

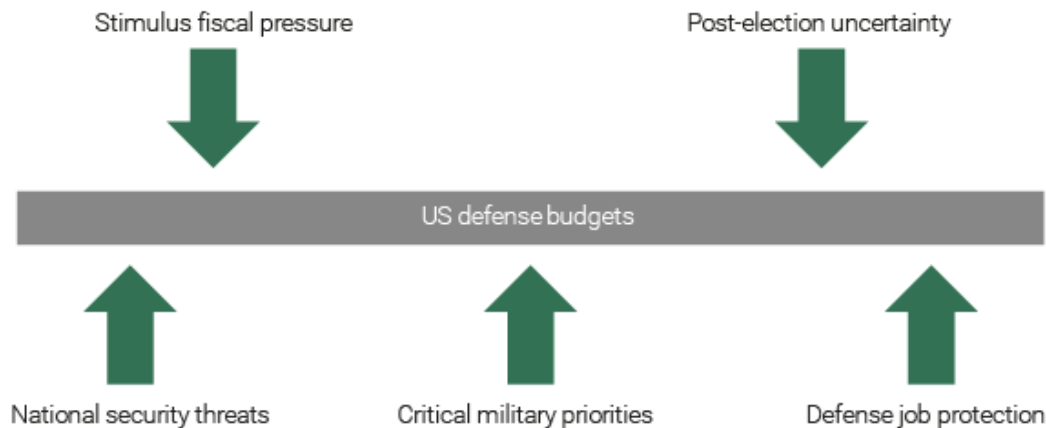
## WITH UNCERTAINTY HIGH, US DEFENSE COMPANIES MUST BE NIMBLE

The AlixPartners A&D Minute

Compared with the precipitous drop in commercial air travel and aircraft deliveries, the US defense industry has only been marginally impacted by COVID-19. The most significant effects have largely been confined to increased costs and delays from split shifts and other safety procedures, supply chain disruptions, and travel restrictions. As a result, unlike commercial aerospace companies, pure defense companies such as **Lockheed Martin** and **Northrop Grumman** recently announced their third-quarter results with year-over-year sales and profit increases. However, the prevailing economic and political climate means there is uncertainty around future budgets and whether defense companies can continue to maintain profitability going forward, let alone grow.

President Donald Trump's five-year defense budget, released in February before the pandemic fully took hold, was essentially flat. In constant dollar terms, the administration had planned a budget that decreased by roughly **half a percent year over year**. Since February, the pandemic and the US elections have introduced uncertainty in this flattish outlook. Strong opposing forces will drive the defense budget over the next few years, complicating predictions for which forces will win and whether overall numbers will be cut, stay flat, or even increase (figure 1). While spending increases seem unlikely at the moment, they are not impossible with current global security threats.

**FIGURE 1: DEFENSE BUDGET FORCES**

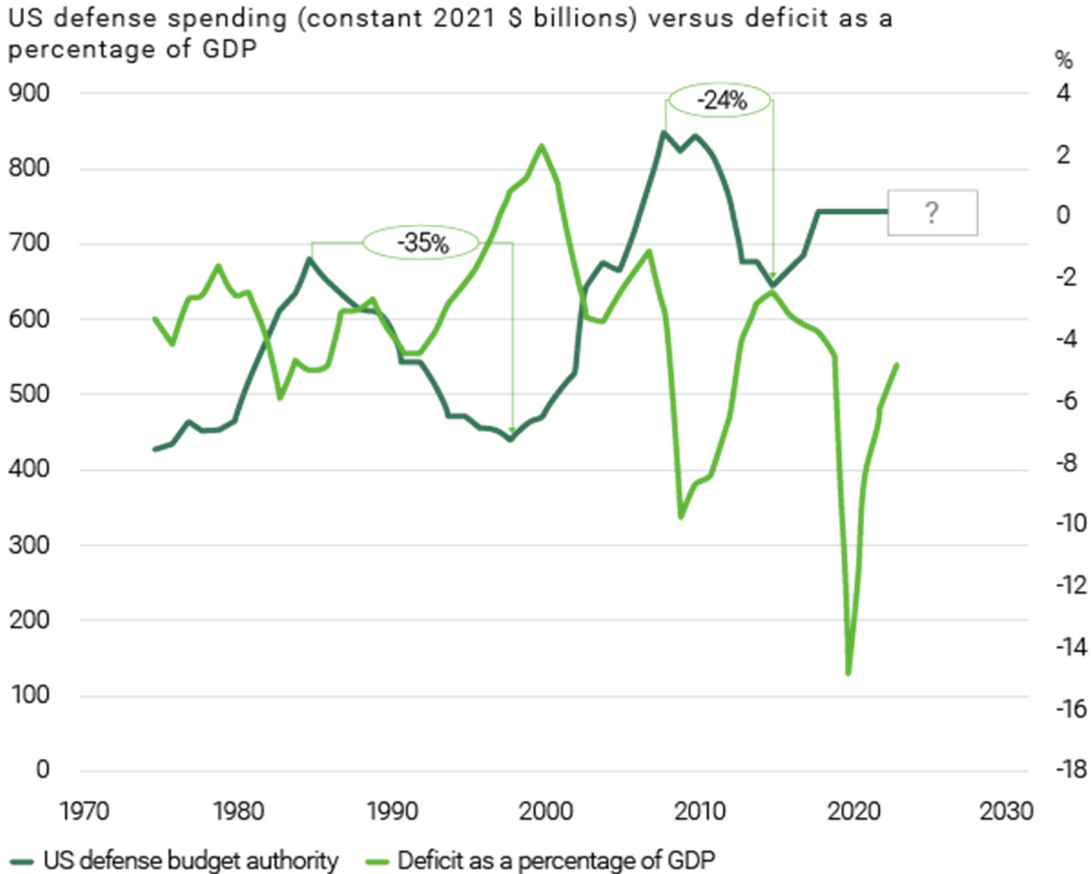


### STIMULUS FISCAL PRESSURE

Enormous downward pressure will come from fiscal strains of stimulus spending. The federal budget deficit for FY2020, which ended September 30, was **\$3.1 trillion** or 14.9% of GDP. This is the largest deficit since those of the World War II era, which ran into 20% and even 30%. Since then, the largest budget deficit incurred by the US government was after the 2008 financial crisis, which was 9.8% of GDP. Because defense spending is by far the largest discretionary portion of the federal budget—more than six times larger than the Department of Health and Human Services, the next largest agency—defense spending is highly negatively correlated with the deficit. Periods of high deficits have historically led to decreases in the

defense budget in real (inflation-adjusted) terms and vice versa (figure 2). The need to eventually pay for the stimulus regardless of if it's through reduced federal spending, higher taxes, or printing money, will put downward pressure on defense budgets in the near term.

**FIGURE 2: THE DEFENSE MARKET IS IMPACTED WITH BOTH IMMEDIATE OPERATIONAL ISSUES AND AN UNCERTAIN FUTURE TOP-LINE OUTLOOK**

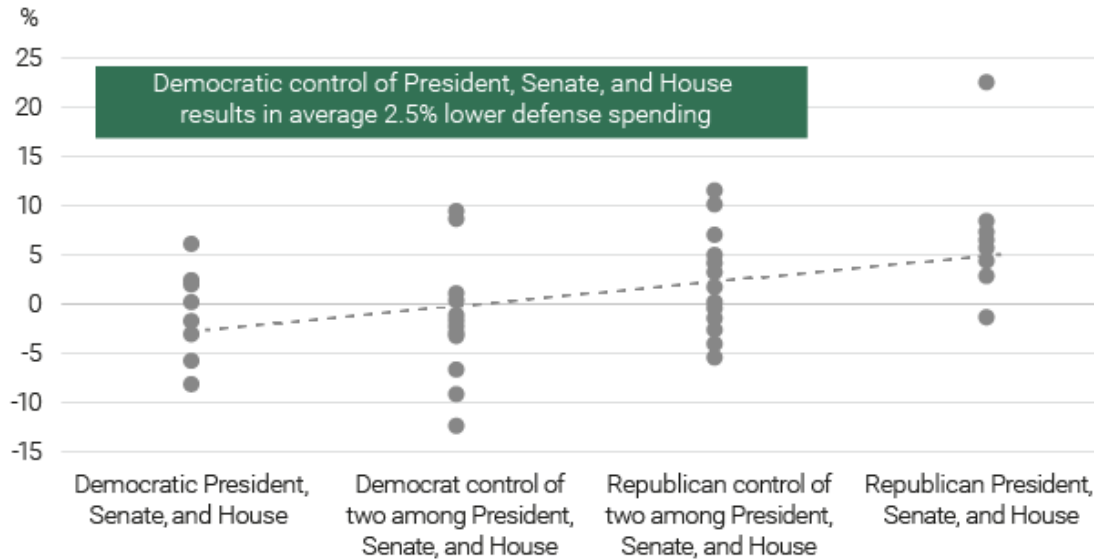


Source: National Defense Budget Estimates for FY2021 (Green Book); Office of Management and Budget; Congressional Budget Office

**POST-ELECTION UNCERTAINTY**

The exact political composition of the US government will remain unclear until January, with the outcome dependent on run-off elections in Georgia that will settle the question of which party controls the Senate. However, with the pandemic still demanding attention and other economic forces at play, there is a possibility of downward pressure and a change in focus on defense budgets. Based on our analysis of the last 40 years of defense budgets, Democratic control of the House of Representatives, the Senate, and the executive branch is associated with an average 2.5% lower defense spending (figure 3).

**FIGURE 3: ANNUAL REAL GROWTH IN US DEFENSE BUDGETS VERSUS PARTY CONTROL 1976 TO 2020**



Source: Publicly available data; AlixPartners analysis

**NATIONAL SECURITY THREATS**

On the other hand, upward pressure is being exerted on defense spending by increasing threats to US security. For example, China’s defense spending has increased every year in the last decade to double since 2010—its defense budget is now roughly a third of the US defense budget. While Russia’s defense budget appears to be under pressure from the global drop in oil prices, it is still estimated to be in the order of \$160 billion, or approximately 20% of recent US defense budgets in like-for-like dollars. In addition, there are continued threats from North Korea and Iran, as well as other nonstate entities and factors.

**CRITICAL MILITARY PRIORITIES**

Evolving military priorities represent another upward force, compelling US military leaders to petition lawmakers for increased funding. For example, the US military will likely continue to ask for increased spending for cybersecurity operations, for growing the naval fleet from approximately 300 ships to 355, for countering hypersonics, and for space, cross domain, and service integration (known as “any sensor, any shooter” battle management), among others.

**DEFENSE JOB PROTECTION**

Finally, defense jobs tend to be higher-paying, technical jobs that are widely spread across the country. Politicians from both parties will be loath to cut defense spending if it affects these jobs during this period of higher unemployment.

Given these opposing forces, it is not clear which direction will win out. Will defense spending increase to match the direction of China's continued escalating spending? Will it stay flat? Or will it be drastically cut to offset pandemic stimulus spending and other domestic agendas?

Given the uncertainty, defense companies will need to be nimble. To do this, we recommend focusing on three key areas:

1. **Deliver on the backlog, on time and at cost:** This means not just focusing on internal operations but keeping tabs on and even helping suppliers that may need assistance. Many defense suppliers are either small, with fewer resources to deal with the pandemic, or have significant commercial aerospace business that has been weakened by the downturn in commercial air travel and may currently be struggling. It is important to identify and proactively support these companies early, before either parts delivery gets delayed or there is need for financial restructuring or worse. At the same time, other suppliers are fighting to grow their defense business to compensate for steep declines in commercial volumes and are willing to find ways to reduce overall program costs. This buyers' market offers opportunities to improve the affordability of weapon systems, leading to increased volumes and—in many cases—profits.
2. **Optimize business portfolios with eye on the future:** Ensure that the company is prepared for current and future technologies, programs, and services that military customers will likely need. This may involve divesting businesses that don't fit anymore and buying businesses to complement other areas that are currently lacking. Doing this will demand a well-defined corporate strategy.
3. **Improve agile development and rapid prototyping capabilities:** **Some military customers** are promoting new digital design and engineering concepts. A large part of being nimble is being able to quickly respond to emergent military customer requirements. Companies that succeed at this tend to be those that have discarded older practices of delivering bespoke, complex weapons systems with long development cycles and instead offer customers flexibility that anticipates their needs for integrated systems.

Irrespective of how upcoming defense budgets take shape, it has never been more apparent that companies that are nimble and can rapidly incorporate new technologies and systems are the ones that will have opportunities for continued growth and success.

**FOR A DEEPER DISCUSSION ABOUT THIS TOPIC, CONTACT:**

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These are the moments when everything is on the line – a sudden shift in the market, an unexpected performance decline, a time-sensitive deal, a fork-in-the-road decision. But it's not what we do that makes a difference, it's how we do it.

Tackling situations when time is of the essence is part of our DNA – so we adopt an action-oriented approach at all times. We work in small, highly qualified teams with specific industry and functional expertise, and we operate at pace, moving quickly from analysis to implementation. We stand shoulder to shoulder with our clients until the job is done, and only measure our success in terms of the results we deliver.

Our approach enables us to help our clients confront and overcome truly future-defining challenges. We partner with you to make the right decisions and take the right actions. And we are right by your side. When it really matters.

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