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### DEFENSE - Defense Subcontractors Look for Strength in Numbers

By DANNY KING

Big defense industry mergers have attracted lots of attention lately, including last week's agreement by Northrop Grumman Corp. to buy Newport News Shipbuilding Inc. for \$2.6 billion.



But the real action in L.A. in the months ahead will be on the subcontractor level, industry officials and analysts said last week.

Activity is coming in two forms – through defense giants spinning off their non-core subsidiaries, making them into autonomous subcontractors; and through smaller subcontractors joining forces to achieve the critical mass needed to compete for the big business.

“The defense giants are driving consolidation because they’re going to put all the work in the larger subcontractor companies,” said David Goodreau, chairman of the Small Manufacturers Association. “(The giants) don’t want to be the owner, but they want to be the boss.”

After years of consolidation, the defense giants now find themselves leveraged to the hilt. To nurse their balance sheets back to health, many are selling off non-core operations and using the proceeds to lighten their debt loads.

Raytheon Co. is soliciting bidders for its Aircraft Integrations unit, so it can focus more intensely on its core electronics business. Last August, Lockheed Martin Corp. sold a transportation systems division, IMS Corp., for \$825 million, so it can focus on its core aircraft assembly business.

“Lockheed has been shrinking rather than growing. They’re trying to pare off the non-core items that are really hurting,” said Paul Nisbet, aerospace analyst at JSA Research Inc.

Likewise, L.A.-based Northrop, whose debt-to-equity ratio has more than doubled since its acquisition of Litton Industries Inc. last April, is more likely to divest assets than acquire them in the months ahead.

Its pending purchase of Newport News will be Northrop’s last large-scale transaction for a while, said Nisbet. “Until they work down their debt by either selling non-core businesses, or through cash flow, they’re not going to be terribly active,” he said.

To achieve cost efficiencies, the major defense firms are opting to deal with a few major subcontractors, rather than with many smaller ones. As a result, several small Southern California subcontractors have emerged as prime takeover targets.

**“I would think General Atomics would be interesting because of its technology in intelligence gathering for pilotless aircraft,” said William Pinney, a principal at Los Angeles-based NewCap Partners Inc.**

**Ironically, San Diego-based General Atomics purchased Lockheed's Energy and Power Systems Group in 1998. Another juicy target, according to Pinney, is Carlsbad, Calif.-based digital communications company ViaSat Inc., which has a market cap of \$295 million.**

Costa Mesa-based Ceradyne Inc. has become more attractive to potential buyers by receiving a U.S. Defense Logistics Agency contract for \$1.8 million to manufacture protective gear for U.S. soldiers.

Ceradyne Chief Executive Joel Moskowitz said defense-related work will account for about 45 percent of his company's revenues next year, up from about 30 percent currently.

But bidders may not be received with open arms. "Companies with a proprietary product would feel this is a time to not be acquired, said Moskowitz.

Even subcontractors that are having trouble obtaining financing may resist outright takeover offers, opting instead to sell a minority stake to an investment firm.

"There are other companies making major investments to try to become a player in the unmanned aircraft business, and we're in the catbird seat in that market," said General Atomics Vice President John Rawls, whose company makes a plane that competes with Northrop's Global Hawk unmanned surveillance aircraft.