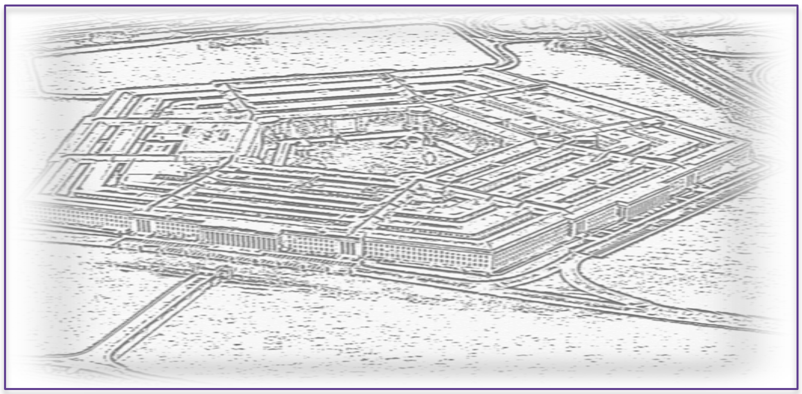
Defense Outlook

2013 and Beyond



An analysis of the Department of the Defense budget position for 2013 and future years.

Prepared by VADM Lou Crenshaw USN (Ret.)
National Aerospace and Defense Industry Leader
Grant Thornton LLP
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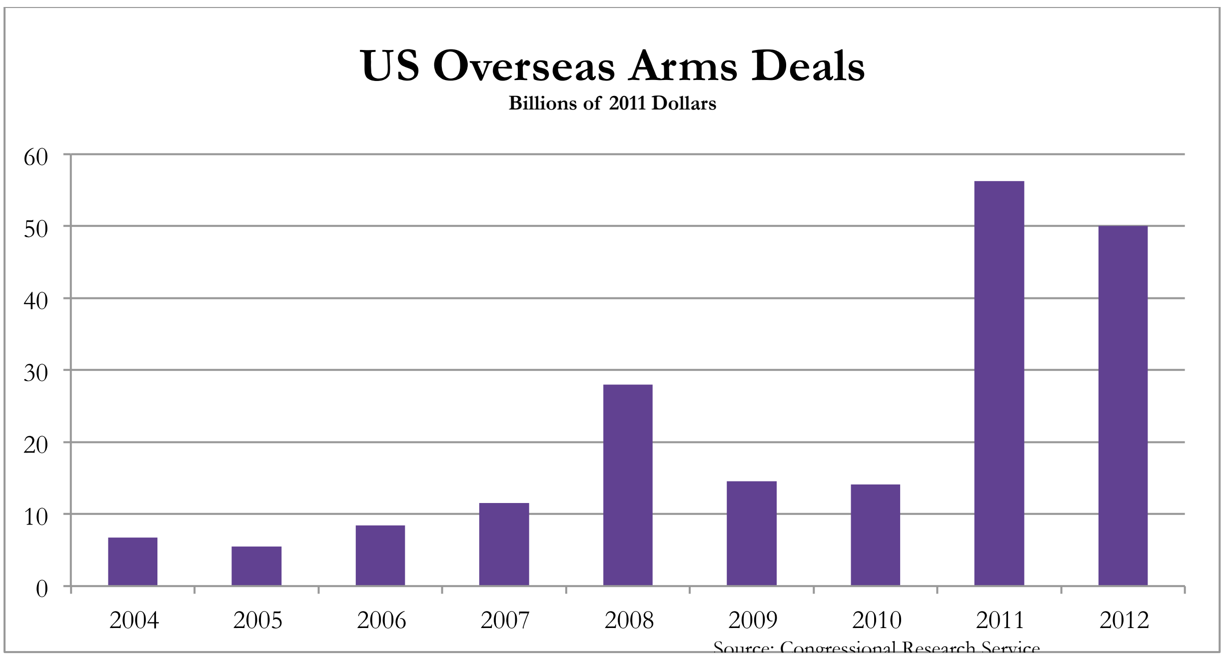
Defense Outlook for 2013 and Beyond

It's been a wild ride for the Defense budget over the past several years. In 2011 my predictions on the DoD budget were all about uncertainty. There was no clarity of the overall budget direction of the Department and funding was subject to the whims of an endless progression of continuing resolutions. In contrast to 2011, last year's budget outlook was all about certainty. The Department's funding was in place and spending levels were relatively stable. As the year wore on however, more and more attention began to be paid to the impacts of the Budget Control Act of 2011 and the failure of the Joint Select Committee on Deficit Reduction (known as the Super Committee) to reach a suitable agreement on deficit reduction. For most of 2012 the Department continued to state that no planning was underway in dealing with the threat of sequestration and the $480 Billion in addition cuts to the levied against the defense budget in Congress failed to put a fix in place. As FY 2012 ended (September 2012), Congress had yet to send a Defense Appropriations or Authorization Bill to the President for signature, and DoD began execution of Fiscal Year 2013 under a Continuing Resolution. While this article is focused on defense-related issues, the fate of a large portion of the aerospace industry is shaped by defense spending. Given the prospects of decreased defense spending in 2012, many in the aerospace industry looked to the commercial sector and overseas markets to offset the expected decrease. In general, this has proved to be an effective strategy given the moderately increased activity in commercial aerospace. Overseas markets also have the potential to develop substantially due in large measure to the provisions of the defense strategy which stress Foreign Military Sales (FMS) to our partners. The data on arms deals the US has brokered with foreign countries shows a significant upturn in 2011 and as of mid-2012 sales have already hit $50 Billion, according to the US State Department. Expect this trend to continue into the future.



A Review of the Bidding

As of January 2013 several key developments have taken place.

1. On September 28, 2012, The President signed a six month Continuing Resolution which funded the Federal Government through March 28, 2013.
2. Around the beginning of December the Department finally acknowledged that planning was indeed underway for dealing with the effects of sequestration. This acknowledgement reflected the practical mood throughout Washington that the prospects of a " Grand Bargain" to fix sequestration were rapidly fading.
3. On January 2, 2013 the Congress passed the American Taxpayer Relief Act of 2012 which included provisions for the delay of implementation of sequestration to March 1, 2013. As a result of the extension, the $63 Billion in cuts for FY 2013 the Department was facing under sequestration was reduced to $45 Billion, but with only about 7 months to implement. One important wrinkle to consider is the lack of discretion DoD will have under sequestration. Under the guidance sent out by the Office of Management and Budget, each line item in the budget will be decremented by roughly 10%. In application, this means that some programs will become unexecutable. You can't buy 90% of a nuclear submarine for example.
4. Also on January 2, 2013, the President signed the National Defense Authorization Act for 2013 which authorized the expenditure of $633 Billion for 2013. This law is mainly used to set policy, authorize weapons system procurement and mandate end strength numbers for the active and reserve forces and does not allow funds to be spent. The legal authority to obligate and expend funds must come from either a Continuing Resolution or an Appropriations Bill.
5. On January 10, 2013 the Deputy Secretary of Defense sent a memorandum to the Services and Defense Agencies entitled <u>Handling Budgetary Uncertainty in Fiscal Year 2013</u> directing immediate spending constraints in order to deal with the potential funding cuts associated with sequestration. He also provided some policy guidelines for use in developing longer range budget plans.

Planning for Sequestration

In his memorandum of January 10, 2013, Deputy Secretary Carter provided some key guidance on how the Department was to plan for life under sequestration. Regardless of the outcome of the issues involved in debt ceiling negotiations or sequestration, his guidance offers some insights into how the Department plans to allocate its remaining resources in FY 2013 and beyond. The memo gave the following long-term planning guidance:

1. Exempt military personnel funding from sequestration
2. Fully protect wartime funding
3. Fully protect Wounded Warrior Programs
4. To extent feasible, protect family-related programs
5. To extent feasible, protect programs most closely associated with the new defense strategy
6. Reduce the civilian workforce, with a variety of options including hiring freezes and furloughs of up to 30 days
7. To extent feasible, protect funding associated with readiness, with cuts focused on later deploying units
8. Protect investment funded in Overseas Contingency Operations
9. Take prudent steps to minimize disruption and added costs by avoiding penalties associated with potential contract cancellations.

Several immediate action items directed by the Deputy Secretary also will have a significant impact on certain government vendors:

1. Immediate reduction in base operating funding, including the curtailment of facilities maintenance, restoration and modernization.
2. Cancellation of 3rd and 4th quarter maintenance availabilities and aviation and ground depot-level maintenance activities by February 15, 2013.
3. Curtail administrative expenses
4. Review contracts for possible cost savings

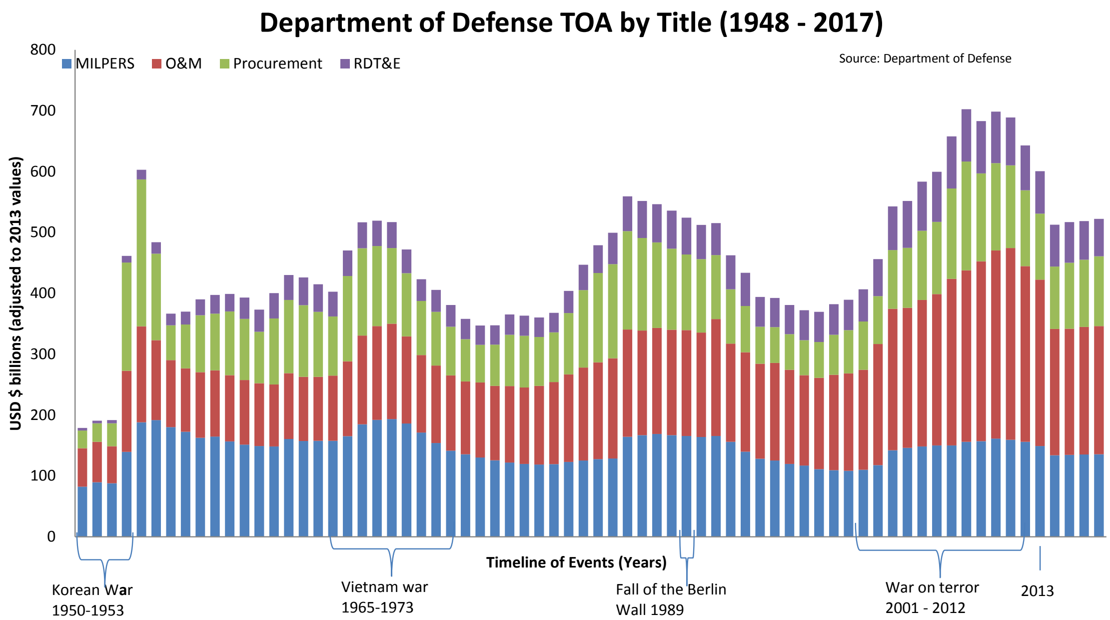
The impact on vendors which supply parts and specialized labor which support the maintenance and upkeep of ships, airplanes and vehicles will be significant and lasting. Cancellation of the last half of the year's maintenance activities will idle many repair facilities and will be difficult to undo. In addition, defense contractors can expect increased contract reviews by contract officers with a focus on performance and ways to reduce contract obligations and limit the exercise of contract options. As an aside, there are some in the industry that feel that cancelling 3rd and 4th quarter maintenance was intended as a "shock and awe" tactic to spur the Congress into action and that it was likely to be reversed. My sense is that this is not the case and genuinely reflects the difficult financial position of the Department in the O&M accounts.

2013 Budget in Flux

The FY2013 National Defense Authorization Act authorized $633 Billion in Defense Spending, including $88.5 Billion in Overseas Contingency Operations (OCO) funds. Currently the Defense Department funding is through a Continuing Resolutions (CR) which expires on March 28, 2013. The CR funding was slightly above the President's 2013 budget and therefore there was not a significant decrease in spending for the first half of 2013, despite the threat of sequestration. In fact, the opposite occurred, especially in the O&M accounts where the unspoken tactic was to "spend it while you have it" instead of saving for a rainy day. While is it impossible to predict the outcome of the current debates in Congress related to the U.S. debt ceiling, sequestration and the CR, it is certain that there will be a significant slowdown in spending. The American Taxpayer Relief Act of 2012 did delay the onset of sequestration to March 1, 2013 and adjusted the potential sequestration reduction from $62 Billion to $45 Billion for the rest of 2013. That number defines the upper limit of impact to the DoD budget. Even if a deal is reached on sequestration, the general feeling around the Beltway is that the DoD budget will be reduced by $150-$250 Billion over ten years. Given those figures it is possible that the remaining 2013 budget could be reduced by as little as $15 Billion. For planning, I would expect to see some figure closer to the $45 Billion reduction, but with more discretion on where to take the cuts.

As of January 2013 DoD was already over spending in the Operations and Maintenance (O&M) accounts to the tune of several Billion dollars and given that approximately one-third of the DoD budget (Personnel) was put off limits, we can expect to see the most significant impact of cuts to be felt in the remaining two-thirds of the budget, namely Procurement and O&M. The initial impacts to the O&M accounts are now known based on Deputy Secretary Carter's guidance to cancel all 3rd and 4th quarter depot-level maintenance. However, industry should expect further cuts in the O&M accounts in "Operations" side of the account including civilian personnel furloughs and reductions to contracts and the people supporting them. Procurement accounts most at risk will be those that are performing poorly, associated with the "old" strategy and those which can be pushed to later years without major impacts (typically modernization and service-life extension projects).

Spending Trends



The chart reflects the DoD trends since the Korean War, adjusted to 2013 dollars for comparison. The significant drop in O&M funding after 2013 occurs because Overseas Contingency Operations funds have not been included. Given the current timeline for force withdrawal from Afghanistan, the effects of OCO will have less impact on the O&M line. As mentioned earlier there are too many unknowns to make an accurate prediction of what will happen to the DoD budget. However, given the guidance on planning for 2013 and beyond and assuming a solution to sequestration provides for around $25-30 Billion per year in cuts it seems reasonable to assume that net effect of phasing out of OCO funding and implementation of sequestration cuts will result in funding as reflected in the chart. If there is no fix to sequestration the numbers will get larger, with most of the cuts in O&M and Procurement spending.

The New Defense Strategy and the Budget

Key to Deputy Secretary Carter's guidance for dealing with the 2013 budget is the focus on protecting funding for uniformed personnel and those programs "most closely associated with the new defense strategy." It is important that those in the Defense industry understand the relevant business impacts of the "new defense strategy." The strategy is outlined in a document entitled Defense Budget Priorities and Choices released by DoD in January of 2012. This document can be obtained at www.gt.com/????????????. The areas which are most relevant to the defense industry are:

1. Investments towards the Asia-Pacific and Middle East regions. These investments would generally be infrastructure and supply chain related in order to support the shift if US forces from US east coast, Atlantic and Europe. Examples include increased spending in parts and bases which support operations in the Asia Pacific region, shipping agreements with companies active in the region and construction of overseas facilities intended to support forward deployed forces.

2. Investments in advanced technology capabilities needed for the future with emphasis on addressing anti-access threats. Most notable in this category are Special Operations forces, unmanned air systems, sea-based unmanned platforms and advance Intelligence, surveillance and Reconnaissance (ISR) systems. Clear winners in this area will be anything related to supporting special operations; Maintenance, Repair and Overhaul (MRO) of unmanned systems; and naval systems in general. Companies which are producing goods and services related to the "old" defense strategy (Cold War, post-Cold War) can expect significant cuts in the demand for their products.
3. Cyber Operations. Cyber operations was one of the few areas which experienced a net growth in funding in 2012 and the trend continues in 2013. The cyber mission area continues to be a critical warfighting capability desired by DoD and investment levels will be sustained in the near term. There are a large number of smaller companies in this marketplace and robust M&A activity will be the order of the day as companies seek to readjust their portfolios to embrace this promising market segment.
4. Other capability enhancements. Several other mission areas will see continued investment and will receive priority above "old" strategic systems. Power projection systems, including new bombers, continued aircraft carrier production, enhanced weapons (cruise missiles for example) and intelligence systems will most likely see some cuts, but not to a significant degree as the Department seeks to retain a robust power projection capability. Certain missile defense capabilities will also be protected, especially those directly supporting homeland defense.
5. Consolidation of medical command. There is a proposal under evaluation which would create a new Defense Health Agency, consolidating all aspects of health care, including base operations, infrastructure and supply chain issues. This will cause those vendors in the military healthcare domain to rethink their market strategies.

The Three R's

All things considered, the defense business environment will be a challenging one for industry. It is clear that budgets will be shrinking, regardless of the outcomes of several key issues facing the county. It is only a question of degree. The Department has offered some hints, some subtle and some not to subtle, about where it intends to spend its increasingly limited resources. Agile, dynamic companies will see this environment as one ripe with possibilities, not only in terms of selling goods and services to DoD, but also in the business opportunities presented by smart acquisitions and divestitures. When all the dust settles, there are three themes which will be prevalent in the Defense industry and indeed federal agencies in general: Regrets, Reductions and Rethinking (The 3 R's)

Regrets:

- Short term efforts to save money prior to FY2013 did not provide the savings needed to deal with the magnitude of cuts which came in the end.
- Planning for sequestration was delayed in hopes of a "Grand Bargain." When planning did begin, there were few options available.
- Saving money by awarding contracts on a Lowest Cost, Technically Acceptable basis led to focus on "Lowest Cost", thereby potentially promoting a culture of mediocrity.
- Shortening contract terms thereby putting unreasonable demands on already over-subscribed contracting officers and increasing Bid and Proposal costs of vendors.

Reductions:

- Little corporate knowledge on how to plan for reductions in funding.
- Personnel pay freezes, furloughs and reductions will drive better performers out of DoD, exacerbating problems with an aging workforce.

- Reductions in training funds will bump against the demands for a more professional workforce and increasing professional certification requirements.
- Reductions in maintenance and infrastructure funding, building a large bow wave of funding requirement in 2014.
- More focus on how to reduce costs to government by limiting vendor profits.

Rethinking:

- The current Defense Strategy must be rethought to reflect affordability.
- Rethinking entitlements will become an obsession and create distractions in dealing with larger issues.
- Looking to the past to deal with the future will bring a new mindset to the budget process.
- Reprioritizing portfolios as industry players seek to add 'New Defense Strategy" capabilities and downplay activities which are seen as Cold War related.

The New Normal

The Defense sector will be a challenging one for government and private sector with no one exempt from the tyranny of the budget axe. But the future is not without opportunities for those dynamic companies with an eye towards growth, even in tough times. Those dynamic companies will profit from the opportunities cited above by reacting early to the signals DoD has sent, focusing on new and different ways of executing the strategy and those delivering complementary capabilities and services. The new normal will be at least half a decade of turmoil in the defense industry as large primes seeks to recraft their market position and the second and third tier suppliers hang on for the ride. Above all else, the US defense market is still the largest on Earth and a budget north of $500 Billion coupled with robust overseas sales still leaves enough for a prosperous future in the defense market.