

Salem Partners – Aerospace & Defense

Quarterly Review

Introduction

Fourth Quarter 2011

Dear Friends,

Happy New Year!

With 2011 in the books, it's now time to examine the highlights (as well as lowlights) of the past year while also setting expectations and preparing for 2012. For Salem Partners, last year held a few important milestones for our practice, as we closed several transactions in the A&D space that were great outcomes for our clients and important for our team as we continue to build our practice. Looking ahead, we expect to capitalize on our 2011 momentum and anticipate growing our market presence through additional closed transactions and happy clients.

From a broader M&A perspective, activity level was a tale of two halves. The 1st half of the year was buoyed by supportive equity and debt markets and continued on the strong pace of 2010. Unfortunately, activity in the 2nd half slowed measurably as the European sovereign debt crisis froze debt markets in the summer and early fall and caused broader uncertainty in the market. In the A&D space, a few headline-grabbing deals were completed over the course of the year including UTC's \$18.4bn purchase of Goodrich and several substantial government services transactions (both SRA International and Vangent). For our targeted client base of middle-market business owners, 2011 was a continuation of the following trends established in 2010: valuations closer to 2006-2007 highs rather than 2009 lows; increased platform and end-market scrutiny, especially in defense; and a receptive strategic and financial buyer community with genuine interest in completing a transaction. We expect these trends to continue into 2012 with increased M&A volume as many business owners are likely to take advantage of expiring capital gains tax treatment and look to complete a transaction this year.

In the A&D industry, uncertainty is the only constant within defense as declining operating tempo, increased political rhetoric around the budget deficit and new visions of a "leaner" military have left many business owners (and Salem Partners) concerned about the outlook for the supplier base that serves our nation's military. Highlights including the killing of Osama bin Laden have been overshadowed by the politicized threats of deeply damaging cuts to defense spending. While it seems as though the next several years will be challenging for the defense industry, there are certainly areas where agile business owners can look for growth including UAVs, cyber security and C4ISR. On the opposite end of the spectrum, commercial aerospace continues its multi-year growth cycle as OEMs announced multiple rate increases to rush to meet the robust demand of the airline industry.

Please enjoy the remainder of our industry review and, as always, we welcome your comments and questions. For those of you attending AFCEA – San Diego or Heli-Expo, shoot us an email if you would like to arrange a meeting.



Trevor Bohn
Managing Director



Sean Walker
Managing Director



HIGHLIGHTS

❖ Salem Outlook

❖ M&A Outlook

❖ Commercial Aero Outlook

❖ Defense Outlook

Salem Partners Outlook for 2012

2011 was characterized by the ongoing bifurcation (in terms of both organic growth as well as investor preference) between commercial aerospace and defense. M&A activity for both sectors was flat to slightly down over 2010 levels with valuations maintaining a tight range. For 2012, we have outlined below our M&A/Capital Markets expectations as well as our industry expectations.

M&A Activity

- **Commercial Aerospace Leads the Way:** Supportive industry conditions are likely to drive significant M&A activity for businesses serving commercial aerospace end-markets. We expect multiple expansion as buyers reward sellers for attractive growth prospects.
- **Expiration of Tax Cuts Encourages Sellers:** It appears nearly certain that federal capital gains taxes are going to increase from 15% to 20% and the introduction of a 3.8% Medicare tax will convince private business owners that 2012 is the year to complete a liquidity event in order to maximize after-tax proceeds.
- **Overall, M&A Activity is likely to remain consistent with 2011 in terms of both activity and valuation.**

Commercial Aero

- **Cracks Show in OEM Orderbook:** For the past several years, the commercial aerospace story has been incredibly positive. While we remain optimistic, the OEMs are starting to appear guilty of overbooking, with significant orders being placed 5+ years in advance to airlines that have limited visibility into operating or financing conditions. Aerospace is notoriously cyclical, and we expect worries of the downward turn to emerge.
- **Aftermarket Growth Continues:** We expect continued economic growth to provide positive momentum to the aftermarket. Deferred maintenance and retrofit/upgrade activity tend to lag in economic upturns and appear poised to accelerate.

Defense

- **Joint Strike Fighter Gets Whacked:** Due to its high-profile status, the JSF remains the most likely program to see significant reductions in order quantity. The procurement of Lot 5 showed the changing dynamic at the DoD as Lockheed was challenged on risk-sharing as well as order quantity (30 versus 35 units). We would advise those hoping for a production ramp to temper expectations as it is likely that the only volume growth will be driven by FMS.
- **DoD Spend as a Presidential Focus:** As the elections draw nearer, the politicization of defense spending is likely to increase. It is an unfortunate reality that despite its importance to national security the defense budget is likely to be used as political tool.

Capital Markets

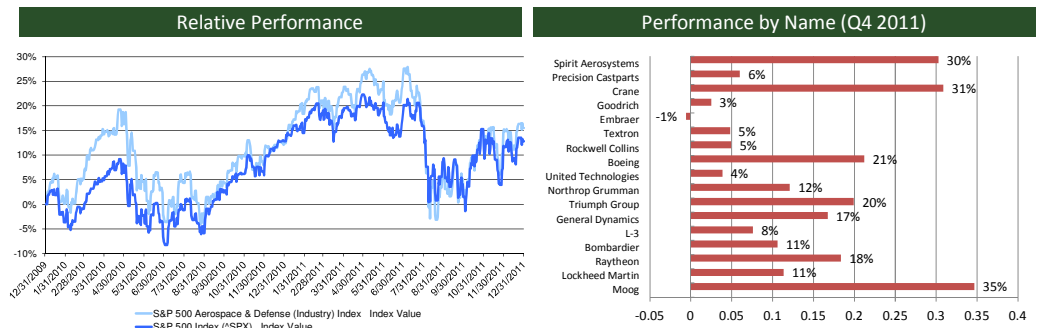
HIGHLIGHTS

Capital Markets Commentary

Capital Markets

Overall improvement in the equity markets in the fourth quarter of 2011 was reflected in strong gains made by aerospace and defense companies, many of which posted double-digit returns for the quarter. Spirit Aerosystems, Crane and Moog made notable recoveries after experiencing sharp losses in the third quarter of 2011.

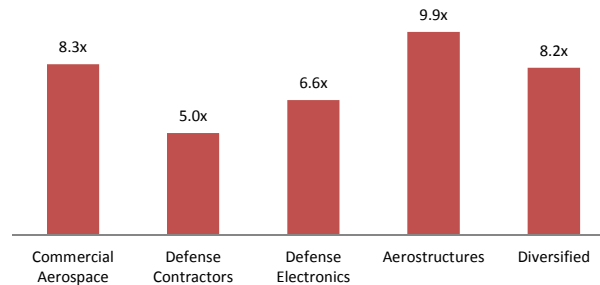
The S&P Aerospace & Defense Index rose 12.3% for the fourth quarter of 2011, slightly outpacing growth in the S&P 500 Index of 11.2% over the same period.



Source: Analyst Research

Source: Analyst Research

Enterprise Value/EBITDA by Subsector



Source: Analyst Research

Select Q4 A&D M&A Activity

Date	Target	Acquirer	Implied EV	EV/Revenue	EV/EBITDA
22-Dec-11	Doss Aviation, Inc.	J.F. Lehman & Company	-	-	-
22-Dec-11	KOR Electronics, Inc.	Mercury Computer Systems, Inc.	\$70	-	-
20-Dec-11	Dell Manufacturing Co. Inc.	Whitcraft, LLC	-	-	-
12-Dec-11	Contour Premium Aircraft Seating Ltd.	Zodiac Aerospace SA	-	-	-
12-Dec-11	Kollmorgen Electro-Optical, Inc.	L-3 Communications Holdings Inc.	210	1.2x	-
1-Dec-11	Flightstar Aircraft Services, Inc.	Moelis Capital Partners LLC	-	-	-
30-Nov-11	Ballard Technology, Inc.	Astronics Corporation	30	-	-
28-Nov-11	Weston EU Limited	Senior plc	84	1.3x	-
16-Nov-11	Selmet Inc.	Blue Point Capital Partners	-	-	-
8-Nov-11	Harco Laboratories, Inc.	TransDigm Group Inc.	84	-	-
4-Nov-11	British Midland plc	IAG	276	0.2x	-
2-Nov-11	Vermont Composites, Inc.	Kaman Aerospace Group, Inc.	40	-	-
1-Nov-11	ASTRUM (UK) Limited	William Cook Holdings Ltd.	-	-	-
28-Oct-11	Point Blank Solutions, Inc.	Sun Capital Partners, Inc.	37	-	-
27-Oct-11	BKW	Applus LGAI Technological Center SA	-	-	-
19-Oct-11	SPARTA, Inc. (Cobham Analytics Solutions)	The Parsons Corporation	350	-	-
11-Oct-11	IAE International Aero Engines AG	Pratt & Whitney Company	4,615	-	-

(\$ in millions)
Source: Analyst Research & Salem Partners estimates

A&D M&A Activity

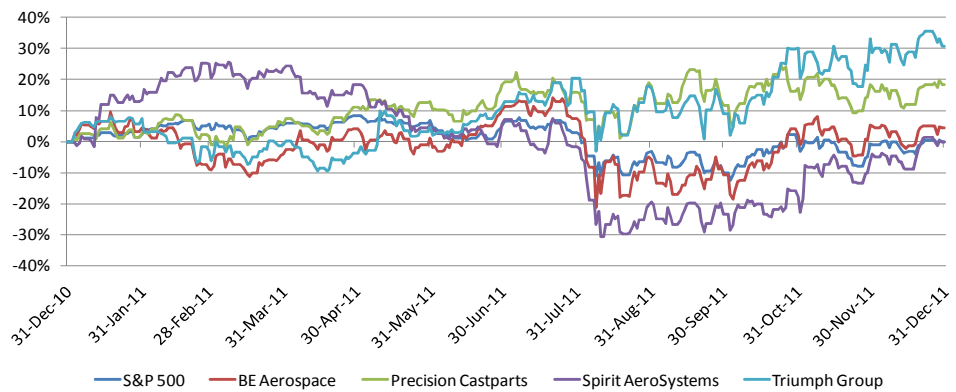
HIGHLIGHTS

❖ Commercial Aerospace

2011 Performance: Key Strategic Companies

Commercial Aerospace			
Outlook <ul style="list-style-type: none"> Commercial aerospace outperformed the broader market in 2011 as macro-economic improvements allowed equity valuations to expand. Notable transactions include Precision Castparts acquisition of Primus and B/E Aerospace's acquisition of TSI Group. 	Valuation Metrics		
		EV/Rev	EV/EBITDA
	B/E Aerospace	2.1x	10.6x
	Precision Castparts	3.6x	13.4x
	Spirit Aerosystems	0.9x	8.0x
Triumph Group	1.2x	8.2x	

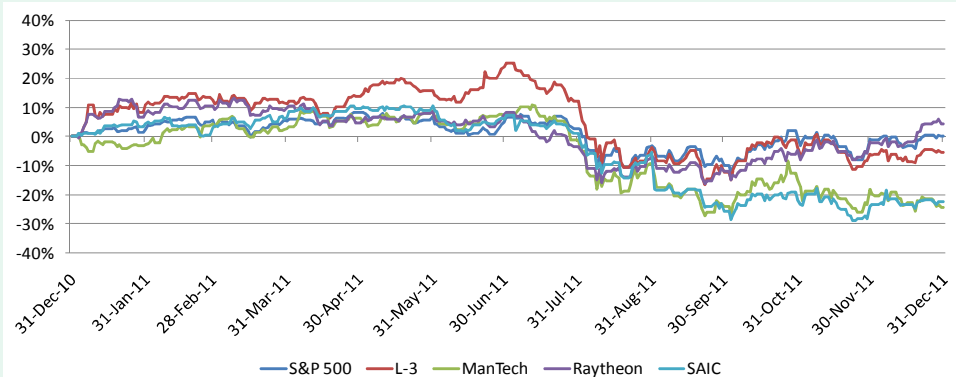
Selected Aerospace Performance by Name: 2011



❖ Defense Industry

Defense			
Outlook <ul style="list-style-type: none"> Defense stocks were flat to down in 2011 with valuations showing declines. Defense companies are challenged by low valuations but still need to make acquisitions to grow in a declining budget environment. 	Valuation Metrics		
		EV/Rev	EV/EBITDA
	L-3 Communications	0.7x	5.5x
	ManTech	0.4x	4.5x
	Raytheon	0.7x	5.8x
SAIC	0.4x	6.0x	

Selected Defense Performance by Name: 2011



HIGHLIGHTS

❖ *Airlines are Profitable*

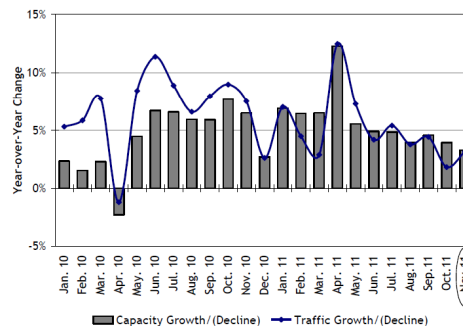
Commercial Aerospace – Year in Review

Commercial aerospace had a strong year in 2011 as global airline traffic continued to grow despite economic uncertainty and a few exogenous shocks. Improving end-market demand combined with higher but manageable fuel costs contributed to a profitable year for global airlines, though results were down from 2010. The dominant theme for investors and private business owners in 2011 was the orderbook and production rates for the major OEMs. Last year both Airbus and Boeing continued to pleasantly surprise with additional rate increases, healthy orderbooks and one long awaited-first delivery.

Improving Airline Health

For the global supply chain, the financial health of the airline industry is a key forward-looking metric into production rates and aftermarket activity. While the recent Chapter 11 filing of American Airlines filled the headlines in the US, the seemingly inevitable bankruptcy will have a limited impact on the supply chain due to the increasingly-global demand for aircraft as well as the overall profitability of the rest of the airline industry. According to IATA, global airlines are expected to report a solidly-profitable year of \$6.9bn (though down from \$15.8bn in 2010). Despite improving operating conditions (traffic growth and load factors) year-over-year, airlines saw reduced profitability due to increased fuel costs and deferred maintenance expense.

Global Airline Traffic and Capacity



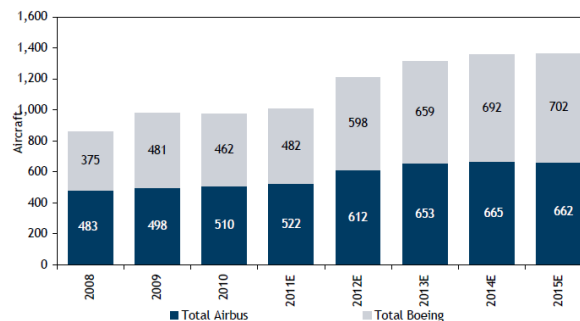
Source: RBC Capital

OEM Orderbooks

After maintaining production rates through the worst of the recession, Boeing and Airbus have continued to announce successive rate increases that are being matched by growing orderbooks. The supply chain has greatly benefited as key platforms such as the B737 and B777 announced ongoing rate increases and the B787 appears poised to finally begin its production ramp. Rate increases have generated significant organic revenue growth for Tier 2 and 3 suppliers over the past year, and it appears likely that will continue into 2012 and 2013.

❖ *Strong Orderbooks*

Airbus and Boeing Deliveries



Source: RBC Capital

HIGHLIGHTS

❖ M&A Brief

Industry M&A – Commercial

September's announcement of the proposed acquisition of Goodrich Corp. by competitor United Technologies Corp. remained the blockbuster aerospace deal of 2011, but Precision Castparts also expanded its engineered parts production capabilities through Tier 2 supplier Primus International, while Allegheny Technologies added machining and casting muscle with the acquisition of Ladish Co. Optimism surrounding commercial build rates and international regional traffic continue to create demand for targets in the commercial space with attractive capabilities or key platform contributions.

Select Commercial M&A Activity				
Date	Value (\$mm)	Target Revenue	Acquired/Target	Acquirer
Pending	\$18,400	\$6,967	Goodrich Corp.	United Technologies Corp.
Pending	-	-	PB Fasteners	Precision Castparts Corp.
Dec-11	\$285	\$95	Tri-Star Electronics International Inc.	Carlisle Companies Inc.
Dec-11	-	-	Doss Aviation Inc.	J.F. Lehman & Co.
Nov-11	-	-	Models & Tools	Altus Capital Partners Inc.
Nov-11	-	-	Sierra Alloys Co. Inc.	Platte River Ventures (PRV Metals LLC)
Oct-11	\$504	\$403	Satair A/S	EADS N.V. (Airbus SAS)
Oct-11	-	-	Numet Machining Techniques Inc.	Kidd & Company LLC
Sep-11	\$288	\$84	Schneller Holdings LLC	TransDigm Group Inc.
Sep-11	\$1	-	Alabama Aircraft Industries Inc.	Kaiser Group Holdings Inc.
Aug-11	\$491	\$355	EMS Technologies Inc.	Honeywell International Inc.
Aug-11	\$900	-	Primus International, Inc.	Precision Castparts Corp.
Aug-11	-	-	North American Aircraft Services Inc.	Mangrove Equity Partners L.P.
Jul-11	\$715	\$350	Souriau S.A.S.	Esterline Corp.
Jul-11	-	-	Triumph Precision Castings Co.; Dynamic Turbine LLC	Torque Capital Group LLC
Jun-11	\$640	\$558	Vector Aerospace Corp.	EADS N.V. (Eurocopter)
Jun-11	-	-	Cirrus Industries Inc.	AVIC
Jun-11	-	-	Quality Forming, LLC	Platte River Ventures (PRV Aerospace LLC)
May-11	\$778	\$403	Ladish Co. Inc.	Allegheny Technologies Inc.
Apr-11	\$186	-	Teledyne Continental Motors Inc.	AVIC International Holding Corp.
Apr-11	-	\$29	BASF Corp. (Surface Technologies)	Curtiss-Wright Corp.
Feb-11	-	-	Eclipse Aerospace Inc.	United Technologies Corp. (Sikorsky)
Jan-11	-	-	Ultimate Aircraft Composites LLC	GA Telesis LLC

Source: DACIS

❖ Commercial M&A

HIGHLIGHTS

❖ *Transforming Military*

❖ *Cuts Continue*

Defense – Year in Review

2011 proved to be a year full of challenges and changes for the defense industry. Going into the year, Salem expected the ongoing focus on the federal deficit as well as continued reductions in operating tempo to result in the first cuts to defense spending since the mid-1990s. It now appears that the Administration has formally decided to transform, and in many ways diminish, our nation's military into a "leaner" version that is focused on addressing next generation challenges from Iran and China versus the current iteration that recently fought in Iraq and Afghanistan. This new vision of the military will require a lower budget as personnel, procurement and O&M costs are reduced.

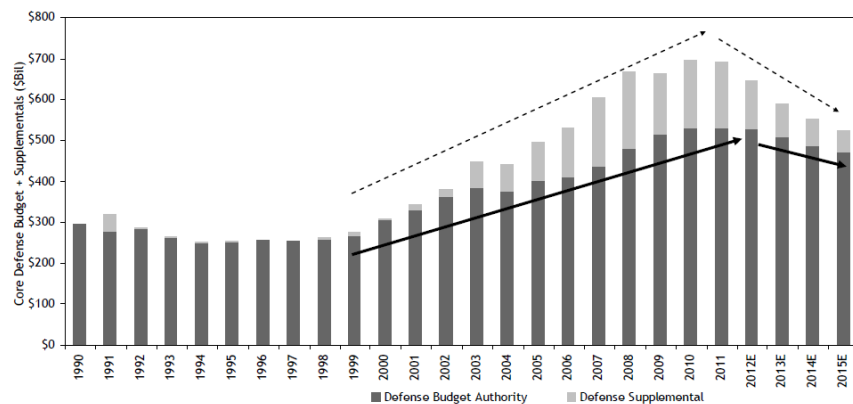
Addressing the Next Threat

As the conflicts in Iraq and Afghanistan wind down, new threats from a dangerously-belligerent Iran and an increasingly-potent China appear to be the next test for our nation's military. For Iran, a multitude of issues have arisen including the increased likelihood of weaponized nuclear capabilities, offensive cyber security initiatives and the well publicized capture of a US Avenger UAV. Over the past several years, China has closed key technological and modernization gaps in its armed forces including the development of a new stealth fighter and aircraft carrier as well as a record number of space launches. Both of these new potential threats to the US present a different challenge to our military than those posed by the guerilla warfare and terrorist activity that characterized our recent engagements. It follows that defense spending priorities will evolve to focus on procurement and R&D efforts in areas such as cyber security, surveillance and SOCOM that will be heavily utilized to defend against evolving threats to security.

Defense Spending

This past year saw the first announcement of definitive cuts to the defense budget, but the total amount of cuts remains unclear. The Budget Control Act of 2011 instituted a severe set of DoD cuts under a sequestration scenario that would result in a 23% reduction to FY2013 funding levels. Even outside of that scenario, the DoD is likely to face at least \$450bn of cuts over the next ten years. Expectations are that most of the savings will be seen through troop reductions and the effect on R&D and procurement will be limited with the exception of a few high-profile programs (Joint Strike Fighter). The chart below illustrates the ongoing downward pressure facing the DoD budget that will likely result in funding levels dipping down to 2006 levels over the next three years.

US Defense Budget



Source: RBC Capital

HIGHLIGHTS

❖ M&A Brief

Industry M&A – Defense

Concerns over reduced spending levels have not hampered defense M&A activity to the extent that many had expected; instead, buyers are looking to add increased capability and gain access to additional platforms in order to drive growth as organic means are limited. Providence Equity Partners made headlines with the \$1.88 billion acquisition of national security and government services technology provider SRA International, while General Dynamics picked up MRAP manufacturer Force Protection, as well as government services provider Vangent.

Select Defense M&A Activity				
Date	Value (\$mm)	Target Revenue	Acquired/Target	Acquirer
Pending	-	-	Tampa Microwave Labs Inc.	Thales S.A.
Pending	-	-	Point Blank Solutions Inc.	Sun Capital
Dec-11	\$360	\$656	Force Protection Inc.	General Dynamics Corp.
Dec-11	-	-	Haigh-Farr Inc.	Vitec Group plc
Dec-11	\$70	-	KOR Electronics Inc.	Mercury Computer Systems Inc.
Dec-11	-	-	Pikewerks Corp.	Raytheon Co.
Dec-11	\$77	-	Zu Industries Inc.	Ultra Electronics Holdings plc
Nov-11	-	\$32	Vermont Composites Inc.	Kaman Corp.
Nov-11	\$126	-	Trivec-Avant Corp.	Cobham plc
Nov-11	\$90	-	Worldwide Information Network Systems Inc.	ManTech International Corp.
Nov-11	\$350	\$323	SPARTA, Inc. (Cobham Analytics Solutions)	Parsons Corp.
Sep-11	\$960	\$760	Vangent Inc.	General Dynamics Corp.
Jul-11	\$90	\$62	General Dynamics Corp. (Detection Systems business)	Chemring Group plc
Jul-11	-	-	BAE Systems plc (Composites Structures business)	EnCore Composites Holdings Inc.
Jul-11	\$266	\$178	Integral Systems Inc.	Kratos Defense & Security Solutions Inc.
Jul-11	\$1,880	\$1,666	SRA International Inc.	Providence Equity Partners
Jul-11	-	-	GMA Cover Corp.	Admiralty Partners Inc.
Jun-11	\$32	\$13	Crossbow Technology Inc.	Moog Inc.
Jun-11	-	-	KaZaK Composites Inc.	Plasan Sasa Ltd.
Jun-11	\$338	\$324	LaBarge Inc.	Ducommun Inc.
Jun-11	\$134	-	RAE Systems Inc.	Vector Capital
Apr-11	\$315	-	Global Defense Technology & Systems Inc.	Ares Management LLC
Apr-11	-	-	Engineering Solutions & Products LLC	Berkshire Partners LLC
Apr-11	-	-	Nobles Manufacturing Inc.	Inverness Graham Investments
Apr-11	-	-	Westland Technologies Inc.	Mangrove Equity Partners L.P.
Apr-11	\$685	\$378	Danaher Corp. (Pacific Scientific Aerospace)	Meggitt plc
Mar-11	\$271	\$188	Herley Industries Inc.	Kratos Defense & Security Solutions Inc.
Mar-11	-	-	Diamondback Tactical LLLP, Ltd. (majority stake)	Torch Hill Investment Partners LLC
Feb-11	-	\$110	ND SatCom (75% stake)	EADS N.V. (Astrium)
Feb-11	\$130	\$180	Todd Shipyards Corp	Vigor Industrial LLC
Feb-11	\$303	\$234	L-1 Identity Solutions Inc. (Intelligence Services Group)	BAE Systems plc
Feb-11	\$525	-	CPI International Inc.	Veritas Capital Fund L.P.
Jan-11	\$13	\$8	Predator Systems Inc.	Curtiss-Wright Corp.
Jan-11	\$490	\$203	Applied Signal Technology Inc.	Raytheon Co.
Jan-11	\$30	\$40	Trident Space & Defense LLC	TeleCommunication Systems Inc.

Source: DACIS

❖ Defense M&A

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