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Tight Credit Is Choking Many Small Suppliers: Watch for Weakened Suppliers to Require Financial Support from Customers. Consolidation May Offer the Best Hope.

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The major defense and aerospace giants are riding out the worst global economic meltdown in generations with their financial health largely unscathed. But the tens of thousands of small companies that supply the prime contractors with components, parts and services face potential financial ruin. This could lead to weaker suppliers going under unless they receive financial support from their customers and also to consolidation among smaller suppliers that would alter the supply chains for major contractors.

These suppliers are at risk of going out of business, not from a lack of orders, but rather from insufficient credit, which they need for working capital, raw materials and payroll. And that credit has all but dried up. Despite the vast infusion of funds from the Treasury Department's Troubled Asset Relief Program (TARP) to keep credit flowing, banks have tightened lending policies after years of tossing cash at whoever asked for it.

U.S. Senator Sherrod Brown (D-OH), chairman of the Senate Banking Subcommittee on Economic Policy, noted earlier this summer at a "Manufacturing and the Credit Crisis" hearing that small suppliers are "getting squeezed on two sides." Customers up the chain are demanding 60-to- 90- day payment terms while companies who sell the raw materials or components are demanding cash down payments. He added, "We are seeing the small supplier cut back or close down routinely."

The loss of reliable suppliers will eventually hurt major defense and aerospace contractors, and the Pentagon. Fewer suppliers might mean less competition and higher prices for components and parts. And when prime contractors turn to other suppliers, they invariably face delays – and eventually cost overruns.

"If that small supplier doesn't survive, you still need to meet production requirements and deadlines," said Lawrence Gelburd, a lecturer on entrepreneurship at Wharton. "Even if you find another supplier that makes the same product at the same price, you still have to integrate with that company's systems and people. That takes time." Other important integration issues include setting up a new internal security system so that trade secrets are not leaked or stolen, says Gelburd.

In some cases, there are few alternatives because there's a single source for certain parts or sub-assemblies. Finding a replacement supplier can hurt the larger company's production schedule and cost estimates, and force them to consider outright buying the supplier for the short-term, "just to make sure the supplier of critical components and sub-assemblies can ride out the storm," says Tom Captain, vice chairman of Deloitte Consulting's global and U.S. aerospace and defense industry practice.

Bringing It In-house

Some companies might instead choose to bring critical work in-house. Gelburd warns, however, that establishing an in-house process can create complications that many larger companies are unprepared to tackle.

"First, making these parts or sub-assemblies was never part of your core mission," said Gelburd. To set up a proper process, a company will need factory space, capital to buy equipment, hire and train workers and to establish a quality assurance program -- "all things that are a pain for company when this is not your core mission." So, it might be most efficient for the prime contractors and other large companies to find ways to keep smaller suppliers on life support.

But during these economic times, large companies worry their suppliers might go out of business after taking payment but before delivering the products. That's the primary reason they are demanding 60-90 day payment terms. At the same time, the suppliers are hard pressed to buy materials without the advance cash flow. This vicious cycle can accelerate a supplier's demise and cause the larger company to demand similar terms from other suppliers, too.

Gelburd notes, however, that there's a way to mitigate the situation: The small supplier could place into escrow critical information that the larger company can tap in case the supplier goes bankrupt. The escrow account might hold hardware plans, software patents, trade secrets and anything else that is agreeable to both parties.

"In the event of bankruptcy, the large company has access to all those plans, software and hardware designs and can carry on without excessive disruption waiting for the bankruptcy court to decide who gets what," said Gelburd. "That would give the big customer a real comfort zone to keep working with the smaller supplier."

Another option is for the supplier to negotiate "milestone" payments, says a Wharton alumnus who runs a company that supplies electronic components for jet fighters. He asked not to be identified because he did not want his customers to be concerned about his company's viability.

"Some of our customers have been very sensitive to the challenges of the current economic climate," he says. "A few are open to milestone payments and releasing payments to us much earlier in the cycle than they would otherwise." These are the companies that understand the importance of keeping their supply chain afloat and, perhaps most importantly, that already had relationships with and confidence in the supplier. Not all companies will consider the health of a small supplier, of course. "As a matter of policy, some companies have slowed down the rate at which they were paying us," said the Wharton alumnus. "Some of these larger companies were essentially taking a forced loan from us through accounts receivable."

Big Programs Fail Small Suppliers

Government programs like TARP --designed to spur lending -- have mostly fallen flat for the small suppliers, say industry observers.

"TARP is focused on addressing the credit crisis and getting money flowing through the economy again, [but] there is still no evidence that this is happening in the industrial sector in any significant way," Eugene Haffely, the chief operating officer of Assembly & Test Worldwide, said before a U.S. Senate Committee on Banking hearing last summer. His company produces custom designed, turnkey automation for a wide range of products, including various defense-related systems. Haffely spoke at the "Manufacturing and the Credit Crisis" hearing on behalf of the Association for Manufacturing Technology (ATM).

He noted that although Congress had bundled the Small Business Administration (SBA) and its 7(a) loan program into The American Recovery and Reinvestment Act of 2009, the lower fees and higher guarantees were not enough to keep the industry afloat. While the SBA has increased lending, many ATM members cannot get SBA loans because they lack the cash flow required. "Given the extreme downturn in the economy, most small businesses have suffered a dramatic decline in business and will not, in the near term, be able to meet normal credit standards," said Haffely.

In today's economic environment, Haffely noted, the President must invoke his executive powers to step in to provide some form of relief and support to these vital players in the supply chain. The Defense Production Act (DPA) gives the President power to mobilize certain industries to produce vital products. Haffely added that Title 3 of the DPA provides for federal loan guarantees to companies that play an important role in the country's defense industrial base. He advised the Senate Banking Committee, which has jurisdiction over the DPA, to consider increasing the loan guarantee so small suppliers can tap credit.

"This program allows assistance to be quickly targeted and precisely applied to the defense-related companies ... that are in desperate need of bank credit," said Haffely.

But not everyone agrees that the credit crisis will hurt the industry at large. There might indeed be fewer suppliers as the industry consolidates, but that will not necessarily lead to higher prices, according to Captain. "The antitrust and trade competition authorities would not allow contraction to the extent that there is only one company that produces radars, or a single company that makes port wheel brakes, or one that produces straps," says Captain. "There will always be competition in the marketplace." He further notes that as the small suppliers consolidate, they will evolve into "super suppliers" with the ability to have greater production and investment abilities. "As they mature and become more sophisticated, they will become more reliable suppliers."

Some already see the formation of "super suppliers" through unexpected ways. The Wharton alumnus sees "access to capital" as a form of competitive advantage where some suppliers have relationships with private equity firms.

"Some companies have put themselves in a better position not because of any better ability to execute, but just because they can tap deeper coffers with their relationships in the financial markets," the alumnus says. "What that says to me is that the larger defense companies need to become creative in the ways they get capital to some of the smaller suppliers if they want to see them weather this storm."