

Interview

MICHAEL STRIANESE

L-3 Chairman, President & CEO

Michael Strianese, L-3's CEO since 2006 and chairman since 2008, has worked to grow the company into a \$12.6 billion giant while wringing inefficiencies from a company that grew through mergers and acquisitions. Perhaps most dramatically, Strianese spun off L-3's service business as DoD spending shrank and operations wound down in Iraq and Afghanistan.

This year, Strianese also served as the chairman of the Aerospace Industries Association, where he spearheaded industry efforts to repeal automatic budget cuts and refine Pentagon acquisition reform plans.

Q. How is AIA working to avert sequestration? Are members of Congress listening? Will they scrap the Budget Control Act?

A. Stopping sequestration has been a difficult process. Educating all the constituents, including new junior lawmakers, has been a challenge. As industry has long said: it's a jobs issue. We lost a lot of good jobs last year – per AIA, tens of thousands. And some losses can't be measured; this environment has made young people reluctant to go into our industry. Fewer and fewer are

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making investments in these career paths. As a result, we're sacrificing a US technological advantage. It's going to be eroded by a lack of R&D investment. Companies are spending less in the era of sequestration, and it is affecting how we manage our businesses. Even with declining sales, we still have to deliver results and therefore we have to scale back. And R&D is scaled to sales volume and earnings.

We need to continue working with Congress to end sequestration and appropriately fund R&D programs that will drive innovation and maintain IRAD investment. This will help improve our productivity and benefit our economy while keeping us on the cutting edge of innovation to maintain military superiority.

Q. DoD wants companies to invest in new products and technologies, but it's not rewarding the ones that do. How does DoD need to change its policies?

A. Companies have a responsibility to shareholders and they have options as to where they

invest their money. Traditionally, defense has lower margins than other industries. Ash Carter understands this well.

Financially, innovation is easier for commercial companies, as they have higher margins – sometimes 30 to 70 percent higher. They have more funds to invest.

Our companies must have healthy balance sheets to make investments. We're reducing costs and managing well through the downturn, but when sales go down, there is less room to absorb investment costs. A security-driven budget and a clear planning ability will help promote innovation.

Q. Are some of DoD's policies at odds with what it needs?

A. Yes. Sometimes, you have to put money up front, incentives, with tax credits and loan guarantees to drive change. A good example of the disconnect is the funding of the Ex-Im Bank; it provides a direct benefit to the US industrial base. It would help exports.

There is a lot of misinformation out there. It is not corporate welfare. Sometimes the Hill does not understand the economics of what keeps industry vital.

Q. AIA met with Frank Kendall on Nov. 1. What did he tell you and what did you tell him?

A. What we heard from Frank was that he is looking for our industry to develop forward-leaning R&D – to increase our investment in new technologies. The current threat environment is unprecedented and countries like Russia and China are investing more in defense R&D. The United States appears not to be keeping up. We understand that and we are trying to increase

R&D investments, but it is a function of our margins.

We asked: how can we increase R&D spending when margins are going down? As an industry, we're consistent with where we should be when margins are dropping as a percentage of sales, year over year. This is especially so in the services area – but then services doesn't require as much R&D.

This tells a story: as sales go down, margins get thinner and it gets harder for companies to maintain R&D levels, when we also have to maintain a certain level of profitability for our shareholders. By comparison, China is investing heavily. Both industry and government have to together address this and keep our nation safe.

Q. Are large defense contractors vulnerable to competition from a new crop of non-traditional players?

A. Competition is not a bad thing, and that commercial firms are looking at defense is not necessarily a bad thing either. It's a natural evolution. Competition makes us all try harder.

The large primes have a role in traditional platform development. We're seeing non-traditional innovation from firms like Amazon and Google. This drives us all to think out of the box, which is good for industry, customers and the U.S. There still is a big gap between what is needed and what is available.

Q. As the game changes, do CEOs have to reeducate their investors?

A. There needs to be a broader reeducation, but not necessarily from CEOs.

The investment community understands the challenges the defense industry is facing. That was a big part of the discussion with Kendall. Investors have been willing to accept lower margins on the certainty of cash flow. Our customer has a stable cash flow, which helps drive earnings and returns value to shareholders.

Better Buying Power actually reduces margins, although that was not a goal. Companies in our industry have been asked to bid for work at lower margin rates because travel, subcontractor and other costs are sometimes not allowable. But when companies get hurt on



L-3



COMPANY PROFILE

■ **Net sales (2013):** \$12.6 billion
■ **Defense revenue (2013):** \$10.3 billion
■ **Employees:** Approximately 48,000
Source: Defense News research

margins, this does not make for a healthy industry.

Q. So how is L-3 making investment calls and where are you putting your money?

A. We try to show a new innovation path to the customer. We work horizontally across the company to help our engineers devise ways to solve technical issues. We also strive to understand what the customer really needs and wants. Sometimes that part is missing – the clarity on future programs, which is what drives budgeting dollars. As CEO, I follow this closely, since I want to continually fuel the R&D pipeline and support short-timeline projects that yield real results.

Of course, we also are interested in longer-term innovation – the projects where we might not see a real return for eight to 10 years. Our technology investment strategy is a mix. Overall, it is worth it, so we do it regularly and have found that it pays dividends.

Many of us are increasing our commercial and international work. That is a natural outgrowth of a challenging environment and some of our R&D investment is geared toward export or adjacent commercial markets.

But we're not always sure what will be funded, or when. That is always a question – when will we see our first order? In this scenario, it is hard to know how much to invest or how fast. You could hit a brick wall if budgeting doesn't materialize.

Q. Where do you see commercial growth?

A. Economic dynamics affect the environment. For instance, transportation-related businesses, airport security, training and simulation are all driven by macro trends. Developing companies are investing in infrastructure. There is big economic activity in

this area – also in shipbuilding, cruise ships, etc.

Q. Have you felt benefits from export control reform?

A. Yes, it is working. There has been progress in reducing bureaucracy and better coordination at both the DoD and Department of State levels. Two examples are unmanned systems and night-vision equipment. The government is truly helping industry – we saw a real uptick in DoD and service chiefs attending shows in Singapore and Farnborough. A lot of that is to promote export sales, and I know Frank Kendall is very attuned to this.

We're getting rules relaxed and creating a more rational environment. In night vision, other countries have this technology available, but we still can't export it. This constraint is hurting us as an industry. It is on the national level. We'd like to see short-term policy change that facilitates exporting in our industry.

Q. What should incoming Defense Secretary Ash Carter be thinking about?

A. First, get the budget act balanced and move away from boom-and-bust funding. He knows that. He really has an understanding of the economics of industry. DoD wants to buy more stuff and pay less for it. He understands keenly the need for the health of our industry by taking action to grow it. He is looking at what [global] regions the U.S. defense industry will be focused on: what future requirements will be influencing R&D, facilities, the marketplace.

In my judgment, the biggest threat in this environment is uncertainty. We need a return to predictability. Acquisition reform will help reduce bureaucracy and redundant procedures. □

By Vago Muradian in Washington