



Top 100: Defense Revenues Down, but Industry Prevailing

By Andrew Clevenger 12:13 p.m. EDT July 27, 2015



(Photo: Lockheed Martin)

WASHINGTON — Lagging defense spending and the large-scale drawdown of US troops in the Middle East spelled another year of decreased revenues for defense contractors.

But industry has largely avoided the dramatic upheavals of previous industrial downturns, with mergers and acquisitions being driven more by opportunistic business decisions than panic over a dwindling pot of money.

Lockheed Martin maintained its chokehold on the top position in this year's Defense News Top 100 — our annual ranking of the world's largest defense companies — with 2014 defense revenues of \$40.128 billion out of \$45.6 billion total revenues. That was down \$366 million, or -0.1 percent, from last year's defense revenues

of \$40.494 billion.

Of the top 10 firms, only United Technologies reported higher defense revenues with \$13.02 billion, a 9.5 percent increase from the year before.



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Analysts suggested that while 2014 is close to the bottom of the defense market, defense spending may continue to go down for another year or two. And when it stops declining, it may not recover as quickly as it did following the large downturn in the 1990s.

"On an outlay basis, I think we have one more year to go," said Steve Grundman, a former Pentagon industrial policy chief who is now a consultant and a member of the Atlantic Council. "I think 2015 will be the bottom for budget authority — I don't think we'll go lower than the 2015 budget authority — but the outlay dip will lag a year, so 2016 is probably the bottom of the outlay cycle."

Byron Callan, an analyst with Capital Alpha Partners, agreed that defense spending is likely to stay around current levels for several years.

"I don't think we're going to see down 5 percent from here, barring another budget crackup in DC," he said. "I would think, for the most part, it's stabilized, and maybe there's a little bit of growth, but it's certainly not a normal growth cycle that we've seen following other defense industry downturns."

Last week, House Speaker John Boehner, R-Ohio, conceded that another continuing resolution was likely the only way to keep the federal government funded beyond September. But without Congress working out a new budget deal, the spending caps of sequestration — loosened for two years under the Ryan-Murray budget deal in 2013 — would once again clamp down on defense spending in fiscal year 2016.

"There is clearly a recognition by the lawmakers that I speak to that we have so many global security challenges and needs to modernize our defense capabilities that we need to increase spending above the budget caps," Marilyn Hewson, Lockheed's chairman, president and CEO, told Defense News, adding that she is not convinced that the market has hit the bottom.

Andrew Hunter, director of the Defense-Industrial Initiatives Group at the Center for Strategic and International Studies, said he is not expecting 2016 to be substantially worse for defense spending than 2015.

"I think 2015 contract spend is going to be worse than 2014, but maybe not as dramatic a drop as the last two years. And that's largely because you have the combination of sequestration and the defense drawdown overseas," he said. "For better or for worse, it does look like both of the budgets, both the base budget and the Overseas Contingency Operations budget, are kind of bottomed out in 2015."

But the market is likely to stay down for quite some time, said Grundman. "This 'long bottom' might be flat to 1 percent real growth for about three or four years, until the end of the decade," he said.

Risers and Fallers

Thales, which last year cracked the top 10 for the first time since 2007, dropped to 12th in 2014. However, much of the French firm's 22.8 percent drop was due to changes in international accounting practices regarding how joint ventures are treated. This change in accounting methodology applied to other European firms as well, but Thales may have been hit particularly hard due to its heavy involvement in joint ventures.

Russian firms, led by Almaz-Antay (\$9.2098 billion, up 10.6 percent), largely posted double digit gains from 2013. While Russia faced significant sanctions from Western countries following its invasion of Crimea and Ukraine, Russia's main export clients include non-Western powers China and India, so defense sales continued largely unchecked. At \$43.8 billion, Russia's domestic defense procurement was also at record levels, providing more fuel for the Russian military engine.

None of the largest climbers, however, were Russian firms. Kawasaki Heavy Industries rose 20 spots (to 46, up from 66), followed by Ultra Electronics (68, up from 86) and PAE (74, up from 85). The biggest drops were by Patria, down 30 spots (to 94 from 64), Oshkosh (to 48 from 27) and ManTech (to 64 from 43).

But despite the years-long downturn, the defense industry remained robust, which reflects how quickly defense firms responded to the new spending landscape.



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"To the credit of the current cast of captains of this industry, it is astonishingly healthy financially. Here, five years into a significant downturn in its primary customer's spending, these are all essentially healthy companies," Grundman said.

This gives them the freedom to pursue a variety of business strategies, from mergers and acquisition to create large-scale efficiencies, as in the Orbital ATK and Harris-Exelis mergers, or to refocus their business models by shedding businesses that don't fit core competencies or exist in market segments loaded with competition, he said.

"Unlike the 1990s, I don't think this industry is going to rush behind a single restructuring thesis. I actually instead believe there's going to be a diversity of strategies, even among the big six," he said. "I think there are going to be some, like Lockheed Martin, that galvanize their strategy behind big platforms: We make tactical airplanes, helicopters and exquisite satellites, and we'd very much like to make bombers and tactical combat vehicles; indeed, they'd love to have a big platform in each domain."

Callan agreed that the sector is likely to see some portfolio reshaping in the future.

"This market is not going to be as growth-y as maybe bullish analysts expect. And so you better be very good at what you do, in the areas that you can concentrate on, and it may devolve into more of a market-share game," he said. "From your rankings standpoint, there may not be much net movement, but there sure will be some pretty interesting rearrangements within these sub-segments."

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