CHANGING SECURITY PRIORITIES, UNCERTAINTY AND LOWER MARGINS

GOVERNMENT DEFENSE CONTRACTING IN THE "NEW NORM"

APRIL 15, 2013

Eight days after the invasion of Iraq on March 19, 2003, Paul Wolfowitz, then deputy defense secretary and a leading proponent of the war, told a Congressional committee: "*We are dealing with a country that can really finance its own reconstruction, and relatively soon*."[i] A decade later, that assessment could not have been more wrong.

This article summarizes how the U.S. government arrived at this moment, the potential impact on defense contractors and on the implications for senior management as they refocus their strategy to the "New Norm" of budget constraints, changing security priorities, increased operating uncertainty and intensified enforcement, new efficiency requirements and lower margins.

The United States has overwhelmingly borne the brunt of both the allied military and reconstruction costs, spending at least $138 billion on private security, logistics and reconstruction contractors, who have supplied everything from diplomatic security to power plants and toilet paper. An analysis by the Financial Times[ii] reveals the extent to which both domestic and foreign companies have profited from the conflict; with the top 10 contractors[iii] securing business worth at least $72 billion. The United States hired more private companies in Iraq than in any previous war, and at times there were more contractors on the ground than military personnel.

With the war in Iraq over, the conflict in Afghanistan winding down and budgetary pressures here at home, the business environment for these defense contractors will continue to change but will not be going away. There are still 14,000 contractors, including 5,500 security guards, in Iraq even though the last troops left in December 2011. Effectively, the United States has created another branch of the military; it's called the "private sector".

In March 2013, Congress managed to avoid a federal government shutdown by agreeing to a continuing resolution, effectively a stop-gap measure to fund federal agencies through September 30th, 2013 with Sequester cuts still in place. While the U.S. Defense Department ("DoD") now has some more flexibility with its funding, defense contractors will continue to be impacted by the reduced operational tempo ("optempo") in Iraq and Afghanistan, budget pressures compounded by sequestration, the Better Buying Power Initiative introduced in 2010 and increased compliance issues. All of these developments are leading to reduced business certainty, lower margins and a more demanding customer for defense contractors. However, before writing-off the Defense Contracting industry, it should be noted that some reports highlight that the Pentagon spends as much as the next 13 largest militaries in the world combined[iv]. Accordingly, it is widely acknowledged that the DoD, with a FY13 budget of $571.2 billion ($525.4 billion in base spending plus $88.5 billion for Overseas Contingency Operations less $42.7 billion for the impact of sequestration) is a huge economic engine for private firms accounting for the largest component (approximately 53.1%) of $1.1 trillion in discretionary spending. In fact, it is estimated that over $329 billion will be spent by the DoD on defense contractors in FY13.

There has been much ink spilled in the media on the changing strategic landscape, budgetary constraints, regulatory, and financial and risk issues for defense contractors. But, less has been written on their combined implications and what senior management teams should be focusing on to mitigate risk and improve profitability. Senior management teams should complete a self-assessment of their business (e.g., management, infrastructure and service offerings) to evaluate the right mix of skill and experience required for their present changing business conditions and to see if their strengths can be complementary to new markets; be it different sub-sectors of the DoD, other agencies of the Federal Government or foreign governments, or commercial or new specialized applications or solutions. Other areas to focus on include core business systems (e.g., bid and proposal, procurement and supply chain, billing and collections) and information systems (i.e., reporting, planning and forecasting for both financial and non-financial data). Efficient and interactive information systems are becoming more important as management now needs to quickly identify trends and poor performing projects and then evaluate the impact of changing strategy to maximize profits. In addition, management needs to be continually adapting to a shifting regulatory environment of intensified enforcement, increasing margin pressure and changing acquisition vehicles.

Valuation multiples of government contractors are already trending downwards due to declining market conditions. In addition, many defense contractors with adequate cash flow are conserving cash due to the uncertainties with federal funding. These conditions have resulted in a dynamic where a reduced number of experienced buyers are looking to supplement their existing business prospects by targeting acquisitions for specialized, well run, typically smaller, companies with good growth opportunities.

CURRENT LANDSCAPE OF DEFENSE SPENDING

The national security landscape in 2013 is far different than it was a mere 15 years ago. America is emerging from more than a decade of wars in Iraq and Afghanistan, but the threat of violent extremism persists and continues to emanate from rogue states (e.g., North Korea, Iran) and ungoverned spaces in the Middle East and North Africa. There also stands an array of other security challenges of varying degrees of risk to the United States; such as the proliferation of dangerous weapons and materials, the increased availability of advanced military technologies in the hands of state and non-state actors, and the risk of regional conflicts that could draw in the United States. For example, cyber-attacks, which barely registered as a threat a decade ago, have grown into a defining security challenge, with potential adversaries seeking the ability to strike at America's security, energy, economic and critical infrastructure with the benefit of anonymity and distance. A strategic review of defense priorities that has been well under way started under Secretary of Defense Robert Gates and continuing under Secretary of Defense Leon Panetta. The DoD has cut $487 billion by rebalancing the defense posture of the U.S. military to the Asia-Pacific region while prioritizing critical capabilities such as cyber security, special operations and unmanned systems.

While the DoD has been preparing for the new strategic environment and inevitable downturn in defense budgets, the DoD had not planned for the far more abrupt and deeper reductions due to the combination of fiscal pressures and gridlocked political process on Capitol Hill. Deep political and institutional obstacles to these necessary reforms will need to be addressed and overcome. Secretary of Defense Chuck Hagel recently expressed concern that *"… despite pruning many major procurement programs over the past four years, the military's modernization strategy still depends on systems that are vastly more expensive and technologically risky than what was promised or budgeted for. We need to continually move forward with designing an acquisition system that responds more efficiently, effectively and quickly to the needs of troops and commanders in the field. One that rewards cost-effectiveness and efficiency, so that our programs do not continue to take longer, cost more, and deliver less than initially planned and promised"*[v]. In addition, fiscal realities will mean another hard look at personnel; the number of people, both military and civilian; the balance between active and reserve personnel and where they are stationed; work tasks; and how we compensate them for their work, service, and loyalty in wages, benefits and health care. This will involve asking tough questions and will require looking at the DoD's organizational chart and command structures, most of which date back to the early years of the Cold War.

REFOCUSED FEDERAL BUDGET

For all the talk coming out of Washington about cutting budgets, Congress appropriated $613.9 billion ($525.4 billion in base spending plus $88.5 billion for Overseas Contingency Operations ("OCO")) which does not include related expenditure for Homeland Security ($39.5 billion) and Veterans Affairs ($61.0 billion). Recently, Congress allocated $42.7 billion of sequestration cuts to the DoD in the fiscal year ending September 30, 2013 ("FY13"). This resulted in a net Defense budget of $571.2 billion, equivalent to 16.5% of the total federal budget of approximately $3.5 trillion or 53.1% of total discretionary spending of approximately $1.1 trillion. Some reports highlight that the Pentagon spends as much as the next 13 largest militaries combined in the world.[vi] It is evident that the DoD is one of the single most significant drivers of the U.S. economy, especially near military bases and the greater Washington, D.C. Metropolitan area.

Funding Levels for Appropriated Programs
(Budget authority in billions of dollars)

	FY11 Actual	FY12 Enacted	FY13 Requested	FY11 % Total	FY12 % Total	FY13 % Total
Base Discretionary Funding by Agency:						
Security Agencies:						
Defense	528.3	530.5	525.4	15.0%	14.8%	15.2%
Other Security Agencies	159.6	153.4	160.5	4.5%	4.3%	4.6%
Subtotal, Security Agencies	**687.9**	**683.9**	**685.9**	**19.5%**	**19.0%**	**19.9%**
Nonsecurity Agencies	370.8	373.4	356.8	10.5%	10.4%	10.3%
Discretionary Cap Adjustments:						
Overseas Contingency Operations (Defense)	158.8	115.1	88.5	4.5%	3.2%	2.6%
Overseas Contingency Operations (Other)	0.7	11.5	8.2	0.0%	0.3%	0.2%
Disaster Relief	-	10.5	5.6	0.0%	0.3%	0.2%
Program Integrity	0.5	0.9	1.8	0.0%	0.0%	0.1%
Other Emergency/Supplemental Funding	(1.3)	-	-	0.0%	0.0%	0.0%
Total, Discretionary Budget Authority	**1,217.4**	**1,195.3**	**1,146.8**	**34.6%**	**33.3%**	**33.2%**
Mandatory Programs:						
Social Security	725.0	773.0	820.0	20.6%	21.5%	23.8%
Medicare	480.0	478.0	528.0	13.6%	13.3%	15.3%
Medicaid	275.0	255.0	283.0	7.8%	7.1%	8.2%
Troubled Asset Relief Program	(38.0)	35.0	12.0	-1.1%	1.0%	0.3%
Other Mandatory Programs	631.0	635.0	571.0	17.9%	17.7%	16.5%
Subtotal, Mandatory Budget Allowance	**$ 2,073.0**	**$ 2,176.0**	**$ 2,214.0**	**58.9%**	**60.5%**	**64.1%**
Net Interest	230.0	223.0	246.0	6.5%	6.2%	7.1%
Adjustments for disaster costs	-	-	2.0	0.0%	0.0%	0.1%
Joint Committee Enforcement	-	-	(71.0)	0.0%	0.0%	-2.1%
Grand Total, Budget Appropriations	**$ 3,520.4**	**$ 3,594.3**	**$ 3,537.8**	**100.0%**	**100.0%**	**102.5%**
Sequestration:						
Defense	n/a	n/a	(42.7)	n/a	n/a	-1.2%
Other Discretionary Programs	n/a	n/a	(28.7)	n/a	n/a	-0.8%
Medicare	n/a	n/a	(9.9)	n/a	n/a	-0.3%
Other Mandatory Programs	n/a	n/a	(4.0)	n/a	n/a	-0.1%
Total Sequestration Cuts	**n/a**	**n/a**	**(85.3)**	**n/a**	**n/a**	**-2.5%**
Budget After Sequestration Cuts	**$ 3,520.4**	**$ 3,594.3**	**$ 3,452.5**	**100.0%**	**100.0%**	**100.0%**

Source: Budget of the United States Government, Fiscal Year 2013 published by the Office of Management & Budget (http://www.whitehouse.gov/omb/budget/overview), Center for Budget and Policy Priorities (March 2013).

Sequestration cuts are impacting DoD more than any other agency. While the $42.7 billion is equivalent to 7.0% (versus 5.4% for non-defense discretionary spending) of the DoD FY13 budget; this represents an estimated 14.0% of the DoD budget for the six months after sequestration was formally implemented and when cuts will formally be required to be made. It is clear that the increasing growth of non-discretionary components (or Mandatory Programs), now accounting for approximately 63.7% of the federal budget in FY13 after the impact of sequestration (FY12: 60.5%) is also squeezing other areas of federal spending. Given this dynamic, the DoD's long term strategy is influenced as much by domestic considerations in Washington D.C. than as existential threats from abroad. The continued ideological differences between Democrats and Republicans and the proverbial 'kicking the can down the road' by elected leaders has prevented Congress from passing an annual budget on time for more than three years. The U.S. government has relied on short-term continuing resolutions to keep paying its bills while avoiding any meaningful budgetary discipline.

The stalemate in Washington resulted in the realization of "Sequester" which is scheduled to impose $500 billion in cuts to the Defense Budget over the next ten years (in addition to the savings from a planned withdrawal from Iraq and Afghanistan). In fact, it is uncertain if Congress will be able to pass the FY14 federal budget given the significant ideological divides in budget proposals recently submitted by the Senate, the House and the President. These deep political divides are plainly visible to all observers as evidenced by the inability of Congress to ultimately avoid the consequences of Sequester with the passage of a comprehensive budget plan.

Under the continuing dynamic of strategic reviews by the DoD forced by sequestration and intense budget debates, military contractors must get used to increased uncertainty together with continued pressure on margins. This will be the "New Norm" for doing business with the U.S. Government at least for the foreseeable future.

Continuing Resolution and the Sequester

Most recently, President Obama signed a continuing resolution, a stopgap spending bill, on March 26, 2013 that will effectively fund approximately $1.1 trillion of discretionary programs through September 2013, equivalent to 31.1% of federal spending (including estimated expenditure for defense contractors of approximately $329 billion). This measure leaves in place $85.3 billion in automatic budget cuts, known as the Sequester, but provides flexibility to administrators to ease the burden of these cuts. The Continuing Resolution also provides another $88.5 billion for overseas military operations in Afghanistan and Iraq and maintains a pay freeze for federal workers. These non-discretionary components of the budget do not require annual spending authorization and remain in force unless modified by Congress.

What's Next?

The DoD will continue to work at prioritizing how to allocate cuts given the President's authority to 'manage' the impact of sequestration. For instance, it is expected that the Pentagon will adjust the number of unpaid furlough days that non-military personnel working for the DoD will be forced to take over the next several months. This will result in an adjustment to the planned furlough from 22 days (effectively a 20% salary cut for 5 months) to 14 days starting mid-June which will reduce the impact of sequestration on as many as 700,000 civilian workers.[vii] For defense contractors, senior management should evaluate whether they have to right size their work force for the impact of change in budgetary priorities and for sequestration. Accordingly, management must be mindful of the compliance requirements relating to The 1988 WARN Act which requires any company with more than 100 employees to issue layoff notices 60 days in advance of any mass layoff or plant closure. Legal opinion and guidance issued by Office of Management and Budget in September 2012 is divided whether these layoff notices need to be distributed even if the implications of sequestration are not yet fully known; however, if these notices are sent out, management will have to be careful in managing the message to both internal and external stakeholders.

Secretary of Defense Chuck Hagel recently stated that "*... the biggest long-term fiscal challenge facing the DoD is not the flat or declining budget, it is the growing imbalance in where money is being spent internally. Left unchecked, spiraling costs to sustain existing structures and institutions, provide benefits to personnel, and develop replacements for aging weapons platforms will eventually crowd out spending on procurement, operations and readiness – the budget categories that enable the military to be and stay prepared*"[viii]. Accordingly, the ultimate burden of spending cuts and the reallocations of resources, including the impact on military contractors, is still not known given the changing strategic priorities across much of the Defense Budget.

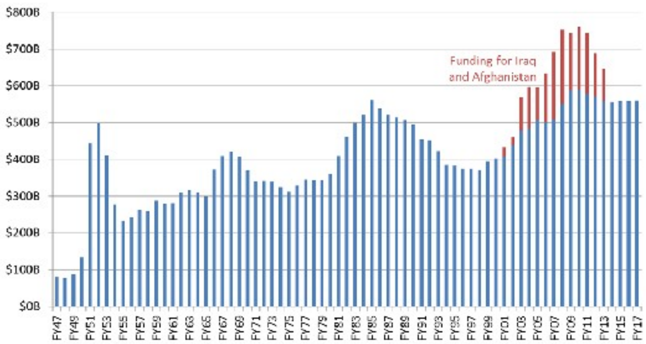
Congress must also address the debt ceiling by the summer to avoid a default on its debt obligations. This vote must be held no later than May 18, 2013 based on current legislative statutes.

PROJECTED DEFENSE SPENDING BEYOND FY13

Although government planning is projected over a multi-year period, the President and Congress can only influence actual budget and programs one year at a time. There will inevitably be unforeseen events and new realities that will alter the future of the Defense Budget despite the current political dynamic of deep partisanship.

Recent historical trends are unlikely to be a reliable predictor for future trends given the reduction in optempo in Iraq and Afghanistan. While defense spending grew 9% per annum[ix] on average from FY00 through FY09, there is normally a significant reduction in defense spending after a war (e.g., Korea, Vietnam, Cold War, Iraq and Afghanistan). Accordingly it is not surprising that total U.S. Defense spending is budgeted to decline by approximately 16.6% in FY14 (before sequestration) from its peak in FY10 following the Obama Administration's initiative which began in 2010 to drawdown troops in Iraq and a planned withdrawal from Afghanistan in 2014. The impact of these phased withdrawals has resulted in a significant reduction in OCO spending from $162.3 billion in FY10 to a planned level of $44.2 billion in FY14.

National Defense Budget Authority (in FY 2013 dollars)



Source: Center for Strategic and Budgetary Assessment, August 2012 Report

What is the Impact of these Budget Cuts to Defense Contractors?

Defense contractors are expected to incur the lion's share of planned cuts related to OCO spending and the Sequester. DoD expenditure on military contractors is estimated to decrease by 6.0% (FY12), 12.4% (FY13) and 7.6% (FY14), respectively, given President Obama and Congress' priority to not further reduce spending on Military Personnel Accounts ("MILPERS") which includes payroll costs for approximately 1.5 million active-duty uniformed personnel.

Allocation of Defense Budget to Contractors ($B)	FY11-A	FY12-F	FY13-B	FY14-B	FY15-B	FY16-B	FY17-B
Base Budget	$ 532.7	$ 530.6	$ 525.4	$ 533.6	$ 545.9	$ 555.9	$ 567.3
OCO [1]	158.8	115.1	88.5	44.1	44.2	44.2	44.2
Original Budget	**691.5**	**645.7**	**613.9**	**577.7**	**590.1**	**600.1**	**611.5**
Growth %	*n/a*	*-6.6%*	*-4.9%*	*-5.9%*	*2.1%*	*1.7%*	*1.9%*
Sequestration Cuts	-	-	(42.7)	(54.6)	(54.6)	(54.6)	(54.7)
Sequestration Budget	**$ 691.5**	**$ 645.7**	**$ 565.8**	**$ 523.0**	**$ 535.5**	**$ 545.5**	**$ 556.8**
Growth %	*n/a*	*-6.6%*	*-12.4%*	*-7.6%*	*2.4%*	*1.9%*	*2.1%*
Contracted Out [1]:							
Original Budget	$ 400.0	$ 375.9	$ 357.4	$ 336.3	$ 343.5	$ 349.4	$ 356.0
Sequestration Cuts	-	-	(28.0)	(31.8)	(31.8)	(31.8)	(31.8)
Sequestration Budget	$ 400.0	$ 375.9	$ 329.4	$ 304.5	$ 311.8	$ 317.6	$ 324.2
% Contracted-Out [1]	*57.8%*	*58.2%*	*58.2%*	*58.2%*	*58.2%*	*58.2%*	*58.2%*
$ Incr./(Decr.) vs. Prior FY	n/a	$ (24.1)	$ (46.5)	$ (24.9)	$ 7.3	$ 5.8	$ 6.6
YOY % Incr./(Decr.)	*n/a*	*-6.0%*	*-12.4%*	*-7.6%*	*2.4%*	*1.9%*	*2.1%*

Source: Lazard Equity Research Note (September 2012), Center for Budget and Policy Priorities (March 2013), and FTI extrapolation and analysis.

[1] Overseas Contingency Operations

[2] Estimated by Lazard Capital markets Equity Research Multi Company Note September 10, 2012 for FY11. However, the contracted out ratio is expected to decrease as MILPERS expenditure is likely to be cut less than other expenditure.

Although Congress had not initially directed sequestration cuts to specific categories of the Defense Budget, it has directed that Military Personnel Accounts (approximately 25% of the total Defense Budget) will not be impacted. As such, this ensured that sequestration cuts would not cause base closures, military layoffs, or reductions in pay for military personnel and thus are more likely to impact defense contractors, particularly those operating in Operations & Maintenance and Procurement where it is generally easier to make immediate, substantial savings which are required to be made in the remaining six months of FY13.

FY13 Budget Authority (including OCO) Pre versus Post Sequestration								
Major Account ($B)	FY13 Budget (Pre Sequestration)				Sequestration		FY13 Budget (Post Sequestration)	
	Base Budget	OCO	Total		Impact		Total	
MILPERS	**$ 135.1**	**$ 14.1**	**$ 149.2**	**24.3%**	-	0.0%	**$ 149.2**	**26.1%**
O&M	208.8	64.0	272.7	44.4%	(25.1)	-9.2%	247.7	43.4%
Procurement	98.8	9.7	108.5	17.7%	(10.0)	-9.2%	98.5	17.3%
RDT&E	69.4	0.2	69.7	11.3%	(6.4)	-9.2%	63.3	11.1%
MILCON	9.6	-	9.6	1.6%	(0.9)	-9.2%	8.7	1.5%
Family Housing	1.7	-	1.7	0.3%	(0.2)	-9.2%	1.5	0.3%
Revolving Mgmt. Funds	2.1	0.5	2.6	0.4%	(0.2)	-9.2%	2.4	0.4%
Non-MILPERS	**390.3**	**74.4**	**464.8**	**75.7%**	**(42.7)**	**-9.2%**	**422.1**	**73.9%**
Total	**$ 525.4**	**$ 88.5**	**$ 613.9**	**100.0%**	**$ (42.7)**	**-7.0%**	**$ 571.2**	**100.0%**

Source: Center for Budget and Policy Priorities (March 2013), DoD FY13 Budget, and FTI extrapolation and analysis.

Note: Illustrative impact given annualized sequestration cuts would be implemented from April 1st through September 30 (end of the government fiscal year). Further Congressional approval would be required to reprogram budgeted expenditures between various categories of the defense budget.

- **Operations & Maintenance** - Appropriations are primarily related to the mobilization of reserve units, communications, transportation, supplies, and the deployment and redeployment of all forces. These activities have been significantly curtailed as approximately 38% of the budget cuts over the past three years have impacted this category of DoD spending.

- **Procurement** – Government spending on acquisition or investment in aircraft, missiles, ammunition, shipbuilding, and other vehicles for use by the U.S. military.

The DoD is undergoing a strategic shift in force readiness given spending and budgetary constraints, wherein U.S. forces will no longer be sized to conduct multiple large-scale, prolonged stability operations[x]. The practical impact of this policy will result in a re-sizing of the Army and Marine Corps while investing in (1) force readiness for the Reserve and National Guard units; (2) procurement of naval surveillance and unmanned aircraft assets; and (3) ballistic missile defense and related equipment systems.

Budget Cuts are only one part of the puzzle impacting Contractors

Better Buying Power Initiative ("BBP")

In 2010, the DoD launched an internal performance improvement initiative called the BBP. The BBP encompasses a set of fundamental acquisition principles to achieve greater efficiencies through affordability, cost control, elimination of unproductive processes, and promotion of competition. These principles were supplemented by DoD guidance in November 2012 that emphasized a stronger emphasis on acquisition management related to affordability caps, controlling costs, employing appropriate contract types, and aligning profitability more closely with DoD goals. As a result of these initiatives, as well as the mandated spending cuts, the DoD has been modifying its procurement requirements for the stated goal of 'doing more with less'. This will likely lead to margin pressure for defense contractors, which will become even more pronounced unless defense contractors further increase their delivery efficiency. Defense contractors must also better define and adhere to what is required by their customer rather than providing more than is required by specifications of the contract. In addition, defense contractors are chasing other markets to compensate for losses in volume in their present programs. This increased competition is further compounding unfavorable trends in margins.

Contract Acquisition Management and Changes in Funding Cycles

The federal government is pressing forward with changes to purchasing on existing and new contracts. For example on existing contracts, the government is looking to reduce volume and scope, either on a temporary or a permanent basis, and has been unexpectedly submitting Indefinite Delivery/Indefinite Quantity ("IDIQ") contracts out for re-bid, especially if the incumbent contractors do not voluntarily lower their presently agreed to contracted prices. For new contracts, the government is leveraging existing IDIQ structures and allowing itself the ability to negotiate at the task order level. While there is a 2009 Presidential directive to shift the risk of performance to government contractors, the DoD has actively managed costs utilizing cost-plus, competitively bid contracts, where margins are legally capped at 10%, and lowest-price, technically acceptable ("LPTA") procurement processes. These procurement changes, along with increased DCAA compliance oversight and bid protests, are resulting in a new status quo of increased uncertainty along with lower volume and margins.

In an effort to conserve cash flow amid the uncertainty in budget appropriations to defense programs, the DoD has shortened and delayed funding cycles for certain programs. In practical terms, sequestration was informally in operation four to five months before March 1, 2013. This has particularly impacted smaller, service orientated military contractors, resulting in increased working capital requirements to fund higher levels of unbilled accounts receivable or "at risk" work where the contractor has not yet received formal authorization to start or continue work. As a result, contractors have found it increasingly difficult to finance these projects given an increase in perceived business risk from lending institutions in this sector. In particular, highly leveraged defense contractors with a non-diverse customer base need to quickly identify these trends in acquisition management by the federal government. These trends may unfavorably impact revenue, profitability and ultimately cash flows resulting in more business uncertainty, making it difficult for management to appropriately and promptly adjust its strategic response to the "*New Norm*".

Intensified Enforcement Environment

The stated policy of the Defense Contract Audit Agency ("DCAA") is to focus review efforts on fewer contracts and on higher dollar returns (quality over quantity). However, the delays in auditing defense contractors has led to a $573 billion backlog stretching back six years for contracts paid but still awaiting auditing. This backlog is equivalent to 88.7% of the DoD budget in FY12. Six years ago, the backlog was $110 billion, equivalent to 18.3% of the FY07 defense budget of $600.9 billion, and less than one-fifth of its current size.[xi] This increase in backlog is partially explained by the difficulties in maintaining good business systems in Iraq and Afghanistan where contracts are typically purchased under cost-plus contracts; the 2011 report from the commission on Wartime Contracting in Iraq and Afghanistan estimated that defense contractors had wasted or lost to fraud as much as $60 billion, or $12 million a day, since 2001[xii]. In addition, Congress is indicating that it is time to "crack down" on wayward contractors, and to make an example of them. For example, on November 16, 2011 at the hearing of the Committee on Homeland Security and Government Affairs, Senator Joseph Lieberman stated the authority to suspend and debar government contractors "*is a tool that is used all too rarely, …it strains the imagination to think that these agencies have not encountered more companies that have overbilled the government, engaged in fraud, or failed to perform or carry out their obligation*.[xiii]" Thus, the message from Congress is that the suspension and debarment officials ("SDO") and the Department of Justice should use less discretion in assessing defense contractors in default and that debarment should be more automatic and mandatory in various circumstances. This change in stance could make a significant impact on this sector as suspended or debarred contractors would be ineligible for new contracts. Congressional interest in suspension and debarment is not likely to dissipate in the near future and therefore contractors must be prepared to engage in early communication with SDOs, which are operating under increased scrutiny, with a defensible administrative record.

There is also internal conflict within the Pentagon as the Defense Inspector General, the supervisory arm of the DCAA, issued a report in March 2013 in which it reviewed 50 audits issued by the DCAA in Government Fiscal Year 2010. The Defense Inspector General found that 37 of these audits (74% of the review sample) were noncompliant with applicable requirements of Generally Accepted Government Auditing Standards ("GAGAS"). The Report stated that "*the abundance of non-compliances with standards identified in the 37 assignments evidenced the need for improvements in the area of competence at the DCAA*".

Unfortunately, these issues within the DCAA have resulted in more uncertainty for defense contractors as the audit agency shifts its priorities, staffing levels and varying areas of focus have resulted in an inconsistent application of regulatory requirements and findings. In addition, issues with the DCAA can sometimes unfairly single out certain contractors over others which can draw management's focus from improving other areas of performance in attempts to enhance the enterprise value of the company.

Additional uncertainty for defense contractors is caused by the inconsistent application of the six year Statute of Limitations for claims made under the Contract Disputes Act. While the six-year time period starts "after the accrual of the claim" (i.e., the date when all events that fix the alleged liability of either the government or the contractor and permit assertion of the claim were known or should have been known), the contractor cannot be certain when this Statute of Limitations has passed as this time limitation is being continually tested at various phases throughout the contract life-cycle and more importantly by the district court in United States v. BNP Paribas SA, No. H-11-3718, 2012 WL 3234233 (S.D. Tex. Aug. 6, 2012). This 2012 court case appears to extend the scope of the Wartime Suspension of Limitations Act, 18 U.S.C. § 3287 (2008) "WSLA", which suspends the statute of limitations until five years after the termination of hostilities applicable to any offense involving fraud or attempted fraud against the United States, to False Claims Act's ("FCA's"). Accordingly, the FCA's six-year statute of limitations has been suspended by the Iraq and Afghanistan conflicts. Moreover, the district court's ruling makes clear that the WSLA's suspension is not limited to FCA cases arising out of wartime contracting or even Defense Department contracting in general, thereby implying that the FCA's statute of limitations would be rendered ineffective in other types of cases, including those involving allegations arising out of the financial and healthcare industries.

The Authorized Contracting Officer ("ACO") can now withholding payments of up to 10% if there are significant deficiencies in the business systems in accordance with DFARS Clause 252.242.7005; accordingly, it is becoming more important for management to ensure that their business systems do not become "Disapproved" as this action may have a significant impact on the cash flows of defense contractor. In addition, defense contractors would find it more difficult (e.g., would require additional documentation and authorization) to win new cost-plus contracts if their accounting system is Disapproved.

What are the High Priority Areas of Focus in the DoD Budget?

Although there are significant budget cuts outlined in the Defense Budget, there are some areas of potential growth including cyber security, power generation and energy efficiency (this issue has been partially driven by the extreme cost of moving fuel to Afghanistan), as well as mental health and other transitional services for military veterans. As outlined in the DoD FY13 Defense Budget, the following are priority goals for the agency:

Area of Budget Priority	Long Term Issue/Initiative	Implications for Government Contractors
1. Cyber security	DoD and the Commercial Sector are facing an increasingly persistent and motivated cyber threat.	Leverage existing capabilities in cyber security to assist peer companies that do not maintain adequate process and controls consistent with enhanced DoD standards.
2. Reduction in Force Readiness	Army and Marine Corps modernization plan calls for reductions (approx. 10%) in Army & Marine troop levels with greater dependence on reserve units to supplement active forces.	Shift focus to military preparedness and rapid mobilization activities (troop transport and training services) needed to succeed in irregular warfare environment.
3. Energy Policy	DoD will continue to establish an 21st century energy policy into force planning, requirements development and acquisition processing.	Partnering with private sector to incorporate alternative energy technology and related applications assisting the DoD in achieving its goals.
4. Acquisition Processing	DoD's "Better Buying Initiative" provides a continuous improvement framework requiring more stringent requirements when procuring products or services from military contractors.	Contractors need to refine bid & proposals that are reflective of the low-priced, technically acceptable ("LPTA" procedures and enhance competitive intelligence to survive in an increasingly competitive sector where margin pressure is exerted by the customer.
Audit Readiness	Preparation of timely audited financial statements will improve the accuracy and reliability of funding information and allow better funds control for management.	Contractors, particularly in the service sector, may need to prepare for the potential impact of short funding cycles that will impair resource planning and short term liquidity.

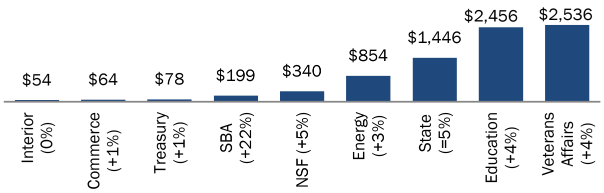
Source: DoD FY13 Budget Request, FTI Analysis

Given the reduced optempo in Iraq and Afghanistan and sequestration, government contractors will need to quickly refocus their capabilities to perhaps a more diverse customer base (e.g., different programs and other agencies) with more exposure to the private sector.

Alternative growth opportunities for a Defense Contractor

Defense contractors are now looking more aggressively outside the defense budget for new opportunities, especially programs which have not been impacted by sequestration, to leverage their complementary capabilities. Based on the current U.S. federal budget, there is significant growth for programs related to Veterans Affairs, Education, the Department of State and the Department of Energy. In fact, growth in several of these departments are complementary to many of the DoD's priorities in 2013, including a successful wind down of military operations in Afghanistan and the related training of the Afghan military, assistance to a growing number of military veterans resulting from a planned reduction in the size of active military troops, and increased emphasis on the development of efficient power generation systems.

U.S Agency Budget Change vs. 2012 ($ in millions)



Source: Deltek Presentation: 2013 Outlook: Issues and Opportunities for Government Contractors

HEALTH OF FINANCIAL MARKETS FOR MILITARY CONTRACTORS

According to a March 2013 Research Note from Standard & Poor's, there are no plans to take immediate rating actions on U.S. defense contractors, as there is considerable uncertainty as to how Congress will execute the spending cuts[xiv]. These cuts, dictated by the actions of the federal legislation, could take months or perhaps years before significantly impacting the revenues or earnings of defense contractors. However, with less business certainty, analysts and lenders are becoming increasingly vigilant in analyzing how well management of defense contractors react to the changing market conditions. It appears that management teams have been intentionally vague in public filings highlighting how the impact of sequestration and its mandated cuts in the Defense Budget can potentially impact their business prospects and related projections. This muted reaction to sequestration is understandable given the uncertainty imposed by Congress in trying to navigate the need for budgetary discipline against their desire to ensure that the key constituents are not unduly harmed by spending the cuts.

While the environment may be well suited for further consolidation in the defense sector, it is unlikely 'mega-acquisitions' will occur as defense contractors build up their cash reserves to act as a buffer in times of uncertainty. However, smaller, specialized and growth acquisitions will likely be pursued by larger, well-capitalized defense contractors in making smart strategic acquisitions to supplement their existing portfolio of business.

Non-Uniform Impacts – the Size Effect

Large Government Contractors

Larger, well capitalized contractors such as Raytheon, General Dynamics and Honeywell are expected to be better insulated to the unfavorable effects of sequestration given (1) their diversification of products and services marketed to various agencies within the federal and state governments as well as the private sector; (2) their ability to quickly shift focus to growing or new areas of the DoD budget such as cyber security and healthcare IT via acquisitions; and (3) the ability to conserve cash to maintain liquidity challenges resulting from changing dynamics relating the funding cycles and mechanism as the government strives to become increasingly efficient.

The challenge of large, well-diversified defense contractors will be to optimally deploy cash given the uncertainty created by actions of the federal government. As such, the Boards of Directors of defense contractors need to focus on how best to manage capital including building up cash reserves, investing in organic growth, funding selective acquisitions (e.g., for new markets or solutions or for economies of scale/synergies) or returning capital to its investors. Now is the time to look internally for potential efficiencies and to potentially redeploy resources to growth areas within the business. The initial savings may not initially lead to increased profits, especially if the majority of the contracts are cost reimbursable, but these actions will lead to a cost structure that is more competitive in bidding for future business.

Smaller Government Contractors

The impact of sequestration on the credit quality of smaller companies is more uncertain because they typically have a less diversified customer base and weaker financial profiles. Highly leveraged companies are also being reviewed in more detail, either as part of the bid process or as part of the annual review, by the federal government to ensure that they have adequate resources to ensure continued uninterrupted service to government customers. However, the fortunes of these companies will ultimately depend on which specific programs are cut and how management reacts. The uncertainty of sequestration on the business planning of these companies will be more pronounced given (1) these contractors may have more limited financial resources; (2) may have more heavily relied on debt to fund the exponential growth leveraged from a Defense Budget that increased from approximately $300 billion in 2000 to over $600 billion in FY12; (3) relatively smaller overhead pools providing limited opportunities to identify cost reductions in overhead to scale back to lower revenue volumes; and (4) potential liquidity challenges resulting from uncertain funding levels and profitability margins.

The challenge of relatively smaller, less diversified defense contractors will be to identify opportunities that yield higher rates of return than their relative cost of capital which will likely increase for defense contractors as lenders require greater returns for the new perceived risk in this sector. Chief Financial Officers ("CFOs") need to be more focused on minimizing overhead (especially non-allowable costs) to become more competitive, as larger companies chase new markets to compensate for unfavorable shifts in funding on their existing contracts. Accordingly, accurate liquidity management, detailed reporting and forecasting are becoming an increasingly important role of the CFO so that management can quickly identify and adapt their business model and infrastructure.

Deal Trends and Recent Valuations

Some analysts have observed that valuation multiples in the defense industry have dropped significantly since 2005 as the growth in the Defense Budget started to level off[xv]. In addition, certain analysts have observed that valuation multiples of firms operating in operations and maintenance (e.g., training, operation of forward military bases, equipment maintenance, etc.) have lagged against similar peers in the military procurement (e.g., manufacturing) businesses[xvi]. Based on a survey, "the government services public valuation multiples have moderated to the 6.0x to 10.0x EBITDA range, which is well below the 10.0x to 14.0x range observed in the early 2000s. However, M&A multiples in government services have averaged a 31% premium to public pricing, making contract disposals accretive in certain instances"[xvii].

Private Equity firms are actively targeting investments in the government contractor sector as they offer predictable profitability and cash flows. This trend is likely to continue for the experienced financial (and experienced strategic) buyers who understand the market and where to focus their due diligence (e.g., EBITDA less changes in working capital, management integrity and access to end customer base, funding of programs, compliance, contract vehicles and length of customer relationship, and IT and reporting systems).

However, less experienced Private Equity firms in this sector will probably become far more cautious in evaluating potential targets given the uncertainty imposed by the federal government that results in less visibility (i.e., lower backlog) and increasing compliance costs (e.g., withholding payments of up to 10% if there are significant deficiencies in the business systems, suspension or disbarment, and management time spent liaising with the DCAA). This may lead to fewer number of buyers in this sector.

"IT WAS THE BEST OF TIMES, IT WAS THE WORST OF TIMES"[xviii]

These times are particularly challenging for defense contractors. However, there are opportunities for management to refocus their business plan, become more efficient profitable to strengthen their companies' position to take advantage of the growth in certain sub-sectors of the defense and non-defense sectors. However, before any new strategies are implemented, we recommend that senior management perform an assessment of the company, management, infrastructure and service offerings to see if their strengths can be complementary to new markets or solutions. For example, companies which have the ability to source thousands of employees for overseas deployments may be able to provide services to FEMA or non-governmental organizations ("NGOs") for domestic or international disasters. In addition, companies which can provide defense IT solutions may be able to provide better systems for the Veterans Affairs agency or for fraud detection for social security programs.

When evaluating these options, management must look at their cost allocations, especially when they are operating under cost plus contracts, as certain expenses may be allocable to the new markets or product offerings and thus alter the cost base of their present contracts. Management should also evaluate if reorganization costs, even costs incurred to reduce future recurring expenses, would be an allowable expense for recharging back to the federal government.

This self-assessment will require management to look 'out of the box' and be more proactive in finding new opportunities. Examples of other opportunities to increase revenue and profitability include:

1. **Identify Alternative Channels for Revenue Growth** – Contractors can identify new alternatives for their existing capabilities by marketing to non-traditional customers such as alternative government agencies (e.g., Homeland Security, Veterans Affairs, CIA) or private market companies that have started to penetrate the government sector (e.g., Amazon). In considering these alternatives, contractors will need to consider past track records of success and augmenting their management teams (e.g., business development teams) with individuals who have demonstrated success in growing businesses in this manner and understand the new customer base.
2. **Identify and Shift Mix of Services to Higher Growth/Margin Areas** – Although there is a general spending decline expected for the U.S. Defense Budget, there are several components that are growing including services related to cyber security, homeland security, and healthcare. Management teams will need to evaluate their business development pipeline to ensure that they are pursuing opportunities in growth areas for their company rather than pursuing new business with more competitive and lower margin areas that will be dilutive in the long-term.
3. **Focus on Developing Specialized Capabilities** – In efforts to expand enterprise value for investors, management may consider focusing on projects that develop specialized capabilities and intellectual property which also reduces the risk of new competitors entering the market place. Several defense contractors maintain business models focused on commoditized services related to providing resources to rebuilding efforts in Iraq and Afghanistan or semi-technical services in telecommunications. These activities can provide a significant source of revenue but tend to be capital intensive and ultimately a drain on long-term earnings and profitability.

Management, particularly CFOs, in the government contracting sector need to become more efficient in identifying and reacting to trends that unfavorably impact future levels of revenue, profitability and cash flows. The obvious areas to cut back are related to overhead so that the company becomes more competitive on future bids and specifically unallowable costs that will provide an immediate uplift to earnings. In addition to considering these forms of cost reductions, management should consider extracting efficiency savings from their business systems, bolstering business and compliance internal controls and developing billing and cash collection procedures to maximize and improve cash flow.

Focus of blocking and tackling to maintain and enhance profitability

1. **Procurement and Supply Chain Effectiveness** – Management often looks to their procurement processes for opportunities to gain increased efficiencies in reducing material and overhead expenses. In addition, the procurement process can be a potential business system for a government contractor that may attract increased regulatory scrutiny by the DCAA given the Defense Department's Better Buying Initiative and historically poor industry governance.

2. **Billing and Collection Controls** – Government contractors that maintain poor internal controls related to customer invoicing can experience severe issues with liquidity and working capital management as evidenced by increasing unbilled revenue. Management needs to have in place effective controls to monitor all phases of the billing process. These processes include the proper calculation of forward pricing rates, the analysis and resolution of "at risk" or unbilled receivables, and the mitigation of billing errors. Government contractors that do not maintain proper analytics and controls related to billing will be exposed to increased regulatory pressure by the DCAA resulting in potential holdbacks of up to 10% that can impair liquidity. In addition, poor transparency relating to billing will likely result in revenue recognition issues that may also impact financial covenants and audits.

3. **Reporting, Planning and Forecast Controls** – As liquidity becomes increasingly difficult to manage given the unfavorable trends in the defense contracting industry, Management needs reliable and detailed reporting and planning tools that provide an understanding of business prospects and to ensure that all compliance rules are followed to reduce future compliance issues and related costs. If a government contractor has weak coordination between Business Development (Pipeline Reporting), financial and operational reporting, FP&A (Budget/Forecasting), Operations and Treasury (Cash Management), management can be caught off guard given potential disconnects between revenue, profitability, liquidity and the change in contract vehicles. These tools also need to be interactive so that management can assess how its potential changes in strategy will impact its business (e.g., infrastructure, work force structure, profitability). Management also needs effective and integrated planning tools in order to manage working capital and effectively promote the business to the capital markets especially as lending institutions are now taking a more active monitoring role. This will not only provide enhanced transparency to operating results but will provide Management with additional abilities to manage and optimize, in real time, the infrastructure of the business for current and future activity without unduly impacting organizational effectiveness.

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[i] Deputy Defense Secretary Paul Wolfowitz's testimony before Congress on March 27, 2003.

[ii] Financial Times article "Contractors reap $138bn from Iraq war" by Anna Fifield dated March 18, 2013.

[iii] Financial Times article "Contractors reap $138bn from Iraq war" by Anna Fifield dated March 18, 2013- Top 10 corporate winners in Iraq since 2003: KBR ($39.5 billion), Agility ($7.4 billion), Kuwait Petroleum Corp. ($6.3 billion), ITT ($4.4 billion), DynCorp ($4.1 billion), Combat Support Associates ($3.4 billion), Blackwater ($1.3 billion), Fluor ($1.5 billion), Triple Canopy ($1.8 billion), and International Oil Trading Co. ($2.1 billion).

[iv] SIPRI Yearbook 2012 (http://www.sipri.org/yearbook/2012/04).

[v] Remarks delivered by Secretary of Defense Chuck Hagel at National Defense University, April 3, 2013.

[vi] SIPRI Yearbook 2012 (http://www.sipri.org/yearbook/2012/04).

[vii] "Defense Secretary to Inflict Furloughs on Himself", US News, Paul Shinkman, April 2, 2013.

[viii] Remarks delivered by Secretary of Defense Chuck Hagel at National Defense University, April 3, 2013.

[ix] CBO-Monthly Budget Review-September 2009.

[x] "Fiscal Year 2013 Budget Request", The United States Department of Defense, February 2012.

[xi] "DoD contract audit plunge in quest for thoroughness", Federal Times, Sarah Chacko, June 11, 2012.

[xii] Financial Times article "Contractors reap $138bn from Iraq war" by Anna Fifield dated March 18, 2013.

[xiii] Weeding Out Bad Contractors: Does the Government Have the Right Tools?, Before the S. Comm. On Homeland Security and Governmental Affairs, 112th Congress 1-2, Harg. 112-358 (2011) (statement of Joseph I. Lieberman).

[xiv] "Sequestration Won't Immediately Affect U.S. Defense Contractors Ratings", Standard & Poor's Rating Services, Christopher Denicolo, March 1, 2013.

[xv] "The government contractor industry: M&A environment and recent deal trends", Grant Thornton, 2011.

[xvi] Equity Research Note (Defense Government Services), Lazard Capital Markets, Michael Lewis, Michael Smith, September 19, 2012.

[xvii] "The government contractor industry: M&A environment and recent deal trends", Grant Thornton, 2011.

[xviii] "A Tale of Two Cities", Charles Dickens, 1859.

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