BUSINESS TRANSITIONS

A LOCAL OFFICIAL'S GUIDE TO DEFENSE INDUSTRY ADJUSTMENT

U.S. Department of Defense
Office of Economic Adjustment

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INTRODUCTION

It is news that no business executive wants to get: you have lost your biggest contract.

It's not unusual for business owners and managers to hear this kind of bad news, but it is a shock all the same. In most cases, firms do their best to move on by finding new replacement contracts or trying to enter new markets. In some cases, however, this transition can be a little more difficult. What if your product or service is no longer needed or has been overtaken by newer technologies, products or services? In these cases, transition challenges are especially tough. Firms need to absorb the pain of lost business, while also retooling and reforming to succeed in new markets. Meanwhile, their managers, employees and neighbors face challenges of their own. What happens to a company town when that company shuts down?

Some defense industry executives and managers—often leaders in their home communities—may be facing this scenario in the coming years. After years of steady growth, U.S. defense budgets are expected to face a period of decreased funding. Concerns about government spending, the drawdowns in Iraq and Afghanistan and a reduced need for new weapons systems, are combining to create a situation where nearly all analysts and experts expect to see significant cuts in defense spending, particularly in areas like new procurement, that affect private defense contractors. As a result, the industry is preparing for a period of belt-tightening.

Communities that are home to large defense firms, military facilities or large clusters of defense-related activity need to be prepared as well. While details of defense budget cuts may not always be immediately known, advance preparation makes sense. Being prepared now can set a community up for success in the long-term, so if a local defense firm loses contracts or is forced to shut its doors, your community can quickly respond and capture new economic opportunities.

Purpose

This Guide is designed to help elected officials understand and move through the process of defense industry transition. What happens if your community is hit by defense budget cuts? What can you do to help the affected business, its employees and the community at large? This Guide offers tips on how community leaders can help. Many of these tips are based on experience from the last instance of major defense downsizing in the early 1990's; others come from the experience of communities that have faced other economic shocks like a major plant closing or a natural disaster.

KEY LESSONS from PRIOR DEFENSE INDUSTRY TRANSITION

Effective defense transition efforts require an understanding of the unique nature of the defense industry, compared to other business sectors.

But, your community response does not need to be 100% defense-unique. Many of the strategies and approaches used in responding to other economic shocks, such as natural disasters or plant closings, can be adapted to assist defense transitions.

There are **numerous federal, state, and local programs to help businesses** as they transition into new markets. Use them!

Defense Budget Cuts as an Economic Shock

While the causes of defense budget cutbacks may be unique, their impacts on the ground are quite similar to other economic shocks, such as a natural disaster or the closing of a manufacturing plant. In each case, a community loses a major economic anchor that provides jobs to local workers. These anchors also help drive other parts of the economy such as local retail, restaurants and suppliers in a manufacturing supply chain.

Communities confronted with these economic shocks face several key challenges. Most immediately, laid-off workers need assistance accessing unemployment benefits and obtaining new employment as quickly as possible. Some workers transition easily to new jobs and careers, but others, such as older manufacturing workers, may need extensive retraining and support.

Support at the community level is also necessary. As workers lose jobs, the local economy is hit by lost revenues and lost incomes.

Community confidence may also be shaken, as long-standing economic certainties give way to an uncertain future. Effective community leadership requires the recognition of the economic loss, but places greater focus on building a brighter future.

Finally, affected businesses need help weathering the storm and identifying new business opportunities. Dealing with these dual requirements is quite complex. As firms are faced with the loss of major contracts, they must seek out new markets and new business opportunities. This is not easy, but it has been accomplished in the past. And that's the primary focus of this Guide.

WHAT IS DIFFERENT ABOUT THE DEFENSE BUSINESS? WHY DOES IT MATTER?

Helping defense contractors adjust requires that "you walk a mile in their shoes." Public officials don't need to be experts on the defense business, but you do need to understand how these business people view the world. In many ways, the defense business is unique, especially when compared to the typical company seen on Main Street or in a strip mall. These unique characteristics include:

- A heavy focus and dependence on government contracts. For example, Lockheed Martin, one of the world's largest defense contractors, gets 82 percent of its revenue from the U.S. government.

- Limited experience in other "civilian" markets, such as selling directly to consumers.
- Working under tight price restrictions for goods and services,
- Operations tend to be concentrated in a few places. They don't have a store in every community!

These unique factors will affect how firms adjust to a period of lower defense spending.

U.S. defense budgets have risen steadily since 2001. Thus, we have limited recent experience with defense industry adjustment. The last big major cutback came in the 1990s at the end of the Cold War, but other related events that are illustrative include recent military base closings and the shutdown of NASA facilities in Florida. These experiences, as well as the history of other economic shocks, provide some excellent guidance on what makes for an effective community response.

If there is one dominant take-away from history, it is this: defense transitions are tough. There is no silver bullet or single pathway to success. Communities and firms have pursued a variety of approaches. Some have succeeded; others have generated results that are more moderate. And some communities have been lucky as new economic engines emerge to replace lost defense jobs. In San Diego, the rise of the local technology sector and firms like Qualcomm (which started as a defense contractor) helped ease the pain of the 1990s defense cuts. Many communities in New England and Long Island also benefited as emerging technology firms helped create new employment opportunities in the wake of major defense industry cutbacks.

Several other important lessons can be gleaned from the 1990s beyond the caution against seeking a silver bullet solution. First, it pays to start early. Where possible, planning for economic transition should occur before a local facility or company shuts its doors or announces major job losses. This early start may not always be feasible because private companies may not know in advance if bad news is on the way. However, in the defense sector, most communities have slightly longer warning times because defense contract cancellations or facility closures typically include some advance notice. When compared to defense facility closures, the warning time for defense contracts is shorter. Yet even in these cases, notification of contract termination may occur several months to a year in advance.

Effective community approaches feature working with firms in advance of factory shutdowns or major layoffs. Where possible, community economic development leaders should monitor local contracting activity to better understand potential risks for contract reductions or cancellations. This early monitoring allows for a quicker reaction in case problems arise.

Second, community leaders must plan for the long haul and should operate under the assumption that they will not immediately replace all of the lost defense jobs. Replacing those jobs, or adding new jobs in the community, is a long-term proposition, and it is unlikely that a single new employer will emerge as a new community savior. Instead, smart communities "hit for singles, not home runs." They develop strategies that support multiple economic drivers to replace lost defense jobs.

LESSONS from HISTORY

- There is No Silver Bullet or Single Pathway to Success
- Community Leaders Must Plan for the Long Haul
- Partnerships with Local Defense Employers are Essential

> "Communities that are home to large defense firms, military facilities, or large clusters of defense-related activity need to be prepared."

Third, close partnerships with local defense employers are essential. Very few firms have succeeded in diversifying away from the defense industry. These rare success stories have resulted from a mix of resolute management focus in support of diversification, smart strategies, strong community support and a dose of luck. Thus, if a firm's management is uncertain or unenthusiastic about diversifying into new markets, its chances of success are relatively small. Recognizing this reality, most large defense contractors opted to remain focused on defense and government business when faced with downsizing in the 1990s. They are likely to maintain this focus today.

In contrast, many smaller firms and subcontractors may have interest in pursuing new markets or diversification opportunities. These firms may be appropriate targets for a regional dislocation aversion strategy that seeks to avoid layoffs or major firm cutbacks. In these cases, it makes sense to link these companies to the many resources focused on business development, such as the local Small Business Development Center, the Manufacturing Extension Partnership office, export promotion programs and the like. These experts can help local firms assess their competitive assets and challenges, and design appropriate strategies for new business development. These options will be discussed in further detail throughout this Guide.

The St. Louis Experience

In 1990, St. Louis was one of the most defense-dependent places in the U.S. One in seven local jobs was tied to the defense industry, with one firm, McDonnell Douglass, alone responsible for 42,000 local jobs. Then, the Cold War ended and the floor dropped out. The region lost 10,000 jobs in six months, and 25,000 jobs between 1990-1994.

Shocked regional leaders convened the St. Louis Defense Adjustment Committee, a coalition of everybody and anybody with an interest in charting a new future for the local economy.

They soon adopted a multi-pronged strategy with a heavy focus on worker retraining, new technology development and business incubation. For business transition, the Committee supported efforts that helped small machine shops retool and enter new markets, and helped displaced engineers start their own companies—and that spurred new community investments in emerging industries like biotechnology and plant sciences.

The early 1990s were a tough stretch for St. Louis, but recovery has happened. Overall, 59,000 local jobs were lost in the defense downturn between 1990 and 1997. But, since then, nearly 107,000 new jobs have been created and the region has emerged stronger, more diverse and more resilient than ever.

WHERE TO START AND HOW TO PROCEED

Key Challenges

As defense contractors face a market with fewer government business opportunities, they face a difficult and fundamental decision point in assessing how to respond. Because defense transitions are so challenging, many firms will opt for a strategy that is sometimes called "stick to your knitting." In this case, the company will either absorb contract losses via downsizing and layoffs and/or aggressively pursue more government business by competing for new contracts or seeking to merge with other defense contractors. This approach was the norm in the 1990s when more than forty large defense contractors ultimately merged into just five new defense conglomerates.

A smaller share of companies will seek to replace lost defense work with other business opportunities, sometimes with other government agencies (local, state or federal) or in commercial markets. Companies and managers that pursue this path face several big challenges, most of which revolve around the need to identify and understand non-defense markets, and then retool and retrain personnel to produce for these new markets. In a typical defense contract, a military service puts out a request for bidders for a new weapon or a new technology. Firms then respond to these "market opportunities." Civilian markets do not work via requests for proposal (RFPs). Instead, companies design new products and seek to sell them using market research, advertising and other techniques that convince customers to do business with them.

Successful diversification requires quick adoption of this commercial mindset by managers and workers. In practice, this may require attracting new workers and managers who have commercial experience while also retaining and retraining the existing team. This can be a tough balancing act as firms try to keep old contracts and identify new business opportunities. Workers need to learn new skills, managers need to learn new ways of doing business and facilities and factories may need to be retooled for new business lines. All of these efforts cost money—for retraining, for the purchase of new equipment and for the development of new market opportunities.

The Need for Early Outreach

Because this process is so challenging, it makes sense to start early. As a community leader, you should begin reaching out to local employers as soon as you are able—even before you have any hard news on potential budget cutbacks or contract terminations. As a first step, you should identify your local defense contractors and assess whether they are potentially at risk. Simply being a defense contractor does not put a firm at risk. In fact, while some cuts are expected, other parts of the defense budget—especially in leading edge technologies—may actually grow over the coming years.

There is no one source to identify local contractors. Much information can come from government data sources, such as Pentagon websites, http://usaspending.gov and also from local economic and workforce development agencies that track industry clusters and local workforce trends. Business associations and networks, such as the local Chamber of Commerce or trade associations like the National Defense Industrial Association (NDIA) can also help. Manufacturing Extension Partnership offices are another source for information and may be able to assist you in surveying the health of defense contractors in your area. Your representatives in Congress may also be able to assist with information gathering. This information will help you develop a preliminary "map" of local defense companies and the potential impact of budget cuts on firms, workers and the wider community.

Find Local Government Contractors

Identifying local defense contracts is more of an art than a science. The defense industry is huge and contracts include military items like uniforms, weapons systems, but they also include items such as food, paint and hardware. As such, finding local defense firms requires a concerted effort. To get started:

1. Begin with the Data	Government data sources, like **http://usaspending.gov** and labor market information from your local Workforce Investment Board are good places to start. This data will help you identify big contracts and larger contractors located in your district.
2. Reach out to Local Defense Firms	Data is helpful but it's not enough to give you a full picture of your local contractor base. Talk to managers at your local defense contractors and ask them about other local firms.
3. Reach out to Business Groups	Your local Chamber of Commerce or manufacturers associations know all about local businesses. They can also help you find "hidden" defense contractors in your community.

This mapping effort should be accompanied by an aggressive outreach effort to local firms and residents. Outreach should focus on information sharing (e.g., what the future defense budget looks like) and the development of preliminary plans in the event of a worst-case scenario. Experience from the 1990s suggests that early community planning helps improve community responses when and if contract terminations are announced.

> "In order for economic adjustment efforts to be successful, the business community must be engaged as essential partners."

Collaborative Planning

In order for economic adjustment efforts to be successful, the business community—business owners, employer human resources representatives, industry associations, Chambers of Commerce and others—must be engaged as essential partners. The business community can inform not only immediate workforce transition efforts, but also help guide mid- and long-term industry sector development activities. The business community's "on-the-ground" insight into industry needs can guide the development of strategies related to education, workforce development, economic development and infrastructure and technology enhancement.

Because of the business community's unique insight—and the credibility that comes with it—communities should engage business as a visible leader of the defense industry adjustment

response. Business leaders should also play major roles in the larger leadership group for economic adjustment efforts. This group should reflect the diversity of the region's employers and other industry stakeholders. Regions should engage business representatives from all major industry sectors, and be sure to include a mix of large, medium and small businesses. It is important to include representatives from well-established businesses, new firms, including entrepreneurial and start-up firms and organizations that represent business interests, such as Chambers of Commerce and industry associations.

Your planning efforts should look at the short term, the medium term and the long term. Over the short term, your community should set up systems to help laid-off workers quickly receive unemployment benefits, job search assistance and retraining if it is needed (See accompanying Guide to Workforce Transitions). In addition, a local support network of key economic development and social service agencies can be set up in advance to assist businesses and the community. These systems will provide essential support tools over the first three to six months after a local facility is downsized or closed.

Meanwhile, you can begin working with local firms to help them develop adjustment strategies to carry them through the medium term (the next 12 to 18 months). Each company will have unique challenges and needs, but typical issues may include the need to identify new markets, to access outside investments or loans, to retrain workers or to receive other kinds of technical assistance.

After companies weather the immediate storm from contract cutbacks, they will ultimately think more systematically about how they can sustain themselves and even grow over the long term. In these instances, linking them to local support networks and other resources that exist can help these companies grow and prosper in the new economic environment. Across the U.S., entrepreneur networks are thriving and it is likely that your region is home to organizations and networks with a mission to help companies grow. Where possible, you should connect local defense contractors to these resources, described in the following section, that help firms from a mix of industries.

KEY SUPPORT RESOURCES

All defense contractors feel the pain when major projects are completed or cancelled, but their ability to respond differs greatly. Large prime contractors typically have the resources to allow them to manage the downsizing process while also systematically pursuing new business opportunities. Smaller firms may lack this capability because they often do not have sufficient staff or the financial resources to invest in market diversification or new business development activities.

Because of these factors, many communities opt to focus on helping smaller firms develop effective responses to defense downsizing. A number of options for working with smaller contractors and suppliers are presented below. While each issue has its own characteristics, they all share one common theme: helping smaller businesses identify new opportunities to soften the blow, or even to replace, their lost defense contract-related business.

As firms look to diversify and generate new business activity, they can pursue a variety of approaches. In reality, most firms pursue a mix of options. In each case, firms and their community partners should look to tap into a wide array of support programs that specialize in new business development-related work.

As you seek to help local companies access support tools and get more connected to business networks, know that you are not alone. Government agencies at the federal, state and local levels manage a host of support programs and sponsor a wide range of business support activities. Meanwhile, local non-profits, private consultants and educational institutions also offer extensive support. In fact, a major challenge for many businesses is simply navigating this complex environment. For that reason, your role as a guide and resource can be a critical lifeline for affected companies.

Reengineering or Retooling an Existing Business

In this case, the company seeks to make its current operations more efficient or profitable. Manufacturing firms are particularly well-suited to pursuing these approaches, which help eliminate inefficiencies in the production process. Concepts like lean production, ISO certification or Six Sigma refer to tools that can help increase productivity. Specialized training for a company's incumbent workforce also supports this mission.

A number of programs have a long history of supporting firm reengineering efforts. The Hollings Manufacturing Extension Partnership (MEP) program is the best known example. Since the 1980s, it has managed a nationwide network of 70 centers, which are staffed by 1,300 technical experts, who help small and medium sized manufacturers become more competitive. Many state governments and university systems also sponsor programs focused on business reengineering.

Identifying and Capturing New Markets

In some ways, the challenge facing defense suppliers seems simple: find new business to replace the lost defense contracting activity. But the reality is more complicated. Identifying new markets, qualifying customers and winning new business is challenging in the best of times. It is especially challenging when a company's leadership is also coping with management of the downsizing process at the same time.

Smaller firms can benefit from targeted business development assistance to help them break into new markets. Technical assistance from organizations such as the national Small Business Development Center (SBDC) Network can be very helpful. Businesses should also consider expansion into global markets. In today's globalized economy, firms that sell only in their own region or even within the U.S., face limits on their growth potential. Moving into export markets, with support from programs like http://export.gov or various state export program initiatives, opens new market opportunities.

Developing New Technologies

Defense-related businesses tend to be more technology-focused than their civilian counterparts. Many of them are familiar with performing research and development (R&D) to develop new products and technologies. Thus, many contractors can benefit from additional R&D investments that can be used to support new market activities.

Many federal programs invest in this effort. The Small Business Investment Research (SBIR) program, which helps small firms develop new technologies for federal agencies, is a critical tool to provide needed capital.

Technology transfer and commercialization activities present other potential options. In these cases, firms can license technology or jointly develop new technologies with researchers at federal research laboratories or university research departments. Most of these organizations operate offices specifically designed to support technology transfer and commercialization.

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Accessing Capital

Most of these transition strategies require up-front investments, thereby pushing firms to seek new sources of capital. Depending on a firm's track record and business plan, it may seek out either debt capital (i.e., loans) or equity investments. Public-sector backed programs typically focus on providing support for the provision of small business loans. A whole range of tools are sponsored by the Small Business Administration. These include: 7(a) loans, 504 loans, SBA-backed microloans and small equity investments that are managed by the Small Business Investment Company (SBIC) program.

Other federal entities, such as the USDA and the Commerce Department's Economic Development Administration (EDA), have invested in state and local Revolving Loan Fund (RLF) programs that also provide needed debt capital. Finally, a whole host of state and local lending programs operate across the country.

Equity capital can be somewhat more difficult for smaller firms to access. These investments generally require some sharing of ownership by the investor, along with an exit strategy to ensure that the investor can recoup his or her investment. Venture capital is probably the best known form of equity investment, but venture capital firms typically invest large amounts (over $10 million on average) in a very small group of specialized firms. Thus, venture capital is a viable option for only a small number of companies.

In contrast, angel investors (individual or small groups of investors) invest smaller amounts in a more diverse array of companies. These investors also operate across the U.S. and can be found in or near most regions. The Angel Capital Association maintains a listing of firms and their locations.

Helping New Firms Start

In addition to supporting new activities by existing firms, the business development process may also see the creation of new companies. Entrepreneurial development is becoming a more important part of community development. These strategies make sense in instances of defense transition as well.

New companies and new entrepreneurs can benefit from all of the programs and ideas cited above. Beyond those business development efforts, communities typically support startups with specialized technical assistance and entrepreneurial training, coaching and mentoring. Depending on the community, these programs may be provided by the local Chamber of Commerce, the SBDC office, a local business incubator or even a private innovation accelerator network. You can find a listing of these programs at the Regional Innovation Acceleration Network (RIAN), at http://www.regionalinnovation.org/content.cfm?article=about-rian.

Training or Retraining Workers

As companies retool, their workers may need to transform their skills as well. A whole host of workforce development and training resources are available to employers; these are summarized in the accompanying Guide to Workforce Transitions.

FINAL THOUGHTS

This short Guide has repeatedly noted that defense transitions are tough, but the experience of the 1990s tells us that most communities do recover. Although the adjustment period can be difficult, regions often end up creating new jobs and more diverse economic opportunities along the way. The 1990s defense downsizing experience also yields another important lesson: local capacity and commitment to change are critical ingredients for success. Communities are more likely to rebound when key stakeholders have strong partnerships and collaborations in place and there is a shared commitment to promoting the region's future economic prosperity. Identifying the health of defense contractors in your area and determining the resources and tools they will need to grow again will help you determine who should be at the table as you develop and carry out an economic adjustment plan. The earlier you start, the stronger your partnerships and collaborations can be when businesses, workers and the community need their help.

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