

Defense Supplier Banks On Being Low-Cost Maker Of Satellite Gear

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Last week, President-elect Obama said he would set up a team to save money in the federal budget. Among the interested observers were defense contractors like **Integral Systems (ISYS)**. Integral provides ground support systems for satellites. Three-quarters of its revenue comes from the U.S. government. The Air Force alone provided more than half its sales in the second quarter.

Obama's plans to pull out of Iraq, along with the decline of the tax base thanks to the recession, don't bode well for defense spending.

But Integral Chief Executive John Higginbotham says his firm can sell to a bargain-hunting government. "We're seen to be a low-cost provider of highly efficient systems," he said. "I think the discriminators that made us successful actually (make the environment) more in our favor, rather than less." Integral's systems are turnkey and off-the-shelf, saving the fuss and expense of custom building for every contract.

Higginbotham says another important discriminator is that the firm's systems combine technologies, such as radio-frequency communications, digital signal processing and spectrum analysis. This suits clients' growing need for integration, he says, especially among its other main client industry: telecom. "We're right at the crossroads of convergence," he said. "These are the technologies that make satellite communications more interoperable with the global communication environment (and) represent exciting growth potential."

In an Aug. 15 note, Dougherty analyst Richard Ryan agreed that Integral's tech portfolio is the broadest around. "We believe (Integral) has developed more satellite ground systems for a greater variety of satellites than any other company," he said.

If government spending does take a hit, Integral may not feel it for a while. Spending cycles in the defense business run three to five years. And funding for space is up 35% over last year, according to Ryan. Integral signaled its investment in this sector in August when it opened office space in three major aerospace centers: Colorado Springs, Colo.; El Segundo, Calif.; and Chantilly, Va. This followed the June move of the company headquarters to a larger building in Maryland.

The summer brought a lot of new things for Integral. Among them was Higginbotham himself, who took over from Alan Baldwin in early July. Much of the present management has come on in the last 14 months, including the chief financial officer and the heads of mergers and acquisitions, human resources and corporate security. The new team set about restructuring the firm's operations. Integral markets its products under several brand names, partly reflecting its acquisition history.

Recently, the firm added a third division, SAT Corp., to the two legacy units in its space communication service segment, Lumistar and RT Logic. It also combined a software line with its commercial group. Higginbotham says these changes came partly for the sake of efficiency

and leanness. But the "fundamental principle," he said, "was the alignment of customer communities with business models."

In his note, Ryan wrote highly of Higginbotham and said he expects him to lead the firm to more acquisitions. Higginbotham affirms that buyouts are part of his strategy. He said Integral will look for companies to enhance core markets and expand into adjacent markets and perhaps score the occasional large, "transformational" buy.

CFO William Bambarger adds that the recession is a good time for a company with low debt and good cash flow to go hunting. "The current economic conditions make some outstanding companies — with great technology, intellectual property and personnel — more limited in their growth opportunities," said Bambarger. "Someone like us can come in with more options at our disposal for those kinds of things, and complement our products with their products."

Integral's management is also seeking opportunities abroad. About 10% of the firm's business comes from outside the U.S., and its two latest deals were in Europe. On Nov. 24, the European division said it agreed to support the region's Polar Mission Control System for the next 15 years.

Integral's internal growth is somewhat lumpy from quarter to quarter, as is true for most contractors. Analyst Ryan expects earnings to grow in a stair-step pattern, as new contracts bring sharp boosts in income, followed by stretches of flatness between deals.

Analysts predict Integral's next quarter, which it is due to report on Dec. 11, will be one of those flat periods. Those polled by Thomson Reuters see profit shrinking 13% from the prior year to 20 cents a share, with sales nearly unchanged at \$36 million. That follows five quarters of strong growth. The fiscal third quarter saw profit rise 56% to 28 cents a share, with sales up 17% to \$41.8 million. Beyond the fourth quarter, analysts expect growth to resume. The 2009 forecast calls for 11% profit gains to \$1.20 a share. Analysts see a 21% increase the following year.