United States General Accounting Office

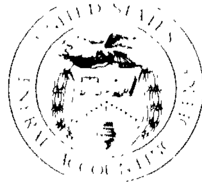
GAO

Report to the Honorable
Roy Dyson, House of Representatives

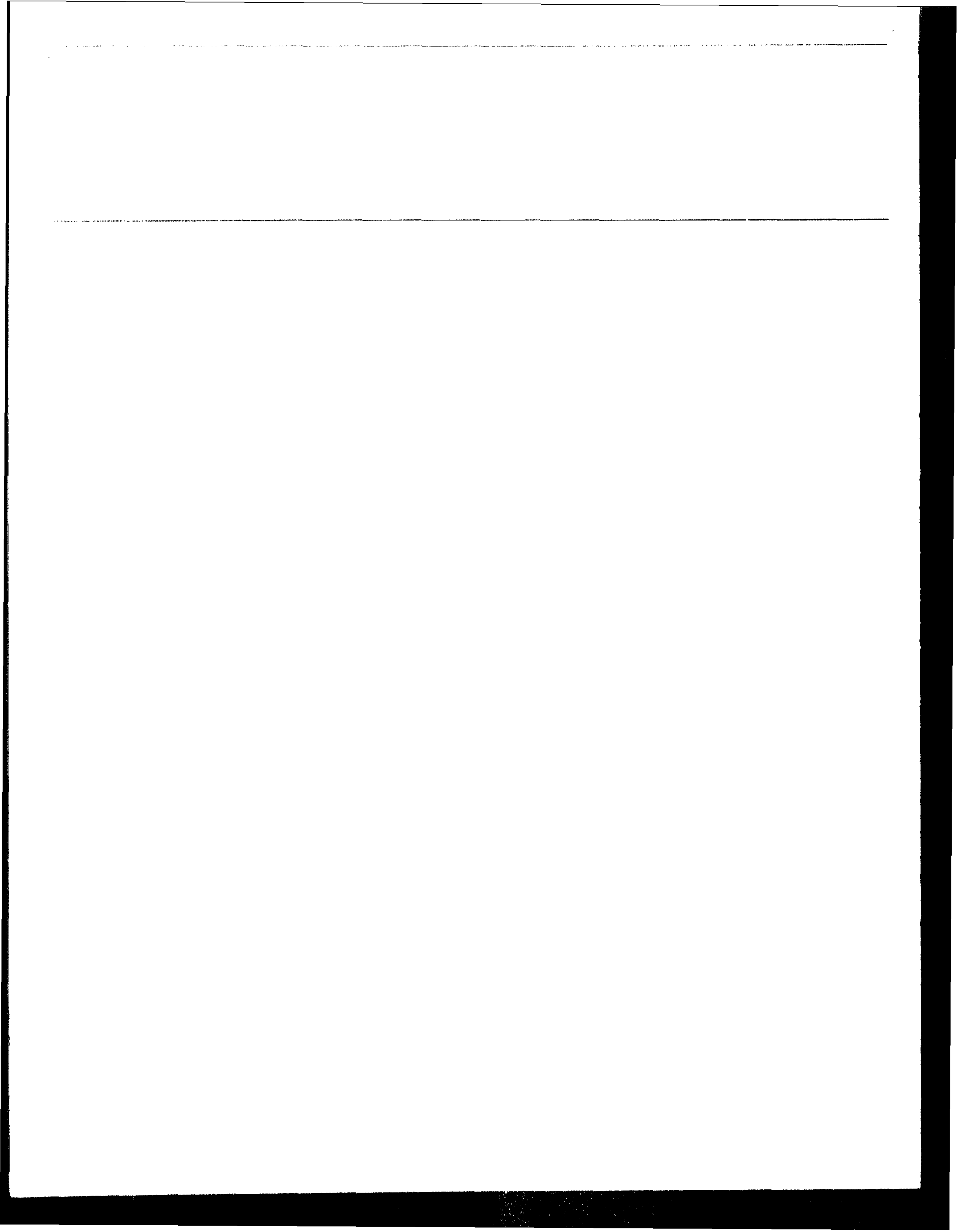
August 1990

GOVERNMENT CONTRACTING

Review of Morton Thiokol Separation



GAO/NSIAD-90-220



GAO

United States
General Accounting Office
Washington, D.C. 20548

National Security and
International Affairs Division

B-239890

August 28, 1990

The Honorable Roy Dyson
House of Representatives

Dear Mr. Dyson:

As you requested, we have reviewed the impact of the Morton Thiokol, Inc., separation on the defense production base. This separation, effective July 1, 1989, created two independent companies—Morton International, Inc., a commercial company, and Thiokol Corporation, which does 98 percent government business.

The objectives of our review were to determine the separation's impact on (1) Thiokol's viability in terms of future sales, (2) Thiokol's ability to service the debt allocated, and (3) the existing Defense and National Aeronautics and Space Administration (NASA) contracts. We also examined the fairness of the debt distribution and the impact of the loss of the automotive airbag operations on Thiokol.

Background

Thiokol Corporation, mainly an aerospace company with some specialty chemical business, was acquired in 1982 by Morton Norwich Products, Inc., a salt and chemical company. The merged companies became Morton Thiokol, Inc. In 1988, Morton Thiokol had total net sales of $2,316.4 million, with $1,248.3 million of that attributed to the components of the new Morton International and $1,068.1 million to the new Thiokol.

Morton Thiokol, Inc., management decided to separate the corporation into two independent companies effective July 1, 1989, because:

- Morton and Thiokol management represented two groups with different and distinct financial, investment, and operating characteristics. There were two different management viewpoints and sets of objectives and two different markets—government/defense and commercial.
- The separation would benefit the stockholders. The aerospace group was perceived as holding down the price of Morton Thiokol stock.

In the separation agreement, the commercial business of Morton Thiokol, Inc., was spun off as a new company named Morton International, Inc., and then the remaining Morton Thiokol, Inc., company was renamed the Thiokol Corporation. Shareholders of Morton Thiokol

received shares in both new companies. At the time the separation occurred, there were common shareholders, but otherwise, the two companies were considered independent. Before the separation, all of Morton Thiokol's current debt was consolidated into long-term debt. Morton International, Inc., the commercial segment, was allocated about $44 million of this long-term debt, while Thiokol Corporation, the segment with all the government contracts, was allocated the remaining $220 million in long-term debt.

Results in Brief

If current sales projections for the Thiokol Corporation materialize as expected over the next 5 to 7 years, we believe that the separation will not be detrimental to the Nation's defense production base. Thiokol should remain viable. Thiokol is the sole source for certain components, such as the current family of solid rocket motors and the nozzles for the advanced solid rocket motors, and is therefore, practically guaranteed that business. In addition, Thiokol's cash flow has increased considerably since the separation. With the projected sales and increased cash flow, Thiokol should be able to service its long-term debt.

The Morton Thiokol separation caused some existing government contracts to have a reduction in cost. This was due to the lowering of the general and administrative (G&A) rate because costs associated with certain Chicago corporate offices are no longer included. The prices of existing firm fixed-price contracts are not affected because those prices are not renegotiable. However, future fixed-price contracts should also reflect less G&A costs, and therefore, lower prices.

Since the separation, Thiokol Corporation has become an independent company, and no longer has access to the former corporation's assets if it should encounter financial difficulties. This is a factor the government will likely have to consider when evaluating whether to continue with any of Thiokol's contracts or programs. The government may have to subsidize Thiokol if the company does have financial problems, or risk delays or nonperformance on other vital government contracts.

Because capital expenditures by the Thiokol segment since 1983 generated most of the debt for Morton Thiokol, Inc., we believe that the debt distribution was equitable.

The transfer of the automotive airbag operations to Morton International appears to be part of Morton Thiokol's overall plan to separate

the government and commercial business. The technology was the property of Morton Thiokol, to be assigned at its discretion. The new Thiokol Corporation is licensed to use the airbag technology in future noncommercial applications. Thiokol appears able to service its debt without the profits from the airbag operations.

Impact on the Defense Industrial Base: Thiokol's Viability in Terms of Sales and Ability to Service Debt

Based on our interviews with Air Force and NASA officials, our study indicates that Thiokol will remain a viable part of the defense industrial base. NASA and the Air Force provide the majority of the contract dollars for the Thiokol Corporation. Air Force and NASA officials provided us with the procurement forecasts of these agencies and said that the contracts that are in place and that are projected will proceed essentially as planned. At the time of our review, neither agency expressed concern that the procurement forecasts for Thiokol would be altered significantly by anticipated defense budget reductions.

Thiokol is the government's sole source for some items, such as the current family of solid rocket motors used for space shuttle launches, and is virtually assured of this business. Air Force and NASA officials said that it really is not economically feasible to keep two sources in operation for these items. Purchases of Thiokol's solid rocket motors are planned through 1995 and beyond. Thiokol also is the sole producer of the nozzles for the advanced solid rocket motor, and these same officials agreed that Thiokol will have that product in its sales base through the late 1990s. Unless Thiokol encounters a major problem with one of its programs, it should be able to service the long-term debt allocated at the separation.

Air Force, NASA, and Defense Logistics Agency officials have concluded that Thiokol's projected business base will be sufficient to ensure the company's viability. Thiokol is regarded as a viable entity by lenders and stock analysts as well. A major bank's financial analysis compared Thiokol's financial structure with other aerospace companies and found that key financial measures for Thiokol were within an "average" range for the companies analyzed. In addition, Thiokol's projected cash flow as a percentage of total debt was stronger than average. One stock analyst's report concluded that Thiokol could have remained viable even if considerably more debt had been allocated to it.

Impact on Existing Defense and NASA Contracts

Since the Morton Thiokol separation, the existing Defense and NASA cost-related contracts have had a reduction in cost because the Morton Thiokol corporate offices' expenses are no longer included in the G&A rate. Some of these former Morton Thiokol corporate officers have moved to Ogden, Utah, as a part of the new Thiokol's corporate management, but the majority of the former Morton Thiokol offices with their management layer are now part of Morton International. We cannot say that there will not be any future cost increases, but initial information from Thiokol indicated that the G&A rate was expected to be reduced by about 25 percent. The latest evaluation of the G&A cost reduction by the Air Force corporate administrative contracting officer showed a decrease of about 10 percent, which would result in decreased contract costs.

Although the prices of existing firm fixed-price contracts were not affected because those prices are not renegotiable, the prices of future contracts should be affected by the reduced G&A rate. For example, according to a NASA official, a recent pricing proposal submitted to NASA, using the most current cost and pricing data, showed a reduction of about 3 percent from the proposal for the same work, based on the previous organizational structure. The new Thiokol Corporation retains ownership of the facilities and equipment regarded as critical to performance on defense and NASA contracts.

If Morton Thiokol, Inc., had spun off the Thiokol segment as a new company, then the remaining Morton Thiokol, Inc., would have been required to execute a novation agreement, giving the government continued rights with the original contracting party. Novation is a contractual procedure whereby the original party to the contract (Morton Thiokol) would guarantee the performance of the new company (Thiokol) on the existing government contracts. Since Morton Thiokol management instead chose to spin off the commercial segment, and rename the remaining government business entity the Thiokol Corporation, the only applicable government regulation required execution of a name change agreement, which does not give the government any further rights with the original contracting party. Morton is no longer responsible for Thiokol's performance on government contracts and Thiokol no longer has access to the former corporation's assets if it encounters financial difficulties. This is a factor the government will likely have to consider when evaluating whether to continue with any of its contracts or programs with Thiokol. The government may be forced to in essence underwrite the company if it does have financial problems, or risk delays or nonperformance on other vital government contracts.

Debt Allocation Appears Equitable

Based on our review, it appears that the allocation of debt was founded on the debt incurred and use of capital by the Thiokol segment over the past several years, and therefore, was equitable. Most government and Thiokol officials we interviewed agreed that the debt allocation was equitable, and the Air Force provided a list of the Thiokol segment's capital expenditures since 1983, which supported this agreement. In addition, government and Thiokol officials indicated that contractual problems resulting from the shuttle Challenger disaster contributed substantially to Thiokol's need for working capital, which increased the Morton Thiokol debt.

Morton Thiokol's Rationale for Debt Allocation

Officials of both new companies said that they believed that the debt allocation was equitable because the Thiokol segment had created most of the Morton Thiokol debt. Further, Morton Thiokol's position was that the purpose for the debt allocation between the two companies was to provide the most total value to the Morton Thiokol stockholders. Morton Thiokol officials believed that as separate companies, the commercial Morton International would have a much higher price to earnings ratio (P/E) than the defense and space contractor, Thiokol. Therefore, the high debt and its related interest expense were allocated to the low P/E company, Thiokol. Under the separation agreement, the shareholders in both companies would be common at the time of separation. Morton Thiokol officials concluded that the high debt would have minimal effect on the company with the low P/E ratio, and that the value of the two stocks after the separation would be greater than the value of the Morton Thiokol stock before the separation. A number of stock analysts made the same conclusion.

A Morton Thiokol official said that they consolidated the long- and short-term debt into new long-term debt structured so that Thiokol would be better able to service it. In addition, Morton International was allocated 87 percent of the June 1989 dividend obligation. The dividend obligation represents an additional liability, and if Thiokol was required to pay its proportionate share of the dividend, this would have been an additional debt burden.

Impact of the Automotive Airbag Operations Transfer

The transfer of the automotive airbag operations took place in May 1988, over a year before the Morton Thiokol separation occurred. Since the airbag's market consists of commercial automobile manufacturers, while the rest of the Thiokol segment's business is government, management officials thought the transfer to the commercial segment seemed

logical. The new Thiokol Corporation has a license to use the airbag technology on future noncommercial applications, such as inflatable helicopter restraint harnesses and bomb ejection systems. Air Force officials told us that some of the airbag development costs were accumulated as Independent Research and Development costs, which are reimbursed in part by the government, while the contractor retains ownership of the developed technology. Other development costs were paid through contracts with automobile manufacturers. Consequently, the rights to the airbag technology were the property of Morton Thiokol, to be assigned at its discretion. Thiokol appears able to service the debt, without the profits from the airbag operations.

Because the airbag operations facilities are physically located within the Thiokol complex, the transfer of ownership to Morton posed some legal questions with respect to liability in the event of an accident. For example, the government's liability could have increased because protection under Utah Workman's Compensation statutes would be lost. Subsequently, the Air Force, Thiokol, and Morton International signed an agreement which will indemnify the U.S. government in event of an accident.

Scope and Methodology

Our work was performed in Ogden, Utah; Chicago, Illinois; and the Washington, D.C. metropolitan area, from July 1989 to April 1990. We interviewed contracting officials at Air Force Systems Command Headquarters, the Air Force Contract Management Division, and the Air Force Plant Representative Office. We also interviewed the Defense Contract Administration Services corporate administrative contracting officer, the president and chief executive, financial, legal and contracting officials of Thiokol Corporation, and the chief financial officer of Morton International, Inc., NASA Headquarters contracting and program officials, and the NASA Marshall Space Flight Center Contracting Officer responsible for Thiokol contracts.

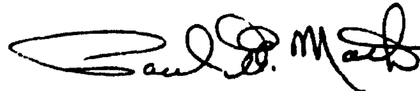
We obtained and analyzed stock analysts' reports, the Defense Logistics Agency's financial analyst's study, briefings by Thiokol officials, and financial data provided in Morton and Thiokol quarterly reports. We reviewed future business projections provided by the Air Force Plant Representative Office based on input from NASA, Air Force, other government agencies, and Thiokol, and corroborated these projections with NASA Headquarters contracting and program officials. Our work was performed in accordance with generally accepted government auditing standards.

We provided a draft of this report to the Department of Defense, NASA, and Thiokol officials for their review and comment. Their comments expressed general concurrance and have been incorporated where appropriate in the report. The Department of Defense letter is included as appendix I.

We plan to distribute this report to the Secretary of Defense, the Administrator of NASA, the Director of the Office of Management and Budget, and appropriate congressional committees. We will make copies available to others upon request.

Please contact me at (202) 275-8400 if you or your staff have any questions concerning this report. Major contributors to this report are Clark G. Adams, Assistant Director, and Carol S. Markson, Evaluator-in-Charge.

Sincerely yours,



Paul F. Math
Director, Research, Development,
Acquisition, and Procurement Issues

Comments From the Department of Defense

ASSISTANT SECRETARY OF DEFENSE
WASHINGTON, D.C. 20301-8000

July 30, 1990

PRODUCTION AND
LOGISTICS
(P/CPF)

Mr. Frank C. Conahan
Assistant Comptroller General
National Security and International
Affairs Division
United States General Accounting Office
Washington, DC 20548

Dear Mr. Conahan:

This is the Department of Defense (DoD) response to the General Accounting Office (GAO) Draft Report GAO/NSIAD-90-220, entitled "GOVERNMENT CONTRACTING: Review of the Morton Thiokol Separation," dated June 26, 1990 (GAO Code 396136/OSD Case 8400).

The Department takes no exception to any of the findings in this draft report. In fact, the GAO findings closely parallel those of the cognizant DoD contract administration office for the Thiokol Corporation during its own review of this matter, conducted prior to the Morton Thiokol separation. That DoD office similarly concluded that the allocation of debt between the two new corporate entities was equitable and that Thiokol's projected business base should be sufficient to ensure the company's continued viability.

Thank you for providing the Department with the opportunity to comment on this draft report.

Sincerely,

David J. Berteau
Principal Deputy

Ordering Information

The first five copies of each GAO report are free. Additional copies are $2 each. Orders should be sent to the following address, accompanied by a check or money order made out to the Superintendent of Documents, when necessary. Orders for 100 or more copies to be mailed to a single address are discounted 25 percent.

U.S. General Accounting Office
P.O. Box 6015
Gaithersburg, MD 20877

Orders may also be placed by calling (202) 275-6241.

United States
General Accounting Office
Washington, D.C. 20548

Official Business
Penalty for Private Use $300

First-Class Mail
Postage & Fees Paid
GAO
Permit No. G100