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LCS-5, -6 Will Keep Separate Combat Systems,
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NAVAL BASE SAN DIEGO --The Navy plans to stick with its strategy of having separate combat systems for the next two Littoral Combat Ships (LCS), Rear Adm. James Murdoch, the head of the program executive office, said this week. The USS Milwaukee (LCS-5) and USS Jackson (LCS-6) went into construction earlier this year. The Milwaukee will join the LCS fleet as a Freedom-class ship, while the Jackson will fall into the Independence class. Both are scheduled to complete sea trials and join the fleet in2014, Murdoch told Defense Daily at a Surface Navy Association conference here Tuesday.

Lockheed Martin [LMT] is building the Freedom class, while General Dynamics [GD] is responsible for the Independence class. Both companies have employed their own combat systems with virtually no commonality for each version of the LCS. Some in industry have suggested that in the current austere budget environment LCS should share a single combat system.

Murdoch said the Navy has not yet decided on whether both classes should have the same combat system or whether the program should shift to a single system. There was no timeframe for a decision and the Navy was awaiting feedback from the two firms, he said. "I'm not going to prejudge that," he said, adding he did not expect any changes in the "immediate term."

The first of the LCS class, the USS Freedom (LCS-1), is due to conduct final sea trials in November as modifications to the vessel near completion (Defense Daily, Aug. 17). Freedom has been dry-docked since June as it receives final, post delivery modifications. Barring "something unexpected," Freedom will leave the dry dock in September and will be put through sea trials in November, Cmdr. Matthew Weber, the ship's commanding officer, recently said.

The LCS program has experienced delays and cost overruns, drawing sharp criticism from Congress. Questions mounted after Freedom suffered from a crack in its hull and parts of its aluminum structure earlier this year. The welding cracks were repaired in the spring, Weber said.

(DEFENSE DAILY

17 AUG 11) ... Mike McCarthy

LPDs, Closure on Course at Avondale, HII Says

Huntington Ingalls Industries (HII) will continue to churn out the U.S. Navy's next LPD San Antonio-class amphibious transport dock ships at its Avondale shipyard in Louisiana even as the company winds down operations there, according to HII executives. The closure should continue as planned, operationally and financially, the executives say. "At Avondale, LPDs-23 and 25 remain under construction, and we continue the early stages of implementing our plan to wind down the operation," HII CEO Michael Petters told investment analysts during the company's Aug. 11 conference call to detail second-quarter financial results. "I want to re-emphasize that this decision was made in light of the Navy's 30-year shipbuilding plan and an overcapacity in the industrial footprint," Petters said. "We continue to see positive performance results on these two ships, which is a testament to the quality of our shipbuilders in Avondale. Let me reiterate that 2013 remains the critical inflection point for Huntington Ingalls as the Avondale shipyard winds down and LPD-25 and [amphibious-assault ship] LHA-6 are delivered."

Still, investment analysts questioned just what effect the Avondale closing could have on HII's shipbuilding plans, especially given recent reports suggesting the company may not be able to recover some of the costs associated with shutting down the yard. As to what obstacles HII faces in the second half of this year, Robert Spingarn of Credit Suisse, asked, "Is it Avondale?" Petters replied, "Relative to Avondale, we've updated our proposal that reflects the experience so far. We've first put that proposal together, we were making some pretty conservative estimates on ... what things are going to cost us relative to this restructuring. As we've gone through and restructured and updated our estimates, we've lowered our estimate for the total cost for the restructuring. So that's just the evidence things are going pretty well." Still, Spingarn asked, "How should we think about the talk that perhaps not all the cost is reimbursable or maybe the better way to ask this is: What is reimbursable? What do you expect?" Petters answered, "This is a negotiation that will be going on between us and the Navy throughout the whole process and so we have an estimate for what we think it will cost. The Navy will have their estimate for what they think it will cost and we'll be both working to refine those estimates, and so I think what is happening here is that you are getting a lot of early publicity I think around this negotiation."

Barbara Niland, HII corporate vice president of business management and chief financial officer, told analysts, "We firmly believe all the costs associated with this restructuring are recoverable. After you've experienced all the actual costs and you negotiate your overhead rates in the out years, and close them out, is when all the final decisions will be made on that."

(AVIATION WEEK 16 AUG 11) ... Michael Fabey

‘Trigger' Round of U.S. Budget Cuts Would Have Huge Impact on Defense

Defense spending cuts of some $350 billion over the next decade contained in the new debt-limit legislation passed by the U.S. Congress correspond with the numbers expected from an earlier goal advanced by President Obama. But the Pentagon leadership described the potential of $600 billion more in automatic spending cuts as disastrous.

The Department of Defense is conducting a comprehensive review of spending after the President called for spending on security to be held below inflation for 12 years. This would amount to a $400 billion cut over previous plans. The cuts outlined in the debt-limit legislation passed August 2 "are largely in line with what we were anticipating and preparing to implement," new Secretary of Defense Leon Panetta said at his first news briefing.

The debt-limit legislation requires $917 billion in cuts to government spending over the next decade, beginning next year. A congressional "super committee," officially the Joint Select Committee on Deficit Reduction, must identify $1.5 trillion in further cuts by November 23. By Christmas, Congress then will vote up or down on the recommendations. Failing agreement in either case, a "trigger mechanism" requires $1.2 trillion in automatic spending cuts, about half for security.

At the August 4 briefing, Panetta described the trigger scenario as "disastrous" to U.S. security. "It would result in a further round of very dangerous cuts across the board," he said. Adm. Mike Mullen, chairman of the Joint Chiefs of Staff, noted, "Programs that can't meet their cost schedule requirements are very much in jeopardy."

No specific programs have been officially identified yet for cuts. Shaun McDougall, U.S. defense budget analyst with Forecast International, said aviation programs that could be vulnerable to trimming are the F-35 Joint Strike Fighter and Marine Corps V-22 Osprey. Programs in early development, such as the Air Force long-range bomber, Army armed aerial scout and Navy/Marine Corps VH-71 presidential helicopter also face uncertainty. "These are basically efforts that were cancelled because of cost and were relaunched," McDougall said. "DOD is going to be on a short leash when it comes to cost, schedule and performance with these programs."

(AVIATION INTERNATIONAL NEWS 15 AUG 11) ... Bill Carey

Advice to Defense Industry: Consolidate or Die

The extent of upcoming cuts to U.S. defense spending remains tough to predict. But one thing appears certain: Budgets for new weapon systems will be heading south, and the arms-making industry still has no coping strategy, analysts warn.

Defense contractors are facing a potentially devastating 50 percent drop in U.S. military weapon buys over the next decade, and unless the industry begins to consolidate soon and shed excess capacity, it could be headed for financial disaster, says Marty Bollinger, director of Booz & Company's aerospace and defense practice.

A substantial drop in procurement funds already has occurred, although it has been largely unnoticed, Bollinger says. During the past three years, the procurement budget has fallen by more than $40 billion - including both the base budget and war-emergency supplemental funding. "It's only now beginning to affect industry because it takes a while for changes in the budget to work their way through the spending process," he says.

Because the Pentagon is still spending unprecedented amounts overall, the average observer would not realize that funds for new weaponry has been on a downward slide. Overall, the base budget for the Defense Department has soared from $480 billion in 2008 to $553 billion requested for 2012. During that same period, procurement funds fell by $41 billion.

That trend only will accelerate as other priorities within the Pentagon's budget continue to squeeze procurement accounts, says Bollinger. One of the rules of Pentagon budgeting is that for every dollar spent on new equipment, you need two dollars for personnel, operations and maintenance. Simple math says that if the top line does not increase, if personnel, operations and maintenance go up by 1 percent, acquisition must go down 2 percent. "We are going to see acquisition budgets go down pretty substantially as the money gets eaten up," he says.

Under the best-case scenario, there could be a 30 to 40 percent reduction in the amount of military equipment that will be developed and purchased over the next five years, Bollinger says. That level of decline is not unlike what happened in the two previous defense downturns, when procurement spending dropped by 50 percent each time. "The question on the table is how industry can possibly cope with a loss of half their market?" he asks. What helped the industry survive the past two cycles was a massive consolidation that wiped hundreds of companies from the sector.

Bollinger cautions that companies this time around will be in a tougher spot because the Defense Department's industrial policy is anti-consolidation. Pentagon leaders already have announced they would oppose mergers of major contractors. According to Frank Kendall, deputy undersecretary of defense for acquisition and technology, the top tier of the industry is off-limits. "We do not believe additional consolidation would be in the interest of the department or the nation," Kendall tells a Senate Armed Services Committee hearing in May. With regard to lower-tier suppliers, mergers would be assessed on a "case-by-case basis," Kendall says.

Bollinger does not see how many companies will survive the coming lean times without a big wave of mergers and acquisitions. The Pentagon's stance "worries me," he says, because it implies that the department is willing to spend money to sustain unneeded industrial infrastructure and, as a result, is fomenting a "hollow industrial base." On the surface, the industry would look fine, until you peel off the layers and you see that the capability has evaporated, he says. If they cannot consolidate, companies will founder because there will not be enough new programs to keep everyone in business.

Companies will have "names on the front of the building but behind it, there will be no engineers," says Bollinger. "That is what worries me about the current industrial policy." Even if mergers are allowed at the lower tiers, that is not going to address the excess capacity problem of large prime contractors, which receive most of the procurement dollars. The Defense Department mistakenly believes that industry can seamlessly reduce capacity when buying falls, he says. "Capacity only gets reduced when companies rationalize and shrink corporate overhead."

Some firms already have laid off employees in an effort to trim overhead costs, but that does not go nearly far enough, Bollinger says. To remain competitive in a smaller market, companies will need to close idle factories, unproductive operations and the infrastructure that goes along with that.

Pentagon officials' reticence on industry mergers ignores reality, he says. The Navy, for instance, has kept two nuclear shipyards open even though there is hardly enough work to keep one alive. Over the past two decades, two parent companies, General Dynamics and Northrop Grumman, acquired two major shipyards each, but did not shed excess capacity, and the sector is now due for major downsizing, Bollinger says. "We have not had a shipyard leave the business in about three decades. ... since Lockheed Martin closed one in 1988," he says. "Competition is a very useful thing if you have frequency of programs and sufficient business to allow multiple competitors to stay alive."

Given the budget outlook, the
Pentagon will not be able to subsidize multiple competitors, and may have to resort to the arsenal model of single suppliers, which is already how many weapon systems are being bought, he says.
A more sensible option would be to allow existing prime contractors to consolidate so they can compete against new non-traditional suppliers, says Bollinger. Already there has been a surge of participation by foreign suppliers and by companies that a few years ago didn't consider themselves traditional defense contractors, he points out. Most of the armored trucks that the Pentagon has bought for the Iraq and Afghanistan wars were foreign designs. The last helicopter the Army bought is a French design. The last aircraft bought by the Air Force is Italian. The last three trainers the U.S. military bought were foreign models. Both variants of the Navy's littoral combat ship are being made by shipyards owned by foreign parent companies. Commercial truck manufacturer Navistar now has a $4 billion defense business.

The government tends to focus on
the "legacy" supply base and on maintaining competition there, he says. That is unrealistic, he adds. The more new entries into the market, the easier it will be for the traditional defense suppliers to make the case to the Pentagon that they should be allowed to consolidate so they can survive and grow, he says.
The defense industry "is going have difficulty attracting risk capital and attracting talent unless there's a mechanism that allows them to grown," Bollinger says. "In a down market, that would be consolidation." During the last downturn, between 1988 and 1995, the industry managed to provide 16 percent annual return to shareholders because of aggressive mergers and acquisitions, he says. "The ones that didn't do anything had negative returns."

The Pentagon's anti-mergers
industrial policy assumes that top tier suppliers are in no financial danger. Although these firms might be in solid shape today, in the absence of new programs, they will wither, Bollinger says. He suggests the Pentagon should call for a BRAC-like base closure process for industrial facilities. That would help companies sidestep the political landmines associated with shutting down facilities. "They're terrified of losing support from their congressional delegations," he says. If all the unneeded facilities were put on one list, Congress would have to vote aye or nay on the whole thing.

Aerospace and defense industry
analyst Scott Thompson, of PricewaterhouseCoopers LLP, anticipates a wave of consolidation sometime in the near future, although not as quickly as other experts had predicted.

According to PwC's quarterly mergers and acquisitions
report, in the second quarter of 2011 there were 13 deals worth $5.3 billion, compared to nearly $10 billion in deals for the first quarter.

"Deal activity during the second quarter declined somewhat from the first quarter of 2011, but this appears to be more of a result of the robust nature of M&A activity during the first quarter than the start of a long-term trend," said Thompson. "Defense companies continuing to reshape their portfolios, ongoing appetite from investors in the booming commercial aerospace sector and the growing stockpiles of cash on corporate balance sheets are all factors contributing to our M&A growth expectations in aerospace and defense."

The consolidation tidal wave that many analysts had forecast probably hasn't happened yet in the defense sector because companies are still shedding unwanted businesses. Just in the past two to three years, for example, Northrop Grumman sold off its TASC defense consulting firm and its shipyards. L-3 in July announced it would spin off its government contracting business, although not the cybersecurity and defense intelligence divisions. ITT also divested its defense segment.

"What we're seeing is a lot of breakups" rather than mergers, Thompson says. But he sees mergers on the horizon. "A fundamental economic law is that in a period of contraction, you are going to have consolidation. You haven't seen it yet because defense companies are now focusing on rebalancing their portfolios," Thompson says. Whereas the commercial aerospace sector has seen far more corporate takeovers as a result of aggressive revenue growth, the defense segment has been moving slower because investors see revenue contraction.

Many potential buyers are holding back until the current budget dust storm settles. "There is a lot of talk about reductions in the defense budget. But what does that really mean?" Thompson asks. "Some of this uncertainty has caused companies to delay consolidation.

Analysts' wary forecast for the industry contrasts with Pentagon officials' rather upbeat rhetoric. Undersecretary of Defense Ashton Carter said in numerous public speeches and briefings to defense contractors that he expects industry to carry on and to continue to make profits even in a downturn. At the Senate hearing, Kendall reassured lawmakers that the industrial base is not going to collapse. "It should be clear that while we anticipate significant change from the environment of the last decade or so, the sky will not fall on our defense industry. ... Even given the reductions that the president has asked us to examine, we believe that there will still be large and fairly stable markets available for the defense industry. We do not foresee a precipitous decline, like the one that the department and industry experienced at the end of the Cold War."

(NATIONAL DEFENSE 15 AUG 11) ... Sandra Erwin

Huntington Ingalls Posts Second-Quarter Profit of $40 Million, Warns of Potential Carrier Delay

NEWPORT NEWS - Huntington Ingalls Industries Inc. on Thursday reported a second-quarter profit of $40 million, or 80 cents per share, narrowly missing Wall Street expectations. That's compared with a loss of $11 million, or 23 cents per share, in the same quarter a year earlier. Sales for the Newport News-based shipbuilder declined to $1.56 billion, down 2.9 percent from the same quarter a year ago, due in part to unfavorable timing of two key ship contracts for its Gulf Coast unit and lower revenues on aircraft carrier programs in Newport News, the company said.

Analysts polled by Thomson Reuters I/B/E/S had expected earnings of 82 cents per share on revenue of $1.65 billion. Shares of Huntington, the nation's largest shipbuilder, closed down 18 cents at $27.83 Thursday, despite a broader market rally. The stock has fallen nearly 33 percent since the company was spun off from Northrop Grumman Corp. on March 31.

Mike Petters, Huntington's president and chief executive officer, said the company's financial performance continues to be hampered by two underperforming shipbuilding contracts on the Gulf Coast that will keep profit margins low until 2013. In a conference call with analysts, Petters said Huntington's goal is to improve its margins to 9 percent by 2015, up from the current 5.8 percent.
The company, he said, remains "well-positioned to support the Navy's and Coast Guard shipbuilding requirements ... and we remain firmly on track to deliver the long-term operating margin we've discussed in the past."

Analysts pressed Petters on a Bloomberg report published earlier this week that said the Huntington-built Gerald R. Ford aircraft carrier could exceed its original contract price by about 11 percent. Huntington received a $5.2 billion contract to build the first-of-its-class carrier in 2008, but the company may exceed that amount by about $562 million, a Navy spokesman confirmed this week. The service, which noted the carrier remains within its cost cap and budget, said the overrun is due to availability of material and "construction inefficiencies."

A
Pentagon document released earlier this year and cited in an Aug. 9 Congressional Research Service report attributes the rising cost to "unfavorable contractor material and labor performance." According to that report, the Navy is working to reduce the overrun. Petters defended the company's performance on the Ford, saying it "remains committed to our financial targets on that program." "The performance on the ship right now is pretty solid," Petters said. "(W)e're very confident with the financial performance on that program."

Petters also addressed the looming uncertainty over the Navy's future budgets, which includes consideration of delaying the purchase of the John F. Kennedy aircraft carrier by up to two years and altering its long-term carrier construction plan.

Each time a multibillion-dollar carrier comes up for budget approval, the program tends "to come under a lot of scrutiny ... and the Kennedy is no different," he said. Petters warned that such a delay would have a wide-ranging impact on the Navy, the 20,000-worker Newport News shipyard and its stable of suppliers.

"Extending the carrier-build cycle to six or seven years not only increases the overall cost of the ship but would also have a severe and far-reaching impact nationwide," he said, noting that the shipyard buys up to $3 billion of materials from suppliers across the country.
The Navy remains in closely held budget deliberations, and likely won't make a final decision on what to do with regard to the Kennedy until later this year.

Huntington said it expects second half sales and profits to be similar to the first half of the year. Through the first six months of 2011, Huntington has posted $85 million in profits on $3.24 billion in revenues.

For 2010, the then-Northrop-owned shipbuilding unit posted earnings of $135 million on $6.72 billion in revenues. Operating margin, long a concern of the company's previous owner, Northrop Grumman Corp., jumped to 5.8 percent from negative 1.2 percent in the same quarter a year earlier. Huntington's second quarter results included a $113 million pre-tax charge related to the company's decision to wind down operations at its Avondale, La., shipyard, which is slated to close in 2013.

(NEWPORT NEWS
DAILY PRESS 12 AUG 11) ... Peter Frost

Electric Boat to Lay Off 65 Conn. Workers

GROTON, Conn.- Submarine maker Electric Boat says it will lay off 65 workers in October.

Spokesman Robert Hamilton said Tuesday the Groton-based company regularly reviews its work force requirements. He says Electric Boat informed workers on Monday. It's the second layoff notice in as many months. The subsidiary of General Dynamics Corp. said in July it plans to ax 104 employees due to a projected softening of the workload for carpenters, machinists and pipefitters.

Electric Boat, which is the U.S. Navy's primary contractor for submarines, said in early July it's hiring hundreds of employees and putting up buildings as it increases production of fast-attack submarines and ramps up design work for ballistic missile vessels. It employs more than 10,000 workers at Groton and Quonset Point, R.I.

(ASSOCIATED PRESS
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