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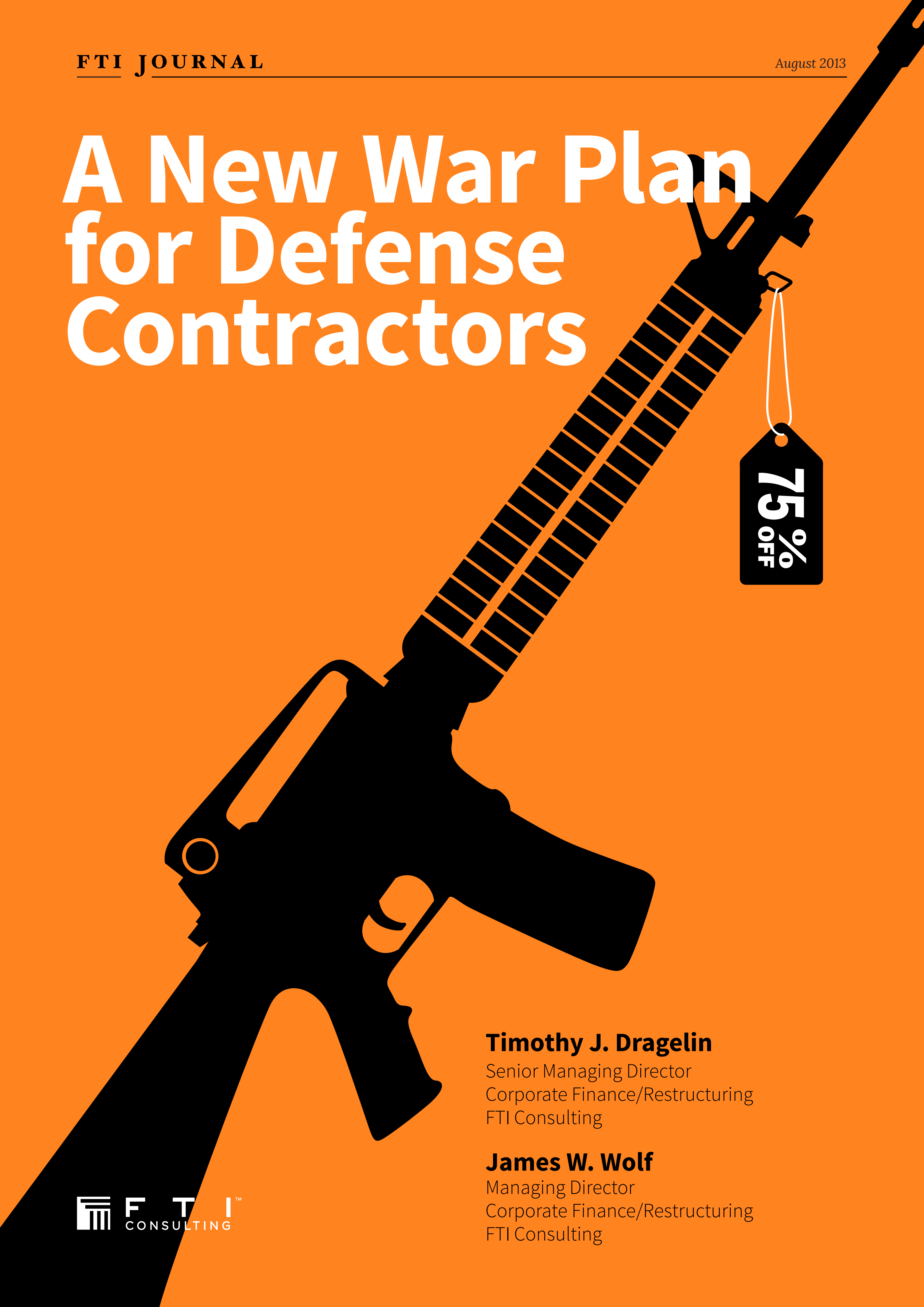
A New War Plan for Defense Contractors



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With the Iraq war over and the Afghanistan conflict in its final stages, relentless pressure on government spending is creating a very different terrain for defense contractors selling to the U.S. military. If they expect to thrive in the "new normal," contractors need to assess their situations and develop different competitive approaches and defenses.

A few statistics paint the picture of the new normal. The U.S. Department of Defense (DOD) budget for contractors is expected to decrease by 12.4 percent in fiscal year (FY) 2013 and another 7.6 percent in FY 2014[1]. The budget for operations and maintenance-related projects alone has taken a 37 percent hit during the last three years. In addition, the budgets for Overseas Contingency Operations spending are projected to plummet from $162 billion in FY 2010 to the $40 billion range by FY 2014. For defense contractors, traditional sources of revenues and profitability are deteriorating. Those that will survive — and thrive in the long run — will adopt more stringent cost controls, compliance programs and increased operational scrutiny.

Opportunities are emerging for companies that are able to develop innovative solutions and/or gear existing capabilities to meet the needs of new customers such as non-defense-related federal and state agencies and foreign governments. In this article, we delve into the forces creating the new normal and discuss what senior managers at defense contractors can do to navigate it successfully.

DEFENSE SPENDING: THE SITUATION TODAY

National security priorities have been shifting for decades. Although the conflicts in Iraq and Afghanistan are dissipating, threats are emerging from North Korea, Iran, and ungoverned regions in the Middle East and North Africa. Dangerous weapons are more widespread, and rogue states and individuals have easier access to military technology. In addition, regional conflicts potentially could require U.S. intervention. Cyber threats — which didn't exist a decade ago — can threaten the country's security, economy and energy grid. The Department of Defense is targeting its resources to these recent threats.

The budget situation, however, is far from stable. The sequester cuts resulted in an automatic decrease of $42.7 billion from the DOD's budget for the 2013 fiscal year. Although a March 2013 resolution restored $85 billion for operations in Iraq and Afghanistan and eased some of the sequester cuts, Congress hasn't reached consensus on a permanent fix. If it fails to address the situation, the defense budget possibly may fall by an additional $500 billion over the next 10 years. To cope with the budget pressures, Chuck Hagel, current Secretary of Defense, is driving efforts to make procurement programs highly efficient, cost-effective and more responsive to military needs.

The DOD has placed a priority on minimizing the budget impact on personnel. Both President Obama and Congress have expressed the desire to preserve funding for military personnel — about 25 percent of the DOD budget — to prevent base closings, layoffs and pay cuts. As a result, defense contractors likely will bear the brunt of the new normal.

THE FUTURE OF DEFENSE SPENDING

Since budgets are developed annually, it is difficult to predict future spending trends. However, history teaches us that defense spending drops significantly when wars end. As the Iraq and Afghanistan conflicts reach their respective conclusions, the reduced need for large peacekeeping forces is shifting the DOD budgetary focus from the U.S. Army and U.S. Marine Corps to the Reserves and the National Guard. In terms of future growth, the DOD is planning to invest in naval surveillance, unmanned aircraft, ballistic missile defense and related equipment systems. Whatever the budget scenario, procurement efficiency will continue to be a priority.

THE BETTER BUYING POWER INITIATIVE

In 2010, the DOD began a comprehensive effort to control costs, eliminate unproductive processes and promote competition among its suppliers. The Better Buying Power initiative gained steam two years later with more specific guidelines for contracts, affordability caps and profit levels in line with DOD expectations. As a result, contractors no longer can depend on quick approval for change orders and compensation for additional products and services not explicitly included in contracts.

The federal government is becoming more stringent with procurement requirements in new and existing contracts as well. Contract renewals for incumbents currently include reduced and more competitive margins. Increasingly, government agencies have been utilizing contract vehicles that shift greater performance risk onto the contractor. In addition, government agency procurement officers have been implementing more competitively bid contracts by leveraging lowest price, technically acceptable bid review processes.

INCREASED REGULATORY SCRUTINY

Although the Defense Contract Audit Agency (DCAA) has a $573 billion backlog stretching six years back, politicians in Washington, D.C., are politically eager to ferret out and punish contractors that overbill or commit fraud. The Pentagon recently chastised the DCAA after a March 2013 report revealed that 37 out of 50 audited contracts were not compliant with Generally Acceptable Government Accounting Standards. As the DCAA scrambles to address its critics — shifting staffing, priorities and areas of focus — it is difficult to predict which contractors will be the next targets. The challenge is compounded by the six-year statute of limitations for claims made under the Contract Disputes Act. The act is inconsistently enforced, and a 2012 district court case — *United States v. BNP Paribas SA* —suspends the statute of limitations until five years after a war ends. Given the complexity of defining the end of modern day conflicts, audits could occur decades after a given contract or transaction has transpired.

CAPITALIZING ON NEW GROWTH

Defense companies must refocus business plans, improve efficiency and position themselves effectively to capitalize on opportunities in both the defense and non-defense sectors. To make the transition, companies should take these critical steps:

1 Evaluate Strengths and Develop New Revenue Sources

Defense companies should thoroughly examine their structure, overhead and offerings to find ways to adapt and bring innovative solutions to the market. For example, companies that can marshal thousands of employees overseas can provide similar services to the Federal Emergency Management Agency (FEMA) or to non-governmental agencies that need support for domestic or international disasters. By the same token, companies that provide defense information technology (IT) solutions can offer those capabilities to improve systems for the Veterans Affairs agency or to bolster fraud detection programs for Medicare and Social Security.

SAIC is a case in point. In 2012, 43 percent of the IT service firm's revenues came from its defense solutions business and 32 percent from cybersecurity. Only 25 percent came from health, energy and civil solutions. After thoroughly evaluating its portfolio of capabilities, the company realized it could leverage its health, energy and civil solutions expertise to add value to other government agencies. As a result, SAIC is scoring new contracts with the Transportation Security Administration, FEMA, the National Aeronautics and Space Administration, the National Institutes of Health and the Pension Benefit Guaranty Corporation.

Along similar lines, security service contractors with experience in places such as Iraq and Afghanistan are offering their services to the private sector. These companies know the drill and can provide their capabilities to a host of government and private sector companies. In May 2013, for example, KBR, Inc. won a contract from the London Mayor's Office for Policing and Crime. The company now designs and manages facilities such as call centers for Britain's largest police force.

2 Contain Costs

Management teams need to focus more on overhead costs, especially when cost-plus contracts are a major source of revenues. In addition, chief financial officers should take a hard look at other expenses that might jeopardize future revenues, profitability and cash flows. It is clear that reducing overhead helps government contractors offer more competitive prices that will assist them in winning new contracts.

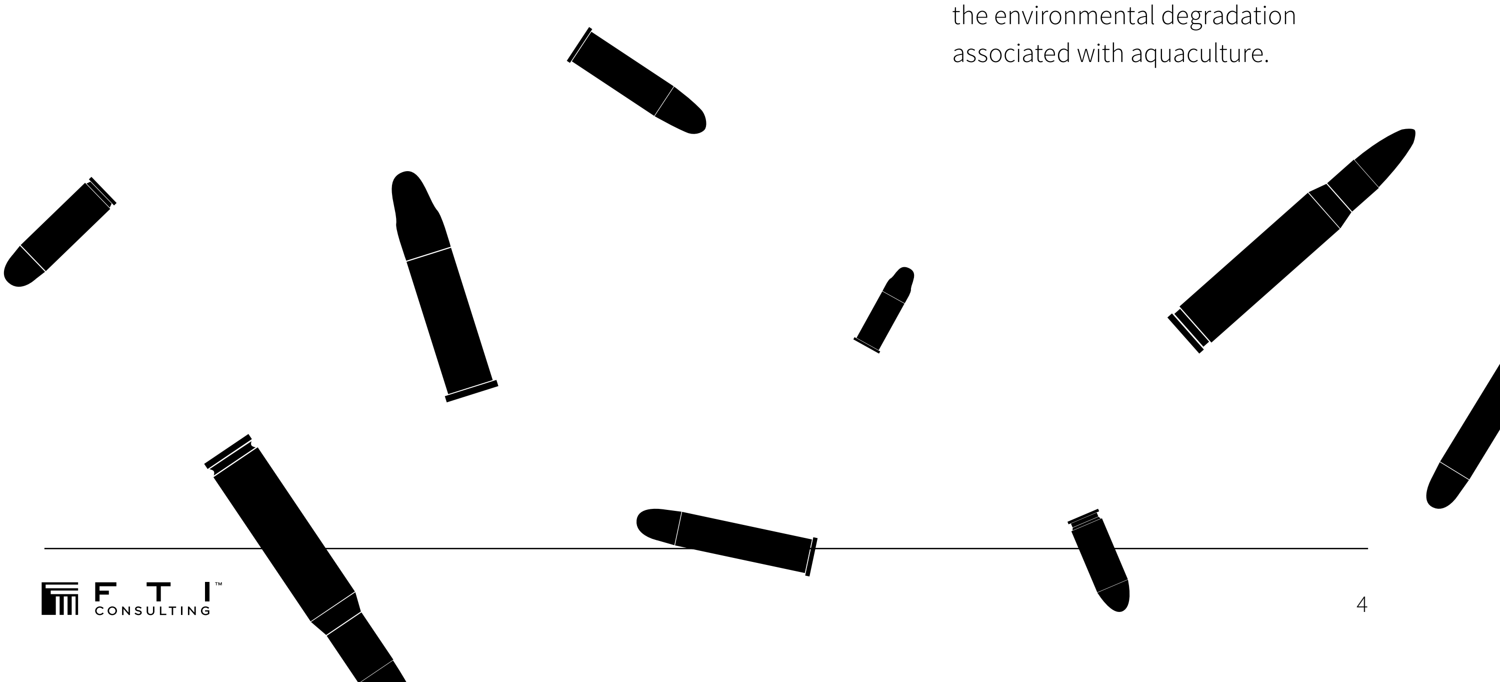
DynCorp, for example, embarked on a major overhaul to improve its cost structure. In April 2013, the company reduced the number of its business units from five to three. The restructuring eliminated many layers of overhead and allowed the company to become a more nimble player. DynCorp now can aggressively invest in its three remaining business units.

Create New Specialized Capabilities

3

Developing specialized capabilities and intellectual property can help separate companies from their competitors. Commoditized services — such as providing resources for rebuilding efforts in Iraq and Afghanistan or semi-technical services in telecommunications — can provide significant revenues. However, service contracts that use unskilled labor and lower-level competencies tend to be highly competitive. The low-margin work can drain long-term earnings and profitability.

Lockheed Martin particularly has been forward looking in developing innovative capabilities and technologies. Seeing the trend toward unmanned aircraft systems, Lockheed Martin acquired companies with this specialized knowledge to boost its existing strengths. Recognizing the challenges that lie ahead in providing potable water, the company built a molecular filtration system that removes sodium, chlorine and other ions from seawater. Lockheed Martin also is creating solutions to address the environmental degradation associated with aquaculture.



The company has partnered with fish producers to construct remotely controlled fish pens that can drift in open sea currents and produce millions of sushi-quality fish with little adverse environmental impact.

THE BASIC BUSINESS PLAYBOOK

In an era of increased government scrutiny and new demands, defense contractors must ensure that their business practices and systems are bulletproof and adaptable. To achieve the needed readiness, companies should concentrate on three areas:

IMPROVED PROCUREMENT PROCESSES:

Material and overhead expenses should be reduced so businesses can bid more aggressively and operate more profitably. In addition, a contractor whose systems aren't buttoned down could attract added scrutiny from the DCAA. An administrative contracting officer can withhold up to 10 percent of payments if a contractor's accounting system appears to have problems. If government auditors disapprove the system, a contractor could face cash flow problems that thwart its ability to win future cost-plus contracts.

STRENGTHENED BILLING AND COLLECTION CONTROLS:

Strong controls can minimize unbilled revenues and fortify liquidity and working capital — both critical for needed investment. Businesses should monitor all phases of the billing process: circulating forward pricing rates, analyzing and resolving at-risk or unbilled receivables, and fixing billing errors. Billing that is less than transparent can jeopardize relationships with lenders and can lead to government audits.

MORE RELIABLE AND DETAILED REPORTING AND PLANNING TOOLS:

These tools can help companies coordinate business development, finance, operations, financial planning and analysis, and treasury functions. Making the tools interactive can assist management in understanding different scenarios and realizing how a change in one contract or project can affect the entire business. These tools also help manage working capital and effectively promote the organization to capital markets. This especially is important as contractors position themselves for future growth.

For the past 10 years — since the invasion of Iraq in March 2003 — the United States has paid the lion's share of the allied military and reconstruction expenses there. The Iraq war cost the United States at least $138 billion, and the top 10 contractors received some $72 billion. That picture is changing. Most defense contractors no longer can rely on their traditional defense customers. To thrive, they must develop new competitive defenses and approaches and adapt to meet the needs of non-traditional customers across the globe. ■

The authors wish to thank Mac Garber, Senior Consultant at FTI Consulting, for his contributions to this article.

Sources:

1-Defense Government Services: Lazard, September 19, 2012.
FTI Consulting analysis.

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