

The status and future of the aerospace/defense industry has been a popular topic here at Apogee Consulting, Inc. Whether it has been a reported [DOD funding shortfall](#), a report from AW&ST forecasting an [industry-wide downturn](#), or a [similar report](#) from Forecast International, or another AW&ST forecast of a 10% industry-wide [workforce reduction](#), readers of this site are (naturally) interested in what lies in store for the A&D industry.

And we've not been entirely pessimistic, either. In [one article](#), we noted that several A&D companies were actually *adding*

to their executive ranks, under the theory that an enhanced focus on program performance and customer relationships would differentiate them from the competition. In

### [another article](#)

, we linked to a report by the Project on Defense Alternatives that postulated a defense spending plateau that would be at least

*five percent higher*

than recent history, even after adjusting for inflation. So even as we

### [report](#)

on industry layoffs and corporate restructurings, we also continue to be guardedly optimistic that some sectors of the industry will maintain current business levels, while other sectors may even thrive in the near-term future.

The seeming contradiction between forecasted spending cuts and cautious optimism continues and may well define the rest of 2010 and 2011 as well. On July 22, 2010, the New York Times [published](#) an article entitled “Pentagon Faces Growing Pressures to Trim Budget.” The article reports—

Mr. Gates is calling for the Pentagon’s budget to keep growing in the long run at 1 percent a year after inflation, plus the costs of the war. It has averaged an inflation-adjusted growth rate of 7 percent a year over the last decade (nearly 12 percent a year without adjusting for inflation), including the costs of the wars. So far, Mr. Obama has asked Congress for an increase in total spending next year of 2.2 percent, to \$708 billion — 6.1 percent higher than the peak under the Bush administration.

Mr. Gates is arguing that if the Pentagon budget is allowed to keep growing by 1 percent a year, he can find 2 percent or 3 percent in savings in the department's bureaucracy to reinvest in the military — and that will be sufficient money to meet national security needs. In one of the paradoxes of Washington budget battles, Mr. Gates, even as he tries to forestall deeper cuts, is trying to kill weapons programs he says the military does not need over the objections of members of Congress who want to protect jobs. ...

At the moment, the administration projects that the Pentagon's base budget and the extra war spending will peak at \$708 billion in the coming fiscal year, though analysts say it is likely that the Pentagon will need at least \$30 billion more in supplemental war financing then.

Two-thirds of Pentagon spending is on personnel costs. It is possible that the

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Pentagon will have to look for the first time at cuts to the health benefits provided to active and retired military personnel and their families.

Some analysts said the Pentagon would eventually come under pressure to reduce the size of the armed forces.

Readers of this site may notice something interesting in the quoted sections of the article, above—the bit about personnel costs. We first brought the personnel cost issue to your attention [here](#), where we reported on an editorial from Dr. Loren Thompson of the Lexington Institute. We [subsequently reported](#) on a GAO comparison between the costs of using private security forces versus costs of the use of State Department security personnel—and we reported that GAO found huge cost increases when government personnel were used, in almost every case it studied. So keep that fact in mind when you hear about Government “insourcing” and hiring of more Pentagon personnel.

[This July 2010 study](#) by Deloitte's Global Aerospace & Defense practice summed up the state of the A&D industry thusly—

Sales in 2009 were essentially flat with a small 1.3% increase, while earnings were down 15.3% from 2008. If not for the large program related write-offs, asset impairments, or regulatory fines at a few of the largest firms, industry profits would have been essentially flat as well. This financial performance could be viewed as positive when compared to the significant negative economic impact of the global recession. The industry continues to demonstrate its resiliency in the face of uncertain economic conditions. The global aerospace and defense (A&D) industry as of midyear 2010 is experiencing the same 'flat' financial performance that was seen in 2009, although results varied widely by individual companies. For the top 25 global A&D firms that have issued quarterly financial statements thus far in calendar 2010 as a group, sales revenue growth was -1.01%, operating profits were -1.94%, and operating margins were -0.94% .... Holding steady on these key financial performance metrics indicates that the global industry has largely held up to the continued downward pressure on defense spending, managed its way through difficult and large-scale product introductions, and experienced continued slow sales in the commercial aircraft and business jet segments.

With respect to the defense sector in particular, the Deloitte report stated—

Some programs of record may be terminated due to cost and schedule overruns or determinations may be made that certain weapons programs conceived to fight the Cold War are no longer necessary. Conversely, programs that can be developed and fielded quickly to address the type of irregular warfare with insurgents and invisible adversaries are becoming more frequent and may attract funding.

For defense contractors, new areas will generate growth in 2010 and beyond. In particular, the number and variety of large hardware-based platforms is expected to decline and more innovation and capability will be found in software integration. Mission capability will increasingly be created by information technology services firms, which are well poised to create competitive advantage through innovation in battle space simulation, directed energy, precision engagement, threat identification, as well as energy and infrastructure security.

We recommend that readers download this report for themselves, as it contains quite a bit of excellent information.

Similarly, Jim McAleese recently briefed on this topic at NCMA's World Congress. We'll hold a detailed review of Jim's presentation for a later article, but we want to note some of his points that seem relevant to this topic. Jim made the following points (which we copy 'n' paste unedited)—

- Secretary Gates did not formally-target large cost savings within RDT&E and Procurement Accounts.

To the contrary, those

Modernization Accounts were intended to be the beneficiary from cuts to manpower-intensive Headquarters, plus O&M.

- The majority of the upcoming Service negotiations on 2012-2016 POM will be conducted by DoD Comptroller; CAPE/PA&E; Joint Staff; and USD(Policy).

However,

USD(AT&L)

has unique Statutory authorities over critical “go/no-go”

Milestone-Decision-Authority

,  
transitioning large-dollar Weapons Programs from one phase of the Acquisition

cycle into the next, ( ranging from Technology Development; to critical Engineering Manufacturing Development; and ultimately Production).

- Specifically, Dr. Carter is statutorily-responsible for making Milestone Decisions on several large-dollar RDT&E Development Programs that are about to be kicked-off by the Military Services. These include Army Ground Combat Vehicle ; continued production of hardware under Army's Brigade Combat Team Modernization ; Navy VXX ; Navy SSBN(X) ; USAF Long-Range-Strike ; and Airborne ISR/SIGINT Platforms.

- This initiative will undoubtedly cause concerns over potential reduction in defense contractor Profits

- . However, as a general rule, for each dollar of actual labor, hardware contractors often have another 80%-100% Overhead , plus another 25%-33% of Corporate G&A , before Profit is even negotiated. This explains why Dr. Carter is so focused on attacking both exquisite Requirements by the Services , in parallel with pockets of low-value Contractor Overhead/G&A

- . Ultimately, Contractor Profits pale by comparison, against both excessive Service Requirements, and duplicative Contractor Overhead.



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- This means that the future ‘Discriminator’ in valuing defense contractors, will become those contractors who outperform negotiated Schedule and target Costs, to actually produce larger quantities of affordable platforms, at greater overall Profit.

We note that Jim’s conclusion—that those contractors who “outperform ... Schedule and target Costs, to ... produce larger quantities of affordable platforms”—will not only have a competitive advantage in the A&D marketplace, but will also enjoy “greater overall Profit,” is pretty much exactly what we’ve been posting here for nearly two years. Let’s repeat together: *program performance equals profits* .

Continuing our theme of the dichotomy between budget cuts and opportunities to grow and thrive, we offer [this Reuters story](#) (compliments of Defense Industry Daily). It points out that U.S. defense budgets may be flattening with respect to domestic sales, but that U.S. defense export sales may well

*surge*

in the near future, according to Vice Admiral Jeffrey Wieringa, head of the Defense Security Cooperation Agency (

[DSCA](#)

). The article states that Vice Admiral Wieringa said in an interview with the news agency that, “U.S. arms sales will be little changed in fiscal 2010 but could surge by nearly one-third to \$50 billion next year.” The article quotes Wieringa

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as saying, “A lot of countries have built up cash reserves and they intend to continue buying.” (We think those countries primarily are located in the Middle East, and the article also mentions India and Brazil.)

To address the expected growth in arms exports, the article notes that DSCA has been growing. According to the article, “Wieringa has worked hard to expand training and staffing for U.S. military and civilian workers involved in global arms sales, boosting his agency's budget from \$373 million in fiscal 2007 to an estimated \$850 million in the fiscal 2012 budget being drafted now.” That growth rate is commensurate with the growth rate experienced by U.S. defense exporters ... but we can't help wondering what Secretary Gates thinks of those numbers, when he has [recently told](#) the Defense Department to get rid of its bureaucracy. But perhaps that's an uncharitable thought, since U.S. A&D companies may well be relying on DSCA to champion their arms exports, and thus keep their top lines healthy and workforces intact.

To summarize, we have tried to present in this article different vectors of analysis on the health of the A&D industry. While times may appear to be tough—and, indeed, we expect vigorous attempts to shed non-value-added overhead functions (and associated headcount)—the picture is not entirely gloomy. Certain sectors will continue to grow, and those companies that perform well in those sectors should survive and even thrive.

