

May 11th, 2011

Major Acquisition Issues

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



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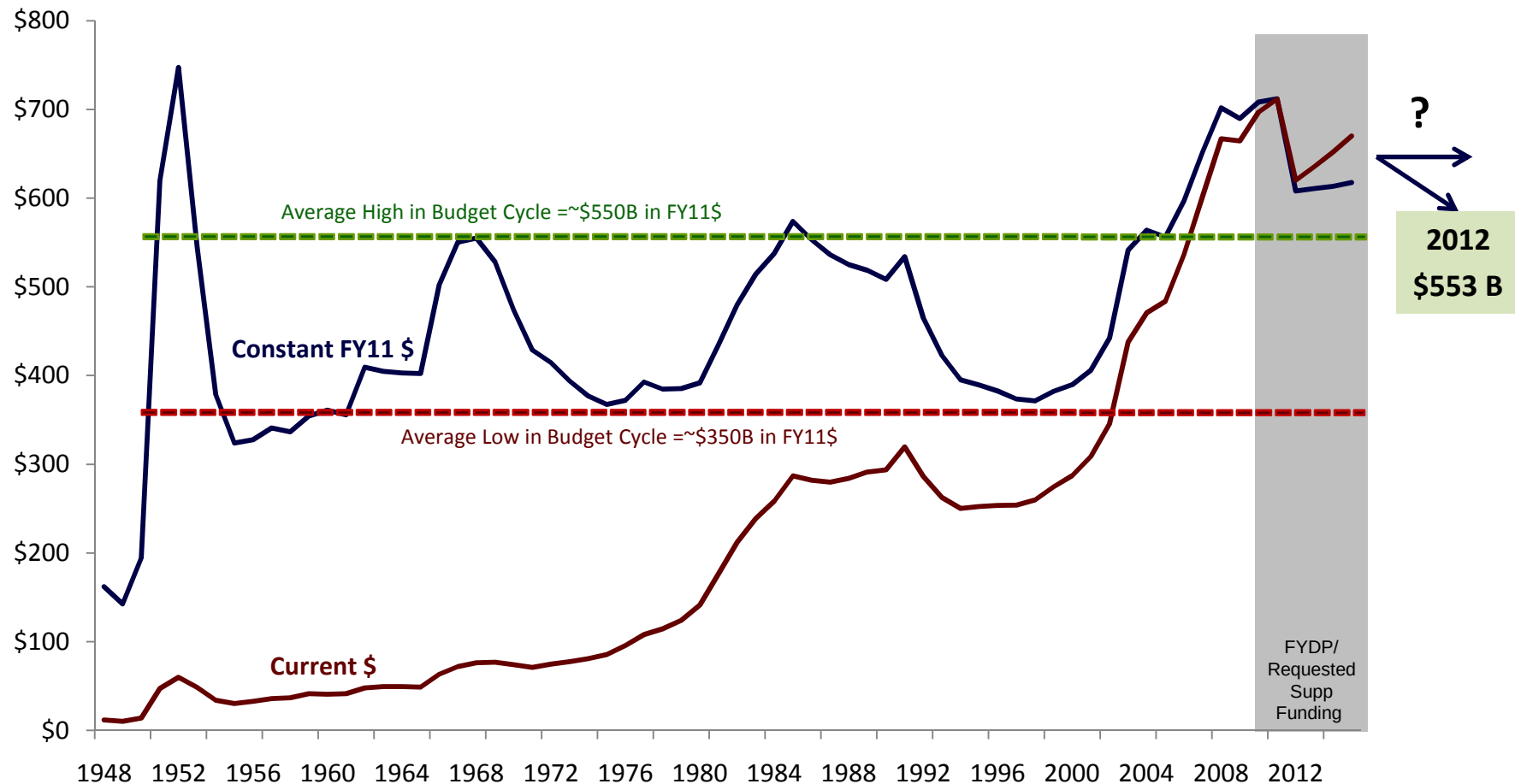
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The Context - where is the US defense budget headed?

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)



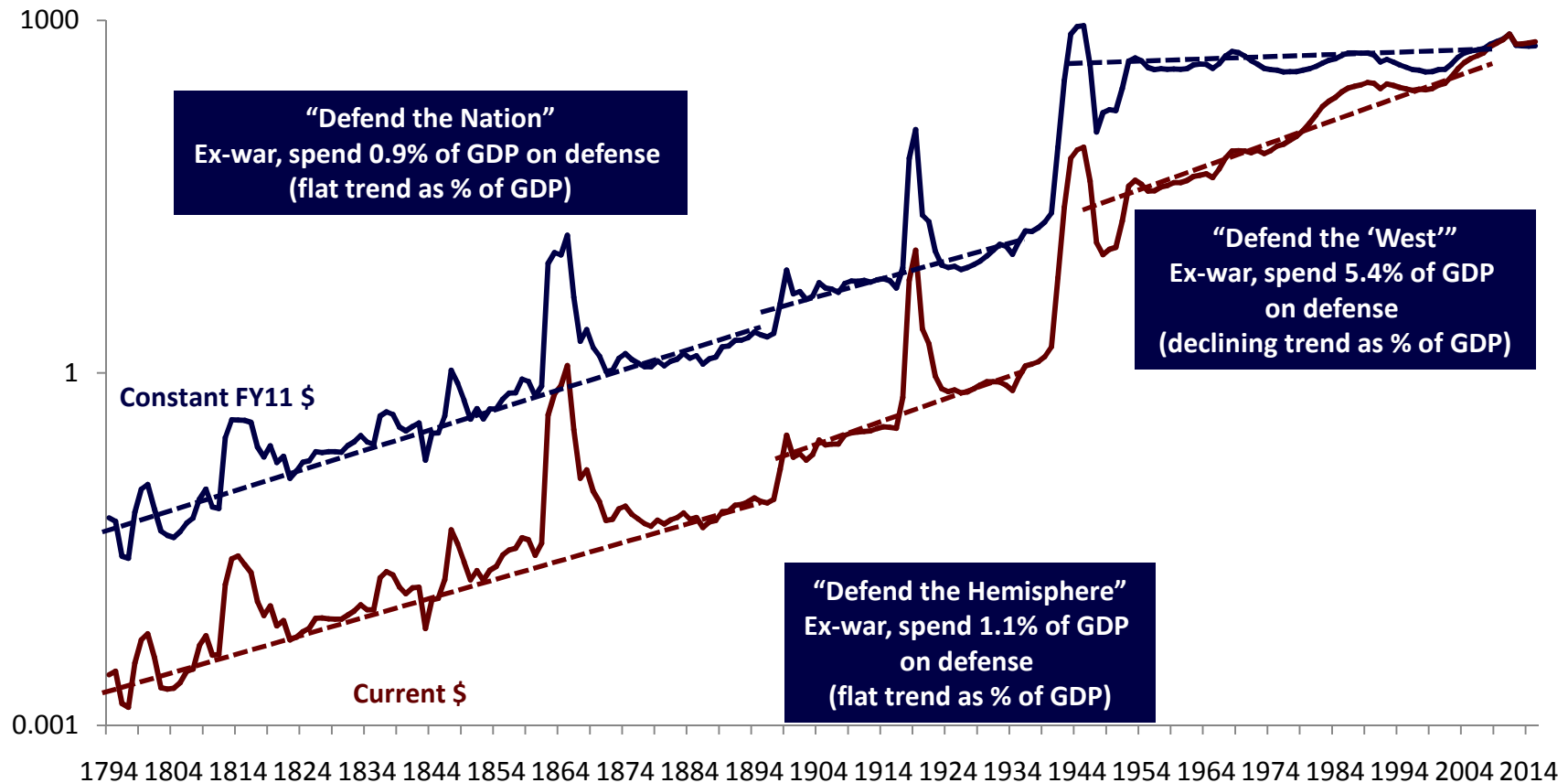
Source: US Department of Defense, RSAdvisors analysis

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

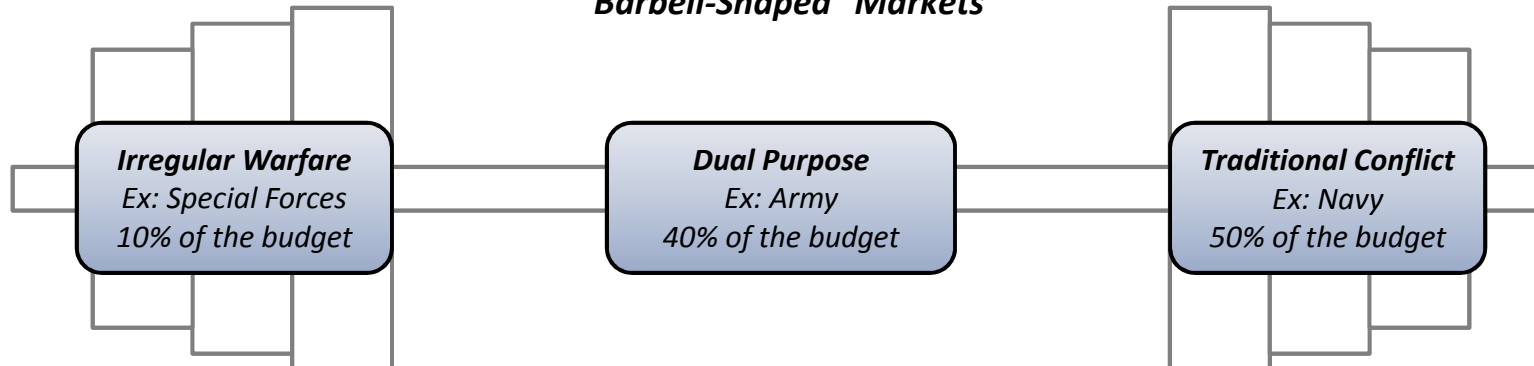


Source: US Department of Commerce, US Department of Defense, RSAdvisors analysis

Irregular Warfare vs Conventional Spending

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

"Barbell-Shaped" Markets



The Long War

Slice #1

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

Reset/Retrofit

Slice #2

Install "black boxes" in existing equipment to plug into network, insert available technology, maintenance, repair

Transformation

Desire for large, horizontal integrating networks, leverage the IT revolution, requires large scale systems integrators

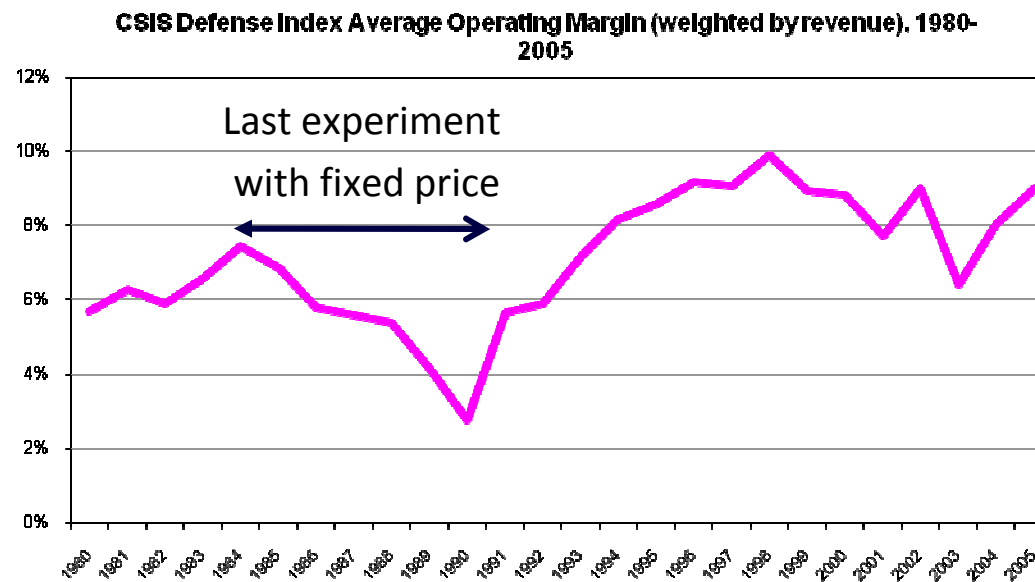
2012 GATES ANNOUNCEMENTS

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

Accelerate Army tactical comms
Modernize Stryker

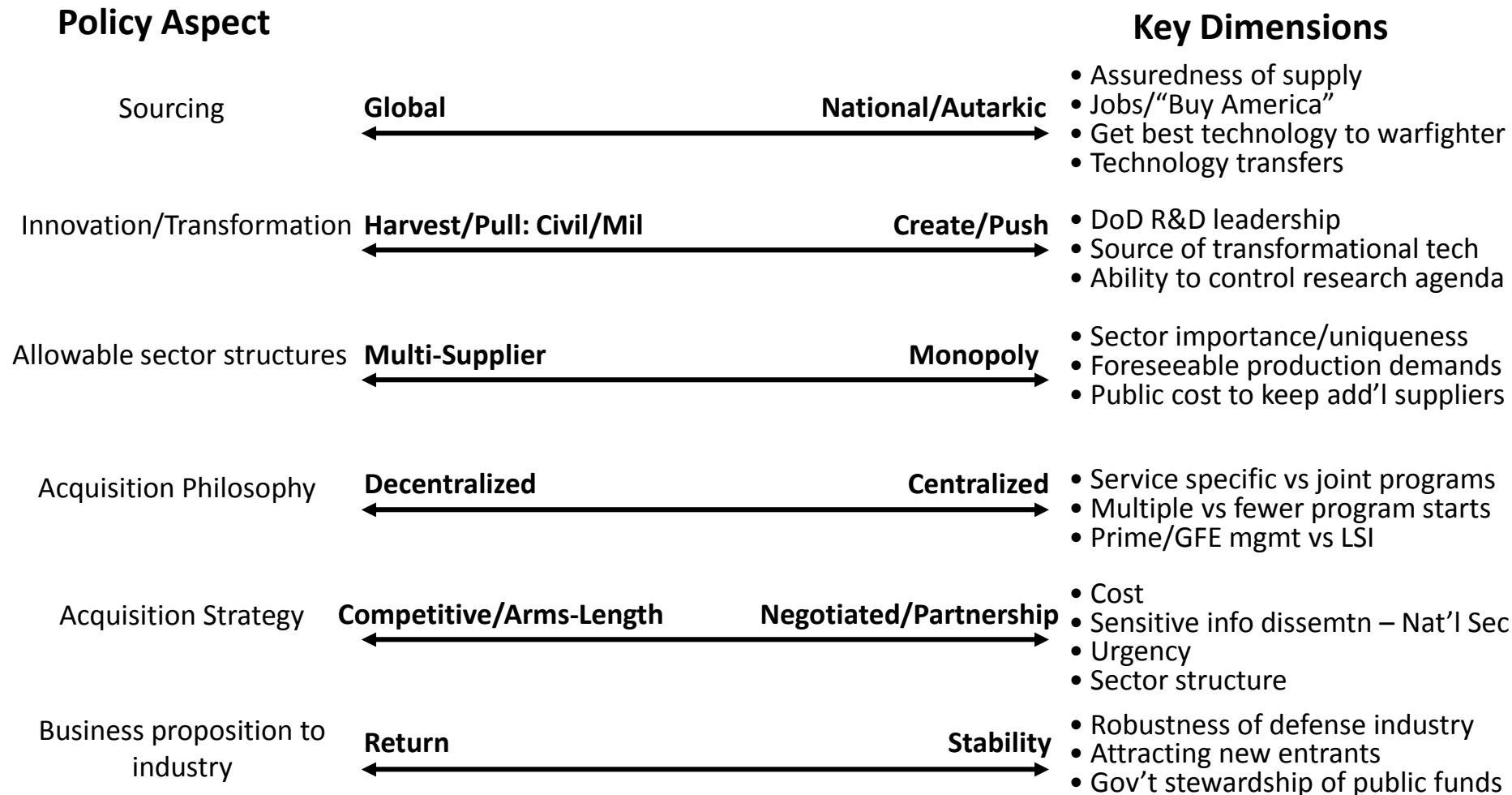
Buy more EELV
Develop Long Range Bomber
Modernize Abrams, Bradleys
Cut Army/Marines 47,000 in 2015
Navy EW improvements
Extra DDG-51, fleet oilers, etc.

- 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

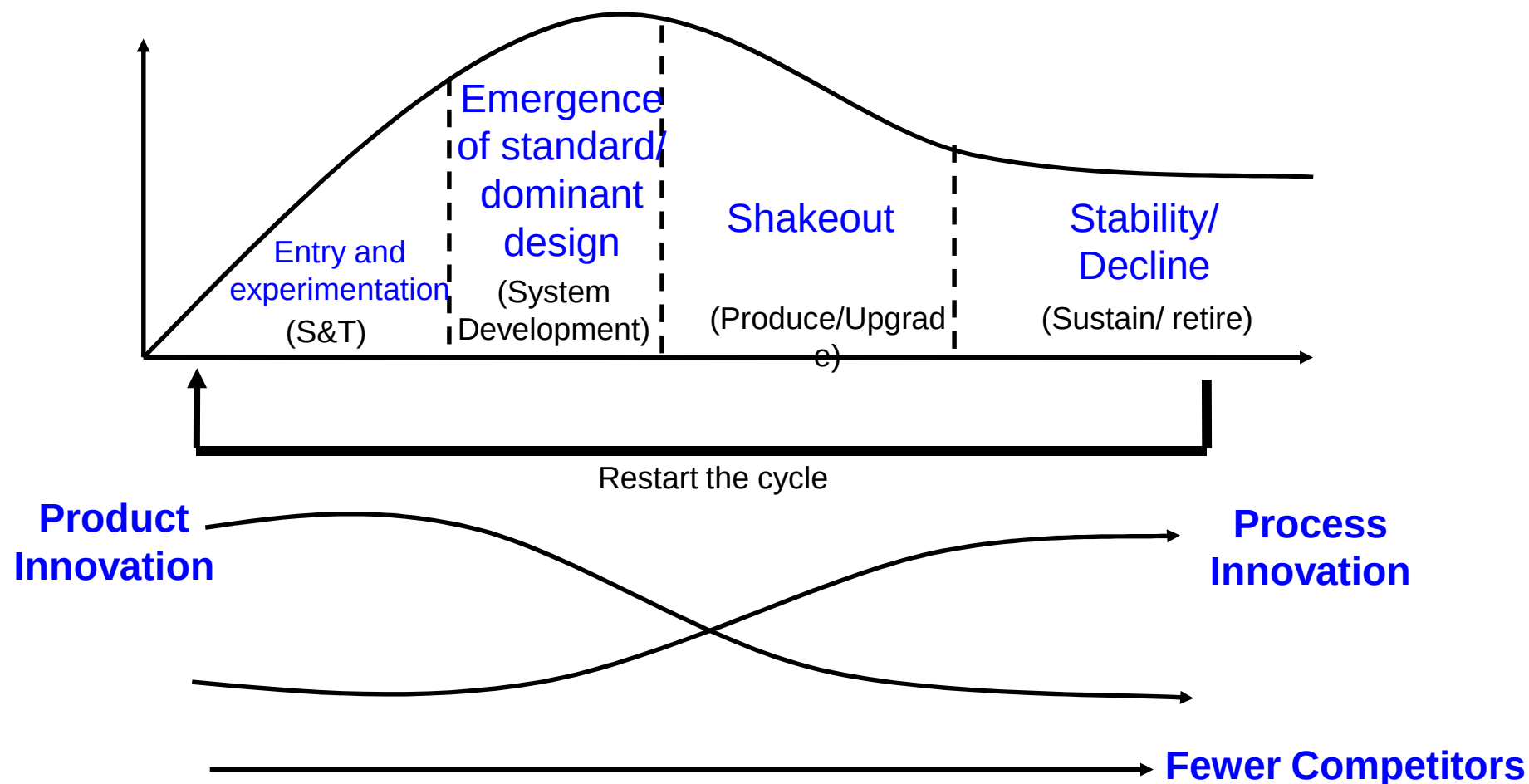


Sources: FactSet, Company Reports, CSIS Analysis.

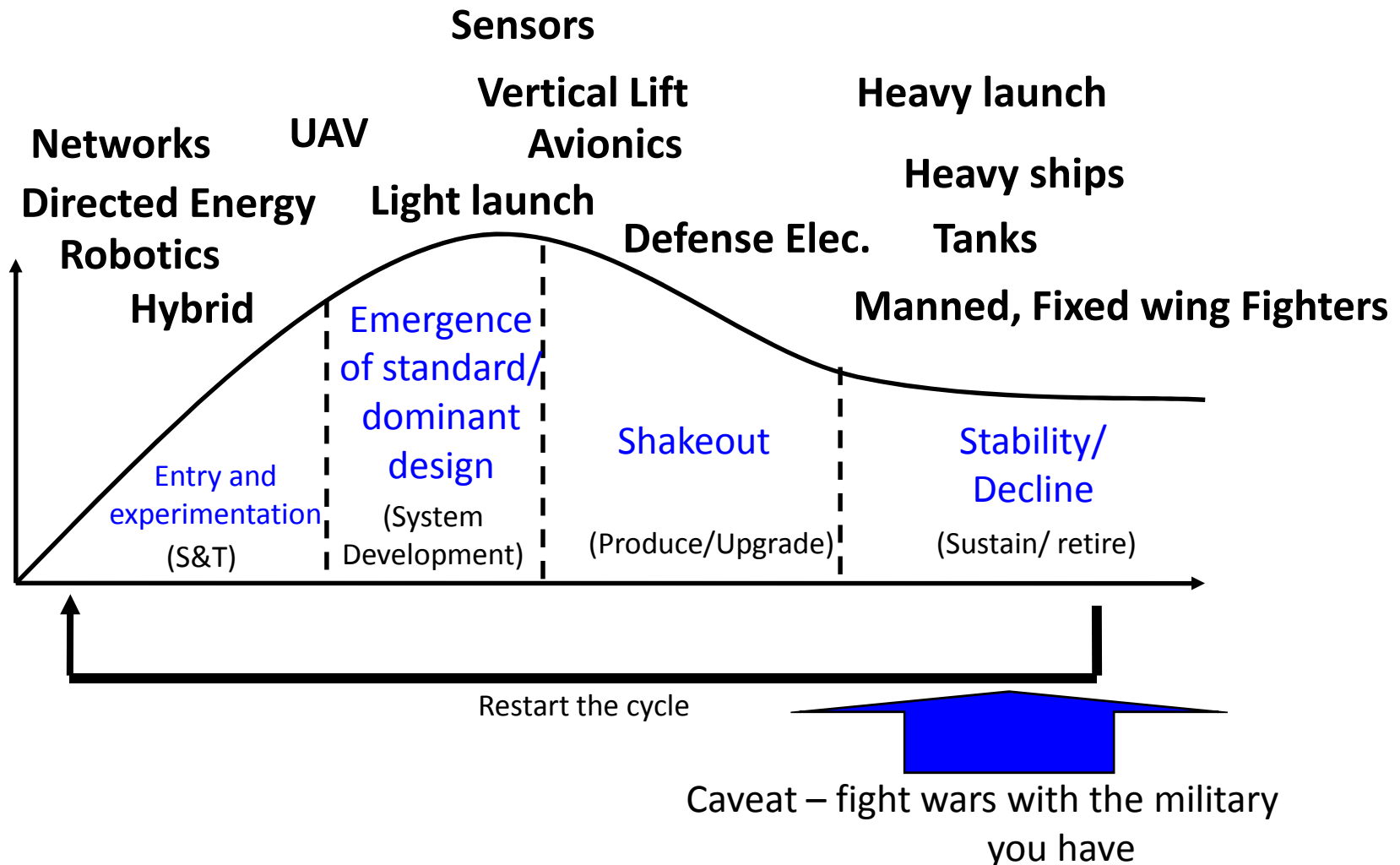
View #1: Defense-Industrial Policy Levers



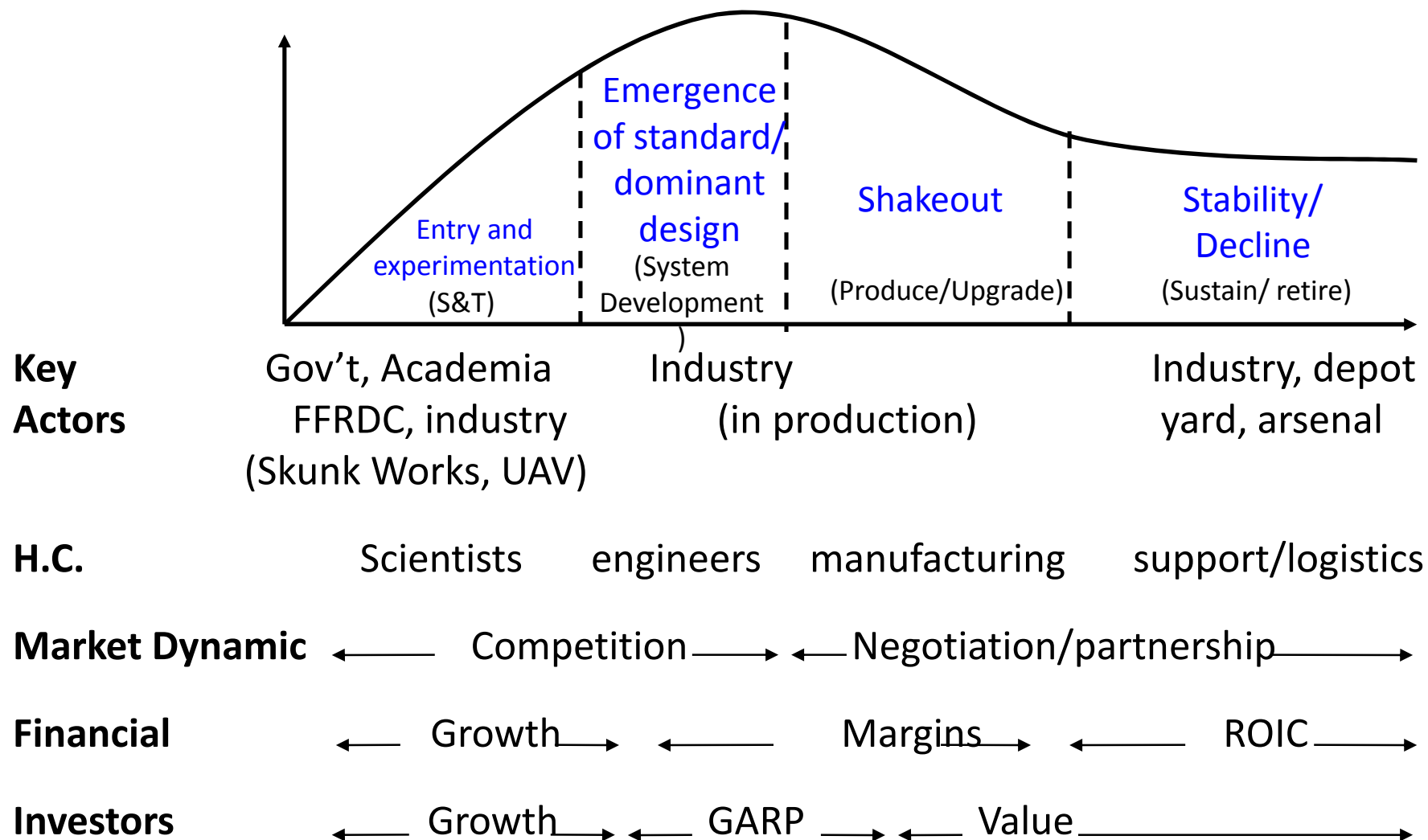
View #2: The Lifecycle of the Technology/Industry Sector...



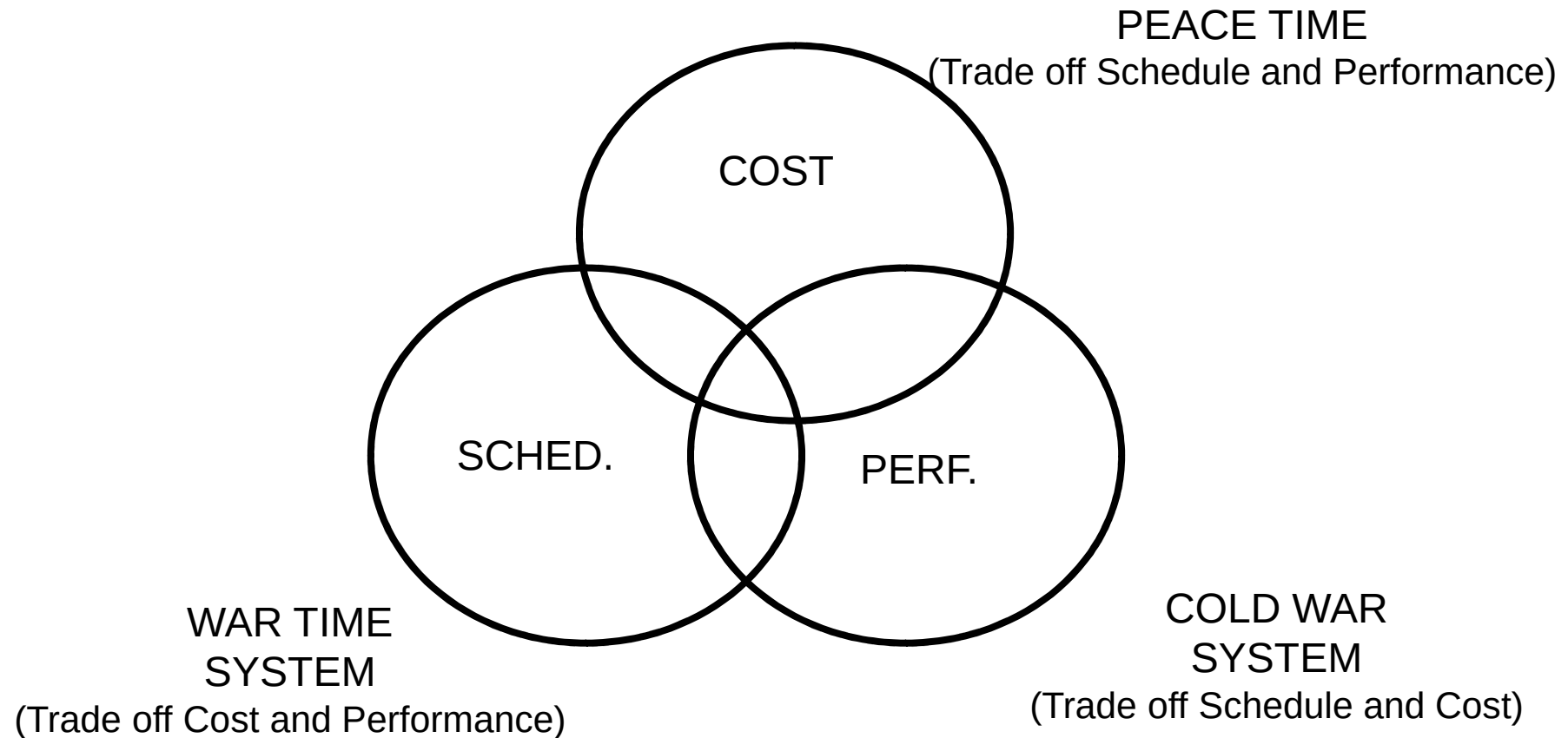
Where You Are in the Lifecycle...



Drives Solutions/Incentive Structures...



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



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

1. What does the industry do with its cash?

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

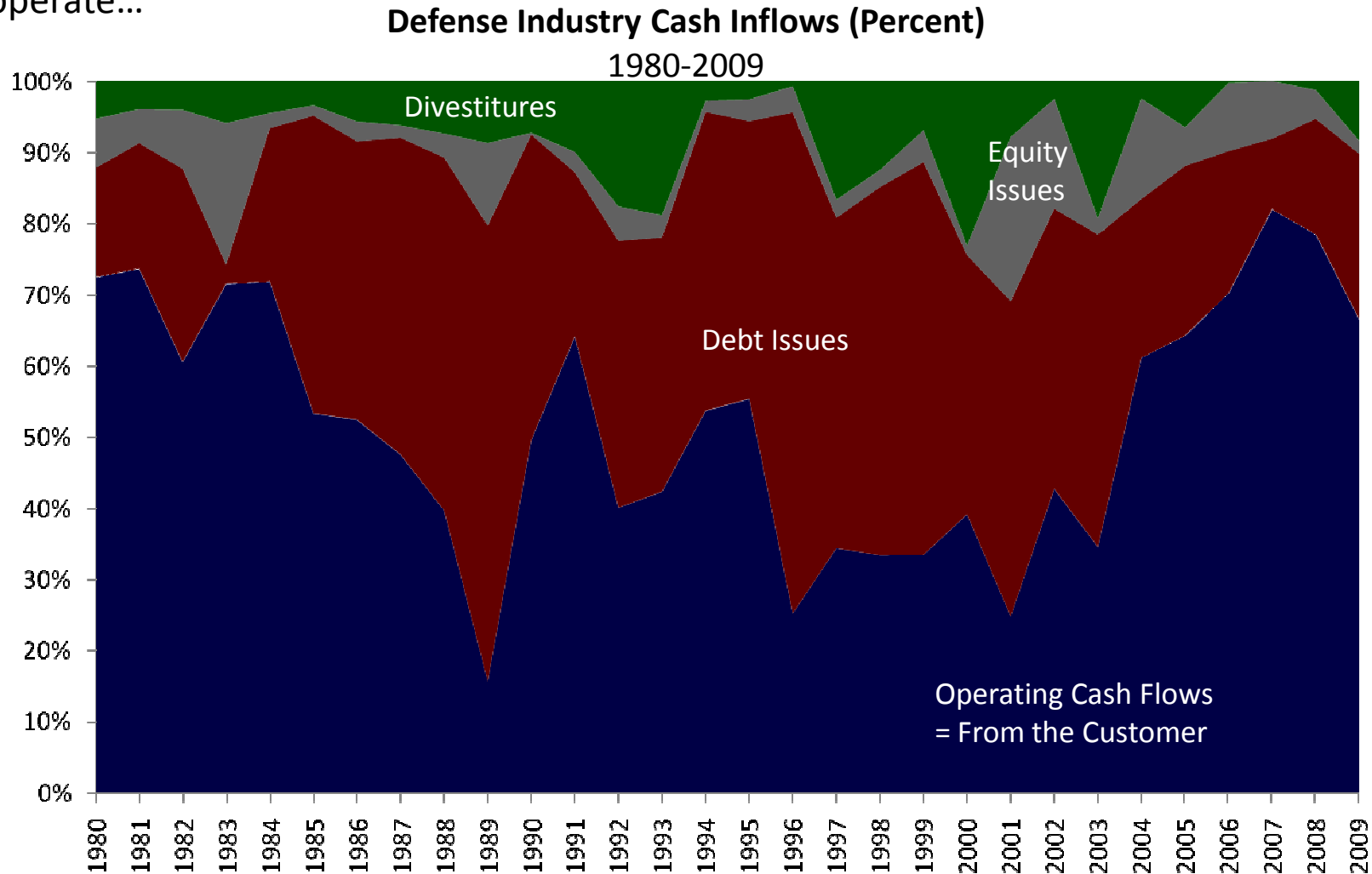
Potential use of the cash

- 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?

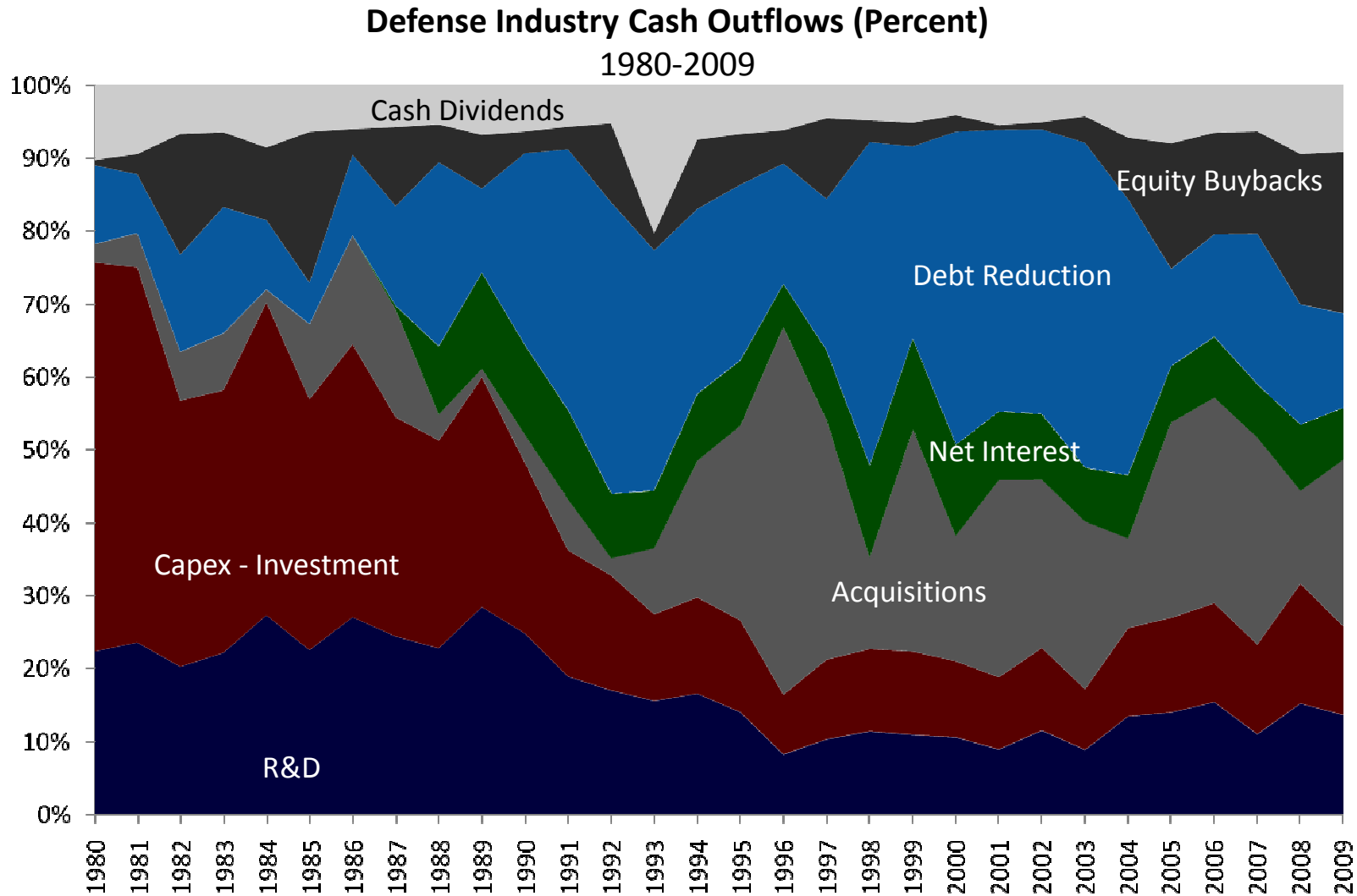
- In the last 30 years, financial markets have provided 40-80% of the capital needed to operate...



Sources: CapitalIQ, FactSet, company filings, RSAdivisors 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 divestures	Big properties are becoming available	- 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	- 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	Finmeccanica 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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