



Health of the Industry:
A Wall Street and K Street Perspective

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**“The Issues of Our Time”:
Defense Budgets and
Future Growth**



FY07 Request Sustained Growth Contrary to Predictions of Slowdown, FY08 Decelerating...

FY08 Budget Request and FY07, FY06 Authorizations (\$ Billions)

	FY2008	FY2007	FY2006	FY08-07 % Change	FY07-06 % Change
Procurement	102	82	77	24.4%	6.5%
RDT&E	75	75	71	0%	5.6%
Total Investment	177	157	148	12.7%	6.1%
Other	294	115	253		
Top Line	471	372	401	26.6%	-7.2%

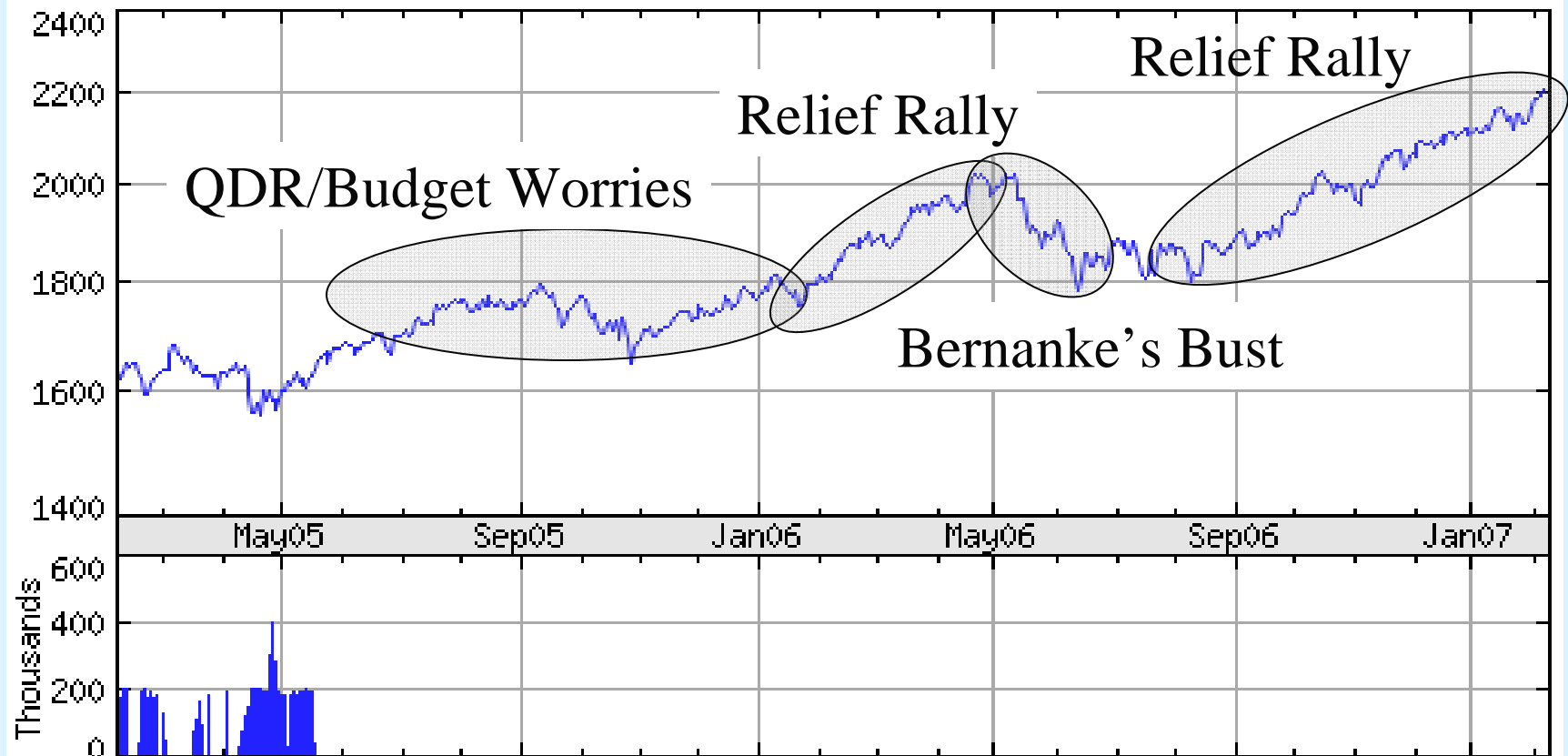
(With Supplmts)

Procurement	134	126	105	6.3%	20.0%
RDT&E	77	77	73	0%	5.5%
Total Investment	211	203	178	3.9%	14.0%
Other	403	390	356	3.3%	9.6%
Top Line	614	593	534	3.5%	11.0%



Wall Street Has Certainly Altered Expectations...

SPADE DEFENSE INDEX
as of 6-Feb-2007



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Wall Street Continues To Value the Sector As Having Growth...

Market Value to EBITDA

	Current	Year End 2006	Year End 2004	Cycle Range
Alliant Tech	8.7x	8.6x	10.7x	
General Dynamics	9.6x	9.1x	8.7x	
Defense Average	9.0x	8.7x	9.3x	4 - 10x



Approaching One of Longest Upramps in Defense Spending in U.S. History...

Defense Outlays

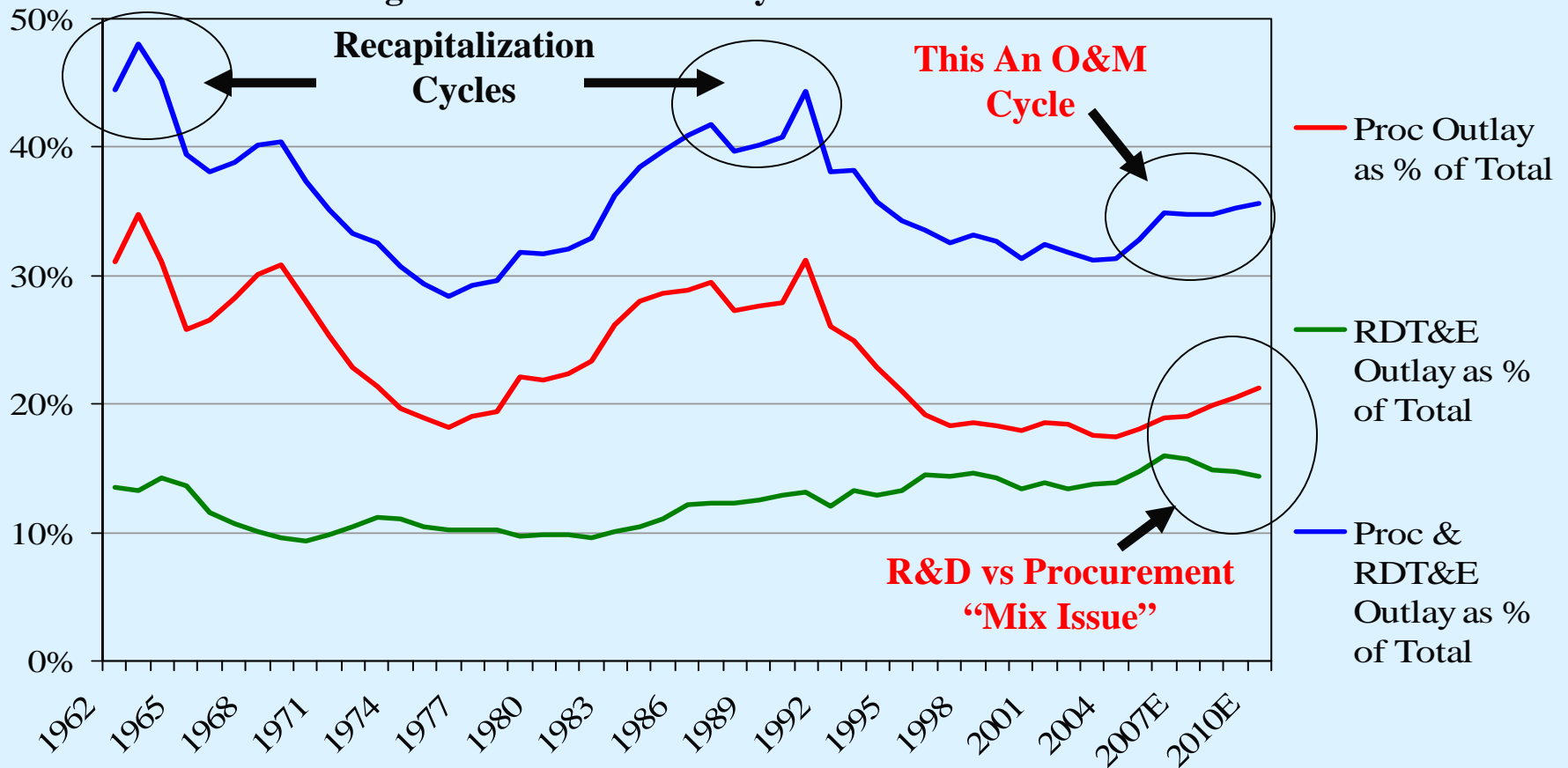
1797-1800	4 years	1902-1904	3 years
1804-1814	10 years	1907-1919	12 years
1822-1837	16 years	1926-1931	6 years
1843-1847	5 years	1934-1945	12 years
1852-1858	7 years	1948-1953	6 years
1860-1865	6 years	1956-1969	13 years
1871-1874	4 years	1976-1989	14 years
1880-1883	4 years	1996-2009??	14 and counting
1886-1899	14 years		

Source: Statistical Abstract of the United States and Budget of the United States Government Historical Tables

The Long Term Budget Pressures Continue...

(O&M Death Spiral, Personnel Costs, Deficits)

Percentages of DoD Total Outlays 1962-2012E





Strategy Take Aways...

- **Two major thrusts**
 - The Long War against terrorist extremists
 - Dissuade near peer competitors – possess unquestioned military superiority so that armed conflict is unthinkable
- **Service moves**
 - Marines – lighter, fill in SOF roles
 - Army – more expeditionary, lighter, more trigger pullers
 - Navy – swap capital for labor, focus on the Pacific
 - Air Force – the near peer insurance policy
- **Will have to be accomplished in resource constrained environment**



Market Implications...

“Bar-bell” Shaped Markets



“Slice” #1

The Long War: rapid acquisition,
Off the shelf/short development,
quick response is key, COCOM centric

Dissuade: very long cycle,
Technology development, platform
oriented but limited production, service
centric

“Slice” #2

Reset/Retrofit: Install “black boxes”
in existing equipment to plug into
network, maintenance/repair

Transformation: Desire for large,
horizontally integrating networks,
leverage the IT revolution

Strategic Question #1: How Do You Organize to Address

Is it one or two industrial bases? Can they be the same suppliers?



Market Implications (Services)...

- **Once Iraq/Afghan surge moderates, what will replace growth?**
 - Aging of federal workforce
 - Increased outsourcing
 - Increased complexity of tasks
- **What area of services**
- **What new models**
 - Public-private partnerships
 - PFI

Strategic Question #2: How Much Services and What?



Strategic Questions...

- **#3 What strategy do you adopt for a slowing market**

From a policy standpoint what markers/guideposts does government want to leave for industry as it decides?

- **Consolidation constrained**
- **Investors afraid of commercial diversification**
“unblemished by success”
 - **Have a successful model with TRW tech spin outs**
- **“Sticking to the plan” requires discipline**



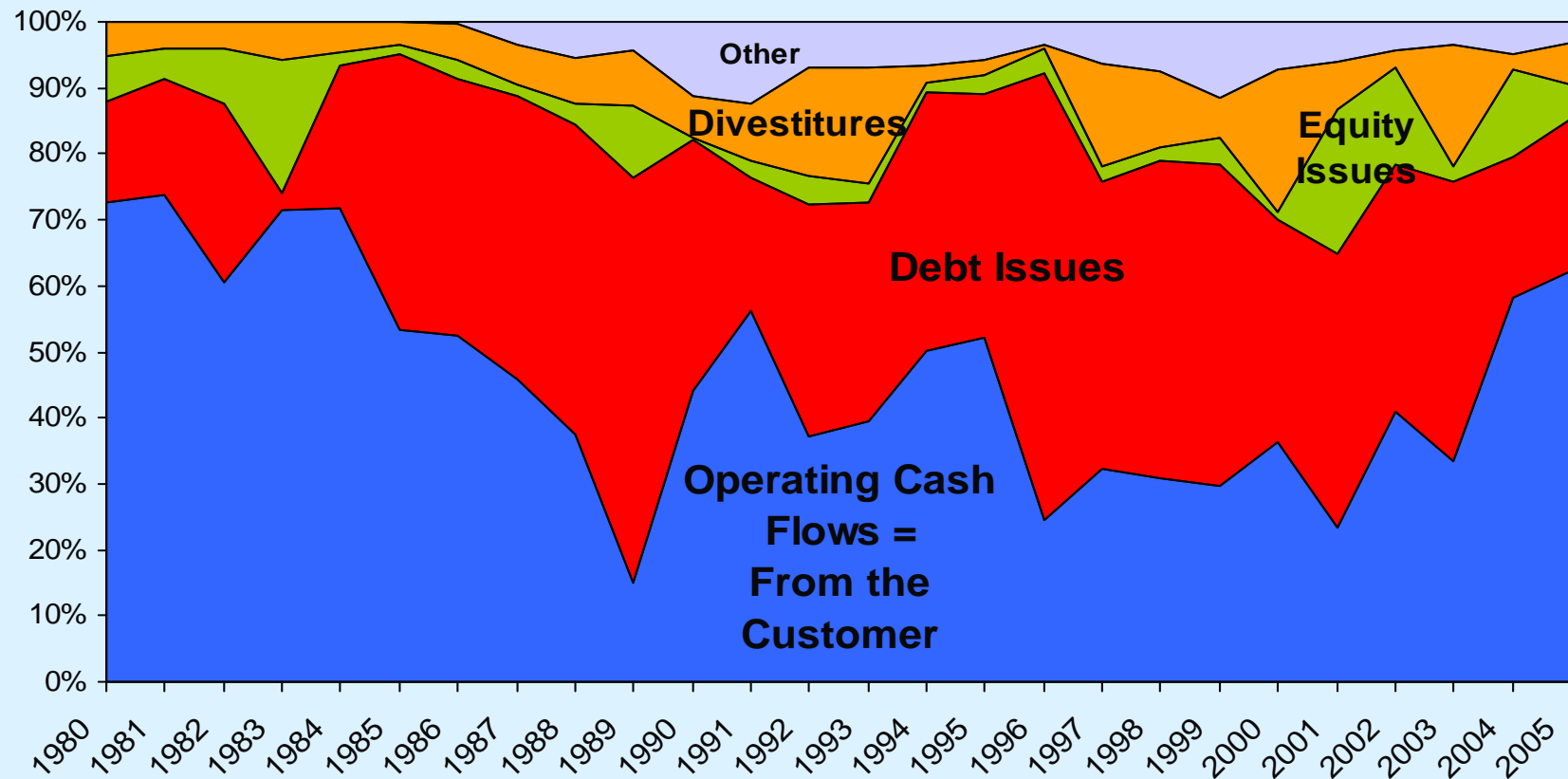
**“The Issues of Our Time”:
Industry Financial
Performance and
Strategies**



Why Care About Wall Street?

In the last 20 years, financial markets have provided 40-80% of the capital needed to operate...

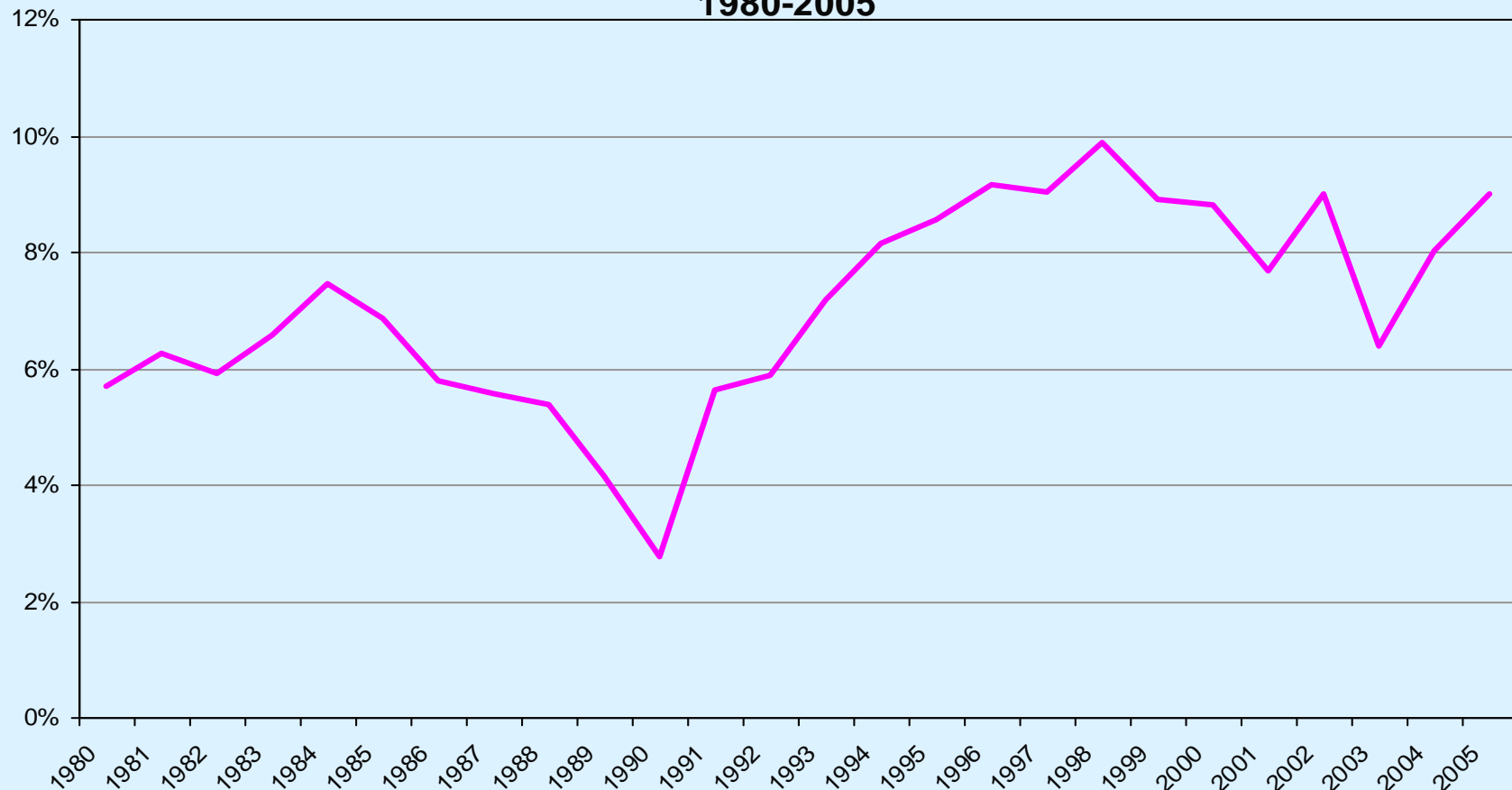
Defense Industry Cash Inflows (Percent), 1980-2005





Overall Defense Industry Margins Near Highs. . .

**CSIS Defense Index Average Operating Margin (weighted by revenue),
1980-2005**

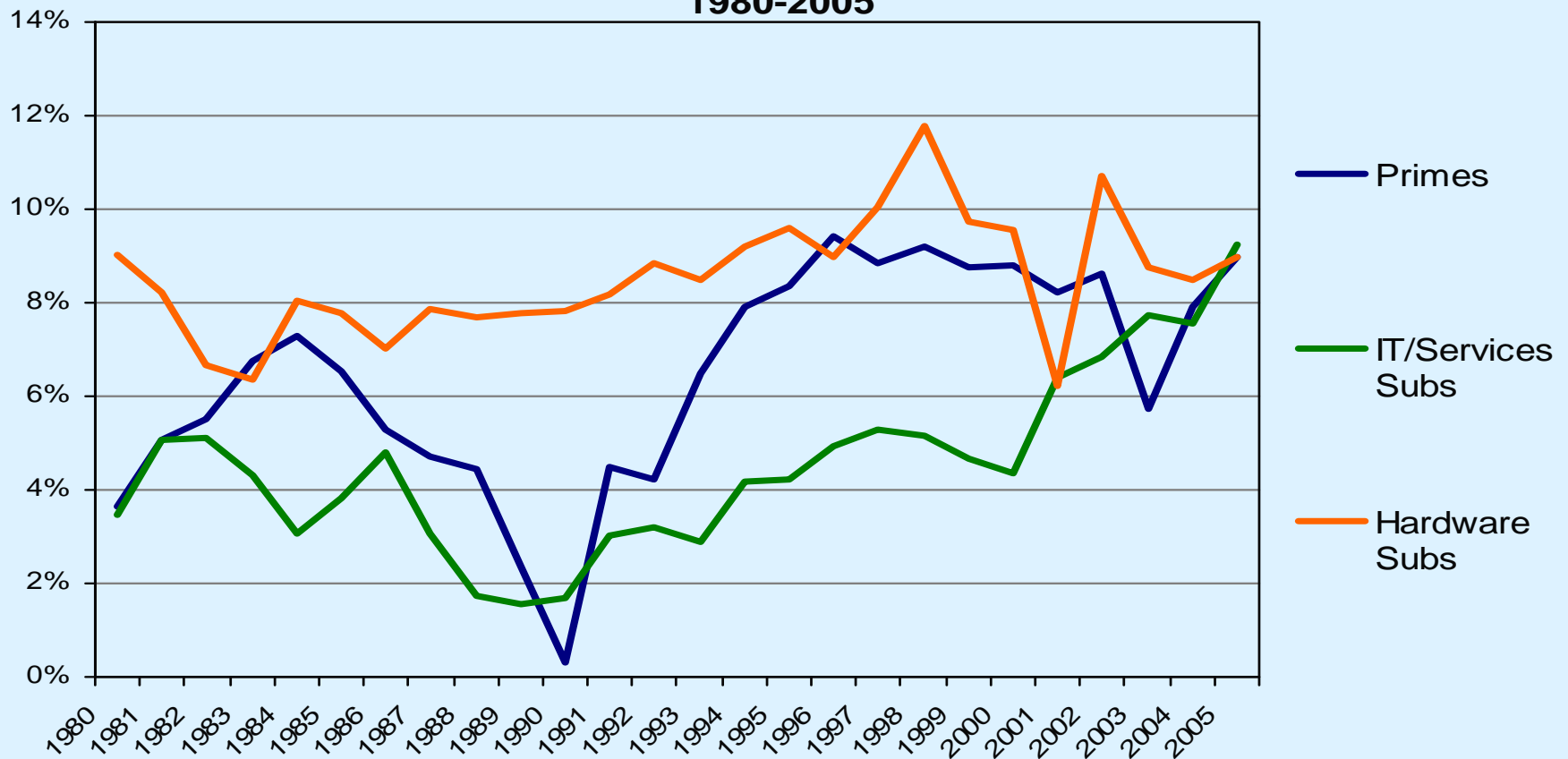


Sources: FactSet, Company Reports, CSIS Analysis.

Note: CSIS Defense Index comprises 36 publicly-traded companies with majority revenues derived from US defense business. Boeing Military results have also been included here.

From A Return Standpoint, Second Tier Does Better...

**Operating Margin by Company Type (weighted by revenue),
1980-2005**



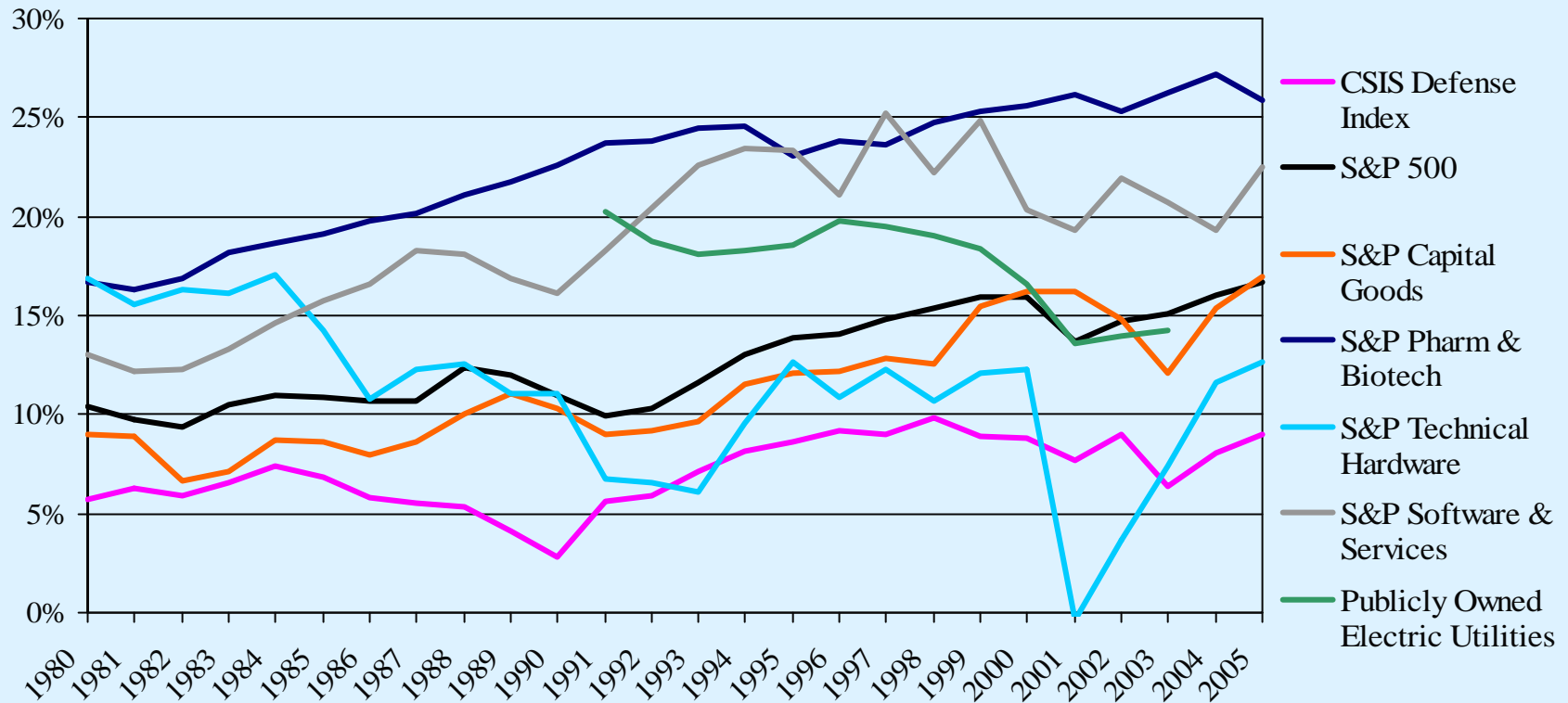
Sources: FactSet, S&P Compustat, Company Reports, CSIS Analysis.

Note: CSIS Defense Index comprises 36 publicly-traded companies with majority revenues derived from US defense business. Boeing Military results have also been included here.



However, Compared to Its Peers the Defense Industry Has the Lowest Returns...

Industry Average Operating Margin, 1980-2005 (weighted by revenue)

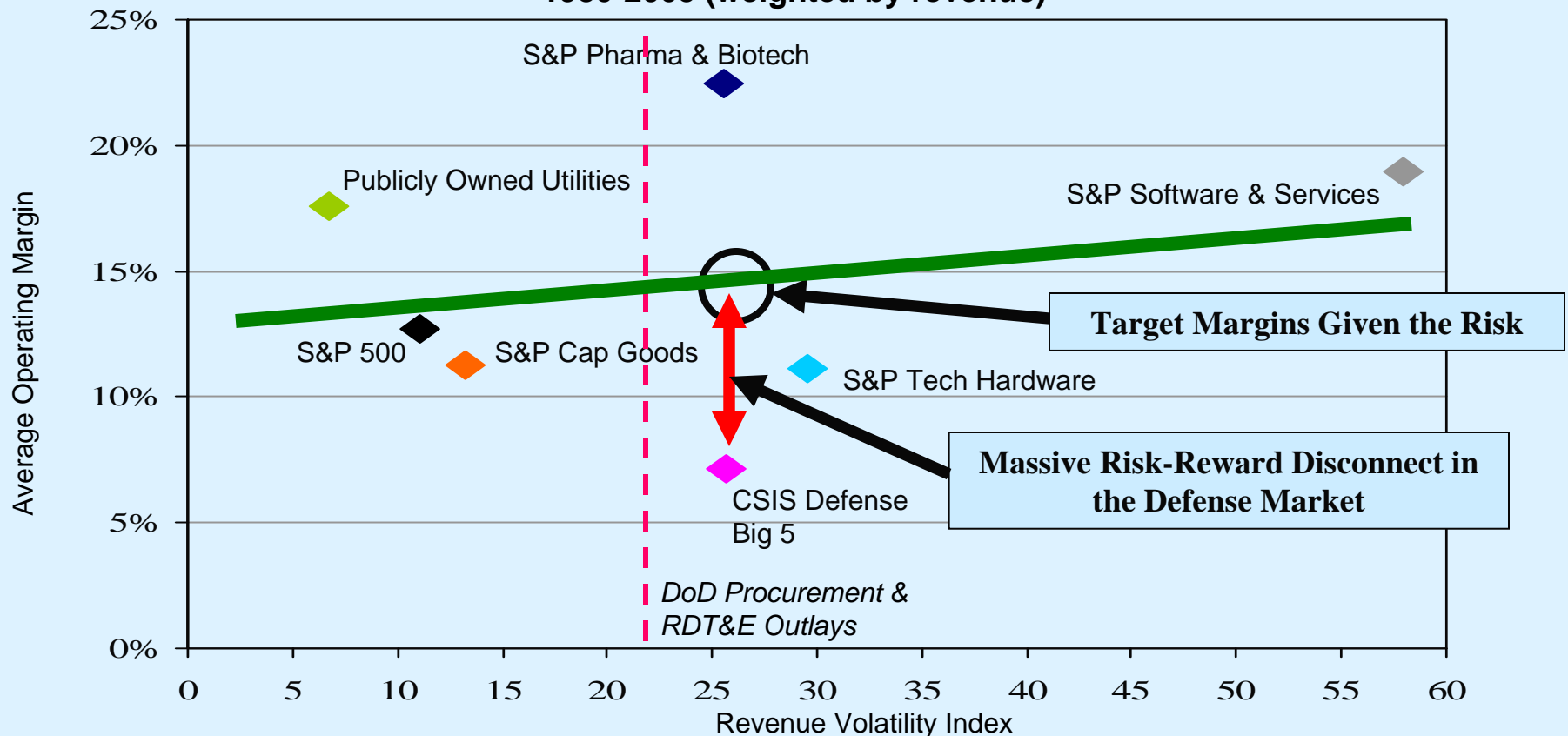


Sources: FactSet, S&P Compustat, Energy Information Administration, Company Reports, CSIS Analysis.

Notes: 1) CSIS Defense Index comprises 36 publicly-traded companies with majority revenues derived from US defense business. Boeing Military results have also been included here.
 (2) S&P Sub-sector constituents accurate back to 1994; composition held constant for years 1980 to 1993.

***Policy Realities Leave Industry With Few Levers to Pull...
If margins cannot be increased, then lower volatility – multi-years, O&M, political***

**Industry Revenue Volatility versus Average Operating Margin,
1980-2005 (weighted by revenue)**

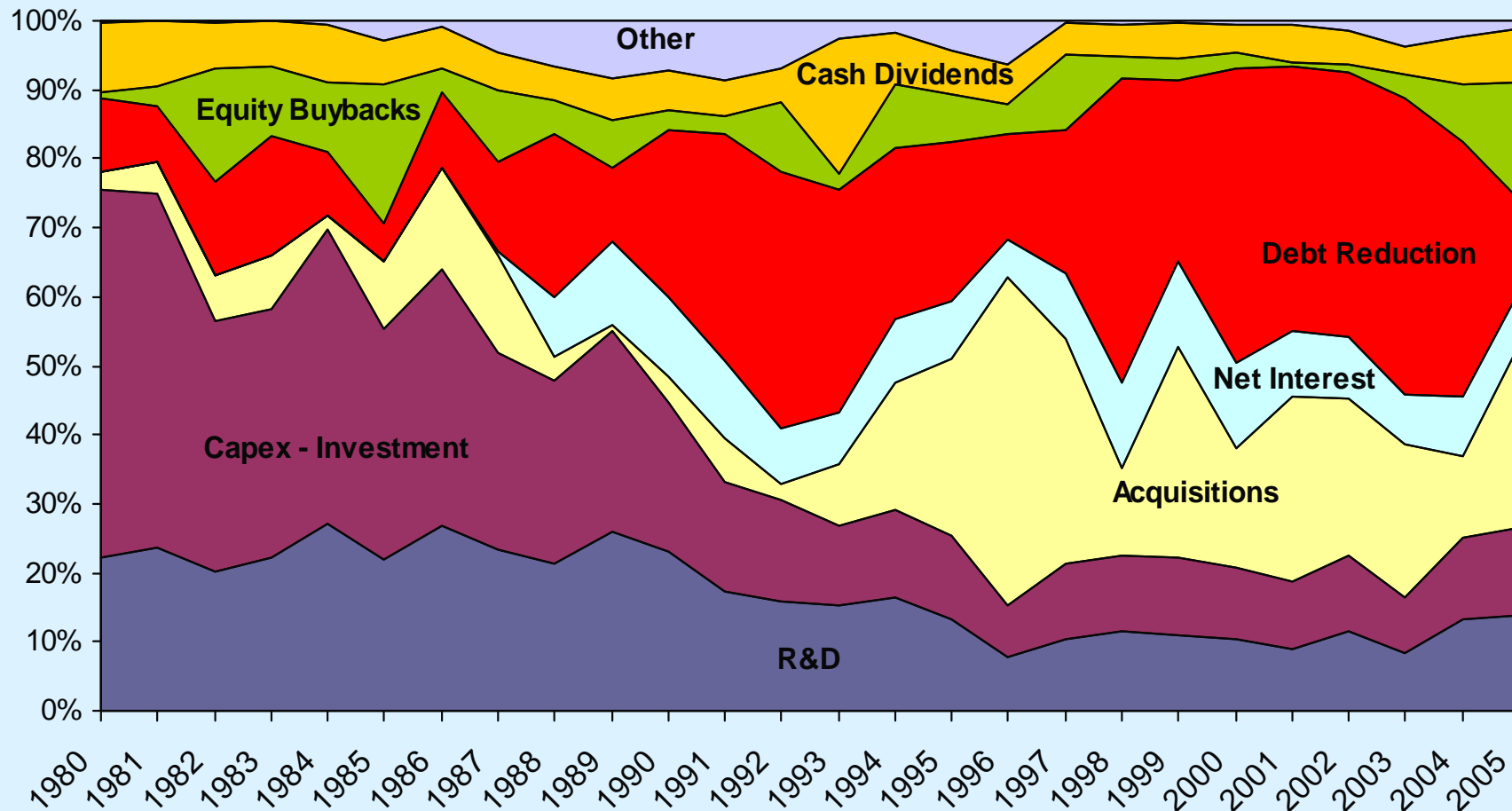


Sources: FactSet, S&P Compustat, Energy Information Administration, National Defense Budget Estimates for FY2004, Company Reports, CSIS Analysis.



Financial Response to the Policy and Market Realities...

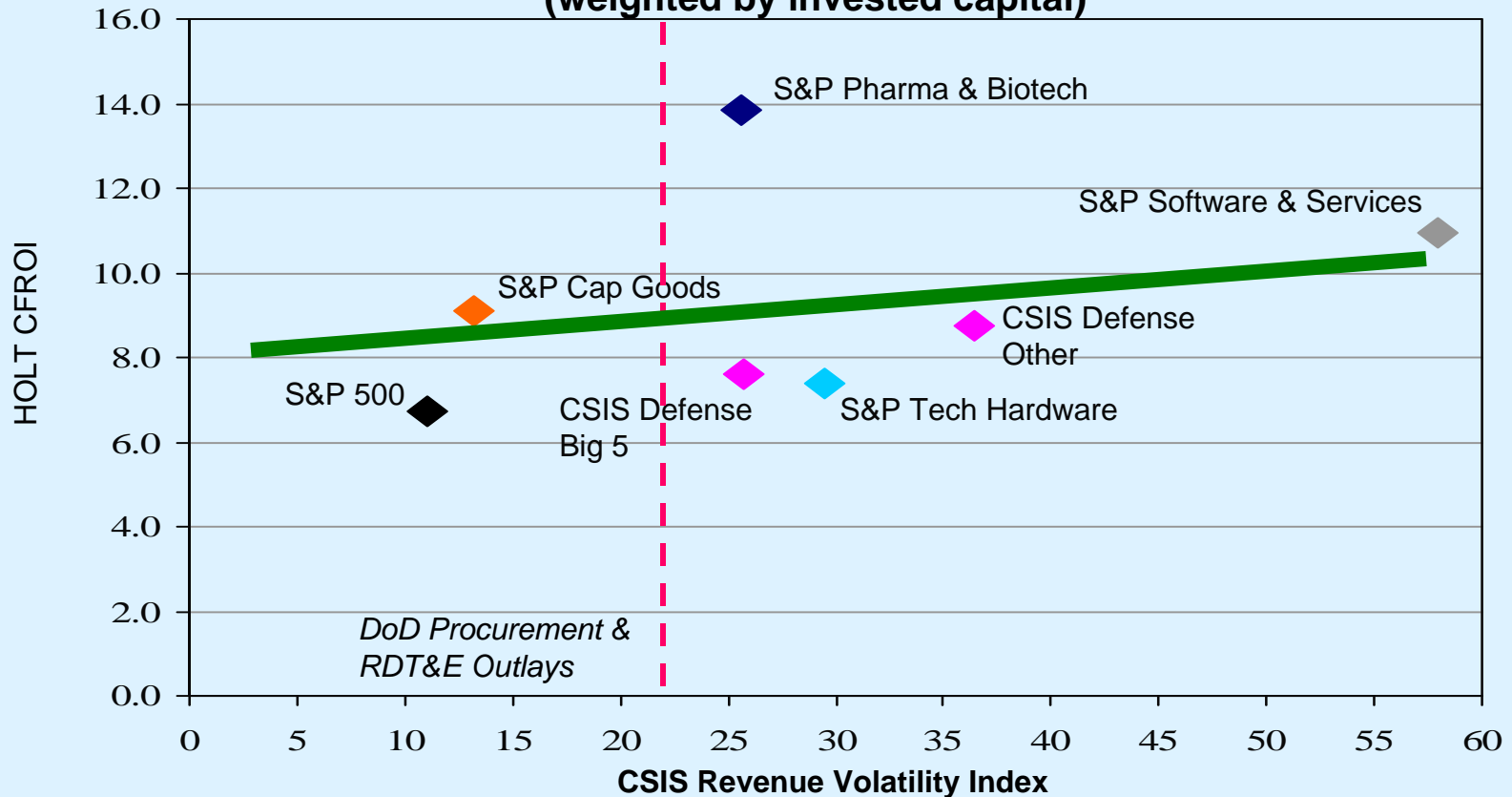
Defense Industry Cash Outflows (Percent)



Sources: FactSet, S&P Compustat, Energy Information Administration, Congressional Reports, CSIS Analysis

With This Strategy Industry “Returned To the Line” and Retained the Interest of Investors ...

Industry Revenue Volatility versus Cash Flow Return on Investment (HOLT CFROI) 1987-2005 (weighted by invested capital)



Sources: FactSet, S&P Compustat, Energy Information Administration, Congressional Reports, CSIS Analysis



It's That Time of the Cycle Again...

- **At this point in every defense cycle, attention is turned to defense industry profitability, program performance, contracting scandals**
 - **“Look at how much they are making” – conflating of revenues and profitability**
 - **Award fees**
 - **“Let’s bring back fixed price development”**
 - **“Caesar’s Wife” is a competitive and strategic advantage for industry and program managers**
 - **Program execution is key!, key!, key! for industry and PMs**



Strategic Questions...

- **#4 If everyone is adopting the same strategy, how do you differentiate?**
- **#5 What does industry do with the cash?
What incentives does government want to establish to shape decisionmaking ?**



**“The Issues of Our Time”:
Changing Relationship
With the Customer**



Changing Nature of the Relationship...

- Customer unsure about what it wants (very fluid environment)
- Future of LSI model
- Vertical Integration and organizational conflict of interest
 - General Dynamics/Anteon transaction
- Rise of new, more distributed customers
 - Regional CoComs – increased input into acquisition
 - Global CoComs – some with pots of money



Strategic Questions...

- **#6 How to organize to address a new customer set and increased complexity**
 - Large, horizontally integration projects (GIG, etc.) demand wide-spanning structures
 - Ambiguous, fluid, chaotic environment with distributed customers demand strong vertical structures
 - Shaping environment critical



Questions/Discussion



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