

**McALEESE AEROSPACE & DEFENSE  
STATE OF THE UNION ADDRESS:  
CREATION OF THE MILITARY/FINANCIAL COMPLEX**

**Presented by:  
James McAleese, Esq.  
McAleese & Associates, P.C.**

**at  
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**McAleese & Associates, P. C.  
7901 Jones Branch Drive, Suite 310, McLean, VA 22102 (703) 917-8900**

## **McAleese State of the Union Agenda**

- 1. The Five "Epochs" of Aerospace & Defense in the 1990s  
(Death of the Historic "Military/Industrial Complex")**
- 2. Aggressive "Full Subsystem Capability" is Critical to Credibility  
(Adopt an "Up-or-Out" Subsystems approach as a mandate)**
- 3. Decisively Embrace the New "Military/Financial Complex"  
(Compelling "National Security Case/Business Case")**
- 4. Civil/Military Integration, BRAC, and other Red Herrings**
- 5. Aggressive Action Jointly Required by Industry/National Security  
"Stakeholders"/Wall Street to Achieve True Shareholder Value**
- 6. Heavy Q&A**

# **I. Five Major "Epochs" of Aerospace & Defense in the 1990s**

- 1. Mergers of U.S. "Big 3" were driven heavily by DoD ("Defense tail wagging prime contractor consolidation dog")**
- 2. Acquisition Reforms to Eliminate Non-Essential Tasks/Speed Fielding (Program Management outsourced to "bundled" platform primes)**
- 3. Mergers & Acq. Reform Triggered "Vertical Integration" Concern (Collision of Lockheed/Northrop with DoD/Justice Department)**
- 4. DoD Encouraged Trans-Atlantic Mergers to Integrate Coalition Warfare/Smart Weapons Directives of Revolution-in-Military-Affairs (Commingling of technology pools will generate "inter-operability" in C4ISR/precision strike to directly save American lives)**
- 5. Abandonment of historic "Military/Industrial Complex" by Wall Street Triggers Intensive Care by DoD**

## II. Acquisition Reform Will Save the Day . . .

### A. Old Business Model -- DoD previously acquired “Federated Subsystems”

- Generated its own military design specifications (**MilSpecs**)
- DoD’s “drivers” were control over design (*e.g.* size, weight, loads, etc.)
- DoD was *de facto* systems integrator for platforms (Associated Contractor Agreements)
- Suppliers received prime contracts (“**full and open**” subsystem competitions)

### Subsystem Suppliers:

- “Worked” DoD (**IR&D**) for “Government Furnished Equipment” (**GFE**) designation
- Goal was to place the “**box into the rack**” or “**hang on the airframe**” as GFE
- Shouldered **minimal R&D costs** with little responsibility for integration of “box” into platform
- “**Frozen**” MilSpec designs put focus on “**produceability**” (comfort level)
- Suppliers “**got healthy**” from **Engineering Change Proposals (ECP)** during production (plus life cycle support on legacy/proprietary systems)
- **Sufficient competitions by each Service allowed “no-bid” option if not profitable**

## **B. Current Business Model - Primes acquire “Integrated Systems”**

- **Reforms effectively delegate subsystem procurements to platform primes (e.g., cockpit, radar, navigation, power, controls, etc.)**
- **DoD has effectively outsourced Program Management to platform primes**
  - Examples are “ACTD,” “Single Process Initiative,” “bundling”
  - Platform Prime assumes “Total Systems Performance Responsibility” (TSPR)
  - Jettisons historic “full and open” DoD competitions for subsystems
  - **Subsystems become “make-or-buy” decision by platform prime**
- **Supplier’s primary customer is no longer DoD, but the platform prime**
- **Shrinking RDT&E pushes suppliers to aggressively “invest” in the “front-end” with prime (become “investors”)**
- **Impossible to “no bid” bundled, “winner-take-all” competition (self-fulfilling prophecy)**
- **Primes must now “buy into” program with huge risk just to survive**

## **II. Acquisition Reform (Continued):**

- **“Black box” production houses** must evolve to **“Full Subsystem Capability”** to hold individual program workshare, let alone industry marketshare
- Drives major requirement for
  - **additional capital**,
  - **additional engineering & integration** staff, and
  - **assumption of increased contractual and legal risk** (up to 30% greater cost)
- But overnight shift from “black box” production to Full Subsystem Capability is **difficult to achieve through internal growth alone** (7% annually is good)
- So the **race is on to “strategically acquire or ally”** to develop Full Subsystems Capability
  - **Best defense in shrinking market is to move up foodchain (“Up-or-Out”)**
  - **Avoid temptation** to simply acquire more “black box” production
  - Target **complementary R&D and integration** to achieve Full Subsystem Capability
- **Must adopt an “Up-or-Out” mandate to be #1 or #2 in World to be able to dictate price/workshare**

## Increased Costs of “Full Subsystem Capability” include:

- **Development cost** - - design, concurrent engineering, and CAD
- **Integration cost** - - of other houses’ black boxes into an integrated suite
- **Quality Assurance**
- Marketing, Lobbying, Contracts/Subcontracts (“**Overhead**” and “**G&A**”)
- **Production Capital** (function of hardware, electronics, software eccentricities)
- **Life Cycle Support** (installation, training, maintenance, spares, logistics)

## Other hazards include:

- **No DoD protection** - limited “flow-down” protections from primes (arbitrary revision of prior “make-or-buy” decisions, former DoD customer “off limits”)
- Performance specs (TSPR is “**blank check**” for implied warranty on fixed-price)
- “**Bundled**” or “**TurnKey**” platform (drives expansion to Full Subsystem Capability)
  
- **Increased “front-end” financial and program risks must be legally pre-empted, or mitigated, to protect RoI and Shareholder Value**
  
- **Again, must be #1 or #2 in World in System or Subsystem to dictate workshare and premium price**

# **All You Ever Wanted to Know About U.S. Antitrust Law But Were Afraid to Ask**

- **Mergers & Acquisitions: “Calm Anti-Competitive Concerns”**

- Antitrust Legal Test: **“ability to exercise market power”**
  - ⇒ **“relevant market”** (mission requirements)
  - ⇒ **“geographic market”** (global v. traditional CONUS)
  - ⇒ **current players & barriers to market entry** (1-2 years)
  - ⇒ **can merging contractors exercise market power? (5% hike for 2 years)**
  - ⇒ if anti-competitive, will **“efficiencies”** outweigh risk?

- **Strategic Alliances (April 2000 Antitrust Collaboration Guidelines):**

- May raise anti-competitive concerns with DoJ/FTC or DoD (**“market collusion”**)
- **“Marriage of necessity”** (all downstream issues must be negotiated up-front)
  - ⇒ Major up-front investment (wholly funded R&D, facilities, personnel)
  - ⇒ Payment issues
  - ⇒ Dispute resolution (no privity with DoD)
  - ⇒ Ownership of proprietary data and software (drives lucrative life cycle support)
  - ⇒ Collection and exit strategies

**Both must be “shepherded” to avoid “dealbreaker” by U.S. “Stakeholders”**

### **III. Enter the New "Military/Financial Complex"**

- Industry currently suffering from **siege mentality**
- Aerospace and defense industry serves two masters
  - One is **DoD**, with all of its key "Stakeholders"
  - The other is our **Shareholders** on Wall Street
- We must decisively ensure that all actions are comprised of both a
  - **compelling "National Security Case" and**
  - **compelling "Business Case"**
- Current alternatives alone are insufficient
  - **Acquisition Reforms** debate "competition," "innovation," and relief from historic fraud/waste/abuse oversight
  - Alternatively, lobbyists propose **Reagan-era spending** budgets under current balanced budget ceilings, when no immediate strategic threat exists.
- **Cannot protect American lives on the battlefield and profitably remain in business without Wall Street at the table**
- **Consequently, decisive steps must be taken by key National Security "Stakeholders," Industry, and Wall Street to weld together the new "Military/Financial Complex"**

### **III. Shareholders Must . . .**

- Focus instead on Return-on-Equity (RoE)
- Experience suggests it **costs ~ 30% total program cost premium** to work for DoD (higher overhead, 15-20 year acquisition cycles, fraud/waste/abuse triggers, etc.)
- Aerospace & Defense Industry is unique in two respects
  - First, it is **externally-funded** and financially self-sufficient
  - Second, stock prices are currently **depressed almost to liquidation value**
    - Despite 15% profitability in DoD production, the actual RoE is far higher because **DoD pays in real-time/near real-time** for
      - All RDT&E
      - 8-12% profit on cost-type RDT&E (no development risk)
      - Special tooling/test equipment and program-specific assets
      - Materials/inventory
      - Depreciated assets
      - 75% fully-burdened costs in monthly progress payments on fixed-price production
      - Government Furnished Property/Equipment (GFP/GFE)
- **Provides a healthy mixture of undervalued, long-term investments in**
  - **U.S. "Big 3" or BAE Systems, or**
  - **Aggressive mid-tier contractors like L-3, Northrop, BF Goodrich, CAE, or**
  - **Aggressive "microcaps" like Titan, DRS Technologies, WDS**

### **III. Industry Must . . .**

- **Incorporate the compelling "National Security Case/Business Case" into all of our operations.**
- **Commit to an "Up-or-Out" plan of becoming #1 or #2 in World in specific platforms, on-board subsystems, or niches**
- **Being #1 or #2 in World dictates premium price and program workshare (Do one thing and do it very, very well)**
- **Clean-off debt and replenish acquisition war chests by**
  - **Aggressively divesting non-essential operations**
  - **Receiving premium value for the divestiture is important,**
  - **But speed in adding true core capability is all-critical to sustaining credibility**
- **Make further cuts in Overhead on the shop floor**
- **Otherwise, we will merely be perceived as**
  - **status quo by Wall Street, and**
  - **asking for unearned Subsidies from our National Security Customers**

### **III. Key National Security "Stakeholders" Must . . .**

1. **Re-assess "winner-take-all" competitions, such as JSF**, to rejuvenate base
    - One optimal solution would be a "**competitive split**"
    - Where the winner could select the **most lucrative subsystems as its workshare**
  2. Conduct **stand-alone "full and open competitions"** for critical subsystems such as air-to-air radar and electronics warfare suites
  3. **Relax antitrust** where a compelling National Security Case exists and alternative types of platforms exist (forward airbases v. carriers)
  4. Make greater use of Public Law 85-804, "Extra-Ordinary Contractual Relief," on **program-specific basis where the relief is non-monetary**
  5. **Two-year funding** of contracts to stabilize programs and "lock-in" savings to DoD and profit to contractors
- **Developing Wish List of "micro-reforms" will not be credible unless applied to big ticket programs (Rubber meets road on major programs)**
  - **Fundamental principle of Acquisition Reform is to reform specific acquisitions**
  - **Must have clear focus on Wall Street compelling "Business Case" in exchange for compelling "National Security Case" on major programs**

## **Key U.S. “Stakeholders”**

- **Service Command** (Source Selection Authority)
- **Assistant Secretary RDA** (ASRDA)
- **Under SecDef (Acq. & Tech.)** (OSD Procurement Executive)
- **Justice Department or Federal Trade Commission** (1992/1997 Horizontal Merger Guidelines; **Beware of April 2000 Collaboration Guidelines**)
- **White House** (BCAG drives U.S. export debate in election year)
- **Congress** (“job erosion”)

## IV. The Myth of Civil/Military Integration

- Civil/Military Integration is intended to enable DoD to buy cutting-edge commercial technology in real-time because traditional defense base is stale
- Intent is to lower cost; fraud/waste/abuse; paperwork; competition barriers to **"pull" in fresh technology** from premium commercial sources
- Recognizes that Silicon Valley **"dot.coms"** are not captives of DoD RDT&E
- Never truly helped defense contractors diversify into commercial products
- Few examples of successful commercial diversification **solely by organic growth** (Titan is strong exception with "techno-incubators")
- Successful examples are acquisition of **mature commercial capability**
  - Boeing Commercial/McDonnell Douglas (reverse diversification)
  - Boeing/Hughes Space & Commo
  - AT&T/GRCI (\$220M)
  - Others driven to replenish acquisition warchest (GD/Gulfstream)
- **"Up-or-Out" Full Subsystem Capability Model dictates divesting non-essential operations to add true core capability**

## Other Notable Red Herrings . . .

- **All humor aside, the steps below are important to long-term Industry health, but will not substantially increase RoE/profitability in 2 years or less**
  1. More **BRAC** (buy a stronger whip and beat dead horse harder)
  2. Develop **DoD Venture Capital Fund** (CIA/In-Q-Tel) (create half-DARPA/half-"dot.com" camel)
  3. Repeal **fraud/waste/abuse** statutes that are recovering \$100Bs in healthcare fraud for U.S. Government (re-raise past scandals of old \$800 horse toilet seats)
  4. Revise "**make or buy**" guidelines (micro-manage dead horse while declaring it free)
  5. **Tax relief legislation** (draw public attention to corporate subsidies for dead horse)
  6. Encourage greater **DoD IR&D** (encourage dead horse to get more exercise)
  7. Mandate that R&D flows down to **2<sup>nd</sup>/3<sup>rd</sup> tier subcontractors** (harness several dead horses together to increase speed)
  8. Scrutinize bundled "winner-take-all" Proposals to **prevent "buy-in"** (shoot the starving horse now to prevent it from dying later)

# What Does This Mean to You?

- Wall Street must have integral seat at "**Military/Financial Complex**" table
- "**Up-or-Out**" **Commitment** to be #1 or #2 in World system/subsystem or niche commands **premium price in flat market**
- **Wall Street pays premium** for being #1 or #2 in World (rest are merely commodities)
- **Full Subsystem Capability** is critical to "Up-or-Out" ("black box" production obsolete)
- Divest non-essential assets to cut debt and then **acquire true core capability**
- Adopt **compelling "National Security Case/Business Case"** for major programs
- **National Security "Stakeholders" must couple "micro-reforms" with restructuring of big ticket programs to maximize benefit**
- **Shareholders will reward most aggressive Full Subsystem contractors by taking long-term positions which will be reflected in RoE and future stockprice**