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After Eight Boom Years for Spending on Military Equipment, Contractors Expect a Slowdown

By Dana Hedgpeth

Washington Post Staff Writer

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At the Walter E. Washington Convention Center last week, Army soldiers, Pentagon weapons buyers and defense company representatives milled about a cavernous trade show floor for a look at the latest military equipment and gadgets.

Huge tanks sat beside armored trucks and machine guns. In one aisle, a stack of fake sandbags were arranged around a free cappuccino stand sponsored by KBR, one of the biggest government contractors in Iraq.

The annual exposition -- put on by the Association of the United States Army -- is one of the largest industry shows of its kind in the country, and the bustling convention floor was a testament to the success of an industry that has enjoyed steadily rising sales over the past eight years.

But the mood at the show was hardly celebratory. Rather, Topic A was whether those good times would continue.

Many assumed they would not.

Attendees worried that a new administration may be forced to cut back on defense spending as the nation strains under a global economic crisis and as presidential contenders talk about the eventuality of bringing troops home. Major weapons systems built by the likes of Falls Church-based General Dynamics or Lockheed Martin of Bethesda are likely to face new scrutiny -- potentially dealing a blow to an industry that has helped insulate the region from deeper economic pain.

"There's a lot of uncertainty out there," said Kevin G. Kroger, president of Pura Dyn, a small Boynton Beach, Fla., company, who came to the trade show to pitch the Army on buying more of its oil filters for armored trucks. "We're not sure where the budgets are going and what's going to get funded. It leaves us nervous."

Indeed, in his report on the show, Ron Epstein, an analyst at Merrill Lynch, said vendors acknowledged their worries about the rescue plan. "We expect the bailout plan will put downward pressure on defense spending," Epstein had written a week earlier in a research note to clients.

Although no one is expecting a dramatic drop in next year's Pentagon budget, there is a widespread expectation that spending will begin to level off. Many contractors have begun to prepare.

With nearly 60 percent of its \$42 billion in annual sales coming from the Defense Department, Lockheed Martin is pursuing other areas of business to compensate for any slowdown in defense spending. For the past eight years, the Bethesda company has tried to expand its information technology services business. Already, it expects double-digit sales growth in that unit this year compared with last year.

In recent years, Lockheed has landed multiyear contracts with such agencies as the National Archives, the Justice Department, Department of Homeland Security, Securities and Exchange Commission and the National Institutes of Health to help manage records and to do other support services. Lockheed also plans to expand the services it provides to peacekeepers in places such as Sudan.

"Our strategy is to leverage our core capabilities in adjacent markets," said Tom Jurkowsky, a Lockheed spokesman. He said the company's chief executive Robert J. Stevens often calls the company a "global security company," as opposed to being just a defense contractor.

Bob Trice, senior vice president of Lockheed's business development unit, said the defense industry is likely to see fewer new weapons programs. For Lockheed, "we're already laser-focused on [information technology] and we will continue to be and we'll do the same with logistics and maintenance."

Raytheon of Waltham, Mass., has begun to diversify by making several acquisitions to bolster its cyber-security capabilities. It also has landed two lucrative training deals: One is a contract worth as much as \$11 billion with Falls Church-based CSC and General Dynamics to do training for the Army; another is a 10-year contract to provide training support to the Federal Aviation Administration's air traffic controllers for \$437 million.

Some companies had hoped to compensate by selling their goods to other nations. But with the world economy also faltering, the expected increases in overseas military sales could be less than anticipated because governments in the Middle East and Asia -- once seen as growth markets -- won't have money to spend on new weapons systems.

"It leaves the outlook for defense spending going from being strong to being dim," said Philip Finnegan, a defense industry analyst at the Teal Group in Fairfax. "It's not a rosy outlook."

Not everyone is so gloomy. Loren Thompson, a defense industry consultant, thinks the credit crisis could work to the industry's advantage if policymakers are looking for ways to jump-start the economy.

"If you want to stimulate the economy you can give a tax break so someone can go buy a TV that's been built in Korea or if you buy weapons it all gets spent here, in the U.S.," Thompson said. "All the bad economic news of the last month works to favor defense stocks and defense companies."

In the past eight years, the Pentagon's defense budget has jumped 86 percent, from \$361 billion to \$672 billion in inflation-adjusted dollars. General Dynamics, for example, got a huge boost to its sales after winning contracts totaling \$1.7 billion to build and service armored vehicles for the Army capable of withstanding roadside bombs in Iraq. Lockheed Martin, the world's largest defense contractor, has also benefited because it manages two of the Pentagon's biggest fighter-jet programs. Northrop Grumman of Los Angeles, which has a large presence in the Washington area, and General Dynamics both have a piece of a \$4 billion deal to help build two Navy submarines.

But the prospects for such programs have dimmed some in recent months. Even before Congress approved its \$700 billion plan to bail out Wall Street, analysts projected defense spending for future weapons programs to tighten. The Pentagon is struggling to meet rising personnel costs as it tries to increase the number of Army troops and Marines. And it has estimated that it may need tens of billions of dollars just to repair and replace tanks, armored trucks and other equipment used in Iraq and Afghanistan.

"The Pentagon has gotten anything it wanted mainly because of the wars," said Rep. John P. Murtha (D-Pa.), chairman of the House Appropriations defense subcommittee.

"We're going to be to the point where they're going to have to come to some real justifications of what's needed. You can't have everything and you're not going to get everything."

Boeing's Future Combat Systems -- a new generation of weapons, combat vehicles, robots and sensors whose systems can communicate with one another through a wireless network -- may be curtailed. It has been criticized for its high cost and complexity.

Likewise, a future destroyer program designed by Northrop Grumman could be on shaky ground, as the Pentagon questions what the Navy can afford.

Lockheed could see an end to production of the F-22 fighter as policymakers debate whether Air Force needs both that aircraft and the less expensive F-35 Joint Strike Fighter. Although Lockheed argues that any cutbacks in the number of F-35 planes ordered could raise the price.

Such decisions will likely be influenced by the next president. Neither John McCain nor Barack Obama have offered many specifics.

McCain recently said he's going to try to save \$160 billion -- in part -- by cutting back on the Pentagon's procurements of big weapons systems.

Richard Danzig, a U.S. Navy secretary during the Clinton administration and an Obama adviser, has said he expected that military spending would remain constant during a Democratic administration but that priorities could shift. He said there is likely to be a focus on "cyber warfare" and unmanned aerial vehicles -- areas that some companies are beefing up in anticipation of possible deals.

But any decisions on individual weapons systems will likely factor in the government's other priorities, whether it be the economic downturn or long-standing issues like Social Security funding.

"This is certainly going to be a very different period than the last eight years have been," said Steven Kosiak, a defense budget analyst at the Center for Strategic and Budgetary Assessments, a Washington policy group.