FINANCIAL COMMUNITY PERCEPTIONS
OF THE DEFENSE INDUSTRY: 1985

by
Patrick J. Davey
and
Francis J. Walsh, Jr.

A report by The Conference Board, Inc. to Logistics Management Institute in fulfillment of the requirements of Subcontract No. RE 406/01, dated October 29, 1984.

March, 1985
**Title:** Defense Financial and Investment Review, Appendix 3; Financial Community Perceptions Of The Defense Industry: 1985

**Authors:** Patrick J. Davey, Francis J. Walsh, Jr.

**Performing Organization:** The Conference Board

**Address:** 845 Third Avenue, New York, NY 10022

**Controlling Office:** Defense Financial and Investment Review, DUSD(AM/DFAIR), The Pentagon, Room 3E144, Washington, D. C. 20301

**Number of Pages:** 79

**Report Date:** March 1985

**Distribution Statement:** Public Release

**Abstract:** The Conference Board made a study of leaders in the nation's financial community concerning their perceptions of the defense contractors with whom they do business to support the Defense Financial and Investment Review study. The report contains a summary of comments from financial executives of commercial banks, life insurance companies, accounting firms, investment rating agencies, investment banking firms, and venture capital firms relating to the suitability and desirability of providing financing to defense oriented firms. (continued)
20. ABSTRACT (Continued)

This report is not required to understand the Defense Financial and Investment Review final report, but it does provide an in-depth look at the financial community perceptions of the defense industry.
ABOUT THE CONFERENCE BOARD

The Conference Board is a business information service whose purpose is to assist senior executives and other leaders in arriving at sound decisions. Since its founding in 1916, the Board has been creating close personal networks of leaders who exchange experience and judgement on significant issues in management practice, economics and public policy. The networks are supported by an international program of research and meetings which The Conference Board staff of more than 350 persons carries out from offices in New York, Ottawa and Brussels.

More than 3,600 organizations in over 50 nations participate in The Conference Board’s work as Associates. The Board is a not-for-profit corporation and the greatest share of its financial support comes from business concerns, many with worldwide operations. The Board also has many Associates among labor unions, colleges and universities, government agencies, libraries and trade and professional associations.
## CONTENTS

<table>
<thead>
<tr>
<th>Section</th>
<th>Page</th>
</tr>
</thead>
<tbody>
<tr>
<td>Preface</td>
<td>1</td>
</tr>
<tr>
<td>Acknowledgements</td>
<td>11</td>
</tr>
<tr>
<td>Background and Purposes of the Study</td>
<td></td>
</tr>
<tr>
<td>Questions to be Addressed</td>
<td>1</td>
</tr>
<tr>
<td>Summary of Findings</td>
<td>2</td>
</tr>
<tr>
<td>Considerations Underlying Financing Decisions</td>
<td>3</td>
</tr>
<tr>
<td>Adequacy of Financing</td>
<td>3</td>
</tr>
<tr>
<td>Effects of Environmental and Procedural Changes</td>
<td>5</td>
</tr>
<tr>
<td>Effects of DoD Procedures on Capital Investments</td>
<td>6</td>
</tr>
<tr>
<td>Conduct of the Study</td>
<td>7</td>
</tr>
<tr>
<td>Commercial Banks</td>
<td>9</td>
</tr>
<tr>
<td>Considerations in Lending to Contractors</td>
<td></td>
</tr>
<tr>
<td>Attitudes Toward Defense Contractors' Loans</td>
<td>11</td>
</tr>
<tr>
<td>Loan Limits</td>
<td>12</td>
</tr>
<tr>
<td>Working Capital vs. Capital Equipment</td>
<td>13</td>
</tr>
<tr>
<td>Information Requirements</td>
<td>14</td>
</tr>
<tr>
<td>Risk Premiums for Contractors' Loans</td>
<td>15</td>
</tr>
<tr>
<td>Terms of Loans</td>
<td>16</td>
</tr>
<tr>
<td>Profitability Indicators</td>
<td>17</td>
</tr>
<tr>
<td>Diversification</td>
<td>18</td>
</tr>
<tr>
<td>Adequacy of Financing</td>
<td>19</td>
</tr>
<tr>
<td>Effects of Recent Changes</td>
<td>20</td>
</tr>
<tr>
<td>Increased Progress Payments</td>
<td>21</td>
</tr>
<tr>
<td>Recognition of Facilities Capital</td>
<td>22</td>
</tr>
<tr>
<td>Multi-year Contracts</td>
<td>23</td>
</tr>
<tr>
<td>Other Matters</td>
<td>24</td>
</tr>
<tr>
<td>Government Ownership of Facilities</td>
<td>25</td>
</tr>
<tr>
<td>Overpriced Parts and Fraud</td>
<td>26</td>
</tr>
<tr>
<td>Proposed Tax Changes</td>
<td>27</td>
</tr>
<tr>
<td>Recommendations by Study Participants</td>
<td>28</td>
</tr>
<tr>
<td>Life Insurance Companies</td>
<td>31</td>
</tr>
<tr>
<td>Extent of Involvement With Defense Contractors</td>
<td>31</td>
</tr>
<tr>
<td>Perceptions of the Defense Industry</td>
<td>32</td>
</tr>
<tr>
<td>Criteria for Lending or Investing</td>
<td>33</td>
</tr>
<tr>
<td>Interest Rates</td>
<td>34</td>
</tr>
<tr>
<td>Effects of Procedural Changes</td>
<td>35</td>
</tr>
<tr>
<td>Effects of Adverse Publicity</td>
<td>36</td>
</tr>
<tr>
<td>Diversification</td>
<td>37</td>
</tr>
<tr>
<td>Recommendations by Participants</td>
<td>38</td>
</tr>
<tr>
<td>Investment Banking Firms</td>
<td>39</td>
</tr>
<tr>
<td>General Perceptions of Defense Industry</td>
<td>39</td>
</tr>
<tr>
<td>Problems</td>
<td>40</td>
</tr>
<tr>
<td>Diversification</td>
<td>40</td>
</tr>
<tr>
<td>Topic</td>
<td>Page</td>
</tr>
<tr>
<td>----------------------------------------------------------------------</td>
<td>------</td>
</tr>
<tr>
<td>Rating Agencies</td>
<td>42</td>
</tr>
<tr>
<td>General Impressions of Defense Contractors</td>
<td>42</td>
</tr>
<tr>
<td>Financing Outlook</td>
<td>44</td>
</tr>
<tr>
<td>Investment in Facilities</td>
<td>44</td>
</tr>
<tr>
<td>Criteria for Evaluation</td>
<td>45</td>
</tr>
<tr>
<td>Diversity and priority of programs</td>
<td>45</td>
</tr>
<tr>
<td>Management strategy</td>
<td>45</td>
</tr>
<tr>
<td>Cost control and efficiency</td>
<td>45</td>
</tr>
<tr>
<td>Future prospects</td>
<td>45</td>
</tr>
<tr>
<td>Recommendations by Participants</td>
<td>46</td>
</tr>
<tr>
<td>Security Analysts</td>
<td>47</td>
</tr>
<tr>
<td>Perceptions of the Defense Industry</td>
<td>47</td>
</tr>
<tr>
<td>Problems of the Industry</td>
<td>48</td>
</tr>
<tr>
<td>Investment in Facilities</td>
<td>49</td>
</tr>
<tr>
<td>Diversification</td>
<td>49</td>
</tr>
<tr>
<td>Accounting Firms</td>
<td>50</td>
</tr>
<tr>
<td>General Impressions of Defense Contractors</td>
<td>50</td>
</tr>
<tr>
<td>Adequacy of Profits</td>
<td>52</td>
</tr>
<tr>
<td>Incentives to Modernize Facilities</td>
<td>52</td>
</tr>
<tr>
<td>The Completed Contract Method of Accounting</td>
<td>55</td>
</tr>
<tr>
<td>Progress Payments</td>
<td>56</td>
</tr>
<tr>
<td>Spare Parts Pricing</td>
<td>57</td>
</tr>
<tr>
<td>Proposed Changes in Tax Laws</td>
<td>58</td>
</tr>
<tr>
<td>Recommendations by Participants</td>
<td>58</td>
</tr>
</tbody>
</table>

Appendix

Interview Guide
Survey Questionnaire
Preface

As a part of the Defense Financial and Investment Review (DFAIR), the U.S. Department of Defense contracted with Logistics Management Institute, of Bethesda, Maryland, to undertake several specific studies in support of a comprehensive evaluation of contract pricing, financing, and profit. Logistics Management Institute, in turn, has subcontracted with The Conference Board, Inc. to make a study of leaders in the nation's financial community concerning their perceptions of the defense contractors with whom they do business.

Although Logistics Management Institute participated in the planning of this study, The Conference Board was solely responsible for the choice of respondents, the conduct of the interviews and the mail survey, analysis of the information gathered, and the preparation of this report. Because all of the interviews were off-the-record and all questionnaire respondents were promised confidentiality, the participants cannot be identified.

The Conference Board's role in this study was to gather and report information supplied by cooperating executives, including, where appropriate, their perceptions, personal opinions, and recommendations. The Board and the authors offer no conclusions or recommendations concerning what actions, if any, the sponsors of this project should take in response to the findings reported here.
Acknowledgements

One of the pleasant duties of authorship is to express appreciation to the many people who contributed their time and talents to the project. First and foremost, our thanks are due to the thirty four leaders, from various sectors of the financial community, who granted often lengthy personal interviews. Second, we are grateful to the executives of twenty seven commercial banks who completed an extensive survey questionnaire. Without the generous contributions of these three score participants this study could not have been done.

Another group that made a significant contribution by providing financial support, advice and background information during the planning and execution of the study, were members of the staff of Logistics Management Institute of Bethesda, Maryland, especially Robert K. Wood, Program Director, and his colleagues: James B. Lessig, Vice President, Paul R. McClenon, Myron G. Myers, Donna J.S. Peterson and Harry Tayloe.

Representatives of the Department of Defense also furnished timely guidance and information during the conduct of this study, especially Colonel Ronald R. Finkbiner, USAF, Director of the Defense Financial and Investment Review, Carol Frick, and Joseph Sousa.

Because of his long experience and his familiarity with an earlier study of this type (Profit '76), Major General George Miller, Headquarters USAF, Office of the Comptroller, made a significant contribution to the planning of this project.

Last, but not least, we wish to thank our associates at The Conference Board, especially James K. Brown, who provided overall executive supervision, and Celeste Kelliher, who transformed sometimes indecipherable drafts into a finished report with accuracy and dispatch.

P.J.D.
P.J.W.
BACKGROUND AND PURPOSES OF THE STUDY

The United States Department of Defense (DoD) faces a formidable task in its attempts to contain the costs of military procurement while, at the same time, seeking to maintain the economic health of the industrial base on which so much of the nation's security depends. Even in normal times, the pursuit of these objectives is challenging; but in the turbulent climate generated by the present rapid buildup of the national defense capability, the task has become even more complicated.

The Defense Financial and Investment Review (DFAIR) was authorized to examine and evaluate DoD contract pricing, financing, and profit policies to ensure that they result in equitable, efficient, and effective spending of public funds while maintaining the viability of the national defense industrial base.

As a part of this effort, The Conference Board has been asked to make a study of leaders in the nation's financial community concerning their perceptions of the defense contractors with whom they do business. These companies may be either prime contractors or subcontractors but their involvement in defense contracting is sufficiently great that their fortunes are materially affected by Defense Department procurement policies and practices. (Our study, therefore, does not include such industrial giants as the IBM Corporation or General Electric Company, which in fact do a great deal of work for the defense effort, but such work is relatively insignificant in relation to their total civilian-oriented activities.)

The financial institutions to be contacted included: commercial banks,
life insurance companies, accounting firms, investment rating agencies, investment banking firms, and venture capital firms. The purpose of this report is to present The Conference Board's findings.

Questions to be Addressed

Assessing the perceptions of key individuals in these institutions involves the consideration of a number of questions and issues that have an important bearing on the financial status of defense contractors and on the decisions of lenders and other suppliers of capital. The following basic questions were emphasized during the gathering of data for this study:

(1) What considerations underlie lenders' decisions to provide financing for defense contractors and subcontractors? How do these considerations differ from those prevailing for borrowers who are in ordinary commercial lines of business?

(2) Is sufficient financing presently available for companies in the defense industry and, if so, is the supply likely to continue to be adequate?

(3) What are the effects on financial community perceptions of the defense contracting industry as a result of environmental and procedural changes in recent years:

(a) The present defense build-up;

(b) Changes in DoD policies and procedures regarding progress payments, multi-year contracts, and recognition of the cost of facilities capital, both in cost and in profit, as a factor in determining the profitability of defense contractors;
(c) Diversification of defense contractors into civilian markets?

(4) As perceived by the financial community, to what extent have defense contractors' investments in more efficient production facilities been influenced by changes in DoD procedures?

Summary of Findings

The Conference Board's data-gathering activities in connection with this study developed a considerable amount of information that is reported in detail in subsequent sections of this report. However, for the sake of brevity, the following summary of responses to the overall questions stated above is presented here.

Considerations Underlying Financing Decisions

At the present time, there is not much difference in the considerations underlying decisions to supply financing to defense contractors as compared with similar considerations for non-defense customers. Commercial bankers and large life insurance companies particularly welcome the business of defense contractors. The prevailing opinion is that the collection experience in this sector of industry is good and the loans are profitable for lenders. In particular, the industry is in good shape because of the present and prospective defense build-up and also because of changes that have been made in DoD profit and financing policy and in economy-wide tax policy.

Adequacy of Financing

None of the participants in this study believes that the
defense contracting industry, in general, has any serious financial problems at the present time. The high level of government spending on the defense build-up in recent years, DoD procedural changes such as progress payment improvements, and various tax-related incentives, have combined to provide ample liquidity to contractors. As a result, bankers and other participants in this study believe that major prime contractors have little need for bank financing at the present time.

The picture is not quite so rosy in the case of some subcontractors, however. As one study participant expresses it, "their situations vary all over the lot." While some are doing well, others are experiencing difficulty. One problem for subcontractors is the reluctance of many prime contractors to share progress payments. Another problem is the time lag that exists before prime contractors become sufficiently backlogged to make it necessary to subcontract some of their work. Finally, there is a persistent feeling among the study participants that subcontractors' managements often do not know how to reap the benefits of defense contracting work; for example, they do not understand the advantages of the provision for recognizing facilities capital.

According to study participants who are suppliers of long-term financing, there is not much demand for long-term funds by companies in the defense industry. What financing is taking place appears to be for non-government purposes such as acquisitions. The study participants feel that contractors are not highly leveraged at the present time.

Nor is there much concern for the future adequacy of financing
for government contractors. The study participants do not foresee any shortage of funds in the markets -- even in the face of continuing large Federal budget deficits. They do not anticipate that defense contractors would be crowded out even in tight financial markets.

**Effects of Environmental and Procedural Changes**

Environmental and procedural changes in recent years that affect defense contractors (e.g., the present defense build-up, improved progress payments, recognition of the cost of facilities capital) are favorably regarded by the participants in this study. Although the progress payment system for government contract work has been in place for years, it has been liberalized since 1976 by increasing the rate of payment. The frequency of payments, however, has been reduced.

These developments are perceived as enhancing the stability and reducing the risks due to uncertainty in the defense business. Some of these changes are considered to be much more important than others. For example, liberalized progress payment schedules are of overriding importance to contractors but, recognition of the cost of facilities capital is considered to be less significant. These matters are covered at much greater length in the detailed discussion sections of this report.

Diversification by defense contractors into non-defense business receives mixed reactions from the study participants. On the one hand, they applaud the strategy of trying to reduce excessive dependence on government contracting; this is considered a sound business
move. On the other hand, they are painfully aware of the notable lack of success that contractors' diversification efforts have experienced in the past. Basically, they feel that attempts to diversify should be approached with caution and that defense industry executives should not "bet the ranch" on such diversification moves.

**Effects of DoD Procedures on Capital Investments**

In recent years, DoD officials have made strong efforts to influence government contractors to invest in modern, efficient production facilities and procedures in an effort to reduce the costs of military procurement. Participants in this study who are familiar with these efforts believe that contractors are, in fact, spending for such improvements to the best of their ability. They believe that liberalized progress payments, for example, have helped greatly by freeing up funds that would otherwise be tied up in inventories. And, they feel that contractors expect high defense spending to continue and, therefore, it is in their best interests to modernize. The participants also believe that recognition of facilities capital is a positive influence in motivating contractors' capital investments.

Economy-wide tax incentives, too, are given a great deal of credit for motivating contractors to upgrade their facilities. Accelerated depreciation, the investment tax credit, and the completed contract method of accounting are highly regarded in this respect. And some participating executives consider these tax incentives to be even more important than DoD incentives.
present time, they are uneasy over the prospect that these tax incentives will be eliminated or severely curtailed.

**Conduct of the Study**

The findings of this study are based entirely on facts and perceptions reported by a group of people who are knowledgeable about the defense industry and, more specifically, about the financial condition and activities of specific companies in that industry. Input from these individuals was obtained through a combination of personal interviews and responses to a mail survey.

The principal input to the study came from personal interviews. In all, interviews at 27 institutions took place and their distribution is as follows:

- Commercial banks: 6
- Life insurance companies: 5
- CPA firms: 4
- Security analysts: 4
- Investment bankers: 4
- Rating agencies: 2
- Venture capital firms: 2
- Total: 27

At a number of these interviews, more than one executive was present. In total, 34 executives participated in the interview program. In accordance with Conference Board policy, the interviewed executives were assured that their remarks were off the record and that no participant or his or her organization would be identified.
Because of the importance of commercial banks in this study, a mail questionnaire was used to expand the number of banking institutions that were contacted.

The following sections of this report discuss the information provided by the various groups participating in the study.
COMMERCIAL BANKS

At the outset of this study, the assumption was that commercial banks would prove to be the most authoritative sources of information on the financial health of the defense contracting community. The reason was that the contractors, like their counterparts in strictly commercial lines of business, were believed to be steady customers at their banks' short-term loan windows. Therefore, the bankers would be intimately acquainted with the contractors' financial affairs. Accordingly, the decision was made to focus the principal research effort on commercial banks that lend to customers who are involved in the defense contracting industry.

In fulfillment of this research strategy, interviews were held with a group of lending officers in six very large New York City Banks, all of whom have major customers in the aerospace, electronics, shipbuilding and other segments of the defense contracting business. A total of 10 senior officers of these banks participated in these interviews. A copy of the interview guide for bank executives is in the Appendix to this report.

In order to gain a broader geographical perspective on conditions in the defense industry, the information-gathering process was expanded (in the case of commercial banks) by conducting a mail survey. A confidential questionnaire was addressed to the chief executive officers of 210 commercial banks located in a variety of geographical areas throughout the nation that are known to be centers of defense contracting activity. A copy of the survey questionnaire appears in the Appendix to this report.
A total of 49 bankers responded to the questionnaire (a response rate of approximately 23%). Of this total, 22 of the cooperators indicated that their involvement with lending to defense contractors was either nonexistent or was so slight that they did not consider it appropriate to attempt answers to the detailed questions in the survey.

In all, 37 banking executives contributed their opinions and experiences to this study; 27 by completing the questionnaire and 10 by granting personal interviews. Because of the stature of the participants, and also because of the fact that comparatively little commercial bank lending to defense contractors is presently taking place (as will be explained later in this report), this rather small sample of bankers can be considered as representative of the best present day thinking prevailing in the banking community concerning defense contractor customers.

In keeping with the objectives of this study, as described earlier, the responses of the participating banking executives are presented in this section of the report in accordance with the following division of topics:

- Considerations in granting loans to defense contractors and subcontractors;
- Adequacy of financing available to defense contractors;
- Bankers' perceptions of effects of recent changes in DoD policies and procedures.

The tabulations of data presented in each of the following sections are based primarily on the survey questionnaire responses,
while the qualitative amplification is derived mostly from the personal interviews.

Considerations in Lending to Contractors

All of the commercial banks participating in this study make loans to companies in the defense industry. However, their loan exposure in this sector of business is quite small for the most part. For example, 23 of the 27 banks answering the survey questionnaire indicate the following percentages of their loan portfolios devoted to the defense business:

- Less that 1%: 10
- 1% - 5%: 12
- Over 5%: 1
- No response: 4

27

The interviewed bank executives report a similarly light exposure to the defense sector. One of them states that his bank has no loans outstanding in this area at present because all of his customers have adequate cash as a result of progress payments by the government. He adds, however, that the bank is committed to large lines of standby credit to some of its aerospace industry customers to back their commercial paper.

This same banker adds that his institution does some financing of aerospace companies' military sales to foreign countries because the EXIMBANK will not finance such sales. This banker also states that he prefers to finance the commercial side of the aerospace industry rather than defense contracts.
All of the other interviewed bank executives agree that their defense contractor customers are in excellent financial condition and that they have little need for bank financing at present. Progress payments are given the major share of the credit for the strong liquid positions of these contractors. And, the interviewed executives also feel that the outlook for these companies — especially in the aerospace industry — is quite strong.

Loans to defense contractors run the gamut from aerospace to shipbuilding to electronics, and to a variety of other less common types of business. Most of the banks supplying information on this point, however, tend to have their business concentrated in only one or two of these areas. Only 3 of them report that they have loans outstanding in all 4 sectors.

Attitudes Toward Defense Contractors' Loans

The surveyed bankers were asked to express their overall attitudes toward loan business with defense contractors and subcontractors. And, they also were asked to indicate the reasons for their opinions. Their responses are summarized in the following tabulations:
<table>
<thead>
<tr>
<th>Reason for Welcoming Contractors' Business (Number of Mentions)</th>
<th>As to Prime Contractors</th>
<th>As to Sub-Contractors</th>
</tr>
</thead>
<tbody>
<tr>
<td>Satisfactory collection experience</td>
<td>16</td>
<td>13</td>
</tr>
<tr>
<td>Good profitability of loans</td>
<td>12</td>
<td>9</td>
</tr>
<tr>
<td>Less risky than commercial loans</td>
<td>2</td>
<td></td>
</tr>
<tr>
<td>Lenders should support defense effort</td>
<td>2</td>
<td></td>
</tr>
<tr>
<td>Favorable industry outlook</td>
<td>1</td>
<td>1</td>
</tr>
<tr>
<td>Improve relations with other customers</td>
<td></td>
<td>1</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Reason for Disliking Contractors' Business (Number of Mentions)</th>
<th>As to Prime Contractors</th>
<th>As to Sub-Contractors</th>
</tr>
</thead>
<tbody>
<tr>
<td>Excessive reliance on one customer</td>
<td>14</td>
<td>15</td>
</tr>
<tr>
<td>Uncertain future of the industry</td>
<td>5</td>
<td>8</td>
</tr>
<tr>
<td>Riskier than commercial loans</td>
<td>3</td>
<td>4</td>
</tr>
<tr>
<td>Poor business practices of borrowers</td>
<td></td>
<td>2</td>
</tr>
<tr>
<td>Problems with government receivables as collateral</td>
<td></td>
<td>2</td>
</tr>
<tr>
<td>Require long-term commitment</td>
<td></td>
<td>1</td>
</tr>
</tbody>
</table>

**Loan Limits**

Loan limits to a single customer are possibly significant indicators of commercial bankers' attitudes toward lending to
defense contractors. The surveyed executives were queried on this point and 26 of the 27 respondents make no distinction in this respect between defense contractors and other borrowers. The one bank that does so considers the diversity and number of government contracts held by the applicant in setting a loan limit. Interviewed bankers who replied to this question state that their loan limits for all customers are set on the basis of prudent judgment and they vary from one borrower to another.

**Working Capital vs. Capital Equipment**

The surveyed bankers were also asked whether they make any distinction between loan applications for working capital purposes as opposed to borrowing to acquire new facilities. Here, the responses were more evenly divided: 14 bankers make no such distinction while 12 do so and one declined to answer this question.

Those who distinguish between loans for working capital and loans for facilities offered the following explanations:

- Bank policy is to lend only for working capital;
- Loans for acquisition of facilities depend upon the duration of the government contract (most are not long enough);
- The risk of longer term loans is higher;
- Banker believes progress payments should meet working capital needs;
- Banker carefully looks into sources of repayment;
- Resale value of facilities is critical;
- Working capital loans are required to have direct assignment of the contracts and field audits;
- Term and pricing of the loans differ according to the purpose.

**Information Requirements**

Bankers require a great deal of information from borrowers in order to evaluate a loan application. A list of categories of information was submitted to the surveyed executives and they were asked to rank the three categories that they consider of greatest significance (1-most important, 2-next in importance, etc.). The following tabulation summarizes their replies (including additional categories reported by the respondents that were not included in the original questionnaire):

<table>
<thead>
<tr>
<th>Category of Information</th>
<th>Total times Ranked</th>
<th>Ranking as to Prime Contractors</th>
<th>Ranking as to Subs</th>
</tr>
</thead>
<tbody>
<tr>
<td>Debt-equity ratio</td>
<td>16</td>
<td>3 2 3</td>
<td>2 3 3</td>
</tr>
<tr>
<td>Specific use of proceeds</td>
<td>16</td>
<td>4 2 3</td>
<td>2 1 4</td>
</tr>
<tr>
<td>Working capital requirements</td>
<td>16</td>
<td>1 6 1</td>
<td>2 5 1</td>
</tr>
<tr>
<td>Past experience as a contractor</td>
<td>16</td>
<td>6 3 -</td>
<td>5 1 1</td>
</tr>
<tr>
<td>Profit projection</td>
<td>14</td>
<td>2 4 3</td>
<td>- 3 2</td>
</tr>
<tr>
<td>Contract(s) terms</td>
<td>13</td>
<td>3 2 3</td>
<td>3 1 1</td>
</tr>
<tr>
<td>Repayment schedule</td>
<td>8</td>
<td>- 1 3</td>
<td>- 1 3</td>
</tr>
<tr>
<td>Progress payments</td>
<td>4</td>
<td>- 1 1</td>
<td>- 2 -</td>
</tr>
<tr>
<td>Amount of present debt</td>
<td>4</td>
<td>- - 2</td>
<td>- - 2</td>
</tr>
<tr>
<td>Cash flow projection</td>
<td>4</td>
<td>1 - 1</td>
<td>1 - 1</td>
</tr>
<tr>
<td>Historical profitability</td>
<td>4</td>
<td>1 1 -</td>
<td>1 1 -</td>
</tr>
<tr>
<td>Pricing</td>
<td>2</td>
<td>- 2 -</td>
<td>- - -</td>
</tr>
</tbody>
</table>

- 15 -
<table>
<thead>
<tr>
<th>Category of Information</th>
<th>Total times Ranked</th>
<th>Prime Contractors 1 2 3</th>
<th>Subs 1 2 3</th>
</tr>
</thead>
<tbody>
<tr>
<td>&quot;Capacity-credit-character&quot;</td>
<td>2</td>
<td>1</td>
<td>- - -</td>
</tr>
<tr>
<td>Duration of project</td>
<td>1</td>
<td>- - -</td>
<td>1 - - -</td>
</tr>
<tr>
<td>General financial condition</td>
<td>1</td>
<td>- - -</td>
<td>1 - - -</td>
</tr>
</tbody>
</table>

The commercial bankers were asked, in addition, whether, and in what ways, the information they demand from subcontractors differs from that required of prime contractors. Fourteen replied that there is no difference. Ten, however, stated that they require the following additional supporting data in the case of subcontractors:

- Information about the prime contractor;
- More emphasis on contract terms and information about progress payments from the prime contractor;
- Past performance and payment experience of the prime contractor;
- Number of subcontractors involved;
- Assignment of accounts receivable and/or the contract.

Three bankers did not respond to this question.

In addition to the information sought directly from the loan applicants, commercial bankers routinely obtain data from sources other than the applicant. Following are the types of information obtained independently:

- Direct inquiries to DoD or to the prime contractor (if the applicant is a subcontractor);
- Evaluation of the applicant's past performance on govern-
ment contracts;
- Information about the applicant's cost controls, planning procedures, financial position, and competence of management;
- Any other information thought pertinent to the applicant;
- Liquidation appraisal for fixed assets.

In the context of this study, one of the key questions is whether there are any significant differences in the information obtained and the evaluation criteria for defense contractor loans as opposed to regular commercial loans. The overwhelming response to this question from the surveyed banking executives (24 out of 27) is that there is no difference. The three bankers who differ from this consensus cite the following differences:

- More emphasis on the provisions of the contracts;
- Consideration of the applicant's past experience as a contractor;
- More detail is obtained if the applicant is not a quality risk.

Executives who were interviewed and who commented on their information requirements also stated that there are no significant differences in their banks concerning the information they obtain about defense contractor loan applicants.

Risk Premiums for Contractors' Loans

A related question is whether lenders impute an additional risk premium when establishing an interest rate for defense contractor loans. Twenty four out of 27 surveyed bankers do not require such a premium. Only 2 do so and one did not answer this
question. Of the two who replied in the affirmative, one charges a fraction over the prime rate and the other imposes a premium only when there are special administrative expenses involved in the loan.

Only one of the interviewed bankers stated that his institution charges a risk premium to defense contractors. He describes it as "slight" and says that it is much less at present than it was 8 or 9 years ago.

**Terms of Loans**

In setting the terms of defense contractor loans, four bankers report that their approach is the same as for loans to other customers. But, the others list special considerations that apply to contractors:

- Duration of the contract or contracts;
- Borrower's cash flow for repayment;
- Contractor's backlog;
- Purpose of the loan.

**Profitability Indicators**

The surveyed bankers were asked to state whether they consider profitability indicators (e.g., ROI or profit margin) to be higher or lower for defense contractors than they are for companies in commercial lines of business. Their answers are as follows:

<p>| | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Higher</td>
<td>9</td>
</tr>
<tr>
<td>Lower</td>
<td>3</td>
</tr>
<tr>
<td>Don't know</td>
<td>12</td>
</tr>
<tr>
<td>Depends on type of contract</td>
<td>1</td>
</tr>
</tbody>
</table>
Two of the interviewed bankers who commented on this point think that they are lower.

Most of the surveyed bankers consider profit margin as the most appropriate measure for discriminating within an industry in evaluating loan applicants; 19 of them favor this indicator. Three prefer cash flow; return on investment (ROI) and overall financial condition are preferred by 2 each. Two others each name historical performance and ability of perform the contract. One surveyed banker did not answer this question.

**Diversification**

Commercial bankers who were interviewed as well as those who participated in the mail survey were asked about their reactions to changes by contractors in their commitments to defense work. For example, some large contractors have made attempts to diversify into markets for civilian products.

The bankers participating in this study believe that attempts by contractors to diversify in this way immediately cause a caution light to flash. Several believe that managements of defense industry companies simply do not know how to transfer their skills to civilian markets; another points out that defense contracting is an entirely different world from the commercial market place and it is not reasonable to expect company managements to be proficient in both. Still another becomes uneasy when a borrower attempts to penetrate a business where it has no established track record.
Nevertheless, some of the interviewed bankers believe that diversification moves can be successful and desirable if the new venture is related to the company's principal business. Going into defense contracting is approved also if the company has the necessary capability.

In spite of the bankers' general reservations, however, some of them believe that diversification moves by defense contractors will accelerate because of the healthy financial condition that they presently enjoy.

**Adequacy of Financing**

A major objective of this study is to determine commercial bankers' perceptions of the adequacy of financing available to defense contractors, both now and in the future.

None of the bankers contacted in connection with this study (or for that matter, any other financial specialists who were interviewed) believes that the major defense contracting companies, as a group, have any serious financial problems at the present time. The high level of government spending on the defense build-up in recent years, DoD procedural changes, such as progress payment improvements, and various economy-wide tax incentives (accelerated depreciation, and use of the completed contract method of accounting for income tax purposes) have combined to provide ample liquidity. As a result, bankers and other interviewed executives believe that defense prime contractors have relatively little need at the present time for bank financing. What funds they demand are more likely to be for non-defense purposes such as acquisitions.
Several bankers add that their contractor customers have been paying down their indebtedness and, in general, are not highly leveraged.

The situation with regard to smaller companies, especially subcontractors, is not so clear. Subcontractors do not always share in the benefits of progress payments and their financial condition can vary widely from one company to another. One executive feels that, at least, the present condition of subcontractors, as a group, is no worse than it usually is.

The bankers, commenting on the future adequacy of funding for defense contractors, do not see any serious problems cropping up in the near future. They expect the present high level of defense spending to continue — at least for the balance of the present administration. And, some expect the new Strategic Defense Initiative ("Star Wars") will provide a high level of spending for a long time to come. None of them believes that defense contractors are likely to be "crowded out" in any future needs for financing.

Nevertheless, some caution is in order despite the general optimism. Several interviewed bankers are apprehensive that some of the present favorable financial influences cited above could be curtailed or eliminated entirely. For example, tinkering with tax incentives is not looked on with favor. The same feeling prevails, of course, with regard to non-defense companies. And, some believe there is always a possibility that anti-contractor sentiment could bring about a significant modification in the present system of progress payments.
Effects of Recent Changes in Contracting Procedures

Banking executives who were interviewed in connection with this study, and who have been involved with lending to defense contractors for about the last ten years, report that the environment of the business has changed greatly during that time and, as a result, their own perceptions are considerably different. As one of them observes, the industry was "flat on its back" a decade ago and now it is healthy. While a great deal of the credit for this transformation must be given to the higher level of spending by the Federal government on the defense program in recent years, there are a number of other factors that contribute to the present financial well-being of the contracting industry.

The most frequently mentioned recent amendments in procedures and the attitudes and perceptions of the participating banking executives concerning them will be presented in the ensuing discussion of:

- Increased Progress payments;
- Recognition of facilities capital;
- Multi-year contracts.

**Increased Progress Payments**

Progress payments, wherein defense contractors can present bills to the government for between 90% and 100% of their costs as incurred under fixed price contracts, are an important innovation in the defense contracting environment. Bankers are very much aware of the existence of this benefit to contractors. Of the 27 survey responses, only one did not know of its existence and one
other did not reply to this question.

The responding bankers regard progress payments as very important in strengthening a contractor's cash flow and working capital position (the most frequently cited benefit). Some others feel that these payments simply improve the outlook for contracting. One banker laments that progress payments reduce the banks' lending opportunities. And, three respondents say that such payments have no effect on their perceptions of contractors' financial soundness.

When asked how important they would regard small changes in the government's progress payment policies, the surveyed bankers replied as follows:

- Moderately important 15
- Very important 6
- Of slight importance 5
- No response 1

27

The bankers also were asked for their reactions in the event progress payments to a specific contractor were suspended because of unsatisfactory product quality. The most frequently stated reaction is that such a suspension is appropriate and that the government should not pay for unsatisfactory work. Some others regard this development as serious enough to cause re-examination of their relationship with the borrower or even to suspend financing as well. Some others replied that this is simply one of the risks of the defense business which affects the lender as well as the contractor.
The surveyed banking executives also were asked whether they believe progress payments largely provide for a contractor's or subcontractor's working capital needs and that bank loans generally are obtained primarily for investment in facilities and to back up commercial paper. Their replies are as follows:

- No.............. 11
- Yes.............. 7
- Don't know...... 4
- No response..... 4

One banker stated that it depends on the nature of the contract.

Recognition of Facilities Capital

An important pricing policy change, introduced since 1976, is the recognition of facilities capital used on a contract. This provision is in two forms. An imputed cost of capital is now an allowable contract cost, and the formula for developing an appropriate profit includes an allowance based on capital employed. Together, they make facilities capital a major factor in contract pricing.

It is somewhat surprising that a high percentage of surveyed bankers (12 out of 27) were not aware of the recognition of facilities capital in pricing. Most of the respondents regard the recognition of facilities capital as a positive development from the lender's point of view. They believe that it is an aid to the contractors' profitability and improves their financial stability. On the unfavorable side, some bankers say that it might result in payments to some contractors without commensurate benefit to the government.
Seven respondents say that recognition of facilities capital has little or no effect on their perceptions of the defense contracting business.

The interviewed bankers who commented on this point view the changes favorably; but one of them feels that it is not a matter of great importance.

On a related issue, the bankers were asked for suggestions as to how DoD might influence contractors to invest in more cost-saving facilities and to improve operating efficiency. The two most frequently offered recommendations are to provide additional profit incentives for contractors who make such improvements and to widen the system of competitive bidding (emphasizing responsible bidders, of course). Other suggestions include: more tax credits, enforcing limits on cost overruns, allowing interest expense as a cost of doing business, and improving government audit procedures by better coordination among audit agencies.

Multi-year Contracts

Multi-year contracts, in place of annual contracts are favored by many people who are acquainted with the government contracting business because they believe such agreements permit contractors to plan more effectively, operate more efficiently, and provide products at lower cost to the government.

The interviewed bankers who commented on this point are in favor of such multi-year contracts because they reduce the uncertainty of the defense business and increase the contractors' backlogs — which the bankers like. Some of these bankers are
convinced that greater use of multi-year contracts is in the best interests of both contractors and the government.

The surveyed bankers were asked whether the availability of multi-year contracts has influenced their perceptions of the financial soundness of their defense contractor borrowers. Their replies:

Yes 13
No 11
No response 3

In addition, they were asked whether these multi-year contracts have reduced uncertainty to any degree. Their responses are as follows:

Yes 18
No 6
No response 3

Other Matters

The interviewed bankers and the survey participants were queried on several other matters concerning the defense contracting industry and their responses are summarized in this section.

Government Ownership of Facilities

The participating bankers are overwhelming opposed to government ownership of defense production facilities. The only circumstances in which they see such ownership justified are a national emergency (war) or if there are serious security reasons.
No respondent favors government ownership as a general principle.

**Overpriced Parts and Fraud**

The surveyed bankers are fairly evenly divided on the question of whether recent publicity about spare parts pricing, alleged fraud and kickbacks on the part of some defense contractors affects their perceptions of the risk in lending to the defense industry. Fourteen respondents say it does affect their perceptions; 11 reply that it does not; and 2 did not answer this question. Those who are affected feel that integrity (character-capacity-credit) is a vital part of the lending relationship and that revelations of wrongdoing damage this relationship. Those who hold the opposite view believe that a certain amount of dishonesty is widespread in business, not only in the defense industry; and the allegations are probably exaggerated for political reasons.

Two of the interviewed bankers also commented on this point. One believes that such publicity only adds to the already low esteem in which many investors hold the defense industry. But, the other feels it is healthy for all concerned to bring these charges out into the open and deal with them.

**Proposed Tax Changes**

The bankers who responded to the survey questionnaire are about evenly divided in their reactions to recently proposed changes in Federal income tax policies (those involving longer asset lives, reduced investment credits, and modification of the completed contract method of accounting). Twelve executives reply that such changes would affect their perceptions of the desirability
of loans to defense contractors. The reasons are that these changes would adversely affect cash flows and profits. On the other hand, 10 bankers do not believe these proposed changes would affect their perceptions — mainly because they would apply to all industry sectors, not only to the defense contracting business. Five bankers did not reply to this question.

Recommendations by Study Participants

The survey participants were asked to suggest changes in DoD policies and regulations that might help in meeting the government's objectives of ensuring the effective use of public money while, at the same time maintaining the financial health of the defense contracting industry. Most of the respondents declined to answer this question citing their role as bankers with insufficient knowledge of government procedures and regulations. However, a few did offer the following recommendations:

- Implement the Grace Commission proposals;
- Provide incentives for efficiency and cost savings;
- Reduce contractors' risks on highly specialized R&D work;
- Resolve disputes more quickly, thereby reducing costs;
- Improve profit margins of smaller contractors;
- Increase amount of qualified competitive bidding;
- More consistent enforcement of regulations;
- Reduce escalation of allowable overhead rates.

Some of the interviewed executives in the large New York banks also offered a few specific recommendations and comments:

- Avoid tinkering with recent procedural changes (especially
progress payments). They have not been in place long enough to know whether changes are really needed;

- "Hand-to-mouth" procurement should be replaced by longer-term contracts;

- Reconsider cost-plus contract pricing. It is potentially wasteful because it does not sufficiently motivate contractors to control costs;

- The military establishment needs to improve its credibility. One way to do this is to curb the appetite for "everfancier" hardware (goldplating);

- The present rotation policy for high level military officers needs to be re-examined;

- Congress should be encouraged to exercise more oversight of the defense program and be less directly involved. The banker who suggested this realizes it is idealistic and probably unattainable but feels that it would improve efficiency and reduce costs if it could be accomplished.

Going beyond these recommendations, the interviewed banking executives expressed concern over several things. One is the poor public image of defense contractors. They say that "defense" is a dirty word to many people, the press conveys the impression that the taxpayers are being cheated, and the public gets upset if contractors make money. The result is that the cost of equity capital for defense contractors is increased and this, in turn, increases the cost of military procurement.

Another cause for concern is the "feast or famine" atmosphere
in which the defense industry operates. While the prospects are
good now, the bankers are very aware of the possibility that the
political climate could change drastically and return the industry
to its former distressed condition.

Some bankers feel uneasy about the continuation of certain
financial benefits that defense contractors presently enjoy,
specifically, the rate of progress payments and the completed
contract method of tax accounting. One New York banker declares
flatly that elimination of these aids would put large contractors
into an unsustainably high degree of leverage.
LIFE INSURANCE COMPANIES

Life insurance companies constitute an important source of longer-term financing for many sectors of industry, including defense contractors. A total of five life insurance companies granted interviews for this study. Four of them fall into the very large category of insurers and all four have investments in defense contracting companies. The fifth, a moderate-size firm, has a very small commitment to this business and its spokesman stated that it is primarily the largest insurance companies that invest in the defense industry. In all, five executives were interviewed -- one from each company.

Extent of Involvement With Defense Contractors

Three of the five insurance company executives are involved with lending and another is in charge of his firm's equity portfolio. The lending officers report that their commitments to companies in the defense industry -- although substantial in terms of dollars -- is not great in relation to their total portfolios. Less than 5% is the level reported by two companies and "modest" is reported by the third. The equity commitment in the fourth insurance company is 4-6% of the company's common stock portfolio. This company's spokesman says that this proportion is somewhat higher than the 3% of the S&P index that is made up of defense contractors' stocks.

Life insurance companies are big players in the private placement market. One of the interviewed executives says that in a business as volatile as defense products manufacturing, management
likes to be in a position to revise borrowing covenants quickly, if necessary. Private placements offer the possibility of doing this because the relatively few lenders who are involved are highly sophisticated and usually willing to be flexible. In contrast, changing bond indentures in public offerings is virtually impossible.

Perceptions of the Defense Industry

The interviewed insurance company executives are unanimous in their favorable attitudes toward investments in defense contracting firms. They feel that prospects for the industry are bright because of the present defense build-up and they consider that the political climate is favorable for a continuation of this trend. Right now, the risk inherent in the business caused by dealing with a single customer is relatively low, although it is unquestionably higher than in the case of companies operating in civilian markets. One executive, commenting on this point, believes that subcontractors may have less risk than primes because they tend to subcontract on a number of projects with different prime contractors, thereby diversifying their exposure.

Another executive points out that some contractors are vulnerable because of their involvement with programs having an uncertain future, citing the MX missile as an example.

But, a lending officer with many years of experience declares that he does not recall ever having a troubled loan with a defense contractor, even though such loans are usually for periods of up to 20 years.
Criteria for Lending or Investing

The participating executives who are responsible for lending to defense contractors have pretty much the same criteria for evaluating these companies as they do for ordinary commercial borrowers. For example, security is of paramount importance; the lender wants to be paid back in accordance with the terms of the loan. Also, the lender is concerned with the current condition of the industry and its outlook. Naturally, it also pays close attention to "fundamentals" such as the applicant's financial condition, the results of ratio analysis, the quality of its management, and the state of its labor relations.

Considerations peculiar to the defense industry center around the specific programs and contracts that the loan applicant is involved in. Insurers carefully examine the duration of contracts because they like the maturity dates of their loans to correspond with the completion of contracts or programs.

The prior record of the borrower is another important factor, both as to his defense contracting experience and also as to his history of repaying previous loans. One lending executive, commenting on subcontractors, states that the considerations in lending to these companies do not differ much from those applying to prime contractors.

Interest Rates

One lending executive commented on the question of risk premiums in setting interest rates for defense contractors. He states very positively that his company does not impute such premiums
because interest rates are market-driven, and, despite the large
size of his company, it must be competitive in this area if it
wants defense contractors' business. Furthermore, he feels that,
in general, companies in the defense business are no more risky
than ordinary commercial borrowers.

Effects of Procedural Changes

Two of the insurance company executives offered their opinions
on certain changes that have taken place in the defense contracting
environment during the last 10 years: progress payments, multi-
year contracts, recognition of facilities capital, fixed price plus
incentive contracts, etc. One of the executives believes strongly
that these developments are all positive factors that strengthen
the defense contracting industry, especially in comparison with
their situation some years ago when the contractors' problems were
much more severe.

The other executive, who is in charge of his company's equity
portfolio, agrees that these things are improvements and he keeps
informed about them, but he does not consider them to be of out-
standing importance from the viewpoint of an equity investor. He
points out that these things affect all of the companies in the
industry and his job is to look for developments that would work to
the advantage or disadvantage of individual firms and thereby
affect the prices of their stocks.

Effects of Adverse Publicity

Two of the interviewed executives have strong feelings about
allegations of fraud and dishonesty that have recently been leveled
against some defense contractors. One lending officer asserts that he would not want to be associated with such contractors because he feels that it would reflect unfavorably upon any lender who would finance these firms. And the other executive declares that he would not purchase the stocks of such firms for his company's portfolio.

**Diversification**

One of the insurance company lending officers commented about the attempts by some defense contractors to diversify into civilian markets. He admits to having ambivalent feelings about this development. Naturally, he thinks it is a good idea for a company to lessen its dependence on government work. But, he would worry about "how big a bet" the company proposed to make in order to diversify. In short, he prefers to see gradual moves toward diversification because defense contractors have had a lot of trouble in the past in transferring their skills to non-governmental activities.

**Recommendations by Participants**

Some of the interviewed executives made recommendations for improvements in the defense contracting business. Most were rather general, e.g., continuation of improvements already in place, reduce design changes, and eliminate inter-service rivalries that run up the cost of military hardware.

More specifically, they favor greater use of multi-year contracts because this would result in better planning, smoother production runs, lower unit costs, and greater profit potential.
VENTURE CAPITAL FIRMS

Venture capital firms sometimes provide financing for companies in the defense industry. These government contractors typically are suppliers of defense electronics products and they have branched into government contracting as an outgrowth of the expertise they have developed in civilian markets. Furthermore, these contractors are far removed from the corporate giants who obtain their financing from the large commercial banks and other financial intermediaries previously discussed in this report. The contractors who do business with venture capital firms generally are quite small and the dollar amounts of their financing deals are correspondingly modest: $500,000 to $2,000,000, as described by the participants in this study.

Executives of two companies that supply venture capital to firms in the defense electronics industry were interviewed in connection with this study. Both of them concentrate their efforts on companies that are past the start-up stage and are actually functioning but have not yet matured. These companies are typically subcontractors making components for some of the giant corporations in the industry. However, some of the smaller companies also have prime contracts of their own.

Condition and Outlook

The interviewed venture capitalists indicated that providing financing for companies in the defense industry is not presently a major part of their business, although they would be glad to have more of it. They feel that they can be a big help to these com-

- 36 -
panies by providing "up front" financing when it is most needed.

The executives consider their clients to be in fairly good financial condition and they regard the near-term outlook to be favorable. They say that progress payments are a great help to prime contractors but subcontractors are often denied the benefits of such payments because prime contractors are very grudging about passing them along.

One of the venture capitalists says emphatically that prime contractors will never share progress payments on development work. He adds, however, that a subcontractor often can persuade a prime contractor to be more generous when the subcontractor produces certain devices that are wanted very badly by the prime contractor.

Another factor that helps to keep the defense electronics industry healthy, according to one of the interviewed executives, is the exclusion of foreign competition because of security considerations.

Criteria for Investment

Both of the interviewed executives are very much concerned with the quality of management of the companies for which they provide financing. According to one of them however, the supply of capable managers is very thin at present in the defense electronics industry. And, he adds that critics' proposals to limit executive compensation in the government contracting field are a big mistake because such actions would only worsen the shortage.

In this and in most other respects, the criteria used to judge
defense-related ventures are not much different from ordinary commercial ventures.

However, one of the participants mentioned still another feature that he likes to see in a defense electronics company: a real and urgent need by the military forces for the components manufactured by the client. He considers it ideal when the product is so pressingly needed that there is no time for competitive bidding.

Recommendations by Participants

Only one of the participants offered a recommendation. He believes that efforts should be made to encourage more venture capital firms to get involved with the defense industry. He asserts that government contracting can be profitable for small contractors and, as a consequence, to venture capitalists as well. He believes that most venture capital firms do not understand the complexities of the defense business and the related government procedures and, as a result, they are reluctant to participate in such business.
INVESTMENT BANKING FIRMS

Investment banking firms play a key economic role in the process of assembling capital and channeling it into productive uses. They supply a number of important services for their corporate clients including: arranging long-term financing in which the securities of issuing corporations are sold and distributed to investors, providing financial advice to their clients, and planning and negotiating merger and acquisition deals.

The input to this study by investment bankers was not extensive, principally because their defense contractor clients have not recently needed much outside financing, mainly because of progress payments. Nevertheless, four executives from four New York investment banking firms were interviewed and their views are presented herewith.

General Perceptions of the Defense Industry

All of the investment bankers consider defense contractors to be in excellent financial condition at the present time, especially the top dozen or so firms in the industry. They have sufficient cash and are using it for debt reduction, acquisitions of other companies, adding to plant and equipment, increasing dividends, repurchasing stock, and reducing their liabilities for deferred taxes.

The contractors are considered to be profitable, managements are well regarded; and, according to one banker, all of the houses on the Street are anxious to accommodate them.

The outlook for these major firms is bright, according to the
investment bankers, and they can get all of the money that they want. Even allowing for Federal budget compromises, defense spending is expected to continue at a high level in the years immediately ahead.

One of the executives commented on the condition of smaller contractors, including subcontractors. He says that their situations vary all over the lot and they have to be assessed on an individual basis.

Problems

Defense contractors are not without their problems, however, in spite of the generally rosy picture outlined above. The investment bankers are aware that political influences could intervene to reduce defense budgets and, as a matter of fact, some believe that real annual growth of the industry is already tapering off. And, another executive is concerned about shortages of engineers and other technicians who are capable of dealing with so-called "Star Wars" technology. Another investment banker cites as problems: congressional interference, inter-service rivalries, and similar but competitive (and expensive) weapons systems.

Finally, political pressures to limit contractors' profits are always a threat to the industry. One of the bankers believes that defense contractors suffered through some bad times a few years ago and should not now be barred from enjoying the good ones.

Diversification

All of the investment bankers commented on efforts by defense contractors to diversify into non-government work and thereby reduce
their dependence on one large customer. It is somewhat surprising that none expressed either strong approval or disapproval of these efforts. As one of them sees it, such programs have to be judged on their individual merits.

Another participant predicts that some consolidation within the defense industry is likely, with some prime contractors absorbing subcontractors.
RATING AGENCIES

Independent investment rating agencies are similar to certified public accountants, another group of participants in this study, in their ability to adopt attitudes of independence and detachment from the companies under their scrutiny. In fact, it is their professional duty to have such a point of view; and, it is this characteristic that makes their input especially important in the context of this study.

Two of the major rating organizations were interviewed and a total of four of their executives -- 2 from each firm -- participated in the discussions.

General Impressions of Defense Contractors

The interviewed executives are in agreement that the defense contractors whose fortunes they follow are in pretty good financial condition at the present time and are at least on a par with industry in general. They have generally improved during the last ten years and the main reason is the present expansion in military hardware procurement.

Cash flows are regarded as adequate due to the system of progress payments that is presently in effect. These payments, according to the rating agency executives, have virtually eliminated the need for defense contractors to seek short-term bank financing.

Another element in the defense contracting picture that the rating agencies view with favor is the inflation protection that contractors enjoy because of the cost escalation features incorpor-
ated in present day contracts.

Although borrowing is largely unnecessary for working capital needs, two of the rating agency executives point out that some contractors have done long term borrowing for other purposes, such as to finance acquisitions and to diversify into civilian markets. The rating agency executives observe, however, that past attempts at diversification by contractors have been largely unsuccessful.

Further evidence of cash sufficiency is the fact that some contractors have been able to reduce debt and one contractor has repurchased some of its own common stock.

As far as the profit picture is concerned, the rating agency executives regard the performance of defense contractors as relatively modest compared with industry in general, although they are adequate in the context of defense contracting.

Some chronic problems of the industry continue to have a negative effect on contractors' profits, e.g., the cyclicality of the business depending upon the ebb and flow of political sentiment and international tensions and the risk of doing business with a single large customer. The interviewed executives believe these considerations are a major cause for the rather low esteem in which the investing public holds defense contractors and they account for the generally low price/earnings ratios of these companies' stocks.

The rating agency executives' view of subcontractors is not particularly pessimistic in comparison with some other groups that commented on this point. They observe that more companies are
attempting to get into the defense business, as subcontractors, to take advantage of the opportunities offered by the build-up. And, they add that stories about pressures exerted on subcontractors by prime contractors are somewhat exaggerated. They claim that military hardware subcontractors are not as hard-pressed as suppliers to the major automobile manufacturers, for example.

**Financing Outlook**

The interviewed executives do not foresee any problems as far as availability of financing for contractors is concerned. They warn, however, that any serious cutback in the availability of the completed contract method of accounting for income tax purposes (and the resulting deferred tax account balances) would force the defense industry to look for additional outside financing. The rating agency executives consider the deferred taxes accumulating in many contractors' balance sheets to be an important source of funds and some of them have come to regard these large credit balances as part of corporate capital.

**Investment in Facilities**

There has been a significant increase during the past 5 years in the investment in new facilities by defense contractors, according to the rating agency executives. The reason is the contractors' expectations of continued business. Another reason is a shift from cost plus as a basis for contract pricing to the fixed price plus incentives basis for production contracts. The rating agencies believe this change motivates investment in more efficient facilities.

The agency executives also think that government ownership of
defense production facilities can be a big help to contractors because it eliminates the risk of a contractor being left with an expensive but useless plant if the government suddenly terminates the program.

Criteria for Evaluation

Apart from close attention to the "fundamentals" of security analysis, such as examination of trends in cash flows, ratios, coverages, and other basic indicators, the rating agency executives stress certain other considerations in evaluating defense contractors. These are:

- **Diversity and priority of programs**: a company with numerous contracts in a variety of programs is more favorably regarded than one in only one or two large programs. Also, companies involved in programs that have an uncertain future (e.g., the MX missile) are less favorably regarded.

- **Management strategy**: it is considered to be a favorable sign if contractors are able to protect themselves from the vagaries of the defense business.

- **Cost control and efficiency**: companies that demonstrate ability to control costs and that are willing to spend money for technological advances that increase efficiency are favorably regarded.

- **Future prospects**: rating agencies are very sensitive to political influences that could affect the future prospects of the defense industry. These influences are considered more important than a company's historical performance.
Recommendations by Participants

The only recommendation that was offered by any of the rating agency executives is that multi-year contracts be more widely employed. They believe that the cost of military procurement could be reduced if large batches were produced. They also feel that some programs are stretched out for political reasons and this tendency increases costs.
SECURITY ANALYSTS

Security analysts have a rather different perspective from some of the other groups who were interviewed in connection with this study. Their main interest is to discover and recommend common stocks that will outperform the market. In contrast with commercial bankers and life insurance company lending officers, for example, who have continuing -- and sometimes very long term -- relationships with their borrowers, security analysts have little or no direct concern with the companies they follow. In this respect, they have a highly detached and frequently skeptical attitude toward these companies and their industries.

Four top level analysts with a group of large investment and money management firms were interviewed. All are specialists in the defense industry, with aerospace companies as their primary interest.

Perceptions of the Defense Industry

The security analysts are unanimous in their favorable appraisal of the present financial health of defense contractors. They cite these firms' highly liquid positions and favorable cash flows that result from large government defense budgets, progress payments, and the completed contract method of accounting. They also consider these companies to be profitable.

As far as recommending defense company stocks is concerned, only one analyst believes they are a good investment. He believes the prices of such stocks are still relatively cheap and, therefore, are good buys. Another analyst, however, takes the position that
such stocks are mere speculations and not investments; he cites the cyclicality and uncertainty of the business as his reasons and he feels that these characteristics make defense industry stocks less attractive than those of commercial businesses.

Three of the analysts observe that defense industry stocks have lower price/earnings ratios than those of companies in other industries; and they blame the uncertainty of the business for this phenomenon.

All of the analysts believe the outlook for the defense contracting industry for the next few years to be favorable. However, one of them believes that the peak of public support for high defense budgets has passed and that, as a result, the growth in spending for military hardware will level off.

Problems of the Industry

Despite their favorable appraisal of the financial health of the defense contracting industry and of its prospects, the interviewed security analysts cite a number of serious problems besetting some of these companies.

Not surprisingly, a poor public perception of defense contractors is considered to be a major problem and it has not been helped by recent bad publicity concerning spare parts prices. The analysts feel that defense contractors' public image has a depressing effect on the prices of their stocks.

Turning to the government's side of the problem picture, two of the analysts commented on the issue of dual sourcing. One believes that this is a good policy because it promotes competition. The
other disagrees, saying that dual sourcing freezes the state-of-the-art by keeping both suppliers reasonably content and inhibiting either from attempting a significant technological breakthrough.

Other criticisms leveled by the analysts at the government's role in defense management are:

- Manpower is not well utilized;
- There is too much proliferation of weapons systems that are only marginally different from each other;
- Congress mismanages the defense budget, adding a great deal of waste and extravagance by acceding to the demands of constituencies rather than concentrating on military needs and economic necessity.

Investment in Facilities

One of the analysts believes that until recently, not much investment in facilities was undertaken by defense contractors. He observes that there was overcapacity in the industry and, therefore, no need for investment.

Diversification

The two analysts who commented on the subject of diversification take a dim view of defense contractors' efforts to move into civilian markets because of the past unfavorable results of some companies' attempts along these lines. Nevertheless, one analyst predicts a quickening of the diversification pace in the near future because of the purchasing power that many contractors now enjoy. He concedes that, despite the experiences of some contractors, other companies have done rather well in their diversification programs.
ACCOUNTING FIRMS

Partners in major accounting firms who provide auditing and other accounting services to clients in the defense industry are in an unusually favorable position to assess the general situation of firms in that industry. In addition, CPAs are able to give an appraisal of the effects of certain rather technical developments that have been introduced in recent years such as the recognition of facilities capital in determining contractors' costs and profits and the likely results of recently proposed changes in Federal income tax laws.

Accordingly, four large accounting firms were asked to grant interviews for this study and a total of five partners of these firms participated in the interviews.

General Impressions of Defense Contractors

The interviewed CPAs are in agreement that major contractors are in pretty good shape at the present time — certainly much better than they were, say, ten years ago. Furthermore, because of the continuing expansion of the national defense budget and relatively mild inflation in the costs of materials and labor, the outlook for the future is favorable.

Their view of smaller contractors, and especially subcontractors, is not quite so optimistic; although one partner believes these smaller companies are in no worse shape than they usually are. Another CPA observes that some smaller contractors are failing to keep up with technological progress and he fears that this will result in a further weakening of their position.
Another CPA believes that the position of subcontractors is improving because the major prime contractors are now farming out more of their work. He explains that, when defense business is slow, primes tend to take work back into their own shops to keep their work forces intact. And, when an upswing comes along the subcontractors generally lag 2 or 3 years behind before they begin to enjoy prosperity.

One of the participating CPAs points to a situation that he regards as a negative factor in the outlook for contractors. He believes there is an attitude among some people in Washington that defense contractors are making too much money. One evidence of this is a move to have contractors bear more of the cost risk in new, state-of-the-art development programs. He points out that in these programs it is extremely difficult to predict what a prototype will cost to build and that contractors face a potential financial squeeze in such projects.

This CPA also believes that a change in the income tax law, several years ago, modifying the effects of the completed contract method of accounting for determining taxable income, is a negative factor in defense contractors' prosperity. He says that contractors had been able to defer hundreds of millions of dollars in taxes and this gave them funds to invest in new facilities. Under present law, not so much of this will be available. He believes this development is unfavorable but it is one that the industry can handle.
Adequacy of Profits

The interviewed CPAs are not enthusiastic about the profitability of defense contractors. As a group, they regard contractors' profits as barely adequate. One partner believes that, in relation to the risks involved they are not adequate at all.

Another partner reports a mixed picture. He believes that profits on production contracts are adequate. But, R&D, high-tech, state-of-the-art contracts often result in losses, or low profits at best. Too many of the latter, he believes, are on a fixed price basis and companies knowingly underbid on them in the hope that they will result in production contracts. He also points out that companies consciously accept high risk contracts in order to retain their engineering staffs and work forces.

Several of the CPAs observe that the investing public has a low opinion of the ability of defense contractors to generate superior profits under the profit guidelines imposed by the government (although one partner considers these guidelines to be more flexible than the public realizes). In any event, public perceptions of the defense industry tend to make the stocks of defense contractors rather unpopular and this is the reason for their low price/earnings ratios.

Incentives to Modernize Facilities

One of the basic questions addressed by this study is whether defense contractors are actually investing in modern, cost-efficient production facilities, and a closely related question is whether the incentives provided by the government in recent years to
motivate contractors to make such investments have had the desired effect.

The CPAs participating in this study believe that contractors are investing in facilities to the best of their ability. One partner says that his clients think the defense business will continue to be good and they are taking a long-term view by gearing up for continued growth. He believes that progress payments have helped greatly by releasing funds that otherwise would be tied up in inventories.

The study participants tend to segregate government-sponsored investment incentives into two groups: tax incentives provided by the Treasury Department and other incentives provided by the Department of Defense.

Tax incentives, of course, apply to industry in general and some of the CPAs believe they do not particularly favor defense contractors although they agree that these tax breaks do, in fact, encourage investment. They point particularly to tax rules which permit faster depreciation, and also to the investment tax credit, as strong investment motivators and they unanimously oppose proposals to modify these tax benefits because this will discourage business investment across the board. One partner points out that many procurement programs are state-of-the-art and long production runs are not assured. Therefore, contractors are reluctant to invest in expensive facilities. He believes that recently proposed tax law changes affecting the Accelerated Cost Recovery System (ACRS) and the Investment Tax Credit (ITC) are already having a negative
effect on defense contractors' capital investment plans.

Turning to investment incentives that are specifically designed to motivate defense contractors, the CPAs have rather mixed reactions. These investment motivators include Cost Accounting Standard (CAS) 414 which permits an imputed cost of facilities capital to be included in contract costs and the inclusion of a facilities-related factor in determining profit. The participating CPAs applaud these developments because they show that government recognizes the importance of capital in contract pricing. They are unanimous in their opinion that these provisions are important and should be retained. However, they also allege that, in practice, the recognition of facilities capital is often diluted.

The first culprit that they point to is CAS 409, which mandates longer depreciation periods for physical facilities. The partners believe that this ruling should be repealed because it counteracts the good effects of CAS 414. The CPAs are very strongly in agreement that faster depreciation is a powerful investment motivator.

A major obstacle to achieving the full benefits of the new recognition of facilities capital in pricing is the tendency of some contracting officers to evaluate profit objectives in percentages of total cost. One of the CPAs explains that the contracting officers seem to say in effect, "I know this contractor should get about 10% profit. If I allow the imputed cost under CAS 414, the profit on facilities capital, and all the regular mark-ups on estimated cost, the profit will climb to 13%; I will have to use
the lower ends of the guideline ranges to get back to 10%." So, the contractors perceive that they are no better off than they were before. This CPA concludes that, in theory, the recognition of facilities capital in pricing is a fine idea. But, as actually applied in the negotiating process, it does not provide any great incentive to invest.

On a related but somewhat different subject, the CPAs are not enthusiastic about government ownership of defense production facilities. Those who commented on this point believe that it will do nothing but increase the national defense budget.

The Completed Contract Method of Accounting

The participating CPAs noted the importance of the completed contract method of accounting for income tax purposes as a means of strengthening the financial position of defense contractors. Other participants in this study made this point also. Under the completed contract method, the contractor does not recognize the profit on a project until the work is completed and the profit can be accurately measured. This method contrasts with the percentage of completion method which permits the recognition of profit as various stages of the contract are completed. Both methods are acceptable under generally accepted accounting principles (GAAP) and companies in all types of industries where long-term projects are common (not only defense contractors) must make a choice as to which accounting method to use. A common practice for such companies is to adopt the percentage of completion method for the financial statements that they issue to their stockholders and
to use the completed contract basis for the purpose of preparing their income tax returns.

This choice permits the contractors to defer payment of their income taxes until a contract is fully completed and gives them substantial amounts of funds to add to their working capital. As noted earlier in this discussion, amendments to the tax law several years ago modified this benefit to some degree but it is still important.

One of the CPAs commented on the public criticism of the completed contract method as a "loophole" by which defense contractors escape from income taxation. He observes that corporate America as a whole pays very little income tax and he feels that the defense industry should not be singled out in respect to this issue.

**Progress Payments**

The participating CPAs believe that progress payments have been beneficial to defense contractors and that these companies are much better off, as a result, than they were some years ago. As one partner observes, "if companies perform within the limits of their contracts they are not greatly in need of bank financing."

The partners feel that progress payments are important because of the long-term nature of many defense projects and the size of the capital investment that is required. They also point out that in non-defense work where large projects are carried out (e.g., building civilian aircraft) advance payments and progress payments are the norm.

Progress payments are considered to be even more important to
small and medium-size defense contractors. However, one of the CPAs believes that some of these smaller contractors are disadvantaged by the practice of reducing the frequency of progress payments to once a month. He also points out that payment up to 30 days from billing is considered timely.

Spare Parts Pricing

The participating CPAs agree that in such a large undertaking as the current defense build-up, there is bound to be some waste and possible dishonesty. However, they believe that such situations have been exaggerated. One partner points out, for example, that the Inspector General, in 1983, issued a report on contractors' spare parts pricing policies and concluded that the dollar amount of unreasonable prices and the quantities of materials involved are small. Corrective actions were taken (Competition in Contracting Act of 1984 and changes in FAR regulations) to regulate the overhead a contractor can allocate to supplies.

The accountants point to the following influences as the causes of apparent overpricing by contractors:

- Overspecification or "gold plating" by procurement officials;
- Misinterpretations resulting from following CASB rules that specify how indirect costs must be allocated and also the tendency to view such allocations as unreasonable when taken out of context;
- Confusion as to how to price spare parts that accumulate substantial costs for storage and warehousing, apart from their intrinsic value.
Proposed Changes in Tax Laws

The interviewed CPAs are pretty much in agreement that the proposals for income tax reform put forth recently by the Treasury Department would be disincentives for all capital-intensive industry, including defense contractors.

They believe that limitations on accelerated depreciation and the investment tax credit would reduce incentives to invest in more efficient facilities. They add that limitations on the R&D credit would probably affect high-tech companies more than the defense industry. Of course, as one partner points out, there is some overlap because some big government contractors are also high-tech companies. He adds that, while contractors benefit somewhat from the R&D credit, it is not really great enough to motivate them to do much more R&D work than they would otherwise do.

Recommendations by Participants

Apart from general suggestions, echoed by many other interviewees, to "make defense procurement more businesslike," the cooperating CPAs had some specific recommendations to improve the relationships of defense contractors with the Department of Defense:

- Make greater use of multi-year contracts with fixed prices;
- Eliminate supplements (by DoD, NASA, and GSA) to the April 1984 Federal Acquisition Regulations (FAR);
- Reduce the amount of post-award policing of contractors (by GAO, DCAA, IG, etc.). This duplication only drives up costs without accomplishing much. Furthermore, it discourages managements from seeking defense business because
of the constant need to defend their actions.

- Other specific suggestions include increasing competitive procurement, educating small and medium-size contractors, and keeping cost accounting rule-making out of the hands of DoD.
APPENDIX

Interview Guide
Survey Questionnaire
Interview Guide for Meetings With Commercial Bankers

General Information:

1. Conference Board Interviewer ____________________________

2. Bank ____________________________
   Name ____________________________
   Address ____________________________ Zip __________________
   Telephone ____________________________

3. Names and titles of Executive(s) interviewed:
   ____________________________
   ____________________________

4. Date and time ____________________________

Introductory Remarks:

1. Objective of the study:

   To assist DoD in evaluating the financial health of the defense contracting industry. Conclusions of DoD may result in recommendations for changes in contracting procedures, possibly including new legislation.

2. We hope to elicit from you and other bankers your experience, opinions and perspectives about banking relationships with defense contractors as well as your recommendations for improving these relationships.

3. This study is authorized by the Deputy Secretary of Defense. The prime contractor is Logistics Management Institute, of Bethesda, Maryland. LMI is a nonprofit institution that provides management advice and develops management systems for agencies of the DoD as well as for other government agencies.

4. My employer, The Conference Board, is a subcontractor to LMI. It is a nonprofit institution also, headquartered in N.Y.C. (Ask if interviewee knows about TCB; if not, explain).

   (a) We are reporters; make no recommendations.

   (b) Confidentiality; no attribution.
5. Definition of defense contractor -
A prime contractor or subcontractor that:

(a) manufactures products or provides services unique to the mission of DoD on a negotiated contract basis; and

(b) whose involvement in defense contracting is sufficiently great that its fortunes are materially affected by DoD procurement policies and practices (would exclude companies like IBM or GM, for example).

Specific Questions:

1. (a) In general, how do you regard loans to defense contractors? (Check all that apply):

Welcome them because:

Less risky than commercial ideas
Collection experience has been satisfactory
Profitability of these loans is good
Duty of lenders to support the defense effort
Other (please specify):

Dislike them because:

Riskier than commercial loans
Unsatisfactory profitability of the industry
Uncertain future of the industry
Excessive reliance on a single customer
Poor business practices of contractors
Other (please specify):

(b) Approximately what percentage of your present portfolio consists of loans to defense contractors?

(c) Can you break down this total (by percentages) among industry groups?

Aerospace
Shipbuilding
Electronics
All other

100 %
(d) Are loan limits to a single contractor based on (please check all that apply):

- A percentage of total loan portfolio
- Geographical considerations
- Other (please specify)

__________________________
__________________________
__________________________

(e) Would these loan limits be different for commercial borrowers?

Yes  ____  No  ____

2. When a defense contractor applies for a loan, what major categories of information do you require? (Interviewer - ask about each of following):

- Debt/equity ratio
- Specific use of proceeds
- Contract terms
- Pricing
- Profit projection
- Duration of projects
- Repayment schedule
- Progress payments
- Depreciation
- Necessity for new facilities
- Working capital requirements
- Amount of present debt outstanding
- Past experience as a defense contractor
- Other (please specify):

__________________________

3. Do you make any distinction between loans for working capital purposes vs. loans to acquire new facilities?

Yes  ____  No  ____

Comments: ________________________________

4. What other information do you check out independently of the contractor? (Interviewer -- ask about each of the following):

- Direct inquiries to DoD or to the prime contractor
- Evaluation of applicant's past performance on government contracts
- Detailed analysis of the applicant's cost controls, planning procedures, financial position, competence of management, etc.
- Other (please specify):

__________________________
5. In approximate order of importance, what are the criteria used to evaluate the acceptability of the loan?

________________________________________________________________________
________________________________________________________________________
________________________________________________________________________
________________________________________________________________________

6. Are there significant differences in the information obtained and the evaluation criteria for defense contractor loans as opposed to regular commercial loans?

Yes ____ No ____

If yes, please explain __________________________________________________________
________________________________________________________________________
________________________________________________________________________

7. Are your present policies involving loans to defense contractors significantly different from those you followed 3, 5, or 10 years ago?

Yes ____ No ____

If yes, how and why? __________________________________________________________
________________________________________________________________________
________________________________________________________________________

8. (a) Has the availability of multi-year contracts influenced your perceptions of the financial soundness of your defense contractor borrowers?

Yes ____ No ____

(b) Have these multi-year contracts reduced uncertainty to any degree?

Yes ____ No ____

9. (a) Has the recent defense build-up influenced your perceptions of the instability or riskiness of the defense contracting industry?

Yes ____ No ____

(b) If yes, please explain:

________________________________________________________________________
________________________________________________________________________
10. (a) Do you believe that measures of profitability (e.g., ROI or profit margin) are higher or lower for companies in the defense contracting business, compared with strictly commercial businesses?

Higher ______  Lower ______  Don't know ______

(b) Which of these measures do you consider as the most relevant for evaluating defense contractors?

ROI ______  Profit Margin ______  Other (specify) ______

11. (a) Are you aware that an imputed cost of facilities capital is now an allowable factor for defense contractors in determining profit on contracts?

Yes _____  No _____

(b) What effect does this development have on your view of the financial soundness and profitability of defense contractors?

________________________________________________________________________

________________________________________________________________________

________________________________________________________________________

12. (a) Are you aware that defense contractors receive progress payments as they perform work for the government (e.g., they can present bills for between 90% and 100% of their costs as incurred under fixed price contracts?)

Yes _____  No _____

(b) What effect does this provision have on your perception of the financial soundness of defense contractors?

________________________________________________________________________

________________________________________________________________________

________________________________________________________________________

(c) How important are small changes in the government's progress payment policies?

Slight _____  Moderate _____  Very important _____

13. (a) Do you believe that progress payments largely provide for a contractor's working capital and that bank loans generally are obtained primarily for investment in facilities and equipment?

Yes _____  No _____  Don't know _____
(b) What is the basis for determining the term of loans to defense contractors?


(c) How does this differ from commercial loans?


14. (a) Do you regard leasing as more or less advantageous for defense contractors in comparison with commercial businesses?

More advantageous ______ Less advantageous ______

Don't know ______

(b) What is the trend of such leasing?

Increasing _____ Decreasing _____ Steady _____ Don't know _____

(c) What are the major advantages and disadvantages of such leasing? Why?


15. Some borrower's commitments to defense work change significantly from time to time. When a company sharply increases or decreases its percentage of government work (in relation to its total sales), what is your reaction?


16. (a) Do you impute an additional risk premium when establishing an interest rate for a defense contractor loan?

Yes _____ No _____

(b) If yes, how much (e.g., how much over loans to commercial borrowers)?


17. Under what circumstances would you favor government ownership of defense production facilities?


18. Can you suggest ways to influence defense contractors to invest in cost-saving facilities or improved operational efficiencies (e.g., multi-year procurement, more generous progress payments, more generous profit policy)?

General Questions:

19. A basic objective of the Department of Defense is to ensure the effective use of public money on defense projects while, at the same time, maintaining the financial health of the defense contracting industry. Can you suggest any changes in DoD policies and regulations that will help in achieving this objective?

Note to Interviewer:

During the interview, try to elicit (or note spontaneous) comments on any of the following matters, particularly as they might contain suggestions for changes that would advance the DoD's basic objective (noted in #25, above):

(a) Depreciation policies
(b) Interest as a cost
(c) Change orders
(d) Transferability of defense capabilities to commercial business
(e) Cancellations
(f) Competition
(g) Buy-ins (same as "low ball" pricing)
(h) Pricing of contracts (fixed fee, cost plus, incentives, escalation clauses)
(i) Continuing communications between DoD and contractors
(j) Cost overruns
(k) Allowability of incurred costs
(l) Uninsurable risks (e.g., Agent Orange)
(m) Suspension of progress payments where quality is unsatisfactory
(n) Does recent publicity about overpriced parts, fraud and kickbacks on the part of certain defense contractors affect your perception of risk in lending to the defense industry?
A SURVEY BY THE CONFERENCE BOARD, INC.
ATTITUDES OF BANKERS TOWARD DEFENSE CONTRACTORS

I - GENERAL INFORMATION

FOR THE PURPOSES OF THIS STUDY, A DEFENSE CONTRACTOR IS DEFINED AS A PRIME CONTRACTOR OR SUBCONTRACTOR THAT:

1. MANUFACTURERS PRODUCTS OR PROVIDES SERVICES UNIQUE TO THE MISSION OF THE DEPARTMENT OF DEFENSE ON A NEGOTIATED CONTRACT BASIS: AND

2. WHOSE INVOLVEMENT IN DEFENSE CONTRACTING IS SUFFICIENTLY GREAT THAT ITS FORTUNES ARE MATERIALLY AFFECTED BY DEFENSE DEPARTMENT PROCUREMENT POLICIES AND PRACTICES (THIS WOULD EXCLUDE COMPANIES SUCH AS IBM OR GENERAL MOTORS FOR EXAMPLE).

1. (a) Does your bank presently have loans outstanding with defense prime contractors and/or subcontractors?
   □ Yes □ No

(b) If not, have you made such loans during the past 5 years?
   □ Yes □ No

(If your answer to both questions is "no," please skip the remainder of this questionnaire, but we would appreciate your returning it to the above address. Thank you for your cooperation.)

2. (a) Approximately what percentage of your present portfolio consists of loans to defense contractors and/or subcontractors?
   __________%  

(b) Will you please break down this total (by approximate percentages) among industry groups?

<table>
<thead>
<tr>
<th>Industry</th>
<th>Percentage</th>
</tr>
</thead>
<tbody>
<tr>
<td>Aerospace</td>
<td>__________%</td>
</tr>
<tr>
<td>Shipbuilding</td>
<td>__________%</td>
</tr>
<tr>
<td>Electronics</td>
<td>__________%</td>
</tr>
<tr>
<td>All other</td>
<td>__________%</td>
</tr>
</tbody>
</table>


3. In general, what is your bank’s policy regarding loans to defense contractors and subcontractors? (Check all that apply):

<table>
<thead>
<tr>
<th>We welcome them because:</th>
<th>As to Prime Contractors</th>
<th>As to Subcontractors</th>
</tr>
</thead>
<tbody>
<tr>
<td>Less risky than other commercial loans</td>
<td>□</td>
<td>□</td>
</tr>
<tr>
<td>Collection experience has been satisfactory</td>
<td>□</td>
<td>□</td>
</tr>
<tr>
<td>Profitability of these loans is good</td>
<td>□</td>
<td>□</td>
</tr>
<tr>
<td>Lenders should support the defense effort</td>
<td>□</td>
<td>□</td>
</tr>
<tr>
<td>Other reasons (please specify)</td>
<td>□</td>
<td>□</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>We dislike them because:</th>
</tr>
</thead>
<tbody>
<tr>
<td>Riskier than other commercial loans</td>
</tr>
<tr>
<td>Unsatisfactory profitability of the industry</td>
</tr>
<tr>
<td>Uncertain future of the industry</td>
</tr>
<tr>
<td>Make for excessive reliance by the contractor on a single customer</td>
</tr>
<tr>
<td>Poor business practices of companies in the industry</td>
</tr>
<tr>
<td>Other reasons (please specify)</td>
</tr>
<tr>
<td></td>
</tr>
</tbody>
</table>

In general: (please check only one in each column:)

| We welcome them more than we dislike them | □ | □ |
| We dislike them more than we welcome them | □ | □ |

II - CONSIDERATIONS IN GRANTING LOANS TO CONTRACTORS AND SUBCONTRACTORS

4. (a) Are loan limits to a single contractor (other than those prescribed by law or regulation) based on (please check all that apply):

- □ A percentage of your total loan portfolio
- □ Geographical considerations
- □ Other (please specify):

(b) Are these loan limits different for regular commercial borrowers?

- □ Yes
- □ No

(c) If yes, please explain:

5. Do you make any distinction between loan applications from defense contractors and subcontractors for working capital purposes and for loans to acquire new facilities?

- □ Yes
- □ No

If yes, please explain:
6. (a) When a defense contractor applies for a loan, what major categories of information do you require? (Please check all that apply and rank the three that you consider most significant in the order of their importance; 1—most important, 2—next in importance, etc.):

- [ ] Debt equity ratio
- [ ] Specific use of proceeds
- [ ] Contract(s) terms
- [ ] Pricing
- [ ] Profit projection
- [ ] Duration of project
- [ ] Repayment schedule
- [ ] Progress payments
- [ ] Depreciation
- [ ] Necessity for new facilities
- [ ] Working capital requirements
- [ ] Amount of present debt outstanding
- [ ] Past experience as a defense contractor
- [ ] Other (please specify):

<table>
<thead>
<tr>
<th>Prime Contractors</th>
<th>Subcontractors</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
</tr>
</tbody>
</table>

(b) Please indicate in what ways, if any, the information you require from subcontractors differs from that required of prime contractors:

- [ ] No difference (check if applicable)
- [ ] Differs as follows (please specify):

7. What other information do you check out independently of the applicant? (Please check all that apply):

- [ ] Direct inquiries to DoD or to the prime contractor (if the applicant is a subcontractor)
- [ ] Evaluation of applicant’s past performance on government contracts
- [ ] Analysis of the applicant’s cost controls, planning procedures, financial position, competence of management, etc.
- [ ] Other (please specify):

8. Are there significant differences in the information obtained and the evaluation criteria for defense contractor loans as opposed to regular commercial loans?

- [ ] Yes  [ ] No

If yes, please explain:

[ ]
9. (a) Do you customarily impute an additional risk premium when establishing an interest rate for a defense contractor loan?

☐ Yes    ☐ No

(b) If yes, how much (e.g., how much over loans to regular commercial borrowers)?

(c) What is the basis for determining the term of a loan to a defense contractor?

10. (a) Do you believe that measures of profitability (e.g., ROI or profit margin) are higher or lower for companies in the defense contracting business, as compared with strictly commercial businesses?

☐ Higher    ☐ Lower    ☐ Don’t know

(b) Which of these measures do you consider to be the most appropriate for evaluating defense contractors and subcontractors as loan applicants? (Please check only one):

☐ ROI    ☐ Profit Margin    ☐ Other (please specify)

11. Some borrowers’ commitments to defense work change significantly from time to time. When a company sharply increases or decreases its percentage of government work in relation to its total sales, what is your reaction?

12. (2) Are your present policies regarding loans to defense contractors and subcontractors significantly different from those you followed 3, 5 or 10 years ago?

☐ Yes    ☐ No

(b) If yes, how and why

13. (a) Has the availability of multiyear contracts influenced your perceptions of the financial soundness of your defense contractor borrowers?

☐ Yes    ☐ No

(b) Have these multiyear contracts reduced uncertainty to any degree?

☐ Yes    ☐ No

14. (a) Has the defense buildup since 1979 influenced your perceptions of the stability or riskiness of the defense contracting industry?

☐ Yes    ☐ No

(b) If yes, please explain:
15. (a) Are you aware that under existing cost accounting standards, an imputed cost of facilities capital is now an allowable cost for defense contractors in determining profit on contracts as well as a factor in determining profits?

☐ Yes    ☐ No

(b) What effect does this development have on your view of the financial soundness and profitability of defense contractors?

__________________________________________________________________________

16. (a) Are you aware that defense contractors receive progress payments as they perform work for the government (e.g., they can present bills for between 90% and 100% of their cost as incurred under fixed-price contracts)?

☐ Yes    ☐ No

(b) What effect does this provision have on your perception of the financial soundness of defense contractors?

__________________________________________________________________________

(c) How important are small changes in the government’s progress payment policies? (Please check one):

☐ Slight    ☐ Moderate    ☐ Very Important

(d) Please comment on your reaction to the suspension of progress payments to specific contractors if the quality of their products, is unsatisfactory:

__________________________________________________________________________

17. Do you believe that progress payments largely provide for a contractor’s or subcontractor’s working capital and that bank loans generally are obtained primarily for investment in facilities and equipment and to back up commercial paper?

☐ Yes    ☐ No    ☐ Don’t know

18. Under what circumstances would you favor government ownership of defense-production facilities?

__________________________________________________________________________

19. What other ways would you suggest for the Department of Defense to influence defense contractors to invest in cost-saving facilities or improved operational efficiencies?

__________________________________________________________________________

20. A stated objective of the Department of Defense is to ensure the effective use of public money on defense projects while, at the same time, maintaining the financial health of the defense-contracting industry. Can you suggest any changes in DoD policies and regulations that will help in achieving this objective?

__________________________________________________________________________

__________________________________________________________________________

__________________________________________________________________________
21. (a) Do you regard leasing of facilities and equipment by defense contractors and subcontractors as more or less advantageous in comparison with commercial enterprises?
   □ More advantageous  □ Less advantageous  □ Don't know

   (b) What is the trend of such leasing?
   □ Increasing  □ Decreasing  □ Steady  □ Don't know

   (c) What are the major advantages and disadvantages of such leasing?
   _______________________________________________________________________
   _______________________________________________________________________

22. Does recent publicity about overpriced parts, fraud and kickbacks on the part of certain defense contractors affect your perception of risk in lending to the defense industry?
   □ Yes  □ No

   Comments: _______________________________________________________________________
   _______________________________________________________________________

23. (a) Would any of the recently proposed changes in Federal income tax policy (those involving longer asset service lives, reduced investment credits, and modification of the completed contract method of accounting) affect your perception of the desirability of loans to defense contractors?
   □ Yes  □ No

   (b) If yes, please explain _______________________________________________________________________
   _______________________________________________________________________

24. Please supply the following information:
   Name and title of executive completing this questionnaire: _______________________________________________________________________

   Name of institution: ____________________________
   Address: ______________________________________
   _______________________________________________________________________
   _______________________________________________________________________
   Zip: ____________________________

IF THERE ARE ANY OTHER MATTERS THAT YOU THINK WE SHOULD KNOW ABOUT REGARDING BANKERS' RELATIONSHIPS WITH DEFENSE CONTRACTORS AND SUBCONTRACTORS, PLEASE STATE THEM IN ANY WAY YOU WISH IN THE SPACE PROVIDED AT THE END OF THIS QUESTIONNAIRE.

On behalf of the Department of Defense, the Logistics Management Institute, and the Trustees and staff of The Conference Board, we thank you for participating in this project. We believe the results of this study will help significantly in providing for our nation's defense needs at a cost that can be afforded.