Major Acquisition Issues

Naval Post Graduate School
8th Annual Acquisition Research Symposium
Monterey, CA
**Report Documentation Page**

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<th>MAY 2011</th>
<th>3. DATES COVERED</th>
<th>00-00-2011 to 00-00-2011</th>
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<td>Renaissance Strategic Advisors</td>
<td>5d. PROJECT NUMBER</td>
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<td>1300 Wilson Boulevard, Suite 500, Arlington, VA, 22209</td>
<td>5e. TASK NUMBER</td>
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<td>Renaissance Strategic Advisors, 1300 Wilson Boulevard, Suite 500, Arlington, VA, 22209</td>
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<td>11. SPONSOR/MONITOR’S REPORT NUMBER(S)</td>
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<tr>
<td>12. DISTRIBUTION/AVAILABILITY STATEMENT</td>
<td>Approved for public release; distribution unlimited</td>
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<td>Presented at the Naval Postgraduate School’s 8th Annual Acquisition Research Symposium, 10-12 May 2011, Seaside, CA. U.S. Government or Federal Rights License</td>
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<td>17. LIMITATION OF ABSTRACT</td>
<td>Same as Report (SAR)</td>
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*Standard Form 298 (Rev. 8-98)*  
Prescribed by ANSI Std Z39-18
Post-WWII, we have stayed within a $350B-$550B “bounded range”; current wars have us above the range and begs the question...are we in a new band?


Planned Budget Authority in Constant $B Including Supplementals and FY11 FYDP (forecast excludes additional supplementals)

Source: US Department of Defense, RSAdvisors analysis
US defense spending has oscillated within three spending bands over US history.

**The Context - where is the US defense budget headed?**

Historical US Defense Spending

Current and FY11 Constant $ Defense Spending, 1794-2015

- **“Defend the Nation”**
  - Ex-war, spend 0.9% of GDP on defense
  - Flat trend as % of GDP

- **“Defend the ‘West’”**
  - Ex-war, spend 5.4% of GDP on defense
  - Declining trend as % of GDP

- **“Defend the Hemisphere”**
  - Ex-war, spend 1.1% of GDP on defense
  - Flat trend as % of GDP

Source: US Department of Commerce, US Department of Defense, RSAdvisors analysis
And with US DoD facing a wide spectrum of threats, Pentagon continues to balance competing needs.

**Irregular Warfare vs Conventional Spending**

- **Irregular Warfare**
  - Ex: Special Forces
  - 10% of the budget

- **Dual Purpose**
  - Ex: Army
  - 40% of the budget

- **Traditional Conflict**
  - Ex: Navy
  - 50% of the budget

**“Barbell-Shaped” Markets**

- **Slice #1**
  - **The Long War**
    - Rapid acquisition, off-the-shelf/short development, quick response is key, COCOM centric
  - **Deterrence**
    - Very long cycle, tech. development, platform-oriented but limited production, services centric

- **Slice #2**
  - **Reset/Retrofit**
    - Install “black boxes” in existing equipment to plug into network, insert available technology, maintenance, repair
  - **Transformation**
    - Desire for large, horizontal integrating networks, leverage the IT revolution, requires large scale systems integrators

**2012 GATES ANNOUNCEMENTS**

- **Cancel EFV**
- **Buy more Reaper**
- **Increase MC-12**
- **Increase Marine repair/refurb**
- **Fund current operations**
- **Accelerate Army tactical comms**
- **Modernize Stryker**
- **Buy more EELV**
- **Develop Long Range Bomber**
- **Modernize Abrams, Bradleys**
- **Cut Army/Marines 47,000 in 2015**
- **Navy EW improvements**
- **Extra DDG-51, fleet oilers, etc.**
The current environment has several key trends in operation:

- Evolving OCI policy...still being applied differently by various organizations
- Insourcing...appears to be slowing down, introduction of depot issue
- Export control reform ...”once more unto the breach”
- Fixed Price Development...disastrous last time, resisting return

**Major Acquisition Policy Issues**

Sources: FactSet, Company Reports, CSIS Analysis.
# View #1: Defense-Industrial Policy Levers

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<th>Policy Aspect</th>
<th>Key Dimensions</th>
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| Sourcing                      | • Assuredness of supply  
• Jobs/“Buy America”  
• Get best technology to warfighter  
• Technology transfers          |
| Innovation/Transformation     | • DoD R&D leadership  
• Source of transformational tech  
• Ability to control research agenda |
| Allowable sector structures   | • Sector importance/uniqueness  
• Foreseeable production demands  
• Public cost to keep add’l suppliers |
| Acquisition Philosophy        | • Service specific vs joint programs  
• Multiple vs fewer program starts  
• Prime/GFE mgmt vs LSI            |
| Acquisition Strategy          | • Cost  
• Sensitive info dissemtn – Nat’l Sec  
• Urgency  
• Sector structure                |
| Business proposition to industry | • Robustness of defense industry  
• Attracting new entrants  
• Gov’t stewardship of public funds |

- **Global** to **National/Autarkic**
- **Harvest/Pull: Civil/Mil** to **Create/Push**
- **Multi-Supplier** to **Monopoly**
- **Decentralized** to **Centralized**
- **Competitive/Arms-Length** to **Negotiated/Partnership**
- **Return** to **Stability**
View #2: The Lifecycle of the Technology/Industry Sector...

- **Entry and experimentation (S&T)**
- **Emergence of standard/dominant design (System Development)**
- **Shakeout (Produce/Upgrade)**
- **Stability/Decline (Sustain/retire)**

Product Innovation

Process Innovation

Fewer Competitors

Restart the cycle
Where You Are in the Lifecycle...

- Emergence
- Networks
- Directed Energy
- Robotics
- Hybrid
- Vertical Lift
- Avionics
- UAV
- Light launch
- Defense Elec.
- Heavy launch
- Heavy ships
- Tanks
- Manned, Fixed wing Fighters

Entry and experimentation (S&T)
Emergence of standard/dominant design (System Development)
Shakeout (Produce/Upgrade)
Stability/Decline (Sustain/retire)

Restart the cycle

Caveat – fight wars with the military you have

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Drives Solutions/Incentive Structures...

Key

Gov't, Academia
FFRDC, industry
(Skunk Works, UAV)

Industry
(industry in production)

Industry, depot
yard, arsenal

Actors

Entry and experimentation (S&T)
Emergence of standard/dominant
design (System Development)
Shakeout (Produce/Upgrade)
Stability/Decline (Sustain/retire)

H.C.

Scientists
engineers
manufacturing
support/logistics

Market Dynamic

Competition ← Negotiation/partnership

Financial

Growth ← Margins ← ROIC

Investors

Growth ← GARP ← Value

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View #3: What Mode Are you In…

Current Problem – We are in Two Modes! Do you need Two Acquisition Systems?
1. What does the industry do with its cash?

The major aerospace/defense firms have extremely low net debt levels
- About $5 billion of net debt according to company reports or about 2% of enterprise value

The industry now generating $20+ billion of free cash flow

Potential use of the cash
- Reinvest in the business
- Find adjacent growth/diversification
- Acquisitions
- Share repurchases
- Dividends

Sources: CAPIQ, Company released information, RSAdvisors analysis
1. What does the industry do with its cash?

- In the last 30 years, financial markets have provided 40-80% of the capital needed to operate...

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**Defense Industry Redeployment of Capital**

**1980-2009**

- Divestitures
- Equity Issues
- Debt Issues
- Operating Cash Flows = From the Customer

*Sources: CapitalIQ, FactSet, company filings, RSAdvisors analysis*
1. What does the industry do with its cash?

- In the absence of clear demand signals, M&A has substitute for IR&D

Defense Industry Cash Outflows (Percent) 1980-2009

Sources: CapitalIQ, FactSet, company filings, RSAdvisors analysis
The last cycle says that there are advantages to doing something and being first

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<td>M&amp;A</td>
<td>26%</td>
<td>4.1%</td>
<td>7.5x</td>
<td>17.6x</td>
<td>5.3x</td>
<td>5.8x</td>
<td>153%</td>
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<tr>
<td>Commercial Diversification</td>
<td>1%</td>
<td>4.2%</td>
<td>9.4x</td>
<td>14.2x</td>
<td>4.5x</td>
<td>5.8x</td>
<td>55%</td>
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<td>Ride the Wave</td>
<td>-8%</td>
<td>1.4%</td>
<td>13.9x</td>
<td>16.4x</td>
<td>5.1x</td>
<td>5.6x</td>
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Source: RSAdvisors analysis
### 3. Is M&A a viable strategy?

#### Key M&A Trends for the Aerospace & Defense Industry

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<th>Trend</th>
<th>Reason</th>
<th>Evidence</th>
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| **Moving towards an area of strategic divestures** | Big properties are becoming available      | - Lockheed Martin divests PAE  
- Northrop Grumman spins its ship business  
- Argon ST was sold to Boeing                                                                                       |
| **Divest business units with OCI issues**    | Respond to changing government policy       | - Northrop Grumman divests TASC  
- Lockheed Martin divests EIG  
- ITT divests CAS                                                                                                 |
| **Supply chain restructuring**               | Program performance is slipping and costs are rising | Boeing acquires the Vought 787 factory and JV with Alenia to bring the project under tighter management and potentially reduce costs     |
| **Full life cycle support**                  | The aftermarket represents a longer, more stable revenue stream | General Dynamics acquires Jet Aviation (general aviation maintenance, completions, engineering, fixed base operations, & aircraft management) for $2.3B |
| **MOOTW – military operations other than war ("soft power")** | Shift in focus due to Iraq/Afghanistan and new administration | L3 acquires International Resources Group, a support provider of energy, environment and natural resource management, relief and reconstruction, and economic development |
| **Foreign investors seeking access to DoD and US commercial market** | US budget still the only real game in town | Finmeccanica acquires DRS (a supplier of integrated defense electronics products, services and support) for $5.1B |
| **Financial sponsors are making some moves** | Valuations getting attractive,              | Financial sponsors executed 13% of transaction in 2008 over $50M, 11% in 2009, 16% in 2010, 17.6% in 1Q11 according to PWC |

Sources: CAPIQ, Industry news, PWC, RSAdvisors analysis

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