



## Growing When Growth is Hard

**The economic downturn has created a new reality with which corporations will cope for some time to come. How do aerospace and defense companies hold their own, or even sustain growth, in a down cycle?**

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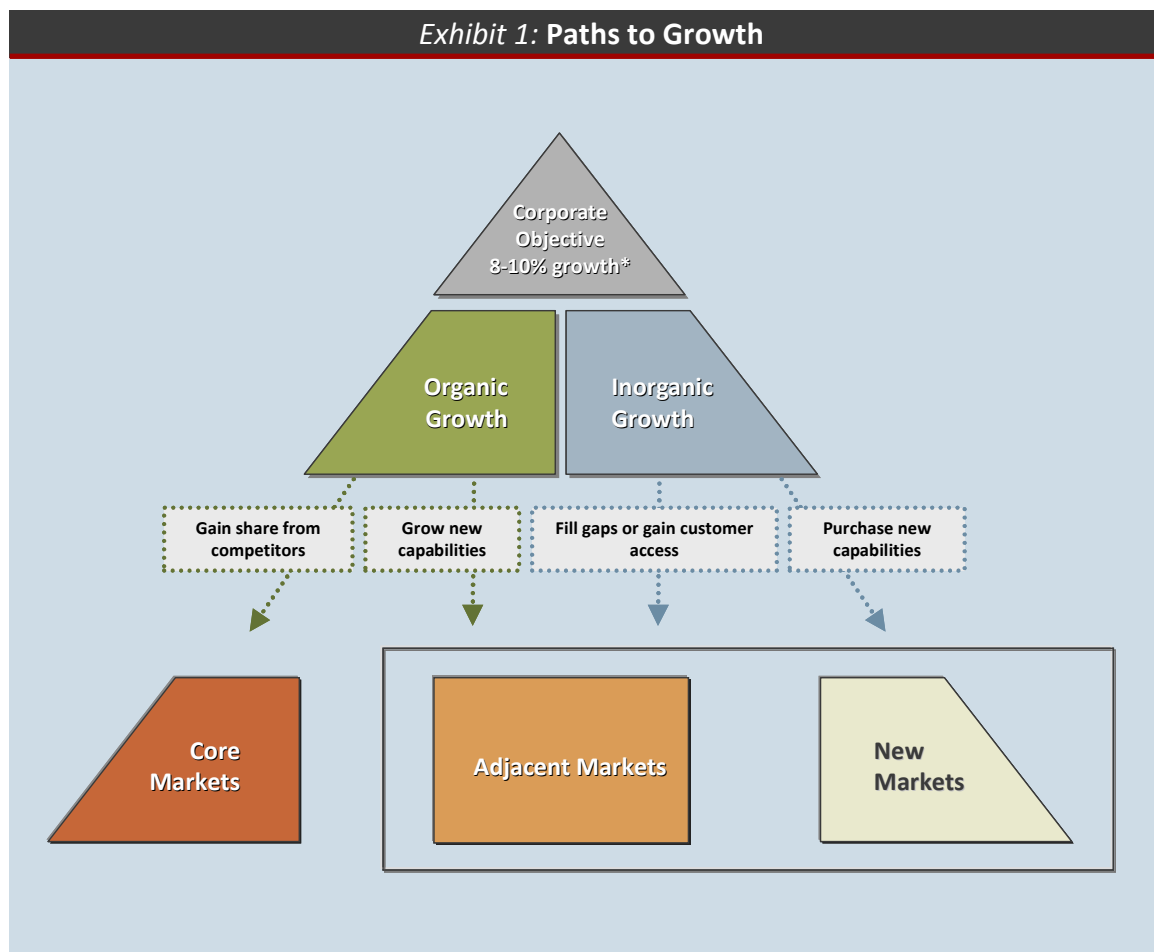
In 2009, a long-awaited moderation in defense spending began in earnest, coinciding with a redirection of defense priorities away from expenditure-heavy platform acquisition and enhancement. A market that is steady but not growing creates a new reality with which corporations serving the defense community will cope for some time to come. For companies primarily focused on aerospace and defense (A&D) in particular, this begs the critical strategic question: How do we hold our own, or even sustain growth, in a down cycle?

***“This new uncertainty requires a broader look at a company’s entire portfolio and markets”***

In such an environment where predictable and robust corporate growth objectives had been standard, this new uncertainty requires a broader look at a company’s entire portfolio and markets.

Given The Avascent Group’s focus on developing and enhancing growth strategies for companies that have the government as a key customer, we find this challenge of growing when growth is hard to be pressing for many of our clients. To answer it, we look to history for examples of companies that have successfully grown in times that posed particular challenges – to companies that have succeeded in growing when growth is hard.

*Exhibit 1: Paths to Growth*



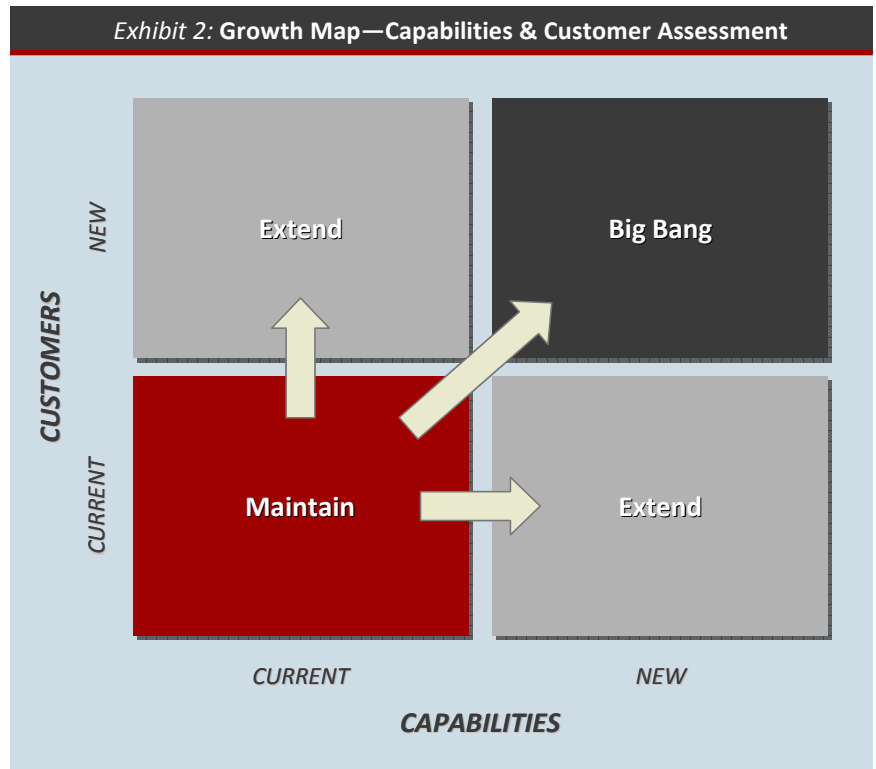
**Notes**

1. Objective growth assumption based on recent past performance

**“For most A&D companies, the judicious application of capital against a few carefully selected adjacent opportunities will provide sustained growth”**

We have found that companies that successfully meet this very stiff challenge have undertaken approaches which are unified by a simple theme: They have sought and found avenues for growth that are realistically attainable from their core strengths. They have succeeded in leveraging their skills to find new markets, new customers or develop new products to sustain growth during periods when their core markets, customers or products are likely to disappoint. Avascent finds that companies that craft a successful strategic response to the growth challenge in a down market inevitably do three things well. They:

1. Leverage core customers and capabilities to pick “short commute” and realistic growth vectors (see *Exhibit 2*)
2. Execute well with a disciplined, detailed plan complete with interim metrics, clear responsibilities and tight accountability; and
3. Execute rapidly and decisively to gain and retain the initiative over competitors.



The market is surprisingly rich in opportunity to do these three things well today. For companies with a traditional footing in A&D, adjacent markets set to grow on a sustained basis in this difficult environment include cyber, infrastructure, logistics, energy, soft power, border and internal security, healthcare and health IT. Of course, not all possible growth markets are realistically accessible to every A&D company — for any given company, a subset of attractive markets are particularly promising in light of its customer relationships and capabilities.

Collectively, customer relationships and capabilities define the “commute distance” from a given company’s core to some of these potential adjacencies. For most A&D companies, the judicious application of capital against a few carefully selected adjacent opportunities will provide sustained growth when the immediate prospects in their core markets are poor.

**Exhibit 3: 1999 vs 2008 Acquisition Strategies of Top 20 A&D Firms**

Rank	1999 Top Defense Contractors		2008 Top Defense Contractors	
1	Lockheed Martin	Post-merger integration focus following intense acquisition activity in mid-1990's	Lockheed Martin	Aggressive acquisition strategy; focus in 2010 will be on cyber security, energy security, and logistics
2	Boeing	Acquired to balance commercial and defense businesses	BAE Systems	Targeted and aggressive acquisition strategy as noted in 1999 list
3	Raytheon	Several large acquisitions with divestitures to tailor its portfolio	Boeing	Aggressive acquisition strategy; most recently began acquiring to move into cyber market and services
4	British Aerospace	Targeted and aggressive acquisition strategy that included Lockheed Martin AES, and a merger with Marconi Electronic Systems to form BAE	Northrop Grumman	Aggressive portfolio approach continues – Essex into cyberspace; sale of TASC
5	GE	Mostly organic innovation, e.g., "power by the hour"	General Dynamics	Aggressive acquisition strategy, leading into multiple adjacent markets
6	Northrop Grumman	Aggressive acquisition strategy in the aerospace and shipbuilding sectors	Raytheon	Significant acquisition strategy, concentrating their position as a defense and technology firm
7	Thomson-CSF	Now the Thales Group, which has made a number of high-profile acquisitions, including a large stake in the Direction des Constructions Navales	EADS	Formed from a merger of Aerospatiale-Matra, CASA, and DASA
8	General Dynamics	Aggressive acquisition strategy, leading into multiple adjacent markets	L-3 Communications	Slowed in recent years – future uncertain
9	DaimlerChrysler Aerospace	Merged with Aerospatiale-Matra and CASA, forming EADS	Finmeccanica	Aggressive US expansion through purchase of DRS Technologies
10	United Technologies Corp	Beginning of strategy around highly integrated M&A approach that would lead to expansion into new sectors	United Technologies Corp	Augmented core sectors and built a Fire & Security business with acquisitions playing a major role; company planning to spend \$5B in 2010
11	Mitsubishi Heavy Industries	Very limited M&A activity	Thales	Has made a number of high-profile acquisitions, including a large stake in the Direction des Constructions Navales
12	Litton Industries	Acquired by Northrop Grumman in 2001	SAIC	Aggressive acquisition strategy, focused in cyber, energy, and ancillary services
13	TRW	Acquired by Northrop Grumman in 2002	ITT	Aggressive acquisition strategy, significantly increasing defense electronics and services
14	Rosvoorouzhnie	An entity of the Russian state, which tried to divide the agency's responsibilities	KBR	Very limited acquisition activity
15	Rheinmetall Group	Limited M&A activity, concentrated in foreign countries	Honeywell	Numerous large purchases, and divestitures aimed at concentrating the company in aerospace
16	Rolls-Royce	Numerous acquisitions consolidating its position in airline engine manufacture and repair	Almaz-Antei	An entity of the Russian state
17	Direction des Constructions Navales	Agency of the French government	Rolls-Royce	Numerous acquisitions consolidating its position in airline engine manufacture and repair
18	Allied Signal	Merged with Honeywell	GE Aviation	Portfolio shaping includes some acquisition activity, e.g., Smiths Aerospace
19	Groupe Dassault Aviation	Limited M&A activity; purchased stakes in a number of businesses, as well as some smaller foreign purchases	Navistar	Very limited acquisition activity
20	Newport News Shipbuilding	Acquired by Northrop Grumman in 2001	MBDA Missile Systems	Very limited acquisition activity; possible target

**Notes**

**1.Acquisition data source: Defense News**

***“Sustained growth in down markets is almost always supported by acquisition”***

Broadly speaking, companies can apply capital in some combination of two ways: by investing in internal, organic development, or by acquiring to gain access to customers and/or capabilities.

In practice, Avascent finds that acquisition almost always plays at least some role in significant, successful strategies for companies that sustain growth in flat or declining markets. Above, *Exhibit 3* illustrates this point, showing that the overwhelming majority of companies that maintained or gained a leading position in the A&D sector in the com-

paratively difficult years preceding 9/11 did so with heavy reliance on non-organic growth – that is, growth by acquisition.

Having said that sustained growth in down markets is almost always supported by acquisition, Avascent finds that three models capture most growth strategies in difficult markets:

- *Acquire to Expand;*
- *Acquire to Consolidate; and*
- *Acquire to Focus & Reposition.*

The following examples illustrate each of these cases.

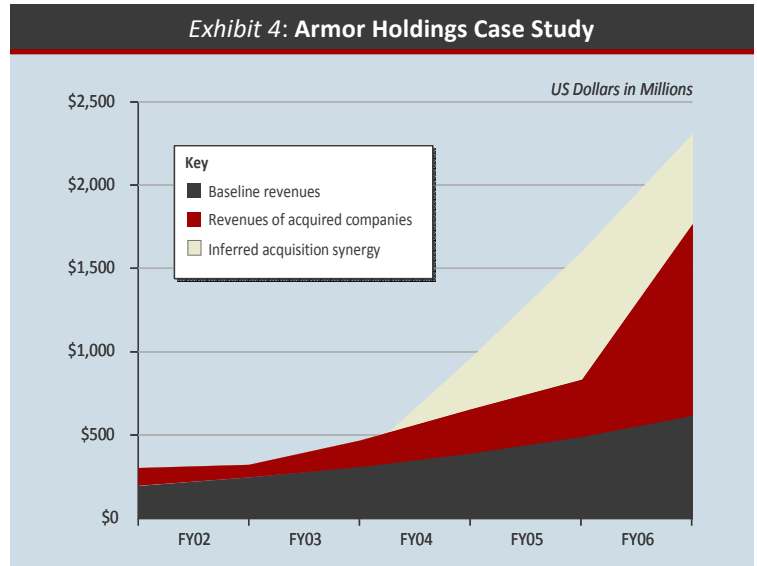
**Acquire to Expand: Armor Holdings**

In the mid-1990s, at the trough of the post-Cold War slump in defense spending, Armor Holdings was a modest \$30 million company supplying personal protection products, mainly to the law enforcement market. In 2001, it acquired O’Gara-Hess & Eisenhardt, a mid-sized vehicle armor provider and began a chain of acquisitions that built Armor Holdings into a leading provider of personal and vehicle protection products that roughly coincided with the unprecedented increase in demand for that equipment driven by the wars in Iraq and Afghanistan. By 2006, the year of its last acquisition (Stewart & Stevenson) prior to its sale to BAE, Armor Holdings had transformed into a \$2.4 billion company through a methodical strategy of adjacent market expansion by acquisition.

**Notes**

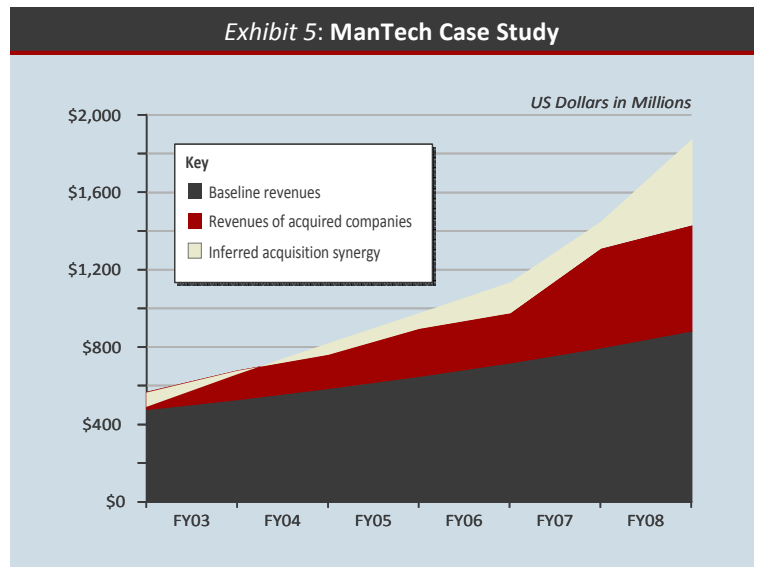
1. FY’s reported here do not coincide with the U.S. Government fiscal year, but instead with the calendar year

2. Financial data source: Reuters



**Acquire to Consolidate: ManTech**

ManTech developed a core business focused on cyber and ancillary services through a string of acquisitions, picking up in 1997 with the purchase of Applied Measurement Systems and Tidewater Consultants. Ten years later, ManTech would purchase McDonald Bradley for \$79M, with a position on DHS’ EA-GLE contract and a strong presence at DIA. Most importantly, ManTech has also shed acquisitions that proved disappointing. A prominent example is MSM Security Services, divested four years after purchase when it became apparent that background checks would remain labor-intensive and resistant to more streamlined, automated routines.



**Acquire to Focus & Reposition: Raytheon**

The mid-1990s saw Raytheon on an acquisitions tear through E-Systems (1995), Chrysler Technologies and Airborne Systems (1996), Hughes A&D and TI's Defense Systems & Electronics business (1997). What was conspicuous was not so much the number of acquisitions, but their size – these four acquisitions added about \$15 billion to the

sons from an examination of firms that have prospered in difficult periods of market cycles.

**First, get ready to acquire.** In a flat market, organic growth is tantamount to stealing market share. Stealing market share means disrupting established customer relationships in markets that are new to you. It is much easier to buy into these markets than

to fight one's way into them.

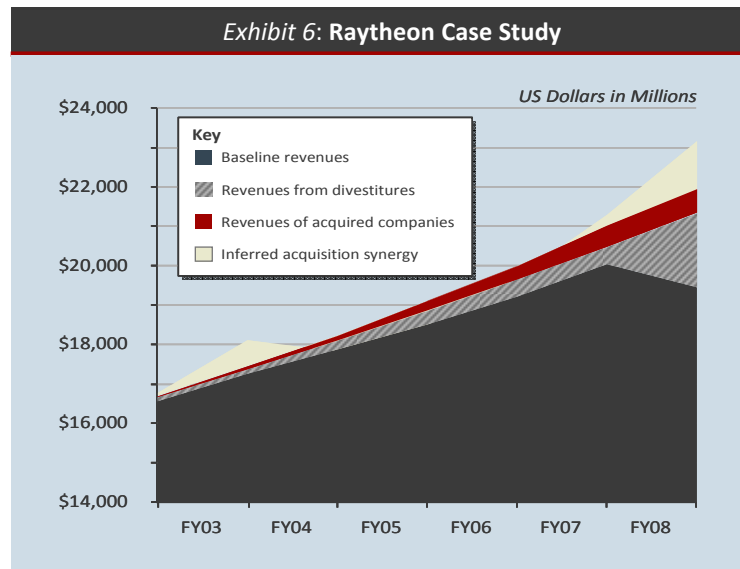
**Second, commit to a coherent strategy.** Saying that your strategy is acquisition is not sufficiently specific.

The firms we profile above have acquired against a discernible strategic theme — expand, reposition, consolidate, focus — there may be others, but a clear and consistent strategic direction to acquisition activity is a hallmark of long-term success.

**Third, choose your markets carefully.** It is much easier

to grow in a growing market than in a flat market. It is easier to grow in a flat market than in a declining market. It is easier to grow in a declining market experiencing a temporary rather than a long-term or permanent decline. Gain a comprehensive understanding of your target market's macroeconomic conditions prior to investment.

**Fourth, look at modest commutes.** The closer a market expansion opportunity is to your core market, customers and capabilities, the easier it will be to successfully enter. The potential rewards must be greater to justify strategic moves more distant from that core. Essentially, you are betting on an expected value calculation, where the magnitude of the reward varies inversely with commute distance around break-even. Bigger rewards closer to core win every time. 🚩



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top line. Simultaneously, Raytheon sold a number of smaller, limited growth businesses focused on commercial customers, including their commercial appliance unit (1997 - \$750M), Montek Company (1998 - \$160M), the training devices and services business (2000 - \$160M), Aircraft Integration Systems (2002 - \$1.13B) and Raytheon Aircraft Co. (2007 - \$3.3B). By the post-9/11 period, Raytheon had transformed from a mixed commercial and defense technology business to a very focused defense player with a strong technology-oriented portfolio that— with the exception of a single year— delivered annual growth in the 4-9% range.

**Conclusion**

What do these examples say to A&D companies considering a strategy in these challenging times? Avascent perceives four key les-



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