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Private and Confidential

Changing Contours of the Defense Industrial Base: An Introduction

Prepared for:

AFCEA

Acquisition Research:
Creating Synergy for Informed Change

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RENAISSANCE
STRATEGIC ADVISORS

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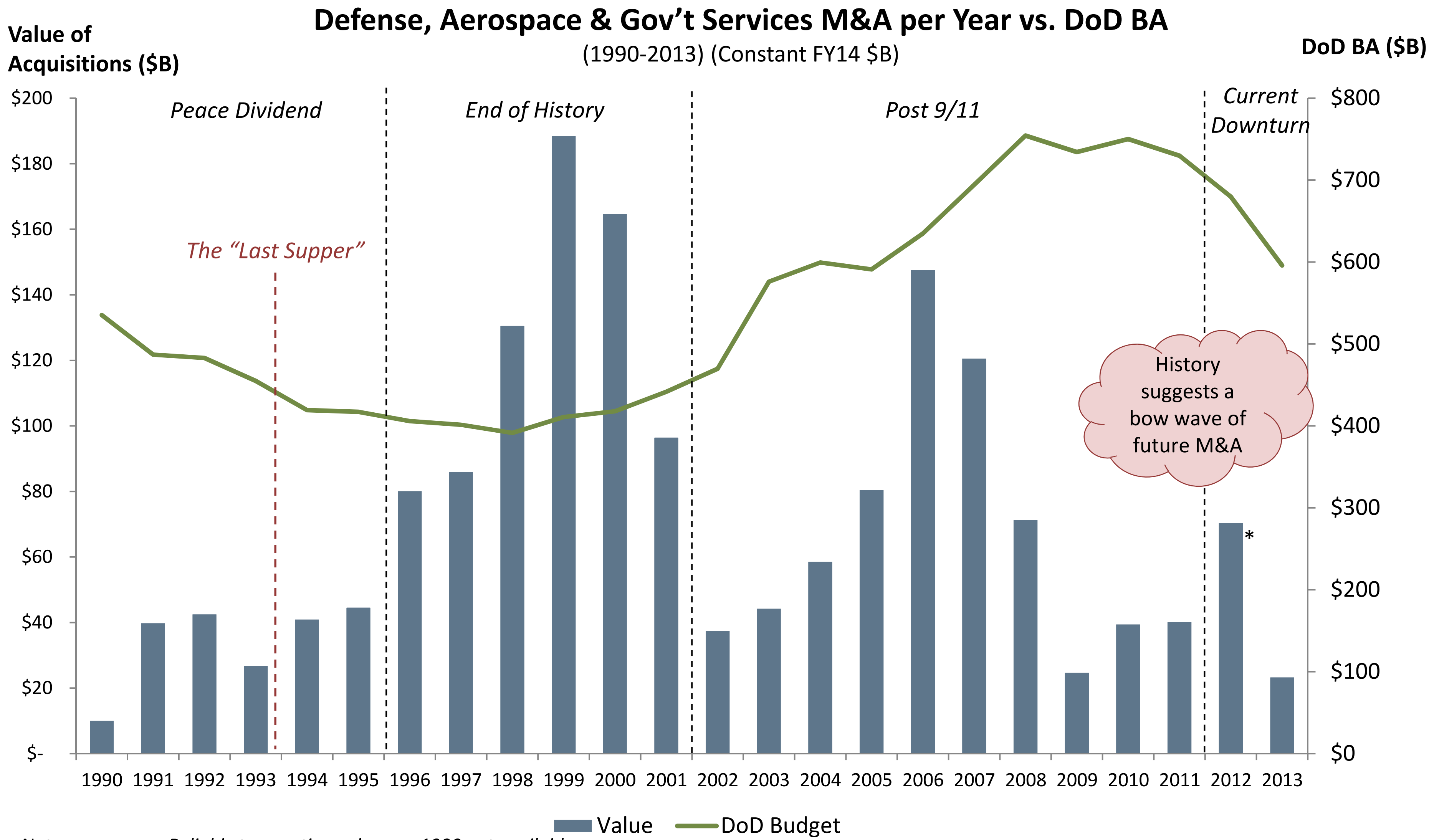
Thoughts on Consolidation

It was the End of History that saw industrial consolidation peak six years after the "Last Supper"



Note: *Reliable transaction value pre-1990 not available*
*** *includes $17B UTC / Goodrich transaction*
Source: *DACIS, RSAdvisors analysis*

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In the last downturn, M&A created the Big Five defense primes, the Defense Hardware Tier 1 providers and Pure Play Services Firms

M&A Activity and Corporate Strategy

(1990 – 1999)

	Strategy	Result
Defense Primes	• Merge / buy peer competitors • Expand portfolio of offerings	Big Five primes emerge with horizontal and vertical integration across platform lifecycle
Defense Hardware Tier 1	• Buy peers to create scale, otherwise sell to consolidators	New mid-tier defense firms emerge (e.g., L-3, EDO, DRS)
USG Service Pure Plays	• Create the market segment • Buy competitors to grow share • Sell to defense primes	Services pure plays attain scale and large services units among the Big Five also grow
Commercial Aero Suppliers w/ Defense Portfolio	• Divest or hold in defense • Pursue M&A in core segment	Tier 1 aerospace super suppliers (e.g., Honeywell, UTC) emerge
Commercial Conglomerates	• Divest defense operations	Commercial conglomerates and major industrials exit the DoD supply chain

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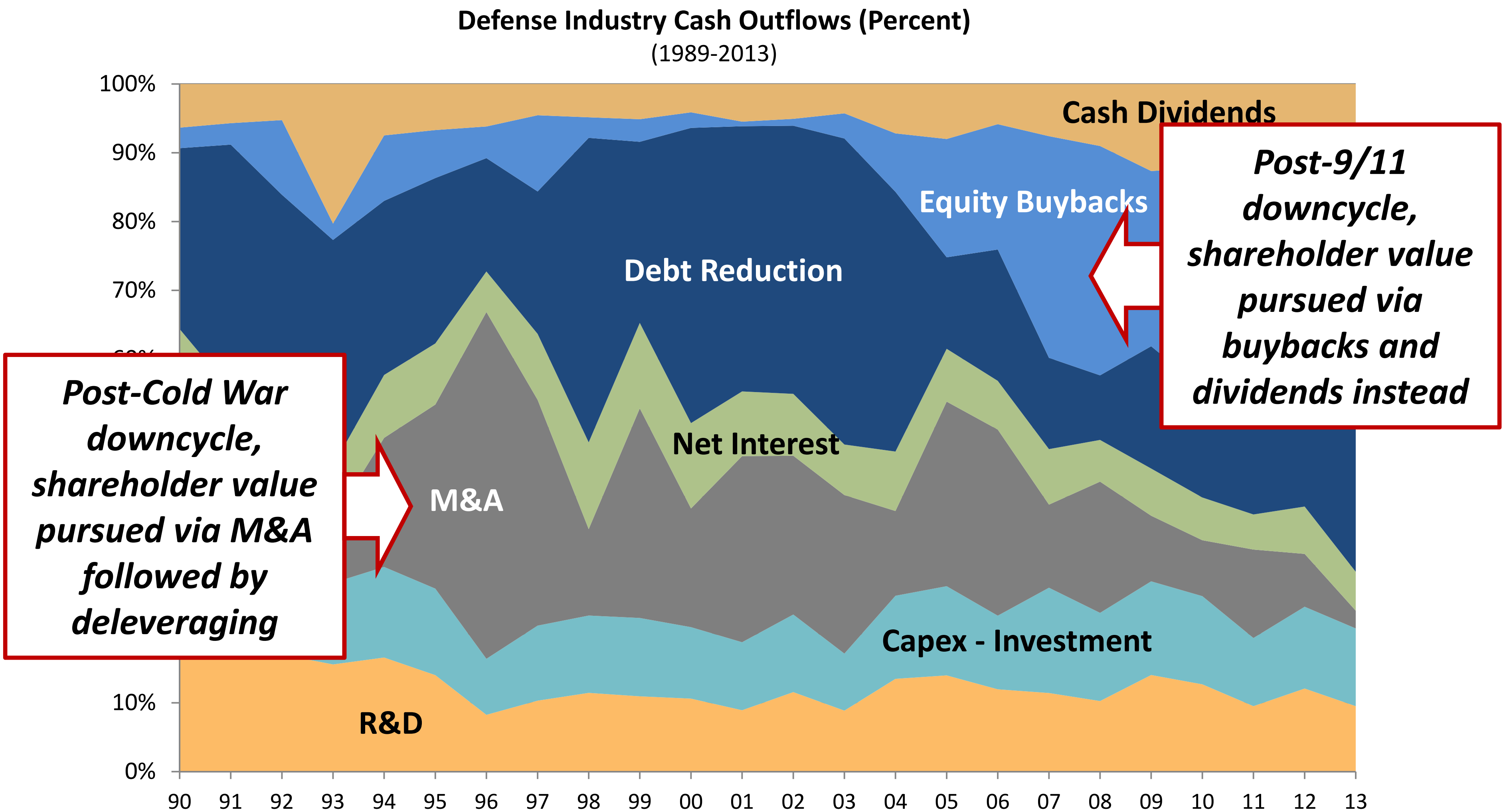
Thoughts on Consolidation

In this down cycle, industry has thus far opted to create shareholder value through dividends and buybacks as opposed to M&A



Source: FactSet, S&P Compustat, Energy Information Administration, National Defense Budget Estimates, CapitalIQ, Company filings, RSAdvisors analysis

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Thoughts on Consolidation

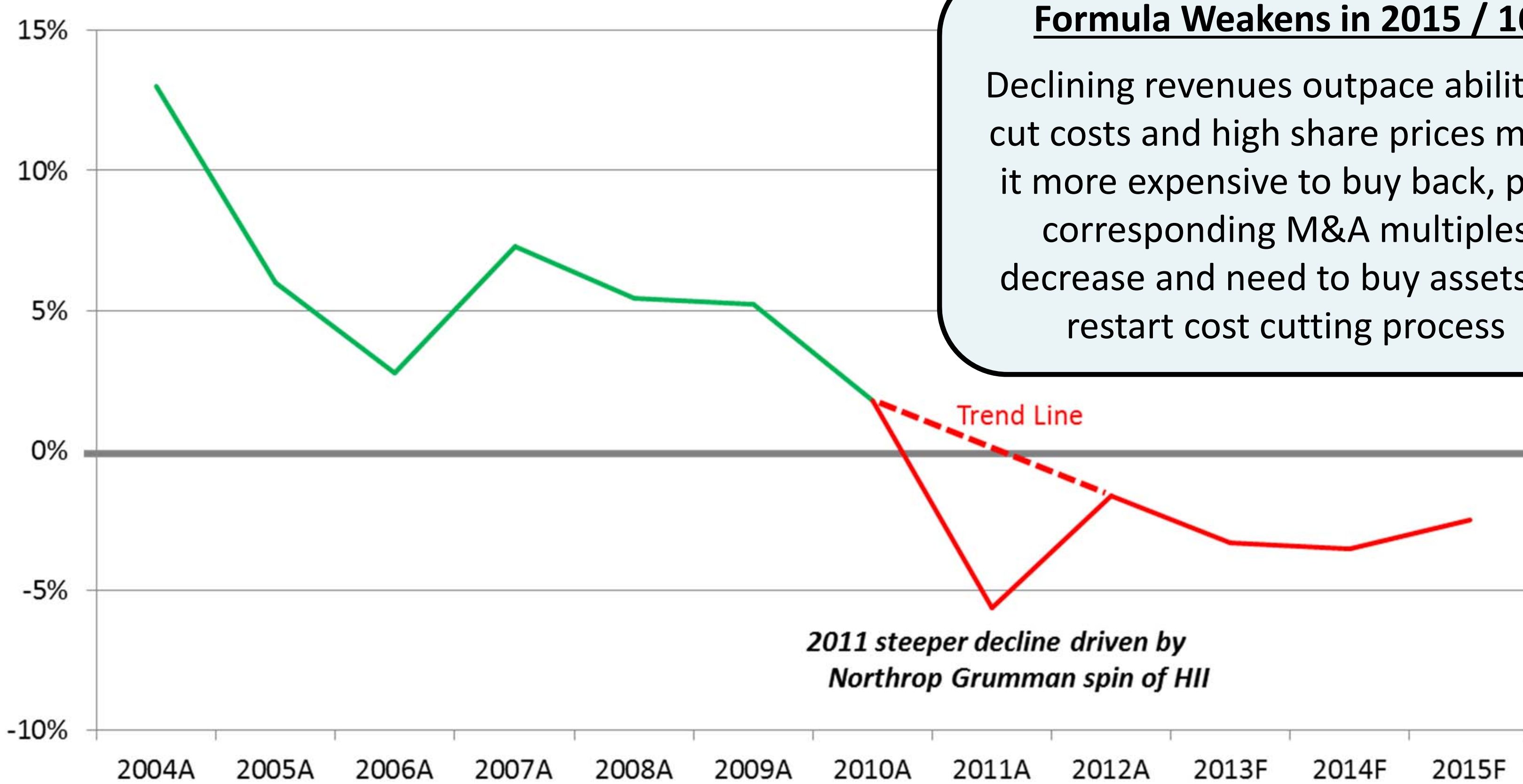
But this will likely change going forward

Average Annual Revenue Growth Rate for DoD Prime Contractors

2004-2015

Formula Weakens in 2015 / 16

Declining revenues outpace ability to cut costs and high share prices make it more expensive to buy back, plus corresponding M&A multiples decrease and need to buy assets to restart cost cutting process



Notes: Data set is a straight average of growth rates for NOC, LMT, RTN, GD
Sources: FactSet, RSAdvisors analysis

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We believe there will be an increase in deal activity over the next 24 months

- Deal activity is picking up as year progresses
- Most significant activity will be in 2015 and 2016
- However, different segments of industry move different times
  – System integrators / hardware contractors: late 2014, but mostly 2015
  – Services contractors: Repositioning since 2009, will accelerate
- We think there will be three waves of M&A over the medium term

2011 - 2014

Phase 1
(post-budget rollover)

Too much uncertainty for significant activity….

2015 - 2017

Phase 2
(emerging clarity)

Budget stability and tightening cash flows incent M&A activity, first mover advantage

2018 - 2021

Phase 3
(into next upcycle)

Activity continues but prices rise as good properties get scarce again and repositioning is complete

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Thoughts on Consolidation

This time, the motivations and effects of consolidation will be different

M&A Activity and Corporate Strategy

(2014 and Forward)

	Expected Future Strategy	Potential Future Steps
Defense Primes	• Acquire vertically into core hardware positions • Divest non-core services	• Actively shape the portfolio over next ~2-years
Defense Hardware Tier 1	• Acquire to create scale, 'own' segments of the value chain • Exit to private equity	• Accelerate M&A activity in 2014 and 2015 • Acquire non-core hardware businesses from prime system integrators, commercial aero companies
USG Service Pure Plays	• Acquire revenue and spread cost across a wider base • Shift business models	• Reduce indirect cost and operation burdens • Manage the portfolio and direct costs • Exit or fail
Commercial Aero Suppliers w/ Defense Portfolio	• Focus on commercial aero • Protect major defense program positions	• Potential divestiture of non-core defense offerings • Vertically integrate Tier 1- to component level providers
Commercial Conglomerates	• Manage market reentry sparked through acquisition • Continue to invest in products, IP that meet dual use demand	• Additional acquisitions of pure-play technology companies with industrial portfolio appeal

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The process of consolidation will be phased: services first, hardware / systems integrators later

- Services contractors already started
  - Didn't go through consolidation wave last downcycle, really just created
  - Huge capacity built up since 2001, fall ~20% off peak (~$50B goes "poof")
  - Smaller firms try to sell near "peak" and some larger ones cleaning house
  - However, now have an unsustainable number of mid-tier firms
  - Integrated prime contractors still retain embedded businesses that should be spun or divested

- Hardware and Systems Integrators reacting more slowly, but increasing
  - Longer term cash flow profile, still working off healthier funding
  - Waiting for more clarity on investment programs from DoD
  - Lots of discussions starting
  - Likely moves in tactical vehicles, defense electronics, weapons

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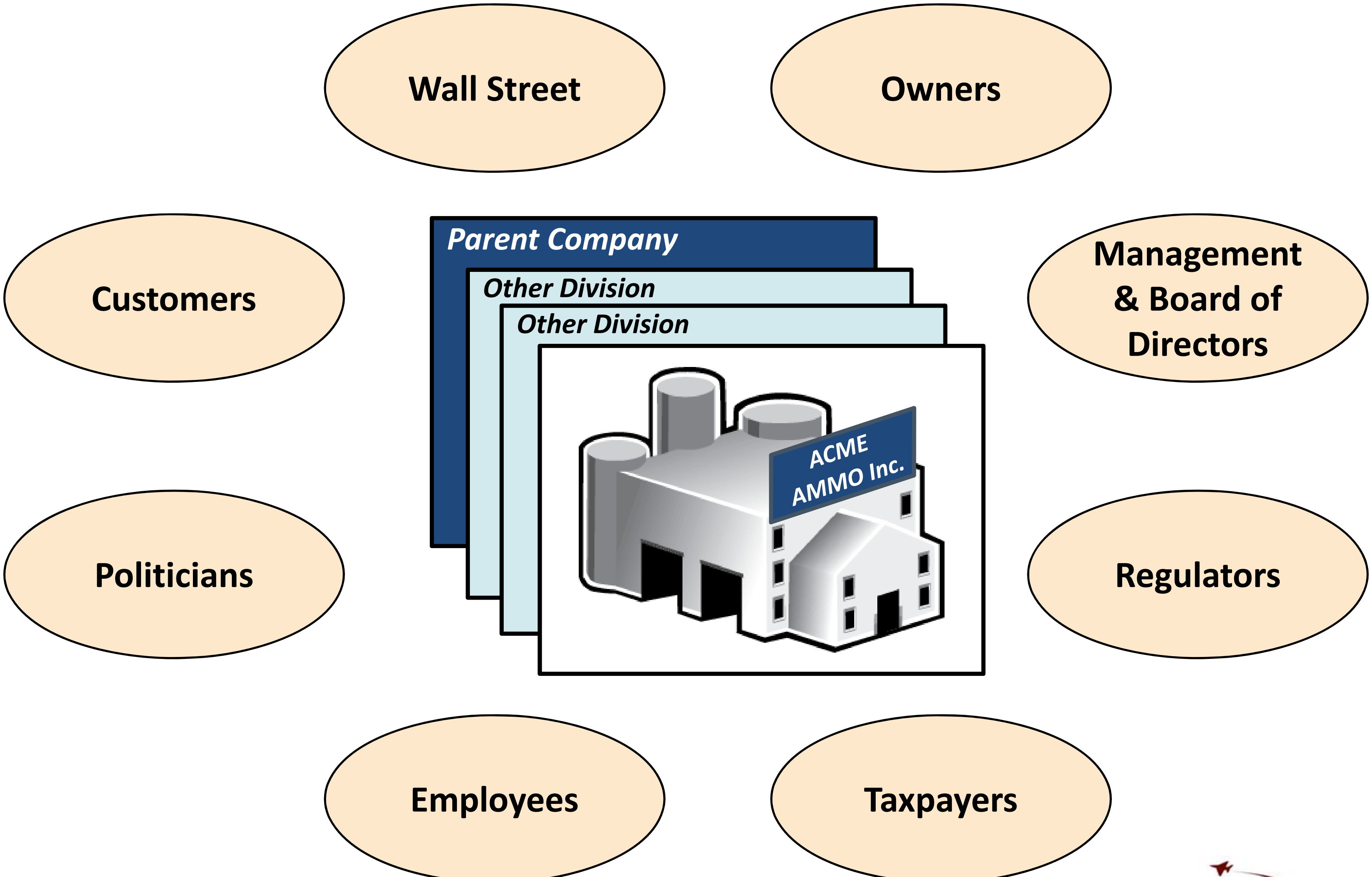
Defense industry stakeholders have different motivations and incentives in this process



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And customers are examining a range of approaches to secure what they need in today's budget environment

Approaches Available to Customers

LPTA	• Contracts personnel continue selecting lowest price (not value) proposals • Rising contract–operator disconnects	**Scaled IDIQ**	• Contract consolidation to gain economies of scale • Clearly demarcates protected business classes (e.g., 8a) from industry • Forces alignment to service offerings to avoid OCI
COTS	• Off-the-shelf solutions proving to work in austere mission environments • Decreases time to market • Reduces obsolescence, costs of ownership	**Differentiation**	• Customers seek affordable best-in-class products / services • Value seen in niche operators
Commercial Business Models	• Demand for turnkey products • Desire for scalable solutions with proven performance in other industries (e.g., COCO, capital leasing) • New incentive and contracting models (e.g., SaaS, Cloud, IaaS)	**Contract Performance**	• USG seeks to reduce program risk, more contracts are Fixed Price (FP) • Requirements on contracts still shift • Increasing contract performance issues – Letters of concern issued – More early re-competes

Sources: RSAdvisors analysis

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Thoughts on Consolidation

For certain offerings, DoD will increasingly take what commercial firms offer with minimal defense-specific customization

DoD Seeks

- Electronic Warfare
- Cyber Security
- Predictive Data Analytics
- Cloud/Virtualization
- Scalable Rich Data
- Multi-OSINT
- Additive Manufacturing
- Broadband Communications

Commercial Firms Provide

- **Commercial firms can justify**
  - Higher R&D expenditure than defense firms
  - Higher multiple M&A to justify these investments
  - Flexible business practices,
  - IP retention

DoD becomes a "lesser included case" for Commercial Firms

Source: TechAmerica, RSAdvisors Analysis

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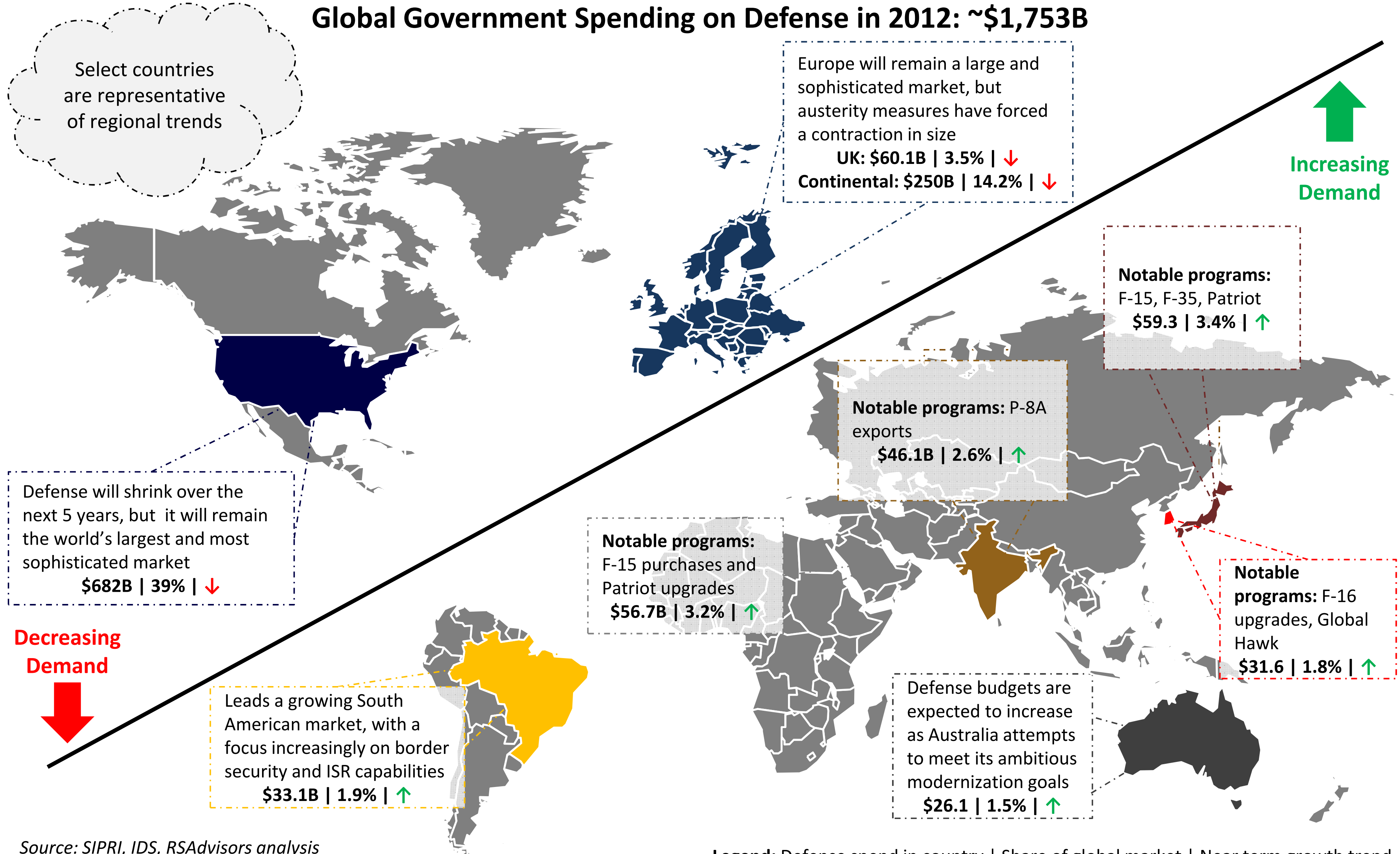
Thoughts on Consolidation

The globalization of the defense industrial base is a key difference between the last downturn and today

Global Government Spending on Defense in 2012: ~$1,753B



Source: SIPRI, IDS, RSAdvisors analysis

Legend: Defense spend in country | Share of global market | Near term growth trend

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Our Panel Will Discuss Ways these Different Factors Have Impacted and Could Shape the Defense Industrial Base

- ***Quarrelsome Committees in US Defense Acquisition: the KC-X Case***
  - Raymond (Chip) Franck, BG (Ret.) USAF, PhD., Professor Emeritus, US Air Force Academy

- ***Rethinking the Buy vs. Lease Decision***
  - Dr. Jacques Gansler, PhD., Vice President for Research, Professor and Roger C. Lipitz Chair in Public Policy and Private Enterprise, Director, Center for Public Policy and Private Enterprise, School of Public Policy, University of Maryland, College Park