

Defense Update

Resiliency and Robustness: what does the DIB need to thrive?

Industry Overview

NDIS calls out weakening defense industrial base

The Department of Defense released its first National Defense Industrial Strategy (NDIS) report. The report outlines ten systematic challenges the Defense Industrial Base (DIB) face and four key strategic priorities intended to create a more robust and resilient set of capabilities. While recent events (the pandemic, Russia-Ukraine conflict, Israel-Hamas conflict) have emphasized shortfalls in the existing DIB, in our view, a history of underfunding, industry consolidation, “just-in-time” production, reliance on international suppliers, and resistance to change has led to a weakening DIB for decades.

Oversea-dependent supply chains create fragility

The four long-term priorities the NDIS puts forth are 1) resilient supply chains, 2) workforce readiness, 3) flexible acquisition, and 4) economic deterrence. In our view, strengthening these four pillars is essential to creating a more robust and deeper set of industrial capabilities. The NDIS highlights that strengthening the DIB requires investment all the way through to the lowest tier suppliers. Tight operating margins and workforce readiness create unique challenges for lower tier suppliers in a funding downturn. The NDIS recommends stronger investment in workforce readiness programs to strength the DIB. Additionally, the NDIS asserts that the DIB has grown weaker due to increased reliance on potentially adversarial nations for critical supplies. Re-shoring and “friend-shoring” mitigate the risk of lost access to certain systems and components.

Non-traditional players may be the next big winners

In the 1990s, the defense industry underwent a period of transformation and consolidation following “the last supper”. The NDIS asserts that this industry consolidation has led to less attractive pricing for the DoD and high barriers to entry for new players. The NDIS recommends investing in methods to lower entry barriers (such as mitigating costs associated with clearances, cloud-networks, and encryption) to encourage smaller and non-traditional contractors to enter the market. We have been highlighting for several months that there seems to be a gradual shift in acceptance at the DoD towards non-traditional players. We expect to see names such as Palantir and other IT and AI-based names to take advantage of this opportunity.

Great ideas, but where are the funds?

While we agree with the general premise of the NDIS and the recommendations it sets forth, we note that none of the action items will be possible without significant investment. This is particularly complicated in a budget constrained environment. At the services level we may see a shift of funds away from traditional procurement accounts and into RDT&E and non-traditional procurement and readiness programs. From a top down approach, we may see an increase in government-wide funds made available specifically for DIB strengthening initiatives. We do expect these changes to be relatively long term, but we believe it is important for investors to understand how funding and acquisition strategies may change as the DoD works to create a more resilient domestic industrial base.

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Timestamp: 09 February 2024 03:00AM EST

09 February 2024

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