



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

National Defense Industrial Association  
2006 Munitions Executive Summit

“Winds of Change - Altering the Munitions Landscape”  
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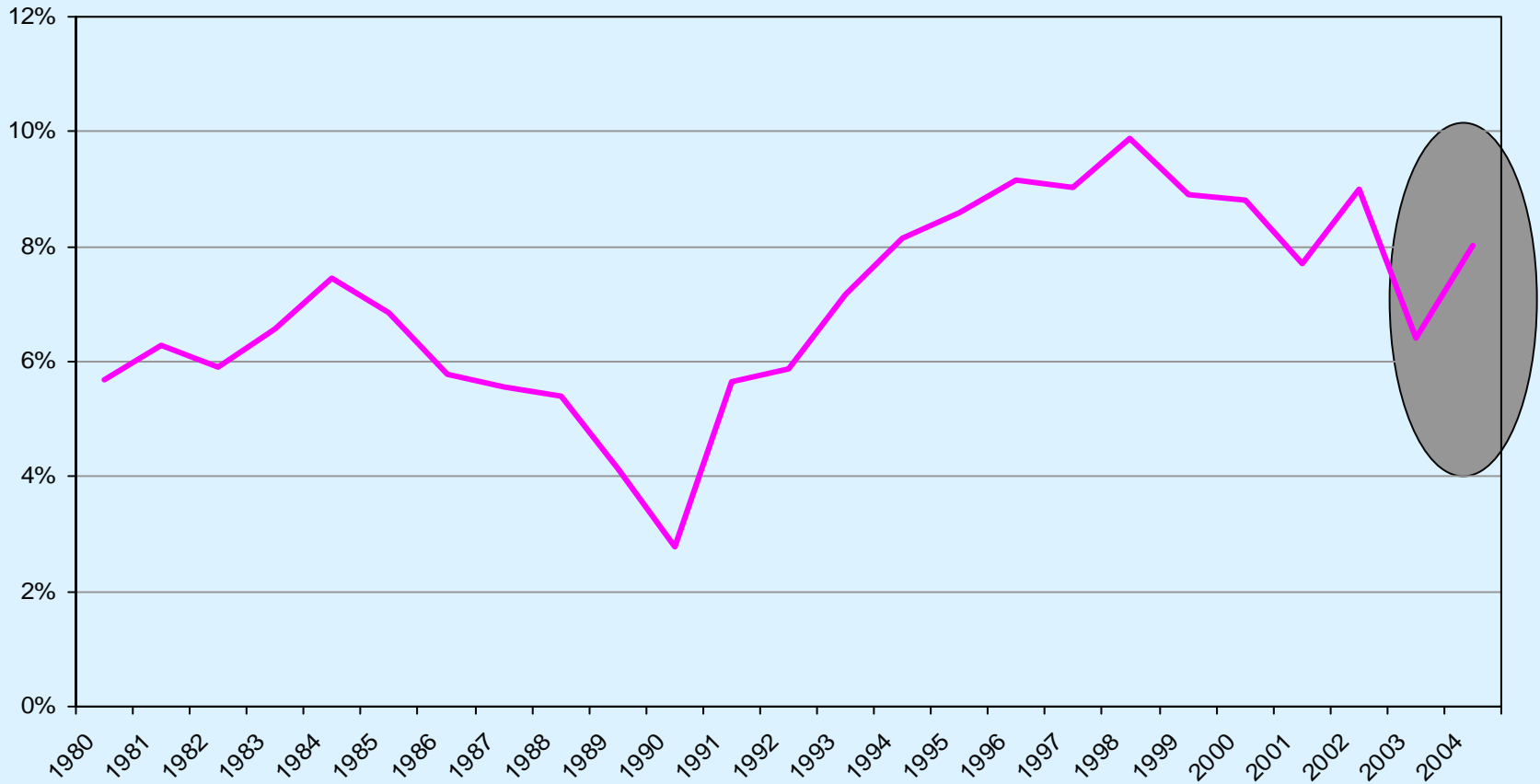
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# *Defense Industry Margins Have Improved . . .*

**CSIS Defense Index Average Operating Margin (weighted by revenue)**



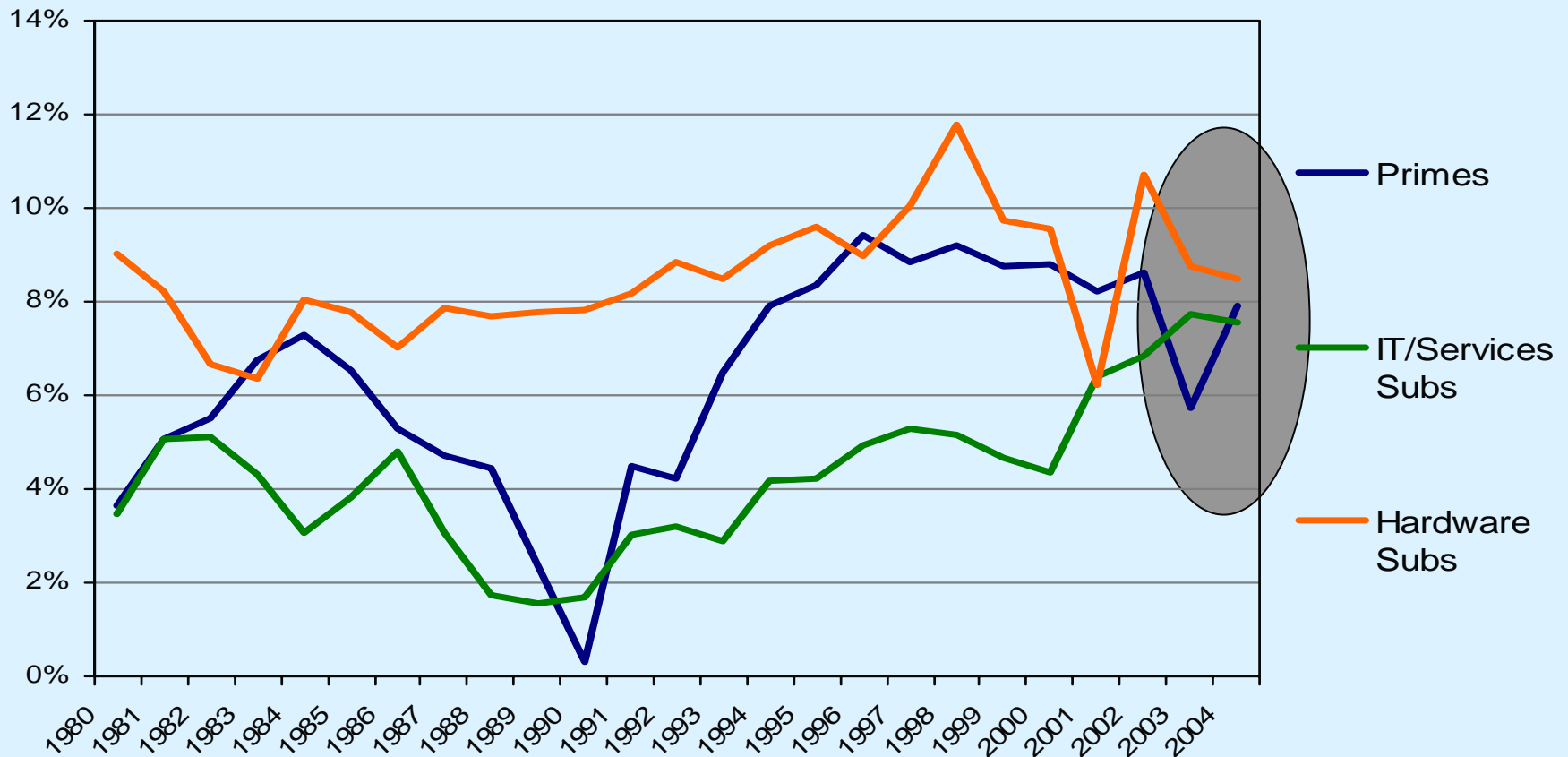
Sources: FactSet, Company Reports, CSIS Analysis.

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)**



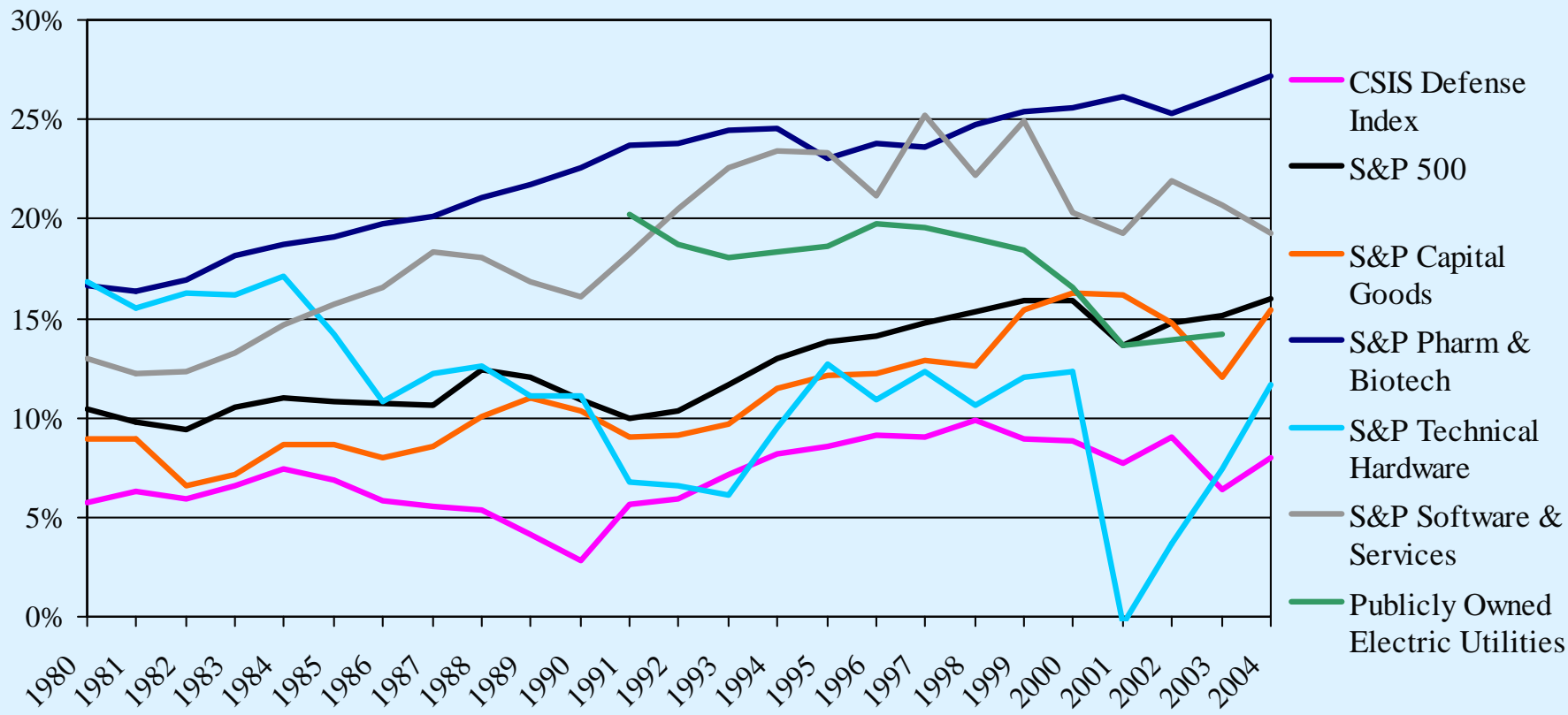
Sources: FactSet, S&P Compustat, Company Reports, CSIS Analysis.

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# *The Industry Continues to Have Lowest Returns...*

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

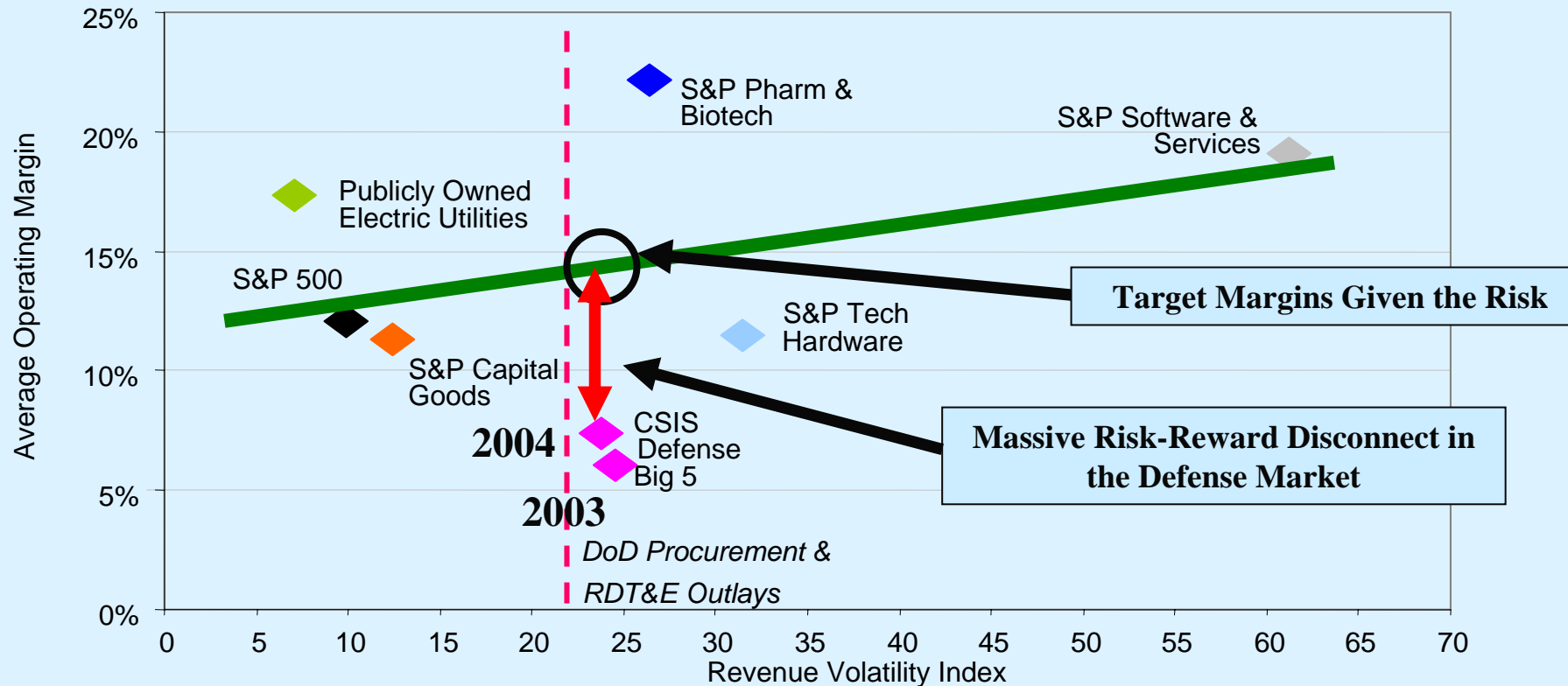


Sources: FactSet, S&P Compustat, Energy Information Administration, Company Reports, CSIS Analysis.

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.  
 (2) S&P Sub-sector constituents accurate back to 1994; composition held constant for years 1980 to 1993.

# *Risk-Reward Disconnect in the Defense Business...*

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



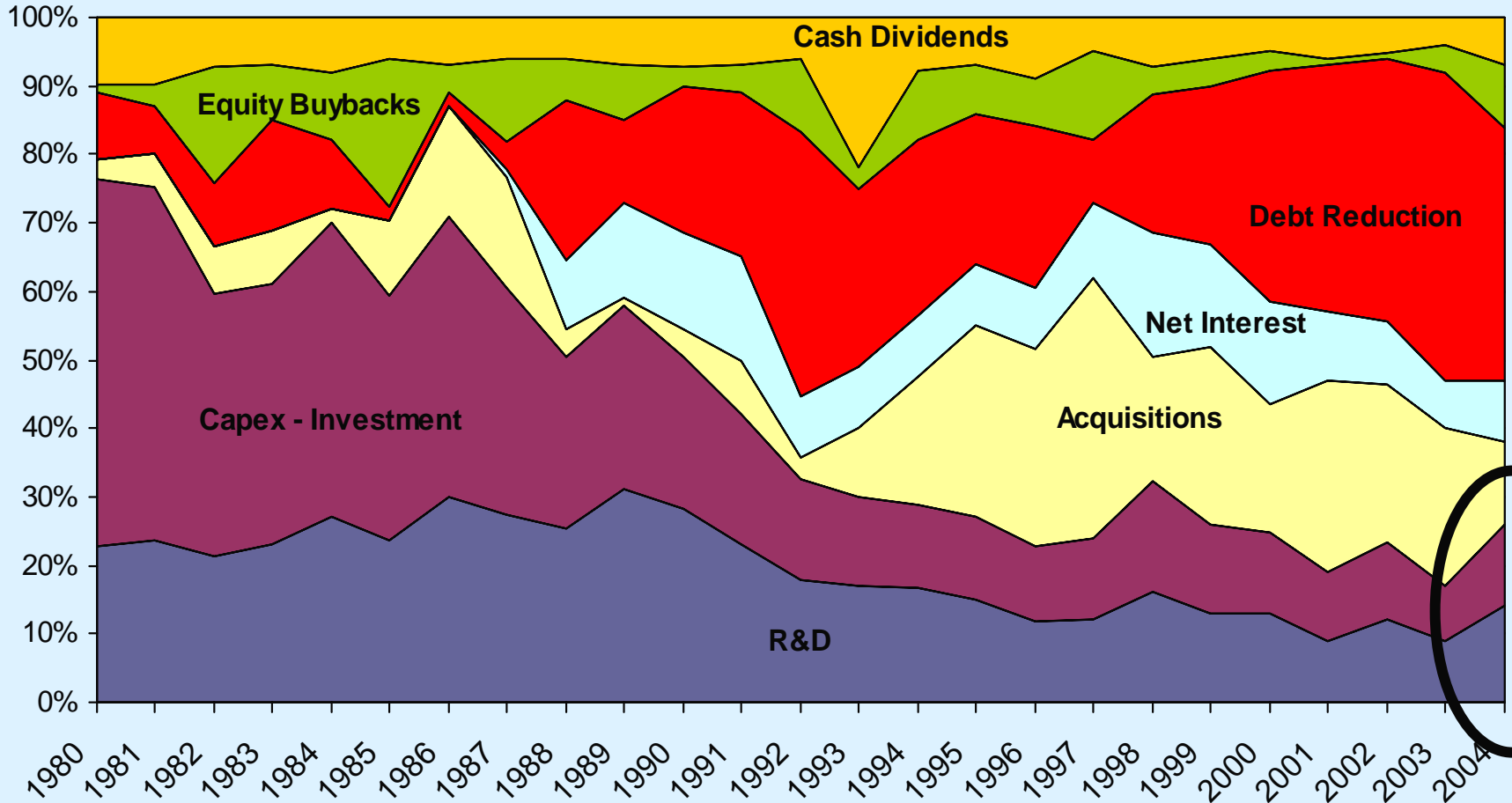
Sources: FactSet, S&P Compustat, Energy Information Administration, National Defense Budget Estimates for FY2004, Company Reports, CSIS Analysis.

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*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



## *Aerospace & Defense Stock Performance...*





*Wall Street Continues To Value the Sector As Having Growth...*

**Market Value to EBITDA**

	<b>Current</b>	<b>Year End 2005</b>	<b>Year End 2004</b>	<b>Cycle Range</b>
<b>Alliant Tech</b>	8.8x	8.8x	10.7x	
<b>General Dynamics</b>	8.1x	8.0x	8.7x	
<b>Defense Average</b>	8.2x	8.2x	9.3x	4 - 10x





# **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**

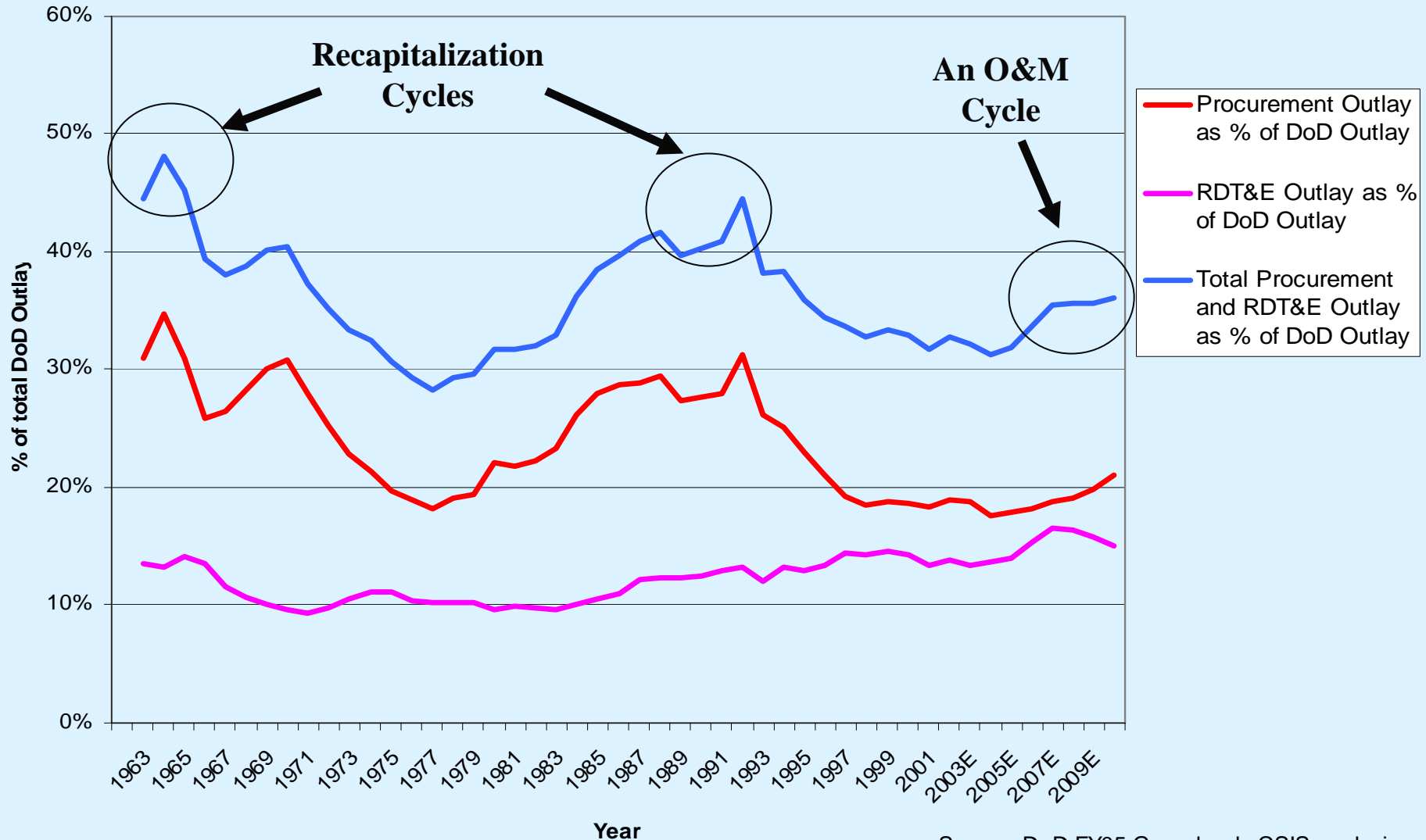




# **Issues Of Our Time: Defense Budgets**



# Cycle Continues...





# **Issues Of Our Time: Globalization**



## *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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