



## Defense Systems

STRATEGY & MARKET SUPPORT



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## Down is the New Up

### Developing Growth Strategies for the Defense Budget Decline

Prime contractors, subsystem manufacturers and component suppliers have benefited from strong growth in the defense market over the past 11 years.<sup>1</sup> Long-term development and procurement programs have grown side-by-side with urgent operational requirements coming out of Iraq and Afghanistan. This growth has not only benefited traditional defense contractors, it has also opened the door to non-traditional suppliers that have brought off-the-shelf competencies and technologies to bear on the complexities of military operations against insurgency threats.

However, all segments of industry must now recognize that this period of growth is ending. While the recent surge in defense spending was somewhat unprecedented, the timing of the end of the growth period fits within the typical nine to eleven year defense market growth and decline cycle. Looked at this way, it should come as no surprise that the 11-year boom in defense spending is drawing to a close. Current strategic planning and business development processes should therefore be focused on how to succeed in this new funding environment.

### FUNDING SCENARIOS

Avascent analysis indicates that the defense industry faces two potential scenarios in terms of market demand:

**Scenario 1— “High-Flat”:** In a best case scenario for industry, the market would flatten at its currently high level. It is important to understand that even if there is no growth in the defense market from FY09 onward, under this scenario, the

<sup>1</sup> Department of Defense *Greenbook*

market would stabilize at a historical high in terms of funding. This scenario is based on the large number of converging budget priorities facing the new administration: aggressive Reset and Recapitalization requirements in the Army and Marine Corps, ageing platforms across all Services requiring significant sustainment and a number of next-generation systems entering procurement. Considering that the FY09 budget is 33% larger than the FY00 budget (in constant year dollars)<sup>2</sup>, this scenario should be viewed as a net positive for industry, especially as compared to the more precipitous decline in the defense market following the Reagan build-up.

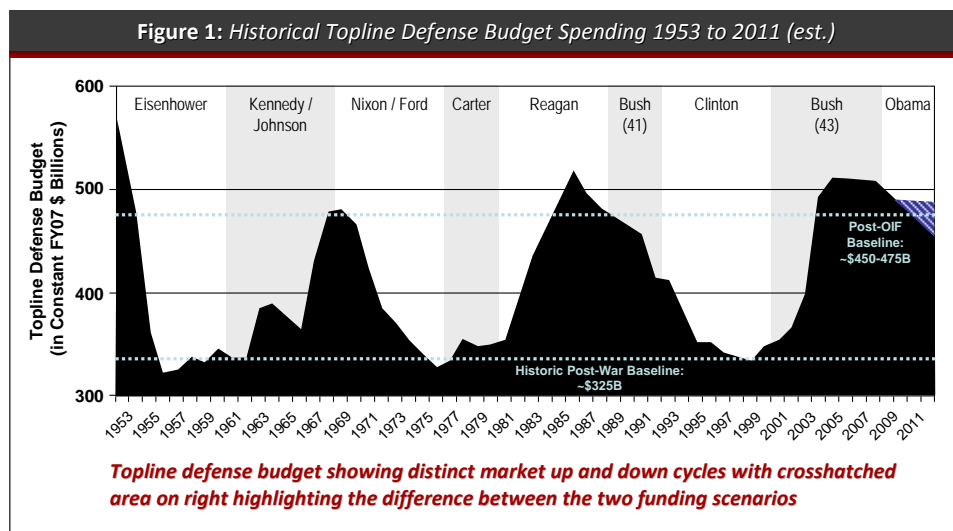
**Scenario 2 — “Gradual Decline”:** Under a less favorable scenario for industry, the market could face a gradual decline over the next 3-5 years. FY09 levels of funding may not be sustainable as certain segments of the defense market near their acquisition targets for major procurement programs and US troops withdraw from Iraq. The post-war requirements for resetting the deployed force would put downward pressure on other programs, particularly if sustainment funding is moved into the base budget. While the budget would not likely see a decline to FY01 levels, it may experience a reduction to FY04 levels before the next upward trend begins again. This resulting baseline would be lower than the one described in the “High Flat” scenario but certainly higher than those witnessed in past downward cycles.

The most important implication of both scenarios is that defense contractors should avoid a “sky is falling” mentality that sometimes accompanies normal defense market cycles. Whether facing a flattening of the market or even gradual decline, it is important to remember that the defense industry has faced far worse in the past. That said, there will be winners and there will be losers in this new environment. Those firms that will do the best are already positioning for growth.

## INDUSTRIAL BASE SUSTAINMENT

Under either scenario, a key question for both the DoD and industry will be how to sustain the robust industrial base grown rapidly during Operations Iraqi Freedom and Enduring Freedom. The sheer volume of new equipment procured over the last few years, and the urgency with which it was developed and deployed, has expanded the industrial base considerably. This base includes a number of new contractors, expanded production capacity for existing contractors, and commercial suppliers who have become government contractors due to a significant market demand.

Compounding this horizontal and vertical growth of the industrial base is an emergence of increasingly specialized technology applications to defeat insurgency threats that have not traditionally been a priority for militaries structured for conventional warfare. These technology applications include a wide range of special mission aircraft, force protection technologies, mine protected vehicles, unmanned systems, and surveillance technologies tailored to long-term, urban, counter-insurgency operations rather than rapid defeat of conventional forces.



<sup>2</sup> Avascent Budget Database

Sustaining such a large industrial production base with a shrinking set of opportunities and decreased funding is not possible in the mid- to long-term for the DoD. This market will inevitably face a period of contraction and possibly consolidation that will leave the resulting competitive landscape looking far different than it does today.

## INDUSTRIAL CAPABILITIES SUSTAINMENT

Recognizing the value of the current industrial base, the risks inherent in its loss, and the cost required to sustain it, the DoD will have to make difficult decisions between what Army Acquisition, Technology & Logistics (AT&L) has termed the **industrial base** and **industrial capability**. Industrial capability is defined as the competencies and capacity inside and outside the industrial base to rapidly respond to emerging requirements.

A prime example of the power of industrial capabilities over the traditional industrial base is the MRAP program. As the requirements for mine protected vehicles grew from a niche application for combat engineers to an urgent operational need for the larger force, the DoD could not turn to an established industrial base built to meet requirements for nearly 16,000 vehicles.<sup>3</sup> Existing industrial base sources simply were not able to meet demand.

Instead, the DoD pulsed industrial capabilities to quickly develop, prototype, test, procure, and deploy vehicles from a large number of contractors inside and outside the established tactical vehicle industrial base. Likewise, demand for automotive components, armor, and other vehicle subsystems tapped subcontractors outside the traditional supply chains of established players.

While many of these prime contractors and subs were ultimately unsuccessful in winning large production orders, they were able to demonstrate new technologies and capabilities to a market that had been closed to all but a few insiders.

An analysis of the MRAP example suggests successful future applications of the industrial capabilities model will include:

- *Sustainment of low-level development funding for potentially valuable technologies*
- *Application of niche, off-the-shelf technologies*
- *Utilization of untapped commercial and defense production capacity*

- *Rapid development and prototyping of production ready vehicles*
- *Promulgation of targeted performance specifications to maximize engineering trades and minimize requirements creep*
- *Reliance on live fire testing to ensure paper designs defeat real-world threats*
- *Employment of flexible contracting methods both to increase the speed of the acquisition process and to attract commercial suppliers*
- *Reliance on industry to rationalize once the need is met*

This last point highlights the key questions facing defense contractors today: how should industry adapt to the fact that the government can not preserve the current industrial base and what are the implications for their near-, mid-, and long-term strategies?

## STRATEGIC IMPLICATIONS

While companies in the defense space will continue to argue that their industrial base position is the most worthy of preservation, in the end the DoD will have to make difficult decisions that will impact the financial fortunes of all segments of the supply chain, from very largest defense primes to the very smallest component suppliers. There are some lessons learned from other downturns that all companies facing this issue should consider:

**Don't Just Survive, Grow.** Avoiding symptoms of irrationality in the post-war budget environment – “we will see continued growth across the board” and “this is the darkest moment the defense market has ever faced” – is the first step in developing an effective risk mitigation strategy. Many companies will look at what seems like a bleak outlook and either hunker down to preserve share or perhaps look to exit the market.

Hunkering down implies a decrease in investment in core technology development as well as sales and marketing efforts. While a degree of cost consciousness is prudent, companies must avoid cutting too deeply at risk of losing the very differentiators which will help them preserve or expand their share of the market. Exiting the defense market may ultimately be the rational choice for some companies; however,

<sup>3</sup>Exact number is 15,858 not including M-ATV. Source: Mine-Resistant, Ambush-Protected (MRAP) Vehicles: Background and Issues for Congress. Andrew Feickert. Congressional Research Service. June 15, 2009.

there are still enough open opportunities to justify continued investment in growing a market position.

Some segments will, in fact, see growth in coming years but difficult budget trades will be required to ensure the sustainment of that growth. The competitive environment could shift dramatically as companies that seemed like the largest threats become less competitive as a result of program cuts, or exit the market altogether. Companies that are willing to brave the defense markets may find themselves even better positioned for the next up-swing.

**Mitigate Risk by Sharing it with Others.** The risks inherent in the current defense market are clear but the mitigation strategies required for strong business plans are more difficult to discern. What is clear is that there is strength in numbers and going it alone may not have as strong a risk-reward balance as it did a few years ago. Finding partners, licensing innovative technologies, or perhaps even making a strategic acquisition or two can significantly bolster the competitive prospects for a host of companies.

Incumbent primes and suppliers may find that the integration of an emergent teammate reduces the impact of decreased corporate IRAD dollars through the infusion of off-the-shelf technologies from other markets. In turn, emergent primes and suppliers may find that the integration of an incumbent teammate increases the chances for continued DoD interest and support.

The business implications of decreased share of platform dollars, internal investment, or erosion of margin are heavily outweighed by the rewards of securing a position on a key program. Considering the outlook for the defense market, acquisitions may look more attractive than they did during the up-swing when multiples soared for the latest hot company. There will be bargains to be had in the coming years.

**Stay Focused on the Customer.** The heightened risk in the defense market means that contractors at every level of the supply chain must intensify their focus on customer requirements to stay competitive. To neglect customer priorities, either consciously or through the shuffle of corporate planning, can be the kiss of death in the defense market where there is a single customer.

## CONCLUSION

To be sure, defense customers are facing at least as big a problem as industry. Competition, cost pressure, and con-

straints on development and acquisition timeframes will all increase as the Services face a mountain of post-war priorities with a thinner wallet. These customers expect increased oversight of their decisions, particularly as companies fight to the bitter end for key contracts through protests and legal action. Being cognizant of customer pressure points will likely mean the difference between success and failure.

During the defense up-swing, DoD customer communities, desperate for solutions, circumvented traditional purchasing habits to meet urgent operational requirements. As demand declines, we are unlikely to see a continued revolution in contracting and procurement policy; rather a retrenchment into old habits and processes that have guided defense procurement for the last 60 years should be expected. While there have been calls for large-scale defense reform, Avascen's past experiences as an observer of this market have demonstrated that meaningful change is difficult to achieve.

Companies must adapt to changing customer attitudes and buying habits. Commercially-oriented emergent primes and suppliers courted by the DoD with exceptional contracting arrangements will now be forced back into the normal acquisition bureaucracy. Within certain acquisition communities such as MRAP, companies have established strong customer networks that may lose relevance. The sales and marketing processes used to establish those networks may become less effective over time, with incumbent primes and suppliers recapturing some of their traditional competitive advantages in government contracting expertise.

In conclusion, incumbent and emergent primes and suppliers must develop strong contingency plans and strategies to maintain and grow market share over the next few years. Those that can adapt to changing customer requirements and purchasing habits, as well as align offerings to the more austere years ahead, can certainly be successful in the defense market for years to come.

To read further about this framework explored further in specific market segments see:

- *Is Your Base Safe? Competing for Tactical Wheeled Vehicle Programs in a Constrained Funding Environment*
- *Reinventing the Wheel: Planning for the Aftermath of FCS Manned Ground Vehicle (MGV) Cancellation*

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