The Defense Contractor Dilemma: Lessons from Dot-Coms, E-Commerce and Vaporware

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"We're well-established, and we've been profitable for years, but our stock is dead in the water, with a low valuation and few prospects for doing any better. Yet, dot-coms and 'new economy' companies with no profits and very little revenue are trading at astronomical prices, even after the recent sell-off. Is there anything we can do to increase our valuation?"
-- a complaint often voiced by defense contractors

The corporate mindset of many defense contractors is wrong for the commercial marketplace, so they are not often well received on the stock market.

As an investment banker who has worked with many defense contractors, I can respond to that question with a qualified "yes." If a company has technology that can be adapted for commercial products, it may--just *may* -- be able to do what's necessary to convince Wall Street that its stock is entitled to a higher valuation.

I'll suggest two different ways of adapting to the commercial marketplace later. First, some background to explain why there's such a wide gap between the valuations of today's high-flier stocks and those of defense contractors, particularly the smaller subcontractors and component manufacturers.

Wall Street views the defense industry as a *mature* industry, one that is in a slow-growth mode. Investors won't pay much for a company that's earning five percent on equity and anticipates increasing its sales from \$500 million today to \$575 million in five years. But they'll jam phone lines and overheat the Internet to buy the stock of a company that appears likely to go from zero to \$2 billion in revenues in the same timeframe.

The reasons for this are many but can be reduced to two main themes. First is the market. Investors love rapid growth. The "new economy" is providing lots of that, while the defense markets are generally stalled. The second is the structure and behavior of commercial versus defense or government markets. **Table 1** lists a few differences.

COMMERCIAL MARKETS	GOVERNMENT MARKETS
Market size adjusts smoothly	Erratic buying behavior
Development risk born by seller	Development risk born by buyer
Many buyers	One or very few buyers
Many compete for share of market	Few competitors for all or most of a market
Most product offerings are similar	Product offerings are usually different
Price set by marginal utility	Any price paid for desired performance

Table 1 The structure and behavior of government and commercial markets differ in many ways.

The structure of government markets often results in cutting-edge technology evolving within the companies that serve them. Managers believe that Wall Street should be excited about them and rightly so. Indeed, many defense contractors have technologies and skills that are applicable to commercial markets. But these companies and their managers tend to think that commercial markets behave like the government markets. For example, defense contractors and aerospace companies tend to focus on prototypes, spending a lot of money proving that something will work. They then produce products that are very expensive and serve limited markets. Management will be justifiably proud of the achievement, but Wall Street won't pay much attention to it. What Wall Street wants to hear is that the company has adapted the product to a commercial application and now dominates a large market that will continue to grow for many years to come.

The first step a defense contractor must take toward addressing the commercial market is to concede that its corporate mindset is *wrong* for the commercial marketplace. There is no way that executives and managers of a defense company can, overnight, bring a whole new perspective to their business. What's needed is a completely separate, commercially focused organization to handle everything from adapting the company's technology to new products to marketing and distribution. This can be done either by creating a new division or subsidiary or by acquiring all or part of another company.

Establishing a new division can be expensive. It's unlikely that outside investors can be persuaded to finance such a venture, unless senior management is fully committed to adapting to this new market *and* the new organization is staffed by managers with a proven track record in commercial markets. Therefore, the company will have to use retained earnings or leverage its balance sheet to finance the business, neither of which may be possible.

Acquisitions can be an excellent alternative for some defense contractors seeking to increase shareholder value. This tactic has several advantages, including the fact that buying an existing company may be cheaper than building anew, and that time to market will be less than what would be required by establishing a new division. An acquired company may also have distribution in place with an existing customer base for the parent company's new product.

Here's an example of a company that made the kind of transition I'm advocating. Until mid-1999, ViaSat, Inc. (Carlsbad, CA), was a military subcontractor. ViaSat made advanced digital satellite telecommunications and other networking and signal processing equipment, primarily for defense markets.

ViaSat's technology was generally acknowledged to be very good, and for some time management had been seeking to penetrate the rapidly expanding commercial marketplace. The company went to considerable expense to accomplish this feat, with only modest success. Worst of all, the effort was totally unrecognized by Wall Street. As a result, ViaSat's stock price stalled at around $10 a share, with unknown prospects for any significant appreciation. Enterprise value was around $85 million or about 1.2 times prior year's sales.

Management decided to take the acquisition route to reach its goal. On January 18, 2000, the company announced an agreement to acquire the satellite networks business of Scientific-Atlanta, which would allow them to accelerate their growth in the commercial segment of the business. For $65 million in cash, ViaSat acquired personnel, technology, products and -- most importantly -- distribution capabilities through which to market its products on the commercial market. What it all boiled down to, as the company said in a news release, was that the acquisition "substantially increases ViaSat's global resources and customer base."

The announcement of the acquisition captured the interest of the market. As often happens in speculative stock markets, investors quickly bid up the price of ViaSat's stock to around $87 a share. To finance the $65 million acquisition, Viasat issued 2.3 million shares at $30 per share. At this price, enterprise value (market value plus debt) was $317 million, or around two times trailing *pro forma* combined sales. As of mid-June, enterprise value had climbed to $520 million, or about six times higher than before the acquisition was announced.

In summary, even if a defense contractor is successful in adapting its technology to the commercial marketplace via a new division or an acquisition, it's not likely to achieve the valuations of today's super-high-fliers in the Internet world. But it is possible that its multiples will increase to a level that will make its stockholders much happier.

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