

Salem Partners – Aerospace & Defense

Quarterly Review

Introduction

Second Quarter 2010

Dear Friends,

Hope your summer is off to a great start!

After beginning 2010 with a bang, M&A activity slowed slightly in the second quarter as several disconcerting macroeconomic indicators reintroduced uncertainty in the capital markets. Concerns over a “double-dip” recession and growing fiscal deficits have combined to cause widening credit spreads and declines in public equity valuations. This dynamic has moderated risk appetite among strategic and financial buyers and slowed the pace of M&A activity.

That said, the volume and number of M&A and capital raising transactions remain well above comparable 2009 levels. For our clients and prospects, we continue to receive strong interest in high-quality Aerospace & Defense businesses. Based on our recent experiences in the market, investors and strategic buyers are eager to execute on M&A strategies but are focused on key indicators of a potential acquisition's future financial performance including backlog and program exposure.

In this issue of our Quarterly Review you will find the following topics addressed:

- Capital Markets Update
- Defense Update
 - Budget vs. Deficit
 - Update on Troop Levels
- Commercial Aerospace Update
 - Effect of Currency Movements
 - OEM vs. Aftermarket
- Detailed Aircraft Funding Update
 - UAV's
 - Attack Aircraft

We would be more than happy to provide a tailored M&A update for your sub-sector at any time. Also, please contact us to discuss any of the transactions we have in the market and our upcoming deals for the second half of 2010.

Sincerely,



Trevor Bohn
Managing Director



Sean Walker
Managing Director



HIGHLIGHTS

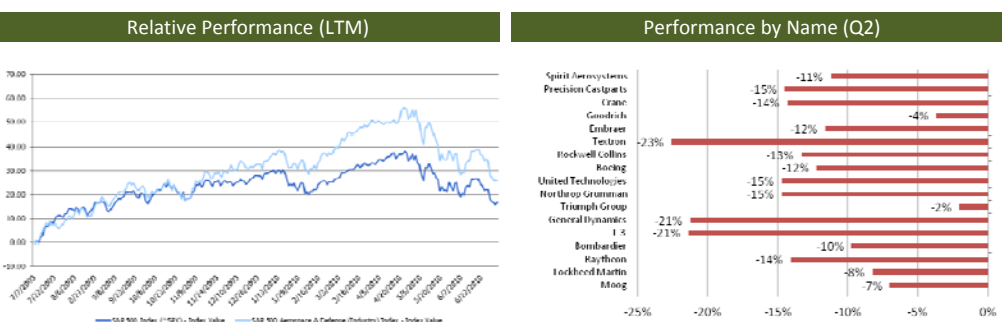
Capital Markets Commentary

Capital Markets

Capital Markets

Equity markets declined in the second quarter of 2010 as investors grew concerned over sustained high-levels of unemployment and sovereign debt issues in Europe. The A&D index declined modestly with large, diversified defense contractors facing the most headwinds on concerns over declining defense budgets.

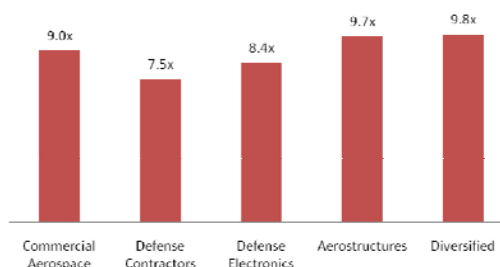
Following on the Q1 trend of headline, blockbuster deals Boeing has announced a proposed acquisition of Argon S/T for \$777 million. The deal is a continuation of the recent surge in C4ISR transactions and demonstrates a renewed commitment by Boeing to the space.



Source: Analyst Research

Source: Analyst Research

Enterprise Value/EBITDA by Subsector



Source: Analyst Research

A&D M&A Activity

A&D M&A Activity

Date	Target	Target Description	Buyer	Enterprise Value	Revenue	EBITDA	Multiples	
							EV/Rev	EV/EBITDA
Pending	Argon ST Inc	Provider of C4ISR systems including sensors, countermeasures and information operations	Boeing Co	\$777	\$353	\$44	2.2x	17.6x
Pending	STADCO	Designer and manufacturer of composite tooling for the A&D markets	Corinthian Capital	n/p	n/p	n/p	n/p	n/p
Pending	LifePort Inc	Manufacturers air medical systems, lightweight armor, interior furnishings and galley equipment	Sikorsky Aerospace Service	n/p	\$65	n/p	n/p	n/p
Jun-10	Haydon Enterprises	Manufacturer of motion control devices for A&D applications	AMETEK Inc	\$270	\$85	n/p	n/p	n/p
Jun-10	Matricon Inc	Designs information technology systems to manage production, optimize operations and monitor assets	Honeywell International	\$139	\$87	\$7	1.6x	18.6x
Jun-10	Saint-Gobain Advanced Ceramics	Manufacturer of technical ceramics for A&D applications	Coorstek, Inc	\$245	\$165	n/p	1.5x	n/p
May-10	CapRock Communications, Inc	Provider of mission-critical managed satellite communications	Harris Corp	\$525	\$359	\$54	1.5x	9.7x
May-10	Atlantic Marine Holdings	Provides vessel maintenance, repair, overhaul and conversion	BAE Systems Inc	\$352	n/p	n/p	n/p	n/p
May-10	AP Labs Group	Designs and develops highly complex and robust computer systems	Kontron AG	n/p	n/p	n/p	n/p	n/p
Apr-10	Insight Technology, Inc	Designs and develops mission critical night vision and electro-optical equipment	L-3 Communications Corp	\$613	\$290	\$68	2.1x	9.0x
Apr-10	Aviation Worldwide Services (AWS)	Provider of expeditionary airlift services and aircraft modifications	AAR Corp.	\$200	n/p	n/p	n/p	n/p
Apr-10	Blackhawk Industries Products Group	Provider of high-quality tactical gear	Alliant Techsystems Inc	n/p	n/p	n/p	n/p	n/p

Source: Analyst Research & Salem Partners estimates

HIGHLIGHTS

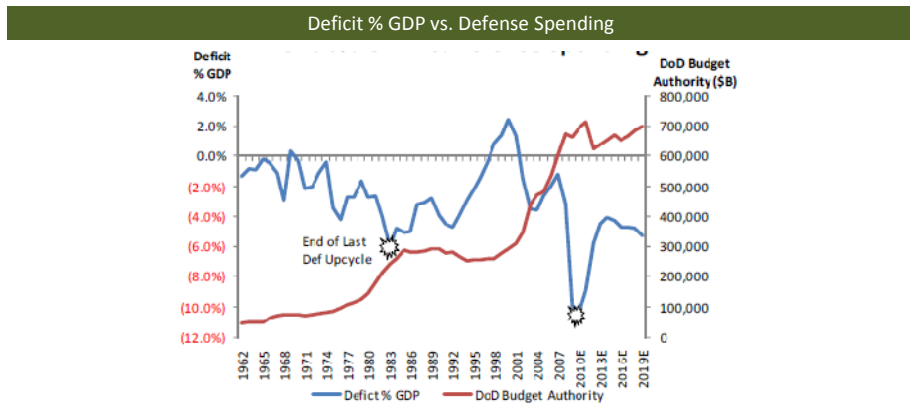
❖ *Defense Spending & the US Deficit*

Industry Headlines - Defense

Defense Budget & Deficit

As fiscal deficits around the world increase, there are widespread concerns among industry participants that global defense spending will come under increased scrutiny. As the US Government has utilized quantitative easing and fiscal stimulus at unprecedented levels, the ability for the US to sustain current levels of defense spending has come into doubt. This issue is expected to come into focus during mid-term elections as a swing towards a more fiscally conservative governing body could have a negative near-term effect on the A&D supply chain.

Historically, declines in defense spending have been preceded by increases in the US deficit. The chart below illustrates how the previous defense spending down-cycle coincided with a then record fiscal deficit.

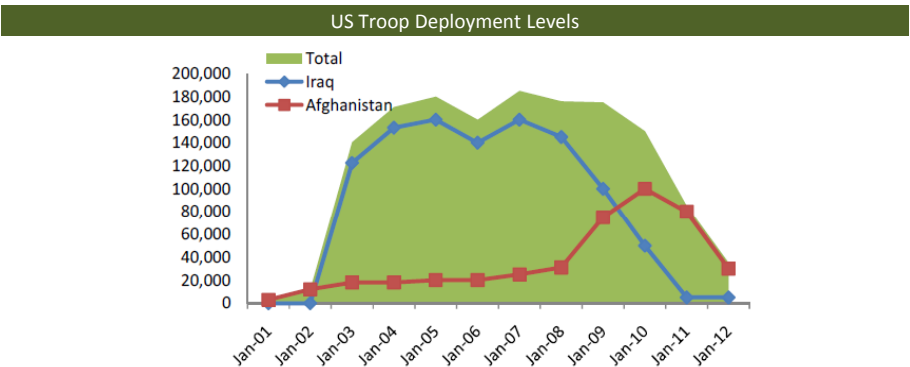


Source: Analyst Research

Iraq & Afghanistan

❖ *McCrystal Out*

Recent developments in Iraq and Afghanistan have made headlines as General McCrystal's resignation led to the appointment of General Petraeus as top commander in Afghanistan. While newsworthy, the recent change in leadership is of less importance to the A&D supply chain than changes in troop deployment levels. Troop levels, already below the 2007 peak, are scheduled to begin a more rapid decline through the summer and into 2011. Roughly 50% of the growth in DoD spending from 2000 – 2008 has been attributed to wartime related spending in Iraq and Afghanistan. As these conflicts wind down, declines in the operations and maintenance portion of the defense budget are increasingly viewed as inevitable.



Source: Analyst Research

HIGHLIGHTS

❖ Reversing Trends in the FX market

Industry Headlines - Aerospace

Effect of Currency Movements in USD/EUR

The past three months have seen enormous moves in the currency market as a flight to quality into the USD has strengthened the USD/EUR tremendously. This shift is significant as years of a gradually weakening USD had challenged European-based suppliers with dollar denominated revenue and EUR costs. The recent currency movements could present new challenges to domestic suppliers as a stronger dollar could put export sales at a pricing disadvantage compared to foreign alternatives. The recent strengthening of the dollar over the past five months is the equivalent of an 18% price increase in US-denominated goods for European buyers. In an already challenging economic environment, industry analysts have begun expressing concern that Boeing can continue strengthening its order book as Airbus will be able to leverage declining domestic production costs.

USD/EUR Exchange Rate Movements



Source: Analyst Research

Importance of Emerging vs. Developed Markets

For commercial aerospace, the end-market dynamics of the commercial build-cycle and aftermarket have diverged significantly over the past several years. With emerging markets now comprising 54%+ of OEM backlog, the new build schedule is reliant on continued growth in developing markets. For the aftermarket, developed countries are the predominant driver of new business as fleet distribution remains weighted in the US and Europe.

❖ BRIC vs. Developed

Global OEM Backlog		Fleet Distribution (5+ Years)	
Africa	4%	Africa	7%
Asia	30%	Asia	13%
Latin America	7%	Latin America	8%
Middle East	12%	Middle East	3%
Total Emerging Market	54%	Total Emerging Market	32%
Australasia	4%	Australasia	3%
Europe	24%	Europe	27%
North America	15%	North America	36%
Japan	3%	Japan	2%
Total Developed Market	46%	Total Developed Market	68%

HIGHLIGHTS

❖ Aircraft 30 Year Plan

Industry Spotlight – Aircraft Procurement Primer

Aircraft 30 Year Procurement Plan

For an owner of a Tier II or III Aerospace & Defense company, a key component of accreting long-term shareholder value is securing work packages or long-term agreements on programs that are central to the Department of Defense's strategic vision. These programs tend to have the most political support and are able to secure increasingly scarce procurement dollars.

Performing a detailed program review will be a central due diligence item during any potential capital raising or M&A event for both deal structuring and valuation. As a complimentary service, Salem Partners has assembled a aircraft procurement primer to give our current and potential clients a condensed version of the recent funding trends and outlooks.

Aircraft Investment Plan: FY2011-FY2040

Keeping with the investment themes detailed in the *2011 Quadrennial Defense Review (QDR)*, the Department of Defense released the Future Years Defense Program (FYDP) to detail the long-term aviation force structure and investment plan. The report detailed the following four key investment items:

Persistent, Unmanned ISR Capabilities

Rapidly expand number of UAV platforms from the current 300 to 800 by FY2020. In addition, continue to expand mission envelope of existing platforms by improving sensor systems and replacing USAF Predators with next-generation Reapers.

Sufficient Enabler Capability & Capacity

Major goal to improve both lift and tanker fleets. Notable recapitalization of USAF tanker fleet underway with goal of 109 new KC-X tankers by FY2020. Both USAF and Navy currently recapitalizing intratheater lift inventories.

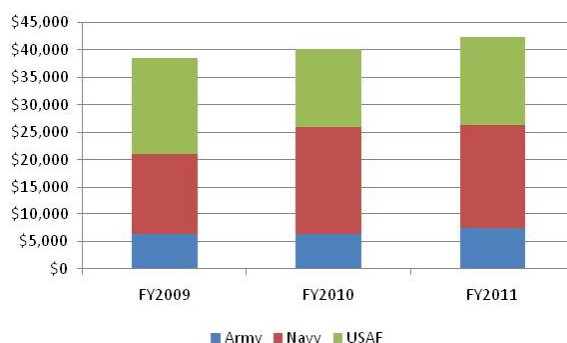
5th Generation Fighter/Attack Fleet

Transition total DoD inventory to 5th generation fighter aircraft. Major goal of JSF is to increase 5th generation fleet from 7% of current inventory to 34% by FY2020. Stated goal of full-retirement of legacy aircraft by FY2040.

Modernized Long-Range Strike Capability

In addition to continuing long-term modernization programs on existing inventories, begin analysis of need beyond FY2040 including plans for a family of solutions (both manned and unmanned).

Aircraft Procurement Spending



Source: Analyst Research

HIGHLIGHTS

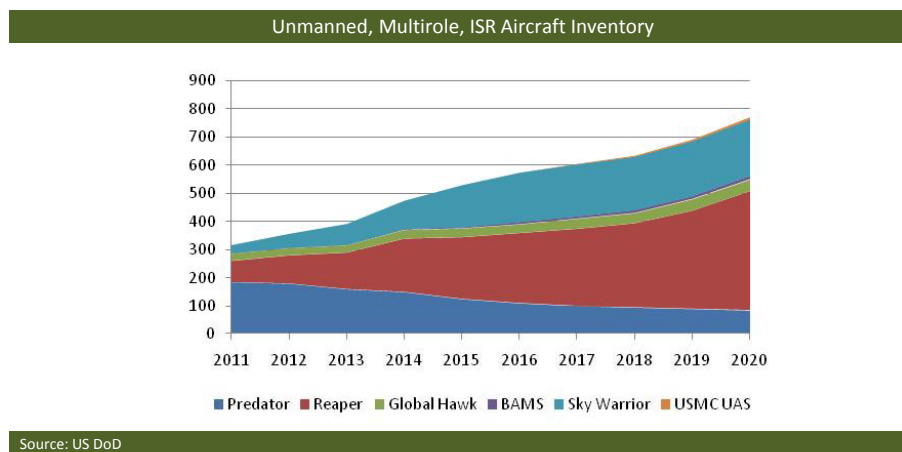
❖ Aircraft 30 Year Plan

Industry Spotlight – Aircraft Procurement Primer

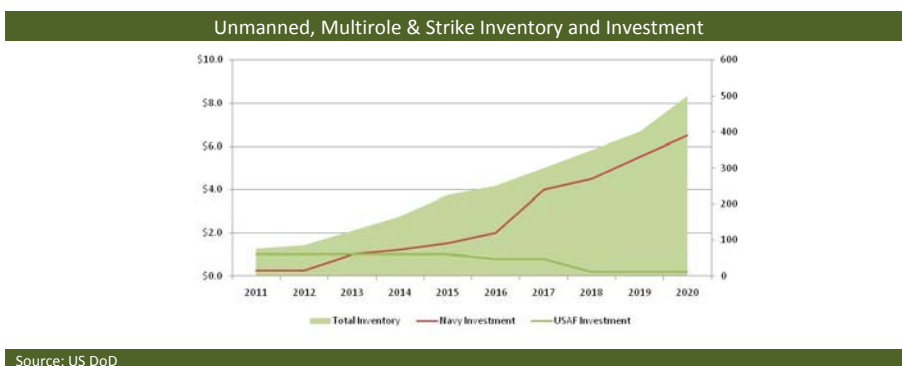
Unmanned, Multirole ISR Aircraft Inventory

The DoD has clearly emphasized expanding Unmanned capabilities in both the ISR and multi-mission roles. In the near-term, the USAF will concentrate on transitioning the existing fleet of MQ-1 Predators into MQ-9 Reapers. Concurrently, the Reaper fleet will be outfitted with the Wide-Area Aerial Sensor (WAAS) to provide an increased optical field-of-view and greater area coverage. Over the long-term, the Navy will focus on accelerating the development of a carrier-based unmanned aircraft, and the Marine Corps plans to develop a multirole UAS.

The below chart illustrates the substantial growth ahead as well as the transition towards next-generation capabilities. It is important to note that the below chart understates the complete UAV landscape as it includes only Group 4 & 5 systems:



UAV's have been established as a strategic necessity for ISR mission profiles, but the consensus among industry analysts is that next generation UAV technology will greatly expand upon current fighter/attack capabilities. The below chart illustrates the growing investment and corresponding inventory build-up of UAV's with attack capabilities:



Conclusion

The Unmanned vehicle space is clearly one of the most attractive, high-growth areas of the DoD budget. Strategic and financial buyers have aggressively pursued acquisition targets that are positioned to benefit from the shift towards unmanned systems. In an environment where DoD dollars are increasingly uncertain, the UAV space will remain attractive for several years to come.

HIGHLIGHTS

❖ Aircraft 30 Year Plan

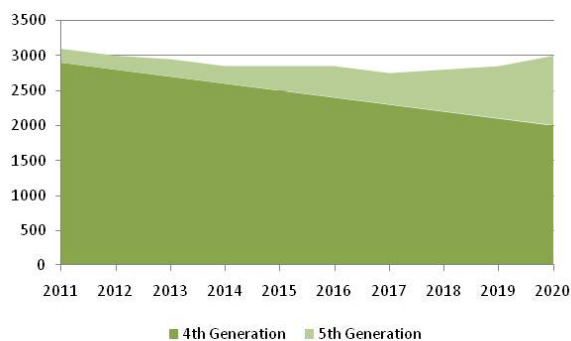
Industry Spotlight – Aircraft Procurement Primer

Fighter/Attack Aircraft

The largest single procurement line item over the next ten years will be the Joint Strike Fighter (JSF). The DoD has selected the JSF as the key platform to transition both the USAF and USN's inventory into fifth-generation fighter/attack platforms. The current fleet of fourth generation aircraft faces limitations due to aging and lack of modernized stealth and electronic warfare capabilities.

The upcoming production ramp will present the A&D supply chain with a great deal of opportunity for high-volume, sustained production level of a government program. While headline risk certainly exists for such high-profile program, the outlook for JSF production appears strong.

Fighter/Attack Aircraft Inventory FY2011 – FY2020



Source: US DoD

In addition to the overall trend of a transition from fourth to fifth generation assets, the below chart provides line-item detail for a selected group of significant procurement items:

Aircraft Funding & Quantity

		FY2009		FY2010		FY2011	
		Funding	Quantity	Funding	Quantity	Funding	Quantity
Aircraft – Joint Service							
MQ-1/MQ-9	Predator & Reaper	931	69	1,181	60	1,863	77
RQ-4	Global Hawk	1,422	7	1,422	4	1,517	4
RQ-7/RQ-11	Shadow & Raven	109	802	224	1,375	90	328
C-130J	Hercules	1,289	15	1,021	6	1,440	17
F-35	JSF	7,046	14	11,218	30	11,449	43
V-22	Osprey	2,798	36	2,998	35	2,802	35
Aircraft – Army							
AH-64	Apache	203	-	368	8	587	16
CH-47	Chinook	709	28	1,067	37	1,251	42
UH-60	Blackhawk	1,146	66	1,430	81	1,412	74
Aircraft – Navy/Marines							
E-2/D	Hawkeye	940	2	1,141	3	1,133	4
F/A-18 E/F	Super Hornet	1,951	23	1,700	18	1,996	22
EA-18G	Growler	1,753	22	1,710	22	1,117	12
P-8A	Poseidon	1,200	-	2,968	6	2,920	7
Aircraft – Air Force							
C-17	Globemaster	2,488	8	2,580	10	14	-
KC-X	New Tanker	23	-	15	-	864	-

Source: US DoD

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