Strategic Challenges and Opportunities Facing the Defense Industry

New York, NY
6 Questions for the Defense Industry

1. What does the industry do with its cash?
2. What strategies were adopted during the last inflection point?
3. Is M&A a viable strategy?
4. How important will the internationals defense markets be as a source of future growth?
5. What if everyone is wrong and there is no downturn?
6. What are current valuations telling us?
### 1. What does the industry do with its cash?

<table>
<thead>
<tr>
<th>Company</th>
<th>Cash and Equivalents ($M)*</th>
</tr>
</thead>
<tbody>
<tr>
<td>Boeing</td>
<td>$9,215</td>
</tr>
<tr>
<td>BAE</td>
<td>$5,966</td>
</tr>
<tr>
<td>United Technologies</td>
<td>$4,449</td>
</tr>
<tr>
<td>Finmeccanica</td>
<td>$3,769</td>
</tr>
<tr>
<td>Northrop Grumman</td>
<td>$3,275</td>
</tr>
<tr>
<td>Raytheon</td>
<td>$2,642</td>
</tr>
<tr>
<td>Lockheed Martin</td>
<td>$2,391</td>
</tr>
<tr>
<td>General Dynamics</td>
<td>$2,263</td>
</tr>
<tr>
<td>ITT</td>
<td>$1,216</td>
</tr>
<tr>
<td>L-3</td>
<td>$1,016</td>
</tr>
<tr>
<td>SAIC</td>
<td>$936</td>
</tr>
<tr>
<td>Harris</td>
<td>$281</td>
</tr>
<tr>
<td>CACI</td>
<td>$208</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>$38,568</strong></td>
</tr>
</tbody>
</table>

*Note: All numbers from 2009 Annual Reports
Sources: CAPIQ, RSAdvisors analysis*
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...

**Defense Industry Cash Inflows (Percent) 1980-2009**

- Divestitures
- Equity Issues
- Debt Issues
- Operating Cash Flows = From the Customer

Sources: CapitalIQ, FactSet, company filings, RSAdvisors analysis
1. What does the industry do with its cash?

Defense Industry Cash Outflows (Percent)
1980-2009

- Cash Dividends
- Equity Buybacks
- Debt Reduction
- Net Interest
- Acquisitions
- Capex - Investment
- R&D

Sources: CapitalIQ, FactSet, company filings, RSAdvisors analysis
2. What strategies were adopted during the last inflection point?

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

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

<table>
<thead>
<tr>
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</tr>
</thead>
<tbody>
<tr>
<td>M&amp;A</td>
<td>26%</td>
<td>4.1%</td>
<td>7.5x</td>
<td>17.6x</td>
<td>5.3x</td>
<td>5.8x</td>
<td>153%</td>
</tr>
<tr>
<td>Commercial Diversification</td>
<td>1%</td>
<td>4.2%</td>
<td>9.4x</td>
<td>14.2x</td>
<td>4.5x</td>
<td>5.8x</td>
<td>55%</td>
</tr>
<tr>
<td>Ride the Wave</td>
<td>-8%</td>
<td>1.4%</td>
<td>13.9x</td>
<td>16.4x</td>
<td>5.1x</td>
<td>5.6x</td>
<td>88%</td>
</tr>
</tbody>
</table>

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

<table>
<thead>
<tr>
<th></th>
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<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>M&amp;A</td>
<td>56%</td>
<td>4.5%</td>
<td>18.4x</td>
<td>18.2x</td>
<td>5.5x</td>
<td>7.7x</td>
<td>88%</td>
</tr>
</tbody>
</table>

Source: RSAdvisors analysis
2. What strategies were adopted during the last inflection point?

Strategies for a Downturn

- Cyber Networks
- Directed Energy
- Robotics
- Hybrid
- Entry and experimentation (S&T)

- Sensors
  - Vertical lift avionics
  - UAV

- Light Launch
- Defense electronics

- Heavy launch
  - Heavy ships
  - Tanks
  - Manned, fixed wing fighters

- Shakeout
  - (Produce/Upgrade)

- Stability / Decline
  - (Sustain/retire)

Restart the cycle

Source: RSAdvisors analysis

Caveat

Fight wars with the military you have

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3. Is M&A a viable strategy?

- Of the 42 transactions proposed in 2009, the Pentagon only objected to 2 of them and one was asked to be moved to a “Merchant Supply Agreement”

<table>
<thead>
<tr>
<th>Acquirer</th>
<th>Target</th>
<th>Value ($M)</th>
<th>Pentagon’s Position</th>
<th>Product Area</th>
</tr>
</thead>
<tbody>
<tr>
<td>Atlantic Marine Holdings</td>
<td>Boston Ship Acquisition</td>
<td>N/A</td>
<td>Object, but insufficient case for Antitrust Agencies to intervene</td>
<td>Military Sealift Command Ship Repair</td>
</tr>
<tr>
<td>Microsemi</td>
<td>Semicoa</td>
<td>$25</td>
<td>Objected. Supported Divestiture</td>
<td>Space-Qualified Transistors &amp; Diodes</td>
</tr>
<tr>
<td>L-3</td>
<td>Chesapeake Sciences</td>
<td>N/A</td>
<td>Merchant Supply Agreement</td>
<td>Undersea Warfare Sensors</td>
</tr>
</tbody>
</table>

- No “Last Supper” or broad policy statement yet
- Undertaking sector by sector reviews to assess health of particular industrial bases, and to identify policy positions regarding competition, M&A, etc.

Sources: US Department of Defense, RSAdvisors analysis
## 3. Is M&A a viable strategy?

**Key M&A Trends for the Aerospace & Defense Industry**

<table>
<thead>
<tr>
<th>Trend</th>
<th>Reason</th>
<th>Evidence</th>
</tr>
</thead>
<tbody>
<tr>
<td>Moving towards an area of strategic divestures</td>
<td>Big properties are becoming available</td>
<td>- Northrop is looking to sell its ship business</td>
</tr>
<tr>
<td></td>
<td></td>
<td>- Lockheed’s services business is for sale</td>
</tr>
<tr>
<td></td>
<td></td>
<td>- BAE is selling its Platforms Solutions business</td>
</tr>
<tr>
<td></td>
<td></td>
<td>- Argon ST was sold to Boeing</td>
</tr>
<tr>
<td></td>
<td></td>
<td>- Northrop sold its service business (TASC)</td>
</tr>
<tr>
<td>Supply chain restructuring</td>
<td>Program performance is slipping and costs are rising</td>
<td>Boeing acquires the Vought 787 factory and JV with Alenia to bring the project under tighter management and potentially reduce costs</td>
</tr>
<tr>
<td>Full life cycle support</td>
<td>The aftermarket represents a longer, more stable revenue stream</td>
<td>General Dynamics acquires Jet Aviation (general aviation maintenance, completions, engineering, fixed base operations, &amp; aircraft management) for $2.3B</td>
</tr>
<tr>
<td>MOOTW – military operations other than war (“soft power”)</td>
<td>Shift in focus due to Iraq/Afghanistan and new administration</td>
<td>L3 acquires International Resources Group, a support provider of energy, environment and natural resource management, relief and reconstruction, and economic development</td>
</tr>
<tr>
<td>Foreign investors seeking access to DoD and US commercial market</td>
<td>US budget still the only real game in town</td>
<td>Finmeccanica acquires DRS (a supplier of integrated defense electronics products, services and support) for $5.1B</td>
</tr>
<tr>
<td>Financial sponsors are making some moves</td>
<td>Increased willingness to lend in addition to senior management looking to potentially divest assets</td>
<td>Financial sponsors executed 13% of transaction in 2008 over $50M, 11% in 2009, and 20% in the first half of 2010, according to PWC</td>
</tr>
</tbody>
</table>

Sources: CAPIQ, Industry news, PWC, RSAdvisors analysis
3. Is M&A a viable strategy?

Since 2009 Defense deals have been happening at high multiples with a particular emphasis on Cyber deals:

- Cyber: 10.8x
- C4ISR: 9.6x
- Other Defense: 7.2x

Source: PWC, KippsDeSanto & Co, RSAdvisors analysis
3. Is M&A a viable strategy?

- There is a clear premium being placed on scale businesses...

**Disclosed Aerospace & Defense Mergers & Acquisitions**
2008 vs. 2009 vs. up to 1st Half 2010

**Median Deal Value / EBITDA Over $50M***

*Note: Only includes Q12010
Sources: CAPIQ, PWC, RSAdvisors analysis
3. Is M&A a viable strategy?

- Private Equity firms have shown a growing interest in the defense market over the past few years

### Private Equity Investment Strategies

- **Seek out well managed companies in out-of-favor sectors**
  - Carlyle’s early model
  - Limited play as “low-hanging fruit” is gone and the rise in popularity of defense investing

- **Assemble large firms through the acquisition and integration of multiple firms**
  - Popular over the last 5-years, but large firms that can be integrated are limited
  - E.g. Anteon, Overwatch Systems

- **Assemble niche firms through the acquisition and integration of multiple firms in same market/tech space**
  - Growing interest in niche tech markets and service markets (e.g. Intel/Black)
  - PE behaving more like traditional firms with a “synergy and fit” model vice “buy-hold-sell”
4. How important will the international defense markets be as a source of future growth?

- Although small in $$ terms, there are many markets showing positive growth over the next 5 years.
5. What if everyone is wrong and there is no downturn?

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

### Historical US Defense Spending

Current and FY11 Constant $B Defense Spending, 1794-2015

- **“Defend the Nation”**
  - Ex-war, spend 0.9% of GDP on defense
  - Flat trend as % of GDP

- **“Defend the Hemisphere”**
  - Ex-war, spend 1.1% of GDP on defense
  - Flat trend as % of GDP

- **“Defend the ‘West’”**
  - Ex-war, spend 5.4% of GDP on defense
  - Declining trend as % of GDP

Sources: US Department of Commerce, US Department of Defense, RSAdvisors analysis
5. What if everyone is wrong and there is no downturn?

...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?


Planned Budget Authority in Constant $B Including Supplementals and FY11 FYDP (does not forecast additional supplementals)

Sources: US Department of Defense, RSAdvisors analysis
5. What if everyone is wrong and there is no downturn?

- And with US DoD facing a wide spectrum of threats, from the fight of today to future, near-peer adversaries, how do you organize to address it?

**“Barbell-Shaped” Markets**

- **Irregular Warfare**
  - Ex: Special Forces
  - 10% of the budget

- **Dual Purpose**
  - Ex: Army
  - 40% of the budget

- **Traditional Conflict**
  - Ex: Navy
  - 50% of the budget

**Slice #1**

**The Long War**
- Rapid acquisition, off-the-shelf/short development, quick response is key, COCOM centric

**Deterrence**
- Very long cycle, tech. development, platform-oriented but limited production, services centric

**Slice #2**

**Reset/Retrofit**
- Install “black boxes” in existing equipment to plug into network, maintenance, repair

**Transformation**
- Desire for large, horizontal integrating networks, leverage the IT revolution

**Slice #3**

**Operational and Policy Support Oriented Services**
- Logistics, operations, and intelligence support

**High-skilled Services**
- Technically skilled services

*Is it one or two industrial bases? Can they be the same suppliers? How does DoD organize?*

Sources: US Department of Defense, RSAdvisors analysis
6. **What are current valuations telling us?**

- The industry is trading in lockstep, public markets not differentiating...

### Primes

<table>
<thead>
<tr>
<th></th>
<th>TEV/LTM EBITDA</th>
<th>TEV/NTM EBITDA</th>
<th>P/LTM EPS</th>
<th>P/NTM EPS</th>
</tr>
</thead>
<tbody>
<tr>
<td>BAE</td>
<td>3.92x</td>
<td>4.85x</td>
<td>8.76x</td>
<td>8.42x</td>
</tr>
<tr>
<td>GD</td>
<td>6.31x</td>
<td>6.62x</td>
<td>11.81x</td>
<td>11.25x</td>
</tr>
<tr>
<td>LMT</td>
<td>5.27x</td>
<td>5.27x</td>
<td>10.73x</td>
<td>9.65x</td>
</tr>
<tr>
<td>NOC</td>
<td>5.67x</td>
<td>6.18x</td>
<td>12.07x</td>
<td>12.66x</td>
</tr>
<tr>
<td>RTN</td>
<td>6.08x</td>
<td>5.22x</td>
<td>11.96x</td>
<td>9.96x</td>
</tr>
<tr>
<td><strong>AVG</strong></td>
<td><strong>5.45x</strong></td>
<td><strong>5.63x</strong></td>
<td><strong>11.07x</strong></td>
<td><strong>10.39x</strong></td>
</tr>
</tbody>
</table>

| Boeing* | 7.78x | 7.52x | 16.66x | 15.75x |

### Professional Services

<table>
<thead>
<tr>
<th></th>
<th>TEV/LTM EBITDA</th>
<th>TEV/NTM EBITDA</th>
<th>P/LTM EPS</th>
<th>P/NTM EPS</th>
</tr>
</thead>
<tbody>
<tr>
<td>CACI</td>
<td>7.33x</td>
<td>7.51x</td>
<td>14.46x</td>
<td>15.00x</td>
</tr>
<tr>
<td>CGI Group</td>
<td>6.05x</td>
<td>6.52x</td>
<td>14.14x</td>
<td>15.61x</td>
</tr>
<tr>
<td>ManTech</td>
<td>6.79x</td>
<td>7.89x</td>
<td>12.39x</td>
<td>13.39x</td>
</tr>
<tr>
<td>SAIC</td>
<td>6.35x</td>
<td>6.53x</td>
<td>11.54x</td>
<td>12.69x</td>
</tr>
<tr>
<td>SRA</td>
<td>7.39x</td>
<td>7.62x</td>
<td>15.82x</td>
<td>16.72x</td>
</tr>
<tr>
<td>CSC</td>
<td>3.83x</td>
<td>3.83x</td>
<td>11.70x</td>
<td>9.91x</td>
</tr>
<tr>
<td><strong>AVG</strong></td>
<td><strong>6.69x</strong></td>
<td><strong>7.19x</strong></td>
<td><strong>14.20x</strong></td>
<td><strong>14.84x</strong></td>
</tr>
</tbody>
</table>

**Note:** * Boeing not included in averages, numbers as of 11/5/2010 market close  
Sources: CAPIQ, RSAdvisors analysis
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