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Top-Performing Companies

Top-Performing Companies Study Sees Rocky Horizon

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Mixed Blessings

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At first glance, results of the 2013 Top-Performing Companies (TPC) study suggest that the aerospace/defense industry is prospering, and the outlook going forward looks equally auspicious—especially for U.S. companies.

Among the largest systems integrators, the scores on which rankings are based improved to their highest level since the TPC study was introduced in 1996—an indication that prime contractors generally have grown leaner, made huge strides in leveraging economies of scale and have become more disciplined in how they deploy capital. Among the 60 or so publicly traded companies in the global TPC universe, earnings—a key indicator—surged 9.6% last year.

Commercial aircraft manufacturers and their suppliers set new records not just for profits, but also for sales, backlog, production and revenues. Surging commercial aircraft demand more than offset a declining defense market. On the government contracting side, seven of the 10 largest companies with a concentration of defense-related revenues enjoyed flat-to-higher operating margins, reflecting increased operating efficiencies.

Among companies that generate revenues of more than \$20 billion, [Boeing](#) improved its TPC score to 92, its second-best showing in the last 10 years, and it took top honors for the third consecutive year. [Lockheed Martin](#) and [Honeywell](#) rounded out the top three. [Huntington Ingalls](#) surged from eighth place last year to take the No. 1 position in the medium-size category, largely on the strength of a nearly 50% improvement in operating profit. In the small-size category, [Exelis](#) emerged as the top-ranked company on the basis of management's effective realignment of the organization's electronics-related businesses following the spin-off from [ITT](#) in 2011.

While the TPC results for the most recent fiscal year stir titillating comparisons between individual companies, it is performance-over-time that is the better gauge of operating competitiveness. Based on that measure, [Lockheed Martin](#)—the top-ranked large company for four years from 2007-10—came out on top.

To be sure, this is a series of positives for the industry as whole. Upon closer examination, however, this year's TPC data also portend outsized challenges in the years ahead for both the commercial and defense sectors.

Strategically, the first troubling omen relates to research and development (R&D) spending. This is a cash-generating industry and, despite hefty profits, most large- and medium-size U.S. companies appear

to be taking an overly risk-averse approach to how much of their own resources they allocate for R&D, as a percentage of revenue, in favor of more near-term value-creation activities. These include buybacks of shares, paying off pension obligations and reducing debt.

“Defense companies have been very cautious in how they run their businesses, with a sharp focus on cost-control measures, but it is time to start making some strategic decisions and to deploy capital,” says Tom Captain, vice chairman of [Deloitte Consulting](#) and a member of the TPC advisory team. “They are not going to grow by continuing



down the same path.”

Boeing, which plowed about 3.5% of its revenues into independent R&D in 2013, repurchased at least \$1.3 billion stock shares through February of this year—well ahead of 2013’s \$700 million quarterly average. [General Dynamics](#), which has nearly zero net debt and completed an accelerated \$1.1-billion share buyback in late January, invested a scant 1% in IR&D last year.

[United Technologies Corp.](#) (UTC) appears to be the most committed large company when it comes to science and innovation; it funneled 4% of its revenue in 2013 to IR&D—which is consistent with the innovations it has introduced in recent years. In just the past seven years, UTC has risked, annually, nearly \$2 billion of its own money on disruptive, potentially game-changing revenues technologies. Out of this high-stakes strategy came the X-2 Technology Demonstrator, a next-generation rotorcraft, as well as the geared turbofan engine, for which Pratt & Whitney has at least 5,300 firm orders and commitments from airline customers.

Then there was UTC’s strategic \$18.4 billion acquisition of [Goodrich](#), which transformed the buyer—already a multi-industry company—into an aerospace super-supplier with greater marketing and negotiating clout globally. “With the Goodrich acquisition, UTC bucked the trend among the largest companies in recent years in terms of opting for capital investment, rather than returning the capital to shareholders,” says Thompson.

[Airbus](#) Group, formerly [EADS](#), led European companies in IR&D investment, at 5.5%. No less noteworthy was [Finmeccanica](#); although finishing last in the 2013 rankings, it was among the five largest spenders on IR&D.

For months, the [Defense Department](#) has been publicly exhorting U.S. companies to boost their investments in certain technologies that are critical to national defense and that also offer the greatest potential for future revenue growth. For its part, the Pentagon has allowed its investment in research, development, test and evaluation to shrink

by about 28% since its peak in 2009. While no aerospace/defense company seems to have a firm grasp of what constitutes the right amount of IR&D for future generations of technology, the current unfavorable comparison with European companies could have implications for competitiveness in global markets in years to come.

“Defense contractors have been successful by focusing on the balance sheet and low-risk strategies at the expense of growth,” notes Steven Grundman, a member of

the TPC advisory team and George Lund Fellow at the Atlantic Council, a Washington-based organization. “My question is whether they can ever be growth companies again without alienating their investors?”

Defense companies also have been focused on taking costs out of their operations as part of a broader initiative to reduce the price of the equipment they supply to government customers. No contractors dare risk back-sliding in such efforts, cautions TPC adviser Scott Thompson, a partner and U.S. A&D leader for PwC. “More can be done,” he says. “Defense companies thus far have done a good job of responding to [the Defense Department’s] affordability challenge, but expectations continue to rise.”

Another troubling sign is that half of the world’s 10 highest-ranked defense-oriented operating units saw defense-related revenues decline. Profit growth in the face of flat or declining revenue is all but unsustainable, and so the issue for prime contractors is where to find—or how to create—a new or improved engine for revenue growth. For the 10 largest companies in the TPC universe with a concentration of defense revenues, there was a 5.1% decline in operating profits due mainly to weak operating results from [BAE](#) and [Finmeccanica](#).

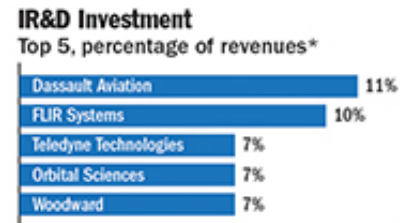
Competition is intense between U.S. and European companies, with Russian and Chinese entities thrown into the mix, to expand revenue streams outside of their

domestic markets. In the U.S., defense export authorizations continue to be a bright spot for U.S. companies—quadruple the amount generated a decade ago.

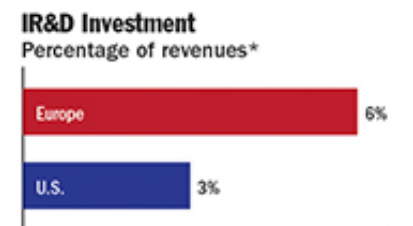
Overall though, Western defense contractors still need to be more than exporters; they must become far more international, says Michael Finley, A&D advisory principal at PwC and a member of the TPC advisory team. “Defense companies need to focus on developing affordable solutions for international customers, not just offer U.S.-made equipment for export that many countries simply cannot afford.”



* Includes companies with annual fiscal 2013 revenues exceeding U.S. \$5 billion
Computation: Sum of revenues remaining after production and marketing costs in relation to total revenues



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Of the large pure-play defense contractors, [Raytheon](#) may be the best in class in growing its international business. Because of this, the company has the strategic advantage of a more diverse set of customers. Nearly 30% of Raytheon’s sales are from outside the U.S.

Much of this success comes from “taking 80-percent solutions internationally and addressing lower price points in the marketplace, versus the more exquisite solutions it sells to U.S. government customers,” says Harlan Irvine, principal with Deloitte Consulting and a member of the TPC Council of Advisers.

Another potential source of revenue growth is identifying opportunities in technologically adjacent commercial markets. While the industry has a long history of miserable failure at such initiatives—mostly as a result of trying to build such businesses within government-compliance defense operations—there are success stories. One is Alliant TechSystems, with its ATK Sporting Group, a portfolio-based consumer-branded products company that produces and sells firearms and accessories for hunting, recreational shooting and other outdoor-activity markets. The company last week announced a merger between its Aerospace and Defense Groups and [Orbital Sciences Corp.](#), along with the spin-off of its Sporting Group as a stand-alone publicly traded company (see page 30). Alliant TechSystems was one of the most forward-looking defense contractors in terms of exploiting its core technologies to grow a commercial business.

An analysis of TPC results also reveals a disturbing dichotomy in operating profit growth, which was concentrated among the 25 largest companies. Smaller suppliers in aggregate showed a significant decline, but there were exceptions. Four of the industry’s top five “cash machines” were in the small-size category.

TransDigm Group had an industry-leading operating profit margin of 40%, followed by Precision Castparts, a medium-size company, at 27%; and [Rockwell Collins](#) and B/E Aerospace tied at 19%. Median TPC scores among smaller companies dropped 13%, and only nine of the 33 (27%) represented in this year’s study showed improvement.

The upshot is that some of the larger OEMs are squeezing suppliers’ profit margins by demanding price concessions, especially in the commercial sector. “They’re pushing a lot of pain down the supply chain, with the expectation that lower-tier players will figure out how to achieve higher operating efficiencies, and there are very few suppliers that can afford to say ‘no’ to large aircraft manufacturers,” says Jim Schwendinger, retired global leader of the A&D practice of Deloitte Consulting and a long-time TPC adviser. On the other hand, Schwendinger adds, “If the OEMs don’t put pressure on the supply chain, there is little incentive for suppliers to get better.”

Some parts of the supply chain already are struggling to keep up with record aircraft production rates. Whether smaller companies will be able to transition to OEMs’ more stringent risk-sharing business model will remain an open question for some time. Both sides will have to work more collaboratively than they are currently doing, says Schwendinger.

If nothing else, OEMs’ price-concession mandates in the pursuit of higher profit margins may increase the risk of program and supply-chain disruptions, says Captain. “It is one thing to demand more, but if the OEMs don’t offer help they could face even bigger problems in the future,” he says. “By squeezing small companies’ profits, OEMs will force them toward consolidation, because they need scale to meet OEMs’ expectations.”

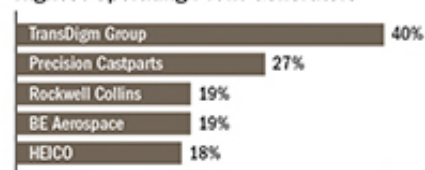
As in nearly all previous annual TPC studies, in 2013 European OEMs tended to land in the bottom one-third of the rankings among large companies. Operating margins provided the most dramatic testimony to the difference in performance between the two groups of companies in 2012-13. U.S. contractors with annual revenues exceeding \$5 billion increased to 11.1% from 10.3%, while they declined for European contractors, to 5.9% from 6.3%.

“One of the most striking features of the TPC analysis is where Europe ranks year-after-year,” says long time TPC adviser Antoine Gelain, A&D practice leader of Candestic, a London-based consulting firm. “They consistently underperform their American counterparts. Ten years ago, I said it was about scale. Five years ago, I said it was about political interference and inefficient legacy operations that made them hard to manage. I’ve run out of excuses.”

Airbus Group’s operating margins at the company level, although improving, were roughly half of Boeing’s (7.3% versus 3.9%). The large gap “brings into question the efficiency of the cost and asset base, as well as [new-aircraft] pricing behavior at Airbus [commercial], and the ability of the European A&D industry to rationalize assets and labor while the government tries to protect jobs,” observes Gelain.

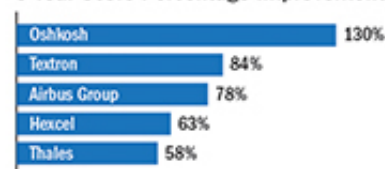
The operating performance of Europe’s major defense contractors is much the same: weak and not very competitive, prompting Captain to wonder whether there is enough country-specific defense business to support the industrial base, and whether the defense sector

Cash Machines Highest Operating Profit Generators*



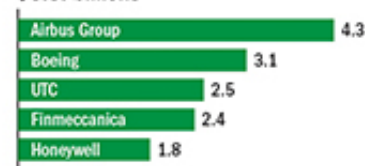
*Computation: Percentage of revenues remaining after production and marketing costs to total revenues

Most Improved 5-Year Score Percentage Improvement*



*Average 5-Year score exceeds 50

IR&D Investment \$U.S. billions



finally is ripe for consolidation.

Gelain notes that Airbus Group announced significant layoffs and streamlining of its business portfolio in its defense and space operations at the end of 2013, but it likely will take two years to complete the process. "There is a pronounced lack of flexibility and maneuverability in how Airbus and other European companies are run, and it has a direct impact on their competitiveness," he says. "They all are penalized by systemic costs specific to the European environment."

The irony is that Europe's large aerospace companies are far more aggressive in investing their own resources in new technology than are their U.S. counterparts. Europe spent \$12.6 billion compared to the U.S. companies' \$10.5 billion. As a percentage of revenue, the European industry's investment was about twice as much (6% versus 3%).

But IR&D does not necessarily translate into more innovative products or revolutionary technologies that will open new markets or displace entrenched competitors, as Finmeccanica's executives can attest. And therein lies a critical difference. The fact that European companies continue to lag so far behind in overall competitiveness is as much about shortcomings in asset management, labor productivity, duplication of effort across geographies—and management vision—as it is about R&D investment per se.

Perhaps the most glaring outlier across the breadth of TPC results for 2013 is United Technologies Corp., which ranked ninth. As counterintuitive as this may seem, there is an explanation: Key operating and financial metrics used in the TPC methodology were skewed by the company's \$18.4 billion acquisition of Goodrich in 2012. "UTC gets high marks for making such a strategic investment instead of giving the money back to shareholders," says TPC project team adviser John Stack, managing director and aerospace leader at The McLean Group.

Were it not for the distortion in metrics caused by the huge goodwill UTC took on with the Goodrich acquisition, the company would have ranked much higher in its category. As it is, UTC increased revenue by 8.5% last year, the second-best in its peer group, and it improved operating profit by more than 14%, the fourth-highest rate of change in its peer group. In addition, UTC generated operating margins of 13%, up 14% in dollar terms over the prior year. "This is an extremely well-managed company," says Thompson.

Rockwell Collins's weak showing in the 2013 rankings was affected in much the same way due to its \$1.4 billion strategic acquisition of Arinc, which loaded the company's balance sheet with a large amount of goodwill at the end of the year. Both companies have a lot of unfinished integration tasks, and the cash flows that are being generated are still insufficient to cover all of the additional goodwill that came with the acquisitions.

Rockwell consistently has achieved some of the highest scores across all TPC's metrics year-after-year, reinforcing the truism that performance over time—not single-year spikes or dips—is the most valid measure of competitiveness.

The industry's defense and commercial sectors are on a solid financial footing for now. But just as the two are succeeding for different reasons, they also face their own sets of challenges. On the commercial side, creeping complacency, program execution and supply chain management could act as spoilers. On the defense side, "whitewater rafting while the water level is dropping comes to mind," says Schwendinger.

"It is a time of opportunity, but only for those companies who demonstrate vision and leadership," he says.

Anthony L. Velocci, Jr., was editor-in-chief of Aviation Week & Space Technology from 2003-12.

**2014
AEROSPA
CE &
DEFENSE
RANKINGS
REVENUES
GREATER
THAN \$20
BILLION**

RANK	COMPANY	RESULTS ENDING	2013 REVENUE (\$ millions) TOTAL SCORE	
1	Boeing	Dec. 13	\$86,623	92

2	Lockheed Martin	Dec. 13	\$45,358	88
3	Honeywell International	Dec. 13	\$39,055	80
4	General Dynamics	Dec. 13	\$31,218	79
5	Raytheon	Dec. 13	\$23,706	79
6	Northrop Grumman	Dec. 13	\$24,661	77
7	Rolls-Royce	Dec. 13	\$24,481	77
8	Airbus Group	Dec. 13	\$78,687	67
9	United Technologies	Dec. 13	\$62,626	64
10	BAE Systems	Dec. 13	\$26,613	54
11	Finmeccanica	Dec. 13	\$21,291	34

**2014
AEROSPACE &
DEFENSE
RANKINGS
REVENUES
BETWEEN
\$5 - \$20
BILLION**

RANK	COMPANY	RESULTS ENDING	2013 REVENUE (\$ millions)	TOTAL SCORE
1	Huntington Ingalls	Dec. 13	\$6,820	77
2	Oshkosh	Dec. 13	\$7,446	73
3	Thales	Dec. 13	\$18,849	67
4	Precision Castparts	Dec. 13	\$9,524	66
5	Dassault Aviation	Dec. 13	\$6,099	64
6	Zodiac	Aug. 13	\$5,076	62
7	Embraer	Dec. 13	\$5,774	60
8	GKN	Dec. 13	\$11,261	60
9	Textron	Dec. 13	\$12,104	58
10	L-3 Communications	Dec. 13	\$12,629	57
11	Safran	Dec. 13	\$19,542	54
12	Bombardier	Dec. 13	\$18,151	53
13	Rheinmetall	Dec. 13	\$6,268	44
14	Serco Group	Dec. 13	\$6,767	39
15	Spirit Aerosystem	Dec. 13	\$5,961	27

**2014
AEROSPA
CE &
DEFENSE
RANKINGS**

**REVENUES
BETWEEN
\$1 - \$5
BILLION**

RANK	COMPANY	RESULTS ENDING	2013 REVENUE (\$ millions)	
			TOTAL SCORE	
1	Exelis	Dec. 13	\$4,816	64
2	Ultra Electronics	Dec. 13	\$1,176	63
3	FLIR Systems	Dec. 13	\$1,496	63
4	Hexcel	Dec. 13	\$1,678	62
5	Harris	Dec. 13	\$4,978	61
6	Orbital Sciences	Dec. 13	\$1,365	60
7	Senior	Dec. 13	\$1,223	60
8	HEICO	Oct. 13	\$1,009	59
9	B/E Aerospace	Dec. 13	\$3,484	58
10	Rockwell Collins	Dec. 13	\$4,619	58
11	GenCorp	Nov. 13	\$1,383	57
12	Alliant Technologies	Dec. 13	\$4,583	56
13	Kaman	Dec. 13	\$1,682	56
14	MTU Aero Engines	Dec. 13	\$4,969	55
15	Elbit Systems	Dec. 13	\$2,925	53
16	Moog	Dec. 13	\$2,633	50
17	Teledyne Technologies	Dec. 13	\$2,339	50
18	Woodward	Dec. 13	\$1,957	49
19	Babcock International Group	Sep. 13	\$4,968	48
20	Cobham	Dec. 13	\$2,824	46
21	Esterline	Oct. 13	\$1,970	46
22	TransDigm Group	Dec. 13	\$2,023	46
23	Kennametal	Dec. 13	\$2,637	45

24	Triumph Group	Dec. 13	\$3,813	44
25	Curtiss-Wright	Dec. 13	\$2,511	44
26	Saab	Dec. 13	\$3,628	43
27	Meggitt	Dec. 13	\$2,584	42
28	AAR	Nov. 13	\$2,129	39
29	Indra Sistemas	Dec. 13	\$3,938	39
30	Barnes Group	Dec. 13	\$1,092	38
31	BBA Aviation	Dec. 13	\$2,113	35
32	CAE	Dec. 13	\$2,039	26
33	Allegheny Technologies	Dec. 13	\$4,044	21

AVERAGE 5-YEAR RANKING

REVENUES GREATER THAN \$20 BILLION

RANK	COMPANY	AVERAGE 5-YEAR SCORE
1	Lockheed Martin	85
2	Boeing	83
3	General Dynamics	82
4	Raytheon	79
5	Northrop Grumman	76
6	Rolls-Royce	76
7	Honeywell International	70
8	United Technologies Corp.	69
9	BAE Systems	67
10	Airbus Group	60
11	Finmeccanica	37

AVERAGE 5-YEAR RANKING

REVENUES BETWEEN \$5 - \$20 BILLION

RANK	COMPANY	AVERAGE 5-YEAR SCORE
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1	Precision Castparts	71
2	Dassault Aviation	69
3	Bombardier	66
4	Oshkosh	65
5	Embraer	61
6	L-3 Communications	60
7	Zodiac	59
8	GKN	58
9	Rheinmetall	55
10	Thales	55
11	Safran	55
12	Spirit Aerosystems	52
13	Serco	51
14	Textron	50

AVERAGE 5-YEAR RANKING**REVENUES BETWEEN \$1 - \$5 BILLION**

RANK	COMPANY	TOTAL SCORE
1	Rockwell Collins	78
2	FLIR Systems	75
3	Ultra Electronics	70
4	GenCorp	69
5	Harris	68
6	HEICO	67
7	MTU Aero Engines	65
8	Orbital Sciences	62
9	Senior	60
10	Kaman	59
11	Alliant Techsystems	58
12	Teledyne Technologies	58
13	Saab	55
14	Hexcel	55
15	B/E Aerospace	55
16	Woodward	55
17	Cobham	54
18	Indra Sistemas	53
19	Elbit Systems	53
20	Triumph Group	52
21	TransDigm Group	51
22	Kennametal	51
23	Babcock International Group	49
24	Esterline	46
25	Moog	46
26	AAR	45
27	Curtiss-Wright	44
28	CAE	44
29	Meggitt	44
30	Barnes Group	42
31	BBA Aviation	41
32	Allegheny	40

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