

May 11th, 2011

Major Acquisition Issues

Naval Post Graduate School
8th Annual Acquisition Research Symposium
Monterey, CA



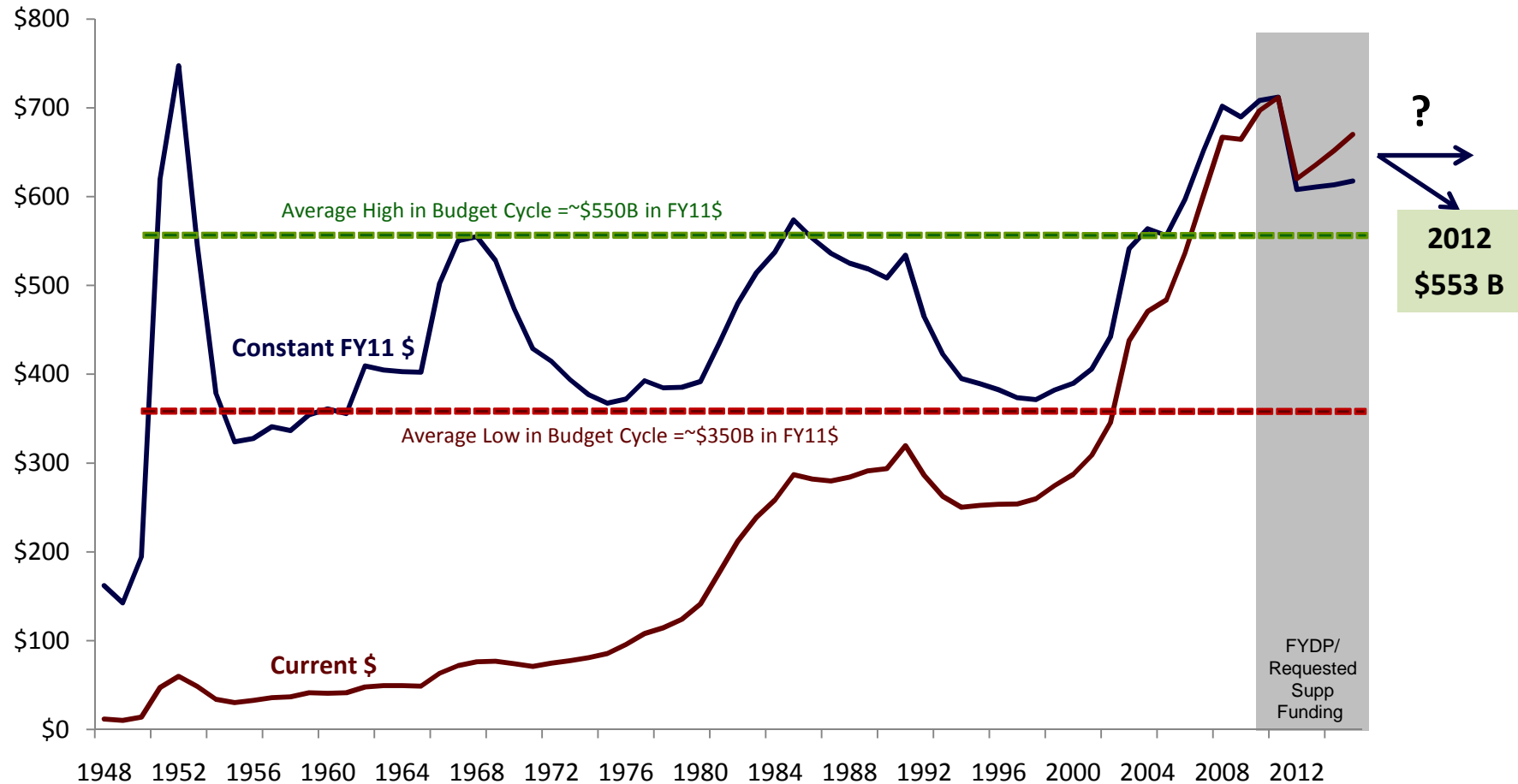
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The Context - where is the US defense budget headed?

Post-WWII, we have stayed within a \$350B-\$550B “bounded range”; current wars have us above the range and begs the question...are we in a new band?

Modern US Defense Spending, 1948-2015

Planned Budget Authority in Constant \$B Including Supplementals and FY11 FYDP (forecast excludes additional supplementals)

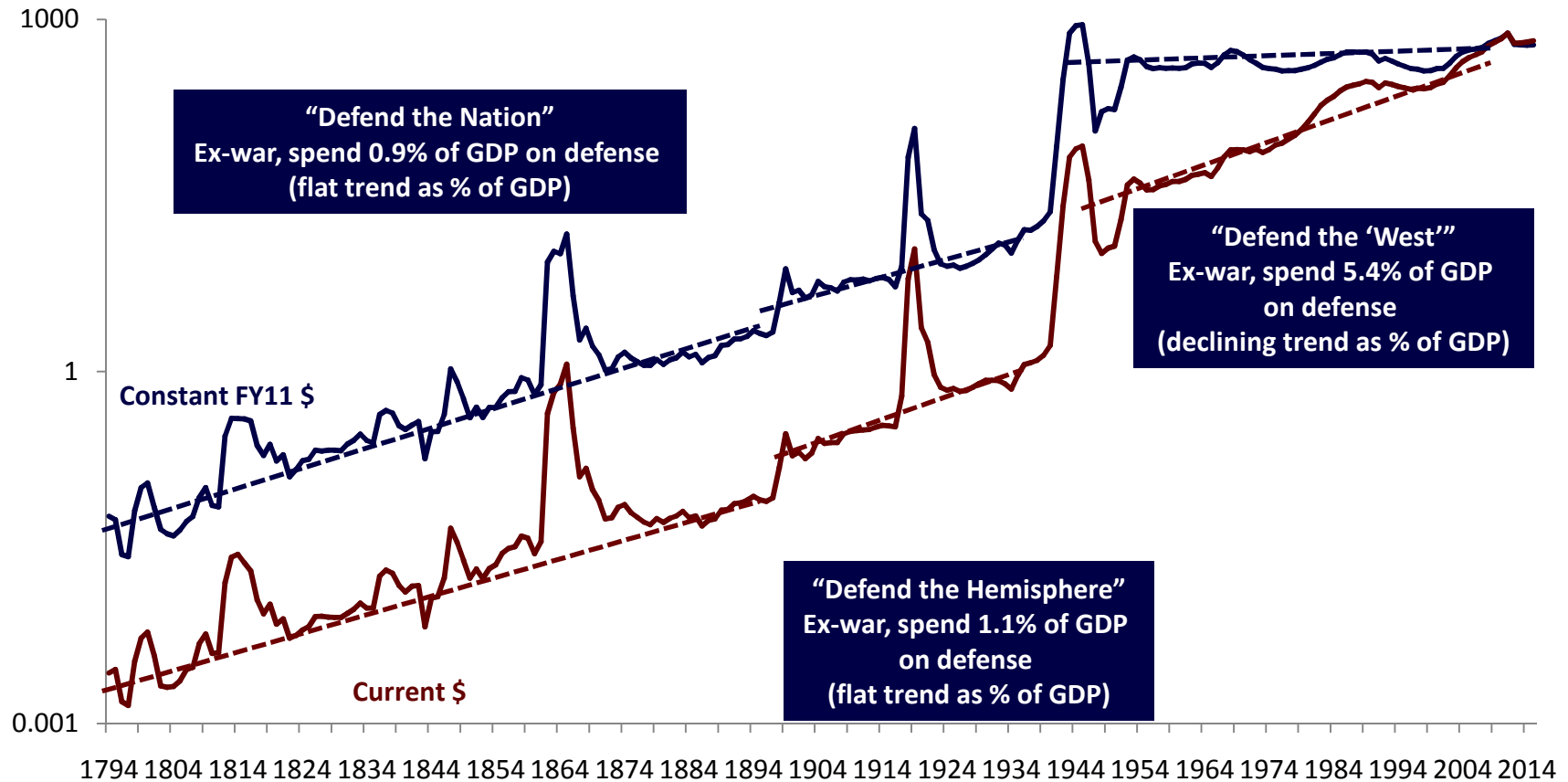


Source: US Department of Defense, RSAdvisors analysis

The Context - where is the US defense budget headed?

US defense spending has oscillated within three spending bands over US history

Historical US Defense Spending
Current and FY11 Constant \$ Defense Spending, 1794-2015

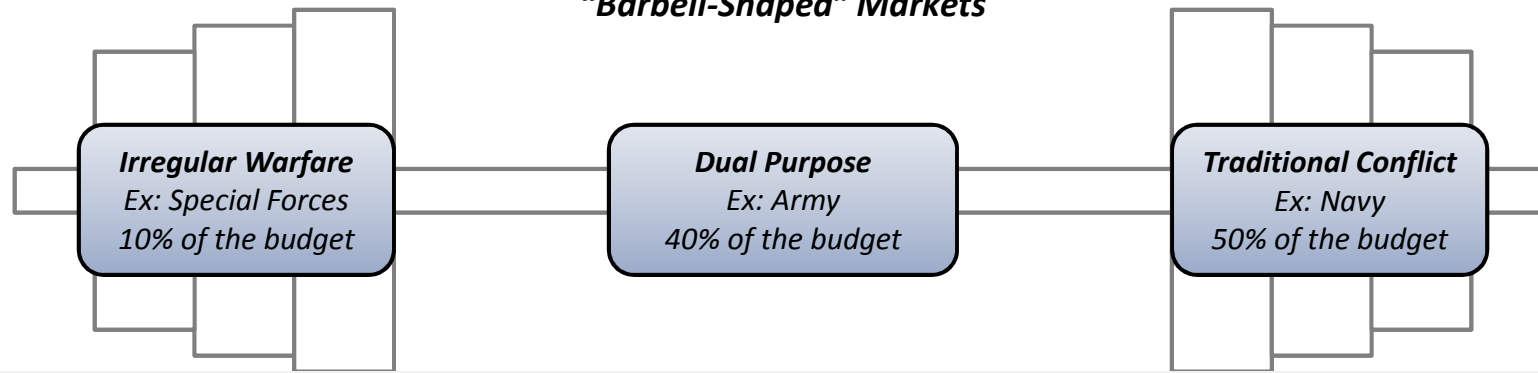


Source: US Department of Commerce, US Department of Defense, RSAdvisors analysis

**Irregular Warfare vs
Conventional Spending**

**And with US DoD facing a wide spectrum of threats, Pentagon continues to
balance competing needs**

"Barbell-Shaped" Markets



| | | |
|-----------------|---|---|
| | <u>The Long War</u> | <u>Deterrence</u> |
| Slice #1 | <i>Rapid acquisition, off-the-shelf/short development, quick response is key, COCOM centric</i> | <i>Very long cycle, tech. development, platform-oriented but limited production, services centric</i> |

| | | |
|-----------------|---|--|
| | <u>Reset/Retrofit</u> | <u>Transformation</u> |
| Slice #2 | <i>Install "black boxes" in existing equipment to plug into network, insert available technology, maintenance, repair</i> | <i>Desire for large, horizontal integrating networks, leverage the IT revolution, requires large scale systems integrators</i> |

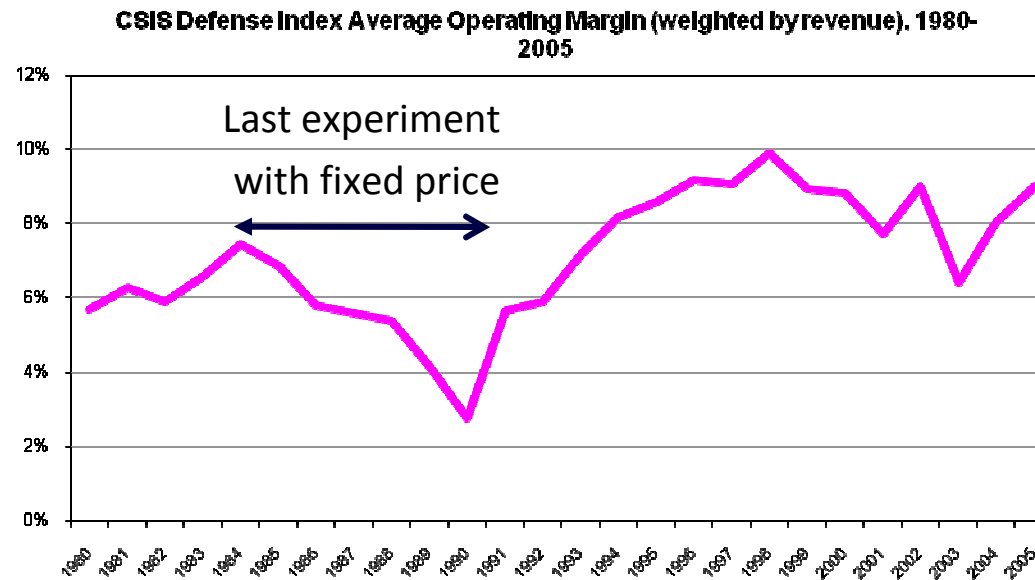
2012 GATES ANNOUNCEMENTS

- Cancel EFV
- Buy more Reaper
- Increase MC-12
- Increase Marine repair/refurb
- Fund current operations

- Accelerate Army tactical comms
- Modernize Stryker

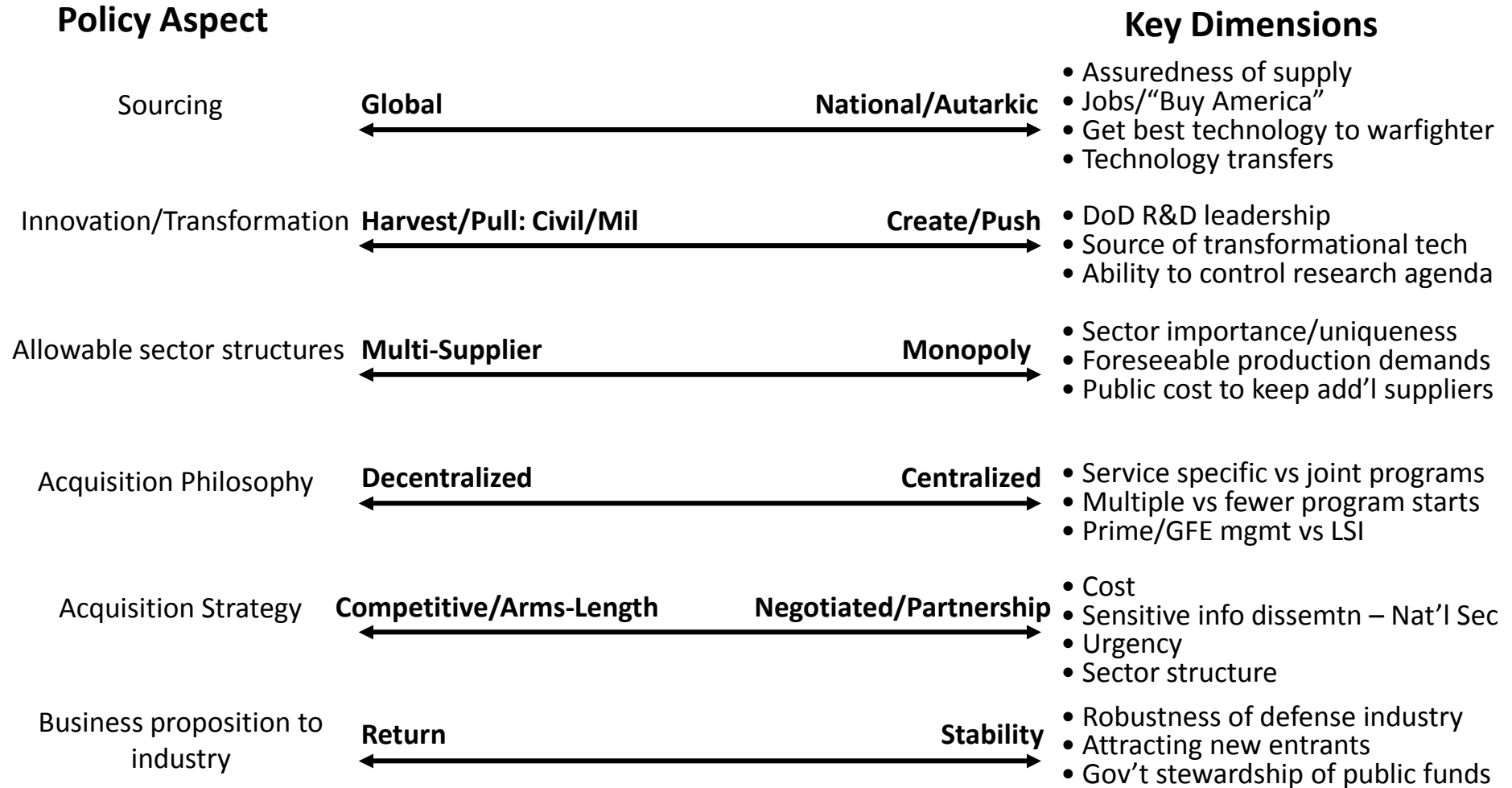
- Buy more EELV
- Develop Long Range Bomber
- Modernize Abrams, Bradleys
- Cut Army/Marines 47,000 in 2015
- Navy EW improvements
- Extra DDG-51, fleet oilers, etc.

- Evolving OCI policy...still being applied differently by various organizations
- Insourcing...appears to be slowing down, introduction of depot issue
- Export control reform ..."once more unto the breach"
- Fixed Price Development...disastrous last time, resisting return

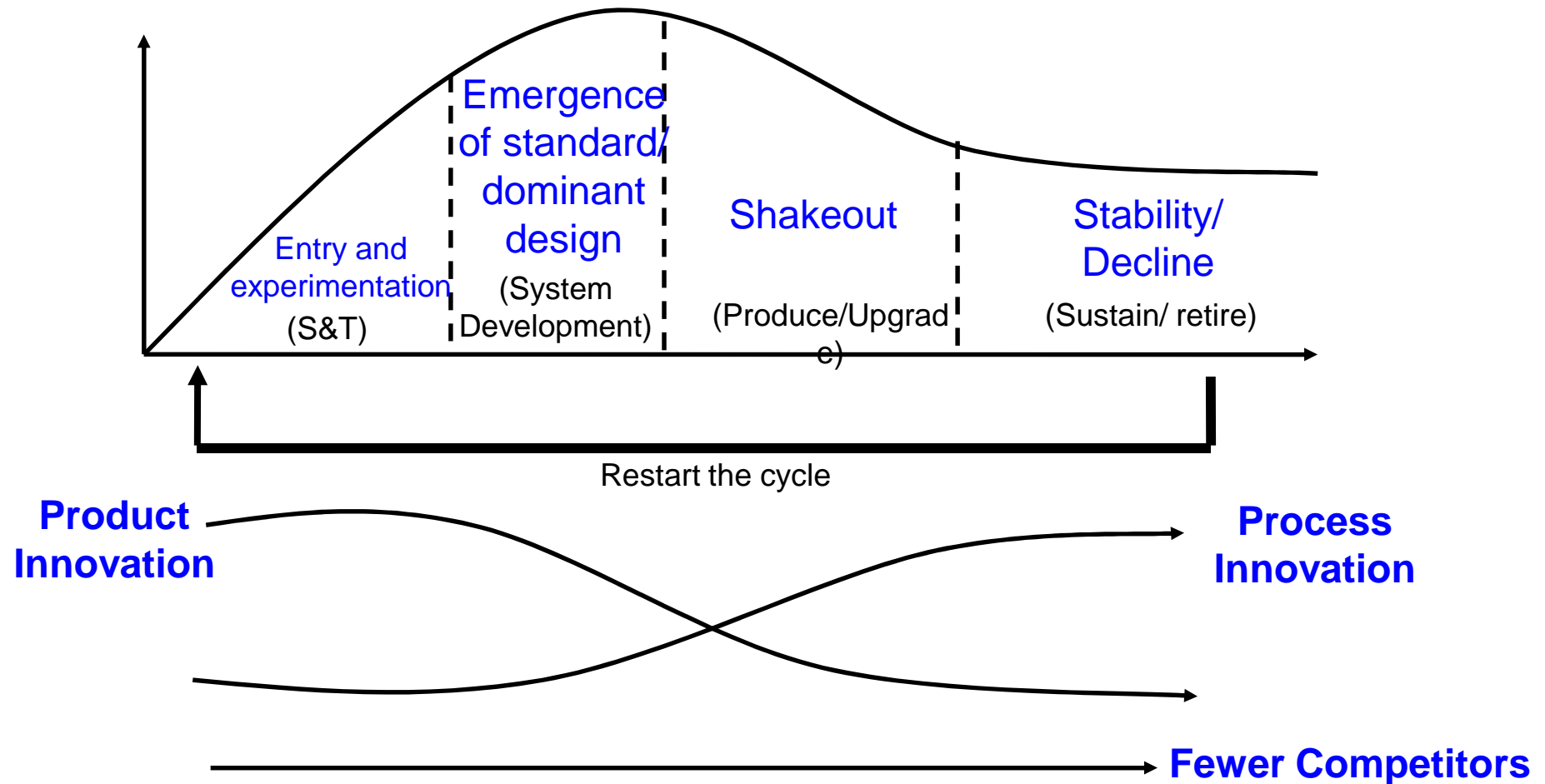


Sources: FactSet, Company Reports, CSIS Analysis.

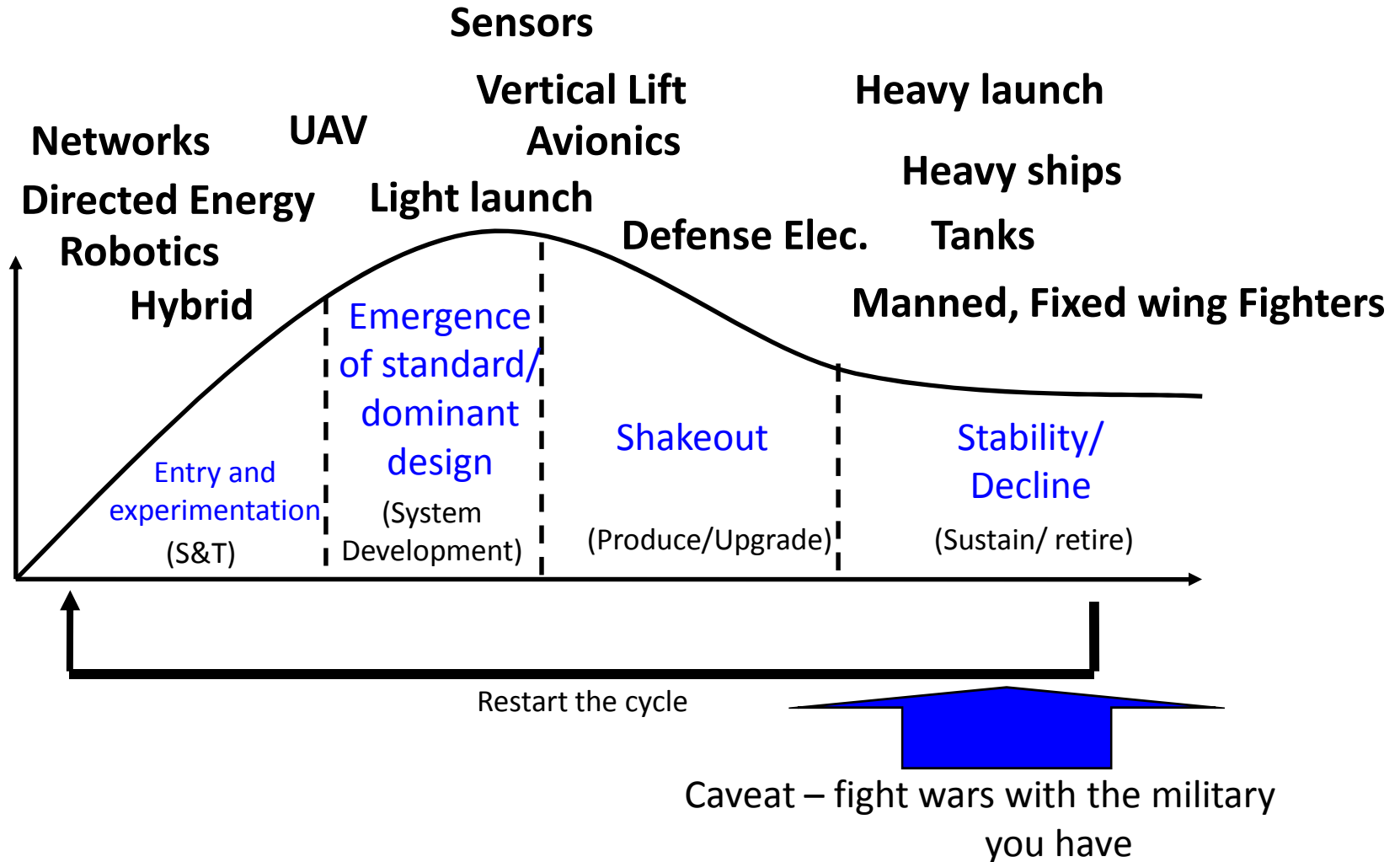
View #1: Defense-Industrial Policy Levers



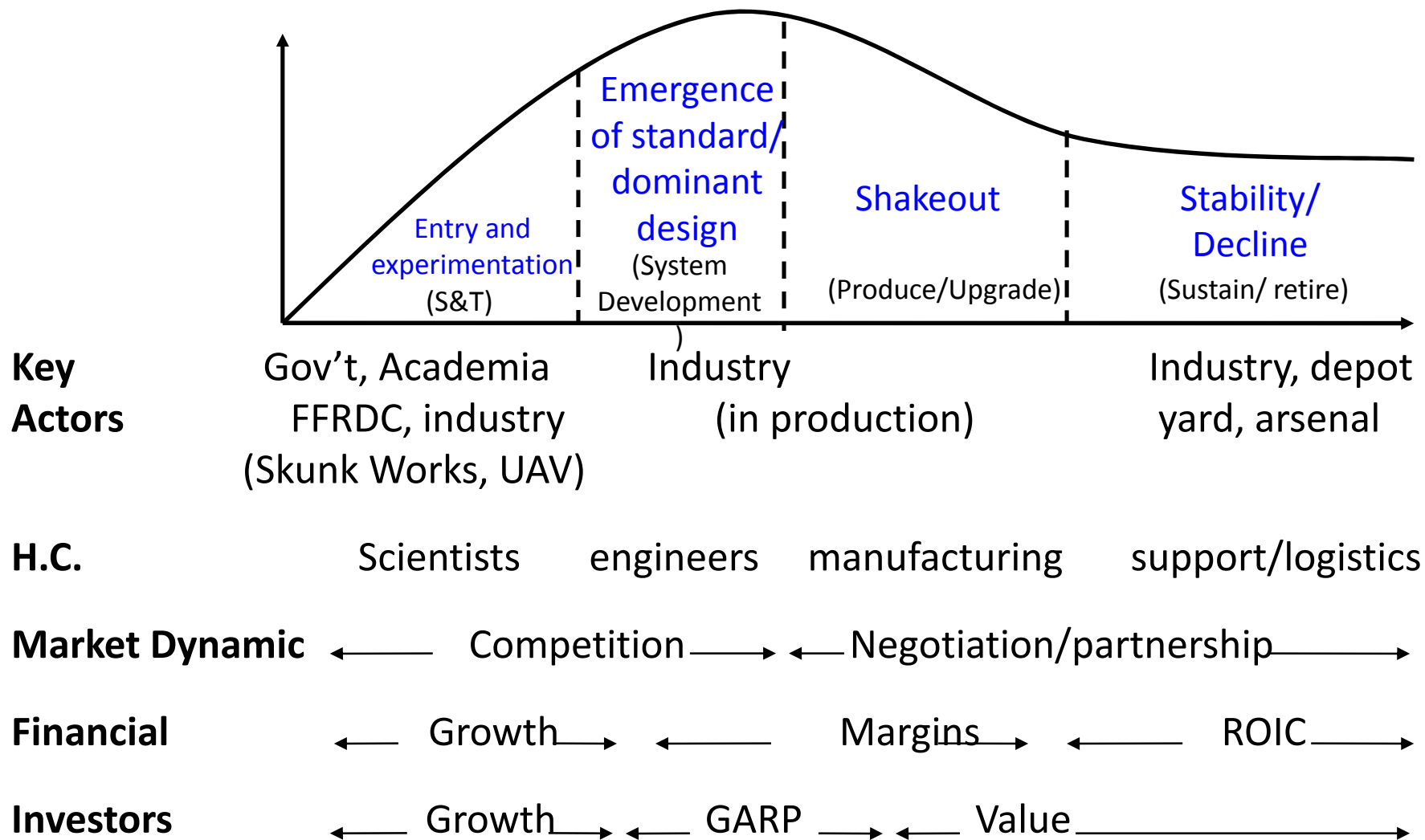
View #2: The Lifecycle of the Technology/Industry Sector...



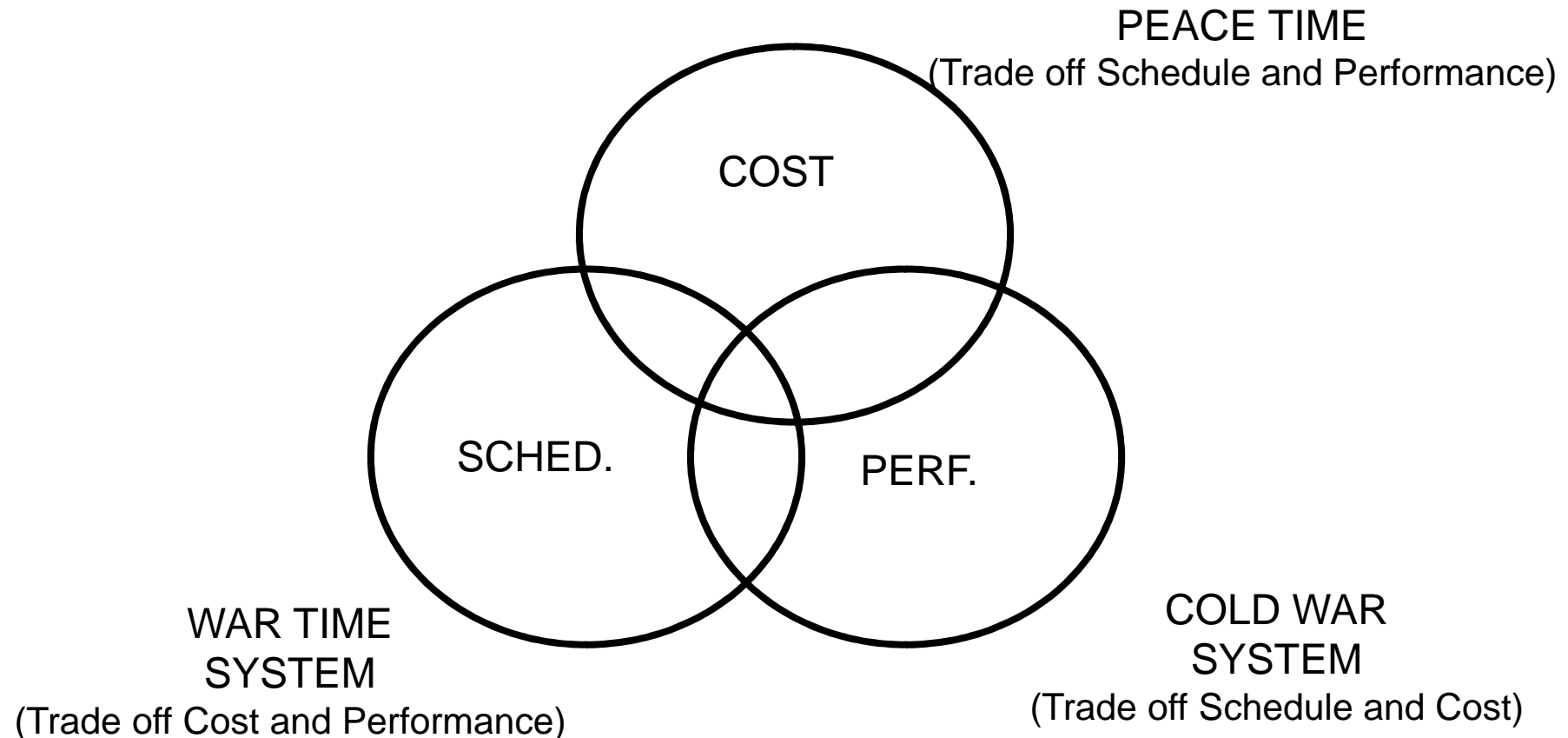
Where You Are in the Lifecycle...



Drives Solutions/Incentive Structures...



View #3: What Mode Are you In...



Current Problem – We are in Two Modes! Do you need Two Acquisition Systems?

The major aerospace/defense firms have extremely low net debt levels

- About \$5 billion of net debt according to company reports or about 2% of enterprise value

The industry now generating \$20+ billion of free cash flow

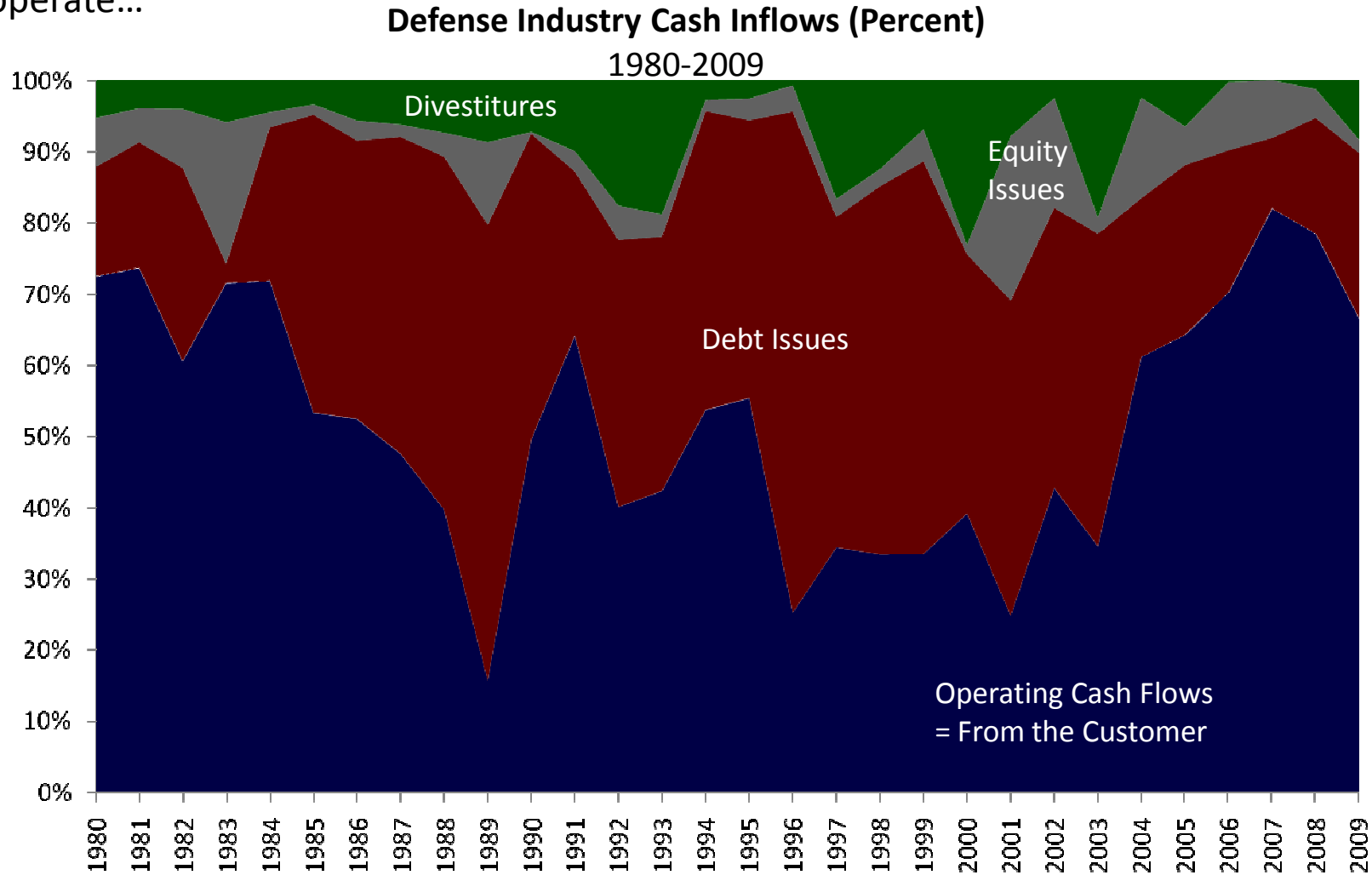
Potential use of the cash

- Reinvest in the business
- Find adjacent growth/diversification
- Acquisitions
- Share repurchases
- Dividends

Sources: CAPIQ, Company released information, RSAdvisors analysis

1. What does the industry do with its cash?

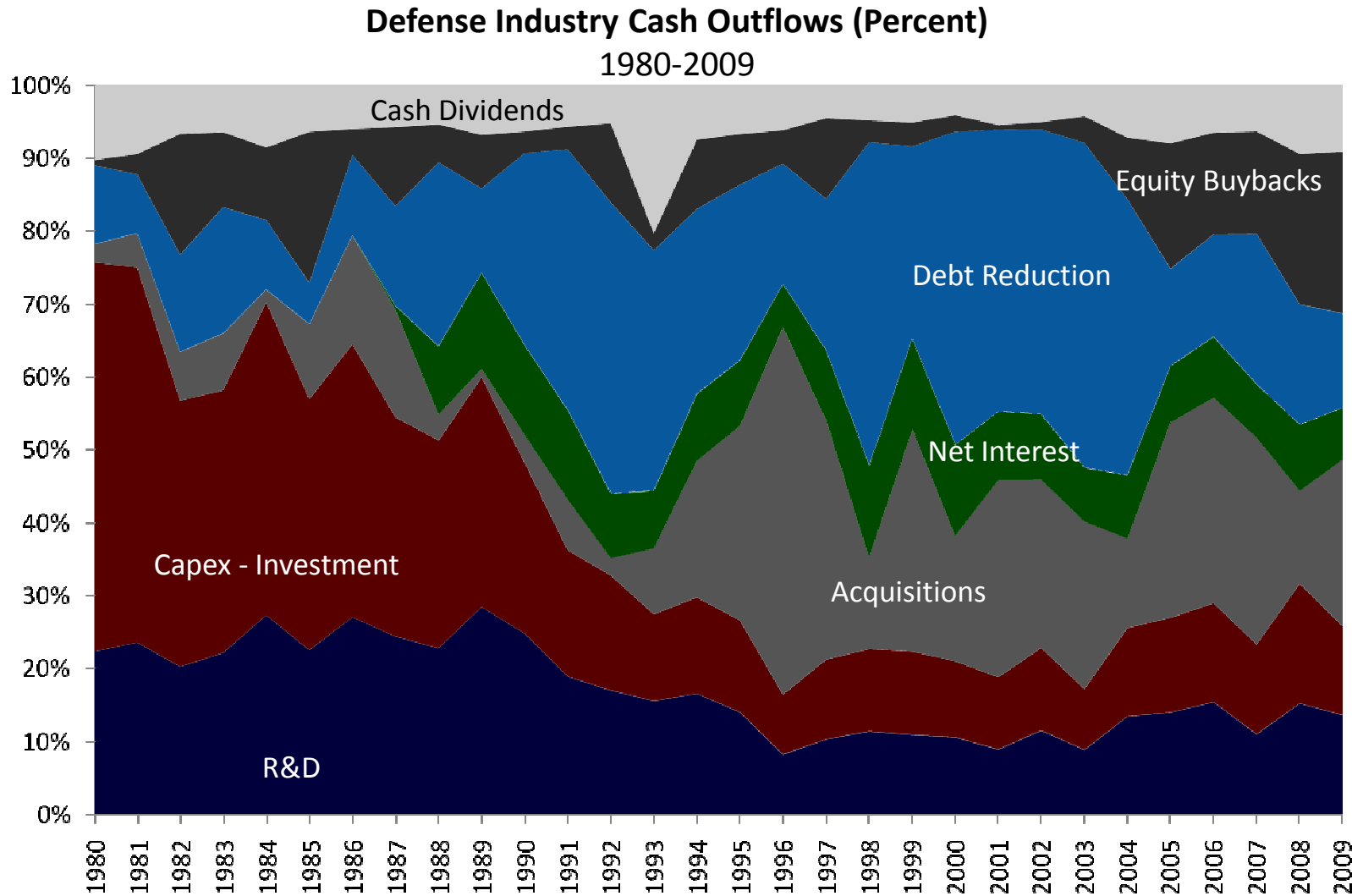
- In the last 30 years, financial markets have provided 40-80% of the capital needed to operate...



Sources: CapitalIQ, FactSet, company filings, RSA advisors analysis

1. What does the industry do with its cash?

- In the absence of clear demand signals, M&A has substitute for IR&D



Sources: CapitalIQ, FactSet, company filings, RSAdivisors analysis

- The last cycle says that there are advantages to doing something and being first

Strategies Adopted by the Top 20 Defense Firms, 1991-1994

| Strategy | Revenue Growth | Earnings Margin | P/E 1991 | P/E 1994 | EV/EBIT 1991 | EV/EBIT 1994 | Share Performance |
|----------------------------|----------------|-----------------|----------|----------|--------------|--------------|-------------------|
| M&A | 26% | 4.1% | 7.5x | 17.6x | 5.3x | 5.8x | 153% |
| Commercial Diversification | 1% | 4.2% | 9.4x | 14.2x | 4.5x | 5.8x | 55% |
| Ride the Wave | -8% | 1.4% | 13.9x | 16.4x | 5.1x | 5.6x | 88% |

Strategies Adopted by the Top 20 Defense Firms, 1994-1999

| Strategy | Revenue Growth | Earnings Margin | P/E 1994 | P/E 1999 | EV/EBIT 1994 | EV/EBIT 1999 | Share Performance |
|----------|----------------|-----------------|----------|----------|--------------|--------------|-------------------|
| M&A | 56% | 4.5% | 18.4x | 18.2x | 5.5x | 7.7x | 88% |

Source: RSAdvisors analysis

Key M&A Trends for the Aerospace & Defense Industry

| Trend | Reason | Evidence |
|---|---|--|
| Moving towards an area of strategic divestitures | Big properties are becoming available | <ul style="list-style-type: none"> - Lockheed Martin divests PAE - Northrop Grumman spins its ship business - Argon ST was sold to Boeing |
| Divest business units with OCI issues | Respond to changing government policy | <ul style="list-style-type: none"> - Northrop Grumman divests TASC - Lockheed Martin divests EIG - ITT divests CAS |
| Supply chain restructuring | Program performance is slipping and costs are rising | Boeing acquires the Vought 787 factory and JV with Alenia to bring the project under tighter management and potentially reduce costs |
| Full life cycle support | The aftermarket represents a longer, more stable revenue stream | General Dynamics acquires Jet Aviation (general aviation maintenance, completions, engineering, fixed base operations, & aircraft management) for \$2.3B |
| MOOTW – military operations other than war (“soft power”) | Shift in focus due to Iraq/Afghanistan and new administration | L3 acquires International Resources Group, a support provider of energy, environment and natural resource management, relief and reconstruction, and economic development |
| Foreign investors seeking access to DoD and US commercial market | US budget still the only real game in town | Finmecannica acquires DRS (a supplier of integrated defense electronics products, services and support) for \$5.1B |
| Financial sponsors are making some moves | Valuations getting attractive, | Financial sponsors executed 13% of transaction in 2008 over \$50M, 11% in 2009, 16% in 2010, 17.6% in 1Q11 according to PWC |

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