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Defense Firms Position to Cushion a Budgetary Blow

A constrained federal budget, exacerbated by the recent financial crisis and the upcoming Presidential election, is having a profound impact on the capital markets' perceptions of defense firms as well as recent and future mergers and acquisitions ("M&A") activity in the defense industry.

For defense industry participants, cycles in spending are nothing new. The peace dividend that resulted from the fall of the Berlin Wall and the end of the Cold War put the pinchers on the U.S. defense budget. In constant 2008 dollars, the defense budget declined from $557 billion in 1985, the height of the Reagan build-up, to $382 billion in 2000. Of course, ever since September 11, defense spending has undergone a marked shift. Including $180 billion of expenditures on the wars in Iraq and Afghanistan, the defense budget reached $694 billion in fiscal 2008, an increase of 82%. Companies in the defense sector benefitted from this robust funding environment, delivering record profits and generating hoards of cash over the past several years.

All Good Things Must Come to an End

But the budgetary halcyon days appear to be ending. With the $700 billion bailout package and potential impact from a likely recession, the director of the Congressional Budget Office recently estimated the annual deficit could hit $750 billion in fiscal 2009. Some analysts have estimated the deficit could reach as high as $1 trillion. These projections represent a big jump from the already elevated deficit of $452 billion posted in fiscal 2008.

Moreover, the upcoming Presidential election is casting a cloud of uncertainty over future defense spending, with both major party aspirants to residency at 1600 Pennsylvania Avenue ramping up their rhetoric against prevailing defense contracting practices and costs. Both candidates are likely to look closely at large, expensive programs that have tended to provide "less bang, more buck," and crack down harshly on fraud, waste, and abuse in defense spending. For example, Senator McCain said in the first debate that he would stop the government from entering into cost-plus contracts and require fixed-price contracts.

Throw all these ingredients into the pot and you come up with a proverbial fiscal stew that legislators are going to find hard to stomach. Despite the threats from the ongoing Global War on Terror, the high operational tempo in Iraq and Afghanistan, and developments such as Russia's invasion of Georgia, something has to give in the defense budget equation.

The upshot is the Pentagon is facing a number of difficult budget decisions involving trade-offs between personnel, procurement, and future weapons spending. Some programs have already faced the axe, or could soon be on the chopping block. For example, the Defense Department recently terminated the $6.2 billion Armed Reconnaissance Helicopter program, after costs for each helicopter rose nearly 70% and development costs more than doubled. Other large platform procurements, such as the F-22 Raptor, the DDG Zumwalt class destroyer, and the Future Combat Systems, are likely to come under intense scrutiny over the coming months, assessing both their need and expense.

Investors in the firms that are either prime contractors for or major suppliers to these high-dollar programs have begun to cast a wary eye on the industry, a sharp turnabout from the recent share price performance of the sector. From the beginning of 2002 to the end of 2007, an index of major prime defense contractors (General Dynamics, Lockheed Martin, L-3 Communications, Northrop Grumman, and Raytheon) generated an average annual return of 13.0%, compared to 4.1% for the S&P 500. Over the past few months, as the financial crisis has picked up steam and the federal government has committed billions of dollars of its scarce resources to the bailout, the shine has come off defense stocks. Between September 1st and October 17th, the same defense contractor index underperformed the S&P 500 by about 3 percentage points.

Follow the Money

The shifting budget sands have already had a discernible effect on M&A activity in the sector. To avoid being left out in the cold when the budget door swings shut (or at least partially closes), proactive firms have started to more aggressively acquire companies with the capabilities to address high-level budget priorities typically insulated from cutbacks in defense spending. One recent example of this phenomenon occurred earlier this year when Boeing acquired unmanned aerial vehicle ("UAV") maker Insitu. Recognizing that the sun is setting on procurements of multi-billion dollar, multi-year manned aircraft programs (the F-35 Joint Strike Fighter and F-22 are perhaps the last of this endangered species), Boeing responded by expanding its capabilities in the unmanned systems market.

With healthy balance sheets and ample cash from several years of substantial defense spending, companies in the sector will continue to pursue strategic transactions. In addition to UAVs, other niches within the defense industry likely to experience significant M&A activity over the coming years include C4ISR, cyber security, logistics support services, and maintenance repair and overhaul.

The defense industry has always been something of a roller coaster ride, both for industry participants and investors. But the current environment, with budget pressures, economic crises, and Administration changes, will make the ride over the next couple of years bumpier than it has been in many years. Defense contractors that are well positioned in priority funding niches will continue to attract attention from buyers seeking to make the ride a little smoother.