

# Salem Partners – Aerospace & Defense

## Quarterly Review

### Introduction

Second Quarter 2009

Dear Friends,

We are pleased to share Salem Partners' inaugural Aerospace & Defense Quarterly Review with you. The second quarter proved to be very opportunistic for select areas of the global supply chain, however, many new challenges arose for companies in the sector.

M&A activity remains resilient in the middle market with several transactions announced across the various sub-sectors. Access to capital continues to be constrained, with more and more companies recognizing the need for additional exposure to new investors and creditors beyond their traditional relationships.

As with many of you, we are attending industry organizations' annual meetings and we are observing several dynamics that will drive the balance of 2009 and trend towards stabilization into 2010. Over this period, you can expect our team to provide advice grounded in true industry expertise and real time knowledge of the markets.

We are interested in meeting with you at your headquarters, our office in Los Angeles or at any of the following events, which we plan to attend:

- EAA AirVenture: July 27<sup>th</sup> and 28<sup>th</sup> (Oshkosh, WI)
- ACG Los Angeles: September 15<sup>th</sup> and 16<sup>th</sup> (Beverly Hills, CA)
- Composites World Expo: September 29<sup>th</sup> and 30<sup>th</sup> (Schauburg, IL)
- AUSA: October 6<sup>th</sup> and 7<sup>th</sup> (Washington DC)
- NBAA: October 20<sup>th</sup> – 22<sup>nd</sup> (Orange County Convention Center, Orlando, FL)

Sincerely,



Trevor Bohn  
Managing Director



Sean Walker  
Managing Director





## 100 Years at Le Bourget

### HIGHLIGHTS

- ❖ *Paris Air Show exceeds limited expectations*
- ❖ *Aircraft financing market is stabilizing*
- ❖ *OEM's reassure a nervous supply chain*
- ❖ *Orders Fell Precipitously*

Given the difficulties surrounding most tiers of the commercial aerospace industry, expectations for the 100<sup>th</sup> Air Show were muted as attendees braced themselves for continued pessimistic predictions and forecasts. New order announcements slowed to a trickle as OEMs focused on securing existing backlog and supplier reassurance. To put the order decline in perspective, Airbus orders fell 57% from Farnborough levels while Boeing's decline was even more precipitous at 97%.

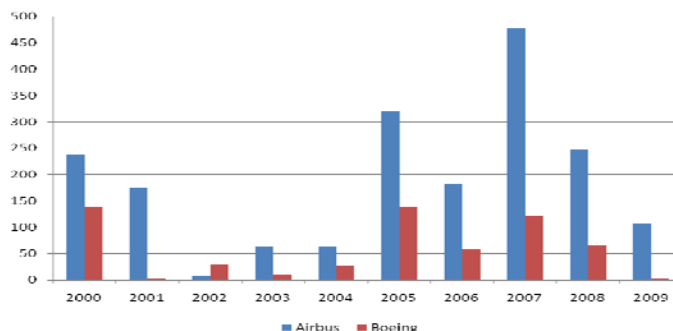
Disappointing order totals and the additional delay of the B787 were balanced by build-rate reassurances to the supply chain and positive sentiment regarding the aftermarket. Traffic declines have shown signs of slowing with international freight travel declining YoY by 17%, an improvement over the past five monthly declines of +20%. Though the show was a far cry from the champagne soaked celebration of 2007, a general consensus emerged that the commercial aerospace industry has stabilized somewhat with hopes for a recovery during 2010.

Both Boeing and Airbus have been plagued by concerns surrounding their "true" risk-adjusted orderbooks as global airlines have struggled with traffic declines (particularly business travel) and unprofitable fuel hedging positions. The airlines have struggled with access to the capital markets as investors are wary of the challenging operating environment. To address the issue the US Export-Import Bank has more than doubled its market share of financing for both new and used aircraft. This dynamic along with the (slowly) healing aircraft equipment leasing industry and secondary market appears to be limiting additional cancellations and deterioration of the OEMs' backlogs. The leasing industry will be further aided by the completion of the ILFC divestiture which has been slowed by the company's existing capital structure and uncertain economic conditions.

The OEMs took advantage of the Air Show to reassure the skittish supply chain that there are no plans to materially reduce build rates despite market rumors to the contrary. Suppliers throughout the chain have delayed capital investments in new machinery or facility expansions as build rate uncertainty has complicated capital investment. This dynamic has been most pronounced on the Tier II and III as privately held and investor owned businesses are still recovering from the Boeing strike.

This year's Air Show helped to allay concerns of a deepening down cycle for commercial aerospace as the OEM's appear resolved to continue with current build rates based on improving financing conditions and stronger airline operating environments. Based on lessons learned from past down cycles industry participants have braced for the worst, but optimists exist with predictions for a bottoming with limited build rate reductions and a relatively smooth recovery beginning in 2010.

Air Show Orders



Source: Analyst Research



## HIGHLIGHTS

❖ *Defense Budget Controversy*

❖ *F-22 Export?*

❖ *FCS is Axed*

❖ *Oshkosh is Rolling*

❖ *Smooth Sailing for the DDG-51*

# Industry Headlines - Defense



## Fighter Aircraft

Over the protests of Defense Secretary Gates, both houses of Congress have approved a defense budget that includes an additional \$1.75 billion for continued production of seven additional F-22 Raptors. The bill passed despite the disapproval of senior Senate Armed Services Committee members, John McCain (R-Arizona) and Carl Levin (D-Michigan). This move will present President Obama with a controversial decision to pass the bill or to issue his first presidential veto. The decision highlights the Administration's efforts to limit costly Cold War – era programs at the expense of near and medium term operational capabilities.

Momentum for a modified F-22 to be made available through FMS is building as Senator Daniel Inouye (D-Hawaii) has held exploratory conversations with Japan regarding the potential export of 40 Raptors. With a unit cost of nearly \$290 million, the F-22 will never reach high volumes but the supplier base should be reassured that a wide range of efforts are being made to keep the production line open.

## Land Vehicles

The Army's Future Combat Systems began with the goal of making the Army a lighter and more sophisticated force by replacing aging land vehicles (such as the M-1) with a new generation of both manned and unmanned systems that were all interoperable and linked by a next generation communication network. The results of the program failed to live up to its lofty goals as required technological advances were slow to arrive and the procurement of 17 new systems proved to be too broad of a scope. The Pentagon chose to cancel the ~\$300 billion Program citing the manned vehicle portion as well as the lack of "pay for performance" contracting structure as the major causes. The Army will re-focus modernization plans on a number of integrated acquisition programs with new cost structures and more targeted goals.

Oshkosh was awarded a \$1.1 billion contract to supply 2,244 M-ATV to the US Armed Forces in Afghanistan. The award demonstrates the adaptability of the wheeled vehicle platform to adjust to new operating conditions while continuing to provide the troops with a highly secure method of transportation. Follow-on contracts are expected to be announced in the coming months with expectations for significantly higher volumes.

## Marine Systems

The DDG – 51 program was seen as a winner in Defense Secretary Gates' budget proposal as funding was increased for continued production of the multi-purpose ship. The successful completion of the ship's super trial paves the way for delivery of the 26<sup>th</sup> ship to the Navy by the end of the summer.

## HIGHLIGHTS

### ❖ *Cyber Security – An Attractive Niche*

### ❖ *Transaction Spotlight*

### ❖ *Government Services M&A Activity*

# Government Services - Overview



## Cyber Security

In an ever increasingly digitized world, the need to protect proprietary online information has never been more pronounced. The Obama Administration has made the improvement of our nation's cyber-security the highest priority as recent cyber breaches have demonstrated both our weakness and vulnerability to virtual attacks.

The attractiveness of this niche has garnered the attention of nearly all Government Services businesses but none more so than Boeing. This comes as somewhat of a surprise given that Boeing has long left the IT space to competitors such as Northrop, General Dynamics and Lockheed Martin. Over the past year Boeing has purchased three smaller companies to expand its cyber-security footprint. The most recent of the three purchases, eXMeritus, provides both hardware and software for sharing information securely across classified and unclassified networks.

Over the next 12 months, Salem Partners expects continued activity within this niche as the attractive growth opportunities available will continue to drive M&A activity within this fragmented market.

## Veritas Acquires Kroll Industries

Veritas Capital announced the acquisition of Kroll Government Services from Kroll Inc (a division of Marsh & McLennan) for an undisclosed consideration. The newly formed KeyPoint Government Solutions will provide security clearance background investigations and employee screening services to US government agencies.

The transaction is welcome news to the Government Services industry as the entrance of a well-known acquirer such as Veritas Capital provides a signal that valuations within the space are compelling to strategic-minded investors. Salem expects M&A activity within the space to increase in the 2<sup>nd</sup> half of 2009 due to pent up demand and attractive valuations.

## Government Services M&A

Date	Target	Target Description	Buyer
Jun-09	Accelience Group	Consulting services for the intelligence community including operations, analysis and mission support	A-T Solutions
Jun-09	Kroll Gov. Services	Division of Kroll that focused on US Government screening efforts	Keypoint Government Solutions
May-09	Wyle Holdings	Aerospace service company focused on providing component testing services	Court Square Capital
May-09	Labat-Anderson	Consulting firm specializing in information systems and services	US Investigation Services
May-09	Cyveillance	Provides internet monitoring cyber security infrastructure	QinetiQ
May-09	XWAVE	Information technology company providing sophisticated IT solutions	CAE
May-09	Analytic Methods	Provides computational fluid dynamics software and consulting services	Israel Aerospace
Apr-09	24/7 Solutions	Provides professional managed hosting for IT-related services	SENTEL Corp
Apr-09	Argotek	An Information Assurance and Systems Security Engineering company	Cobham Plc

Source: Analyst Research

## HIGHLIGHTS

# Salem Perspective - JSF



### Joint Strike Fighter: Growth Capital Demands

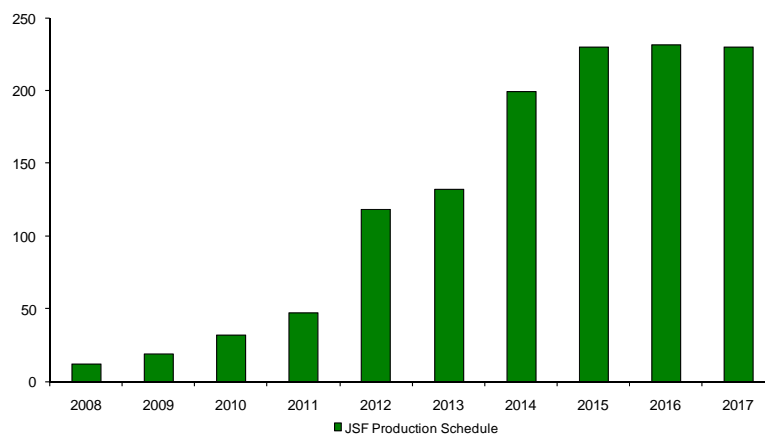
Now that the JSF has been formally selected as the future of US air superiority it will fall on the supply chain to produce the aircraft in the aggressive timeline that has been established. Those who have secured Long Term Agreements are facing substantial capital investment requirements ahead of the projected build schedule.

The raw numbers are simply staggering as production rates are set to sky rocket to roughly 30 aircraft/month by 2014 representing a CAGR of 28%. This aggressive timeline presents an incredible opportunity for the A&D supply chain to capitalize on a military aircraft being produced at rates that have not been approached since the F-16. That said, the corresponding massive capital expenditure requirements could not come at a worse time for a supply chain that has arguably never been more undercapitalized. Many suppliers have made significant investments in programs such as the B787, A400M, etc. that have yet to show any return on capital. Also, the effect of the Boeing strike just truly passed as production delays caused dramatic increases in working capital and weak cash positions. These two dynamics coupled with the ongoing credit crisis has made capital a scarce commodity.

This dynamic presents the average middle-market aerospace supplier with a dilemma without a simple solution. The JSF presents an unparalleled opportunity for transformational growth but requires a substantial initial investment in facilities and machinery unlike anything the supply chain has seen for the past 20 years. These circumstances will drive a new wave of consolidation and recapitalization among Tier II and III supply chain members as business owners seek capital partners to assist in the bright but expensive future ahead. Those who missed out on JSF work packages will be aggressively pursuing investments in companies that were able to secure work on the aircraft providing a significant driver of M&A activity.

### ❖ JSF Build-Rate Acceleration

Joint Strike Fighter Projected Build Rate



Source: Analyst Research



# Capital Markets

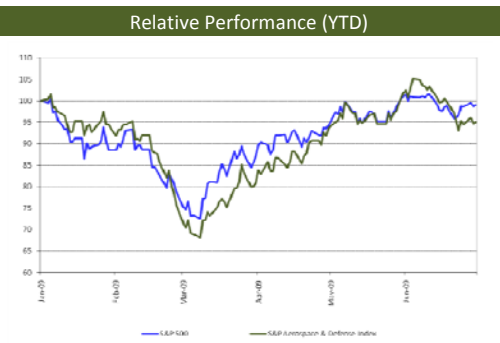
## HIGHLIGHTS

### Capital Markets Commentary

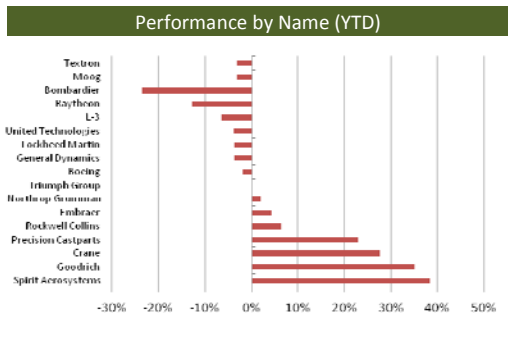
#### Capital Markets

The S&P Aerospace and Defense Index continues to trade roughly in line with the broader market bouncing off of the lows reached towards the end of Q1. Market sentiment improved as a productive Paris Air Show and several large DoD contract awards provided good news for the entire sector.

Valuations have bounced significantly with Defense Contractors leading the surge higher.

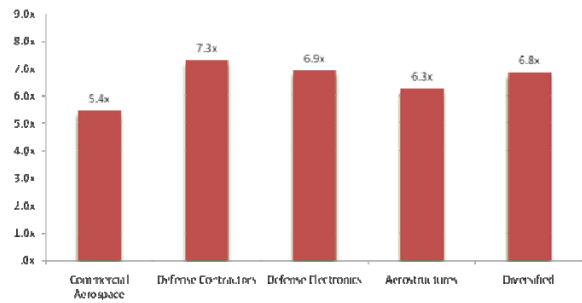


Source: Analyst Research



Source: Analyst Research

#### Enterprise Value/EBITDA by Subsector



Source: Analyst Research

### A&D M&A Activity

Date	Target	Target Description	Buyer	Enterprise Value	Revenue	EBITDA	Multiples	
							EV/Rev	EV/EBITDA
Pending	Exote	Finnish manufacturer of body armor	TBD	n/p	n/p	n/p	n/p	n/p
Pending	Enrise	Manufacturer of defense and aerospace electronic devices and subsystems and telecom equipment	TBD	n/p	n/p	n/p	n/p	n/p
Jun-09	Defense Venture Group	Manufacturer of armored vehicles and force protection products	JF Lehman	n/p	n/p	n/p	n/p	n/p
Jun-09	eXMeritus	Develops interconnection systems at various levels of classification	Boeing Co	n/p	n/p	n/p	n/p	n/p
Jun-09	Diaphorm Technologies	Designs and manufactures ballistic helmets	Ceradyne Inc	\$10	n/p	n/p	n/p	n/p
Jun-09	Advanced Ceramics Research	Producer of UAVs and advanced ceramics materials	BAE Systems	n/p	n/p	n/p	n/p	n/p
Jun-09	Asys Technologies Inc	Designer of IR sensors and systems and multi-axis stabilized cameras	General Dynamics Corp	\$640	\$255	\$49	2.5x	13.1x
Jun-09	DataPath Inc	Integrates, manages and deploys satellite communication systems for military and commercial customers	Rockwell Collins Inc	\$129	\$258	na	.5x	n/a
May-09	Thales SA (20% stake)	Designs mission critical systems for aerospace, defense and security markets	Dassault Aviation	\$7,948	\$13,247	\$1,242	.6x	6.4x
Apr-09	Kinetics Ltd	Provides life support systems, NBC/BRN protection and detection systems	Elbit Systems Ltd	\$232	n/p	n/p	n/p	n/p
Apr-09	Argotek, Inc	Provides information assurance and systems security engineering	Cobham Plc	\$36	n/p	n/p	n/p	n/p
Apr-09	HR Textron	Producer of motion control systems and components	Woodward Governor	\$376	\$235	\$31	1.6x	12.0x

Source: Analyst Research

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