

The Global Financial Crisis and Implications for the Defence Industrial Base

by Dr Jeffrey Bradford

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As the Roman statesman Cicero observed some two millennia ago, "the sinews of war are infinite money". Translating into modern day language, a healthy economy, it could be suggested, is seen as the pre-requisite for a strong defence industrial capability.

The current crisis, originating in the US sub-prime market, rippled outwards into the wider US financial markets in 2007 and has spread like a contagion around the globe, causing challenges for governments and commerce alike. For the defence industry there are demand challenges (in terms of new constraints on government budgets) as well as supply challenges (in terms of contractors being able to access capital for investment into major capital expenditure programmes).

The latest challenge to the health of the world's financial system started with a crisis in the bundling of debt for home owners unable to borrow at normal rates (i.e. sub-prime rate lending). The early stages of this crisis of liquidity seemed to leave the leading defence industrial players largely unaffected. In late 2007 investment bank analysts were forecasting defence as being one of only three sectors to post positive growth in 2008 due to its favoured

position with Government as well as the ongoing defence commitments in the Middle East and Afghanistan.

The recent slump in markets picked up speed in late summer and early autumn, piercing the shield of apparent invulnerability of leading defence stocks. The US election of Barack Obama was preceded by an apparent rally in the stock market, now facing sharp falls as the economy seeks to understand the likely approach the US Government will take to the business community.

Considering leading US defence contractors, the table below provides a summary of what has transpired over the recent 52-week cycle.

In terms of share price variation, the top five US contractors have experienced an average fall of nearly 50% over the past 52 weeks. Boeing, experiencing difficulties with the Air Tanker contract for the USAF as well as labour difficulties with the unions, has suffered the steepest fall. Raytheon and Lockheed Martin have weathered the battering storm of share prices best.

Amongst the leading UK contractors (see Table 2) BAE Systems, VT Group and QinetiQ have expanded their operations into the United States and despite falls in share price likely enjoyed an increase in earnings due to currency rates – readers no doubt remember the US \$: £ exchange rate being in the region of 2 to 1 through late autumn. However, as challenges in the UK economy emerge with a vengeance the exchange rate has fallen to around \$1.50 to the £1 taking the edge off this benefit.

Company (Stock Code ¹)	52-week share price ²	Market Capitalisation ³	Price/Earnings Ratio (PER) ⁴
Boeing (BA)	\$36.17 – \$93.64	\$29.0Bn	7.3x
General Dynamics (GD)	\$47.81 – \$95.13	\$20.1Bn	8.6x
Lockheed Martin (LMT)	\$67.38 – \$120.30	\$32.1Bn	10.4x
Northrop Grumman (NOC)	\$33.96 – \$83.49	\$13.2Bn	8.1x
Raytheon (RTN)	\$41.81 – \$67.49	\$20.5Bn	11.5x

Table 1: Key US listed defence companies

Company (Stock Code ¹)	52-week share price ²	Market Capitalisation ³	Price/Earnings ratio (PER) ⁴
BAE Systems (Lon:BA)	£2.94 – £5.14	N/A	N/A
Babcock (Lon:BAB)	£3.06 – £6.50	N/A	N/A
QinetiQ (Lon:QQ)	£1.29 – £2.35	N/A	N/A
VT Group (Lon:VTG)	£4.32 – £7.06	N/A	N/A

Table 2: Key UK listed defence companies

Likely Trends in 2009

Looking from this position into 2009, a few clear trends can be observed:

- Firstly, as the industry uses the US dollar as its currency, American defence exports will be cheaper and therefore more competitive in the international markets. Additionally, Urgent Operational Requirements (UOR) purchases from the USA will be more expensive, as will efforts to piggy-back on US programmes in the Network Enabled Capability sphere due to the strengthening of the US dollar exchange rate against the pound sterling.
- Secondly, a stronger dollar will embolden companies seeking to make acquisitions overseas. The most obvious targets, given DOD preoccupation with C4ISTAR and space programmes, make for an increased likelihood of companies operating in the high-value electronics-driven niche as potential targets.
- Thirdly, the credit crunch is going to make it generally more expensive for companies to fund acquisition, investment and their existing lines of debt. This will risk erosion of profitability and, once basic cost-cutting measures are implemented, will make the cost of doing business higher.
- Fourthly, the credit crunch is increasingly making governments prioritise public spending into investments in other areas of the economy, drawing funds away from defence at a difficult time.
- Lastly, the key projects for contractors in 2009 will likely be split around the very hi-tech, operations and maintenance opportunities.

For example, to observe the contract flow being issued by US DOD over the past year it is quite telling that the vast number of major programmes are based around communications, surveillance and information management. The major new platform programmes such as the Joint Strike Fighter (F-35) and Future Combat System face review by an incoming administration. Whilst the JSF programme will likely survive, loss of the vertical take-off variant would be a major blow to the UK's future aircraft carrier (CVF) programme and its expeditionary warfare strategy.

At the other end of the scale the operating tempo in Iraq and Afghanistan creates innumerable opportunities for the in-service support and spiral development of existing platforms. The BAE Systems acquisition of Armor Group seems to have been a well thought through decision which will pay dividends.

Prospects for Defence Departments

Turning to the perspective of defence departments, whilst some in the defence establishment feel less well disposed to the idea of profitability of defence contractors, the current pinch in the credit markets, coupled with falls in valuation, will make it harder to secure finance for investment in their businesses, product development and so forth. Furthermore, weakness in the industry will reinforce pressure to merge or acquire smaller competitors – with less choice for the end customer and less competition.

In addition, defence departments across Europe and the United States will feel more political pressure to favour particular domestic suppliers and this will place greater pressure on process and the bureaucracy. In the same way in which small deals are now being signed off in investment banks at the highest level, so we may see a similar affliction whereby investment approvals boards find themselves applying significant scrutiny to what would normally be minor programmes.

Turning the Corner

2009 will likely see a turning point for the current economic troubles and in particular the defence industry. Given its pricing in US dollars and the recent strengthening of the dollar, US defence companies will be first to benefit. The dual threat of economic hardship and corporate predators strengthened by beneficial exchange rates represents a potent mix for international players in the defence industry to be concerned with. ■

NOTES

¹ Stock code refers to the quick reference code assigned by the relevant stock exchange to a particular company. All data is taken from 5 December 2008

² 52-week share price refers to the highest and lowest value of a particular share price in a 52-week period

³ Market capitalisation identifies the value of an enterprise calculated as the number of shares in issue multiplied by the market price per share

⁴ The PER is how much an investor is paying for each GBP or USD of the company's profits (earnings)