

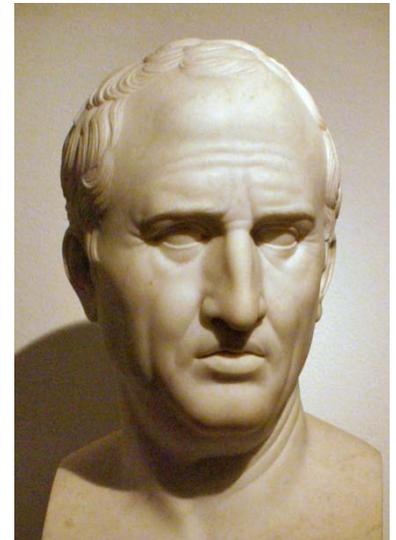


Global Economic Effects on the Defense Industry

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"The sinews of War are Infinite Money"

Cicero – Roman philosopher, statesman, political theorist
and Roman Constitutionalist, 106 BC – 43 BC



Overview

The outlook for the Defense Industry in the near term is driven by 3 principal factors:

1. The overall economic downturn.
 2. Political trends and priorities in domestic budgets.
 3. Public perceptions of the military threat to national and international interests and values.
- The combination of these factors suggests that, as in past downturns, the industry will be forced to adjust to prosper.

The Impact of Global Economic Effects

- In 2007, analysts forecasting positive 2008 growth in only 3 commercial sectors – Defense being one.
 - Favored position with Govts and caused by Middle East and Afghanistan commitments.
- By mid 2009, the US economy had suffered its worst decline in 26 years.
- In US, as well as elsewhere, leading defense contractors stocks have fallen 30-40%:
 - Boeing circa 40%, Northrop Grumman 30%.
 - Europe - BAES, Finmeccanica etc, by similar amounts.
 - PE Multiples at lowest levels since the early 1990s.
 - Defense stocks no longer seen as “counter-cyclical?”

The Impact of Global Economic Effects (2)

Further complicating the picture:

- Some of the biggest international defense companies maintain product lines directly exposed to commercial market downturns.
- Major defense firms have pension funds heavily invested in equity markets that must be replenished; worsened by impending retirement of the baby-boomers.
- Pace of the economic recovery—if the recession is over—appears prolonged: a “U”, not a “V”.
- Do the other trends affecting defense spending appear more promising?

Political Trends are Not Encouraging

- In the UK, several large ticket items are potentially under threat:
 - Strategic Nuclear Deterrence as one?
 - UK “QDR” under way .
- In the US, priorities of the Obama administration are domestic, not Defense:
 - Stimulus ignored Defense spending.
 - April 2009 announced cuts (F22, periodicity of aircraft carrier builds, shipbuilding) taken without regard for industrial base.
 - Health care and economic recovery expenditures project long-term deficits and constraints on discretionary spending.
- “Greater quantities of systems that represent the 75% solution instead of smaller quantities of 99% systems” - Def Sec Robert Gates.
 - Opportunities for smaller, niche, more agile, international, COTS-based solutions?

Threat Perception Could Speed Recovery *(or not)*

- Stateless Terrorists create both near and far security challenges, threaten homeland security of industrialized democracies.
- Conduct and success of US, allied “Two-war” strategy will affect Defense spending:
 - Drawdown in Iraq.
 - Afghanistan strategy: Surge ground forces or high-tech, SOF from a distance? Predator strikes vs boots on the ground?
- State actors, traditional powers also threaten security of our nations:
 - Cyber challenge is everyday battle employed by state and non-state actors.
 - US QDR will seek to balance irregular and “high-end asymmetric” threats.
- “Wild cards” could change the game:
 - Nuclear threats in North Korea, Iran.
 - Failed states: Pakistan’s future?
 - China, Taiwan and “anti-access” capabilities.



Industry Response - Opportunities Abound?

- Pursue Govt - Industry Partnerships:
 - Partner to find economies of scale, leverage legacy systems.
- Execute internal reforms:
 - Restructure, lower overhead, pursue adjacent markets, merge or acquire.
 - Consolidation, divestiture.
 - Industries need to become more global?
- Shift to Services and O&M as Investment accounts decline:
 - Full life-cycle support services becoming the norm.
- Encourage International partnerships enhancing interoperability:
 - F-35, NATO AGS.
 - Next generation tanker.
 - Streamlined export/import policies.
- Focus on Homeland Security:
 - Protecting National Infrastructure – cyber-defense, border security.
 - Improving Analytical Software for Intelligence agencies.
 - Combat IED's and chemical and biological threats home and abroad.
 - Critical infrastructure protection.

Summary

The outlook for the Defense Industry in the near term, based on the impact of the global economic recession, the political environment, and the threat perception, is not rosy:

- The economic downturn has affected defense companies and their market valuation severely.
- Political priorities in the US and elsewhere stress domestic discretionary spending, while deficit spending imposes top-line constraints on defense.
- Public perceptions of the military threat suggest current levels of defense spending are adequate, if not inflated.
- As in past downturns, the industry will be forced to adjust; the lessons of the past apply: restructuring, cost optimization, program execution, global competitiveness and cooperation.

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