

# STIMULUS OFFERS A RARE CHANCE FOR DEFENSE AGENCIES TO BUY BETTER

By Matt Schlueter, Troy Thomas, Greg Mallory, Bob Tevelson, Harish Hemmige, Danny Werfel, and Daniel Yoon

**I**N THE NEXT FEW weeks, defense agencies worldwide will have a fleeting opportunity to enhance their buying power. Those that seize the moment are likely to benefit from new purchasing patterns that improve their military readiness while meeting national needs. The catalyst for this once-in-a-blue-moon opening is the rapid disbursement of stimulus funding to shore up critical sectors and beleaguered supply chains in the wake of COVID-19.

Chief among the funding recipients will be the aerospace and defense (A&D) sector. In the US, for example, a significant portion of the recently approved \$2 trillion stimulus funding will ultimately flow to defense and security agencies—and, through them, to the national-security industrial base. A top priority for defense agencies is to provide direct medical and logistical support for COVID-specific needs. Close behind comes their responsibility to support the economy and industrial base of their respective nations, particularly suppliers of critical defense components. As many in the commercial world have discovered, to-

day's lean supply chains expose the vulnerabilities of third- and fourth-tier suppliers half a world away.

Everywhere, time is of the essence. In the US, \$1 billion in defense funds will be allocated shortly, with another \$3 billion to be decided on soon after. Saudi Arabia's government is distributing funds already. Germany is close behind. Lawmakers in Australia have just passed their stimulus funding package. Directors of acquisition, contract chiefs, and directors of industrial policy at defense agencies must act now—in lockstep with their military counterparts.

## The “Slush Fund” Hazard

But a lot can go wrong. Defense agencies have never had to distribute funds so quickly and in such large amounts, and many are ill-equipped to do so effectively. In fact, history shows that agencies tend to disburse such funds to shore up suppliers, potentially at the expense of ensuring commensurate value in operational capability or affordability. Further, some well-inten-

tioned defense stimulus funding may actually accelerate suppliers' financial challenges or even force them to close if their cost structures (both fixed and variable) are not fully appreciated.

Budget "plus-ups" and year-end funding come closest to planned distribution processes for the defense stimulus. These typically involve sending "urgent taskers" down chains of command and asking working-level units to identify shovel-ready projects for immediate funding. Contracting rules may be relaxed in such circumstances, leading to rapid funding for pet projects and a proliferation of other hastily assembled sole-source contracts. Programs are evaluated according to how much funding they obligate and spend rather than how much value they create.

If this pattern continues, the immediate availability of stimulus funding and the urgency to spend it could create a slush fund mentality among both defense organizations and suppliers, causing money to be expended with minimal prioritization or accountability. In the past, shifting political winds and public sentiment have done little to alleviate this problem. After the September 11 attacks in the US, for example, funds poured into national security, but defense budgets subsequently came under scrutiny and in many cases were cut sharply.

## The Triple-Win Stimulus Opening

There is an effective way forward. Managed appropriately, the current stimulus funds offer defense agencies an opportunity to achieve a "triple win" across three crucial and interrelated objectives:

- Enhancing military readiness, capability, and capacity
- Strengthening the defense industrial base, especially for critical suppliers at risk
- Capturing affordability that increases long-term buying power

Our recommended approach involves five steps, discussed below in order of priority.

### **ENSURE THAT STIMULUS FUNDS DON'T HARM SUPPLIERS**

This is an issue to act on at once. It may seem counterintuitive that funding could have a negative impact on suppliers, but it can. Although purely defense-focused suppliers can rely on relatively unaffected government contracts during the COVID-19 crisis, many others do not have that luxury. A&D companies with commercial aerospace exposure are at higher risk because of dwindling cash reserves, lower liquidity, and plummeting demand. And for many smaller upstream suppliers of parts for Boeing's grounded 737 MAX airliner, the situation is precarious indeed.

The move that might seem most rational for distressed suppliers would be to (temporarily) shutter production, thus curtailing variable *and* fixed costs while they wait for commercial demand to rebound. But in the event that such suppliers are directed by defense agencies to leave the lights on at facilities that only partially serve defense customers, these producers will have to transfer significant overhead and operating costs—typically absorbed across a portfolio of commercial and defense orders—to the smaller defense base.

Thus, the risk is that well-meaning efforts to avert supply chain damage accelerate and augment it. What's needed right now is a clear plan for reviewing and understanding the true nature of each supplier's cost structure.

### **QUICKLY REVISE CURRENT STIMULUS GUIDANCE**

The next pressing priority must become part of every interaction with every defense contractor from today onward. Essentially, it calls for replacing a spend, spend, spend mindset with a market-based one.

The spend mentality is likely to precipitate a rush to commit funds before full due diligence can be done on supplier costs. And it can disrupt ongoing affordability initiatives, which need thoughtful execution in

order to realize the full potential of savings, especially in situations where supplier options are limited.

The shift to a market-based mindset will entail dramatic cultural, operational, and management changes—changes more easily adopted in wartime, when established norms and protocols are often relaxed. But it is essential. Instead of fearing that they'll get in trouble if they don't use up all available funding, acquisition directors and other defense agency chiefs must provide revised guidance that includes parameters for ensuring capability and value, as well as utilization of flexible financial accounts such as the Defense Modernization Account.

A market mindset also calls for greater clarity on the metrics used to evaluate success. “Percentage of stimulus funding expended” is a woefully insufficient measure of success or failure; it should be balanced with other considerations, including:

- Cost per unit (as an agency spends more, individual unit prices decrease)
- Time to field a program (further investment accelerates capability fielding)
- Readiness (more spending translates into improved availability)

Revised stimulus guidance can extend to investments made for the express purpose of establishing second sources of critical components. Or it can address government investments in machinery or equipment that allow contractors to take ownership of these assets after using them effectively rent-free for some predetermined period. Such arrangements require clear government guidance but can be particularly helpful for contractors that have both government and commercial lines of business.

### **CONVENE A “CAPTAINS OF INDUSTRY” SUMMIT**

The third priority is to get senior leaders onboard. For most defense stimulus funding, the authority to determine distribution

will be pushed down to the various agencies. That is suboptimal, especially in unprecedented times like these. Instead, defense organizations should, inside a few weeks, convene high-level government and supplier executives with the influence and authority to strike large, cross-program deals while overseeing a balanced distribution of funds across the entire industrial supply base. The crisis may even open doors for major moves that can only be charted and decided at the highest levels of government and industry. Leaders should reach agreement on a straw-man proposal in a matter of days, or weeks at most.

There are precedents for such urgent summits. They are a proven way to enable the degree and velocity of change needed—and to develop solutions that can bring about the “triple win” described earlier.

### **CONSOLIDATE SUPPLIER NEGOTIATIONS**

The fourth priority is to think in terms of scale across a portfolio of programs. Defense suppliers often have multiple negotiations for weapons systems or services happening concurrently across several program offices in a defense organization. Or a contract for one weapons platform may be coming up while a similar contract for the same platform is ongoing. Because these negotiations are fragmented, the agency is not capitalizing on the potential purchasing scale available to increase affordability. Acquisition at scale is vital, given that many purchases are from single or sole-source suppliers. Consolidating these negotiations will afford defense agencies greater leverage to demand more value; in return, they can support the stability of the industrial base by offering more compelling packages to suppliers.

### **ACHIEVE AND MAINTAIN THE NEEDED BUSINESS INTELLIGENCE**

The last priority addresses the fact that many defense organizations lack a deep understanding of their supply chain risks and opportunities. They typically do not have sufficient insight into the operations of their national-security industrial bases—

production capacity and current inventories, for example—and of these companies' financials, including their true profit margins, market-based costs, and more. This opacity is even more of a problem with subtler suppliers and nontraditional (i.e., "emerging") players. Defense agencies can use the stimulus to determine, in detail, the current status of their supply chains. This knowledge can help build a lasting business intelligence capability. Such investments will repay themselves long after the current stimulus funding is spent.

**T**HIS IS A defining moment. Defense leaders rarely have such an opportunity to make a lasting change in how they buy platforms and services. The sudden release of unprecedented levels of stimulus funding gives them enormous leverage to push for market-based approaches to defense contracting and, in effect, to become better buyers.

### About the Authors

**Matt Schlueter** is a managing director and partner at BCG and the global leader of the firm's work in public-sector defense and security. You may contact him by email at [schlueter.matthew@bcgfed.com](mailto:schlueter.matthew@bcgfed.com).

**Troy Thomas** is a partner and associate director in BCG's Washington, DC, office. Before joining the firm, he served on the National Security Council as Special Assistant to the President for National Security Affairs, Senior Director for Defense Policy, and Director for Strategic Planning. You may contact him by email at [thomas.troy@bcgfed.com](mailto:thomas.troy@bcgfed.com).

**Greg Mallory** is a managing director and senior partner at BCG Federal Corp and the leader of the firm's Industrial Goods practice in North America. You may contact him by email at [mallory.greg@bcgfed.com](mailto:mallory.greg@bcgfed.com).

**Bob Tevelson** is a managing director and senior partner in BCG's Philadelphia office. You may contact him by email at [tevelson.robert@bcg.com](mailto:tevelson.robert@bcg.com).

**Harish Hemmig** is a managing director and partner at BCG Federal Corp. You may contact him by email at [hemmig.harish@bcgfed.com](mailto:hemmig.harish@bcgfed.com).

**Danny Werfel** is a managing director and partner at BCG Federal Corp. You may contact him by email at [werfel.danny@bcgfed.com](mailto:werfel.danny@bcgfed.com).

**Daniel Yoon** is a lead knowledge analyst in BCG's Washington, DC, office. You may contact him by email at [yoon.daniel@bcg.com](mailto:yoon.daniel@bcg.com).

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