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Defense Industry In Distress: Opportunities, Obstacles

Law360, New York (May 01, 2014, 1:04 PM ET) -- The U.S. defense industry is facing a new battle — financial distress. Withdrawal of U.S. forces from Afghanistan and Iraq combined with reductions in the defense budget and sequestration have taken a toll on many U.S. defense contractors' balance sheets. Industry analysts believe that this decline may be slowed by several strategies, but many U.S. defense contractors lack both the capital and time necessary to implement them. For industry competitors and private investment funds with the appetite and liquidity, this article will present a brief roadmap to capitalizing on distressed defense opportunities.

General Industry Outlook

The decline in global defense revenues is a trend that is anticipated to continue. In early 2014, the Deloitte 2014 Global Aerospace and Defense Industry Outlook projected a global decline in defense revenues for 2013 of 2.5 percent. While 2013 year-end earnings are still being reported by many of the major U.S. defense contractors, of those available, the top U.S. defense contractors reported declines between 2 percent and 5 percent, with certain outliers reporting declines of approximately 20 percent.

Analysts predict that this trend in declining revenues will be partially offset in 2014 and 2015 by the defense industry's implementation of one or more of three strategies. Firstly — international expansion into new regions. As reported in IHS Inc.'s 2014 Balance of Trade Report, dramatic growth in 2013 defense imports was seen in the Middle East (predominately Saudi Arabia and the United Arab Emirates), India, Russia, South Korea and Brazil. Secondly — the development and sale of next-generation defense technology. Indeed, in March 2014 alone, there were at least three significant acquisitions in the cybersecurity sector by major strategic and financial players that supplemented existing platforms and portfolios. Finally — and reminiscent of the fallout from the defense downturn in the 1990s — an increase in acquisitions and consolidation of weaker companies.

The common denominators of these strategies are capital and time. These strategies will work for some in the defense industry, but the lack of time and access to capital will pose a major obstacle for midcap contractors and, in some cases, even a few larger defense companies.

International Expansion

As attractive as international expansion is, it is not as simple as knocking on the door of the local sovereign defense ministry. It requires time, exhaustive research and costly, complicated planning to implement the requisite infrastructure. Many foreign nations employ stringent investment or "offset" requirements. In the UAE, for example, one of the largest defense importers in the Middle East, the offset obligation is 60 percent of the aggregate contract value. Its neighbor Kuwait, imposes a 35 percent obligation on the aggregate value of supply contracts, while Saudi Arabia, the largest defense importer in the Middle East, does not have any publicly established obligation, and instead imposes offset requirements on a contract by contract basis.

As if these offset requirements were not burdensome enough, many regions that are large defense importers have other capital intense operational requirements. For instance, if a contract requires the physical presence of employees in the subject country, most regions require compliance with local labor laws, such as employee indemnity payments (in lieu of pension contributions), obligations to employ minimum percentages of local citizens, and strict guidelines on the issuance of work visas for foreign nationals.

This is not to mention the need to maintain additional controls for various statutory compliance requirements, such as the Foreign Corrupt Practices Act and the International Traffic in Arms Regulations, which make international expansion increasingly prohibitive. For all of these reasons, international expansion is no quick fix for liquidity-strapped defense contractors' balance sheets.

New Technology

Like international expansion, research and development of "next-generation" technology, such as data analytics and unmanned combat vehicles, also requires sizeable capital and time commitments. From a timing perspective alone, the proof of concept phase (in other words, taking idea to prototype) can generally take between two and three years. While this initial phase may require less time depending on the scale of technology or the ability to leverage existing technology, it exemplifies why "next generation" technology is not necessarily a realistic balance sheet solution.

Following the proof of concept phase, cash-strapped contractors will likely need to seek U.S. governmental funding to ease the financial burden of further development. Assuming the best case scenario in obtaining U.S. government funding, the subsequent product development phase including operational testing — could take between one and five years. If final governmental consents are granted, only then can a contractor start the production implementation process. Of course, this timeline varies based on the scale of technology, but it also does not factor the patent application process. While contractors can elect to pursue patents on a parallel path or, even take the riskier approach of foregoing patents, that process generally takes two to five years.

An equally challenging barrier to leveraging new technology to right-size revenues is the amount of capital required to go from proof of concept to production of product. According to the 2014 Global R&D Funding Forecast prepared by Batelle and the R&D Magazine, of the surveyed companies in the aerospace, defense and security industry, 56 percent were pessimistic about their 2014 R&D budgets and 40 percent of the respondents

expressed belief that their R&D staff budgets were not large enough to satisfy company goals.

According to the report, R&D costs are becoming a significant issue for 46 percent of the industry, with 44 percent of the respondents expressing concern that their aging R&D infrastructures are affecting work. Thus, given the significant investment of time and capital necessary for the development, manufacture and sale of new technology as a means to fill the gap left by the decreased U.S. defense budget, this strategy may not be a practicable solution for contractors with looming debt maturities and shrinking revenues.

Acquiring U.S. Defense Companies Through Chapter 11 of the U.S. Bankruptcy Code

The acquisition of defense contractors may not be an option for financially distressed U.S. defense companies, but it presents appealing investment opportunities for healthier industry competitors or private investment firms.

Over the last four years, there has been a trend in the number of defense-related Chapter 11 filings. In recent months, the industry has watched the ongoing restructuring negotiations in which Alion Science and Technology secured yet another Band-Aid extension on its revolving credit agreement through April 30, 2014, and IAP Worldwide Services, on April 3, 2014, agreed to grant first and second lien lenders with 100 percent of its reorganized equity.

Based on reports from distressed commentators, IAP Worldwide and Alion are not alone in pursuing restructuring options. Recently, industry commentators have speculated about potential restructuring discussions involving a manufacturer of mobile-military and response solutions and a provider of cybertechnology defense services.

If the current climate is an indicator of a round of consolidations like those seen in the 1990s, industry competitors and financial players should begin to consider the pros and cons of acquiring distressed defense assets through the Chapter 11 sale process. Under Section 363 of the Bankruptcy Code, purchasers acquire assets of a debtor with the certainty provided by a bankruptcy court order that ownership of the assets is free and clear of liens, claims, fraudulent transfer claims, and certain successor liability. In most cases, the debtor seeks a purchaser prior to the commencement of its Chapter 11 case, known as the “stalking horse bidder.”

The debtor then seeks approval from the bankruptcy court of various bidding procedures for potential competing bids. If additional bids are submitted by competing purchasers, an auction is held at which the “highest or best bid” is selected. Although a stalking horse bidder is subject to potential outbidding and must expend greater resources in negotiating the initial deal, performing due diligence and setting the floor on value, a stalking horse bidder gains access to several key advantages in the sale process. In most 363 sales processes, the stalking horse bidder has the ability to negotiate favorable bidding procedures, which typically include an expense reimbursement and a break-up fee (customarily, 3 to 5 percent) if it is not the successful bidder.

In this context, the stalking horse bidder secures a material advantage because it can get a head start in obtaining governmental approvals that are critical to the ownership and operation of a U.S. defense business. A

363 sale typically obviates the need to obtain many of the consents required to transfer contracts that are otherwise required in a sale outside of bankruptcy. However, U.S. defense companies are rife with industry-specific nuances that require careful consideration by potential investors. Thus, when evaluating a bid that offers higher cash but requires governmental consents, execution risk could tip the scales in the favor of a stalking horse that has already been vetted by the U.S. government.

Foreign Ownership, Control or Influence

A U.S. company is considered under foreign ownership, control or influence ("FOCI") whenever a foreign interest has the power, direct or indirect, whether or not exercised, to direct or decide matters affecting the management or operations of that company. For purposes of FOCI, the power to direct is not limited to ownership of securities, but can also be implicated by contractual arrangements, such as debt instruments.

Consideration of FOCI is important for potential buyers that are publicly owned or private investment funds with foreign limited partners because it may require an additional level of planning to satisfy two important governmental consent processes. First, if a purchaser is considered under FOCI, the transaction may be subject to review by the Committee on Foreign Investment in the United States, a process which can take 30 to 90 days. Purchasers under FOCI that do not submit to the CFIUS process run the risk of having the president block or unwind a transaction if there is sufficient evidence that it poses a threat to national security.

The second FOCI-related process is crucial to the application and maintenance of security clearances which are integral to the ability to perform many U.S. defense contracts. Indeed, the U.S. Department of Defense recently published for comment new uniform FOCI rules for security clearances granted by both the DOD and non-DOD agencies.

To be clear, FOCI is not an insurmountable obstacle if approached with the requisite amount of planning. Both the current and proposed DOD rules are actually aimed at facilitating foreign investment by permitting the transaction while still ensuring that foreign firms cannot undermine U.S. security through unauthorized access to classified information.

Depending on the level of FOCI (i.e., 5 percent versus 51 percent), the DOD security clearance rules provide various measures to negate or mitigate unauthorized access to classified information, such as adoption of special board resolutions, formation of executive-level security committees, appointment of a technology control officer, voting trust agreement, proxy agreement, special security agreement, modification of loan agreements or other contracts with foreign interest.

Government Contracts

For many defense contractors, one of the primary — if not the fundamental — drivers of value are their contracts. Generally, a primary benefit provided to asset purchasers by the Bankruptcy Code is the ability to take assignment of contracts without the consent of the counter-party. However, when it comes to prime contracts

with the U.S. government (and in some instances, sub-contracts to a prime contract), purchasers do not have those same benefits. In addressing this particular issue, some commentators have wrestled with the question of whether the U.S. Anti-Assignment Act's restrictions on the transfer of U.S. government contracts is preempted by the Bankruptcy Code.

While academically interesting, it ignores the practical implication that almost every prime U.S. defense contract is terminable for convenience by the U.S. government. Since the Bankruptcy Code cannot prevent the U.S. government from terminating its contracts for convenience post-closing (and potentially, during the Chapter 11 case), potential purchasers should consider this issue when evaluating any proposed acquisition. Moreover, it emphasizes the benefit a stalking horse enjoys in having the additional time to obtain governmental consents.

Another factor investors should consider in evaluating a target's government contracts is whether the target is operating under a small business qualification. Since the U.S. government sets aside a certain percentage of low-cost contracts for small business qualified companies, an investor will need to determine what percentage of revenues are derived from those contracts, whether the business can be acquired without the loss of the small business qualification, and the impact that such a loss would have on valuation.

Takeaways

The obstacles to restoring revenues for some contractors in the U.S. defense industry create opportunities for others with the requisite time and resources. Whether it is an industrial competitor seeking to enter new lines of business or expand market share, or a distressed private investment firm that has been searching for new places to invest capital, the current environment could create acquisition opportunities at a discount.

Given the United States' propensity to entangle itself in armed conflict, the current economic environment is unlikely to be a "new normal" for the U.S. defense industry. With the proper planning, investors may be able to realize several multiples on their investments if they can capitalize on distressed U.S. defense contractors now and ride out the current lull in the industry.

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