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Spending Plateaus**

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The U.S. defense sector has been a critical engine in creating jobs and profits over the past decade. But as the government begins to slash defense spending the industry is joining other American sectors in retrenching by laying off thousands of workers.

The wider U.S. economy is expected to rebound eventually after several ups and downs. But this overall recovery will have little bearing, analysts say, on the job outlook in the defense industry, which is largely driven by the Pentagon's shifting short- and long-term priorities. Defense companies are maneuvering to survive in this new environment.

"Our customers have said they will be reorganizing -- and I mean absolutely every single one of them," said Wayne Plucker, a senior industry analyst for Frost & Sullivan's Aerospace and Defense group, a research and consulting firm. "Once a few of them started reorganizing, it became an avalanche."

Lockheed Martin, for example, said on September 8 that it was undertaking a huge restructuring that would include a 25% reduction in top executive slots. Some 600 executives have already said they would take early retirement packages. This is part of Lockheed Martin's larger plan to eliminate some 10,000 employees in the United States this year.

At the end of July, Boeing's chairman and CEO, James McNerney, announced second-quarter earnings results and noted an 8% decline in defense revenue. He added that Boeing would have another round of layoffs that proportionally will include rank-and-file workers, middle managers and executives.

The list of defense companies that have announced layoffs in the thousands over the past year continues to grow. It includes such industry giants as General Dynamics, Northrop Grumman and Raytheon, and smaller companies like L-3 Communications.

The strain on the bottom line has grown from several directions. Internally, business pressures - like a drive to boost profits or to streamline less relevant operations -- is driving the layoffs. Externally, defense companies face a changing landscape with the Pentagon's cost cutting efforts as well as new directions in weapons acquisitions.

The 75% Solution

The Defense Department, for example, is taking the pragmatic approach of trying to do more with fewer new technologies. This is Defense Secretary Robert Gates' great gambit: to move away from developing "exotic" weapon systems that are highly specialized and towards designing systems that can be harnessed for a variety of missions. The prime example is the development of the F-35 Joint Strike Fighter, a general do-it-all fighter jet. On the outs are the

likes of the specialized stealth F-22 Raptor, which analysts consider the “the last of its breed.”

Defense officials have noted that if the F-35 works as planned (it is still undergoing rigorous testing), the Pentagon will mix and match, and supplement its deployment with the use of Unmanned Aerial Vehicles (UAVs). In other words, the military’s arsenal will include more and more generalized equipment that can be tweaked or modified to carry out any mission rather than a small handful of very specialized systems for specific missions. “For example, the Intelligent Surveillance Reconnaissance jets are highly specialized and sophisticated, but we only have a handful,” said Plucker. “That makes them expensive to build.”

“The Pentagon recognizes the benefits of the 75% solution -- the purchase of generalized hardware that can meet most of their needs,” he continued. “The 75% solution also allows an economy of scale.”

Gates and his military advisers hold UAVs as a cost-effective model for the 21st century, where intelligence gathering and surveillance, along with a targeted and deadly missile strike capability, come from the same system. It is easier to train UAV operators than “in-the-seat” pilots; a single UAV can loiter over a single spot unseen for hours on end, while a manned jet is more easily spotted and has to manage fuel and human exhaustion.

UAV makers like Northrop Grumman and Lockheed Martin cannot build them fast enough for the military’s demand in Afghanistan and Iraq. The short-term downside for the economy, however, is that it takes fewer workers to build UAV systems than it does to build larger, more complex fighter jets, cargo planes and refueling tankers.

After a decade of rising defense spending under George Bush, the defense industry is seeing the closest thing to austerity measures under President Barak Obama, who has asked his Defense Secretary Robert Gates -- the lone holdover from the Bush cabinet -- to make deep cuts in numerous weapons programs and to overhaul others.

The Pentagon is even restructuring the types of contracts it will sign with defense companies. One of the biggest changes: the DoD’s move toward fixed-price contracts from the existing cost-plus awards. Fixed-prices force contractors to assume risks for delays and cost overruns. The current standard, cost-plus contracts, promise an agreed-upon price plus any expenses that are incurred from delays and development detours. While cost-plus contracts do not offer any incentives to companies to control costs, since they are guaranteed fixed profit margin, a fixed-price contract is fraught with the possibility that design or manufacturing problems can lead to delays and escalating costs.

Some programs that have seen reductions include Lockheed Martin’s F-22 advanced stealth jet fighter, which is nearing the end of its production life; the Army’s \$160 billion Future Combat Systems, which has been restructured; and the Presidential helicopter program, which has been on and off the chopping block several times depending on the changing political winds.

The great game in defense is that lawmakers are always eager to work with contractors to bring jobs and tax revenues to their states while defense companies are skilled at threatening to move operations from one congressional district to another unless they receive tax or other regulatory breaks. But most analysts agree that companies are unlikely to be playing hardball by announcing or making layoffs in the hopes of protecting endangered programs.

“I think it is too difficult for businesses to leverage something that is otherwise so difficult to change as their manpower levels,” said Baker Spring, an analyst at the Heritage Foundation, a conservative think tank in Washington, D.C. Regardless of political maneuverings, the Defense Department’s budgetary crunch means inevitable manpower cuts in the near and long term.

Pressure for Profits

Given this business climate, defense companies are beginning to face their internal pressures to keep profits high.

“These companies have to survive the investment market as much as the defense market,” said Spring. Analysts look for companies with healthy profit margins, and the problem is that the defense sector now has slightly below-average margins. “The profit margins in defense are obviously low enough in my judgment that it is difficult for defense companies to encourage the investment they would like to see.”

To maintain margins and investment interest, analysts say, stockholders and boards are urging management to slash the workforce. Contractors had cranked up production during the Bush years, but with declining spending they find themselves with excess production capacity, or too many workers.

“There isn’t a backlog of supplies, but rather an excess of capacity, and with the draw-down on the horizon, that excess capacity will only grow larger,” said Plucker. “Excess capacity equals shrinking margins, and that is an absolute ‘no, no’ for boards of directors.”

Some of the problems are self-inflicted from poor strategic decisions. For example, at the height of the Afghan and Iraq wars, defense companies competed aggressively for contracts -- big and small. One tactic, say analysts, was to acquire smaller companies that already had won contracts. With credit flowing freely at the time, a quick acquisition was routine. This strategy, however, brought in not only another revenue stream but also a new set of employees. With the spending slowdown, the strategy has proven to be more of a burden as many of those acquisitions are proving to be poor fits longer term.

“Some companies made highly suspect acquisitions over the last number of years -- probably chasing an individual contract,” said Plucker. “That contract may now have expired and the company really wants to divest themselves of all those workers.”

Getting rid of excess capacity, however, is not always the ideal business strategy. During a

downturn trained employees are turned out but when demand picks up, they might then be working elsewhere. Companies then have to hire workers who must first be trained -- an expensive proposition that slows productivity when it is needed most. Layoffs also divert funds toward severance packages, raising expenses -- at least in the short-term.

Robert J. Chalfin, a lecturer at Wharton, says companies instead can look elsewhere for savings. They can find waste and inefficiencies in their process engineering. "I think companies can take a really hard look at expenses and see what type of expenses could be reduced or all together eliminated," he said.