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REPORT TO THE CONGRESS

BY THE COMPTROLLER GENERAL OF THE UNITED STATES

Implementation Of Emergency Loan Guarantee Act

Lockheed Aircraft Corporation
Emergency Loan Guarantee Board

This is the current status of Lockheed's financial and other problems and their possible impact on Lockheed's ability to repay the Government guaranteed loans. It also includes a valuation of the collateral securing those loans.

PSAD-76-63 JAN. 30, 1976

COMPTROLLER GENERAL OF THE UNITED STATES
WASHINGTON, D.C. 20548

B-169300

C1 To the President of the Senate and the
Speaker of the House of Representatives

CNG 02284

This is our fourth report on activities of the Lockheed Aircraft Corporation, Burbank, California, the only business to apply for a guaranteed loan under the Emergency Loan Guarantee Act, 1971 (15 U.S.C. 1841, Supp. I, 1971). The law established the Emergency Loan Guarantee Board to administer loans in amounts up to but not exceeding $250 million. As of September 30, 1975, loans guaranteed to Lockheed totaled $195 million. AGC 01477

We have been making reviews pursuant to the Emergency Loan Guarantee Act; the Budget and Accounting Act, 1921 (31 U.S.C. 53); and the Accounting and Auditing Act of 1950 (31 U.S.C. 67). This report is being issued to keep the Congress abreast of the company's ability to repay its Government-guaranteed borrowings.

We reviewed corporate actions which had a material effect on Lockheed's financial structure. We examined the bases for Lockheed's forecasts of cash flow and revenues and compared these forecasts with actual transactions. We also made such tests of the accounting records and major cash transfers as we deemed necessary.

We relied on the examinations performed by Lockheed's independent external auditors, particularly as those examinations related to verifying assets pledged to protect the Government's interests. Corporate assets pledged as security for the loan are the outstanding shares of stock of five wholly owned subsidiaries and certain machinery and equipment.

The emergency loan guarantee fund, used by the Board to pay expenses and to fulfill its obligations under the act totaled $19,103,016 as of September 30, 1975, after deducting expenses of $597,167. Of this amount, $17,569,918 was invested in Treasury bills with the balance representing available cash. The loan fund was accumulated from guarantee and commitment fees that Lockheed paid and interest on Treasury bills.

UNRESOLVED GOVERNMENT ACTIONS ON DISCLOSURE OF LOCKHEED'S PAYMENTS TO FOREIGN OFFICIALS

Negotiations are underway between Lockheed and the Securities and Exchange Commission regarding the extent of the company's disclosure of its payments to foreign officials and political organizations as a means of promoting sales. Lockheed has indicated that about $24.2 million in "kickbacks" have been paid to foreigners since 1970.

Company officials have declined to furnish details of the foreign transactions--all of which have been a well-kept secret until June of 1975. Neither the company's external auditors nor a number of Lockheed directors were aware of the procedures used for foreign sales promotion until mid-year 1975. Lockheed has taken the position that the foreign payments were in keeping with business practices in many foreign countries and were not illegal under the laws of the United States.

Lockheed officials believe that the company's ability to fully realize foreign sales, forecast at almost $4 billion for the 5 years 1975 through 1979, may be placed in considerable jeopardy if the Securities and Exchange Commission and the Emergency Loan Guarantee Board take certain actions within their authority. For For instance, Lockheed believes that successful legal action by the Commission to force it to fully disclose the details of the company's payments to foreign officials may seriously reduce Lockheed's foreign market potential.

Among other considerations which hinge on the final resolution with the Commission is the current financing plans Lockheed has negotiated with its lending banks. A major part of the plan provides for converting bank loans and certain debentures to preferred stock. (See pp. 5 and 6.) This part of the plan cannot be consummated, however, without stockholder approval. The company's annual stockholders' meeting has been deferred on three occasions and has not been rescheduled at this writing because of the lack of agreement leading to a consent decree with the Commission as to the extent of disclosure in the corporation's proxy statement regarding its foreign payments.

Legal proceedings initiated by the Commission are in progress in the U.S. District Court for the District of Columbia. On December 15, 1975, the court ordered Lockheed to give the Commission access to the documents which it is demanding, and two days later the court amended its December 15 order to require that the documents should remain subject to the continuing jurisdiction of the court.

Lockheed issued a management policy statement in October 1975 for the selection and use of international consultants. The policy prohibits payments to or agreements with any consultant in violation of United States and foreign laws. The new policy also prohibits payments to consultants which are not allowable deductions as ordinary and necessary business expenses for Federal income tax purposes.

NEW CAPITALIZATION

Because of its continuing need for working capital to finance the TriStar program, Lockheed and its lending banks have sought various methods to increase its equity capital and restructure its outstanding debts and credit arrangements. The company had previously negotiated a tentative agreement with Textron, Inc., and the banks which were intended to strengthen Lockheed's financial position.

The tripartite negotiations provided for converting $275 million of bank loans into Lockheed preferred stock--an action which would have released the Government's loan guarantee of $195 million. At the same time, Textron agreed to invest $100 million into the company's equity. However, in February 1975 the negotiations were canceled because of delays in implementing the refinancing plan.

One of the major delays concerned the final resolution of Lockheed Shipbuilding and Construction Company claims against the Navy on certain ship construction contracts which have been referred to the Department of Justice for investigation. Details concerning the basis for the referral have not been disclosed. Previously, a settlement of the claims had been agreed to early in 1971 by the Navy and Lockheed. At that time, a settlement of $62 million was contemplated covering claims of about $159 million, subject to further administrative proceedings within the Navy. Provisional payments totaling $49 million were made to Lockheed with a $13 million balance due on completion of the administrative proceedings.

Since the Navy had not paid the final $13 million, Lockheed filed an appeal in May 1973 with the Armed Services Board of Contract Appeals for resolution of the claims. After filing the appeal, the Navy determined that only $6.8 million of the $159 million in claims had been adequately substantiated. On May 14, 1975, it was announced that the Armed Services Board ruled in favor of Lockheed and upheld the full amount of the $62 million settlement. An appeal by the Navy to the ruling was rejected by the Armed Services Board on October 24, 1975. The Armed Services Board concluded that the Government had failed to advance any persuasive reasons to show why its previous decision should have been modified in any way. At the end of October 1975, however, the Department of Justice was still investigating and had neither made public nor advised Lockheed of the specific details concerning the matters of investigation.

Lockheed's continued efforts to seek a solution to enhance its financial structure culminated in negotiations on April 1, 1975, with its lending banks on a three-phase financing and recapitalization program subject to approval by the Loan Guarantee Board. The program was approved by the Board on May 17, 1975, and by the lending banks on May 20, 1975, and was designed to reduce financial uncertainties and improve the company's marketing posture as well as to improve earnings and build up shareholders' equity during the next few years.

The first phase of the program, the essential parts of which are described below, was effective as of April 1, 1975.

Phase 1

--The company's $650 million 1971 credit agreement and the Government loan guarantee, both due to expire at the end of 1975, have been extended through 1977. In addition, the terms of the 1974 Credit and Security Agreement which provided for additional short-term bank financing of up to $75 million secured by flight line and finished L-1011 aircraft awaiting delivery against firm orders, are also amended to extend the termination date through December 31, 1977.

--The interest rate on the nonguaranteed portion of the bank loans has been reduced to 4 percent a year for a period of 2 years. Thereafter, interest charged will revert to the prime rate plus 1 percent.

--The company has issued warrants to the banks covering the purchase of 1.75 million shares of common stock at $7 per share.

The second and third phases of the program which will require approval of the corporate shareholders and debenture holders before they become effective provide essentially for the following.

Phase 2

--The conversion of $43 million of nonguaranteed bank loans and $7 million of deferred interest to a new series A preferred stock providing for a cumulative dividend rate of 9.5 percent.

--The company will issue warrants to the banks covering the purchase of an additional 1.25 million shares of common stock at $7 per share.

(The agreement originally established a time limitation of November 15, 1975, for phase 2 to be implemented. The company has negotiated an agreement with the lending banks to extend this date to May 1976, because of the uncertainty surrounding the timing of a stockholders' meeting.)

Phase 3

--An offer to exchange 4-1/4 percent Convertible Subordinated Debentures, up to the total issue of

$125 million, to a new Series B preferred stock, the dividend rate of which will be determined at the time of issue.

--If at least $45 million of the debentures is exchanged for preferred stock, the banks will convert an additional $25 million of nonguaranteed loans to Series A preferred stock. If less than $45 million of the debentures is exchanged, the banks will convert additional bank loans only to the extent that the exchange exceeds $25 million.

(December 31, 1975, had been originally established as the closing date for phase 3 to be fully implemented. Lockheed also negotiated an extension of the closing date of phase 3 to August 1976.)

We noted that the financing agreement does not state whether the terms of the first phase would remain in force in the event the second and third phases are not fulfilled within the prescribed time limits. Company officials stated, however, that based on opinion of Lockheed counsel, the terms of phase 1 would not be impaired even though phases 2 and 3 were not implemented.

STATUS OF GUARANTEED LOANS

The Emergency Loan Guarantee Act of 1971 provided that guaranteed loans shall be repayable in not more than 5 years, but may be renewable for not more than an additional 3 years. In May 1975 the Emergency Loan Guarantee Board extended the Government's guarantee through the end of 1977 although the company's current cash flow projections do not anticipate full payment of its guaranteed borrowings before 1979. These circumstances would indicate that the Board may be called on again to consider a further extension for repayment of the guaranteed loans within the limits provided by law. Lockheed forecasts that guaranteed borrowings at the end of 1977 will total $118 million.

As of December 31, 1975, Lockheed's overall bank loans totaled $595 million, of which $195 million was guaranteed by the Government.

The reduction in loan principal will not be consistently sustained, according to the company's December 1974 5-year financial forecast, through the succeeding year. Although Lockheed expects that additional borrowings of $40 million will be needed during 1976 to meet the company's financial commitments, the company expects that this additional loan of $40 million will be repaid before the end of the year.

Collateral

The book value of the assets pledged as collateral for the guaranteed loans totaled $190 million at the end of December 1974. Available property tax bills for 1974 covering real and personal properties with a book value of $85 million listed the market value for these assets at $234 million. Book values or current market values are not necessarily reliable indicators of amounts that could be realized in the event of forced liquidation. Nevertheless, on the basis of the property tax assessments and generally favorable earnings of the pledged operating subsidiaries (3-year average of $24.4 million after taxes), we believe that the Government's interests are adequately safeguarded.

CORPORATE 5-YEAR FORECAST

Lockheed's forecast projects operating profits for the 1975-79 period sufficient to maintain the company's stability, but insufficient to liquidate its guaranteed bank loans by the end of 1978--the maximum time provided by law. The projected profits and cash flow for the 5-year period assumes that the financial plan with the company's lending banks (see pp. 5 and 6) will be fully operative. Also, Lockheed must substantially achieve all of its projected forecast premises, a significant part of which includes expected revenues from foreign sources. However, the potential results arising from the actions of the Government agencies concerned with the company's payments to foreign officials (see pp. 2 and 3), may seriously inhibit Lockheed's future success in foreign markets and invalidate its current forecasts.

Lockheed projects the total L-1011 TriStar production program at 300 aircraft through 1984. The company's December

1974 forecast indicated that about one-half of the TriStars scheduled for delivery during the succeeding 5 years will be to foreign carriers. Consequently, the unresolved problems discussed on pages 2 and 3 may undermine the fulfillment of these sales. Lockheed's forecast of December 1974 projected delivery of 90 L-1011's through 1979 but because of the anticipated cutback in TriStar production (see p. 10) the company's forecast may not materialize. In addition, the uncertainties presented by general economic conditions and energy supply problems, make long-range forecasting of limited value.

The prediction of 300 TriStar sales through 1984 is based on Lockheed's market analysis of future requirements for wide-bodied commercial passenger aircraft. The Federal Aviation Administration in its September 1974 Aviation Forecasts for fiscal years 1975-1986, has estimated that as many as 381 wide-bodied, 3-engine jet aircraft (160 L-1011's and 221 DC-10's), will be in the service of U.S. air carriers by the end of 1981. This estimate is more optimistic than the 128 L-1011's forecast by Lockheed to be operating domestically as of that date.

In order to enhance the sales potential of the TriStar, Lockheed has been offering three modified versions for sale with increased range.

10 Cathay Pacific Airways has ordered four longer range DLG 01069
11 TriStars including two optional "second buys"; and Gulf Air DLG 01070
has ordered eight including four optional second buys. Saudi
1 Arabia's national airline (Saudia) has ordered four longer CNG 00780
range TriStars but is accepting three shorter range versions
until a new Rolls-Royce engine is available. These three
will be retrofitted with the new engine. Both Cathay
and Saudia have already placed the new airplane in service.

FINANCIAL DATA

Government sales continue to be the mainstay of Lockheed's business although they are no longer such a dominant factor. These sales have averaged about 75 percent of total sales during the last 5 years, 1970 through 1974. During 1974, Lockheed's sales of $3.28 billion included $2.04 billion of Government business or about 62 percent of total sales for the year. Sales for the first 9 months of 1975 have totaled $2.53 billion, as compared to $2.34 billion for the same period in 1974. About 63 percent of the 9-month 1975 sales represented Government business.

The L-1011 TriStar aircraft program is, as it has been since its inception, crucial to Lockheed's financial stability mainly because of the company's tremendous investment in developing the aircraft. TriStar inventories represented about 56 percent of the corporation's current assets of about $1.3 billion at the end of third quarter 1975. These amounts reflect a writeoff of $448 million in development costs from the TriStar inventory at the end of 1974 under a recently adopted ruling by the Financial Accounting Standards Board relating to research and development costs.

Lockheed's financial performance in 1974 was encouraging and resulted in an improvement in its cash position. The company's net profit was $23.2 million on operations which represented an increase of $9.5 million over the prior year (restated to reflect the change in L-1011 inventory accounting), and was accomplished after absorbing substantial interest expense of $10.27 million. The improved performance enabled Lockheed to reduce its anticipated borrowings during 1974 and to repay $50 million of the guaranteed loans. The company's net worth was substantially eroded, however, by the TriStar inventory adjustment. At December 30, 1973, Lockheed's net worth totaled $283.2 million, but less than 10 percent of this amount ($26.5 million) remained at yearend 1974.

Reported corporate profits for the first 9 months of 1975 showed a substantial upturn, primarily because of the reduced interest rate on $400 million of nonguaranteed bank borrowings as provided by phase 1 of the three-phase financing program with the company's lending banks. (See p. 5.) The company reported 9-month net earnings for 1975 of $37.4 million as compared to $18.5 million for the first 9 months of 1974. Lockheed's net earnings are based on the assumption of a 300-airplane L-1011 TriStar program. Because of the increased earnings during the first 9 months of 1975, shareholders' equity increased from $26.5 million at December 31, 1974, to $67.4 million.

L-1011 SALES AND PRODUCTION

At the end of September 1975 the company had received 154 firm orders, 118 of which had been already delivered and the balance scheduled for delivery through 1980. TriStar customers have also made commitments for 51 optional second buys to be produced and delivered by the end of 1984.

Depressed economic conditions and energy supply factors have had an adverse effect on the air transportation industry including some of Lockheed's customers. Pacific Southwest Airlines gave notice that it was unable to accept delivery of the three aircraft scheduled for delivery in 1975 and 1976. There are no provisions in the Airlines' sales contracts for deferral or cancellation of aircraft deliveries. Lockheed has taken no legal action against the Airlines at this time and is attempting to find other users for the three aircraft.

Lockheed has also tentatively agreed to reschedule in later years four of six L-1011's that are scheduled for delivery to Eastern Airlines in 1976. In addition, the company has agreed to delay delivery of two TriStars to Trans World Airlines from 1975 to 1976.

The depressed state of the airline industry has caused Lockheed to further stretch out its TriStar production schedule. In its December 1973 forecast, the company anticipated producing and delivering at least 200 L-1011's through 1978. Deteriorating economic conditions, however, have motivated the company to further reconsider its projected TriStar production schedule. In its December 1974 forecast, the company projected that an overall total of about 180 to 185 L-1011 aircraft would be delivered through 1979.

In its third-quarterly report for 1975, however, Lockheed indicated that the rate of TriStar production in the near term would decrease and may be at a level of only about nine aircraft annually during the next 2 or 3 years. The sales goal projected by Lockheed in December 1974 averaged 14 aircraft annually.

GENERAL OBSERVATIONS

Despite Lockheed's improved profits for 1974, and reported earnings for the first 9 months of 1975--$37.4 million as compared to $18.5 million for the same period in 1974--Lockheed does not anticipate complete repayment of its guaranteed loans even within the extended period provided by law, considering the various negative factors discussed above. Principal among these factors are the contingencies involved in the company's efforts to improve its equity capital position, and the substantial downward revision of anticipated revenues from TriStar sales from 1975 to 1979.

The company believes that an L-1011 program of 300 aircraft should result in recovery of its TriStar inventory investment of $719.8 million at the end of September 1975. Lockheed acknowledges, however, that continued financing will be needed until the L-1011 inventory is substantially liquidated.

In our previous report, we noted that L-1011 production costs had sizably increased over the amounts anticipated. This trend has been reversed in 1975, principally as a result of the company's reevaluation of its projected production requirements. It is apparent, however, and Lockheed management concurs, that L-1011 production costs which are significantly over the previous estimates or sales which are significantly under those projected, could result in material losses in the future.

We are sending copies of this report to the Director, Office of Management and Budget, and to the Chairman, Emergency Loan Guarantee Board.

Thomas B. Staats
Comptroller General
of the United States

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