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US Navy Push for More Hornets Reshapes Cost, Export Picture

By **CHRISTOPHER P. CAVAS**

WASHINGTON — The needs of the US Navy aside, the prospect of keeping Boeing in the business of building Super Hornet fighters raises any number of cost issues, along with the possibility of more future exports.

Last week, Navy officials made the case for requesting additional funding for two to three dozen more F/A-18s in order to have enough aircraft to meet missions as the service awaits the F-35C.

"Where are they going to get the money for it?" asked Byron Callan, a defense market analyst with Capital Alpha Partners, echoing the most obvious question in a town where sequestration-related spending restrictions are a pervasive topic.

"It answers the question of 'how do I keep the Boeing line open so



US NAVY

Hornet Questions: Two single-seat F/A-18E strike fighters from Strike Fighter Squadron 37 maneuver together. The F/A-18 is the mainstay of the US Navy's carrier aviation squadrons.

when I decide to truncate the Joint Strike Fighter there will still be something there?" said Jerry Hendrix, a former director of Navy History now working as a defense analyst with the Center for Strategic

and Budgetary Assessments. He referred to long-standing suspicions that the Navy wants to reduce its buy of 680 Lockheed Martin F-35s, something the ser-

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Analysts: Sikorsky Decision May Signal Trend

By **AARON MEHTA**

WASHINGTON — United Technologies will spend the next several months weighing whether to divest its Sikorsky unit, in what analysts say is a reflection of shrinking profit margins across the defense sector.

The review, which will be complete by the end of the year, is looking at setting up Sikorsky as a stand-alone company, and the official line out of United Technologies Corp. (UTC) is that nothing has been decided.

But during a March 12 analyst



US AIR FORCE

Going Solo? United Technologies is weighing a spinoff of Sikorsky, producer of the UH-60 Black Hawk helicopter.

event, UTC President and CEO Gregory Hayes indicated that Sikorsky is no longer a good fit for

UTC.

Sikorsky is "just not quite as attractive as the rest of the businesses," Hayes said, noting the subsidiary's role "as a platform provider, as opposed to a system provider, differentiates Sikorsky from the rest of the portfolio."

Hayes called the decision "not an easy one," but said it is "the right one for Sikorsky's customers, for Sikorsky's employees, and for our shareholders."

A divestment would not be altogether surprising. Analysts contacted for this article agreed it

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DEFENSE

ULA To Retire Delta IV, Push for More RD-180s

By AARON MEHTA

WASHINGTON — The United Launch Alliance (ULA) has decided to retire all but the heavy variant of the Delta IV space launch vehicle, a decision that will likely cause fireworks at a congressional hearing scheduled for this week.

The March 17 hearing of the House Armed Services Committee will feature SpaceX CEO Gwynne Shotwell and ULA President Tory Bruno testifying on "Assured Access to Space." And while their appearance will be followed by a panel of top US Air Force officials, the two industry voices are expected to be the most interesting as ULA is prepared to push for more freedom to buy a Russian-made engine that its launchers need.

It's a pivotal time for ULA, which is facing two existential threats to its long-standing business model.

On the one side, SpaceX is expected to be certified for military space launch under the Air Force's Evolved Expendable Launch Vehicle (EELV) program by the middle of the year, providing the first com-



US AIR FORCE

Going Out of Style? ULA may retire the non-heavy Delta IV rocket configuration.

petitor to ULA for EELV contracts.

At the same time, Congress banned future procurements of the RD-180, a Russian-made engine vital to ULA's Atlas V launch vehicle, following Moscow's aggression in Crimea. That, in turn, has forced the company to invest in a new engine program and a redesign of the Atlas, while working toward a new launch vehicle design.

However, Air Force Secretary Deborah Lee James last month said the RD-180 replacement won't be certified before the supply of RD-180 engines run out.

"All of the technical experts with whom I have consulted have told me this is not a one- or two- or three-year deal," James said. "You're looking at six years, maybe seven years to develop an engine,

and another year or two beyond that to integrate. This truly is rocket science. These are hard technical problems and so to have that 2019 date there is pretty aggressive, and I'm not sure we can make it."

James added that she would like to bring technical experts in to talk to Congress about this issue, because "I'm not sure 2019 is doable."

While the RD-180 engine issue is not related to SpaceX, the latter company feels the Russian ties are a chance to turn public opinion against ULA, with SpaceX founder Elon Musk quick to bring it up at any opportunity.

The Russian issue forces ULA to spend internal R&D funds on a new engine while relying on the pricey Delta IV to compete with SpaceX once the RD-180 stash runs out around 2019.

But ULA may have thrown a wrench into things with its decision to retire all but the Delta IV Heavy rocket configuration.

"We're looking to retire Delta around the 2018-2019 timeframe," Bruno told Defense News on March 3. "The only reason we have

both platforms today is because the government policy was to have two, and we are the only guys so we have to have two. That policy has changed now and it says two providers, which is fine. Competition is good. I'm actually a big fan of it."

On average, Bruno said, the Delta is 30 percent more expensive than an Atlas V, and hence would not have a real chance versus the Falcon 9 in a competitive environment. Keeping the two lines going is a big cost for ULA, he added, which means it makes sense that once the Falcon 9 is certified, ULA would provide only the Atlas V and the occasional Delta Heavy launch.

Bruno did say the company would keep the Delta vehicle going if the Air Force requested it, but that the service would have to "be in a position to fully support the cost of the Deltas," something it would need to decide on shortly.

At the upcoming hearing, ULA will push for more RD-180 purchases, in order to bridge the gap between 2019 and when its next-gen engine comes online. And SpaceX will attempt to shoot that argument down, saying the Delta retirement is just a political ploy to force open more sales. □

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SIKORSKY

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made sense, as UTC's other businesses are primarily service-based. And while Sikorsky is still a profitable, \$7 billion company, its profit margins are not near those of the other UTC branches.

Byron Callan, an analyst with Capital Alpha Partners, said this may be part of a larger trend of companies looking at the defense sector and deciding that their weaker military-based units may be ripe for pruning.

"If the military business outlook was as strong as some people make it out to be, you wouldn't be seeing these sorts of decisions," Callan said. "You wouldn't see Exelis being sold to Harris, ATK merging with Orbital.

"It's also a strong signal that to stay in this business may require more investment, and certainly further cost reduction, and some companies will make that decision and some will make the decision to just get out," he added.

Anita Antenucci, senior managing director at Houlihan Lokey, said the spinoff of defense firms is a subtle trend that is part of the larger wave of mergers and acquisitions that experts have been waiting for. She said it's an option more viable now than in the 1990s, when the public was less likely to support small, independent defense firms on the market.

She called it "quite predictable" that spinoff companies become targets for either acquisition or mergers after they become stand-alone firms. "It's like a halfway house, where these companies exist as stand-alone entities while the market sorts itself out.

"I think you will find many, many exam-

ples of this, but there will be more transactions without spinoffs than with," she said. "It won't be a majority, but it will certainly be impactful."

Steve Grundman, principal of Grundman Advisory and Lund Fellow at the Atlantic Council, sees another potential trend, one that could have consequences for the defense industry.

"While it's not yet the rule, UTC's announcement appears to repeat a template of multi-industrials exiting or curtailing their exposure to defense," Grundman said.

"It's a playbook for the industry as a whole that I would regard as a regressive, unwelcome trend — the retreat from the defense market of multi-industrials — because I regard the participation of strong multi-industrial companies in the defense sector as improving its stability and propensity to innovate."

He points to the 2011 spinoff of Exelis from parent company ITT. Exelis, the defense arm of ITT, was given the chance to stand on its own, while ITT removed itself from a sector that many saw as beginning to shrink as the US prepared to draw down from Iraq and Afghanistan.

Mike Blades, an analyst with Frost & Sullivan, said it is smart for big conglomerates to begin limiting their role in defense.

"Those large companies will never get out of that business, but spreading that risk will be a big concern for how they run their business from now on," Blades said.

There aren't many multi-industrials left in the defense sector. General Electric, Honeywell, and to a lesser extent Thales all fit the bill, Grundman said. But the best example may be Finmeccanica, which is looking to curtail its defense exposure both in Europe

and the United States. In particular, the company is looking to shed subsidiary DRS' Aviation and Logistics, as well as Training Communications and Network solutions.

DRS has struggled in recent years, and Finmeccanica CEO Mauro Moretti has indicated he would be willing to sell the unit at some point. In that way, Finmeccanica also fits the pattern of selling off weaker units as the industry slows down.

If UTC divests Sikorsky, analysts agree that a spinoff is much more likely than a sale to a rival competitor, for both market and tax reasons.

US tax law says that the sale of a company results in a gain tax; a spinoff does not need to pay that tax.

But there is a wrinkle: If the spinoff is bought by another company within a two-year period, the burden of proof is on the original company to prove this wasn't a tax avoidance scheme. After two years, the burden shifts to the IRS to prove anything is amiss.

Because of how long Sikorsky has been owned by UTC, the tax bill for a sale would be huge, likely negating the possibility of another firm buying Sikorsky from UTC in the short term.

That's not a major issue for the rotorcraft unit. The analysts all agreed a stand-alone Sikorsky would be able to survive, and Hayes pledged not to cripple Sikorsky with debt if it was spun off, saying, "we want to make sure they will be a successful, stand-alone company."

The picture remains blurry about potential buyers after the two-year period has passed. While Sikorsky has a huge portfolio, it is not one that matches up well with another rotorcraft company.

According to a Teal Group analysis, military rotorcraft saw a 7.9 percent compound annual growth rate between 2004 and 2013, with an unheard of 66 percent jump from 2008-2012.

That unsustainable growth has slowed and is projected to continue to decline, while the commercial market is on an upswing.

The fact that Sikorsky is stronger in the military helicopter market hurts it as a potential pickup, Blades said. Hayes noted Sikorsky's reference to a "predominantly military" customer base in UTC's official announcement of the strategic review.

"If you read between the lines, it's not that they make helicopters. It's that they make military helicopters," Blades said, emphasizing the word military.

"It's a business, but it's not an explosive growth business."

"All the other stuff UTC does is going to be demanded and needed, not just on the military but also on the commercial side," he added. "Their CEO is charged with growth, and while Sikorsky may have steady sales, it won't show huge growth."

Teal Group's Richard Aboulafia doubts Sikorsky would be absorbed by one of its rivals in the rotorcraft market, for both financial and political reasons.

"I don't think anyone has the stomach for a European firm buying Sikorsky," Aboulafia said.

"Textron just doesn't have the cash to do this, so it won't be Bell Helicopter. As for Boeing, someone would kill that merger — it could be DoJ or DoD, but there would be so many knives out that there's no way." □

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