

**Aerospace Industry Consolidation
- The Supplier Race to Acquire or Strategically Ally -**

**Aerospace Finance
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Bluntly Speaking...

- 1.) Are the “big three” good buys?
 - 2.) Immediate Shareholder Value will be in Mid-Tier Consolidation (“Show me the money!”)
 - 3.) Is civil/military integration for real? (“stealth barriers”)
 - 4.) One Roadmap to Future DoD Acquisition Reform (“Mother of all ricebowls”)
- **Pulling it all together: (1) Strong corporate resolve, (2) Strategic Plan of Action, and (3) decisive legal/financial execution will be required to grow marketshare, revenue, and earnings to maximize Shareholder Value**

High Level Consolidation Is Complete

- **Mergers of “Big 3” Were Primarily Driven By Defense Considerations**
 - “Defense tail wagging prime contractor consolidation dog”
 - Driven by DoD Procurement budget “implosion”(70% hit)
 - DoD actively encouraged mergers (“The Last Supper”)
 - Three major DoD companies, with others relegated to second or third tier suppliers (Boeing, Lockheed Martin, and Raytheon -- **Northrop?**)
 - Accelerating consolidation as suppliers evolve to “Full Subsystem Capability” under Emerging Business Model
- U.S. acquisition of European Contractors unlikely, but the reverse is already coming true

“Out with the Old, In with the New”

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

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

• Suppliers/Subcontractors:

- “Worked” DoD customer (IR&D) so that products were designated “GFE” (pre-empting aircraft prime from absorbing their “black box” production)
- Goal was to place the “**box into the rack**” or “**hang on the airframe**” as GFE
- Shouldered minimal R&D costs and had little or no responsibility for integration of “box” into platform (early version of “Plug and Play”)
- “Frozen” MilSpec designs put focus on “produceability” (tremendous comfort level)
- Suppliers “**got healthy**” from Engineering Change Proposals and “technology refreshment” during production (plus sole-source capture of life cycle support)

B. Emerging Business Model - - Primes now acquire “Integrated Systems”

(e.g. airframe, cockpit, radar, navigation, power, controls, etc.)

- **New DoD acquisition reforms effectively delegate authority for subsystems to the prime contractors**
 - ⇒ Prime assumes “**Total Systems Performance**” responsibility (TSPR) for platforms (GFE subsystems virtually eliminated)
 - ⇒ Jettisons “full and open” DoD competition requirement for subsystems
 - ⇒ **Everything becomes “make-or-buy” decision by platform prime**
- Suppliers’ primary customer is no longer DoD, but the platform prime contractor
- Shrinking RDT&E budgets are driving platform primes to push suppliers to aggressively “invest” in the “front-end” of programs (become “investors”)
- Subcontractors now participate in design, development, and integration with prime
- “**Black box**” production houses must evolve to “**full subsystem capability**” to hold program workshare, let alone marketshare
- **Drives major requirement for (1) additional capital, (2) additional engineering & integration staff, and (3) assumption of increased contractual and legal risk (up to 30% greater cost)**

Acquisition Reform & Prime Consolidation Collectively Drive Supplier Mergers & Acquisitions

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- **The perception of “vertical integration” is driving supply chain consolidation**
- Many suppliers fear primes will pull subcontractor workshare “in-house” where production has been “stretched” or partially terminated (prime’s earnings or debt retirement schedules at risk)
- Best defense in shrinking market is to move up foodchain (or exit market) (Industry “lightning rod” of Teledyne Ryan v. Boeing on AH-64)
- **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 gain full systems capability**
 - **Avoid temptation to simply acquire more “black box” production** in shrinking market (“buggy whip” monopoly)
 - **Target complementary R&D and integration** to achieve full subsystem capability
 - Once these “alliances” or “super-suppliers” are formed, it will be nearly impossible to successfully enter or compete within the given market

Increased Costs of “Full Subsystem Capability” include:

- Development cost - - design, concurrent engineering, and CAD
- Integration cost - - of other houses’ black boxes into 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 (e.g. no guaranteed payment, arbitrary revision of prior “make-or-buy” decisions, loss of formal due process, former DoD customer “off limits”)
- Performance specs (TSPR is “**blank check**” for *de facto* implied warranty on fixed-price subcontract)
- “Bundled” products (drives expansion to subsystem capability)
- No “engineering change” orders from Government (increases dispute potential)
- **Increased “front-end” financial and program risks must be legally pre-empted, or mitigated, to protect RoI and Shareholder Value**

LAW 101 - Calm Anti-Competitive Concerns

A. Mergers & Acquisitions

- The days of DoJ/DoD’s “great deference” on defense mergers are over
- 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?

B. Strategic Alliances

- May raise anti-competitive concerns with DoJ or DoD (**“market collusion”** & **“Organizational Conflicts-of-Interest”**)
- “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

C. Both must be “shepherded” to avoid DoJ /DoD “dealbreaker”

The Myth of Civil/Military Integration

- Civil/military production is achievable in commodities, but not feasible in most weapon systems (e.g. computers, food, medicine, clothing)

Major differences include:

- DoD buys in “bulk” and stockpiles v. commercial “just-in-time”
- DoD uses “cost-based pricing” to avoid even perception of “**fraud, waste, abuse**”(False Claims Act, whistleblower suits, DoDIG, etc.)
- Commercial world uses “top line” pricing (“fool me once/but not twice”)
- Socio-economic policies (subsidize small & small disadvantaged bus.)
- **Caps on profit** (6% fee A/E, 15% fee R&D, 10% fee all other cost-type services)
- Antiquated costs principles (e.g. executive compensation caps, prohibition on interest, “no step up/down” in M&A, “transactional tax” during Novation)
- **Mere purchase of “commercial items” does not precipitate immediate use of commercial buying practices (i.e. judgment)**

One Roadmap to Future DoD Acquisition Reform

- DoD Budget Frozen at \$250B per year for foreseeable future
- Projected Budget “Surplus” Slated for Medicare/Social Security/Tax Cuts
- Procurement Account - The Historic “Billpayer” for
 - “Readiness”
 - “Quality of Life”
 - Bosnia and emergency operations
- Annual Procurement Deficit - - \$15 Billion
 - Procurement - \$45B (\$60B per year needed (“tooth”))
 - RDT&E - \$36B
 - Military Personnel - \$69B
 - O&M - \$94B (“tail”)
- Target the “tail” to generate savings for Procurement

Potential Long-Term Evolution into a “Defense Acquisition Corps” and a “Defense Materiel Command”

- Would require many years to achieve “rightsizing” and could occur in three phases (benefit is elimination of redundant RDA programs and personnel):
 - FY ‘98 DoD Auth. Act lays baseline (April ‘98, “Section 912 Report”)
 - Keep the Services, but consolidate RDA & Logistics corps
 - First - Establish exclusive Service “responsibilities” for major program areas (USAF - all Tactical aircraft; Army - all helicopter; Navy - all ships), and then cascade down to all smaller systems -- (first 2 years)
 - Second - Consolidate Service acquisition and logistics functions at OSD or into “Defense Acquisition Corps” and “Defense Materiel Command”
 - Third - potential consolidation of some “Roles and Missions” (Services will fight jointly, but “purple-suit” DoD very unlikely)
- **Consolidating the Services’ redundant RDA programs and duplicative logistics infrastructure will be painful, but necessary to close the \$15B annual Procurement Gap (“Mother of all ricebowls”)**

What Does This Mean to You?

- Prime Contractor Consolidation almost complete (next crisis/war will trigger huge windfall)

- DoD Acquisition Reforms mean that primes are now suppliers' primary customer instead of traditional DoD
- Prime Consolidation & DoD Acquisition Reforms collectively make “black box” production obsolete
- New Business Model emerges of “full subsystem capability” to grow industry marketshare, program workshare, gross revenues, and long-term earnings (major short-term cost threat)
- Suppliers now have “green light” by DoJ/DoD to merge & acquire (“the other shoe is about to drop”)
- This has triggered Supplier “Race to Acquire or Strategically Ally” (“He who hesitates is lost”)
- **Requires: (1) strong Corporate resolve, (2) Strategic Plan of Action, (3) shrewd Legal fencing of financial/contractual risk, and (4) decisive execution to generate strong RoI and maximize Shareholder Value**