Health of the Industry:
A Wall Street and K Street Perspective

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Defense Industry Margins Have Improved...

CSIS Defense Index Average Operating Margin (weighted by revenue)

Sources: FactSet, Company Reports, CSIS Analysis.
Note: CSIS Defense Index comprises 36 publicly-traded companies with majority revenues derived from US defense business. Boeing Military results have also been included here.
From A Return Standpoint, Second Tier Does Better…

Operating Margin by Company Type (weighted by revenue)

- Primes
- IT/Services Subs
- Hardware Subs

Sources: FactSet, S&P Compustat, Company Reports, CSIS Analysis.

Note: CSIS Defense Index comprises 36 publicly-traded companies with majority revenues derived from US defense business. Boeing Military results have also been included here.
The Industry Continues to Have Lowest Returns…

Industry Average Operating Margin, 1980-2004 (weighted by revenue)

Sources: FactSet, S&P Compustat, Energy Information Administration, Company Reports, CSIS Analysis.

Notes: 1) CSIS Defense Index comprises 36 publicly-traded companies with majority revenues derived from US defense business. Boeing Military results have also been included here.
Risk-Reward Disconnect in the Defense Business...

Industry Revenue Volatility versus Average Operating Margin, 1980-2004 (weighted by revenue)

Target Margins Given the Risk

Massive Risk-Reward Disconnect in the Defense Market


Notes: 1) CSIS Defense Index comprises 36 publicly-traded companies with majority revenues derived from US defense business. Boeing Military results have also been included here.
Financial Response to the Policy and Market Realities...

Defense Industry Cash Outflows, 1980-2004

Sources: FactSet, S&P Compustat, Energy Information Administration, Congressional Reports, CSIS Analysis
Wall Street Continues To Value the Sector As Having Growth...

## Market Value to EBITDA

<table>
<thead>
<tr>
<th></th>
<th>Current</th>
<th>Year End 2005</th>
<th>Year End 2004</th>
<th>Cycle Range</th>
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</thead>
<tbody>
<tr>
<td><strong>Alliant Tech</strong></td>
<td>8.8x</td>
<td>8.8x</td>
<td>10.7x</td>
<td></td>
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<tr>
<td><strong>General Dynamics</strong></td>
<td>8.1x</td>
<td>8.0x</td>
<td>8.7x</td>
<td></td>
</tr>
<tr>
<td><strong>Defense Average</strong></td>
<td>8.2x</td>
<td>8.2x</td>
<td>9.3x</td>
<td>4 - 10x</td>
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Sources: Credit Suisse
Issues Of Our Time:
Acquisition Reform
Recent/Current Studies...

- CSIS Beyond Goldwater Nichols Phase 2
- DSB 2005 Summer Study: Assessment of Transformation – Defense Industry and Acquisition Subpanel
- Defense Acquisition Performance Assessment Panel
- Quadrennial Defense Review
- Others (GAO roundtable, Congressional roundtables and hearings, internal DoD studies, etc.)
BGN - Defense Acquisition Overview

• **Restore Service Chiefs’ authority over PEOs/PMs**
  – SAEs report to Service Chiefs & Secretaries, not USD (AT&L)

• Restore strategic direction to defense acquisition by elevating DDR&E function in AT&L
  – Re-named USD (TL&A) to underscore priority given to how technology can enable future capabilities to meet joint needs

• OSD acquisition focus limited to acquisition policy guidelines and milestone decisions for select major programs and acquisition policy guidelines
  – Sharply reduce AT&L personnel levels

• **Expand and fund rapid acquisition process**

BUT

• Must be combined with robust process for determining joint capability needs
  – Only the CoComs have operational requirements
BGN - Defining Joint Capability Needs

• **Build a COCOM-centric process** for identifying and advocating joint capability requirements that has the following elements:
  – Identify and prioritize short-term joint capability requirements through an enhanced IPL process
    • Enhanced J-8 capability in the Commands
    • CJCS responsible for aggregating and prioritizing joint requirements
  – Functional commands take lead on determining longer-term capability needs in their respective areas
  – As interim step, **create a Washington-based, JFCOM capability**, headed by a 3-star, to determine and advocate the longer-term joint capability needs of the regional commands
    • Decide after two years whether a Joint Capability Command is necessary for this critical function
BGN - Defining Joint Capability Needs

• To **build a truly joint, demand-oriented JROC**, replace the Service Vices with the COCOM Deputies and add civilian representation
  – Provides a clean division between advocacy of the supply and demand side of the process
  • Military Services and Functional Commands compete on how best to meet the operational requirements of the Combatant Commands
• Implement Phase 1 recommendation for a refocused OSD (PA&E) that both manages a NSC-like process for making strategic choices and provides analysis to inform those choices; **make PA&E a member of the JROC**
• Also **add refocused OSD (AT&L) and OSD (Policy)** to bring a defense-wide, demand-side and technology-push perspective
BGN - Defining Joint Capability Needs

- Implement BG-N Phase 1 recommendation to form a JTF with budgetary and acquisition authority for Joint C3
  - Defense-wide funding line
    - Take Title 10 authority away from Services for C2 down to the tactical level
    - Either STRATCOM or JFCOM, but not both, which could create a horizontal “seam”
    - UCP 02 assigns “Global C2” to STRATCOM
      - Under BRAC, plans to merge DISA and JTF for Global Network Operations and co-located with NSA
    - JFCOM given responsibility for “Theater C2” and organizing and training JTF headquarters
      - Could use DISA to ensure seamless interoperability from strategic to tactical
  - Need to revisit division of labor in UCP
Restore Strategic Direction to OSD Acquisition

• Before 1986, DDR&E was #3 OSD official and the strategic architect for how technology could enable step-level increases in future capabilities
  – Served as SecDef’s Chief Technology Officer and drove investments that led to current U.S. military dominance (e.g., precision, stealth, etc.)
  – Reforms of 1986 eclipsed this function with process management

• Elevate DDR&E function to primacy in an Under Secretary for Technology, Logistics & Acquisition
  – DDR&E as Principal Deputy
  – With a DoD-wide budget line to promote transforming investments and enhanced approval authority over service S&T programs
  – Seat on JROC
Issues/Findings: Acquisition Reform

• DAPA Panel (Gold and Red Team)
  – Return acquisition to military
  – Add USD (AT&L) to JROC
  – Create acquisition stabilization account and management reserve
  – SAE – 5 year terms
  – Pool of pre-cleared people
  – Budget to 80% level
  – Replace JCIDS with COCOM led process
  – Time as independent variable
  – Risk based source selection

• DSB 2005 Summer Study: Assessment of Transformation – Defense Industry and Acquisition Subpanel

• QDR
Issues Of Our Time:
Defense Budgets
Cycle Continues…

Recapitalization Cycles
An O&M Cycle

Source: DoD FY05 Greenbook, CSIS analysis
Issues...

- Rising protectionism
  - Buy America / Berry Amendment / Fortress Europe
- Technology transfer/export controls
  - Improvements in processing times
  - No progress on the broader strategic issue
- Offsets
  - Rising %’s, increased “bureaucratization”
- The “China Dilemma”
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