bcg.perspectives
by THE BOSTON CONSULTING GROUP

A NEW PROCUREMENT STRATEGY FOR DEFENSE CONTRACTORS

By Thomas Peddicord, Robert Tevelson, Greg Mallory, and Matt Aaronson

The business environment for US defense contractors has become far more challenging over the past five years than it was during much of the previous decade. Sequestration, shrinking defense budgets, and a reduction in the number of programs being funded have limited growth of the industry overall, creating a pervasive winner-take-all dynamic. Competition for the smaller number of contracts that remain available is more intense, and affordability is usually a key consideration in determining who wins.

As a result, contractors have seen revenue drop. From 2010 through 2014, the compound annual growth rate (CAGR) of sales for US-based defense contractors declined by an average of 1% each year. Exacerbating the problem for most prime contractors is the challenge of pressuring their suppliers to reduce costs. In fact, many suppliers have developed new business models that have enabled them to increase revenue and margins over the same period. For defense suppliers, revenue grew by 5% (CAGR) from 2010 through 2014.

As a result, profits during this period have accrued disproportionately along the value chain. Average earnings before interest and taxes (EBIT) margins for prime contractors have flatlined at 11%, while higher-tier suppliers now average 15% margins. In the aggregate, prime contractors are being squeezed on both sides. Their customer, the US government, is demanding that they reduce the cost of their programs. Yet they are unable to pass the cost pressure along to their suppliers, and many suppliers are raising prices of components. (Part of the reason suppliers have been able to generate higher margins has to do with supplier business models that increasingly take advantage of Department of Defense procurement regulations. See the sidebar, “Creating Profits by Shifting from FAR 15 to FAR 12.”)

This situation is unsustainable for prime contractors. They need to take action to systematically wring costs out of their supply chain. Although some management teams believe that they can’t effectively reduce supply chain costs—because of the

CREATING PROFITS BY SHIFTING FROM FAR 15 TO FAR 12

The government typically acquires defense products and services through a particular chapter of its Federal Acquisition Regulation (FAR), known as FAR 15, which specifies contracting and negotiating terms—mainly regarding cost transparency and fair profits. Over the past decade, however, suppliers have increasingly asserted that the products they sell to the government should be covered by a different chapter of the regulation, FAR 12, which stipulates public-sector use of products and services that are already commercially available. (For example, a technology company doesn't need to design a special laptop specifically for government use; it can simply sell laptops from its existing product lineup.)

FAR 12 was designed to speed up the procurement process and to allow the government to take advantage of the commercial market's investment in and development of products. Because such products were already sold on the market, the government expected the provisions of FAR 12 to result in lower costs and easier determinations of what the government should pay.

Initially, FAR 12 didn't apply directly to large-scale weapons systems and programs—or to their subcomponents from defense suppliers—since these products are not commercially available. But many suppliers to defense companies have gradually figured out how to redesignate their products to fit under the FAR 12 rules. Ironically, doing so enables them to introduce more-opaque pricing, contrary to the intent of the regulation. In some cases, the products aren't commercially available, even though suppliers claim that they are. And because there is no competitive market for these products, the price is essentially whatever the supplier says it is (within reason). If suppliers in this position launch internal cost-saving measures such as manufacturing efficiency or smarter procurement, their prices remain consistent, and they get to keep the difference as profit.

Currently, a significant majority of lower-tier defense suppliers sell through FAR 12, and in the past several years their customers (prime contractors) and the ultimate end user (the government) have found it more and more difficult to determine the true cost of their products. This regulatory shift is a major reason why suppliers have been able to increase their revenue and margins, even as prime contractors are being squeezed.

way suppliers (particularly those that manufacture complex components) become embedded in defense programs—we have developed an approach to help drive down supplier costs. The approach consists of three elements:

- Gaining better insight into supplier costs
- Applying leverage to existing suppliers to reduce costs
- Generating an enterprise-wide view of spending

Using these strategies to reduce sourcing costs entails overturning some conventional wisdom about the relative strength and market position of defense suppliers. In our experience, however, doing so can help major contractors not only increase margins but also capture new business, by helping them develop affordable programs that meet the budgetary constraints of their customer.

Suppliers can benefit from this approach, too, especially if the resulting cost efficiencies encourage the government to buy less-expensive systems in greater volume.

Gaining Better Insight into Supplier Costs

Many prime contractors simply don't have a clear idea of their suppliers' true costs, and as a result they often operate as if those costs were fixed. But new tools are emerging to help companies gain better insight into such costs. Some of these tools were developed in other manufacturing-based industries and have migrated to defense. For example, "should-cost" analysis sets aside the current asking price of a component and instead determines what the item should cost, on the basis of labor, materials, overhead, and profit margins.

A more advanced version of this tool is market-based should-cost modeling, which lets contractors map commercial market pricing and economics for their suppliers. For example, one prime contractor had been purchasing an electronic system from the same supplier for almost 20 years. During that period, the supplier had steadily raised prices by 2% to 4% each year. In response, the contractor applied several market tools to determine a fair price for the electronic system. Through this process, the contractor found that the supplier's patents for the product had expired and that new competitors were entering the market. By using tools to identify fair prices for the supplier and its competitors, the prime contractor was able to negotiate a 40% price reduction with the supplier.

Tear-down analysis is another tool that contractors can use to gain greater insight into supplier prices. This type of analysis starts with the completed component that a supplier provides and breaks it into its constituent pieces, in order to determine a realistic cost of the component. Meanwhile, in FAR 12 situations, contractors can push back against their suppliers—in some cases by coordinating with the government—to determine whether products are actually commercially available or are undeservedly benefiting from that designation.

In each instance, the objective of the tool is to help contractors gain an accurate sense of supply chain costs, so that they can respond to their suppliers' pricing demands with facts and evidence.

Applying Leverage to Existing Suppliers to Reduce Costs

Empowered with information from deep analyses of supplier costs, contractors can take the next step—applying leverage to suppliers to press for lower costs. This step is critical because insight alone does not create savings. Many contractors think that they cannot effectively negotiate with suppliers that are (or appear to be) the sole source of a particular component. In other instances, prime contractors may be dealing with suppliers that have participated in a program for a long time and therefore seem to have a strong negotiating position. We have found, however, that many suppliers are not as embedded as they might seem. Prime contractors can create leverage if they look across the enterprise and seek ways to rethink requirements.

Leverage on the contractor's side can take several forms. One is to offer the supplier an opportunity to participate in a major new program, in exchange for better pricing on current programs. A more advanced approach involves the possibility of developing the capabilities and expertise to manufacture the component internally, thereby removing suppliers from the equation entirely. Contractors can also develop a business case to invest in competitors—or even to build up competitors from scratch. For example, if a single company is the only existing source of a component needed for a current program, the contractor might consider adopting an "incubator" role by funding a second company to develop similar technology.

Either measure—bringing production of the component in-house or helping foster competition in the market—can be expensive and complex, and requires a formal analysis to determine whether the potential cost savings over the life of the program justify the investment. Notably, the goal isn't necessarily to stop working with the established supplier. Rather, it's to introduce some competition in order to es-

cape a captive-market situation, gain negotiating leverage, and exercise some control over sourcing costs. In some cases it's also about helping suppliers understand where their cost structure is excessive and where they need to focus to meet savings goals.

In one instance, a prime contractor wanted to create pricing leverage for a system with technical requirements that only one supplier could meet. The contractor invested in redesigning the system so that other suppliers could compete. The result was a cost reduction of more than 30% for that system.

Generating an Enterprise-Wide View of Spending

Most contractors operate multiple programs, and in some cases they work with the same supplier across two or more of them. Yet supplier negotiations often occur in isolation, with autonomous program managers negotiating independently. Looking across programs and generating an enterprise view of spending for individual suppliers can give contractors a better idea of actual costs. For example, a supplier might be charging a substantially different price for similar components across two programs.

In addition, the ability to bundle multiple purchases as part of a broader business relationship can strengthen a contractor's negotiating position. Because it is buying in greater volume, the contractor may be able to leverage strong positions in some programs to compensate for weaker positions in others. Achieving these measures requires executive coordination and support, to persuade program managers to think in terms of overall company objectives, rather than focusing more narrowly on the priorities of their individual project.

Key Success Factors

To apply this approach successfully, prime contractors should focus on three key factors. First, they need to determine the size of the opportunity they can generate by being smarter about sourcing costs, in order to develop a business case for future moves. Gains will come through cost savings on current programs and through new revenue streams that they win by developing more-affordable programs. Second, they should assess the leverage they have with their suppliers, together with their organizational willingness to apply it. Third, they need to understand and build up the capabilities needed to reduce costs—through tools such as market pricing analysis, should-cost analytics, and insight into how suppliers generate value. We have helped several clients reduce their supplier costs; and in those instances, their investment to build up new capabilities has yielded a positive ROI in the form of future savings.

In sum, clear cost-reduction opportunities exist for prime contractors that adopt a systematic approach. The world has changed, and contractors need to take measures to adapt. Simply rolling up supplier costs and passing them along to the end user is a guaranteed way to lose business to the competition. Instead, by becoming more strategic in their sourcing and supply chain management, contractors can reduce costs, win new business, and improve their financial performance in a market that keeps getting tougher.

About the Authors

Thomas Peddicord is a partner and managing director in the Washington office of The Boston Consulting Group. You may contact him by e-mail at peddicord.thomas@bcg.com.

Robert Tevelson is a senior partner and managing director in the firm's Philadelphia office. He is the global leader of the procurement topic area. You may contact him by e-mail at tevelson.robert@bcg.com.

Greg Mallory is a senior partner and managing director in the firm's Washington office. He is the global leader of the aerospace and defense sector. You may contact him by e-mail at mallory.greg@bcg.com.

Matt Aaronson is a partner and managing director in the firm's Chicago office. He is the leader of the aerospace and defense sector in the United States. You may contact him by e-mail at aaronson.matt@bcg.com.

The Boston Consulting Group (BCG) is a global management consulting firm and the world's leading advisor on business strategy. We partner with clients from the private, public, and not-for-profit sectors in all regions to identify their highest-value opportunities, address their most critical challenges, and transform their enterprises. Our customized approach combines deep insight into the dynamics of companies and markets with close collaboration at all levels of the client organization. This ensures that our clients achieve sustainable competitive advantage, build more capable organizations, and secure lasting results. Founded in 1963, BCG is a private company with 85 offices in 48 countries. For more information, please visit bcg.com.

© The Boston Consulting Group, Inc. 2016.
All rights reserved.
2/16