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
Thoughts on Consolidation

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

Defense, Aerospace & Gov’t Services M&A per Year vs. DoD BA
(1990-2013) (Constant FY14 $B)

Value of Acquisitions ($B)

Value
DoD Budget

Peace Dividend
End of History
Post 9/11
Current Downturn

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)

<table>
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<tr>
<th>Strategy</th>
<th>Result</th>
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</table>
| 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 |
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
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, RSAAdvisors analysis
Thoughts on Consolidation

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

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<tbody>
<tr>
<td>Phase 1 (post-budget rollover)</td>
<td>Phase 2 (emerging clarity)</td>
<td>Phase 3 (into next upcycle)</td>
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<tr>
<td>Too much uncertainty for significant activity….</td>
<td>Budget stability and tightening cash flows incent M&amp;A activity, first mover advantage</td>
<td>Activity continues but prices rise as good properties get scarce again and repositioning is complete</td>
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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)

<table>
<thead>
<tr>
<th>Expected Future Strategy</th>
<th>Potential Future Steps</th>
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<tbody>
<tr>
<td><strong>Defense Primes</strong></td>
<td>• Actively shape the portfolio over next ~2-years</td>
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<tr>
<td>• Acquire vertically into core hardware positions</td>
<td>• Accelerate M&amp;A activity in 2014 and 2015</td>
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<tr>
<td>• Divest non-core services</td>
<td>• Acquire non-core hardware businesses from prime system integrators, commercial aero companies</td>
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<tr>
<td><strong>Defense Hardware Tier 1</strong></td>
<td>• Reduce indirect cost and operation burdens</td>
</tr>
<tr>
<td>• Acquire to create scale, ‘own’ segments of the value chain</td>
<td>• Manage the portfolio and direct costs</td>
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<tr>
<td>• Exit to private equity</td>
<td>• Exit or fail</td>
</tr>
<tr>
<td><strong>USG Service Pure Plays</strong></td>
<td>• Potential divestiture of non-core defense offerings</td>
</tr>
<tr>
<td>• Acquire revenue and spread cost across a wider base</td>
<td>• Vertically integrate Tier 1- to component level providers</td>
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<td>• Shift business models</td>
<td>• Additional acquisitions of pure-play technology companies with industrial portfolio appeal</td>
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<td><strong>Commercial Aero Suppliers w/ Defense Portfolio</strong></td>
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<tr>
<td>• Focus on commercial aero</td>
<td></td>
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<tr>
<td>• Protect major defense program positions</td>
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<tr>
<td><strong>Commercial Conglomerates</strong></td>
<td></td>
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<tr>
<td>• Manage market reentry sparked through acquisition</td>
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<td>• Continue to invest in products, IP that meet dual use demand</td>
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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
Defense industry stakeholders have different motivations and incentives in this process.
And customers are examining a range of approaches to secure what they need in today’s budget environment.

### Approaches Available to Customers

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

- **Europe** will remain a large and sophisticated market, but austerity measures have forced a contraction in size.
  - UK: $60.1B | 3.5% | ↓
  - Continental: $250B | 14.2% | ↓

- **Defense will shrink over the next 5 years, but it will remain the world’s largest and most sophisticated market.**
  - $682B | 39% | ↓

- **Decreasing Demand**

- **Leads a growing South American market, with a focus increasingly on border security and ISR capabilities.**
  - $33.1B | 1.9% | ↑

- **Notable programs:**
  - F-15 purchases and Patriot upgrades
  - $56.7B | 3.2% | ↑

- **Notable programs:**
  - F-16 upgrades, Global Hawk
  - $31.6B | 1.8% | ↑

- **Notable programs:**
  - P-8A exports
  - $46.1B | 2.6% | ↑

- **Defense budgets are expected to increase as Australia attempts to meet its ambitious modernization goals.**
  - $26.1B | 1.5% | ↑

Source: SIPRI, IDS, RSAadvisors analysis

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