DEFENSE SECRETARY GATES ANNOUNCES BROAD CONTRACTOR FUNDING CUTS

THE LATEST PENTAGON COST-CUTTING WILL RESHAPE THE LANDSCAPE FOR SERVICE SUPPORT CONTRACTORS.

Defense Secretary Robert Gates announced on August 9th that he will push the Department of Defense (DoD) to find $100 billion in savings over the next 5 years. The implementing memorandum was issued on August 16th and provides very specific guidance on where and how the cuts will be made, but almost no details of who will be cut and when.

Broad spending shifts and changing budget landscapes are nothing new for government contractors, particularly those supporting DoD. In fact, successful firms have developed an aptitude for observing and analyzing these changes and following the shifting flow of opportunity. Two things make this proposed spending change different:

» **Scope:** Saving $100 billion over 5 years will require cuts that are both broad and deep

» **Target:** Tucked between headline-grabbing initiatives such as the closing of a Pentagon office and the elimination of the Joint Forces Command is the call to reduce funding for service support contractors by 10 percent a year for each of the next three years. For service support contractors, this is one those 'wait, that's ME!' moments.

With the details of the cuts in hand, contractors are coming to the realization that they no longer have the luxury of observation and analysis. Based on the language of Sec. Gates memo, it seems likely that the cuts in service support contractor funding, in particular, may already be underway.

1. What does this mean for service support contractors?
2. What are the possible scenarios?
3. What can contractors do to prepare to survive (and even prosper) during the changes?

This white paper aims to address these questions and propose specific, actionable steps firms can take to prepare themselves to navigate the new landscape of service support contracting and increase their competitiveness.

During Mr. Gates August 9th speech, he made clear that "the task before us is not to reduce the department's top line budget. Rather, it is to significantly reduce its excess overhead costs and apply the savings to force structure and modernization." He offered new details about how that might happen:

» Reduce funding for service support contractors by 10 percent a year for the next three years

» Close JFCOM, a command that includes some 2,800 military and civilian personnel and 3,000 contractors

» Freeze the number of OSD, defense agency and Combatant Command billets at the fiscal 2010 levels for the next three years

» Freeze at FY10 levels the number of civilian senior executive, general and flag officer, and PAS positions

» Consolidate IT infrastructure facilities

» Freeze the number of DoD required oversight reports and cut the dollars for advisory studies by 25 percent

» Review of all outside boards and commissions for the purpose of eliminating those no longer needed and cutting overall funding available for studies by 25 percent in FY 11

WHAT DOES SECRETARY GATES' INITIATIVE MEAN FOR SERVICE SUPPORT CONTRACTORS?

Situational Awareness

Looking back, this is not so much a surprise as it is a dose of reality. After Sec. Gates took office in 2006 under George W. Bush, he gave a series of speeches outlining major reforms that his successor should undertake, addressing issues that included weapons procurement and career promotion policy. His reforms were viewed as progressive at the time, but with only two years in office, and faced with a long list of crises in Iraq and elsewhere, it was clear Sec. Gates would not have time to enact those steps himself. When Sec. Gates was asked by Barack Obama to stay on as Defense Secretary, he was effectively given the green light to implement his own plan[i]. Many wondered out loud whether Sec. Gates could or would turn his words into reality.

The legacy of Defense Secretary Robert Gates is still being written, but his track record is unmistakable:

- He is the only career CIA officer in history to rise from entry-level employee to Director
- Gates successfully cut 31 military programs during the first two years of the Obama administration
- Labeled a Republican Hawk, Gates is in favor of increased military spending. He has also shown a penchant for achieving this funding by cutting nonessential funding and programs
- Gates' success is attributed to his ability to manage relationships and expectations within and between military leadership and the oval office

In April 2009, Sec. Gates delivered a budget address which sent shock waves through the military community for its boldness[ii]. And, it wasn't just a speech. He halted production on the F-22 Raptor and phased out the Navy's DDG-1000 stealth destroyer. He also cancelled a number of Army weapons programs considered to be expensive and outdated. At the same time, he directed more money towards the wildly successful drone program and more than doubled the F-35 Joint Strike Fighter, a smaller, cheaper stealth aircraft. The message was clear—the money is not endless and the needs are changing.

The message for the service support contractor community should be clear—Sec. Gates is a man of action, so it would be prudent to closely monitor his decisions and listen to his words. The language in his implementing memorandum is instructive. He does not propose changes or recommend funding changes to a future Federal Budget. He simply says "I am directing" (the cuts). Today's political, economic and military climates only support his initiatives. For service support contractors, the funding cuts are not proposed or even pending, they're here.

» Secretary Gates has proven that he is not afraid to cut programs and costs. In the last two years, he has cut 31 programs including the F-22 Raptor, the DDG-1000 destroyer, and a number of outdated weapon systems.

Damage Assessment

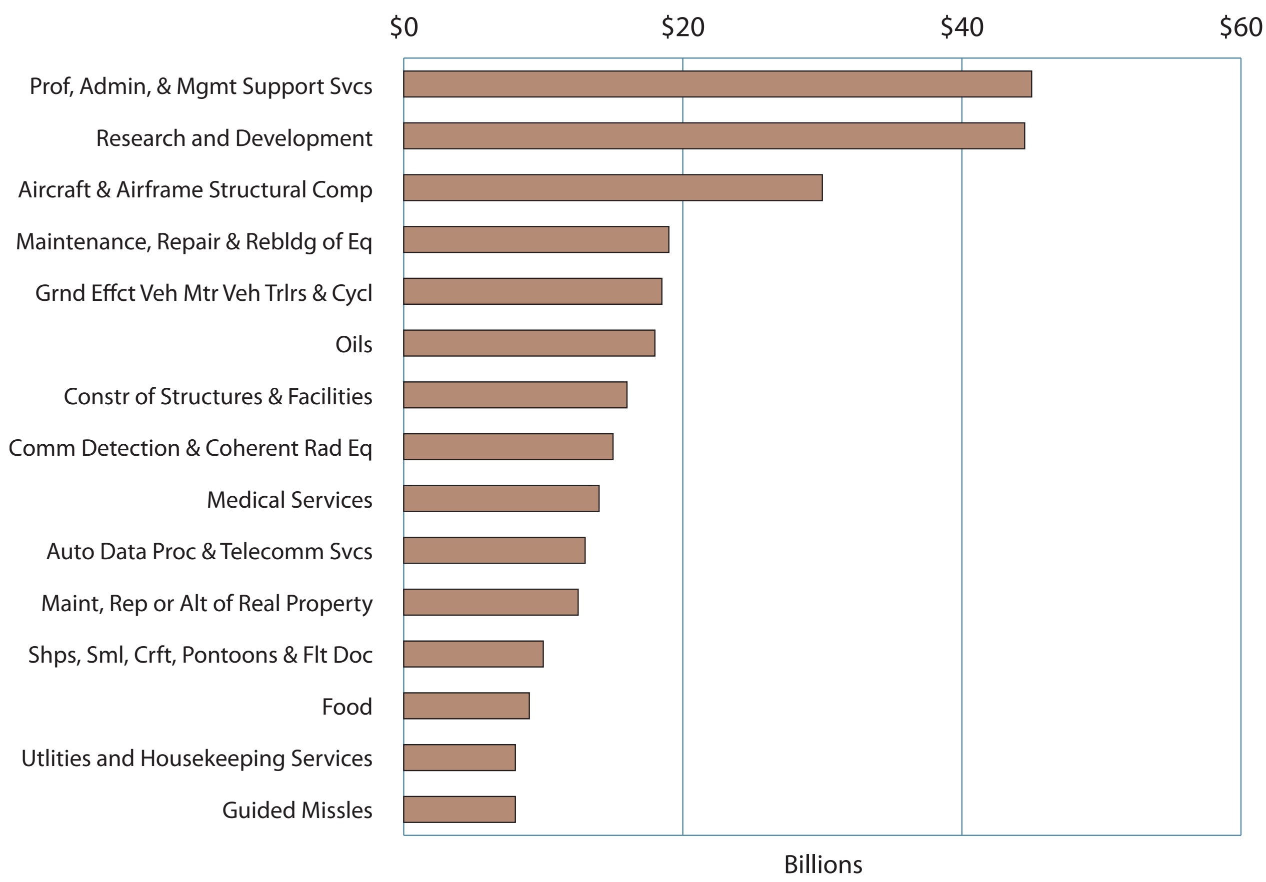
This leaves thousands of government contractors to imagine and anticipate what a 10% reduction in spending per year looks like. For service support contractors, the more important question is 'what does this cut look like for my firm?'

Let's start at the top. The budget category that Sec. Gates is referring to when he says 'service support contractors' is contained within the Federal Supply Group known as Professional, Administrative & Management Support Services—commonly referred to as PAMS. PAMS is the funding for services that provide assistance and management support for the day to day operations of all the programs in DoD. It's also the largest single category of overall federal spending, at more than $73 billion for fiscal year 2009. More than $45 billion of the FY 2009 PAMS funding was obligated by DoD, making it the leading spending category there as well[iii].

The sheer size of PAMS is overwhelming, so it is interesting to look at how it compares to the rest of military spending. Research and Development is a close second to PAMS, but after that there is a very quick drop off in spending. Scanning down the list reveals categories such as Maintenance, Oils, Medical Services, Food—all arguably more mission critical to a military deployed in Afghanistan and redeploying from Iraq than PAMS. When viewed in this context, it becomes clear why Sec. Gates has targeted PAMS for significant reductions.

» 10% of the $45 billion PAMS budget picks up over $4.5B in savings for DoD—a significant dent in Sec. Gates' $20 billion annual savings goal.

Top 2009 Budget Categories - DoD Only
Source: EagleEye



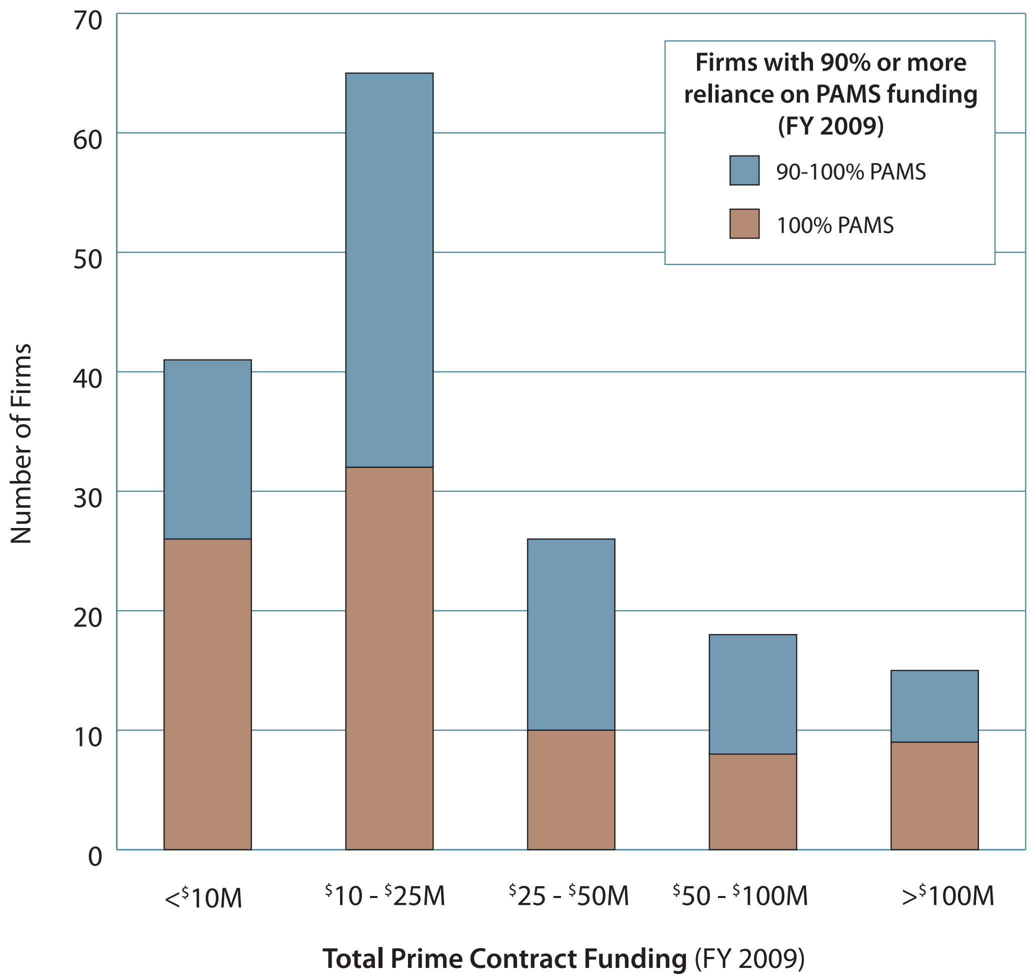
Naming the Targets

Now, let's unmask PAMS and talk about whose contracts are funded from this category. As a part of this analysis, we looked at all the companies receiving DoD PAMS funding in FY 2009 starting with those receiving the most and working our way down. Looking just at PAMS, contracts with the top 500 companies represent 93% of all DoD PAMS funding, so the bulk of the impact of a 10% annual reduction will be felt by the firms in this group.

What we found was a stable of firms ranging from household names such as KBR, Northrop Grumman and Lockheed Martin at the top to a slew of lesser-known companies with as little as $10 million of DoD PAMS funding each year. Of course, those household-name companies also tend to be rather diversified. Even deep cuts in DoD PAMS funding are unlikely to have a lasting effect on their fortunes.

Some of the firms in the group, however, have a very heavy reliance on DoD PAMS funding. Fully one-third of the 500 companies on the list receive more than 90% of their funding from this one source. This group of 165 firms represents nearly $11 billion of the $42 billion DoD PAMS budget. 84 of these firms get 100% of their contract funding from the PAMS Federal Supply Group and all of that from DoD. This will become a key element when we discuss the ability of service support contractors to weather the cuts.

» A large number of firms rely heavily—in some cases 100%—on PAMS funding. These firms have a critical exposure to the planned funding cuts.



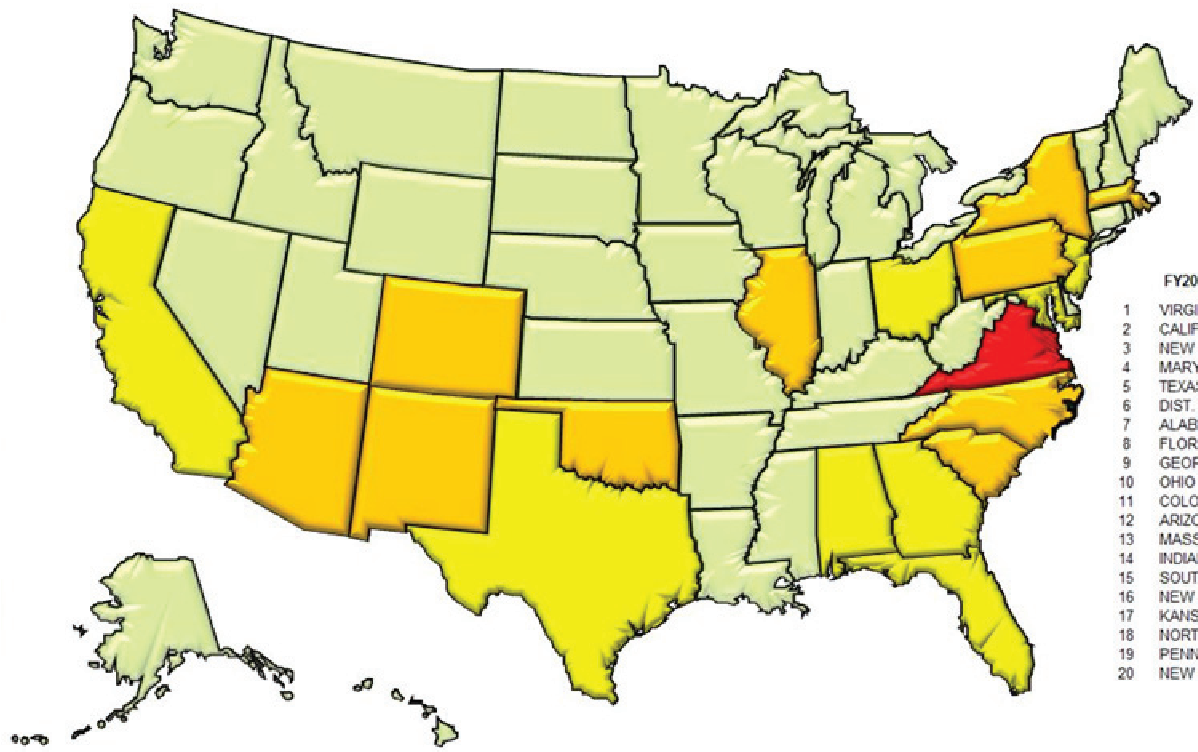
Placing the Targets

Perhaps as important as who the targets are is where they are. For that analysis, we again turned to the FPDS data as supplied by Eagle Eye©. Here's what we found. When we looked at the place of performance of each contract funded with DoD PAMS money, the states at risk literally jumped off the page. The state receiving the most DoD PAMS money is, not surprisingly, Virginia. What is surprising is the huge gap between number one and number two. Contracts performed in Virginia were funded with DoD PAMS money in FY2009 to the tune of more than $10.8 billion. California was a far distant second at just $3.8 billion followed by New Jersey at $3.1 billion and Maryland at $2.9 billion.

Of course, how much PAMS money was spent in the state is just a precursor to the question of "How much does the state stand to lose?" In the case of Virginia, it could amount to more than a billion dollars a year for the next three years. To put that in perspective, using our rule of thumb equating one million dollars of PAMS funding to ten service support contractor jobs, Virginia could be looking at losing ten thousand jobs a year for the next three years.

The top twenty states listed in the Figure below received $34 billion of the $38 billion of DoD PAMS money spent in the continental United States. The difference between that number and the $45 billion total is spent overseas. More than eighty percent of it was spent in Iraq, Afghanistan and Kuwait while the rest was spread over more than 90 other foreign countries.

Given that it is very unlikely that expenditures for support contractors in a war zone can be drastically cut, the entire ten percent ($4.5B) cut may have to come from domestic contracts. That means the cut could be closer to twelve percent across contracts and contractors in locations other than the war zones.



FY2009 PAMS Funding

1	VIRGINIA	$10.8
2	CALIFORNIA	$3.8
3	NEW JERSEY	$3.1
4	MARYLAND	$2.9
5	TEXAS	$2.3
6	DIST. OF COLUMBIA	$1.9
7	ALABAMA	$1.6
8	FLORIDA	$1.4
9	GEORGIA	$0.9
10	OHIO	$0.8
11	COLORADO	$0.7
12	ARIZONA	$0.7
13	MASSACHUSETTS	$0.7
14	INDIANA	$0.6
15	SOUTH CAROLINA	$0.5
16	NEW YORK	$0.4
17	KANSAS	$0.4
18	NORTH CAROLINA	$0.4
19	PENNSYLVANIA	$0.4
20	NEW MEXICO	$0.3

WHAT ARE THE LIKELY SCENARIOS FOR CARRYING OUT SEC. GATES' PLAN?

Sec. Gates fully expects to receive less money in fiscal year 2012 than it currently takes to run DoD. He has eliminated the guesswork for us by concluding that "to preclude reductions in military capabilities that America needs today and those required for the future, that spending difference will need to be made up elsewhere in the department."[iv] Based on what we saw previously regarding the size of DoD spending buckets, 'elsewhere in the department' puts PAMS squarely in the crosshairs of budget cuts. And, in an effort to defend a 1% annual growth in the defense budget in perpetuity (a goal he floated during his August 9th speech), Sec. Gates has few options but to make this budget cut successful.

This is not the first time PAMS has come under attack. As recently as April 2009, President Obama launched the 'insourcing' initiative, stating the government's desire to replace service support contractors with full-time government employees. The aim was to reduce costs and regain control of essential government functions. Sec. Gates himself conceded in his August 9th speech that "we weren't seeing the savings we had hoped from insourcing." Regardless of the result of the insourcing experiment, insourcing alone cannot achieve the level of savings needed to protect the defense budget. Sec. Gates is clear about this: "…you don't get at contractors by cutting people…. the only way, we've decided, that you get at the contractor base is to cut the dollars." So cut the dollars he will.

» Secretary Gates acknowledges that his insourcing initiative has not produced the savings he had hoped for. With no other clear options, the pressure is intense to reduce "service support contractor" presence in DoD via across the board funding cuts.

Scenario #1: Uniform Across the Board Cuts

Supposing for a moment that a 10% across the board cut is even possible, the next question is "will it be uniform?" As unlikely as that might be, assume for a moment that it will be, and let's jump directly to how will it affect the contractors whose funding is cut.

Even the largest (and most diversified) of the DoD service support contractors will feel the impact, but beyond a reorganization here and there and maybe a "blip" in the stock price, it is unlikely there will be long term effects.

The mid-sized contractors for whom PAMS funding is a more significant funding source will feel the effect of the cuts to a greater degree. There will almost certainly be layoffs from the staffs of affected contracts. For some companies, there may also be cuts across the indirect functions as firms struggle to contain the effect on overhead of a declining direct labor base. Some may even close field offices in an effort to shed fixed costs in those same pools.

For the small and mid-sized contractors for whom PAMS is the dominant funding source, the impact of this scenario is more severe. Their layoffs of direct charge staff may be a significantly larger percentage of the firm's total direct labor.

The impact to overhead rates may also be significantly greater. As DoD cuts support services dollars, they are also likely to cut contractor positions in contractor facilities to a much greater degree than positions housed in Government-provided space. This would have the effect of isolating the rate impact to only certain pools. Unfortunately, those pools are also the ones with fixed costs like leases and equipment that are much harder to shed to offset a decline in the direct labor base.

Even if affected firms are able to mitigate the first year effects, the second and third year cuts will simply cause the same problem all over again. The "easy" cuts, however, will have already been taken. In years two and three, there may not be any more fixed costs that can be shed. Further cuts to indirect labor may be difficult or impossible. And, the successive cuts in the direct labor base may cause some rates to rise to uncompetitive levels.

In years two and three, the effect on some firms may reach far beyond just a reduced bottom line or a "rate problem." Some firms may find themselves in such a disadvantaged market position that they can no longer win business at all. For those firms, a 10% across the board cut of PAMS funding for three years running could be fatal.

Scenario #2: An Uneven Distribution of the Cuts

Some firms may not be touched at all by the cuts, while others may suffer considerably more than a 10% impact. It is not possible to tell at this point which firms will fall into which category.

Some programs will "dodge the bullet" because they are critical, others because their contracts are not really subject to being cut. For example, the Government of Japan receives more than $140 million a year in PAMS money for maintenance of overseas bases. It is unlikely those contracts can be cut. If not, that $14 million cut will have to be absorbed by someone else.

Some contractors will also dodge the bullet to some extent. Larger firms invest heavily in various forms of advocacy specifically in an attempt to influence decisions like budget and program cuts. To the extent those efforts are successful in deflecting funding cuts, smaller firms will be left to absorb the impact.

What is clear is that casualties will occur. The process described earlier—lost business leading to higher overhead rates leading to decreased competitiveness—will likely result in firms offering themselves for sale. Mergers and acquisition activity may pick up but valuations will almost certainly suffer. There will be an industry-wide game of musical chairs as firms scramble to find new and stable partners to do new business with, distressed businesses to acquire, or large firms to acquire the remnants of their backlog.

» A flat 10% reduction would affect some firms significantly more than others depending on their reliance on PAMS funding. However, it is unlikely that the cuts will be distributed evenly across contractors.

Timing is Everything

Resistance to the cuts is developing rapidly. The proposal to disband the Joint Services Command has prompted the Virginia Congressional Delegation to threaten litigation to block the cut. Any information concerning how the contract funding cuts will occur is being very closely held. Without details, it is difficult for any specific interest groups to oppose them.

Timing is everything, and the questions of who, when and how remain largely unanswered. Hearings are scheduled for both the Senate and the House, but they are unlikely to be particularly informative. We can expect that Sec. Gates will use his experience and knowledge of the system to execute these cuts in an expedient manner. He will go out of his way to avoid telegraphing specific contracts or areas of the DoD that will be targeted until absolutely necessary. But working backwards, for these cuts to have an effect on fiscal year 2011, his team has probably already asked Program Managers to prioritize their contracts. It is even possible that the cuts will be dictated from the Comptrollers' offices as a mathematical exercise. At the latest, we anticipate the effects of cuts to begin at or soon after the beginning of the fiscal year.

What can service support contractors do to prepare?

It has been said that "luck is what happens when preparation meets opportunity." Service support contractor firms that prosper over the next few years will need all three.

Preparation

The Defense budget has grown more than 60% in real terms from FY 2001 to FY 2011. Business has been booming across all acquisition categories, not just in service support contracting. Sec. Gates himself describes acquisition in DoD as the "culture of endless money." In this environment, many firms have become adept at growing quickly. For some firms, their ability to prosper as they shrink may now be tested.

What follows is a brief outline of what every firm should be doing—at a minimum—to prepare for contract funding cuts:

» Conduct an internal assessment of where the breakpoints are in the business if the company had to shrink 10% overnight. Then run the same assessment assuming 20% and 30% reductions. The question for many businesses will be how to shed fixed costs from indirect pools fast enough to remain viable.

» Start now to actively seek buyers or renters for facilities and equipment that could be idled by a contract loss or de-scope.

» Create a more aggressive plan for retiring assets, and a less aggressive plan for replacing those assets.

» Bolster your network of partners to improve your competitive posture.

Opportunity

While it is clearly the intent of Sec. Gates to shrink DoD's expenditures on service support contractors, he also says clearly that he does not anticipate a net decrease in the total Defense budget. For this to be the case, there must be gains in some other area of DoD acquisition.

Other shifts in priorities and funding in recent years did not even approach the magnitude of these initiatives. Firms experiencing cuts or contract losses sufficient to threaten their viability will seek to shed both direct and indirect costs in the form of personnel, real and personal property and, possibly, even entire business units. Some of these assets may be sold at fire sale prices. And, as contracts unwind, highly capable, fully trained and certified resources will become available at very cost-effective rates. Savvy firms will have a clear understanding of their business model and business needs and will be waiting in the wings to take full advantage of opportunities as they become available.

Luck

A little luck goes a long way. The coming season is sure to be one of high anxiety and high risks. And, with high risk can come high rewards. What's not certain is which firms will be impacted and by how much. As illustrated earlier, if successful, the target 10% reduction in support services will result in $4.5 billion being stripped from PAMS spending. That's a big number that will touch many firms in a meaningful away. However, it leaves $38 billion worth of services contracts intact. It is very reasonable to assume that many companies will survive and some will even grow.

About Deltek

Since the company was founded in 1983, Deltek has been laser-focused on serving the unique needs of government contractors. Our software solutions offer capabilities for all types of contractors – from small to mid-size firms to the largest Fortune 500 government contractors. Our customers rely on Deltek to measure business results, optimize performance, streamline operations and win new business.

You can count on Deltek to follow industry developments closely. From our CLARITY initiatives to the govWin network, we intend to leverage our unique position to gather and disseminate important information and breaking industry news in the government contracting world. As developments unfold, continue to check back at www.deltek.com/Clarity for the most recent information and analysis.

Footnotes

i. www.foreignpolicy.com/articles/2010/08/16/the_transformer?page=full
ii. www.defense.gov/speeches/speech.aspx?speechid=1341
iii. Eagle Eye
iv. www.defense.gov/speeches/speech.aspx?speechid=1496

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