

**Trans-Atlantic Aerospace & Defense Consolidation
- At the Cross-Roads-**

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Bluntly Speaking...

- 1.) Is European Consolidation Necessary?
- 2.) Drivers of U.S. Defense Consolidation
- 3.) DoD Acquisition Reforms Drive Shift to “Full Subsystem Capability”
- 4.) Immediate U.S. Shareholder Value lies in Mid-Tier Consolidation
- 5.) Trans-Atlantic Players, Agendas, and “Big Picture” Drivers
- 6.) One Roadmap to Future DoD Acquisition Reform (“Mother of all ricebowls”)

U.S. 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 mid-tier consolidation as suppliers now evolve to “Full Subsystem Capability” under Emerging Business Model
- **Immediate 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 Subsystems”

- 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) for “Government Furnished Equipment” (GFE) designation (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, if any, 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 acquire “Integrated Systems”

- **New DoD Acquisition Reforms effectively delegate subsystem procurement authority to the platform prime contractors (e.g. airframe, cockpit, radar, navigation, power, controls, etc.)**
- **DoD is effectively outsourcing program management, contract administration, and financial risk to platform prime.**
 - ⇒ Examples are “ACTD,” “Single Process Initiative,” “bundling,” “commercial item,”
 - ⇒ 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**
- **Supplier’s 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 and participate in design, development, and integration with prime (become “investors”)**
- **“Black box” production houses must evolve to “Full Subsystem Capability” to hold individual program workshare, let alone industry 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

- **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**
 - **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 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 (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” or “TurnKey” platform (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**

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

A. Mergers & Acquisitions: “Calm Anti-Competitive Concerns”

- 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 “dealbreaker” by U.S. “Stakeholders”

Key U.S. “Stakeholders”

- Service Command (source selection on future procurements)
- Assistant Secretary RDA (ASRDA)
- USD(A&T) (Gansler is the real decision maker)
- DepSecDef/SecDef (“tie-breaker”)
- Justice Department or Federal Trade Commission (legal enforcement)
- Treasury Department (“CFIUS” review)
- Defense Security Services (Old “DIS” does “FOCI” test)
- White House (“door swings both ways” after “McBoeing” v. Airbus)
- Congress (short-term concerns over “job erosion”)

Key Trends Driving Trans-Atlantic

- “Revolution in Military Affairs” (RMA) centers on “Reconnaissance/Strike” and “Coalition Warfare” (1MRC, plus one humanitarian “mini-MRC”)
- “Battlespace Dominance” is enabled by real-time C4ISR and “brilliant weapons” (e.g. CEC, LEAP, UAV/UCAV, JDAM/JSOW/JASSM)
- Coalition Warfare drives “Inter-operability” requirements with Allies (e.g. C4ISR, logistics, heavy airlift)
- Inter-operability drives a clear DoD preference for Europe to mirror U.S. “two source” rule to compete major “downselects” among two Trans-Atlantic Industrial Teams, e.g. MEADS, Tracer/FSCS. (“sweeten deal” with Tech. Transfer and U.S. RDT&E)
- Trans-Atlantic platform “downselects” are consistent with current U.S. policy of “bundled” TSPR platform contracts (no more separate subsystem buys by competing sister commands)
- Current U.S. public concern over technology export will drive increased U.S./EC policy “harmonization” (e.g. security, technology export, Foreign Corrupt Practices Act, Foreign military aid)

The Plot Thickens (continued)

- Being played out against backdrop of DoD sister initiative of U.S. Civil/Military Integration
 - ⇒ Harness commercial cycle times in IT and composites
 - ⇒ Leverage scarce R&D,
 - ⇒ Roll DoD production into large commercial production runs
 - ⇒ Tap into existing “just-in-time” commercial logistics infrastructure

- Joint co-development programs exist, but political/economic *quid pro quo* drives need for more flexible acquisitions (Tracer/FSCS, Apache Longbow, JSF, MEADS, Broach)

- Compressed cycle time also increases program stability and funding stream in face of unrealistic FYDP

- Over-arching fears of “Fortress Europe” drive U.S. “Stakeholders”
 - ⇒ U.S. concerns over various scenarios of single national champions
 - ⇒ single EADC (defeats “two competitor” rule)
 - ⇒ single European platform houses, e.g. missiles, satellites, military aircraft launch vehicles

One Roadmap to Future DoD Acquisition Reform

- DoD Budget Frozen at about \$250-270B per year for foreseeable future
- **Extra \$1B in FY'99 by current Administration, with promise of major out-year Procurement Account increases, received with healthy skepticism.**
- Projected Federal Budget “Surplus” Slated for Medicare/Social Security/Tax Cuts
- DoD Procurement Account - The Historic “Billpayer” for
 - “Readiness”
 - “Quality of Life”
 - Bosnia and emergency operations
- Annual DoD 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) (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”)**
- **Designating single-Service “lead buyers” would be consistent with “two team” Trans-Atlantic Competitions (instead of piecemeal competing programs)**

What Does This Mean to Europe?

- DoD Acquisition Reforms mean that U.S. supplier's primary customer is now one of "Big 3" instead of historic DoD (U.S. suppliers fighting same battle as offshore contractors)
- DoD concerns over "Vertical Integration" mean suppliers now have "green light" to merge or acquire (rationalize the other 50% of workshare in industrial base)
- Emerging Business Model of "Full Subsystem Capability" presents immediate merger or acquisition targets to European Contractors (Rule of Thumb \leq \$2/3B)
- "TurnKey" platform buys under performance specifications provide greater flexibility for European contractors to supply entire on-board subsystems under "Big 3" primes (avoid historic bias of "buy American")
- U.S. commitment to Coalition Warfare presents "last chance" for Trans-Atlantic "Two Team" approach with DoD (as opposed to single European Company versus. all of DoD and "Big 3")

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