

US defence industry can learn from past downturns

Now is the time for companies to clean up cluttered portfolios, learn to make affordable products, and look in new places for growth, argue **Kevin Dehoff, John Dowdy, and John Niehaus**

Since the Second World War the United States has been the world's largest defence customer by far. The conflicts in Iraq and Afghanistan during the past decade accelerated US spending, driving it to historic heights and increasing its global share of a USD1.55 trillion market to 44%. Now, with those wars winding down and acute pressure on public finances, the defence budget is rapidly shrinking.

For all the talk about sequestration, the industry has seen this before. In the last downturn in defence spending between 1985 and 1998 the Pentagon reduced spending on a scale similar to that of today. Investment by the US Department of Defense fell 52% from peak (1985) to trough (1995) and did not start to recover until the late 1990s.

However, many defence companies found a way to thrive during the downturn. The 'last supper' encouraged consolidation; firms that heeded the advice and moved early and decisively to restructure their portfolio of businesses did best. When spending began to increase again, these companies were in a better position than others to benefit.

Today's downturn will proba-

bly last longer than previous versions. Fiscal pressures caused by the mounting federal deficit and complicated by persistent growth in mandatory entitlements will likely prolong the reductions in defence spending. Another big difference between the current and previous downturn is that the potential for consolidation and industry rationalisation is

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much more limited today. The 10 largest companies now command 58% of the total revenue of the top 100 players, compared with 39% in 1991.

The next wave of mergers and acquisitions (M&A) will be different compared with the past. Instead of wholesale consolidation, the unit of measure will be businesses and divisions. Many companies have built up portfolios over the past 20 years without sufficient attention to rationalising them. As a result, they contain a mix of some very healthy businesses and others

that are challenged. With little chance for more megamergers that would remove unproductive capacity from the industry, companies are going to have to do it themselves, either by selling less attractive businesses, substantially restructuring them, or spinning them out. We have begun to see some of this already, with Northrop Grumman spinning off its shipbuilding business in March 2012 to form Huntington Ingalls Industries. Companies that understand the changing nature of security threats and US defence strategy have an opportunity to acquire defence assets now at what may be seen as bargain prices by the end of the decade.

But M&A alone will not carry the day. There is a new dynamic in defence contracting. Industry and government have long struggled to check the relentless growth in the costs of developing and producing modern weapon systems. Recently the Pentagon has taken steps to break the back of this problem; it now seeks to cap costs by stating what it can afford to pay and making clear its intention not to pay more.

To succeed in this new world, industry must overhaul its business model, capabilities, and culture to build products that the

customer wants and can afford, and ensure that cost cuts stick. Building a better relationship with the customer is essential. Industry leaders should extend a helpful hand while simultaneously making it clear that a true peer-at-the-table partnership is required to craft affordable, high-value mission solutions.

Production and manufacturing systems designed around optimistic volume projections and long production runs should be shelved in favour of low-volume (and thus more realistic) flexible manufacturing approaches with shorter production cycles.

Defence companies will have to establish a global base of suppliers, casting a wide net to improve competition and add redundancy.

Finally, defence companies will also need to sharpen their ability to identify new sources of growth. Although almost all defence sectors will shrink, companies should scour the landscape for the few higher-growth segments that are likely to remain. The 'pivot to the Pacific' emphasised in recent revisions to the National Military Strategy prioritised certain investment capabilities and force-structure levels. Intelligence, surveillance, and reconnaissance systems; undersea and surface ship capabilities; long-range strike aircraft; strike missiles; missile defence; electronic warfare; and capabilities needed to operate in sophisticated anti-access/area-denial threat environments are in demand, while capabilities needed to support deployed ground forces are on the wane.

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