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Standard Form 298 (Rev. 8-98)  
Prescribed by ANSI Std Z39-18
DoD Strategy Document Take Aways…

• **Two major thrusts**
  - The Long War against terrorist extremists
  - Dissuade near peer competitors – possess unquestioned military superiority so that armed conflict is unthinkable

• **Service moves**
  - Marines – lighter, fill in SOF roles
  - Army – more expeditionary, lighter, more trigger pullers
  - Navy – swap capital for labor, focus on the Pacific
  - Air Force – the near peer insurance policy

• **Will have to be accomplished in resource constrained environment**
Market Implications…

“Bar-bell” Shaped Markets

“Slice” #1

The Long War: rapid acquisition,
Off the shelf/short development,
quick response is key, COCOM centric

“Slice” #2

Dissuade: very long cycle,
Technology development, platform
oriented but limited production, service
centric

Reset/Retrofit: Install “black boxes”
in existing equipment to improve and
“plug into network”

Transformation: Desire for large,
horizontally integrating networks,
leverage the IT revolution
The Lifecycle of the Technology/Industry Sector…

- **Entry and experimentation** (S&T)
- **Emergence of standard/dominant design** (System Development)
- **Shakeout** (Produce/Upgrade)
- **Stability/Decline** (Sustain/retire)

Product Innovation

Process Innovation

Fewer Competitors
Where You Are in the Lifecycle...

Networks
Directed Energy
Robotics
Hybrid

Emergence of standard/dominant design
(System Development)

Sensors
Vertical Lift
Avionics

Entry and experimentation
(S&T)

Light launch

Defense Elec.

Heavy launch
Heavy ships

Manned, Fixed wing Fighters

Shakeout
(Produce/Upgrade)

Stability/Decline
(Sustain/retire)

Restart the cycle

Caveat – fight wars with the military you have
And Solutions/Incentive Structures…

Key Actors
- Gov’t, Academia
- FFRDC, industry (Skunk Works, UAV)
- Industry (in production)
- Industry, depot yard, arsenal

H.C.
- Scientists
- Engineers
- Manufacturing
- Support/logistics

Market Dynamic
- Competition
- Negotiation/partnership

Financial
- Growth
- Margins
- ROIC

Investors
- Growth
- GARP
- Value
The Cost-To-Capability Curve “Going Asymptotic”...

- Two choices
  - Brutal focus on efficiency/process innovation
  - Restart the cycle/move to a new curve/product innovation
Heart of the Industry…

Entry and experimentation (S&T) → Emergence of standard/dominant design (System Development) → Shakeout (Produce/Upgrade) → Stability/Decline (Sustain/retire)

Key issue – relationship between government and industry (LSI’s, etc.)
Dynamic, innovative, active...

- Entry and experimentation (S&T)
- Emergence of standard/dominant design (System Development)
- Shakeout (Produce/Upgrade)
- Stability/Decline (Sustain/retire)
Industry Financial Performance and Strategies
Why Care About Wall Street?

In the last 20 years, financial markets have provided 40-80% of the capital needed to operate...

Defense Industry Cash Inflows (Percent), 1980-2005

Sources: FactSet, S&P Compustat, Annual Reports, CSIS Analysis
Overall Defense Industry Margins Near Highs.

CSIS Defense Index Average Operating Margin (weighted by revenue),
1980-2005

Sources: FactSet, Company Reports, CSIS Analysis.

Note: CSIS Defense Index comprises 36 publicly-traded companies with majority revenues derived from US defense business. Boeing Military results have also been included here.
From A Return Standpoint, Second Tier Does Better…

Operating Margin by Company Type (weighted by revenue), 1980-2005

Sources: FactSet, S&P Compustat, Company Reports, CSIS Analysis.

Note: CSIS Defense Index comprises 36 publicly-traded companies with majority revenues derived from US defense business. Boeing Military results have also been included here.
However, Compared to Its Peers the Defense Industry Has the Lowest Returns…

Industry Average Operating Margin, 1980-2005 (weighted by revenue)

Sources: FactSet, S&P Compustat, Energy Information Administration, Company Reports, CSIS Analysis.

Notes: 1) CSIS Defense Index comprises 36 publicly-traded companies with majority revenues derived from US defense business. Boeing Military results have also been included here.
When Actually Measured, Volatility of the Defense Market is Higher Than Conventional Wisdom...

Industry Revenue Volatility, 1980-2005

Sources: FactSet, S&P Compustat, Energy Information Administration, National Defense Budget Estimates for FY2004, CSIS Analysis

Notes: 1) CSIS Defense Index comprises 36 publicly-traded companies with majority revenues derived from US defense business. Boeing Military revenues have also been included here.
(2) S&P Sub-sector constituents accurate back to 1994; composition held constant for years 1980 to 1993.
Policy Realities Leave Industry With Few Levers to Pull…

If margins cannot be increased, then lower volatility – multi-years, O&M, political

Industry Revenue Volatility versus Average Operating Margin, 1980-2005 (weighted by revenue)

Financial Response to the Policy and Market Realities...

Defense Industry Cash Outflows (Percent)

- Equity Buybacks
- Cash Dividends
- Debt Reduction
- Net Interest
- Acquisitions
- Capex - Investment
- R&D
- Other

Sources: FactSet, S&P Compustat, Energy Information Administration, Congressional Reports, CSIS Analysis
With This Strategy Industry “Returned To the Line” and Retained the Interest of Investors ...

Industry Revenue Volatility versus Cash Flow Return on Investment (HOLT CFROI) 1987-2005 (weighted by invested capital)

Sources: FactSet, S&P Compustat, Energy Information Administration, Congressional Reports, CSIS Analysis
Questions/Discussion
About CSIS

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