

# Salem Partners – Aerospace & Defense

## Quarterly Review

### Introduction

Third Quarter 2011

Dear Friends,

We hope you had a pleasant summer and that you were able to enjoy some R&R.

For Salem Partners, our summer was busy, and we are pleased to announce that our client, North American Aircraft Services (NAAS), has been recapitalized by Mangrove Equity Partners. NAAS is a leading provider of fuel-tank maintenance services and serves a variety of leading MROs.

In the capital markets, we saw the return of volatility as the ongoing sovereign debt crisis in Europe translated into a challenging late summer for the equity and credit markets. The S&P 500 slipped into negative territory for the year and investor appetite for risk-assets declined. The market choppiness had a dampening effect on M&A activity as credit availability for leveraged buy-outs (especially for +\$25 million of EBITDA) was reduced and spreads widened. Despite the environment, United Technologies announced its intention to acquire Goodrich for +\$18bn. In our view, this deal further demonstrates the long-term strength of the commercial aerospace end-markets and is a great indicator of the strength of the M&A market for strong A&D-centric businesses.

In the commercial aerospace industry, the major headline of the third quarter was the successful first delivery of the B787 Dreamliner. Obviously eagerly anticipated by the supply chain, the delivery has provided yet another positive headline for the commercial aerospace industry already flying high with expanding build-rates and solid after-market growth. In business aviation, our team recently returned from a busy NBAA show and came away convinced that the malaise that characterized 2008 & 2009 is firmly in the rear-view mirror. In this industry review we examine a few M&A trends specifically in the machining sector.

In the defense industry, the most significant news event was the detail around the agreement on the US debt ceiling resolution which included some potentially damaging mandatory defense spending cuts. If significant progress is not made towards deficit reduction matters, several high-profile, next-generation platforms are being targeted as cost saving targets. While the headwinds around defense spending certainly have had a negative effect on the AUSA show, the excitement and optimism that permeated AUVSI was in direct contrast. In this review, we will demonstrate a “down-side” scenario for DoD spending and the corresponding damage inflicted on the supply-chain.

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

Sincerely,



Managing Director



Managing Director



## M&A – NAAS Recapitalized by Mangrove

### HIGHLIGHTS

- ❖ NAAS  
Recapitalization



#### **About NAAS**

Based in San Antonio, TX, North American Aircraft Services Inc. and its subsidiaries provide specialized aerospace services with a focus on fuel systems maintenance and repair. The company's customer base includes both military and commercial aviation organizations such as Boeing, PEMCO, TIMCO and ST Engineering. In addition to its core services, NAAS provides composite manufacturing through its subsidiary, Turbo Mach LLC. With 14 locations, including international operations in Panama and Europe, NAAS employs approximately 200 personnel.

#### **About Mangrove**

Mangrove Equity Partners, L.P. is a Tampa, FL-based middle market private equity fund. From its captive equity fund, Mangrove sponsors owners and operators in management buy-outs, management buy-ins, majority recapitalizations, family succession recaps, and industry consolidations.

#### **Salem's Role**

Salem Partners acted as the exclusive investment banking advisor for NAAS. Salem developed and executed a process that led to a successful recapitalization of the company that allowed the founder and primary shareholder to achieve liquidity after successfully running the business for over 20 years. Additionally, management was able to retain a significant equity stake in the business and partner with a seasoned middle market private equity group.

# Capital Markets

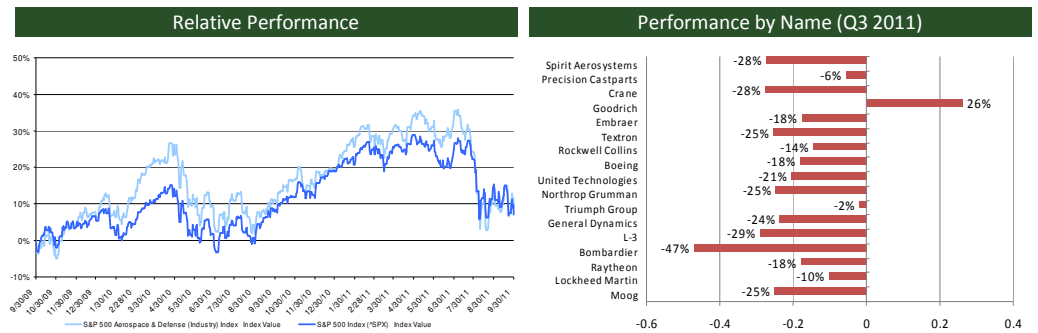
## HIGHLIGHTS

### Capital Markets Commentary

#### Capital Markets

The third quarter of 2011 saw aerospace and defense company stock prices return gains experienced over the last 12 months, due primarily to a market-wide downturn in August. Goodrich Corp. produced the only significant gain over the quarter, resulting from the announced and pending acquisition of the company by United Technologies Corp. in September.

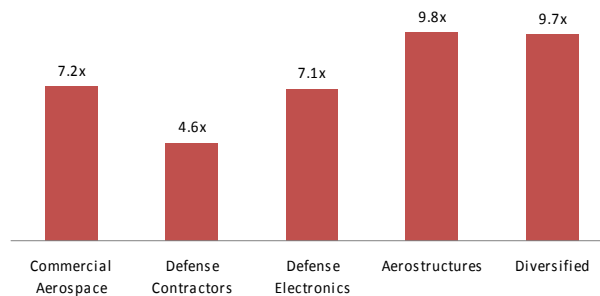
The S&P Aerospace & Defense Index fell 18.4% percent for the third quarter of 2011, while the S&P 500 Index decreased 14.3% over the same period.



Source: Analyst Research

Source: Analyst Research

#### Enterprise Value/EBITDA by Subsector



Source: Analyst Research

#### A&D M&A Activity

Date	Target	Acquirer	Implied EV	EV/Revenue	EV/EBITDA
23-Sep-11	PFW Aerospace AG	Airbus S.A.S.	-	-	-
21-Sep-11	Goodrich Corp.	United Technologies Corp.	\$18,123	2.4x	12.8x
21-Sep-11	Aero Technology, Inc.	Precision Aviation Group, Inc.	-	-	-
15-Sep-11	Trivec Avant Corporation	Cobham plc	144	-	4.5x
14-Sep-11	Hawkes Remotes, Inc.	Battelle Memorial Institute, Inc.	-	-	-
12-Sep-11	Consolidated Precision Products, Inc.	Warburg Pincus L.L.C.	-	-	-
2-Sep-11	Storm Aviation Limited	FT Technics Jet	-	-	-
29-Aug-11	Point Blank Solutions, Inc.	The Gores Group L.L.C.	30	-	-
26-Aug-11	Lamsco West; Bolsan Co.; Attewell Ltd.	Bridgepoint Development Capital	84	-	-
22-Aug-11	GCM North American Aerospace, LLC	Klune Industries, Inc.	-	-	-
16-Aug-11	North American Aircraft Services, Inc.	Mangrove Equity Partners, LLC	-	-	-
5-Aug-11	Schneller, LLC	TransDigm Group Inc.	289	-	-
3-Aug-11	Retan Aerospace Inc.	MTU Aero Engines Holding AG	-	-	-
26-Jul-11	Metron Aviation, Inc.	Airbus Americas, Inc.	-	-	-
18-Jul-11	Air Italy S.p.a.	Meridiana Fly	232	0.8x	-
13-Jul-11	Flightcraft, Inc.	Atlantic Aviation Corporation	-	-	-
10-Jul-11	Primus International, Inc.	Precision Castparts Corp.	900	-	-

(\$ in millions)

Source: Analyst Research & Salem Partners estimates

### A&D M&A Activity

## HIGHLIGHTS

### ❖ Boeing 787

# Industry Headlines - Aerospace

## First Boeing 787 Delivered

On September 25<sup>th</sup>, Japanese operator All Nippon Airways was the first recipient of Boeing's long-awaited 787 Dreamliner. The long-range wide-body seats between 210 and 290 passengers, depending on configuration, and is touted by Boeing to be its most fuel-efficient aircraft, due in large part to the pioneering use of composites for the majority of its makeup. Expectations of a 20% reduction in fuel consumption over comparably-sized aircraft, among other features, propelled the Dreamliner to a current backlog of 821 aircraft, making the 787 the fastest-selling wide-body in history.

Last month's delivery, however, was one of the few bright spots for the program. While the 787 is expected to sell for ~\$200 million per aircraft at list prices, Boeing CEO Jim McNerney warned that the 787 would not actually begin generating profits until the latter part of the decade. A slowly-accelerating production schedule, numerous delays and supply chain mismanagement have frustrated platform suppliers and prompted some carriers to demand penalties to compensate for the more than three-year delay over the originally-promised delivery date.

Date	Event
Jan-03	Boeing proposes development of 7E7 (name later changed to 787)
Dec-03	Boeing announces non-traditional subassembly approach to Dreamliner construction
Apr-04	All Nippon Airways places firm order for 50 Dreamliners to be delivered in late 2008
Dec-06	First six 787s 5,000lbs heavier than initially specified, further weight-reduction efforts needed
Jul-07	Dreamliner rollout ceremony
Aug-07	Original planned first flight date
Sep-07	Boeing announces 3-month delay due to supply shortage and incomplete software
Oct-07	Further 3-month delay to 1st flight, 6-month delay to 1st deliveries due to supply chain issues
Jan-08	Additional 3-month delay in first flight due to unexpected subassembly work
Apr-08	Boeing announces delay in first flight until Q4 2008, initial deliveries delayed 15 months
Nov-08	Further delays announced due to improper fasteners and machinists' strike
Dec-08	Boeing announces that 1st flight will be delayed until Q2 2009
Jun-09	Further postponement of 1st flight announced
Aug-09	Boeing announces 1st flight to occur by the end of 2009, deliveries expected at the end of 2010
Dec-09	Boeing conducts 787 maiden flight
Aug-10	An engine blowout during testing causes Boeing to delay delivery of the 787 until early 2011
Aug-10	Boeing receives compensation claims from airlines due to delivery delays
Nov-10	Boeing announces further delays to address issues discovered during flight testing
Nov-10	Flight testing suspended due to an in-flight fire in the main cabin during testing
Jan-11	Boeing announces postponement of first delivery until Q3 2011
Aug-11	The 787 is certified by the FAA and EASA
Sep-11	The first 787 delivered to All Nippon Airways, scheduled to enter service October 26, 2011

The delivery of the first 787 brings with it relief for subcontractors and suppliers, and ensures a healthy platform with expected longevity. While production of the aircraft is currently only at an estimated two units per month, Boeing expects that it will slowly accelerate production rates to a peak level of 10 Dreamliners per month by 2013. In addition to the growing backlog of over 800 orders for production, suppliers are further encouraged by the three to four decades of maintenance, repair and replacement parts that accompany the operation of a new workhorse component of operator fleets.

HIGHLIGHTS

## Industry Headlines - Aerospace (continued)



Date	Jul-11	Nov-10
Acquirer	Precision Castparts Corp.	Allegheny Technologies
Target	Primus International	Ladish Co.
Implied EV	\$900mm	\$790mm
Implied EV/Revenue	N/A	2.1x
Implied EV/EBITDA	N/A	14.5x

### Machining and Processing M&A

The November acquisition of Ladish Co. by Allegheny Technologies and July acquisition of Primus International by Precision Castparts Corp. bring to light the trend of consolidation of the machining and processing industry over the past year. These headline deals (Salem estimates both were completed at double-digit EBITDA multiples) have placed the machining sector in the spot-light.

New and growing commercial platforms, including the A320NEO, 737 and 787, have bolstered supplier backlog and workload projections. These platforms are projected to continue growing into the future, ensuring supplier work levels not only for the initial production timeline, but well into the medium-term as build-rates appear strong through 2015. Optimism surrounding commercial air traffic growth, especially in developing regions, has further brightened the luster of the commercial aerospace landscape. This positive backdrop is attractive to growth orientated investors (both financial and strategic) looking for attractive acquisition opportunities with bright revenue outlooks.

The impending defense budget cuts and elimination of Overseas Continuing Operations spending have further encouraged M&A activity in the machining/processing space by prompting strategic acquirers to seek growth via an M&A strategy as organic opportunities are limited.

The increased acquisition appetite has elevated valuation multiples to attractive levels for sellers. Businesses that unsuccessfully sought liquidity during 2008-2009 have taken advantage of the resurging interest in the space. We expect M&A activity in the machining/processing space to be extremely active going into 2012 as sellers look to capitalize on these positive industry dynamics.

Other Notable Machining & Processing Transactions YTD		
Date	Target	Acquirer
Mar-11	Weaver Manufacturing, Inc.	Synchronous Aerospace Group
Apr-11	Steel Parts Manufacturing, Inc.	Monomoy Capital Partners
Jun-11	MW Industries Inc.	Genstar Capital, LLC
Jun-11	Quality Forming, Inc.	PRV Aerospace, LLC
Jul-11	Triumph Precision Castings Co.	Torque Capital Group LLC
Jul-11	Dynamic Turbine, LLC	Torque Capital Group LLC
Aug-11	GCM North American Aerospace	Klune Industries, Inc.
Sep-11	Premier Precision Group (Stewart Machining division; Jet Processing division)	Spell Capital

<sup>1</sup>Source: CapitalIQ

# Industry Headlines - Defense

## HIGHLIGHTS

### ❖ Debt Ceiling Compromise

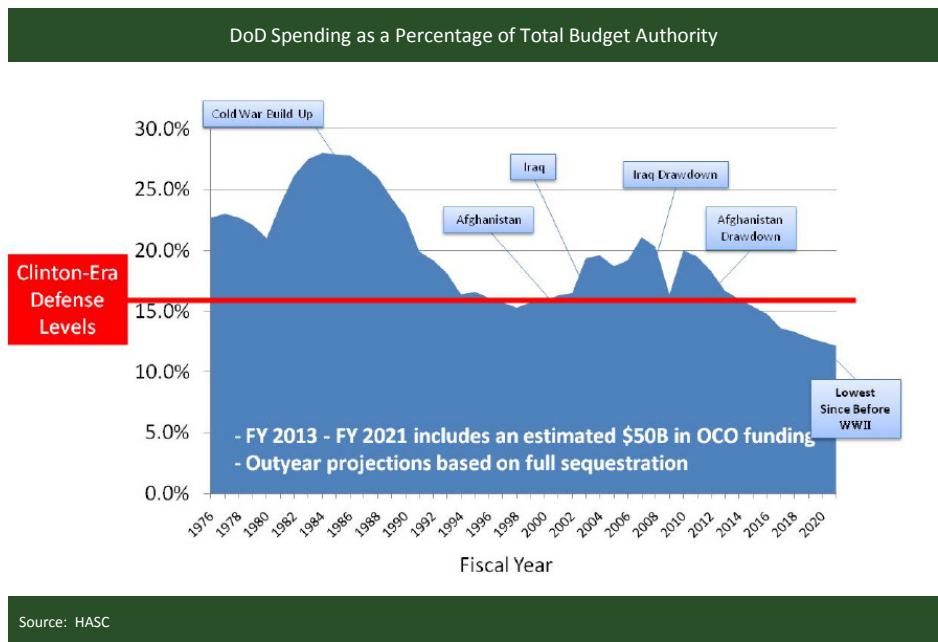
#### Debt Ceiling Compromise

The single biggest development for the defense industry over the past several months (maybe years) was the agreement reached to settle the debt ceiling issue. As a result of negotiations that stretched on for months, our two political parties have reached an agreement that, although light on details, indicates an uncertain future for the DoD budget. To simplify, there has been an agreement to immediately cut \$350bn over the next ten years from the DoD budget. While this cut will certainly be felt by the industrial base, the agreement also includes a scenario that includes the possibility for truly damaging budget cuts. A bi-partisan committee has been created with the sole task of reducing the federal deficit by an additional **\$1.5 trillion** by the end of November. If that committee is unable to agree on sufficient deficit reduction measures, there will be an automatic trigger that reduces DoD spending by an additional \$500bn over the next ten years.

### ❖ Down-Side Scenario

Leveraging the detailed analysis provided by the House Armed Service Committee (“HASC”), it is this down-side or sequestration scenario that we will explore. Needless to say, a reduction of \$850bn (\$350bn + \$500bn automatic cut) over a ten year period will have a materially negative effect on not only our nation’s security but also on the military – industrial base.

To put the level of cuts in context, it is helpful to understand from a historical perspective how DoD spend as a percent of total federal spending has trended over time. The below graph illustrates the recent increases related to the wars in Iraq and Afghanistan, but also shows how draconian the proposed mandated cuts would be. As a percentage of total federal spending, the US DoD budget would be lower than it was during the mid-1990’s.



## Industry Headlines – Defense (continued)

### HIGHLIGHTS

#### ❖ Major Consequences

#### ❖ Force End-Strength

#### ❖ Force Structure

### Major Consequences of Additional Cuts

When analyzing the flow-through effects on defense budget reductions, there are three primary ways to measure the consequences. Each of these scenarios will have a direct effect on business owners that serve the defense end-market.

### Force End-Strength

Reductions in troop end-strength will be part of the discussion to reduce DoD Spending. The Congressional Budget Offices estimates that reducing troop levels to pre 9/11 levels will save approximately \$4.1bn annually. In comparison to the scope of the deficit reduction goals, this savings does not having a meaningful impact on cost reductions efforts; however, substantial reductions in force strength will certainly force a change in national security strategy. Unfortunately it appears that the lessons learned from the most recent conflicts abroad regarding the necessity for “boots on the ground” have been lost in the current funding environment. Additionally, in today’s challenging economic environment it is highly likely that tens of thousands of these soldiers will enter the ranks of the unemployed, especially given the fact that unemployment for Iraq vets is over 22%.

	Today	Current Funding	Super-Committee Fails
Army	569,400	481,000	426,000
Marines	202,000	173,000	145,000
Total	771,400	654,000	571,000

### Force Structure

The bulk of the reductions in DoD spending will likely occur through reductions in the investment and procurement accounts. The impact will be wide-spread and will effect the long-term ability of the DoD to project US military power. The below chart illustrates the likely reductions by major force structure categories:

	1990	2000	Today	Super-Committee Fails
Battalions	172	98	100	60 – 70
Navy Ships	546	316	288	238
USAF Fighter	4355	3602	1990	1512
Bombers	282	153	135	101
Air Lift	872	743	651	494

**HIGHLIGHTS**

❖ *At-Risk Programs*

## Industry Headlines – Defense (continued)

### Force Structure (Continued)

The below chart illustrates the modernization programs that will be most at risk in the downside scenario:

<b>Army</b>	 Ground Combat Vehicle	 Apache Mod.	 JLTV (cancel)
<b>Navy</b>	 F-35C (reduce)	 Aircraft Carriers	 Next-gen Ohio
<b>Air Force</b>	 F-35A (reduce)	 Next-gen bomber	 Next-gen tanker
<b>Marines</b>	 F-35B (cancel)	 V-22 (reduce)	 Personnel Carrier

❖ *Defense Workforce*

### Defense Workforce

Sadly, the effect in the sequestration scenario would be extremely dire for the defense workforce. Defense Secretary Panetta estimates that 1,000,000 jobs will be lost in the downside scenario, with an emphasis on defense-focused geographies such as California, Texas and Virginia. Those job losses will include high-paying skilled labor jobs, including engineering and electronics, that will be challenging to replace.

### Salem Perspective

Without doubt the sequestration scenario would be devastating to the entire A&D supplier-base. While we do not feel that this outcome is the most probable, it is certainly a case that owners and operators of businesses in the A&D industrial base must consider. While there is limited direct action that can be taken, our recommendation continues to follow a few key-themes:

- *Program Awareness:* Understand the funding outlook for key platforms and actively seek diversification, even at the expense of margin
- *Look to Commercial Aerospace:* Macro outlook (and investor preference) favors commercial aerospace. While cyclical, the short- medium term outlook is strong
- *Consider Strategic Alternatives:* Continued consolidation is being driven by the changing market dynamics. As always, timing is key and business owners should stay attuned to any shifts in market sentiment

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