

APRIL 2015



Neil Webb

AEROSPACE AND DEFENSE PRACTICE

Defense outlook 2017: A global survey of defense-industry executives

Business leaders are growing more optimistic and think they can head off challenges from commercial firms.

**John Dowdy and
Elizabeth Oakes**

In October 2014, we conducted a second survey of senior executives from aerospace and defense companies around the globe to take the pulse of the industry and its outlook for the next three years. Thirty-seven industry leaders responded. More than one-third of the respondents are C-level executives, while most others hold positions as senior vice presidents or managing directors. The respondents represent business activity across Asia, Europe, and North and South America. Our questions covered global defense spending, industry trends, challenges in the current business climate, and opportunities for continued growth.

The research yielded some fresh insights and a couple of surprises. While the majority of those

who responded to our previous survey in December 2012 anticipated a marked decline in global defense spending, the outlook now is improved. Nearly two-thirds of those surveyed in 2014 believe that global defense spending will stabilize or even return to a modest level of growth. That growth, however, will come in unexpected ways, outside of traditional home markets and in new segments. In this article, we look at the market shifts that respondents identified and the areas where companies expect to find pockets of growth.

A shifting market

Opinions on the direction of global defense spending range from slightly positive to slightly

negative (Exhibit 1). But regional trends are much clearer. A large portion of executives still believe that defense spending will continue to decline across Europe and North America, although the rate of that decline is less than previously predicted. In 2012, the largest number of executives believed that defense spending would decline across both Europe and North America by 10 to 20 percent; in 2014, the biggest cohort believes that the drop will be only 1 to 5 percent. While views of Africa and South America are a bit more varied, there is now clearly less optimism about growth. About 40 percent of

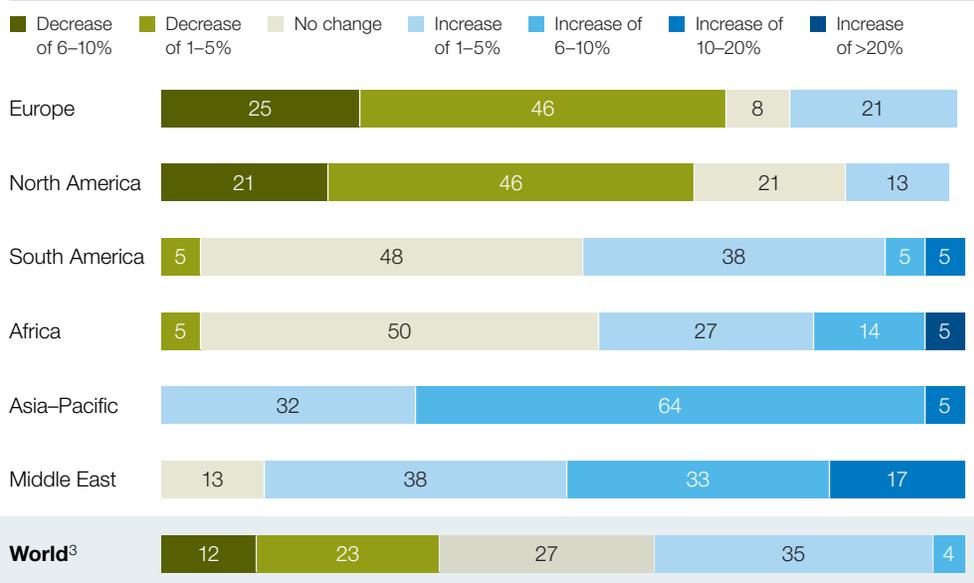
respondents believe that defense spending will remain the same in these geographies, whereas the bulk of respondents in 2012 thought it would increase. Finally, the outlook for both Asia–Pacific and the Middle East remains positive. As in 2012, defense executives in 2014 believe that spending in both regions will continue to grow by 6 to 10 percent in the next three years.

Declining budgets in the Western world and growth in Asia and the Middle East give rise to an overwhelming trend in the defense industry: affordability. About 85 percent

Exhibit 1

Expected changes in defense spending vary for different regions of the world.

% of respondents expecting a decrease, no change, or an increase,¹ n = 21–26²



¹Figures do not sum to 100%, because of rounding.

²For survey questions, n varies between 21 and 26.

³Respondents were not required to rationalize their responses about global spending patterns with their responses about regions.

of executives believe that their customers will shift their focus from procuring systems with the highest possible performance to ones that are more affordable. Nearly all of the respondents named affordability as a top-five issue in their companies. More than two-thirds of defense

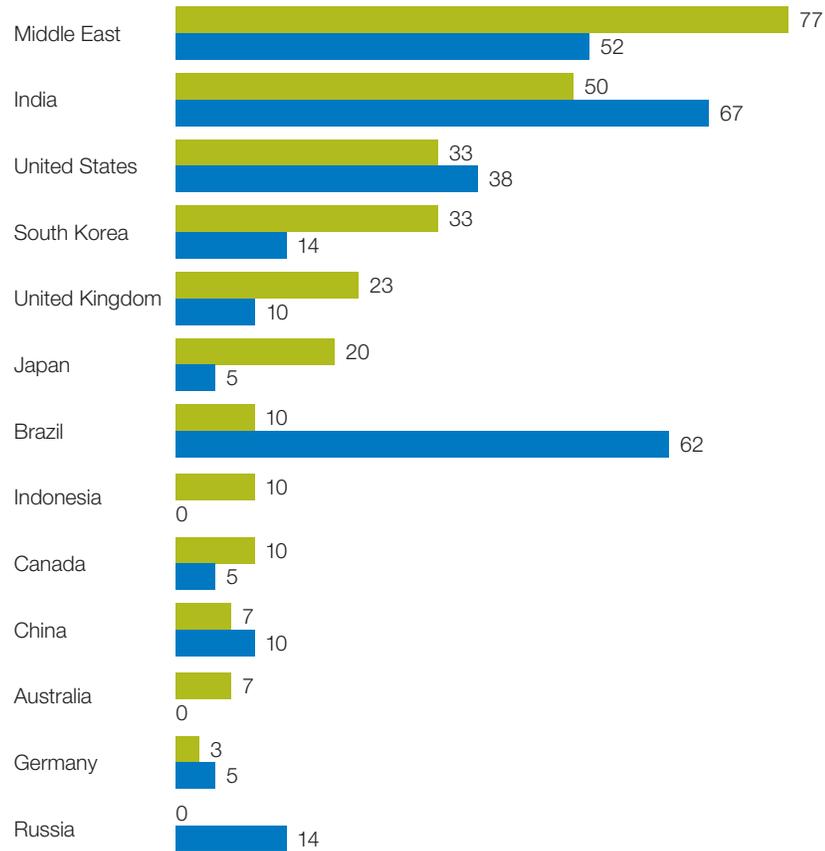
executives find that their companies' efforts to make their products and services more affordable have been moderately successful, and about the same amount believe that suppliers will be able to change their internal processes to deliver more affordable products.

Exhibit 2

The Middle East is today's most attractive international market; Brazil has fallen from favor.

Most attractive markets outside respondents' current area of focus, %¹

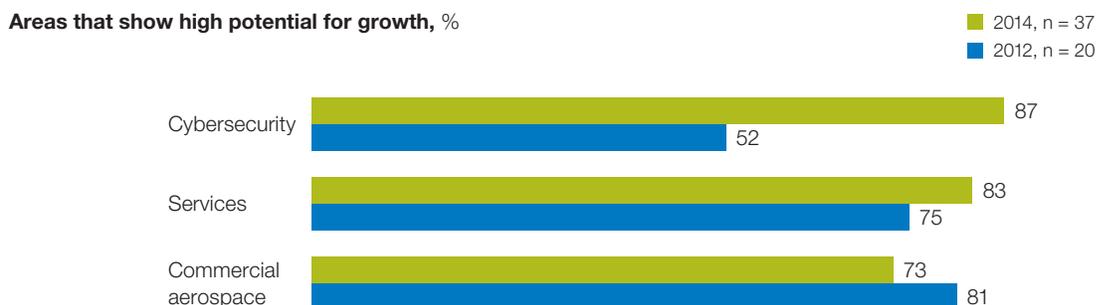
■ 2014, n = 37
 ■ 2012, n = 20



¹ Respondents were asked to identify the 3 most attractive markets outside their area of focus.
 Source: Dec 2012 and Oct 2014 McKinsey surveys of defense-industry executives

Exhibit 3

Companies now say cybersecurity has the most growth potential.



Source: Dec 2012 and Oct 2014 McKinsey surveys of defense-industry executives

Pockets of growth

We asked defense leaders about the most attractive new market locations and new lines of business within their companies. International growth is an overwhelming goal (see “International aspirations: Why international sales may not meet defense companies’ expectations,” on page 10, for more on international sales and affordability). All but one executive said their companies are seeking increased international growth in the next one to three years. Major challenges to international growth include political risks such as export-control regulations and offset requirements, technology-transfer requirements, and intellectual-property issues. Many of these challenges also preoccupied leaders in 2012. But today they are less concerned about their companies’ inherent abilities to make sales in international markets and more about the political landscapes of the customer nations.

Defense executives believe that the Middle East, India, and the United States are the three most attractive markets; South Korea and the United Kingdom round out the top five. Two

large shifts in opinion have taken place since 2012—Brazil and Russia are now seen as less attractive (Exhibit 2).

Growth through new lines of business is also anticipated (Exhibit 3). But two of the most prominent are also fraught with uncertainty. When asked if their companies were seeking increased cybersecurity growth in the next three years, about nine out of ten executives agreed. However, they also identified a long list of challenges, including market immaturity, a fragmented customer base, regulatory uncertainty, competition from nondefense players, and unclear market trends and leaders.

As in 2012, most companies expect services to produce a larger share of revenue in the near future. More than two-thirds of respondents believe that their services businesses will continue to grow, citing outsourcing, affordability, and performance-based logistics as the biggest opportunities. To take advantage will not be easy, though; executives say they are creating specialized business areas, developing truly globalized decision making, entering into risk-

sharing agreements, and pursuing some strategic partnering.

In perhaps the most surprising result of this survey, only half of those polled believe that commercial and nontraditional players will disrupt their companies' products and services. The rest are unconcerned. Those who expect competition from the outside see cybersecurity, gaming technologies, unmanned equipment, and satellite launch as the products most ripe for disruption.

More than 80 percent of defense executives expect continued growth in commercial aerospace, but many seek to retain a balance between their commercial and defense portfolios. When asked about that balance, half say that portfolios will move to a bias toward commercial. Interestingly, a third of executives believe that defense companies will seek to retain an even balance between defense and commercial products.

An industry in flux

In an effort to keep pace with a dynamic market, industry executives predict shifts in the way they manage their portfolios and activities. Almost all executives expect that the rate at which defense companies acquire and/or divest businesses will increase, although opinions are divided about just how much faster changes

will happen. The largest number of executives—more than 40 percent—expect moderate increases in the next three years. As in 2012, a heavy majority in 2014 predict that their companies will be involved in both M&A and divestment activities in the short term. Views on consolidation of the defense industry are divided: nearly half believe that major consolidation will occur, but the rest are doubtful.



The changes from 2012 to 2014 are clear. Defense executives are more aligned and more optimistic about the global defense market. In their view, defense spending is shifting rather than declining outright. Growth is uncertain but achievable. When asked how many points of margin improvement they were targeting over the next three years, all respondents answered with modest growth of between 1 and 5 percent. Identifying the main trends and harnessing the shifts can lead to continued growth in the defense industry. The outlook for 2017 is increasingly international and complex, but it is not without opportunity. ○