

# Salem Partners – Aerospace & Defense

## Quarterly Review

### Introduction

Third Quarter 2010



Dear Friends,

As we enter the final quarter of 2010, the M&A and capital raising environment remains buoyant as both private and institutional sellers have capitalized on receptive market conditions.

From a macro perspective, A&D industry participants have managed to generate improved financial results despite continued weakness in the global economy and an uncertain operating environment. The difference in investor sentiment between commercial aerospace and defense end-markets has become more pronounced over the summer as improving commercial aerospace operating conditions contrast with a highly uncertain defense spending outlook. Many Tier 3 suppliers have benefitted from a robust commercial aerospace environment where both the OEM cycle and aftermarket appear poised to continue their respective recoveries well into 2012. On the other hand, increasing voter sentiment for fiscal austerity is presenting challenges for even the most hawkish members of our governing bodies to appropriate the proper funding to support investment in our military's programs. Though far from a universal opinion, this contrast is a point that must be thoughtfully managed throughout an M&A or capital raising process.

Strong levels of deal making during the summer months continues to demonstrate improving market conditions. From Salem's perspective, financial sponsors have continued to be re-energized from both a buy and sell-side perspective. From the buy-side, significant levels of committed capital combined with limited investing activities over 2008 and 2009 have equity groups eager to put money to work. This combined with improved financing conditions (both availability and low base rates) have equity groups actively participating in (and winning) auctions. From the sell-side, we have seen notable A&D – focused groups exiting successful investments. This quarter along we saw multiple groups including Arlington Capital, JF Lehman and Gridiron Capital exit portfolio companies and posting impressive returns for their investors.

Please enjoy the remainder of our industry review and, as always, we welcome your comments and questions.

Sincerely,

Trevor Bohn  
Managing Director

Sean Walker  
Managing Director

HIGHLIGHTS

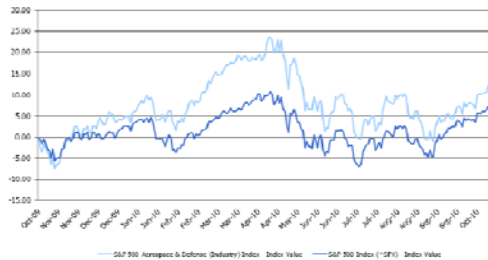
❖ Capital Markets Commentary

# Capital Markets

## Capital Markets

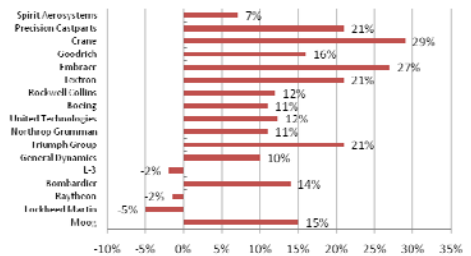
Asset prices rose strongly in Q3 2010, buoyed by an especially strong September as the market was supported by certain improving growth trends, diminishing worries of a “double-dip” and speculation that the Federal Reserve is likely to add additional liquidity to the market through another round of quantitative easing. These factors contributed to a fantastic September for the equity markets as the S&P 500 returned 8.92%.

Relative Performance (LTM)



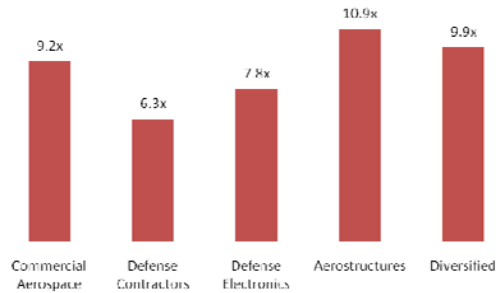
Source: Analyst Research

Performance by Name (Q3 2010)



Source: Analyst Research

Enterprise Value/EBITDA by Subsector



Source: Analyst Research

❖ A&D M&A Activity

A&D M&A Activity

Date	Company	Description	Acquirer	Value
Oct-10	PAS Technologies	Provider of metal processing services to the engine market	KRG Capital	n/a
Oct-10	TSI Group	Provider of design, engineering and fabrication of thermal management systems	B/E Aerospace	\$310
Sep-10	Decrane Holdings	Cabin Management Group of Decrane is a provider of interior products for business aviation	Goodrich Corp	\$280
Aug-10	Stanley Inc	Provider of IT-services to the US and international defense communities	CGI Group Inc	\$1,070
Aug-10	Caprock Communications	Provider of satellite communications products and services to civil and defense end markets	Harris Corp	\$525
Aug-10	Asynchrony Solutions, Inc	Provider of software services for government end-markets	Schafer Group (Metalmark)	n/a
Aug-10	Black Ram Engineering Services	Provides design, analysis and test services for sustainment engineering services	SM&A (Odyssey)	n/a
Jul-10	Atlantic Marine Systems (JF Lehman)	Provider of design, fabrication and overhaul of marine systems	BAE Systems	\$352
Jul-10	DynCorp International	Provider of government services including fleet management, transportation and various support solutions	Cerberus Capital	\$1,500
Jul-10	Stadco	Provider of composite tooling for the aerospace & defense markets	Corinthian Capital	n/a
Jul-10	Maine Machined Products	Provider of metal machining services for the defense and power generation markets	GenX360 Partners	n/a

Source: Analyst Research & Salem Partners estimates

## HIGHLIGHTS

### ❖ Commercial Aerospace Takes Off

### ❖ Highlighted Boeing Platforms

## Industry Headlines - Aerospace

### Commercial Aerospace: Strong OEM Cycle

In sharp contrast to the defense market, commercial aerospace is in the midst of a multi-year acceleration in large aircraft deliveries. The strength of the OEM build-cycle proved naysayers wrong through the recession and has recently gained momentum. Large aircraft deliveries are expected to top 1,000 this year with forecasts for 1,300/year by 2014. In our transactions, we have seen a dramatic increase in investor preference for businesses with a higher mix of commercial aerospace end-markets versus defense. We expect this dynamic to continue throughout 2010 and well into 2011 as several notable commercial aero platforms begin their scheduled production ramps.

The below chart provides an update on several commercial aerospace programs:

Commercial Aerospace: Program Update				
Program	2010E	2011E	2012E	Description
B737	376	375	420	- Backlog of 2,007 units - Announced production increase to 35 planes/month - Unlikely to proceed with re-engine in near-term but likely next candidate for re-design
B787	0	45	70	- Backlog of 863 units - First delivery expected in Q1 2011 - Rate expected to increase to 10 planes/month by end of 2013
B777	70	71	84	- Backlog of 270 units - Revised production rate back to 7 planes/month for 2011 - Decision for re-design to be made after final details of A350XWB revealed
B747	0	14	20	- Backlog of 109 units (mostly freighter) - Planned ramp up to 2 planes/month - First delivery on track for Q1 2011
B767	12	12	12	- Backlog of 55 units - Could see volume growth depending on outcome of KC-X tanker contract

Source: Analyst Research

### Salem Partners Analysis

The backdrop for commercial aerospace has provided a great deal of excitement throughout the supply chain as visibility for work over the next three to four years appears fantastic. From an M&A perspective, our clients with significant content on commercial aerospace platforms have received a strong reception from strategic and financial buyers as the opportunity for robust shareholder returns is clearly identifiable. Investor sentiment for the commercial aerospace industry is flying high, and sellers of businesses in the space are seeing attractive valuations as a reward for tangible growth prospects ahead.

## HIGHLIGHTS

### ❖ FMS Detail

# Industry Headlines - Defense

## International Flavor

With the US defense industry largely focused on the results of the mid-term elections (see Industry Spotlight), there was quite a bit of news from the international community for both FMS and budget outlooks.

## Foreign Military Sales

Recently announced FMS deals have dominated headlines as US-based defense firms seek non-US revenue streams to continue expanding platform life cycles and build-rates. The Administration has signaled an increased willingness to facilitate military exports due to the challenging budgetary environment at home. In August, President Obama signed an executive order to begin reforming the complex export rules that have been a hindrance to defense contractors selling their product to the international market place. Several high-profile FMS agreements have been announced over the past few months:

Sample of Recent FMS Sales		
Buyer	\$ Value	Description
Saudi Arabia	~\$60bn	- 84 F-15 Combat aircraft - 60 new AH-64D Apaches & 72 new Blackhawks - Upgrades to multiple legacy systems
UAE	~\$40bn	- Considering F/A-18E/F Super Hornet - PAC-3 and THAAD missile-defense
India	\$5.8bn	- 10 C-17 strategic-lift aircraft
Israel	\$2.8bn	- 20 (with additional options) F-35s

Source: Analyst Research

For the A&D supply chain these developments are worth noting not simply due to the extension of program lives for these platforms but also for the upcoming offset language written into these purchase agreements. As US-primes face increased pressure to grow revenue from non-US markets, foreign buyers will place stronger, more substantial demands for work to be completed in country. This sort of offset activity has always been a part of both defense and commercial aerospace, but Salem Partners expects the primes to place additional emphasis on their suppliers to offer global program support. For our clients, Tier 2 and Tier 3 suppliers, this trend means that a global strategy and/or footprint is becoming more important than ever.

### ❖ Budget Cuts

## Budget Cuts

Not all news out of the international community has been positive for the A&D industry, as multiple European countries are beginning the first of a series of defense budget reductions.

**United Kingdom:** The UK revealed details of its planned budget shrinking (20% over the next four years) that included troop reductions for each of its service branches as well as substantial reductions in equipment spending. New detail has also emerged that the UK will likely reduce its planned purchases of the F-35 STOVL-variant.

**France:** Will reduce its defense budget by €5bn in FY2011 from its previous level of €32bn.

**China:** In contrast to the rest of the world, China has disclosed a 9% growth in defense spending over 2009 levels. That brings the level of Chinese military spending to \$78bn, but represents a slight slowdown after 10 years of spending growth in excess of 10% annually.

## HIGHLIGHTS

### ❖ November Mid-Term Elections

### ❖ Dems face an uphill battle

# Industry Spotlight – Mid-Term Elections

## November Mid-Terms

Though normally outside our purview, the upcoming mid-term elections could have a profound effect on the outlook for the defense industry over the next several years. The effects of the upcoming election will be more pronounced given the high-volume of turnover and change in key leadership positions upcoming in 2011. Following the release of the finalized DoD budget in February it is expected that Defense Secretary Gates along with Admiral Mike Mullen (chairman Joint Chiefs of Staff), General Norton Schwartz (Chief of Air Force) and General George Casey (Army's top general) will all be leaving the Pentagon or retiring. These upcoming changes, though expected, will place an increased importance on our elected officials and their role in shaping our national security policies.

With this in mind, we have summarized key positions in both Congress and the Senate and prognosticated on the possible electoral outcomes and the subsequent effects to our clientele, the A&D supply chain.

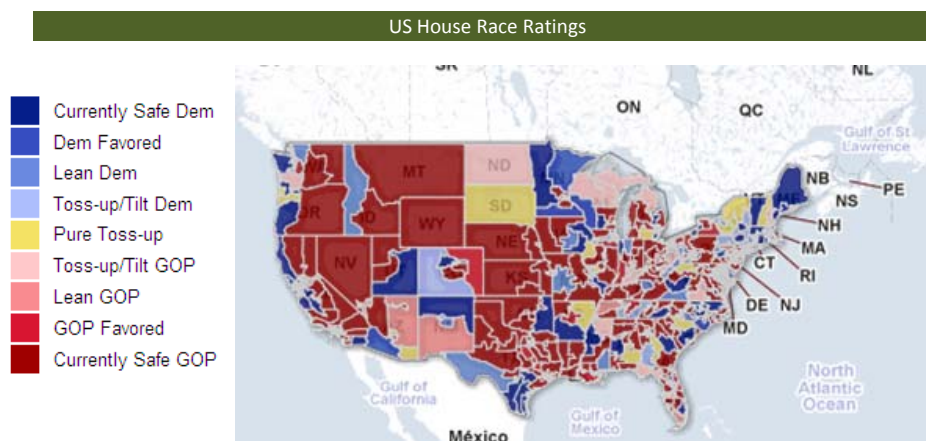
## Current Environment

As it stands today Democrats control both the House of Representatives as well as the Senate. Forecasters have predicted that there will be an increased GOP presence in both Houses, but the prospects for a change of control remains up for debate. Of the two legislative branches, a shift to a GOP majority in the House of Representatives seems to be a more likely scenario, but all possibilities (including the status quo) remain feasible. For the A&D supply chain, the ramifications of the elections will be most directly manifested in four key sub-committee positions:

- House Armed Service Committee
- House Appropriations Subcommittee on Defense
- Senate Armed Service Committee
- Senate Appropriations Subcommittee on Defense

## House of Representatives

The below map shows the current political landscape by color for the races for the House:



Source: Google Maps

# Industry Spotlight – Mid-Term Elections

## HIGHLIGHTS

❖ *House of Representatives: Defense Appropriations Subcommittee*

House Armed Service Committee	
Ranking Members	
Dem: Ike Skelton (Missouri)	GOP: Buck McKeon (California)
Salem Commentary	
<ul style="list-style-type: none"> <li>• Vulnerable to lose seat at election</li> <li>• Supports maintaining troop levels</li> <li>• Supports second engine for JSF</li> <li>• Perceived as a hawkish Democrat</li> <li>• If Skelton loses John Spratt (SC) is seen as his likely heir</li> </ul>	<ul style="list-style-type: none"> <li>• Supportive of Gates' cuts to underperforming platforms</li> <li>• Pro-missile defense</li> <li>• Critical of withdrawal date from Afghanistan</li> <li>• Supports reduced deficit but not reduced DoD budget</li> </ul>
<p><u>Effect of GOP Control:</u> Unlikely to be dramatic change as Mr. Skelton is viewed favorably in defense community. Mr. McKeon would likely be a significant advocate for increased spending on missile defense.</p>	
Source: Analyst Research	

Defense Appropriations Sub-Committee	
Ranking Members	
Dem: Norm Dicks (Washington)	GOP: Bill Young (Florida)
Salem Commentary	
<ul style="list-style-type: none"> <li>• Constituency is supportive of Boeing</li> <li>• Perceived to have tried to influence next-generation tanker contract to Boeing's favor</li> <li>• Next in-line to chair Appropriations Committee</li> <li>• Unclear if he will be able to chair the sub-committee as well</li> </ul>	<ul style="list-style-type: none"> <li>• Will require a waiver to continue in his current post as senior GOP member due to term limits</li> <li>• Perceived to support Navy and Air Force interests above Army</li> <li>• Expected to push for additional funding to grow Navy fleet size (LCS &amp; DDG-1000) as well as support JSF into full-rate production</li> </ul>
<p><u>Effect of GOP Control:</u> Rep. Dicks has been a key figure in shaping Democratic position around Iraq and Afghanistan. GOP control would likely reduce pressure to adhere to withdrawal timelines.</p>	
Source: Analyst Research	

**Conclusion:** A turnover of the House of Reps. to GOP control would be a mild positive for the A&D industry as both Rep. McKeon and Rep. Young have substantial track records as supporters of the Defense industry. That said, both Democrats mentioned are perceived to be generally supportive of defense spending. A scenario where Rep. McKeon and Rep. Young assume chairman roles in their respective committees would be a positive for the struggling shipbuilding industry and would likely force the withdrawal timeline for Afghanistan once again into open debate.

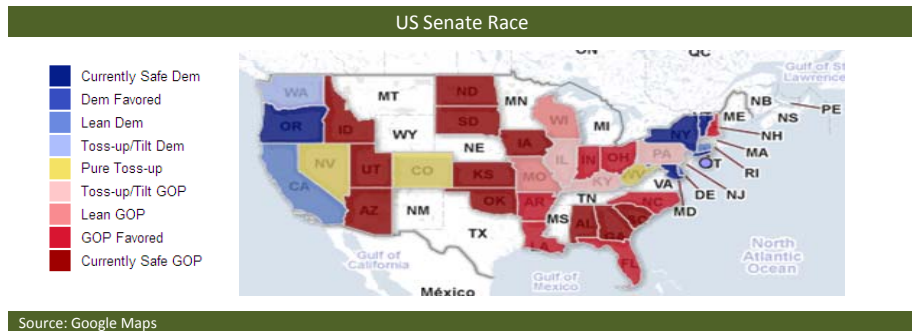
## HIGHLIGHTS

### ❖ Senate Races

# Industry Spotlight – Mid-Term Elections

## Senate

The below map shows the current political landscape by color for the races for the Senate:



## Senate Armed Services Committee

### Ranking Members

Dem: Carl Levin (Michigan)

GOP: John McCain (Arizona)

### Salem Commentary

- Has supported Gates vocally throughout tenure
- Supports second engine for JSF
- Has spoken out against Iraq war and is seen as pro-withdrawal of troops from both theaters
- Has established reputation for exposing cost-overruns and corruption
- Critical of USAF's attempt to replace refueling tankers
- Has been critical of withdrawal timeline

**Effect of GOP Control:** Sen. Levin has been a vocal critic of troop levels and has warned the military about maintaining a July 2011 withdrawal from Afghanistan. A GOP victory would mean McCain would likely pace troop withdrawals to match progress in theater.

Source: Analyst Research

## Senate Appropriations Subcommittee on Defense

### Ranking Members

Dem: Daniel Inouye (Hawaii)

GOP: Thad Cochran (Mississippi)

### Salem Commentary

- Has stated publically that he does not support a freeze in defense spending
- Author of FY2011 committee report that put the JSF on notice for cancellation
- Sponsored a bill to strike language regarding a strict timeline for a withdrawal from Iraq
- Seen as a supporter of the shipbuilding industry given constituency

**Effect of GOP Control:** Both Senators are infamous for their ability to add legislative "pork" into their proceedings. Effect of GOP control would be most directly felt through removal of troop withdrawal timeline. Also, both Senators lead the full appropriations committee.

Source: Analyst Research

**Conclusion:** Similar to the House, key leadership roles in the Senate are filled by experienced members with established track records of supporting defense budget growth. The key differences have been seen at the Senate Armed Services Committee position where Sen. Carl Levin has been vocal in his criticism of the Iraq war.

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