

RATIONALIZING AMERICA'S DEFENSE INDUSTRY

Renewing Investor
Support for the Defense
Industrial Base and
Safeguarding National
Security

KEYNOTE ADDRESS

by

WILLIAM A. ANDERS
Chairman and Chief Executive Officer
General Dynamics Corporation

DEFENSE WEEK
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Anders

Good Evening. I'm honored to be asked to make the Keynote address at Defense Week's 12th Annual Conference.

The focus of this year's conference is how we, as defense suppliers, should respond to the changing defense marketplace. Our overall theme is "Rightsizing, Repositioning, and Restructuring". It represents a new and very important version of the "3Rs" for our industry. In defense, we hear these terms often these days. In fact, they are regularly used interchangeably. Therefore, I'd like to give you my definitions of these "3Rs" so we may differentiate among them.

First: Rightsizing — I think of rightsizing as efficiency. Rightsizing is having just the right number of people, just the right amount of plant, and just the right amount of assets to support a specific task.

Second: Repositioning — I think of repositioning as moving resources from one business or market area to another. For example, diversification is a special and the more extreme case of repositioning.

Third: Restructuring — To me restructuring is financial enhancement. It involves significant changes in the capital structure of a company. Perhaps I'm reminding you of the "restructuring" of the 1980s. But, in the current defense environment, the most important restructuring issue has to be building financial strength and maintaining strong balance sheets, not the "financial engineering" and increased leverage of the past.

Of course the "3Rs", Rightsizing, Repositioning and Restructuring, must have a purpose. They're not just the themes of this conference. They are critical to the health and competence of any company.

"How To Maintain Defense Company Profitability" is also the theme of this conference. If you've been following General Dynamics, you know that I believe that profitability is essential if a company is to be a healthy, reliable defense supplier. However, there is an even more central issue facing all of us today. It is the health and vitality of our country's Defense Industrial Base.

If the companies that make up the Defense Industrial Base are not strong — technically strong and financially strong — the future of the industry is at risk, our country's Defense Industrial Base is at risk, and therefore our national security is at risk. The decisions we in industry and government make, or fail to make, in the near term are critical. Those decisions will determine whether our future Defense Industrial Base is up to the task of truly meeting future threats to our national interests.

Therefore, my overriding theme this evening is the future of our Defense Industrial Base. I want to cover four important issues.

One: I want to look at our deteriorating marketplace. How did we get to where we are today, and what does that mean for the future?

Two: I want to examine the opportunities we, and the government, have to respond constructively to that deterioration. How can we maintain a strong Defense Industrial Base now that the Cold War is over?

Three: I want to look specifically at how General Dynamics and our industry are using the "3Rs" of this conference to cope with marketplace deterioration, and ...

Four: I'll explain why I think the "3Rs" are not enough, by themselves, to assure our future national security. I'm going to add a "4th R" that I firmly believe is critical to the completion of that task.

Before we get too far, I'd like to define what I believe is the mission of our future Defense Industrial Base. To me, our most immediate job is to deliver the present and future procurement backlog to our military forces — with top quality, on time, and at a reasonable cost.

Equally important, but longer term, we must develop new technologies to continually improve our nation's weapons systems. Next, we must maintain the financial strength and flexibility to keep the technology, development, and delivery cycle strong and efficient.

Finally, we probably should have the capability to be able to respond to surges in demand, such as mobilization for future conflicts. But, mobilization, or reconstitution, are very complex national security issues, involving warning times and expensive standby capacity, and therefore I won't presume to suggest national policy on this subject this evening.

I believe the current state of our industry endangers the mission of our Defense Industrial Base, mainly because it is generating low returns and has massive overcapacity. Why is this the case, and what can be done about it?

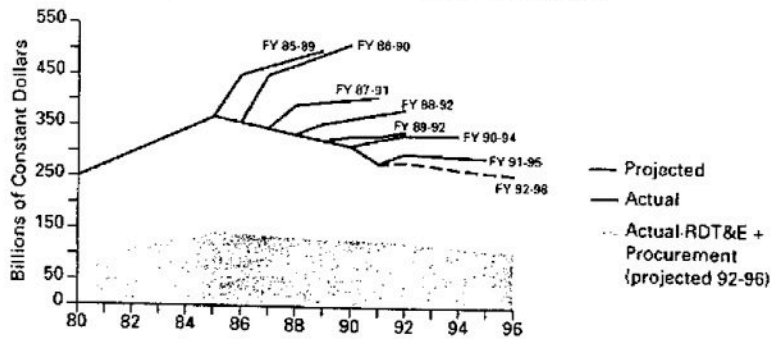
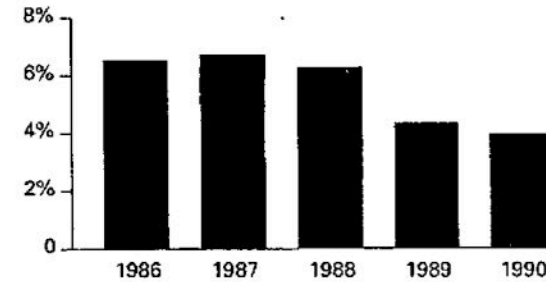


Figure 1

Figure 1 shows overheated planning versus the cold reality of defense budgets of the past. By the way, for accurate perspective, the data for all my charts is given in 1992 dollars, not then-year dollars.

The "fingers" shooting toward the upper right of the chart represent various DoD future 5-year plans and projections through the 1980s. The continuous line at their base represents the reality of the actual budget authority to date. The dashed line represents the recent projections for the future. The shaded area at the bottom represents combined DoD R&D and procurement budget authority, which is basically our industry's market.

As you can see, our industry was stimulated to build new facilities based on some very optimistic plans that never became reality. The industry was building up for the \$400 - \$500 billion defense budgets projected in the mid-1980s. With budgets actually peaking at about \$350 billion in the mid-1980s, defense profitability should have been solid in any case. However, government experimentation with contract terms and conditions, as well as business practices, eroded returns and is now actually increasing unit costs.



Source: Segment Data from S&P Aerospace Index Contractors

Figure 2

Figure 2 clearly shows how profitability declined for companies in the S&P Aerospace Index. Operating profit per dollar of sales fell 46% between 1987 and 1990.

Well, so what if our industry's profitability is below par? Isn't that simply a problem for our shareholders, but not one for our customers and employees? Absolutely not! It's a problem for everyone, and I'll explain why in a moment.

What I find especially important about this chart is that the significant decline began in 1988, before the fall of the Berlin Wall in 1989. In large part, due to experimentation with terms and conditions and business practices, our industry was already getting sick when the the Cold War began to end. And the end of the Cold War has created what I believe to be permanent structural change in an already troubled industry.

What do I mean by permanent structural change? I mean that the cyclical swings in defense spending are over. I think it is unlikely that any "upcycle" is coming

in the foreseeable future. As you can see (Figure 3), defense budgets have cycled rather regularly since WWII. Each sharp decline in defense spending was eventually followed by a strong buildup. Our industry would be sick for a while, and then the continued threat of communism would allow it to regain its strength on the next cycle. Things tended to average out. And, so long as the communist threat was alive and well, we could expect eventually to be pulled out of the doldrums.

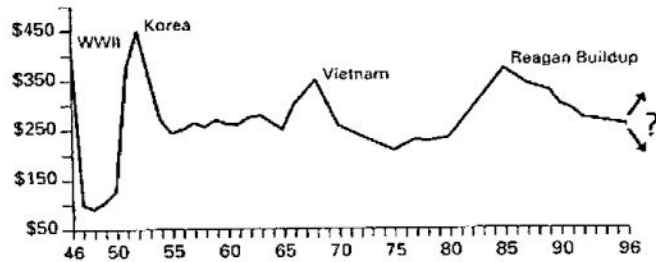


Figure 3

As we look at Figure 3, we see Cold War factors involved in every single upswing. Korea and Vietnam are prime examples, of course. The Reagan Administration's defense buildup created the most recent upswing during the 1980s. In large part, this buildup pushed the Soviets over the edge.

At General Dynamics, we are not projecting a repeat of that cyclic pattern. We believe the collapse of the Soviet Bloc has removed the primary force behind the defense budget's cyclic upswings. We are projecting overall defense budgets to drop further — but still to be a pretty sizable market.

To summarize, massive overcapacity from over-optimistic planning is bearing down on an already financially sick industry. The resulting inefficiencies are driving up unit costs for the DoD and the taxpayer. And signs of a further deteriorating Defense Industrial Base are all around us.

We are losing workforce skills; industry layoffs are likely to total at least 200,000 in the 1990-91 period. R&D skills, management skills, and shop floor skills critical to the defense mission are leaving. While most of this is unavoidable, the current pressures on our industry are encouraging many people we want to keep to jump ship if they can.

There is no question our Defense Industrial Base is going to be smaller. The question facing all of us is, "What do we need for it to be strong, so it truly can fulfill its national security mission?"

I believe the basic answer lies in this simple schematic of the Business Cycle (Figure 4). Investment, research and development, delivery of quality goods and services, reasonable return on investment, and satisfied investors create a circle —



Figure 4

or a closed loop, if you are a control theory type. If that circle, or loop, is unbroken, an industry is healthy. Break any link, and it doesn't work right — it gets sick. While the basic business cycle may seem obvious to many of you, I've found that a surprising number of people in our industry and in government don't seem to understand or care about some of the required links illustrated here.

Perhaps the most commonly overlooked link in this circle is the one between return on investment and investors. If returns to investors are good, they are willing to keep their money in the circle, generating new research, funding plants and jobs, and supporting the delivery of goods and services to the customer. When markets grow, additional money must flow into the circle. When markets decline, so long as returns remain reasonable and free markets prevail, the circle tends to "rightsized" automatically, and some cash should be expected to flow out.

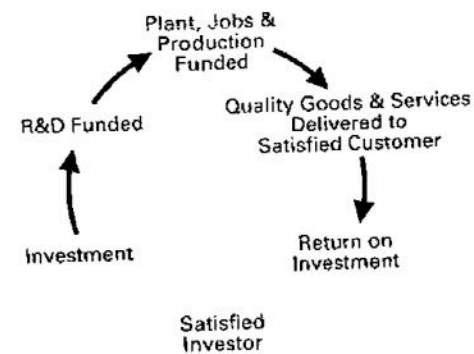


Figure 5

However, if returns to investors are poor, the circle or loop is broken (Figure 5). Investment abandons the industry. Replacement funds are expensive, if they can be

obtained at all. R&D suffers. Skilled workers and efficient plant are endangered. Most important, the efficient and timely delivery of quality goods and services to customers suffers. As a result, customers become less and less willing to support decent returns. The business cycle becomes a vicious broken circle — or, for the pilots in the audience, a death spiral. There is hard evidence that this is exactly what has been happening in the defense industry. And, with pressures increasing, it could worsen in the future. This is not good news for our Defense Industrial Base. We must pull out of the spiral.

Those who will not accept my assertions that we have an anemic industry do not have to go far for real third party corroboration. Investors tell us what they think of a particular company's returns by the premium they will pay, or the discount they demand, for that company's stock. This is generally indicated in the ratio of the stock price to earnings — the price-earnings or "P/E" ratio. A high P/E indicates a company investors favor and a low P/E identifies one they shy away from — unless they can buy it at a debilitating discount. In other words, buy at a low stock price for a given earnings level.

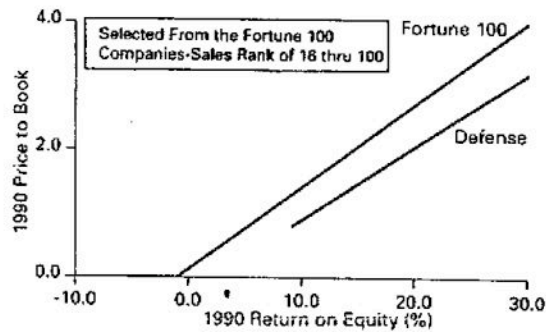


Figure 6

Figure 6 lets us see how much investors are willing to pay to own stock in the Fortune 100, as compared to stock making the same return in the defense industry at the end of 1990. The horizontal axis of the chart shows the ratio of after-tax earnings to shareholder equity, more commonly known as ROE. The vertical axis shows the ratio of stock price to shareholder equity, more commonly known as price to book. Divide one by the other, and you get P/E. The upper slanted line is a "least squares" fit to companies in the Fortune 100, defense and non-defense alike. The lower slanted line represents a similar analysis of just prime contractors in the defense industry. Both lines have a solid correlation factor to the data.

In 1990, the typical after-tax return on equity in defense was slightly less than 10%. I've drawn a vertical line up from that point to help us see how much investors

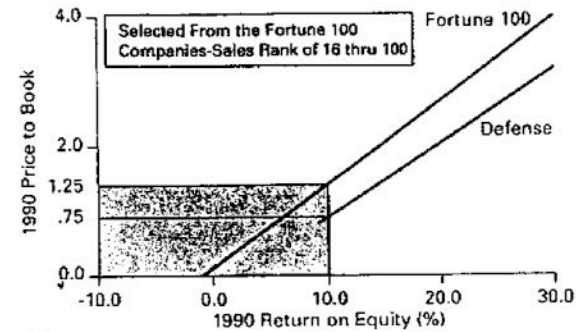


Figure 7

are willing to pay for that return from both groups (Figure 7). We should all find the message here very disturbing. For the same ROE, investors will pay more for stocks in general than they will for defense stocks. Over 60% greater, in fact. In other words, they are heavily "discounting" our industry, thus making it "expensive" for us to obtain new investment funding.

This is clear evidence that the circle is broken for us. Due to their perception of declining volumes and onerous terms and conditions in our industry, investors are demanding more from us than other industries to keep their money in defense. Frankly, these investors are not behaving irrationally. Overall, defense has not been a good business lately, and there are clear signs that it could get worse. Let me show you why.

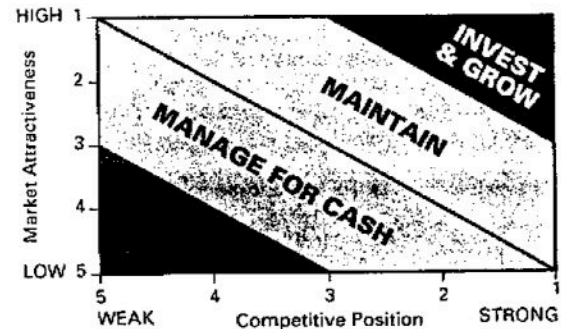


Figure 8

At General Dynamics, we use what we call a strategic matrix to help us with our product line investment planning (Figure 8). The horizontal axis represents the competitive position of a business. The vertical axis represents the attractiveness of its

market. And each diagonal band suggests to what degree you should invest, and how you should manage a business which falls into that band.

Determination of competitive position is subjective, but includes such factors as low costs, good experience, and leading technology. It's the degree to which you have an edge over the other players in your business, or the edge they have over you.

Market attractiveness for any business segment includes such factors as market growth, potential profit margins, and risks. It tells you how well even the best performers can do in a given marketplace.

With some liberties, one can use this matrix to evaluate one market over another. How does defense stack up on the matrix?

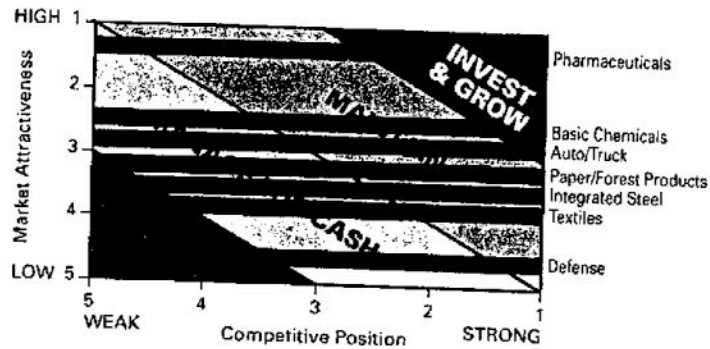


Figure 9

Compared to other industries, defense has been a poor investment, as Wall Street corroborated on the earlier stock price vs return on equity chart. Figure 9 suggests that even the strongest defense companies should be in a "maintenance" mode, and should be no more attractive than, for example, a weak pharmaceutical company.

There's no mystery why investors are "discounting" defense stocks. We have had high risk, negative growth, overcapacity and low margins. Generally, the market is unattractive. That makes most other industries a better overall investment for the investor — and he does have choices.

The strategic matrix also suggests that defense companies are not necessarily investing their own cash wisely (Figure 10).

Should we be putting new money into defense? Not even the strongest competitors are in the "Invest and Grow" sector. Some talk as if they were. The fact is, the chart is basically correct. Right now, beyond a few niches, in general there are no real "Invest & Grow" opportunities in defense.

Should we be leaving all our current defense investment in place? That's what the "Maintain" sector represents. Quite a few defense companies seem to be saying

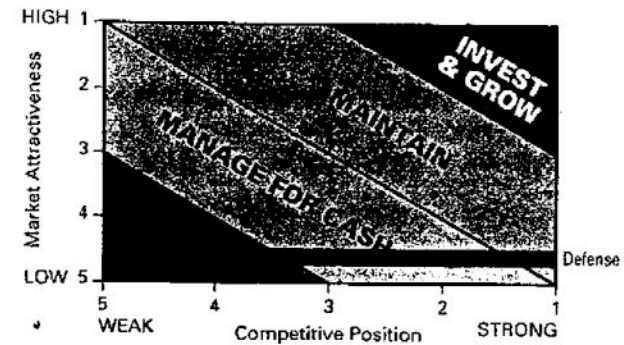


Figure 10

that's their strategy. According to the chart, only the strongest competitors in defense should be keeping their investment constant, based on market realities.

Should we be taking money out? That sounds very un-American, but this matrix suggests that is exactly what most should be doing — managing for cash. Burdening a business with unnecessary assets reduces returns and adds unnecessary costs, making you less attractive to investors as well as your DoD customers.

Should any of our businesses just exit the market? The matrix suggests that our weaker players need to leave the field. But, government policies and practices tend to impede exits from the industry, thus decreasing the motivation for the strong to stay. Continued overcapacity burdens us all. It won't get this country a smaller, but stronger Defense Industrial Base. Indeed, continued overcapacity will guarantee a weak Defense Industrial Base.

However, the strategic matrix has some strong suggestions for how we might reverse these trends (Figure 11).

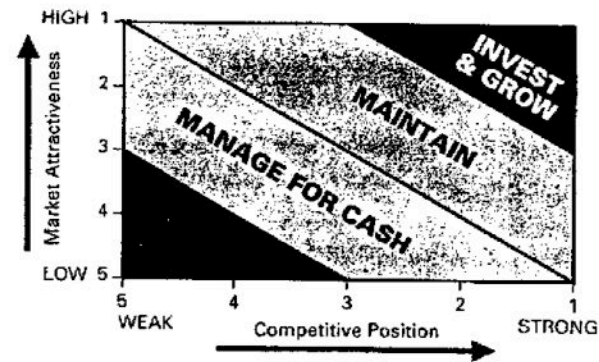


Figure 11

First, those who choose to stay in this market should work to move their best businesses to the right on the matrix. They need to strengthen and continuously improve their competitive positions. This is primarily an industry effort. And it's why we're here. Rightsizing can increase efficiency. Repositioning can put resources where they belong. Restructuring can increase financial strength.

But, so long as the basic market is unattractive, this conference's "3Rs" cannot do the entire job. Clearly, the defense market itself must be moved up the chart. It must be made more attractive to investors if the circle is to remain unbroken. This is primarily in the hands of the government. Our's is not a true free market and the government writes the rules of the game.

Growth is probably not in the cards, but better "rules" — that is, better terms and conditions — could be. Certainly stopping high risk "Fixed Price" development, providing higher progress payments and reasonable returns, and more direct and complete funding of R&D head most lists. Government cannot shirk its role any more than can industry, and passing the buck, or taking only a short-term outlook, will only accelerate our current malaise. There are strong signs that current DoD acquisition leadership agrees with this. But will, or can, they do much about it? I truly hope so. If industry and government both rise to these challenges, we can, together, create a stronger though smaller Defense Industrial Base. What will be the benefits of success?

Reasonably priced investment dollars would be available. R&D and production would operate effectively and efficiently. The resulting job stability would keep the best skills in our industry. Our government would get quality products, on time, at a reasonable cost. And our investors would receive the reasonable returns they deserve for their support. This must be our goal. How are General Dynamics and the overall industry implementing the "3Rs" to get the job done?

Let's start with Rightsizing. If you'll remember, my definition of Rightsizing is creating efficiency.

At General Dynamics, we are adamant that our defense business must be a business. It is not going to be simply a large activity. Accordingly, we're determined to run it like a business. In Rightsizing, our first objective has been to increase productivity and reduce costs and risk in what we call our "old" backlog — the \$23 billion in total funded and unfunded backlog on hand at the beginning of this year when I became chairman (Figure 12).

This backlog is reasonably secure and it isn't going to be worked off anytime soon. It mostly represents long-cycle programs. As we work off this backlog, we have real opportunities to reduce costs and improve our profit margins. And those opportunities all fall in the area of Rightsizing.

For starters, we took over \$1 billion in write-offs at the end of 1990. This eliminated all known risks from the old backlog.

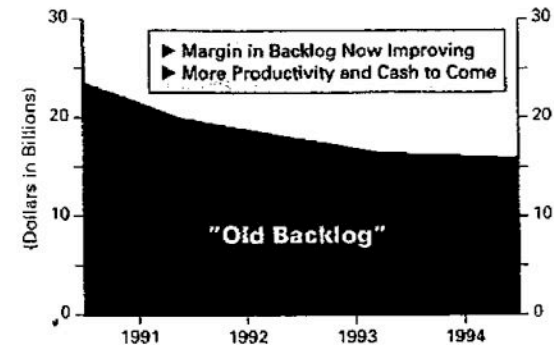


Figure 12

Like many in the industry, our company had been building for growth. Our plants were expanded and modernized. Indeed, they were overbuilt considering our slumping marketplace. Therefore, General Dynamics can, and should, significantly reduce capital investment for a while without harming current or future business.

Operationally, we began to focus on our many opportunities to manage materials and other assets more effectively through inventory reductions and better control of working capital. Focusing on these issues was new to many at GD, but these efforts are paying off. Our "growth culture" is changing to a more businesslike approach. Inventories and other working capital items are shrinking to more efficient levels in each of our businesses, thus reducing costs and improving returns. This, in turn, sharpens our ability to deliver quality product, on schedule, and on budget.

In addition, we are looking for opportunities to consolidate plant and facilities. We are combining divisions and will divest businesses that don't "fit", are undervalued, or are a drag on our progress. We are seeking to eliminate duplicate facilities altogether where we can concentrate volume in the most efficient production lines.

We're giving strong attention to increasing labor productivity. Selected hiring freezes, for example, can get managers to really rethink staffing as attrition reduces a workforce. Already, our productivity, as measured by sales per employee, has increased about 12%. Overall, the initiatives I've just described have permitted us to increase earnings from our old backlog, despite the negative pressures on our industry.

While we work to improve margins on this old backlog, we have been taking a fairly aggressive stance regarding new business. In order to have decent future returns, we know we must build such returns into any bid we make. And, we simply are not going to "buy" volume for volume's sake — bidding programs on a marginal-cost mentality has been an all too common practice in this industry, and a major factor in investor discontent. We thought this stance might tend to limit new business opportunities for General Dynamics. I'm pleased to report we were overly

pessimistic. We have been pleasantly surprised to find that, due to the strengths of our product franchises and “niches”, substantial new business is being won despite our stand on returns.

With about \$11 billion of new business between the first of January and the end of September, we now expect our backlog to total nearly \$27 billion by year-end, \$8 billion more than the \$19 billion we projected earlier in the year (Figure 13).

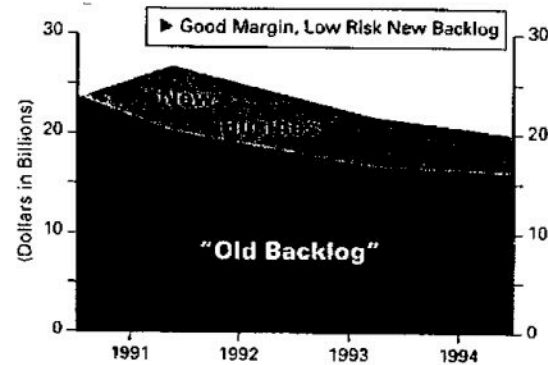


Figure 13

With this \$8 billion positive swing in our anticipated backlog, our efforts at Rightsizing in our defense businesses will generate even greater payoff. The improving margins should help attract investment and give us increased financial strength. The added volume permits us to have a more stable workforce with good jobs. As you would imagine, our employment projections have changed as well. Yes, we will continue to emphasize productivity, and are prepared to take prompt action should volumes not materialize to the degree we now expect. But, as we see it now, with this new business, net reductions in employment should mainly reflect attrition and productivity gains, not heavy layoffs.

At General Dynamics, our aggressive efforts to increase efficiency — to “Rightsize” — are paying off. And that payoff is not only in decent returns on old business, it is appearing as new business with more reasonable terms and conditions as well. We view this as very positive for us. It says that our customer appears to be willing to support real value. We’ve gained market share at a time when many felt our stand was suicidal. This gain has increased our interest in defense, and reduced our dependence on our non-defense businesses.

Is General Dynamics the only company making progress in Rightsizing? Of course not. All of you are trying to become more efficient. However, so long as our industry is burdened by massive overcapacity, none of us will be truly efficient. The

winners — the ones with the relatively stronger competitive position — will just be the least inefficient.

How are we doing on Repositioning?

My definition of Repositioning is the redeployment of resources. While diversification is the repositioning technique most discussed these days, it appears to me that there are actually three broad techniques for redeployment of excess defense resources.

First, you can simply get rid of them through a divestiture of some sort. I’m not sure that all such efforts have been that helpful toward strengthening the Defense Industrial Base. Often, they just shuffle excess capacity around into weaker hands with a higher cost base and less underlying financial strength. That does not generally reduce overall capacity.

Second, you can squeeze your defense operations for cash to invest in some non-defense business you might already have on board. If your defense business is a “leaky boat”, as it appeared for General Dynamics earlier this year, or worse is a “sinking ship”, this may make sense. But such “internal diversification” does raise some significant management and value issues.

For example, it creates a “diversion” for management. Management has to keep shifting its mind-set, because defense is quite different from commercial business, especially for prime contractors. In addition, the more your company moves toward “conglomerate” status, generally the more mediocre your overall earnings become. Conglomerate theory has it that unrelated diversification provides protection to earnings because the markets served are not likely to all be down at the same time. But, unfortunately, the converse is also true — they likely won’t all be up at the same time, either. I say this from experience, since I’ve had to manage in such an environment. Bottom line: there is a good reason why investors generally discount the stocks of conglomerates.

The third redeployment option — I’ll call it “external diversification” — is usually a formula for disaster. Again, if you feel you are on a “sinking ship”, such diversification may seem attractive despite the risks. But I think we should all pay close attention to history on this issue.

As indicated by Figure 14 (on page 14), numerous studies show diversification acquisitions in the non-defense economy are economic failures 50-75% of the time. In addition, a McKinsey study conducted for General Dynamics showed an economic failure rate of 80% for acquisitions of businesses outside of defense by defense contractors. This isn’t surprising. Defense industry management teams generally have little commercial experience and “market savvy”. Most have been “cost plus” and “mil spec” trained. In short: most don’t bring a competitive advantage to non-defense businesses. Frankly, sword makers don’t make good and affordable plowshares.

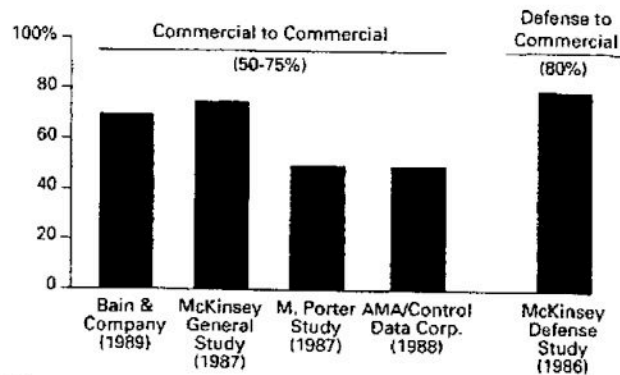


Figure 14

How has General Dynamics approached repositioning? Because our defense business looked like a rather "leaky boat" earlier this year, we took a hard look at redeployment of defense cash into our commercial businesses, especially our Cessna commercial aircraft business as its returns have been quite strong. We also said we would be more open to non-defense businesses than in the past. We felt we might not have a choice if we were to remain a viable entity, long-term, given our conservative projections regarding new defense business.

Since then, our strong new backlog in defense, and our objective evaluation of what our management team really could bring to the table, told us that we had a better chance by doing what most good businesses should do in a stormy, highly competitive situation. We should focus on what we know best: our core defense competencies.

In defense, General Dynamics has the history, the technology, the plant, and the market skills in certain product niches and franchises to generate and maintain strong competitive positions. We are working hard to rapidly develop a more businesslike mind set — or "management culture" — to reinforce these competitive strengths.

Since our high win rate suggests that defense is not a "leaky boat" for General Dynamics, we are reducing our potential for the redeployment of valuable funds for diversification outside the defense industry. In fact, we have decided to lean toward "un-diversification", if that's a word — to "de-conglomerate". We intend to monetize activities where we are not adding real value and to focus on what we know best — defense.

For example, we're outsourcing our routine data processing operations. We weren't really adding value here. We get \$200 million in cash now. We get more efficient data processing later. And those operations end up in a strong, growth-oriented, data processing company. Everybody wins.

Most recently, we decided to divest Cessna. This fine performing division is clearly an undervalued asset so long as it's overshadowed by our defense operations. And, it's not in our main area of expertise. We have great commercial aircraft management at Cessna itself. But the rest of us are primarily defense people. So, with a Cessna divestiture we unlock significant value, reduce our liabilities, add substantially to our financial strength, and eliminate a management diversion, thus allowing us to more clearly focus on core defense competencies. Some say we may be moving too fast. I wish we had started moving even sooner!

In my opinion, the industry's repositioning record is pretty mixed. I see some defense capacity shuffled around, mostly into weaker hands. I see some diversifying out of defense. Good luck! This may create the appearance of growth, but the odds are against profitable returns. At General Dynamics, after studying diversification and its risks, our conclusion was that our management, as a group, didn't bring a clear competitive edge to investment outside defense.

If we have cash that General Dynamics can't invest in good, attractive core defense programs with decent returns — and probably such opportunities will be more scarce in the future — rather than add diversified volume just to look bigger, I believe we should return excess cash to the shareholders. They are the ones who provided the cash in times of industry growth, and they now deserve the right to make their own diversification decisions. So much for Repositioning.

Our third "R" is Restructuring. My definition of Restructuring is financial enhancement. If you've been following General Dynamics, you know that we view financial strength as a necessary element in our strategy for the future.

We've been working successfully to build cash and financial flexibility to serve three priorities: liquidity, investment in our core defense businesses, and shareholder value.

First, we want liquidity so that our customer and our shareholders will know we have the capacity to face the unexpected in a stormy environment. For example, we are quite confident our position regarding the cancellation of the A-12 is sound, and will be upheld in court. However, we are committed to having the financial capacity to honor our deferral agreement should justice not prevail, and still remain financially strong.

In addition, we want the capacity to invest in our core defense businesses, if appropriate. The company's former growth strategy had created sizable modern plants that easily can, for a while, handle additional work with less capital investment. But, if an attractive, profitable program requires carefully targeted investment, we want to be able to handle it — though, frankly, I don't see the needs being great here.

Finally, should there be excess cash left after the above priorities are satisfied — and I believe there will be — we want the ability to return the excess value to our shareholders. The cash we are accumulating comes from past investments made by

them, and it is likely that the smaller Defense Industrial Base of the future will require less embedded investment. Therefore, as I said before, it's only right that excess funds be returned to the investors for reinvestment as they see fit. This will create new jobs and more productive business opportunities in the general economy.

Once again, I view the industry's overall performance as mixed. Some companies are working to build financial strength. Others seem to be waiting for another cyclical defense upswing to bail them out. With the Cold War over, I think that's a very risky approach. Still others seem to be dependent on the government financially. I hope the taxpayer will not allow that to continue. The government can't afford to prop up financially weak suppliers indefinitely. Once again, massive overcapacity is placing a burden on an industry which was already seeing the erosion of returns and financial strength.

Now, let me tell you why I feel that this conference's "3Rs" — Rightsizing, Repositioning and Restructuring — will not, by themselves, create a strong Defense Industrial Base for our national security.

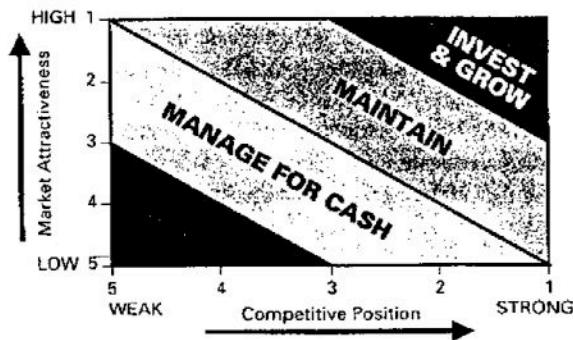


Figure 15

Returning to our lessons from the strategic matrix (Figure 15), remember that the "3Rs" primarily help competitive position — industry's movement to the right on the matrix. They provide virtually no help in increasing the overall attractiveness of a rapidly shrinking market — moving the market upward on the chart.

In my view, we need to add a "4th R" to help here.

We need Rationalization of this industry. We must reduce supply to match demand. Have we really been reducing supply with our "3Rs"? The fact is, most of the capacity remains. It might be mothballed. It might be half used. But most of it is still there. And more importantly, much is still on the books and adding cost to our operations. We need the overcapacity to go away permanently if we are ever to become truly cost-efficient.

In addition, our remaining businesses must have "Critical Mass". By "Critical Mass" I mean that what remains must be strong and efficient. Why is "Critical Mass" important? Because, for example, a concentrated R&D effort is superior to a fragmented and duplicative one. It's important because really efficient production requires economies of scale and no idle plant. Our Defense Industrial Base cannot be a collection of regional "cottage industries" if it is to fulfill its mission well.

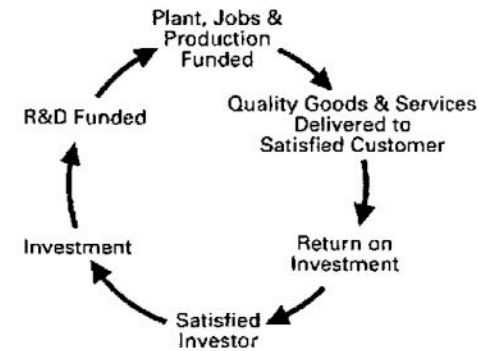


Figure 16

The business cycle (Figure 16) tells us that a strong industry, regardless of its size, needs decent returns to attract investment. That requires a supply/demand balance. When supply greatly exceeds demand, costs go up and both the suppliers and their buyers have a hard time resisting unproductive bidding wars and program auctions. Yes, when that happens prices will go down — for a while — but the business circle gets broken and, long-term, both supplier and buyer lose.

However, with supply and demand in balance and a Critical Mass, you get good, stable jobs to retain the best R&D and production skills. You have the efficiency needed to deliver quality goods and services to the customer on time, and at a reasonable price. And you should have reasonable returns to encourage further investment. The circle is unbroken.

I think it's absolutely clear that a strong Defense Industrial Base will require this industry to not only shed capacity, but to concentrate the remaining capacity into businesses which have Critical Mass.

It seems equally clear that the government cannot, or will not, take the lead in rationalizing our industry. Government direction of this kind of consolidation smacks of "Industrial Policy", and industrial policy is politically unacceptable to the current administration. This is probably just as well since "Industrial Policy" doesn't have a very good track record here, or overseas. Since the government cannot, or will not, lead the way, industry must take the lead.

What are we doing at General Dynamics? We are insisting on Critical Mass in all our core defense businesses. They must be number 1 or number 2 in their areas of expertise. Otherwise, we will take action to "fix" the problem.

At General Dynamics, "fix" means buying or selling programs from or to another company in a particular market in order to create Critical Mass. We're prepared to be a buyer to obtain Critical Mass. However, we will not pay a premium. We are also prepared to sell to another party so they can have Critical Mass. I suppose joint ventures are also possible, but they generally result in extra overhead and inefficiencies compared with a straight buy or sell. If such moves are not possible, we are fully prepared to exit a business as its backlog is delivered. We have the financial capacity to do so.

My challenge to you is for our entire industry to close down and write off truly excess capacity. First we should demand Critical Mass. Step back, take a look at the field, and start doing some serious buying, selling or swapping of businesses to create the kind of Critical Mass each business needs to be a strong and reliable supporter of the future Defense Industrial Base.

Such combinations will create stronger suppliers from weak ones. Buyers of Critical Mass will improve their competitive edge. Sellers will get cash and earnings to help write off remaining excess capacity and build their financial strength. And the government will get the economies of scale necessary for a strong and efficient Defense Industrial Base.

True rationalization requires some businesses to shut down. Not everyone can be number 1 or number 2. Given the negative growth in our market, mediocre third and fourth place suppliers shouldn't be around in five years, or so. Why put the customer, the employees and the stockholders through a long, pointless ordeal? To my mind, cleanly exiting an unsound business takes strong, enlightened management, and is a real act of leadership. General Dynamics is prepared to take action where it's indicated.

Does the government have a role in this process? Absolutely.

While it cannot lead the process, government can encourage and support the rationalization of our industry. How? At the very least, government should not impede the departure of true excess capacity and inefficiency from our marketplace. Losers must be allowed to lose if the winners are to win. Government cannot continue to prop up unneeded capacity if we are to have a strong Defense Industrial Base.

Similarly, dual sourcing does not lower costs through competition if volumes are low. It raises costs, and prevents anyone from having Critical Mass and the resulting economies of scale the government and taxpayer need. And, what if someone "buys in" to a winner-take-all competition? Will that be the kind of supplier to provide a long-term healthy Defense Industrial Base? Where will the skills and new

technology for upgrades come from? Buying on a long-term "best value" approach should be encouraged.

Contracts will have to be novated to permit program transfers that create stronger suppliers.

In addition, teaming seems to have approached an extreme. Though some technology is transferred among team members, overhead is increased. In the past, the major economic drive for teaming seems to have been to share big losses. Loss-driven teaming will have to stop if we are going to have a healthy Defense Industrial Base. And, certainly, the entanglements of teaming make it more difficult for the weaker to leave the marketplace.

Tax laws and contracts may need modification regarding treatment of write-offs and intermediate steps, such as sale/lease-back arrangements.

I understand that the government can't take a big role in creating Critical Mass in our industry. However, right now there is a de facto "industrial policy" at work. That de facto "industrial policy" tends to impede rationalization of excess capacity, and therefore it is contributing to the weakening of our Defense Industrial Base. It must stop. Our companies can't afford it. Investors can't afford it. Employees can't afford it. The government can't afford it. And taxpayers can't afford it.

In summary, we are facing a fundamentally changed market. I believe that change is structural and permanent. Our Defense Industrial Base is weakening. If current trends continue, not only our companies, but our national security is at risk. If our industry, and this nation's Defense Industrial Base, are to be strong, we must eliminate overcapacity. Therefore, the industry must not only Rightsize, Reposition and Restructure — the "3Rs" — it must also Rationalize.

You've heard me say the word "overcapacity" more than any other term I've used tonight. If the "4th R" — rationalization of overcapacity — is the one thought you remember from my presentation, I've accomplished my main objective this evening.

At General Dynamics, we're working to become the kind of defense supplier we believe our government deserves, our employees deserve, and our shareholders deserve:

- We are building substantial financial strength.
- We are managing our old backlog for lower costs, and reasonable returns.
- We are insisting on decent returns on new business, and have found our government customer generally seems willing to permit reasonable returns for value received.
- We are taking a conservative approach to our marketplace.
- We are focusing on our core defense competencies.
- We are off-loading and monetizing our non-core assets into financial strength.

to weather the storms ahead, to invest in defense programs if they are attractive, and to generate value for our investors.

- We're insisting on Critical Mass in each of our businesses. They must be number one or two in their fields. If they aren't we'll either buy, sell or exit to fix the problem.
- We're preparing ourselves to be able to compete with maximum efficiency.

But General Dynamics, or anyone else in the industry, cannot meet that goal without an attractive market. The government has an important role here. The defense market isn't going to grow. Indeed, it is shrinking. But it can have reasonable returns and reasonable risk, if terms and conditions are enhanced and defense overcapacity is permanently eliminated. The government must do its part to make the defense market an attractive place for the winners. The government must encourage rationalization. At the very least, it can stay out of the way in what is hardly a free marketplace.

In conclusion, accepting this challenge of the "4Rs" — Rightsizing, Repositioning, Restructuring, and Rationalization — will benefit everyone:

The remaining companies will get a more healthy marketplace.

The departing companies will not continue to be pulled down by their inefficiencies.

Defense industry shareholders will receive reasonable returns, and will have the motivation to continue to invest in defense.

Our employees will have secure, rewarding jobs.

And our government will get a healthy Defense Industrial Base, with financially strong suppliers, technological leadership, and programs delivered on time, with high quality, and at a reasonable cost to the taxpayer.

Thank you, and good evening.