COMPETITIVE BY DESIGN

ANTHONY L. VELOCCI, JR./NEW YORK

All companies have high expectations of how they will perform as a business—and predictably high opinions of how well they're serving their customers and shareholders.

You see it in their advertising campaigns, news releases, web sites, annual reports, investor briefing, and press relations. It's called "spin," and if it were the basis for gauging the relative competitiveness of publicly traded aerospace and defense companies, a single conclusion would jump out: As a global industry, A&D is populated with more than its fair share of highly competitive, superbly managed enterprises that are generating—as former Boeing executive and now Ford Motor Co. CEO Alan Mulally likes to say—"profitable growth for all."

But it's not. Far from it, and the image that's projected outside may be very different from the telltale trends of what's actually going on inside. The real measure of competitiveness is how well companies employ their resources, as reflected in myriad operational metrics along with such traditional yardsticks as revenue and earnings growth for the latest fiscal year.

The Top-Performing Companies (TPC) Study was launched in 1996 by *Aviation Week & Space Technology* to cut through the hype and identify, in detail, weaknesses in an aerospace/defense company's operational performance—or validate how well it's executing on its business strategy—in changing market conditions. Over the last 12 years, metrics have been continuously refined, with input from industry leaders. Total scores in the 2008 TPC rankings are derived from four categories: Return on Invested Capital, Earnings Momentum, Asset Management and Financial Health. A detailed explanation of the categories is on p. 60. (*Aviation Week* has designed new TPC metrics that are specific to the unique attributes of the airline industry. Those rankings will be published in a special report in our Aug. 11 issue.) To see how an aerospace/defense company scored in a specific category, tables have been posted online at AviationWeek.com/TPC. Beginning on p. 50, companies are ranked in two sets of tables. The first is a one-year snapshot of how they fared in the most recent earnings period.

For an even truer accounting of how well companies employ their resources, the second set of tables ranks each company's average annual score improvement over the past five years. On that basis, it's clear that something is seriously amiss with many of Europe's A&D companies—especially among the largest players (revenue greater than $5 billion). From virtual parity in 2003, the gap between U.S. large systems integrators and their European counterparts is widening as a result of consistently underperforming companies in France, Germany, Italy and elsewhere. Just three ranked in the top 10 for 2007: Thales (No. 5), BAE Systems (No. 6) and Dassault Aviation (No. 9).

Very few have been able to drive or sustain productivity improvements to any meaningful degree. Management has played a role, of course, but they don't bear sole responsibility. Interference by some governments in the private sector and their "nurturing" influence to insulate home-grown businesses and bloated payrolls from market pressures is probably the biggest reason so many European A&D companies compare poorly with their U.S. peers (see p. 58).

But size doesn't necessarily mean slow and inefficient. Case in point is Lockheed Martin, which ranked No. 1 for the most recent earnings year. The company has been employing its assets with increasing efficiency during the last 10 years (see p. 55). To put an exclamation point on the notion that scale doesn't have to be a handicap, consider that Boeing finished No. 3—and nearly tied hard-driving Precision Castparts Corp. for the No. 2 spot in the rankings, no small accomplishment. Neither is the fact that Boeing also posted the fourth-best average score improvement over the past five years among large companies.

2008 TPC COUNCIL OF ADVISERS

Oren Ben-Zeev
Manager, A&D Practice
PricewaterhouseCoopers

David Brezovec
Managing Editor
Standard & Poor's

Tom Captain
Leader, Global A&D Practice
Deloitte LLP

John P. Coykendall
Principal
Deloitte Consulting

Michael J. Dyment
Managing Director and CEO
Nexa Capital Partners

Antoine Gelain
Managing Director
Octagon Partners

Leslie Schafer
Manager, A&D Practice
PricewaterhouseCoopers

James W. Thomas
Partner and Leader
U.S. Advisory A&D Sector
PricewaterhouseCoopers

"One of the more under-celebrated performance stories" is how Tom Captain, Global and U.S. Aerospace and Defense Industry leader and Deloitte LLC vice chairman, describes Raytheon. While it came in at No. 7 for the most recent fiscal year, it was the third-highest scoring company in terms of improvement in the five-year span, also surpassing Lockheed Martin. It too has been working its way up and appears on track to improve its overall competitiveness, as reflected in detailed TPC study results.

The idea that any of them would rank as well as they did would have been unthinkable seven or eight years ago. As the industry's dramatic consolidation was winding down, what all three had in common was sheer size and the fact that they were confronting huge integration and balance-sheet issues following their multiyear buying binge—like giant morning hangovers.

Dominating the bottom third of the large-company rankings are European firms, along with Bombardier and Embraer. Textron was the lone U.S. business in that grouping. The fact that these companies are so much less competitive relative to their peers almost certainly will make a difference in their ability to take advantage of some opportunities and manage challenges in the future, if it isn't already presenting an uphill climb.

For consistency, Rockwell Collins, which ranked No. 1 in the medium-size category (revenues between $1-5 billion), would be hard to beat. If an aerospace/defense company wanted to emulate a consistently high performer over time, Rockwell might well be the model; in terms of improvement over the last 10 years, it is the top-ranked company, with many operating and financial metrics that would compare favorably across industry. There, management's greatest challenge may not be prevailing over rivals to capture "must-win" programs as much as merely sustaining the company's current level of performance and making sure the culture doesn't fall victim to creeping complacency. Rockwell's rate of revenue growth will soon push it into TPC's "large-company" category, raising the bar for all those included in its new peer group.

Ranked No. 1 among small companies (revenues between $250 million and $1 billion) is Ceradyne Inc., and topping the list of the smallest companies (revenues under $250 million) is AeroVironment.

For all the industry's market-driven success in recent years, companies serving defense and commercial customers may be on the cusp of a far less benign business climate that's likely to expose or magnify operational weaknesses. Some strategies that allowed firms to show profitable growth for the last five years may be inadequate for the next five, and managing amid the maelstrom of change could become the central challenge for contractors of every size. Under such operating conditions, companies that are able to move up in the TPC rankings and analysis will define what it really means to be competitive in an increasingly global industry.