Written by Administrator
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We've been predicting this situation for over a year, talking about **DOD funding shortfalls** and **budget cuts** at Federal agencies, leading to a **downturn** affecting the entire aerospace and defense industry. The future is now the present, and A&D companies are making the necessary adjustments to retain their market share in the face of industry challenges. As we **reported** in September 2009, some industry insiders expected company leadership to be smarter about making downsizing decisions this time around, hopefully having learned painful lessons from the last round of cuts in the 90's. In fact, we even **noted** that a couple of defense companies (including Lockheed Martin) were adding to their executive ranks under the assumption that an enhanced focus on strategy, execution, and customer relationships would lead to better results. We could go on, listing and linking to more articles on this topic, but we believe we've made the point—times are getting tough, and the tough times were predictable.

Companies continue to make adjustments in response to market pressures, which now include a new DOD **initiative** to slash contractor overhead. In mid-June 2010, BAE Systems **announced** a reorganization designed for “better delivering our strategy in an increasingly cost-conscious marketplace.” The reorganization details were not provided but, as part of the realignment BAE reportedly will close down its operating headquarters of Electronics, Intelligence and Support divisions (EI&S) effective July 1, 2010.

In addition, Lockheed Martin **announced** on July 6, 2010 that it was “offering incentives to thin out its executive ranks in a move to lower overhead costs” (according to the Wall Street Journal article, link above). The WSJ article also reports that—

‘Our customers are facing increasing demands with constrained resources, and they're relying on us to give them the very best value within these constraints,’ Chairman and Chief Executive Bob Stevens said Tuesday. He specifically mentioned recent comments by Pentagon officials regarding productivity and cost-savings programs.

His comments echo others he made recently about how the defense giant is bracing for belt-tightening at the U.S. Department of Defense. The company also has undergone a business reorganization and has cut back its participation in international trade shows, and it plans to sell two units.

The company is reportedly offering Directors and Vice Presidents a “Voluntary Executive Separation Program,” which consists of “financial incentives” if they leave the company by February, 2011. While Lockheed Martin declined to specify a target number of employees it hopes will accept the VESP incentives, reports indicate that a reduction of 7 percent would not be out of line.

Meanwhile, DOD Comptroller Robert Hale said in a recent **interview** that "U.S. spending on weapons through 2016 likely will grow faster than the overall defense budget, which will have annual increases of only about 1 percent above inflation," according to an article at Bloomberg Businessweek (link above). The article reports that—

'Procurement and research are in the 'gaining' portion of the budget,' Hale said. 'The goal would be to move money from support-type activities -- operations and maintenance, military construction -- into acquisition.'

The foregoing was seen as "good news for defense contractors," according to one industry analyst quoted in the article.

What is one to make of these seemingly contradictory statements—i.e., stating

that overhead must be cut and programs must become more "affordable" while concurrently stating that weapons spending (and indeed the entire DOD budget) will continue to grow? Quite candidly, readers of this site should have seen it coming. We **reported** that "current Defense budget levels are nearly double what they were a decade ago, even after adjusting for inflation." We also opined that, "
if Obama Defense spending is reaching a plateau, that plateau is at least 5 percent higher than recent history in inflation-adjusted dollars." We provided a link to a study by the Project on Defense Alternatives (PDA) that probed the seeming contradiction between real budget growth and the need for more budget. One of the causal factors the PDA study mentioned was DOD spending per uniformed service member, which had increased by nearly
50 percent
per individual over the decade between 2000 and 2010. The study reported that, "t
he increase was enough to bring total personnel expenditures back up to Cold War levels – for a military only 69% as large."

To sum up, it appears as if DOD spending—and *not* contractor spending—is driving the need to develop weapon systems more efficiently, and certainly less expensively, than has been the historic norm. Whether that is possible or not remains to be seen. But in the meantime, defense contractors are reorganizing and cutting overhead in an attempt to be seen as part of the solution, rather than part of the problem.