



Long Term Contracting Strategy & Risks

Overview

In the 1943 movie version of the Titanic directed by Werner Klingler, it opens with Mr. J. Bruce Ismay, White Star's Managing Director, addressing the stockholders. Ismay states: "I called this meeting of the White Star Line to inform you of the following: (1) We have built the Titanic, the largest ship in the world, (2) There have been unforeseen incidents and unexpected difficulties, (3) Construction costs have escalated month after month, (4) We were forced to stretch our finances to the extreme...and what's more, take out substantial loans, (5) As a result...the share price is plummeting...it's out of my hands!" The rest is history.

Contracting for sustained company growth has come a long way since the days of the launching of a Titanic. Maneuvering for success in the aerospace industry has become a complex series of transactions. A supplier of aerospace products must understand business risks and strategic visions when proposing and accepting long-term commitments that can make or break companies. Maintaining contractual baselines is necessary to preserve financial stability and sustaining investments to achieve state-of-the-art automation capital & manufacturing producibility prowess, intellectual property second to none, human capital, technical image & customer acknowledgement of capabilities, and demonstrated performance history. These are key areas for any aerospace company to pursue market share growth and the ability to achieve significant value through long term contracting.

The purpose of this white paper is address important transactional requirements that will ensure financial success or failure regarding strategic decisions to accept a long term contract.

Pre-Award Award

The first major decision is what does the company want to be? Are you an OEM, Tier I, Tier II, or Tier III/IV supplier? Where do you want to be in the next ten years? Has there been established a strategic vision of what the company should be in the next ten to fifteen years along with integrating the products to market lines of production?

In any event, growth starts with a economic and financial analysis of the market, the players, the resources required, and the investment and cash flow requirements to implement the strategic vision. Mergers and acquisitions or negotiating long term strategic agreements with a competitor and a higher tier contractor within the market, if written and negotiated properly, can materially affect the financial requirements and spreading of development risks.

Merger & Acquisitions require the proper Due Diligence to be completed to ensure the right access and awareness of data that can materially make or break merger or acquisition decisions. They are:

- Financial Information: Indebtedness, Cash Flow, Accounts Payable & Receivable, Tax Materials, and Financial Statements (Past and Present)
- Contingent Liabilities: Litigations (pending or threatened), Joint Venture agreements, all existing contracts and subcontracts, government filings, agreements or commitments with government entities regarding clean-up obligations or environmental liabilities
- Contracts, Subcontracts, Agreements & Other Arrangements: Partnership, Corporate Agreements, Joint Venture Agreements, all existing contracts and subcontracts, Tax or Environmental Agreements, Risk Analysis of key contractual terms and conditions [such as warranties, consequential or schedule delay damages/payments, termination for default, active claims and changes, Indemnification, Design Responsibilities, sharing arrangements and Limitation of Funds], pricing agreements below cost, financial guarantee agreements, lawsuits, and insurance exposures.

Pre-Award (continued)

- Proprietary Rights: List and Details of the particulars regarding all existing data covered and protected in accordance with all active Agreements (Company/Joint Venture/Subsidiary) [such as: Non-Disclosure Agreements, Patents, Licenses, Trademarks, Trade Names, Domain Names, Copyrights and Royalties], pending or threatened claims for infringements or other violations of proprietary rights owned or used in the business of the Company, list and description of any suspected or alleged infringement by third parties of intellectual property rights owned by the Company/Joint Venture/Subsidiary, and Employee and Consultant agreements regarding the use of confidential and/or proprietary data.
- Sales & Marketing: Description of the Markets in which the Company/Joint Venture/Subsidiary perform goods and services, customer and sales summary [industry comparison, pricing policies and fluctuations, pricing lists, identification of principal competitors, market share & strategic relationships, current advertising programs, sales policies and remuneration of sales personnel, identification of the ten largest suppliers, current research and development plans/budgets, listing of current and previous marketing reports performed by consultants], and description of R & D organization and product development

If the decision is not to pursue a merger or acquisition as part of the strategic vision in the decision making of a new business opportunity, then the next key step is to examine another form of industrial teaming to mitigate the financial exposure that strategic growth requires such as:

- Joint Venture Agreement(s)
- Memorandum of Understanding (MOU) or Letter of Intent (LOI) that provide for bilateral Long Term Strategic Agreement or Joint Teaming Agreement for best value proposition that lead to long term exclusive contracting opportunities and thus mitigating the risk of the necessary investments.

Pre-Award (continued)

In addition, strategic suppliers who are included in the company's new business pursuit should also be considered for bilateral Long Term Strategic Agreement or Joint Teaming Agreement to mitigate the financial risk of the required investments needed to penetrate and secure the selected market opportunity. Best value should be the major criteria regarding such agreements with suppliers that have demonstrated good performance records and the technical experience to accomplish the complex manufacturing producibility requirements to meet the customer's most important requirements of technical, schedule, and cost evaluation criteria.

The economics of the decision making process of the strategic vision and long term contracting pursuits have to be fully considered and understood before investments have been decided upon. Key areas of economic analysis supporting the decision making process include:

- Determining the manufacturing's product line demand curve for the respective industry
- Key economic factors involving the barriers of entry along with analysis of key competitors and their probable counter responses
- Market structure: highly oligopolistic or monopolistic
- Projected Growth factors of the Industry
- Historical data on market share and related parameters affecting future share outcomes
- Key pricing factors affecting price growth: dependent and independent variables
- Elasticity of demand for key factors of production
- Rates of Return and Cash Flow Projections of investments and NPV projection curves

Formulation of marketing and public relations themes, press releases, advertising, videos of demonstrated technologies and capabilities and customer visits are very important at this phase before the customer issues the request for proposal and no further informal communications are allowed with the customer.

Pre-Award (continued)

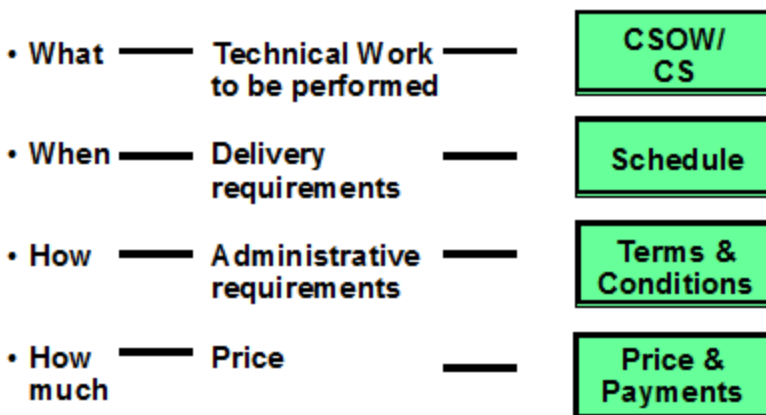
Once the decision has been reached to pursue the new business pursuit which is aligned with the company strategic vision, the final phase of the pre-award process begins: The Proposal Preparation Phase.

Attention to the export requirements and lead times to achieve licenses to export technical data must be understood and applications completed prior to formal release of the request for proposal or established during the proposal and communicated clearly within the proposal.

The request for proposal will specify the proposal delivery requirements such as:

- Technical Volume
- Management Volume (In parallel, Program Execution Plan (PEP) should be developed)
- Cost Volume and certifications if required
- Past Performance
- Model Contract and required certifications
- Executive Volume
- Transmittal Letter including Letters from the Chief Executive Officer committing to the program success and investments

The model contract is the final line of communications and contractual commitments that contain far reaching implications for the company. The key elements need to be fully understood such as:



Pre-Award (continued)

The model contract offering is the final word as to “What” the technical: contract statement of work (CSOW) and contract specifications (CS), schedule, cost/price, payments: non-recurring and recurring, funding limitations, criteria for final acceptance and f.o.b. and thus transfer of ownership, customer furnished data and property, applicable milestone or progress payments, quality requirements, shipping instructions, options, consequential damages, late delivery penalties, criteria for production qualification and design obligations, definitions of what constitutes a “Change,” technical data rights, definitions of Termination for Default or Convenience, what constitutes excusable delays, applicable laws, incorporation of pricing groundrules affecting the rights for equitable changes to price and schedules, economic price adjustments (EPA), indemnifications, amortization of non-recurring, termination liability schedules, build-to-print or design authority with no change board authority (open ended design), how do you know when you are completed, etc., etc.

The lack of understanding of the business risks contained in the model contract offering after intense proposal preparation and final success can materially affect in the most adverse financial way the long term strategic vision of a company.

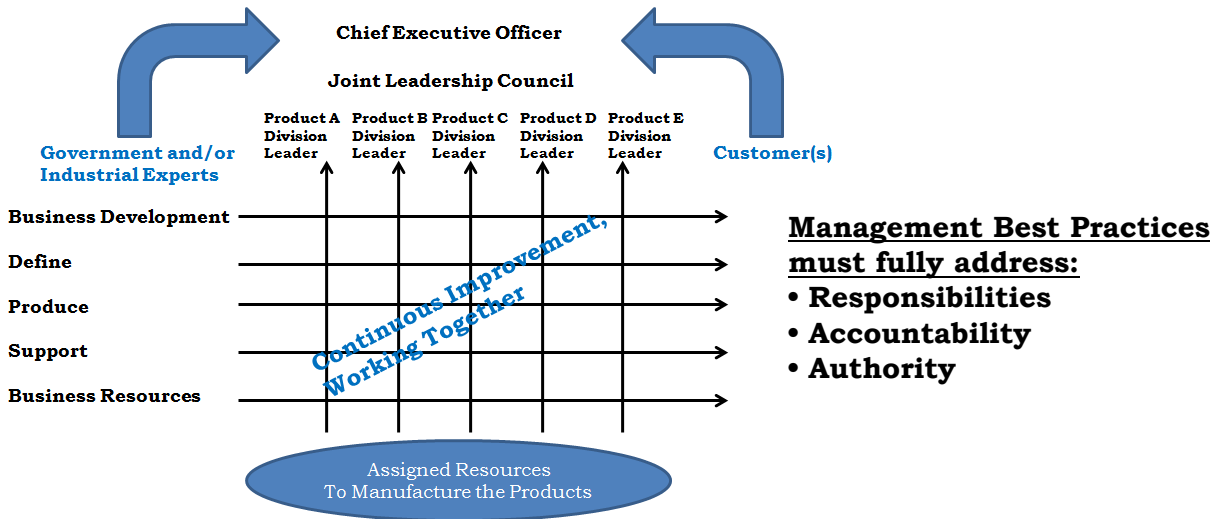
Critical resources for production such as Engineering and manufacturing have become more available for Tier I partners have greater access due to globalization to Engineering services firms and manufacturing skills. Concerns of cost savings have to be integrated with offsets requirements, enhanced market access, and hedging the ever growing currency risk that can affect the strategic vision. The Model Contract pricing specificity need to address these concerns along with key pricing methodology assumptions that have derived the pricing. U.S. DoD procurements provide for FAR Part 15 or FAR Part 12 pricing considerations.

Again, national security regulations such as the U.S.’s International Traffic in Arms Regulations (ITAR) and export compliance have to be taken into account prior to executing all Long Term Contracts.

Post Award

The contract has been awarded. The work begins.

The process of Continuous Process Improvement and the leadership to enhance the product team's ability to deliver best value for the contract products and services must be a priority to ensure quality cycle time, cost, inventory and schedule are met with financial targets of the contract. Starting the team effort correctly with a structure as provided below is important to foment product team work and participation with Kaizan Events, LEAN Manufacturing studies, and individual suggestions and awards resulting from implementation of cost cutting ideas. The failure of implementing such concepts from the start will most often lead to internal conflicts within matrix organizations who don't have product ownership and responsibility.



In addition to the important steps above, improving the financial results for the company when dealing with their customers is ensuring that they do not waive any of their contractual rights or assume responsibilities not expressly required by the long term contract. Every world class company wants to maintain a high level of customer satisfaction with the company products, it is imperative for any company to take every reasonable step to ensure that their contractual

Post Award

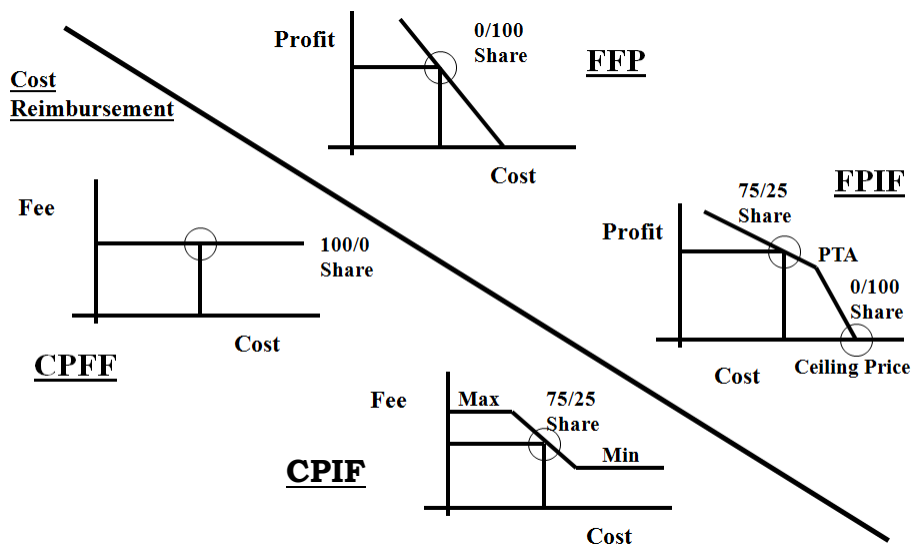
baselines are reviewed to ensure that the contract over time:

- accurately describe the obligations of both contracting parties
- are modified to reflect any changes to those obligations
- Enable the company to receive full payment for its work

A disciplined system with experienced personnel must be in place to assess and evaluate changing requirements in order to promptly identify, assess, give notice, and request contract coverage for customer-caused impacts to the company's contract performance and thus the financial health of the company.

Changes in contract specifications, drawings, or performance requirements will always have some impact on the company's contract obligations, as well as customer requests to re-sequence work or to maintain the same completion schedule even though customer-furnished property or data is late or deficient. Preserving contractual rights that affect price and schedule are major tools in the proper allocation of the company resources.

Types of contracts from Firm Fixed Price to Cost Reimbursement and their relationship to cost and profit are provided below:



Post Award

It is important to remember that the company has a right to their interpretation of the contract / specification if it meets minimum requirements and is reasonable. If a company disagrees with the customer's interpretation, then:


- Keep working under your interpretation
- Notify the customer in writing of the company's position
- Proceed until directed in writing to change
- Document and process a change or claim for an equitable adjustment to price and schedule
- State the undefinitized change on invoices following notifications

The long term contract is the basis for payment, changes and claims, and final protection of a customer proceeding to terminate for default, i.e., the customer can not terminate for default without showing that the company is not performing to the "baseline."

Constructive Changes come from a multitude of areas that require documentation and knowledge of contractual change remedies involving customer actions or inactions that have the effect of changing the terms of the contract. These might include:

Customer Actions Or, Inactions...

Decide Now! ? Should we do it??? ? Don't! Too Risky!



Which can change the terms of the contract.....

And, can be construed to be "Changes"

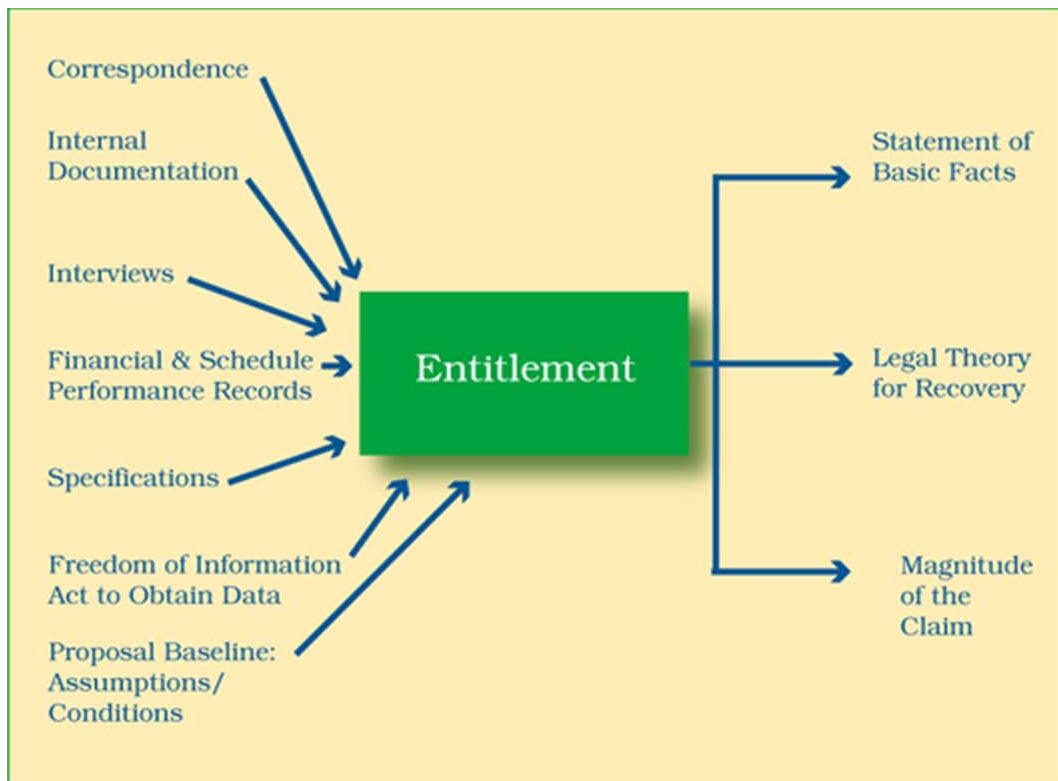
- Acceleration
- Defective Specifications
- Late or defective customer furnished property or data
- Unreasonable inspections, rejections and rework
- Failure to cooperate
- Delaying review and approval of data submittals
- Failure to disclose superior knowledge

Post Award

In addition, constructive changes are also resulting from a series of communications involving the following:

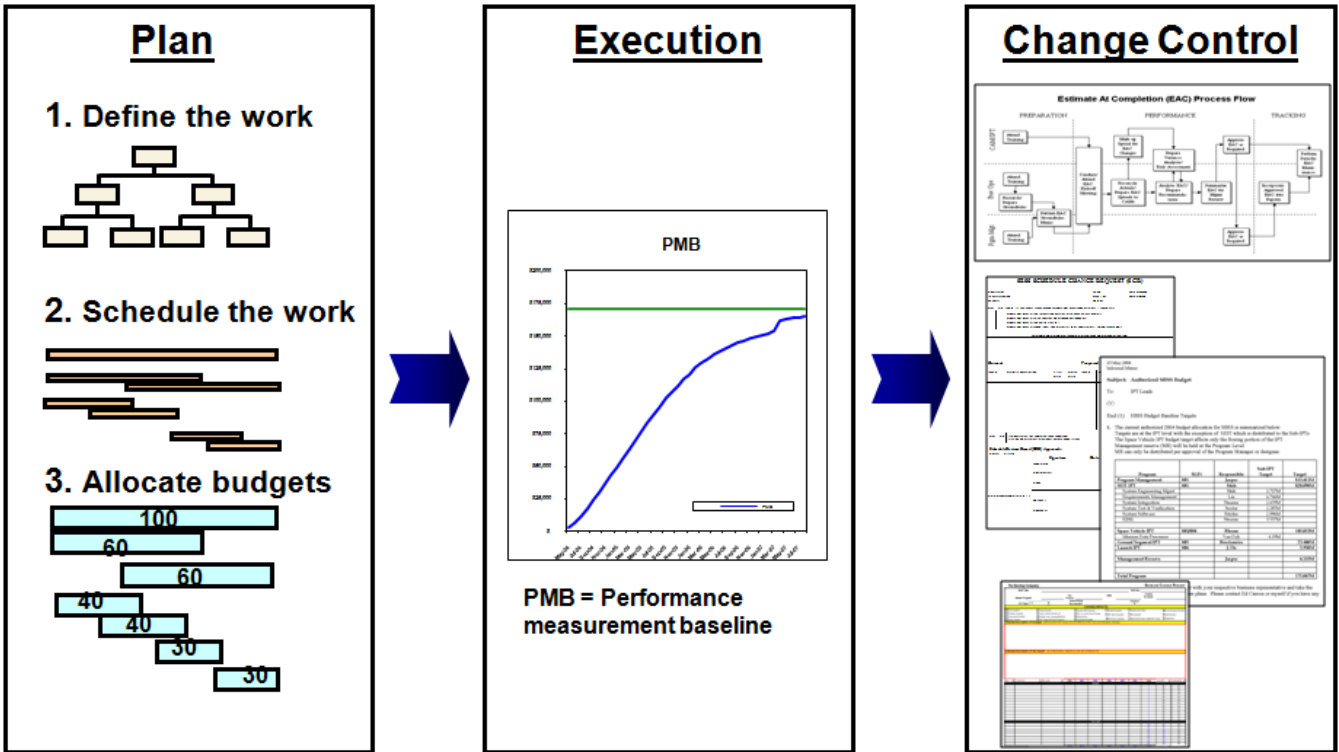
- Correspondence
- Technical Interchange Meetings
- Program Formal Plans
- Corrective Action Plans
- Data Approval Rights
- Delivery & Acceptance
- Customers directing the company suppliers

In many cases, experienced personnel in the field of changes/claim history can provide the business remedies through hard work and research of the facts to mitigate the financial impact of what becomes unpaid accounts receivables.



Summary

All responses to request for proposals that become awarded are actions that define:



The staff at GMC2 have the proven experience in supporting the needs of growing companies from Pre-Award and Post Award transactions. Our mission is to provide our customers with the most viable growth and contractual options to assist them in achieving their business pursuits. We offer extensive managerial and negotiating experience that enables us to ensure the protection of our customers' investments through prudent and constructive change. When coupled with the Request for Equitable Adjustments (REAs), our customers are facilitated in reaching their financial targets and improving the overall health of their growing companies.

As Patrick Henry stated: "...I have but one lamp by which my feet are guided; and that is the lamp of experience. I know no way of judging the future, but by the past...."