

GROWTH STRATEGIES TO TAKE ADVANTAGE OF THE HISTORIC DoD BUDGET INCREASE

A COMMERCIAL BANKING PERSPECTIVE



In September 2017, President Trump proposed a \$52 billion budget increase for the Department of Defense (DoD) for Fiscal Year 2018.¹ Exceeding the expectations of many, Congress responded by passing a nearly \$700 billion total budget.² As a result, businesses are seeking to reap the benefits of this defense spending boost by building or buying new capabilities to take advantage of the anticipated growth in high-profile, high-tech defense programs.

BUILD NEW CAPABILITIES

If choosing to build new capabilities, companies should first ensure that their product or service will fulfill a specific military need and be a strategic fit for the company. Next, companies must ask themselves if they realistically have the time to conduct the research and development required to create the new product and meet the DoD's product specifications by the required date, or in anticipation of the expected need.

Finally, the application and approval process to be a government contractor must also be taken into consideration because of the amount of time required. Even companies who are already an approved government contractor, and want to win another government contract, still have to go through a lengthy bidding and approval process for each proposal they submit. Once approved, despite the many regulations to comply with, the long-term contract should ultimately prove to be a meaningful investment.

Government contracts are not only awarded to large corporations like Lockheed Martin and The Boeing Company but to small businesses as well. In fact, most government agencies set aside a percentage of their contracts for small businesses. In FY 2016, the DoD military departments and agencies awarded \$57.8 billion to small businesses.³

BUY NEW CAPABILITIES

Since building new capabilities is extremely complex and often very time consuming, obtaining new capabilities through acquisition is a more feasible strategy and the path of least resistance in gaining exposure to high-profile, high-tech defense program contracts. If choosing to buy, a company may more quickly realize the upside of their investment since they bypass new product development and building costs. Buying an existing approved government contractor may also help avoid the struggle of trying to win a new contract with the DoD, which tends to award the majority of their contracts to already existing contractors.

Similar to the building process, a company needs to ensure that the acquisition target has an existing product or service that fulfills a specific military need, and that the product or service is a strategic fit that creates synergies with the buyer's existing business. For example, United Technologies made the formal announcement in September that it would be buying Rockwell Collins for \$30 billion – a deal that brings together a host of complementary aviation products and solutions.

While the new aerospace giant can equip jetliners and warplanes from nose to tail, the deal is being viewed as a defensive play. This deal will allow them to become a larger supplier and yield more power in pricing negotiations in aerospace at a time when both The Boeing Company and Airbus are putting a fair amount of pressure on their supply base. Conversely, the recently announced Northrop Grumman/Orbital ATK deal can be seen as an offensive play as the combined company should be able to take advantage of the increased DoD budget, particularly in missiles and space, a fact which seems especially relevant given the current geopolitical climate.

Companies should also keep in mind that although government contracts are transferrable, transfers by means of acquisition require government consent. Fortunately, the military approves all acquisitions prior to deal completion, so companies will have a contract in hand prior to deal closure. Critical to any due diligence process when making an acquisition is to consider the length of time remaining in the target's contracts, as they are often openly re-competed and could be lost business if a competitor wins the new contract.

The two very large M&A transactions mentioned above provide evidence that both the commercial aerospace and defense sectors are garnering significant valuation multiples. United Technologies will purchase Rockwell Collins for \$30 billion, or approximately 14.3x forward EBITDA. Northrop Grumman followed shortly thereafter with its announcement that it would be acquiring Orbital ATK for just over \$9 billion, or approximately 12.8x forward EBITDA. Purchase price multiples and deal activity are likely to continue in an upward trend in 2018 due to the approved defense spending budget.

FINANCING REALITIES

Whether companies decide to build or buy new capabilities, they must determine how to finance the decision. As expected, the defense budget increase has amplified lender interest and confidence in this sector because lenders appreciate the visibility and dependable revenue stream that accompany long-term government contracts. When selecting a lending partner, it is critical to choose one who can not only meet your capital needs, but also provide strategic advice on the industry and new defense programs. Such partners will be extremely beneficial to executives who contemplate entering the sector or broadening their current capabilities.

IT'S TIME TO ACT

With the recent passage of a \$700 billion DoD budget for FY 2018, government agencies have begun awarding new contracts with these funds. Therefore, businesses must start developing their strategies for taking advantage of this historic budget increase now. At Citizens Commercial Bank, our dedicated team of Aerospace & Defense bankers stands ready to provide the financial solutions and business insights you require to take advantage of this significant growth opportunity.



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- ¹ "A New Foundation for American Greatness: Fiscal Year 2018," Executive office of the President of the United States, Office of Management and Budget, 2017
- ² "US Senate passes budget-busting \$700 billion defense policy bill," Defensenews.com, September 18, 2017
- ³ "FY2016 Small Business Procurement Scorecard," U.S. Department of Defense Office of Small Business Programs, February 20, 2017