

Salem Partners – 2010 Outlook

Introduction

Dear Friends,

Happy New Year and best of luck in 2010!

As a key aspect of our advisory services, we are often asked by our clients to opine on timing. In an M&A transaction, accessing the markets at the opportune moment is a vital component of success. The past year in M&A was a tale of two halves. During the first half buyers were paralyzed by a lack of confidence resulting in a multitude of failed transactions; however, the second half gave us many reasons for optimism as market conditions stabilized. On the heels of rapidly improving equity and debt capital markets, we have seen an uptick in deal making activity, particularly in the fourth quarter, as strategic-minded buyers have aggressively re-entered the M&A market.

We believe 2010 will be a year where timing plays a critical role due to the following factors:

- 1)M&A Activity is Accelerating
- 2)Peaking Macro-Level Industry Dynamics
- 3)Strategic Consolidators Re-Entering M&A Market
- 4)Expiration of Bush Tax Cuts Mean Considerably Higher Capital Gains Tax Rates

Anyone of the above rationale on a standalone basis requires dedicated thought and strategy; taken as a whole these four considerations create a compelling case for every stakeholder to consider pursuing a liquidity event. We strongly believe that many businesses in the sector will receive the maximum receptivity in the market during the first half of 2010. A window of opportunity certainly exists in today's market for shareholders to successfully complete a liquidity event or recapitalization. As we have witnessed over the past two years, successfully accessing the M&A and capital markets requires real time knowledge and specialized, full-time expertise.

Sincerely,

Trevor Bohn
Managing Director

Sean Walker
Managing Director



Upcoming Tradeshows

Heli-Expo: February 21st – 23rd
Aviation Weekly MRO: April 20th – 22nd



Merger & Acquisition Activity

HIGHLIGHTS

- ❖ *The M&A Markets have re-accelerated*
- ❖ *Deal Valuations have Rebounded Sharply and Scarcity Premiums are Being Obtained*
- ❖ *High Yield and Private Placement Markets are Open*
- ❖ *Traditional Bank Market Continues to Thaw*
- ❖ *Supply/Demand Imbalance*

- ❖ *Increasing M&A Activity*

The pace of middle-market M&A activity has re-accelerated over the last three months after a nearly eighteen month lull. The reasons and rationale for this improvement are varied but for simplicity's sake can be divided into three primary "M&A Drivers."

Improving Valuations

The discrepancy between valuation expectations for buyers and sellers expanded as the economic crisis unfolded leading to a surge in failed sales and deals pulled from the market. During this time, sellers remained entrenched at previous historically rich valuation levels while buyers sought to pick up businesses at distressed prices. This dynamic has since abated as sellers have adjusted expectations in line with new market realities and buyers are willing to once again pay premium prices for high quality targets.

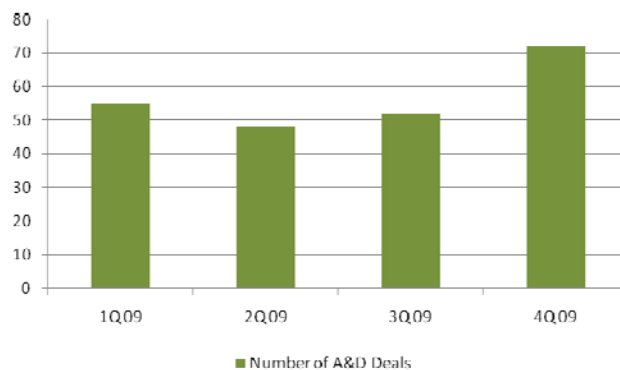
Availability of Capital

Access to the capital markets is an important driver of M&A deal making as both strategic and private equity firms utilize outside capital to fund transactions. Private equity groups have improved access to leveraged financing as banks have increased their willingness to fund middle-market leveraged buyouts. This increased willingness has come as credit spreads have tightened, base rates remain near record lows and high yield bond issuance is surging.

Pent-Up Demand for High Quality Companies

Salem Partners expects a busy first half of 2010 as pent-up demand will begin to be met by quality companies coming to market. On the supply-side, high-quality companies that had put transactions on hold during 2008 and 2009 are expected to capitalize on improved M&A conditions. This supply is eagerly anticipated by both private equity and strategic acquirers. For private equity, pressure is mounting to deploy committed capital raised during the "boom" years in order to generate expected returns. Strategic buyers are eager to bolt-on additional capabilities or product lines that offer access to new programs or customers in order to fulfill shareholder expectations for continued growth despite the current economic environment.

Aerospace & Defense M&A Activity



HIGHLIGHTS

- ❖ *Defense Spending has Leveled and Programs are at Risk*

- ❖ *Decreasing Defense Budget Causing Everyone to Re-Evaluate*

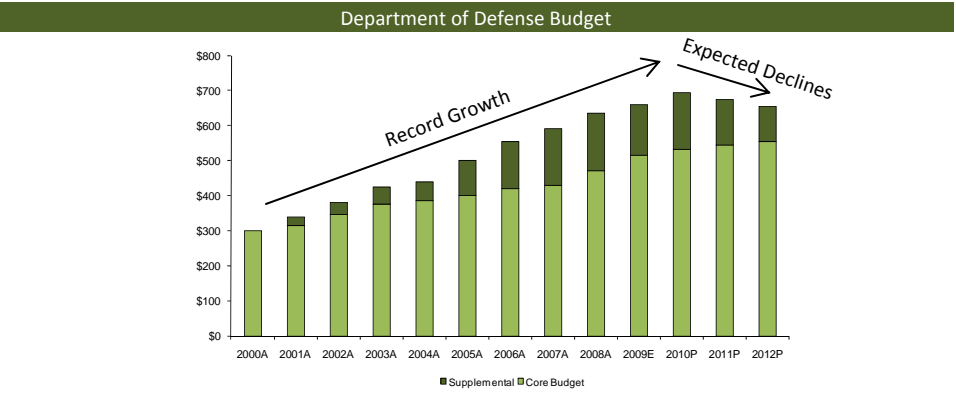
- ❖ *Production Levels Likely to Decrease*

Industry Overview

The two primary macro-level drivers of the A&D industry, the Defense Budget and the Commercial Build Cycle, have provided a supportive environment for industry participants throughout the supply chain to grow and expand over the past several years. Unfortunately, these beneficial conditions appear poised to shift towards a more challenging industry backdrop prompting many middle-market businesses to consider strategic alternatives.

Defense

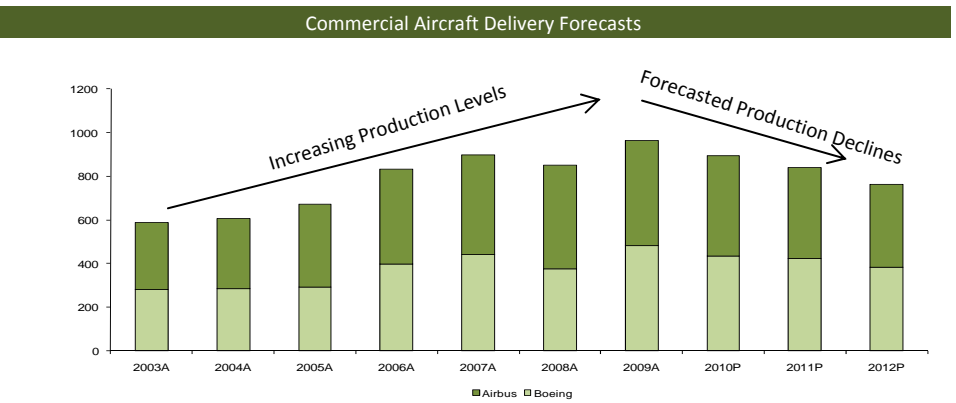
After years of record growth, defense industry participants have begun to prepare for an environment where stimulating the economy, addressing the fiscal deficit and other projects (ie universal healthcare) take priority over defense spending. In the FY2010 defense budget, President Obama and Defense Secretary Gates demonstrated a fundamental shift in defense spending policy as heavy handed budget cuts to various high-profile programs were used to slow growth in defense spending. Future cost savings will likely be driven by delays and quantity reductions in major programs.



Source: Analyst Research

Commercial Aerospace

Despite a forecasted return to air traffic growth in 2010, current production rates at both Boeing and Airbus appear to be unsustainable as aircraft overcapacity and continued challenges in the financing market have made customers increasingly eager to defer or cancel existing orders. Despite the assurances of the OEM's, analysts expect material reductions in both wide and narrow-body build rates to align production levels with demand.



Source: Analyst Research

Key Strategic Consolidators – M&A Outlook

HIGHLIGHTS

- ❖ *Evaluating Consolidators*

- ❖ *Public Comments Declaring Commitment to M&A in 2010*

- ❖ *International Players Also Actively Involved Including EADS*

The importance of the active participation of key strategic partners in an M&A process can not be overstated as these buyers are often able to rationalize the highest valuation.

From an industry perspective, management teams of diversified public companies face a challenge to continue to grow shareholder value despite a deteriorating budgetary environment. With procurement spending set to slow in order to support troops in two theaters, the only way to accomplish this goal is to acquire companies with above-average organic growth opportunities.

Public comments made by prominent industry CEO's and CFO's support this view:

Louis Chenevert (President - United Technologies):

Expects to spend \$3 billion on M&A in 2010 due to "continued challenges in the North American and European commercial construction and commercial aerospace OEM markets."

Michael Strianese (CEO – L-3 Communications):

Said that "the M&A environment has improved and is providing an upside to organic growth"

Scott Kuechle (CFO – Goodrich):

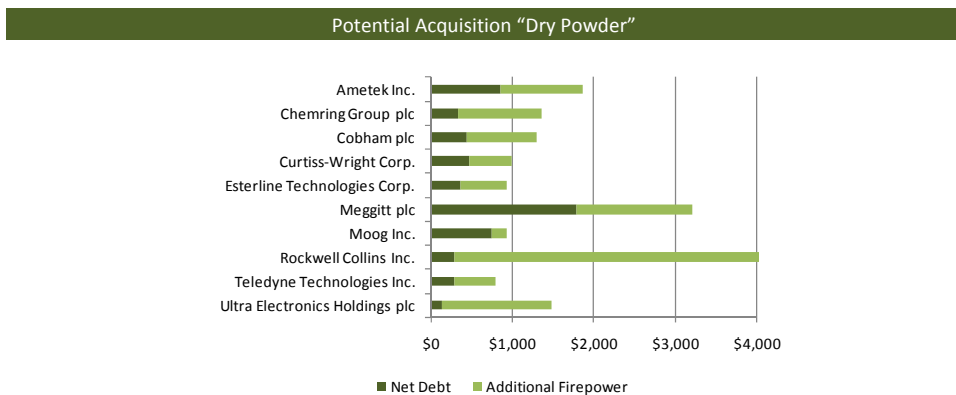
Expects to spend \$500mm - \$1bn on acquisitions next year. He said, "There is a very good pipeline of discussions."

Nick Howley (CEO – Transdigm):

Said that he has 1,500 – 2,000 acquisition candidates in the pipeline and would issue an additional \$500mm of bonds to fund buys

Due to years of historic defense budgets and strong free-cash flow, Tier I & II A&D companies are under levered with significant acquisition "Dry Powder". Aside from the large-cap industrial conglomerates (UTC, Danaher, GE, etc), it is important to realize that there are a range of mid-cap Aerospace & Defense suppliers with sufficient financial resources to complete multiples M&A transactions in 2010.

Below is a chart illustrating the potential acquisition "Dry Powder" of a sampling of relevant Tier I & II A&D suppliers if each increased leverage to 4.0x EBITDA.



- ❖ *Plenty of Dry Powder*

Tax Considerations – Focus on After Tax Proceeds

HIGHLIGHTS

❖ *Timing Implications – After Tax Proceeds in Focus*

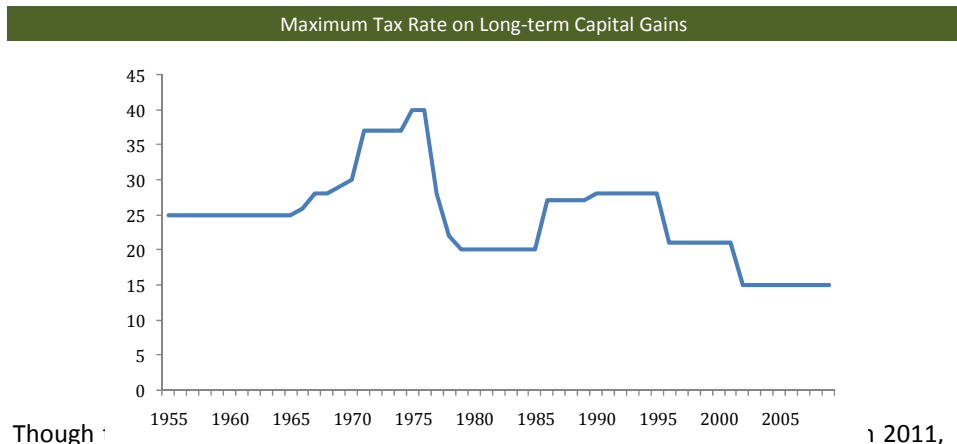
❖ *Trending Back Towards Historic Rates of Long-Term Capital Gains*

❖ *Current Administration and Future Capital Gains Implications*

An often underestimated component of maximizing shareholder returns in an M&A transaction is the difference between announced deal value and after tax proceeds.

Change is coming for federal level tax treatment of capital gains and dividends as several key pieces of tax legislation are set to expire over the next year. The “Bush Tax Cuts” were legislated in the Tax Increase Prevention and Reconciliation Act of 2006 (TIPRA) as an extension of the Jobs and Growth Tax Relief and Reconciliation Act of 2003 (JGTRRA). Acronyms aside, these two pieces of legislation lowered capital gains taxes to 15% for higher income tax payers through December 2010. Upon expiration, capital gains will automatically reset to 20% on January 1st, 2011.

Business owners have grown accustomed to low (by historic standards) capital gains tax treatment. Today’s tax rate of 15% for long-term capital gains is the most shareholder friendly over the past fifty years.



Source: Department of the Treasury, Office of Tax Analysis

From recent statements, it appears that the Administration will raise capital gains rates above 20% and move them closer towards ordinary income levels. On Sept. 18, 2007, Obama discussed capital gains taxes and adjusting the levels back “to something closer to – but no greater than – the rates Ronald Reagan set in 1986.” This would indicate that the current Administration expects to move capital gains tax rates back towards 28% (the 1986 level).

The upcoming changes in 2010 capital gains tax treatment have created a window of opportunity for shareholders to take advantage of historically low rates and with the length of time necessary to complete an M&A process (6 months on average) this window is smaller than many imagine. The effect tax changes will have on after – tax proceeds is material and should be carefully considered when analyzing the correct time to initiate a liquidity event.

HIGHLIGHTS

❖ *First Flight!*

Industry Headlines

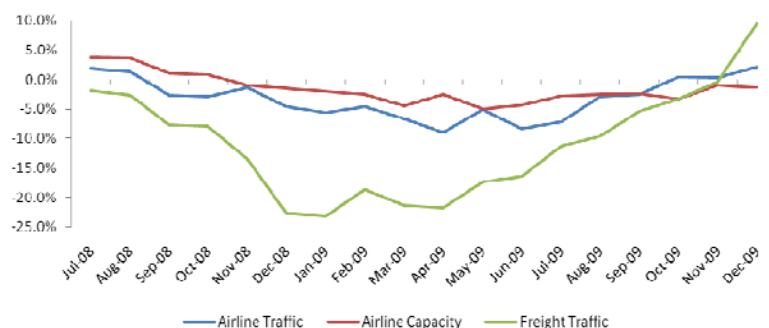
Commercial

After years of anticipation, Boeing successfully completed the first flight of its composite wide-body 787. Though first delivery remains at least nine months away, the long awaited first flight was good news for the supply chain who has tooled up to deliver on 840 orders for the new aircraft. Increases in production rates will help to allay two years of delays that have challenged the global supply chain as capital investments made in anticipation of the program have yet to be fully utilized.

International passenger and freight traffic simultaneously increased year-over-year in November for the first time in eighteen months. The improving operating environment will allow airlines to halt capacity cuts and to continue fleet improvements.

❖ *Improving Operating Conditions*

International Traffic YoY % Change



Source: Analyst Research

Defense

Several important decisions are going to be made in the first quarter regarding the Defense Budget for FY2011. On February 1st, the Obama Administration will submit its DoD budget proposal to Congress for FY11. Within this budget, details are expected to emerge for changes in both the baseline accounts and additional war related spending.

❖ *Key Budget Decisions*

Also, the Quadrennial Defense Review is expected to be finalized early this quarter. This review is designed to illustrate the long-term course of the DoD as it assesses the threats and challenges facing the US today as well as re-balancing the DoD's strategies, capabilities and forces. In light of the attempted act of terrorism in December, industry participants expected a renewed focus on airport and other Homeland Security issues.

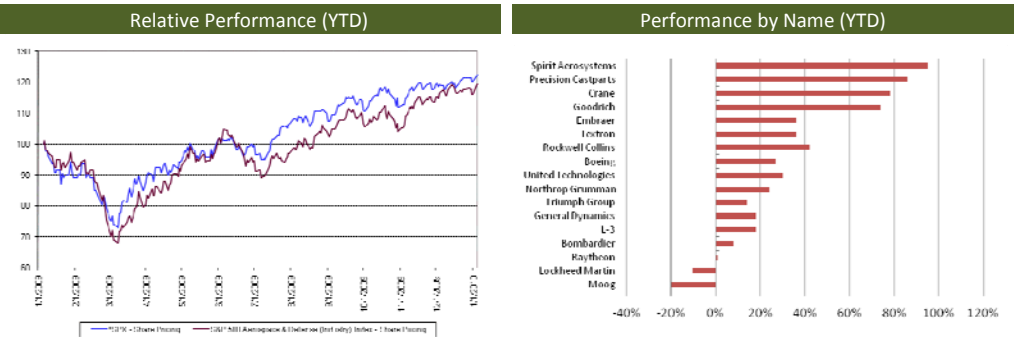
Capital Markets

HIGHLIGHTS

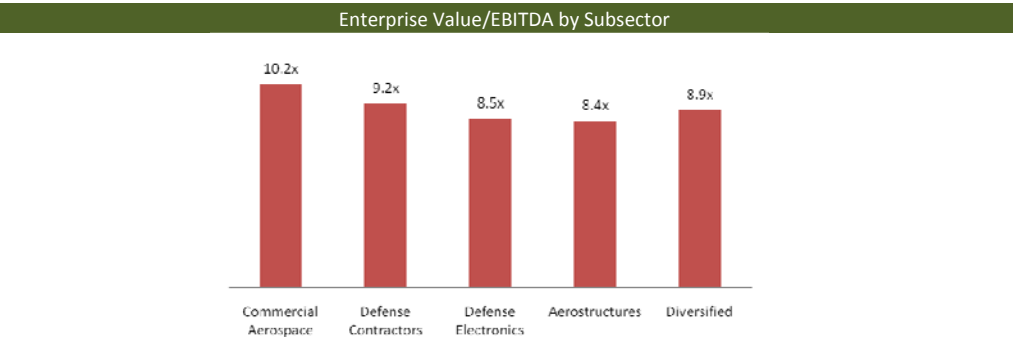
Capital Markets Commentary

Capital Markets

The broad equity markets finished 2009 with solid momentum as the S&P500 finished the year up 24%. For A&D businesses equity investors viewed commercial aerospace exposure in a significantly more positive light than defense business. For the year, commercial aerospace significantly outperformed the broad market and finished the year up 50% while the defense sector struggled due to an uncertain DoD budget environment and finished the year up 13%.



Source: Analyst Research



Source: Analyst Research

A&D M&A Activity

Date	Target	Target Description	Buyer	Enterprise Value	Revenue	EBITDA	Multiples	
							EV/Rev	EV/EBITDA
Dec-09	757 Conversion Assets	Joint venture of Alcoa - SIE consisting of cargo conversion assets	Pemco	n/p	n/p	n/p	n/p	n/p
Dec-09	Cinch Connectors (Safran)	Manufacturer of interconnect products for A&D and telecom customers	Bel Fuse Inc	\$39	\$60	n/p	.7x	n/p
Dec-09	Directed Perception	Provider of pan-tilt motion control systems	FLIR Systems	\$20	n/p	n/p	n/p	n/p
Dec-09	EaglePicher Technologies	Designs and manufactures batteries, battery management systems and energetic devices	OM Group Inc	\$172	\$125	n/p	1.4x	n/p
Dec-09	Merrimac Industries	Produces RF microwave components, assemblies and micro-multifunctional modules	Crane Co	\$51	\$32	\$7	1.6x	7.4x
Dec-09	Atlantic Inertial Systems	Portfolio company of JF Lehman. Provider of guidance, navigation and stabilization products	Goodrich Corp	\$380	n/p	n/p	n/p	n/p
Dec-09	A.E. Petsche	Provider of interconnect products including specialty wire, cable and harness management solutions	Arrow Electronics	n/p	\$220	n/p	n/p	n/p
Dec-09	Run-Flat Tire (Drive Dynamics)	Designs run flat tire systems for the US Government	JF Lehman	n/p	n/p	n/p	n/p	n/p
Dec-09	Sensor Technologies, Inc	Provider of C4ISR solutions and services to the DoD	ManTech International Corp	\$242	\$340	\$30	.7x	8.1x
Nov-09	GE Security	Supplier of security and life safety technologies	United Technologies Corp	\$1,820	n/p	n/p	n/p	n/p
Oct-09	BBN Technologies	Provider of critical solutions for defense and security missions including networking, language and IT	Raytheon Co	\$350	n/p	n/p	n/p	n/p
Oct-09	FACC AG	Designer and manufacturer of composite aerostructures	Xian Aircraft Industry	n/p	\$207	(\$15)	n/p	n/p

Source: Analyst Research & Salem Partners estimates

A&D M&A Activity

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