

A Director's Guide to Defense Conversion: How to Avoid Minefields in the Marketplace

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Defense Conversion:
How to Avoid

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A Director's Guide to Defense Conversion: How to Avoid Minefields in the Marketplace, by John M. Collard, Strategic Management Partners, Inc., published by Director's Monthly.

A Director's Guide to Defense Conversion: How to Avoid Minefields in the Marketplace

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Defense manufacturers that head blindly into uncharted territories are asking for peril.

The nation's shift to a peace-time economy is forcing many companies into a real battle for increased sales. Their defense conversion efforts may be a matter of new products, new markets, or both.

Some companies are finding new, peaceable applications for their military technology. Others remain committed to their product core. But all defense companies are in search of new markets.

Corporate directors are expected to participate in the strategic planning process. If you are a director of a company seeking to find new markets for defense products, you are not only expected to participate in the planning process; you may be needed to lead it.

Even if the companies you serve as a director have not been affected by the defense conversion yet, they will be. Your first reaction to the increased competition may be to advise management to look for new markets. But new markets bring new rules and new ways of doing business, so look before you leap.

New Products

Determine if your company has products and skills that are transferable to new markets. This can be a challenge. Where can you sell a long-range bomber or a guided missile system? To a foreign power? Since foreign military sales are governed by the Pentagon, you probably don't have many choices.

But the technology that was used to develop a given product may have specific applicability in other arenas. The company you serve may have to change the look and feel of what it is offering, depending upon what the new customer needs. San Diego's XXsys Technologies, Inc., is taking the ultrastrong materials it used to pump into B-2 bombers and is now putting them into bridges and roadways.

To move into a new market segment requires a different way of doing business— a fundamental change in approach.

New Markets

The end of the cold war pulled regional economies from their roots and shook off what had been rich soil for easy growth. During the '80s, defense contractors flourished with or without sound strategic planning skills. The government mandate to cut defense spending has forced many contractors to develop such skills — A.S.A.P.

One-time missile manufacturers and former F-14 fabricators are looking for new markets and forcing sales-starved chief executives into new territories without the proficiency to generate revenue once they get there.

Even larger companies have been hit hard. Connecticut's Pratt & Whitney division of United Technologies used to sell some 700 military jet engines a year. This year, orders have dropped to around 50 engines.

Any significant drop in sales usually leads to a shake-up in employment. For example, in Maryland, Westinghouse Corp.'s electronics division has reduced its work force by 40 percent in the past five years. In the height of the defense build up, Westinghouse employed more than 17,000 people in the region. Today, it employs less than 10,000 there.

These companies have been able to diversify their commercial base, but most businesses don't have a back-up plan just in case their major customer walks away. Instead, Plan B often becomes a bootstrap effort to reach out to the "hot market of the month," typically a segment that has been tapped out even as it soars in popularity.

Most boards will look to the wide-ranging and economically unrestrained commercial marketplace for renew opportunities. But pitfalls await anxious CEO's and directors here, as well.

To move into a new market segment requires a different way of doing business — a fundamental change in approach. While a company may be capable of making the shift from government contractor to commercial supplier, and from commercial supplier to international manufacturer, its leaders will need to understand that customer motivation and timing differ in each marketplace.

Typically, you will find management steering a company into one of three major market categories. As you advise and assess strategy, here are points to keep in mind. Here's a look at each major market segment:

Federal buyers are looking for commodity-based solutions. They are looking for value — the best products at the best prices. If your company's marketing efforts are geared toward building relationships first, your competition will be out the door with the contract while your account managers are still warming up to the procurement officer. In this market, management will have to price low to win bids now, then work to cut costs or negotiate adjustments later.

Strategies for Winning Business in New Markets

	Government	Commercial	Global
Contract Environment	Life-cycle award: structured by FAR	Not structured UCC governs	Rules of country: \$ exchange rates
Market Environment	Limited; highest-value wins	Caveat emptor; business abounds	Wide open; who you know/pay
Distribution/ Differentiators	Procurement process; design to spec	Salespeople; alliances	Connections; local presence
Technology Importance	Very important; military-oriented	Solution focus; relationship-driven	Paramount; transferable
To Win:	Give fair value for \$	Demonstrate benefit	Boost local economy

On the other hand, commercial buyers look for cost-effective (typically fixed-price) solutions that operate within the complement of existing investments.

In the international market, price and product are important, but the bottom line is who you know—not just what you are selling.

Government Contracting

Two different markets are open for opportunity within the government contracting sector: "set-asides" for qualified sellers (typically small ones), versus competitive procurement opportunities for all sellers (typically large ones).

Government set-asides are programs targeted to small, and/or minority disadvantaged businesses. There are many such qualified sellers so the key here is to get there first.

If management is targeting the government set-aside market, it will find a constantly churning market of entering and exiting players, all of which are vying for contracts in the \$10,000 to \$10 million range.

What you do is more important in this market than how you do it.

Larger federal procurement contracts are obtained through a lengthy and very competitive bid process. Competition is intense, and scattered among the major aerospace and weapons companies, major suppliers, and established systems integrators. Additionally, there is a second tier of competition brought on by subcontractors who are bundling services to win contracts and become part of larger teams.

Reputation is important when it comes to securing these federal contracts. So is top-to-bottom company support. Competitive bids require a significant corporate commitment just to win the contract.

The low bidder is always the winner in the competitive government contracts market. But the low bidder may not always have the lowest price. Today, contracts are going to the "lowest evaluated bidder," or the bidder who brings the most value for the price to the table. Lowest-evaluated bidders have been beating out the lowest-priced bidders for some time now and are proving to be stiffer competitors. Plan for long lead times, mountains of paperwork, and rock-bottom pricing in the somewhat flat new acquisitions market. Businesses go fishing for deals anywhere from \$5 million to \$100-plus million to \$1 billion in this market segment.

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Commercial Market—Domestic

Most boards will look to the wide-ranging and economically unrestrained commercial marketplace for new opportunities. But pitfalls await anxious CEO's and directors here, as well. With so many potential sellers, this is truly a "buyers market," subject to buyers' whims. Management's industry knowledge is paramount here: the company's products and services must be easily defined and understood.

Good relationships — from service to smiles — mean everything in [the commercial] market.

This market is responsive to relationships, increasing prospects and future stability for service-oriented companies. On the other hand, in this market, unlike the government contracting market, buyers can be fickle. You may be providing exactly what a buyer needs, but that buyer may suddenly decide he or she doesn't like your wristwatch. And if your competitors have similar, yet inferior products, they may still be gaining an advantage if they have invited the buyer out on the golf course three out of the past four weekends.

Good relationships — from service to smiles — mean everything in this market.

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Commercial Market — International

As more businesses wander outside the borders of their native countries, the international market will become increasingly more competitive. Yet companies seeking to move from U.S. government buyers to commercial buyers in other countries won't find it any easier to navigate until others make inroads. For better or worse, the inroads — and the competition — are there. Japan and countries in Europe have been doing defense business internationally for years. U.S. defense businesses are relative newcomers to the international markets, but they are not the only new kids on the block. There's increasing competition from Latin American and Eastern-bloc nations with low labor costs.

If relationships are "key" in the commercial market, in the international market they are "king" — sometimes literally. In the international market, in fact, some relationships can be traced by bloodlines.

Whereas the U.S. welcomes foreign products, many countries limit imports. Both Ford and Honda have proven this point with their widely scattered worldwide plants. Exclusionary tactics often range from burdensome import duties and competition-limiting treaties to competing against local government subsidized bids. And don't be surprised to hear that the company you serve is paying "entry" fees all the way through a power structure that includes distributors who may well be the King's (or President's or Commander-inChief's) nephews. As a director, you will want to be well-versed in the Foreign Corrupt Practices Act, including 1988 amendments, in monitoring these payments.

Foreign buyers are commercial in nature, yet they favor their own suppliers unless what they need can only be purchased abroad. And they may only be outside their own borders for a short time seeking technology transfers, as many technologies are replicable.

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Parting Advice

Here are some summary tips to keep in mind as you serve on the board of a defense manufacturer. Make sure management:

- knows the company's competitive strength's and weaknesses — how do the company's products and services compare to the competition in terms of technology, design, and cost?
- respects the limits of the company's resources — it should build only one or two market niches at a time, not try to conquer the world.
- protects the market share it has already earned while it reaches out for new business. Markets neglected while reaching toward new sales become prime targets for the competition.

Finally, as a director, be willing to throw all assumptions out the window. New markets bring new personalities, customs, and business traditions to the table. Use your experience to help managers adapt.

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Three Case Summaries

A \$25M NASDAQ Manufacturer	A \$33M Weapon Systems Contractor	A \$59M Systems Integrator
Who:		
A \$25M public NASDAQ traded microprocessor based manufacturer defense contractor, provider to US Gov't, NATO countries and contractors; with 240 US employees and 60 European employees.	A \$33M weapons systems development and deployment engineering services to U.S. government contractor providing, especially the air/space segments of the military, SDIO, NASA, and National Laboratories. With 300 employees.	A \$59M systems integration, facility management, networking and engineering U.S. government contractor in the 8a disadvantaged business set-aside program, servicing federal government agencies. With 660 employees.
Situation:		
No sales force. Too many accountants and engineers. Losing money. Market shrinking with defense cutbacks. Bank called the credit line and imposed daily covenant certification. Trade creditors filing suits. Desperate for new capital and leadership. The classic turnaround situation.	No business development function or staff; had not won a major contract in 3 years. Market shrinking with defense cutbacks. Market direction uncertain. B&P funds deteriorating; profit margins eroding. High overhead rates. Prices not competitive. Backlog eroding. Desperate for cash.	Owner was part of everything, wouldn't delegate. 42 percent employee turnover. Business development and program management didn't work together. Had not won a major set-aside contract in 4 years. Never won competitively, at maximum size for 8a contractor. Bank called out of covenant loan. Losing money; no cash. Planned to become \$200M commercial systems integrator in

		five years.
Strategic Recommendations:		
Identify crucial issues and isolate specific causes. Develop realistic long term plan for transition from "product to market" to "integration services" orientation, and a short term option to cut losses if the conditions prohibited a successful turnaround.	Develop a plan to increase sales win ratios. Shift out of defense into environmental air quality improvement to reposition the company to achieve greater value for the owner. Develop creative pricing structure and strategy review process.	Implement plan to graduate from 8a program. Build management team to operate in new competitive commercial and international marketplace. Increase sales win rates, and reposition company in new areas to get greater value for the owners.
Results:		
Successful turnaround of public company. Return of value to investors. The company was recently sold.	New business at historic sales win rates, and expanded operations in new markets.	Winning competitive bids. Following realistic growth expectation of \$120M in 5 years with 40 percent to come from commercial market.

John M. Collard is president and founder of Strategic Management Partners, Inc., an Annapolis, Maryland-based transition and turnaround management firm that specializes in valuation enhancement, corporate renewal, defense conversion and strategic repositioning.

Formerly Collard served as president of Delta Data Systems, a \$25 million manufacturer ill a turnaround. He also was a vice president with Martin Marietta, where he was responsible for turning or transitioning troubled segments.

He serves on the board of directors of both public and privately held companies and is a frequent author and speaker. He is one of only 24 industry professionals who have earned the Certified Turnaround Professional (CTP) designation?. In addition, Collard is currently chairman of the Turnaround Management Association. His company was named as one of the "Twelve Outstanding Turnaround Firms of 1993" by Turnaround and Workouts, a newsletter based in Washington, D. C.

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