to the sale of the assets. This essentially cut the potential purchasers down to trade buyers as these would be the only possible purchasers with production sites and the regulatory approvals required to operate the air countermeasures assets. Given that all prospective buyers had previously rejected the purchase [redacted], the CMA accepts that private equity and finance companies were not viable purchasers for the Air Countermeasures Business and evidence on the marketing efforts for the business as a going concern had demonstrated this.
107. The CMA considered whether the asset sale of the Air Countermeasures Business was sufficiently marketed to trade buyers. Esterline contacted three potential trade purchasers: Chemring, [redacted], for whom the Air Countermeasures Business was only likely to be viable as a standalone business, and submitted that Chemring was the only company interested in the asset sale. The CMA took a cautious approach to relying on Esterline's submissions on the sales process for the Air Countermeasures Business given that it was not formally marketed. However, this evidence taken together with the specificities of the regulatory environment, including the restrictions on non-UK domiciled firms supplying and exporting air countermeasures from the UK, indicates that there was no realistic prospect of a less anticompetitive buyer than Chemring buying the Air Countermeasures Business.
108. In light of the evidence set out above, the CMA believes that there is no alternative purchaser of the Air Countermeasures Business other than Chemring.

Limb 3 - What would happen to the sales of the Air Countermeasures Business absent the Merger?

109. The CMA considered where the sales of Wallop's Air Countermeasures Business might go in the event that this business is not sold to Chemring (and given there is no less anti-competitive purchaser – limb 2).

110. The CMA contacted the Parties' only two UK customers: the MoD and BAE Systems.
111. The MoD submitted that, with regards to its air countermeasures requirements [REDACTED]. Therefore, if Wallop were to exit the market, all of Wallop's sales of air countermeasures products to the MoD would switch to Chemring. It said that Chemring is the only other producer of MTV flares, chaff and advanced spectral flares in the UK.
112. BAE Systemsⁱ said that its only supply contract with Wallop was for MTV flares for the [REDACTED]. BAE Systems said that one of its requirements for this contract was that the MTV flares had to meet UK national standards and be qualified as such by the MoD. Therefore, BAE Systems could also only source MTV flares from either Wallop or Chemring. BAE Systems confirmed that this would also be the case for its forthcoming procurement of MTV flares in 2017. Accordingly, in the event of an exit by Wallop, all of Wallop's sales of air countermeasures products to BAE Systems would also have switched to Chemring.

Conclusion on limb 3

113. In light of the evidence set out above, the CMA believes that if the Air Countermeasures Business of Wallop were to exit the market, the majority (if not all) of its UK sales would divert to Chemring.

Conclusion on the relevant counterfactual

114. For the reasons set out above, the CMA believes that all three limbs of the exiting firm counterfactual are satisfied in this case. The CMA believes that there is no realistic prospect that the Air Countermeasures Business would have continued in operation absent the Merger as there is compelling evidence that it would inevitably have exited the market. The CMA also believes that there is no alternative purchaser of the Air Countermeasures Business other than Chemring. Lastly, the CMA believes that, if the Air Countermeasures Business of Wallop were to exit the market, the majority (if not all) of its UK sales would divert to Chemring.

Conclusion

115. Relative to this counterfactual, the CMA believes that the Merger will not give rise to a realistic prospect of an SLC because, absent the Merger, the same loss of competition in the market would arise.

116. Having reached this conclusion on the relevant counterfactual it was unnecessary for the CMA to carry out a competitive assessment in this case.

Decision

117. Consequently, the CMA does not believe that it is or may be the case that the Merger may be expected to result in an SLC within a market or markets in the United Kingdom.

118. The Merger will therefore **not be referred** under section 33(1) of the Act.

Sheldon Mills
Senior Director, Mergers
Competition and Markets Authority
29 March 2016

ⁱ Speaking on behalf of BAE Systems UK munitions business.