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Analysts Predict New Wave of Industry Consolidation

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Expectations of declining budgets for Pentagon big-ticket weapons and an overall uncertainty about future military spending priorities may set off new rounds of industry mergers and acquisitions, economists say.

But any forthcoming consolidation is not likely to mirror the massive wave of mergers and acquisitions that swept the industry during the early and mid-1990s. Because the industry already has shrunk significantly and is currently dominated by a handful of conglomerates, any future consolidation is expected to involve mostly medium and small companies. Large companies, however, could be participants in what analysts describe as a corporate game of gin rummy as they buy and sell parts of their businesses in order to bolster their cash flow.

A rapid post-Cold War reduction in military budgets and a resulting excess capacity in the defense industry contributed to a tidal wave of company mergers. The consolidation accelerated after the so-called "last supper" in 1993, when then-Deputy Defense Secretary William Perry advised the Pentagon's top contractors to merge if they wanted to survive the coming budget crash.

"Today the major surviving firms are larger than defense companies have ever been in the history of the U.S. defense industry," says Barry D. Watts in a report published by the Center for Strategic and Budgetary Assessments based in Washington.

The degree of consolidation in the mid-1990s varied across sectors. For example, there was about a 70 percent reduction in the number of contractors in the fixed-wing aircraft, tactical missiles and expendable launch vehicles sectors. Other areas, such as surface ships, strategic missiles, satellites and combat vehicles, experienced about a one-third drop in the number of contractors.

The consensus in the industry so far has been that defense firms should stick with military work and avoid diversification into civilian markets. That assumption is now being challenged as companies may seek to shore up their cash flow by changing their portfolios, says W. Alexander Vacca, an industry analyst who participated in a recent forecast study by the Government Electronics and Information Technology Association. The "last supper consensus" appears to be breaking down, he tells an industry conference hosted by GEIA. Investors are no longer convinced that defense contractors should only engage in government work and avoid non-defense customers.

"Companies are playing what Warren Buffet calls 'gin rummy' mergers and acquisitions," Vacca says. "They sit down and swap assets."

New buyers are emerging, including players from non-defense sectors and foreign firms. "Big deals are being done with unusual buyers," he says. Examples include the $4.8 billion acquisition of Smiths Aero by General Electric Co., the $3.9 billion acquisition of DRS Technologies Inc. by Italy's Finmeccanica, the $1.1 billion takeover of AAI Corp. by Textron Inc. and the $1.8 billion purchase of EDO Corp. by ITT Corp.

Investors are willing to consider mergers and acquisition outside defense, Vacca says. "That used to be a scary thing … they would tell you, 'you're crazy.'" Given the industry's past failures to successfully diversify into commercial markets, he says, analysts recommend that companies avoid the pitfalls of so-called corporate "synergies." An aerospace company, for instance, should not try to turn space-age polymers into the next best automobile interior fabric.

Analysts are suggesting that defense contractors should consider buying unrelated companies to generate cash flow — a portfolio approach versus a defense-only strategy, Vacca says. "This was a shock to us on the GEIA team."

Some experts remain skeptical that defense contractors can transition into civilian work successfully.

“If diversification is again tried, defense companies would be wise to focus on complementary businesses that are not too far afield from their core business,” writes Stephen Blanchette Jr., an acquisition manager at the Software Engineering Institute. “Perhaps investors should re-tool their expectations … In trying to push the defense industry toward diversification, investors may find themselves driving their risk up instead of down.”

How the fallout from the economic crisis will shape the defense sector remains to be seen.

“Overall defense spending is going to be limited. In the last few years we’ve seen unprecedented growth, and it’s really unsustainable at this point,” says Shaun McDougall, military market analyst at Forecast International. The upshot for industry is that companies won’t have as much wiggle room and will eye niche markets, such as health care, government services and computer systems, that engender a bit more fiscal stability. “They’re hoping that getting into these markets will offset losses that they might see in other areas,” he says. Some firms have already begun the move.

Still, other companies may follow the traditional route and consolidate, particularly in sectors including communications software and biometrics that have come to fruition in the post-9/11 period, McDougall says. “I think you’re going to see a lot of action in electronics and computer systems … You’re going to see some of these large prime contractors going after specialized electronic companies.”

Given the global economic crisis, it is unlikely that there will be favorable financial market conditions for mergers, economists say, but with potential cuts in the Pentagon’s budget more defense mergers are possible. Such consolidation is likely to occur between U.S. and European companies in the coming years, as well as between second tier U.S. contractors, they predict.

But as the industry consolidates, the government loses out on the competitive market, McDougall cautions. There’s a decreasing incentive for companies to reduce costs if there are no competitors in their sector, he points out.

Nayantara Hensel, assistant professor of economics and finance at the Naval Postgraduate School, has researched the cost-savings associated with defense industry mergers and acquisitions. She examined cost data collected from 1981 to 2006 on more than 300 weapons systems to see whether there were any changes following mergers. Of the technologies examined, between 39 and 44 percent experienced some statistically significant change in either total costs or per unit costs following a merger, she says. Twenty percent of the systems experienced a reduction in per unit cost while 18 percent experienced an increase.

“What that shows is there was more of a reduction of per unit costs than an increase, to the extent that systems were impacted at all,” says Hensel.

More than half of the systems for each armed service was unaffected by the merger activity, she adds. Army and Navy systems overall showed efficiency in per unit costs while Air Force weapons systems revealed a blend of efficiency and inefficiency following consolidation.

For determining the changes, Hensel examined two metrics: cost per unit output and total cost. Cost per unit output is the best measure because there are declining trends when there are economies of scale, she explains. Total cost, on the other hand, could reflect trends that result from other factors, such as fewer orders.

The evidence of reduced per unit costs suggests that there were greater efficiencies following consolidation for many sectors, including rotary aircraft, tactical missiles, surface ships and strategic electronics, she says.

In the tactical missile sector, which had a 70 percent reduction in the number of contractors, Hensel found that about 44 percent of the systems experienced some change in costs as a result of the mergers. In 33 percent of the systems, there was a reduction in per unit costs, while 11 percent of the systems suffered an increase. “That sector suggests there were some efficiencies,” she concludes.

In other divisions, the numbers were evenly split. In fixed-0wing aircraft, for example, about 22 percent of the systems were affected and of those, 11 percent sustained an increase in costs while 11 percent had a reduction. This mixture of efficiencies and inefficiencies following consolidation also was apparent in the tracked combat vehicle sector.

Hensel also found that some categories, such as satellites and strategic missiles, encountered more of an increase in costs following mergers. “That may have been a function of the particular systems I examined. Those were areas where I didn’t have a lot of data points,” she says. Such data suggest that increased concentration in the defense market can lead to inefficiencies.

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