

Northrop Grumman and TRW Merger: Sealing the Deal

By Michelle Ciarrocca

Northrop Grumman's takeover of TRW will make it one of the world's largest defense contractors, rivaling global conglomerates like Lockheed Martin and BAE Systems. After many offers for TRW over the past six months, negotiators agreed to Northrop Grumman's offer of \$60 a share or \$7.8 billion, up 27% from their initial offer of \$47 a share. Other companies bidding included BAE Systems, Raytheon, and General Dynamics—all of which were eager to grab TRW's space and electronics business.

Northrop Grumman is best known for manufacturing the B-2 bomber and the much-touted unmanned Global Hawk, both of which were on display during the U.S. war in Afghanistan. The company's effort to acquire TRW is motivated by a desire to secure more ballistic missile defense contracts, and to gain entry into growing areas of space-based weapons and space sensors. "This enhances the competitive landscape in areas most critical to our nation's defense," said Northrop Chairman Kent Kresa. "It creates a very important space and systems capability in the overall space arena."

Northrop Grumman has ranked #5 among U.S. Pentagon contractors for the past five years, garnering between \$3 billion and \$5 billion in government contracts each year. TRW has ranked from #14 to #8 among the Pentagon's top contractors over the same time period, with between \$800 million and \$2 billion in government contracts a year. Over the past decade, Northrop has acquired a dozen businesses including Newport News Shipbuilding (ranked #3 in 2001, \$5.9 billion) and Litton Industries (ranked #6 in 2000, \$2.7 billion), doubling its revenue and becoming a major player in shipbuilding and unmanned military planes. Northrop's merger with TRW will make it second only to defense giant Lockheed Martin.

As a major contractor in the fields of defense electronics, precision strike systems, shipbuilding, and combat aircraft (prime contractor on the B-2 bomber, major subcontractor on the F-18E/F, and part of Lockheed Martin's winning team in the Joint Strike Fighter competition), Northrop stands to benefit from increases in spending on either conventional or nuclear weapons systems.

The merger would uniquely position Northrop as a company that has something to offer each sector of the defense industry—ships, satellites, lasers, aircraft, and computer networks. Richard Aboulafia, a defense analyst for Teal Group, said the deal would give Northrop "the widest net of products across all the services." Acquisition of TRW would also make Northrop the leading supplier of computer networks to the federal government, maintaining the website for the White House and networks for the National Reconnaissance Organization.

After a decade of consolidation, the merger will leave the U.S. with three major defense contractors—Boeing, Northrop Grumman, and Lockheed Martin. The 1990s bout of government-backed "merger mania" in the military industry accomplished one thing: it resulted in a slightly leaner, considerably meaner, and much more politically powerful corporate military sector. As John Pike of GlobalSecurity.org has noted, a company like Boeing, which since its absorption of McDonnell Douglas has over 250,000 employees, leaves a huge "political footprint" that gives the company immense clout on Capitol Hill. Similarly, after the Lockheed/Martin Marietta merger was consummated, Lockheed Martin put out a slick brochure that bragged openly about its "facilities in all 50 states." Northrop Grumman will now be in a similar position, with annual sales

of more than \$26 billion and 123,000 employees in 44 states.

The geopolitical reach of the defense megafirms is reinforced by millions of dollars in campaign cash. In 2000 the top six U.S. military companies spent over \$6.5 million in contributions to candidates and political parties. In addition to these hefty campaign donations, defense contractors spent an astonishing \$60 million on lobbying in 2000, the most recent year for which full statistics are available. Of that amount, Lockheed Martin spent \$9.7 million on lobbying, while Northrop spent \$6.8 million. These lobbying funds go for items like maintaining armies of lobbyists and PR people in Washington, producing slick materials to present to Congress, and running ads touting company products in Capitol Hill publications.

An industry source said that although the Northrop/TRW merger will concentrate critical aerospace and defense technologies, no significant overlap will occur, so the deal is expected to win regulatory approval from both the Justice Department and the Pentagon. Some have speculated that the combination is likely to stimulate rather than inhibit innovation. Undersecretary of Defense for acquisition, technology, and logistics during the Clinton administration, Jacques S. Gansler, said "The industry is down to the point where each transaction is a special case and must be reviewed on its own merits, and this particular merger offers the opportunity for greater competition in many areas, like in the space systems field."

To its advantage, Northrop Grumman is in a good position with the Bush administration as well. The company has seven former officials, consultants, or shareholders in the Bush administration. Northrop

Grumman's most important link to the administration is Secretary of the Air Force James Roche, a former company vice president who will have much to say about the kinds of long-range aircraft, missiles, and unmanned combat vehicles the Air Force will be purchasing. Joining Roche in the Air Force hierarchy is fellow Northrop Grumman alumnus Nelson F. Gibbs, who served as corporate comptroller at the company from 1991-1999 and is now Assistant Secretary of the Air Force for Installations, Environment, and Logistics. Other key company connections include Deputy Secretary of Defense Paul Wolfowitz, Pentagon Comptroller Dov Zakheim, Vice-Presidential Chief of Staff I. Lewis Libby, and National Aeronautics and Space Administration director Sean O'Keefe, all of whom had consulting contracts or served as paid advisory board members for Northrop Grumman prior to joining the administration.

Interestingly, Secretary of the Air Force James Roche believes consolidation has gone too far. Roche said, "I'm very worried about companies in this industry consolidating to the point where the Air Force will be stuck buying that which someone wants to produce, compared to being able to challenge the industry to come up with ideas that may lead to major breakthroughs in combat capabilities."

He may have a point. The consolidation of the weapons sectors gives arms companies greater leverage over the Pentagon, because the Department of Defense has so few options left when it comes to purchasing a major weapons system, and often the contractors are collaborating with each other on weapons systems. It comes down to if one wins they all win.

Take the case of the Pentagon's three new fighter planes. Boeing is a partner with Lockheed Martin on the Air Force's F-22 stealth fighter plane, Lockheed Martin is teamed up with Northrop Grumman to produce the Joint Strike Fighter, and Boeing and Northrop share work on the F-18 Super Hornet. Despite the fact that the Bush administration advocated "skipping a generation" and threatened to cut one or more of the advanced fighter plane projects, this year's budget includes \$12 billion for the programs.

Another case in point is the Bush administration's treasured missile defense program. Despite its numerous technical problems, enormous costs, and questionable necessity, this year's budget allocates \$7.8 billion to various missile defense projects. If the merger goes through, Northrop will take TRW's place in both the Airborne Laser and Space-based Laser programs alongside team members Boeing and Lockheed. Northrop will assume TRW's role in the Ground-based Midcourse System under the direction of prime contractor Boeing. And the acquisition will make Northrop the prime contractor in the Pentagon's missile tracking Space-Based Infrared System Low (SBIRS Low) program.

With the merger of Northrop Grumman and TRW the U.S. will have one more defense giant to choose from when buying weapons, while Lockheed Martin and Boeing will have one more firm to team up with to build them. Clearly, these interlocking business relationships create a climate in which it often makes more sense for the defense megafirms to team up and use their unprecedented political clout to increase the Pentagon budget pie rather than compete to produce cost-

effective systems for existing programs. And that's just what they've been doing.

Northrop's Recent Major Contract Awards

Joint Strike Fighter (F-35)—

Northrop Grumman is a principal member of the Lockheed Martin team selected to build the next-generation fighter for all three U.S. military services and the British Royal Air Force and Royal Navy. The company expects about \$4 billion in revenues during the development phase of this program.

DD(X)—This \$2.9 billion, four-year program will produce designs for the next-generation, transforma-

tional surface combatants for the U.S. Navy.

Deepwater—Northrop Grumman is an equal partner on this \$11 billion program that will modernize the U.S. Coast Guard's fleet and aircraft over the next 20 years.

TRW's Recent Major Contract Awards

ITS—The U.S. Air Force has selected TRW as one of the awardees for the Information Technology Services contract, which will provide IT services to the Air Force, Department of Defense, and civilian federal agencies. The five-year contract has an estimated value of \$650 million, with a total potential value of \$1 billion if fully used.

JTRS—TRW is a member of a team led by The Boeing Company selected by the U.S. Army to develop the Joint Tactical Radio System (JTRS), the first radio communications system designed for use by all U.S. forces.

SBIRS Low—TRW has been named prime contractor of a combined team for the Department of Defense's missile tracking Space-Based Infrared System Low (SBIRS Low) program, under a new agreement reached with the DoD's Missile Defense Agency.

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