NCMA - Contract Financing and Working Capital Trends

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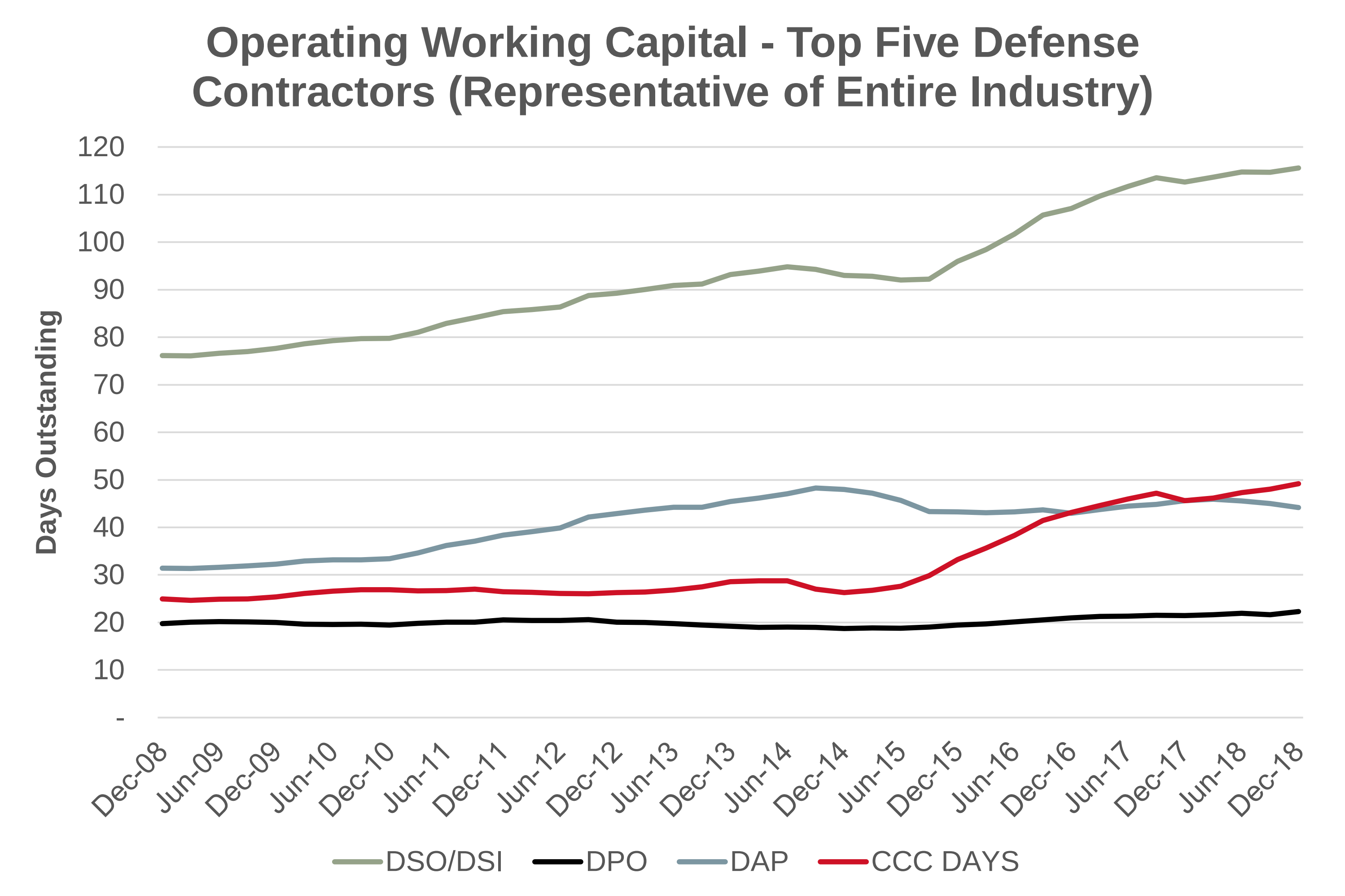
Overview

- Acquisition Policy Trends and Economic Impact / Outlook
- Regulatory Changes and Other Factors Impacting Current Contractor Working Capital Investment Levels
- Performance Based Payments and Progress Payments Proposed Rule (DFARS Case 2017-D019)
- Proposed Rule Actions
- Next Steps – How You Can Help
- Questions

Impact of Acquisition Policy Since Better Buying Power



Impact on Top Five since 2010 *(Entire Industry will be substantially greater)*

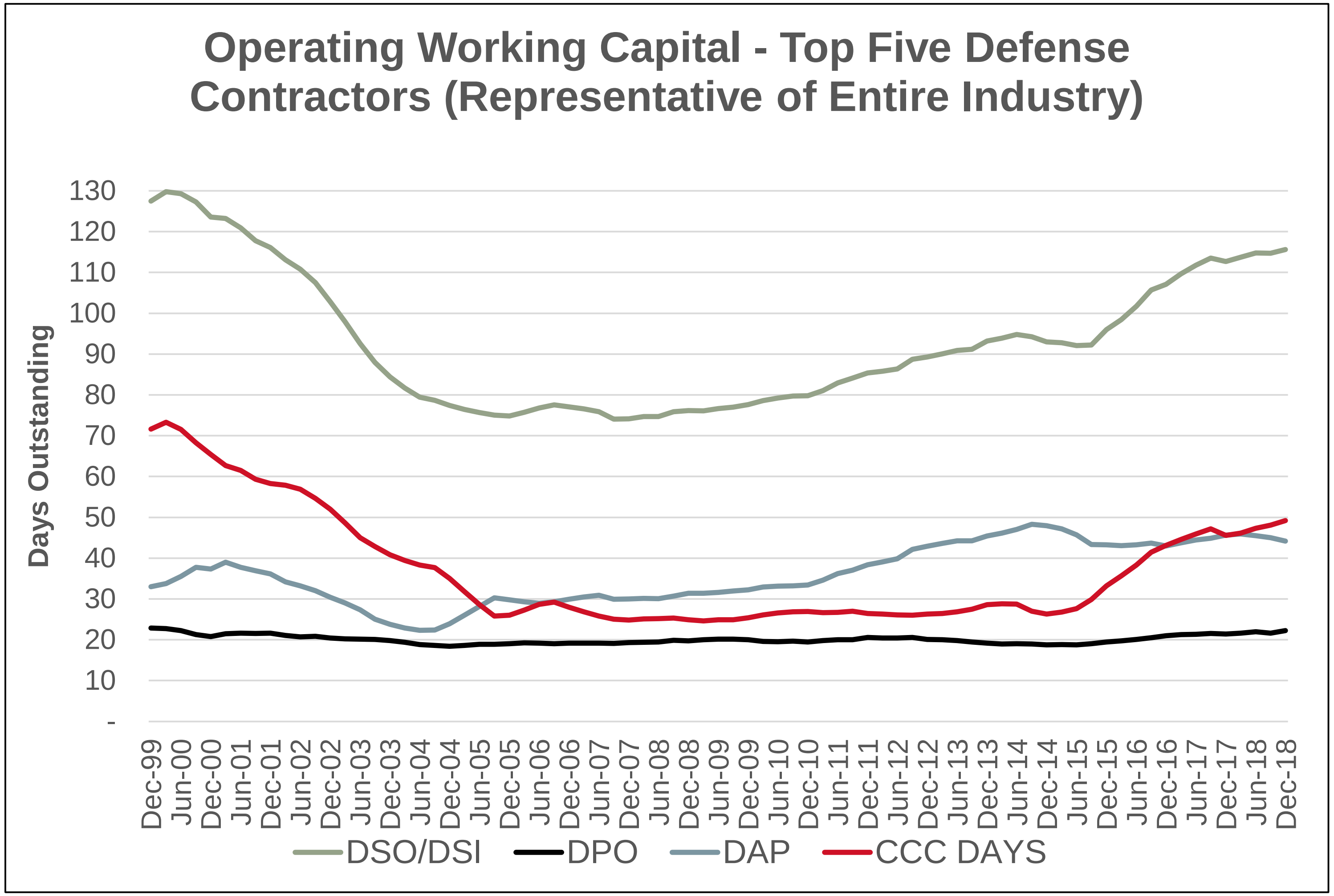
- $18B increase in DSO/DSI
- $10B increase in working capital (ccc)
- $30B increase in Long Term Debt and Obligations *(Not plotted)*

Key factors driving increased working capital levels since BBP:

- PBP utilization declined from 80% of all FP financing to less than 40%
- Increased use of FPI contract types *(Not CPIF)* on EMD/LRIP programs
- Impact BCA *(Low/No growth)* and ultra competitive win-at-any–cost market *(Investments, CFRs, etc…)*
- Increased use of UCAs, especially FMS
- Business system withholds
- Decline in use of Cost Type contracts
- Cumulative impact of not settling indirect rates in a timely manner

Increased program investment limits ability to invest in technologies and capital required to support the USG mission and serves as a disincentive for companies to compete in the Federal Market

Impact of Acquisition Policy Changes Since Economic Crisis of 2000



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11,000 Contractors exited the Federal Market since 2000 (Per Recent CSIS Study). Increased investment requirements and negative budget outlooks most likely contributed to the exodus

Regulatory and Other Factors Impacting Growth in Working Capital Investment Requirements

Item	Key Variables and Factors	Prior to Better Buying Power (Pre 2010)	Since Better Buying Power (Post 2010)
1	**Progress Payment Rates**	Set by regulation. Rates have ranged from 75% to 90% *(80% when DFAIRS study performed)*	80% *(August 2018 Proposed Rule would have reduced to 50%)*
2	**Flexible Progress Payment Rate**	Up to 99% of cost *(Option eliminated in 1992 when PBP financing was introduced)*	No longer offered
3	**Performance Based Payment Financing**	Up to 90% of price *(Introduced in 1992)*	DFARS change implemented in 2014 limited to 100% of incurred cost and required consideration
4	**PBP Utilization**	PBPs represented 80% of all FFP financing provided in 2008	Today PBPs represent less than 40% of financing
5	**Contract Types for Major EMD/LRIP Programs**	CPIF - 100% of cost and earned fee billed every other week	FPI - 80% of incurred cost on Progress Payments or up to 100% of cost on PBPs billed monthly
6	**Alternate Liquidation Rate Utilization**	Declined from 75% of contracts in the 90's to less than 10% today	Less than 10% of Contracts
7	**Federal Income Tax Methodology**	Tax paid on a percent of completion basis *(Paid at completion when DFAIRS study performed)*	Paid on a percent of completion basis
8	**FFP Financing Billing**	Monthly *(Bi-monthly at time of DFAIRS study)*	Monthly
9	**FFP Financing Contract Value Threshold**	Raised to $2M in 2000 then to $2.5M in 2005 *($1M threshold when DFAIRS study performed)*	$2.5M
10	**Business System Withholds**	Did not exist prior to 2011	Requirement to withhold 5% of all payments when a system deficiency exists introduced in 2011
11	**Cost Type Fee Withholds**	Only when needed to protect the interest of the USG	Required on all cost contracts
12	**Utilization of UCAS**	Historic Norm	Increasing to historic highs per DODIG
13	**Contractor Investment/Buy-in**	Historic Norm	High (LPTA). Win at any cost mindset since BCA
14	**DoD Acquisition Budget**	Increasing 80's, declining 90's - Industry crisis, and increasing from 9/11 - 2011	Declining since FY11 Budget Control Act
15	**Inflation / Interest Rates**	Historic Norms *(Historic highs when DFAIRS study performed)*	Historic lows 2008 - 2015. Trending to norm in 2019

Performance Based Payments and Progress Payments Proposed Rule *(DFARS CASE 2017-D019)*

- Sets “customary financing rate” for PBP & Progress Payments to 50% of cost incurred...today customary rate for Progress Payments is 80%
- Established 5 criteria for contractors to receive higher than customary rate (Up to 95%)

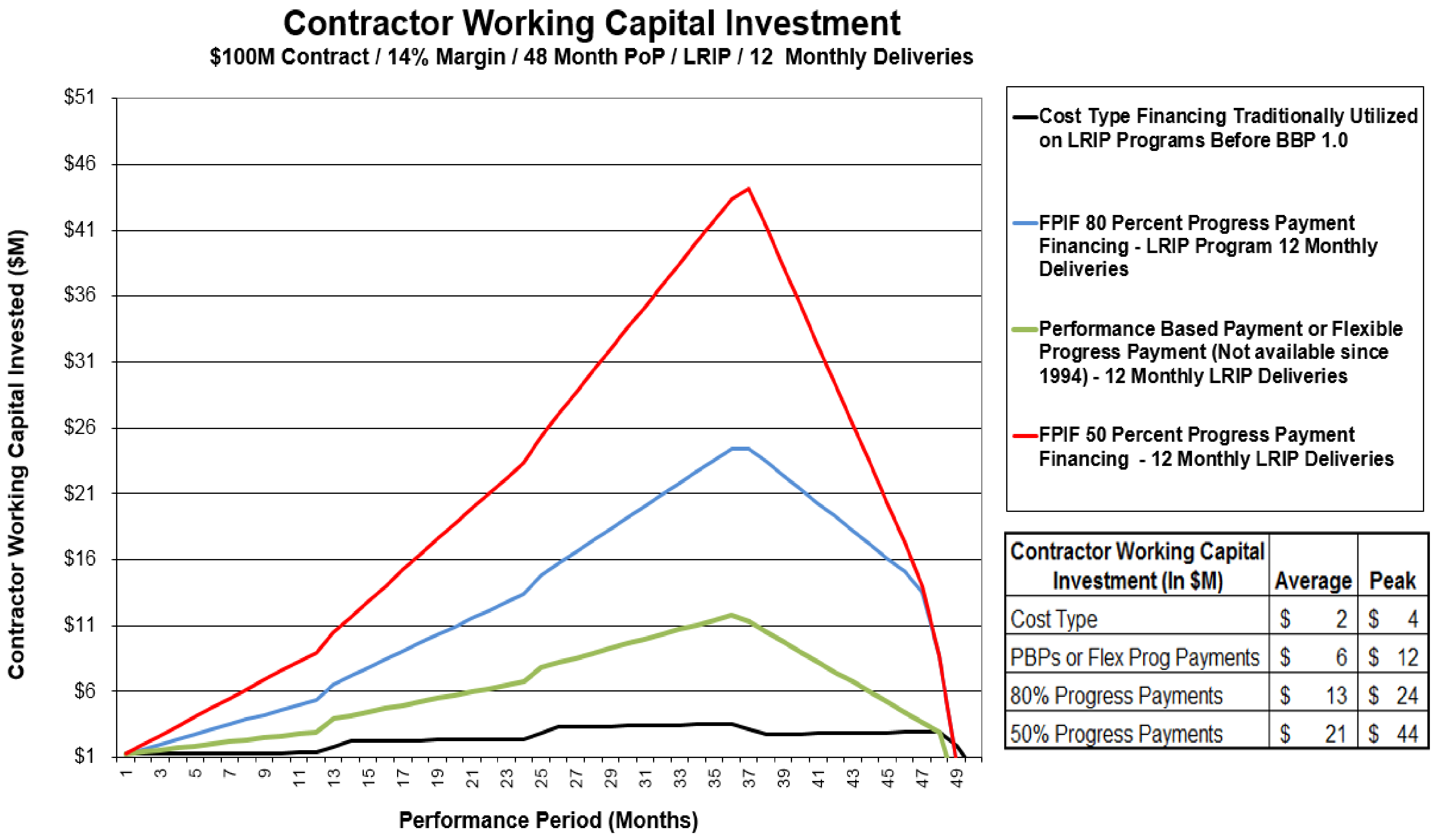
Additional Financing Rate Plus Up	Performance Criteria
10%	Met contractual delivery dates for end items and data items and milestones at least 95% of the time in the preceeding year
10%	Does not have an open level II or IV Corrective Action Request (CAR)
10%	Does not have a significant business system deficiency
8%	At least 95% on time submission of required certified cost and pricing data in the preceeding year
5%	Met its small business subcontracting goals in the preceeding year
3%	Provided subcontracting opportunities to Ability One suppliers
45%	**Total Financing Rate Plus- Up Opportunity (Up to 95% vs 80% today)**

- Establish process for contractors to <u>represent annually to DPC</u> how a contractor does/does not meet those criteria; <u>allows for DPC to dictate what Progress Payment and PBP financing rate</u> a contractor receives for the following year

Industry's Concerns with the Proposed Rule

- Undermines the *National Defense Strategy* by limiting the working capital industry has to invest in technology, facilities, and workforce that brings better capabilities to the warfighter
  - USG Business Case projects financing will decline for several years before rates return and potentially exceeds current levels *(Industry risk - $10 to $20 billion)*
- Raises the cost of American defense products for foreign and domestic customers
  - USG Cost of Funds are always less than Industry's
  - Price recommendations in Weighted Guidelines increase as financing rates decline
- Based on flawed premises and incomplete analyses
  - Criteria selected and an enterprise-wide approach for evaluating performance may not yield actual meaningful value to the USG
- Omits critical implementation details, and contains others that are incomplete, or rely on untested systems and processes
  - Systems currently utilized to measure performance are inaccurate
  - Performance is subject to inconsistent and potentially punitive evaluations that could lead to increased protests
- Will make the defense industry less attractive to investors and doing business with DoD less attractive to commercial and non-traditional companies

Impact Proposed Rule and Better Buying Power Directive on Working Capital - Limited Rate Initial Production Program



Contractor Working Capital Investment (In $M)	Average	Peak
Cost Type	$ 2	$ 4
PBPs or Flex Prog Payments	$ 6	$ 12
80% Progress Payments	$ 13	$ 24
50% Progress Payments	$ 21	$ 44

Working Capital Investment

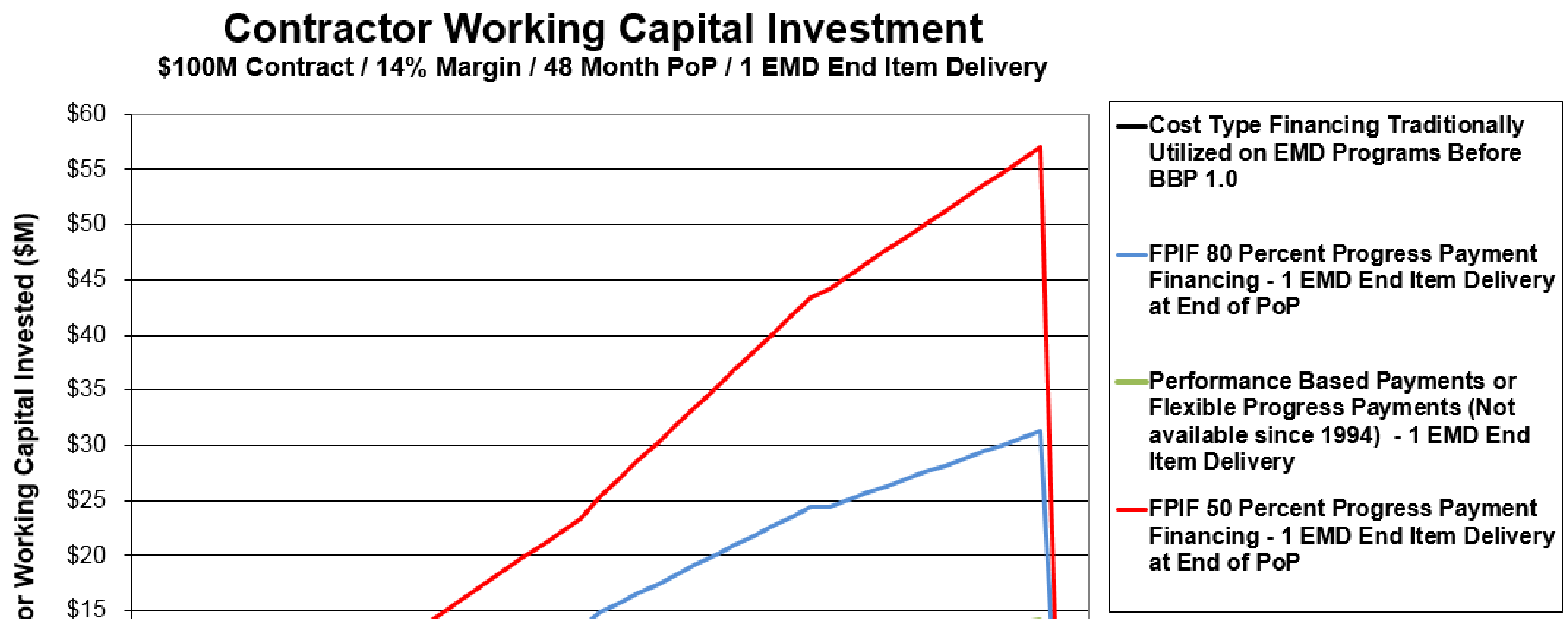
Cost Type Investment Balance: Two weeks unbilled and two weeks billed but not collected labor, material, overhead, G&A and recognized fee

Fixed Price 80% Progress Payment Balance: 20% of ITD cost incurred (Labor, material, overhead and G&A) thru prior month-end and recognized fee, plus 100% of cost incurred and fee in the current month

Fixed Price 50% Progress Payment Balance: 50% of ITD cost incurred (Labor, material, overhead and G&A) thru prior month-end and recognized fee, plus 100% of cost incurred and fee in the current month

Fixed Price Performance Based Payment
Current regulations permit recovery of up to 100% of incurred cost thru prior month-end. Investment balance includes ITD fee and current month cost

Impact Proposed Rule and Better Buying Power Directive on Working Capital - Engineering Manufacturing and Development Program



Contractor Working Capital Investment (In $M)	Average	Peak
Cost Type	$ 2	$ 4
PBPs or Flex Prog Payments	$ 7	$ 14
80% Progress Payments	$ 15	$ 31
50% Progress Payments	$ 26	$ 57

Working Capital Investment

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Performance Based Payments and Progress Payments Proposed Rule – Sequence of Events

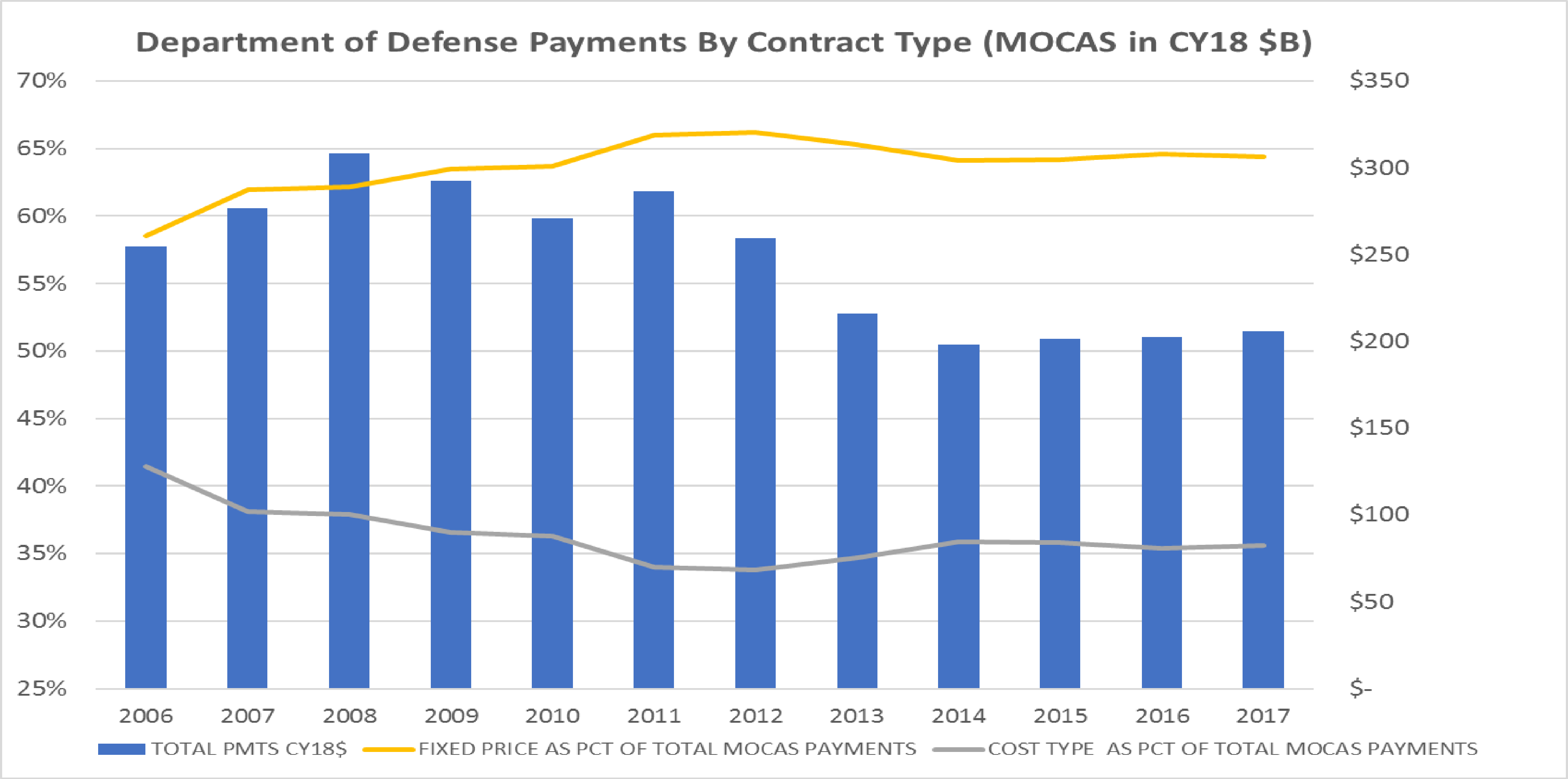
- 24 August 2018 - Proposed Rule issued to reduce contract financing rates to 50% with the opportunity to achieve higher rates when performance objectives are met
- 30 August 2018 – AIA letter expressing concern over proposed rule submitted to OSD AT&L
- Various/Multiple dates … Concerns expressed by associations and individual companies to senior DoD leadership and members of the HASC and SASC
- 4 October 2018 - Proposed rule rescinded in order for DoD to conduct additional research regarding contract financing methods
- 15 December 2018 - Multi-Association CFO level meeting with Eric Chewning and Kim Herrington to discuss industry's concerns and the Department's objectives
- Public Meetings to discuss industry's concerns and the Department's objectives
  - 10 January 2019: Speakers AIA / PSC / NAM / NDIA / Small Business-Ability One
  - 22 January 2019: Speakers AIA / PSC / NAM
  - 19 February 2019: Speakers AIA / PSC / NAM / Small Business-Cymstar
- Various/Multiple dates – DoD meeting with investment community to seek input on contract financing
- 31 March 2019 – GAO report on contract financing and margins due to Congress
- Next 60 days – Proposed rule on Performance Based Payments implementing Section 831 of the FY17 NDAA expected.
- Second rule on Contract Financing expected later in 2019

Next Steps … Things You Can Do

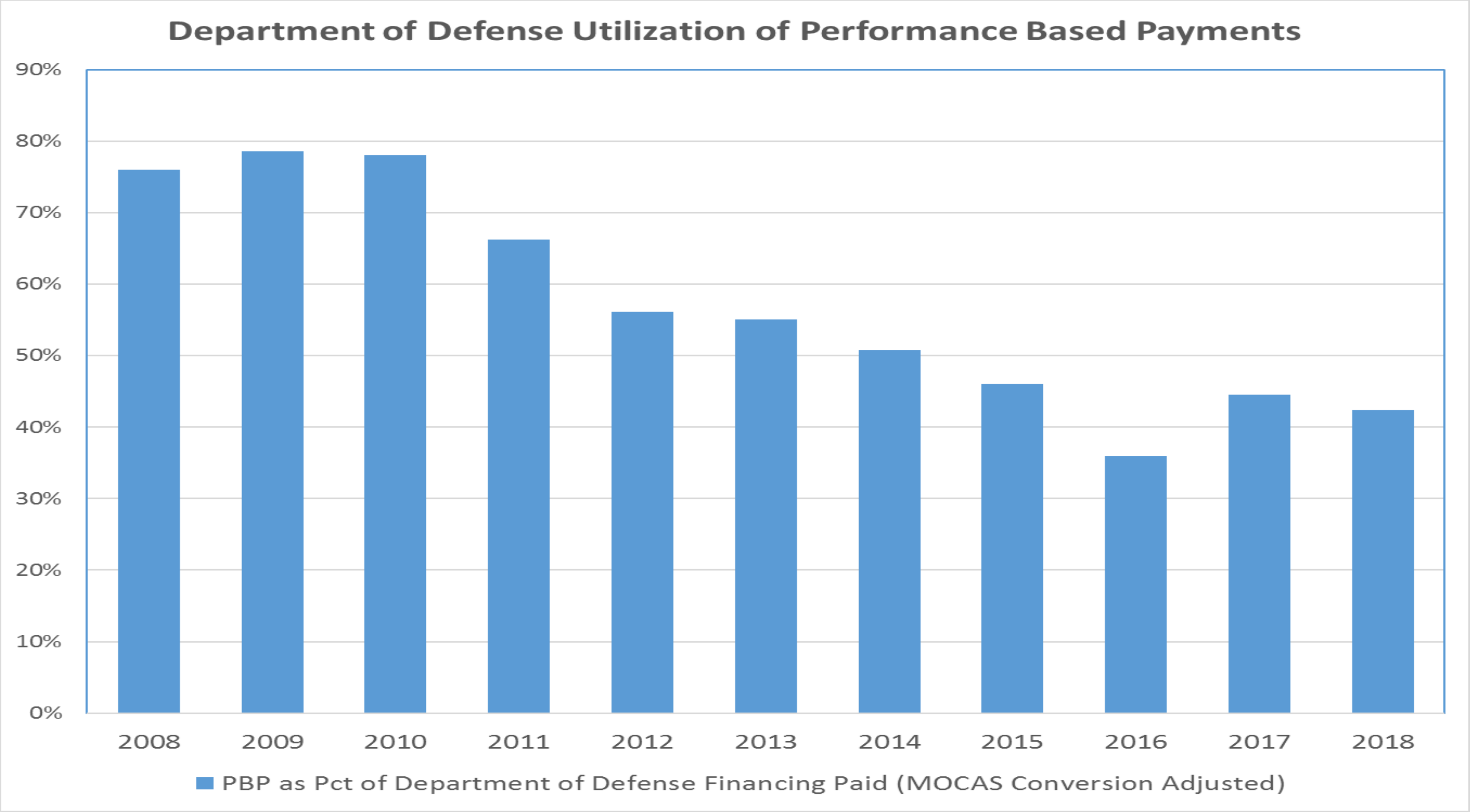
- **Educate your customers on benefits of USG contract financing:**
  - Profit margins do not generally draw companies into the Federal marketplace, reasonable financing and cash flow does
  - Results in lower price/cost to the USG
  - Provides ability / flexibility to invest in R&D, capital, and workforce of the future
  - Essential to support innovation required by the USG/DoD mission
  - Supports the long term health of the industrial base at all levels (Prime and Sub)
- **Participate in Industry efforts *(Individually or through associations)* to achieve Legislative or Regulatory improvements in USG contract financing policies *(AIA, PSC, NAM, NDIA, etc…)***
  - Share contract financing and cash flow challenges experienced since BBP *(September 2010)*
  - Share success stories of how your company's investments have benefitted the USG
  - Evaluate and comment on PBP Rule *(Expected in April/May time frame)*
  - Evaluate and comment on Contract Financing Rule *(When issued)*
  - Support FY20 NDAA proposals that improve the outlook for Contract Financing
  - Evaluate and comment on GAO contract financing review *(Report expected in April)*

Questions

Backup / Additional Information

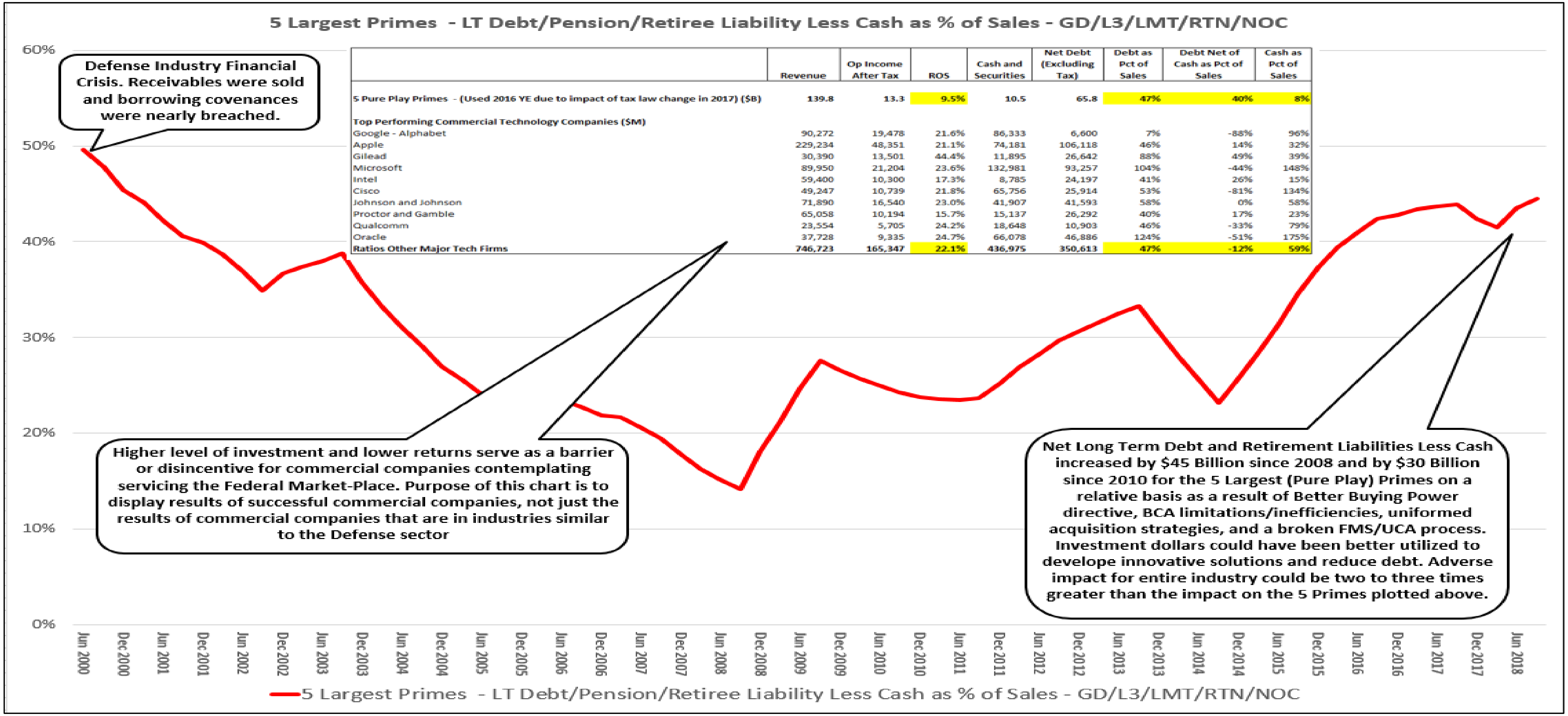


Department of Defense Payments By Contract Type (MOCAS in CY18 $B)
70%
65%
60%
55%
50%
45%
40%
35%
30%
25%
$350
$300
$250
$200
$150
$100
$50
$-
2006
2007
2008
2009
2010
2011
2012
2013
2014
2015
2016
2017
TOTAL PMTS CY18$
FIXED PRICE AS PCT OF TOTAL MOCAS PAYMENTS
COST TYPE AS PCT OF TOTAL MOCAS PAYMENTS



Department of Defense Utilization of Performance Based Payments
90%
80%
70%
60%
50%
40%
30%
20%
10%
0%
2008
2009
2010
2011
2012
2013
2014
2015
2016
2017
2018
PBP as Pct of Department of Defense Financing Paid (MOCAS Conversion Adjusted)

Defense Industry Debt and Long Term Obligation Levels



	Revenue	Op Income After Tax	ROS	Cash and Securities	Net Debt (Excluding Tax)	Debt as Pct of Sales	Debt Net of Cash as Pct of Sales	Cash as Pct of Sales
5 Pure Play Primes - (Used 2016 YE due to impact of tax law change in 2017) ($B)	139.8	13.3	9.5%	10.5	65.8	47%	40%	8%
Top Performing Commercial Technology Companies ($M)								
Google - Alphabet	90,272	19,478	21.6%	86,333	6,600	7%	-88%	96%
Apple	229,234	48,351	21.1%	74,181	106,118	46%	14%	32%
Gilead	30,390	13,501	44.4%	11,895	26,642	88%	49%	39%
Microsoft	89,950	21,204	23.6%	132,981	93,257	104%	-44%	148%
Intel	59,400	10,300	17.3%	8,785	24,197	41%	26%	15%
Cisco	49,247	10,739	21.8%	65,756	25,914	53%	-81%	134%
Johnson and Johnson	71,890	16,540	23.0%	41,907	41,593	58%	0%	58%
Proctor and Gamble	65,058	10,194	15.7%	15,137	26,292	40%	17%	23%
Qualcomm	23,554	5,705	24.2%	18,648	10,903	46%	-33%	79%
Oracle	37,728	9,335	24.7%	66,078	46,886	124%	-51%	175%
Ratios Other Major Tech Firms	746,723	165,347	22.1%	436,975	350,613	47%	-12%	59%