

Salem Partners – Aerospace & Defense

Quarterly Review

Introduction

Third Quarter 2009

Dear Friends,

Over the past quarter, M&A activity showed a high level of resilience and began to show signs of returning to normalized levels of deal-making. For the first time in nearly eighteen months, we saw the return of strategic and private equity investors aggressively pursuing middle-market A&D deals at price points that met seller expectations.

Deal flow has recently increased as several industry and economic headwinds have begun to recede. It has been roughly a year since the credit crisis expanded to a critical phase signified by the Lehman Brothers bankruptcy and Merrill Lynch's rushed sale to BofA. Rampant fear of widespread banking failures and systematic risk paralyzed the investor community and dried up the M&A pipeline. The financial crisis coincided with the conclusion of a record-setting commercial aerospace cycle and jeopardized historically high defense dollars as the government focused its attention on the economy.

With the events of a year ago firmly in the rear view mirror, the pace of M&A activity has increased as pent-up demand for new capabilities, program exposure and product offerings has driven M&A interest by both strategic and private equity investors. Strategic buyers have returned, buoyed by healthy balance sheets and stabilizing environments for their various business lines. While private equity groups remain challenged by limited debt financing, capital must be put to work in order to fulfill return expectations for the life of their funds. As an industry, private equity has over \$500bn of unlevered equity capital and all signs point to increased willingness to spend these dollars. This quarter we have seen a spike in deal-making activity from a multitude of familiar middle-market, A&D-focused private equity groups including Argosy Capital, Vance Street, Arlington Capital and several others. These dynamics combined with improving economic leading indicators around housing and unemployment point to an opening in the M&A window over the next several months and into 2010.

We will once again be busy attending industry trade shows and conferences and look forward to discussing the market environment and trends at any time. Over the next quarter we will be attending the following shows:

AUSA: October 5th – 7th
SAMPE Wichita: October 19th – 21st
Milcom: October 18th – 21st
NBAA: October 20th – 22nd

Sincerely,



Trevor Bohn
Managing Director



Sean Walker
Managing Director



HIGHLIGHTS

❖ *Iran Goes Nuclear*

❖ *Afghanistan Needs More Assets*

❖ *Dismantling Missile Defense*

❖ *Budget Negotiations Continue*

❖ *Navy Hits the Afterburner*

Industry Headlines - Defense



The Plot Thickens

President Obama is facing his most pointed threat to national security as the revelation of a clandestine Iranian nuclear power plant was followed by the most successful testing of ballistic missiles to date by the Iranian government. A confrontation seems inevitable as the President has combined with other world leaders from the UK, France and Russia to condemn the Iranian government's actions and to demand UN inspectors access to the nuclear facility.

In addition to his Iranian conundrum, President Obama faces a deteriorating situation in Afghanistan where General McChrystal, the top American and NATO commander, is requesting additional reinforcements that may number up to 40,000. Given the current force of 68,000 in theater, this request, if honored, would represent a substantial shift in fundamental strategy for the conflict. Afghanistan simply requires more resources to effectively combat the insurgency. The most acute needs being additional soldiers (especially special forces), helicopters and wheeled vehicles.

Missile Defense

In a reversal of a major Bush-era policy, Obama has moved to scrap plans for a European missile shield in favor of a more flexible, marine-based solution. This move has been widely interpreted as an attempt to gain favor with Russia who had been vocally opposed to the missile shield. These efforts appear to have been successful in the short-term as Russia has been somewhat surprisingly critical of Iran's nuclear efforts. For the supplier base, this move is an overall positive for Lockheed and Raytheon who are heavily invested in the marine-based solutions, but this is a negative for Boeing who is the primary supplier of ground-based shield technology.

Defense Budget

The defense budget has continued on its path to law with a few key developments over the past three months. The Administration has made it clear there are three key items that would elicit a Presidential veto: 1) An alternative JSF engine, 2) procurement funding for the F-22 and 3) funding for the VH-71 Presidential helicopter. Notably the inclusion of an additional 10 C-17's was not among the Administration's key offenses.

Aircraft

The Navy announced plans to bring the planned date for the deployment of the F-35C six months ahead of schedule. This development is part of an ongoing effort to address the shortfall in Navy fighters due to faster than expected deterioration of the existing F/A-18 fleet. Boeing has proactively moved to address this concern and is in talks to provide 150 additional F/A-18's at a significant discount ahead of F-35C deployment.

The ongoing saga of replacing the aging Air Force aerial tanker has hit another speed bump as Northrop has already protested the latest effort to re-start the \$35 billion competition. This is the third attempt to award the lucrative contract that is likely to fail as both Boeing and Northrop have been unable to emerge as the clear victor in the contest. The competition has become increasingly political (even more so than most military awards) and now includes vocal support for each side from senior Senators. The end of the bickering would be welcome news to a supply chain eager to secure long-term work packages regardless of the prime contractor.

HIGHLIGHTS

❖ *Leading Indicators Point to Light at the End of Tunnel*

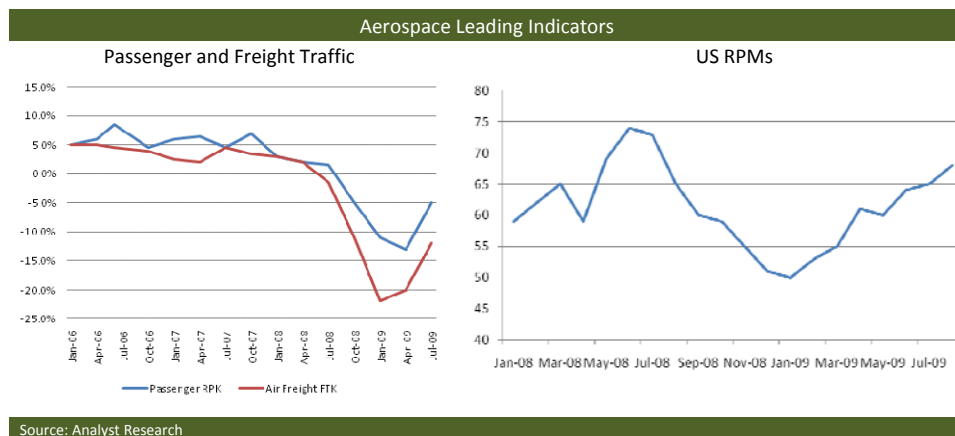
❖ *Financing Market Opens for Airlines*

❖ *Bizjet sentiment improves with internationals leading demand*

Industry Headlines - Aerospace

Commercial Aerospace

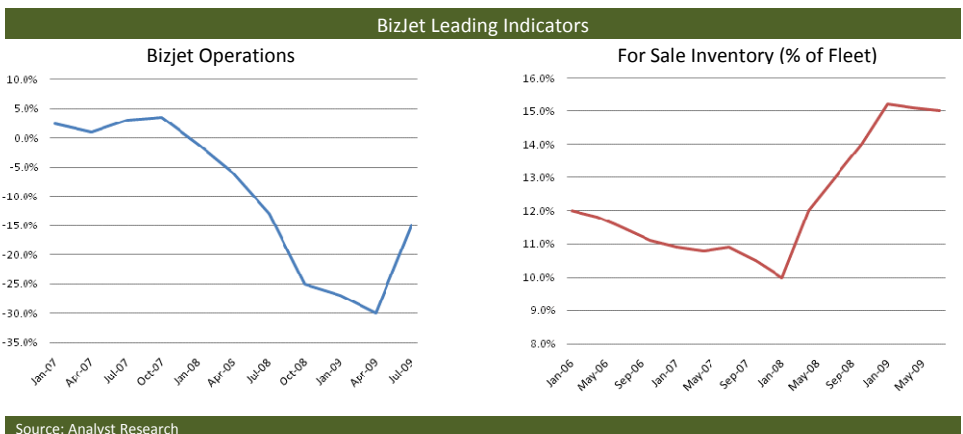
Two key aerospace leading indicators, air traffic and airline profitability, have improved this quarter providing hope that the aerospace industry, along with the global economy, has begun to emerge from the recession. Both passenger and freight traffic appear to have reached a turning point with Year-over-Year decreases of ~5% and ~10% respectively. This data shows considerable improvement over Q1 decreases in excess of 12% (passenger) and 20% (freight). Concurrently, airline operating metrics have rallied with US RPMs recovering strongly over the past several months.



Over the past month, airlines have taken advantage of a stronger operating environment, as well as increased investor risk appetite, to tap the capital markets for substantial financings. Both Delta and American Airlines made headlines by selling a combined \$2 billion worth of high yield notes. This comes as welcome news to the broader supply chain providing reassurance that airlines will be able to accept delivery of ordered aircraft.

Business Aviation

After a gut wrenching nine months, it appears that the biz jet industry has reached an equilibrium and further losses will be minimal. Early indicators show slowing declines in bizjet operations and a stabilization of used inventory for sale. The Salem Team will be attending the NBAA show in Orlando to gain further insight into this dynamic space.



HIGHLIGHTS

❖ *Services M&A activity is strong*

❖ *C-17 Attracts Dollars*

❖ *BRAC Contract Dollars Flow*

❖ *Government Services M&A Activity*

Industry Headlines – Gov. Services



Services M&A Activity

Services deal-making activity has been strong this quarter as several privately and publically held companies are engaged in active sales processes or have recently announced transactions. Notable deals include Northrop's rumored sale of its TASC division, Xerox's purchase of ACS (\$6.4bn) and Dell's purchase of Perot systems (\$3.9bn). Multiple smaller, privately held businesses are also pursuing M&A transactions as multiples in the space for premium assets have remained attractive.

C – 17 Globemaster Sustainment Partnership

While the future of the C-17's procurement appears to be on track over the near term, maintaining the fleet has become a valued opportunity for the supply chain as the initial contract for the Sustainment Partnership has a value of \$4.9bn. The goal of the sustainment contract is to maintain consistent support at gradually increasing levels of availability and capability. As part of the contract, Boeing performs technical and engineering support as well as acting as the prime contractor on the Material Improvement Project ("MIP") which allows for retrofit and performance upgrades to the existing fleet. Improvements include adding armor shielding, navigation and communication upgrades, and various infrared and nighttime ops installations are all highly sought after opportunities for the supply chain.

BRAC Update

Since its inception in 2005, the Base Realignment and Closure ("BRAC") program has seen multiple substantial contract awards been awarded; however over the past quarter these awards have heated up as the process has progressed.

One significant winner in the 2005 process has been San Antonio, Texas where over \$2bn will be spent to relocate thousands of military and federal personnel. The majority of construction will take place at Fort Sam Houston, Camp Bullis and Randolph Air Force Base. With completion set for September 2011, awards have been given to Balfour and AMEC Earth & Environmental.

Government Services M&A

Date	Target	Target Description	Buyer	Enterprise Value	Revenue	EBITDA	Multiples	
							EV/Rev	EV/EBITDA
Pending	Affiliated Computer Services	Provider of business process outsourcing and IT services to government and commercial clients	Xerox	\$9,330	\$6,523	\$1,038	1.4x	8.1x
Pending	Perot Systems Group	Provider of IT and business services to worldwide clients	Dell Inc	\$3,772	\$2,643	\$278	1.4x	13.6x
Sep-09	Phoenix Consulting Group	Provider of training courses and materials and management consulting and augmentation services	Dyncorp	n/p	n/p	n/p	n/p	n/p
Sep-09	Milcom Industrial Designs	Provides technical documentation, technical publications and recruiting services for A&D companies	GP Strategies Corp	n/p	n/p	n/p	n/p	n/p
Sep-09	GE's Homeland Security	Provides systems and services to protect airports, ports and borders	Safran Group	\$580	\$260	n/p	2.2x	n/p
Sep-09	Systems Technology Solutions	Contractor providing engineering, logistics and IT services to the US government	Evermedia Group	n/p	n/p	n/p	n/p	n/p
Sep-09	Pysis Engineering	Provides systems engineering, software engineering and cloud computing for the DoD and US Intelligence	Applied Signal Tech	\$20	\$12	n/p	1.7x	n/p
Aug-09	Seaweed Systems	Developer of embedded graphics solutions for the US military and aerospace market	CAE, Inc	n/p	n/p	n/p	n/p	n/p
Aug-09	Lim and Nascimento Engineering Corp	Provider of engineering services including project management and design/development services	AECOM Technology Corp	n/p	n/p	n/p	n/p	n/p
Aug-09	i2S	Provider of IT, engineering and professional services to the NSA and intelligence agencies	Camber Corp	n/p	n/p	n/p	n/p	n/p
Jul-09	US Logistics	Engages in the maintenance, reset and overhaul of tactical military vehicles and aircraft	Ranger Aerospace	n/p	\$40	n/p	n/p	n/p
Jul-09	Entrust	Provider of digital certificates, PKI security and encryption software	Thoma Bravo	\$124	n/p	n/p	n/p	n/p

Source: Analyst Research

HIGHLIGHTS

Capital Markets Commentary

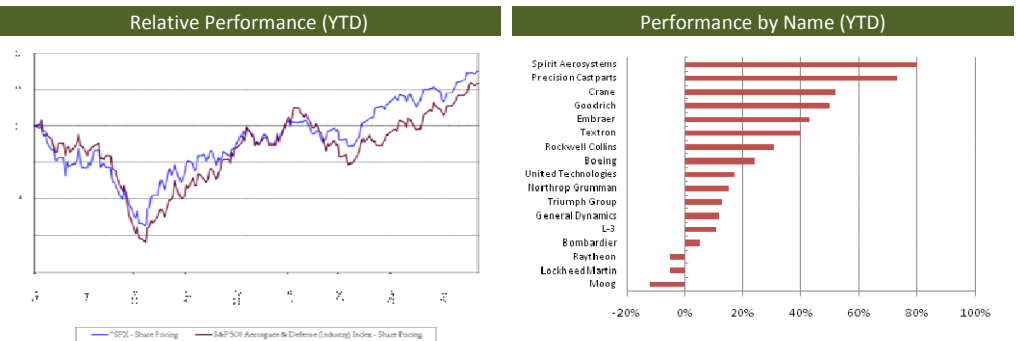
Capital Markets

Capital Markets

The capital markets were open this quarter as several Aerospace & Defense names came to market with equity and debt offerings including the following:

- Oshkosh Truck (NYSE: OSK): \$325mm equity offering
- Transdigm Group Inc (NYSE: TDG): \$425mm 5-year notes
- Kratos Defense & Security (Nasdaq: KTOS.D): \$20mm equity offering

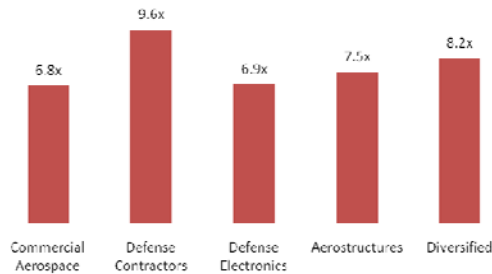
The increased risk appetite demonstrated by these (and other) successful offerings is welcome news to the sector as access to the capital markets has been limited during the credit crisis.



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	Soneticom	Provider of precision geolocation systems and communications products	DRS Technologies	n/p	n/p	n/p	n/p	n/p
Pending	Hi-Shear Technology	Producer of low shock pyrotechnic satellite separation systems and initiators	Chemring Plc	\$125	\$26	\$12	4.8x	10.8x
Sep-09	Semicoa	Designer of discrete semiconductors and optoelectronics for military/aerospace markets	Vance Street Capital	\$16	n/p	n/p	n/p	n/p
Sep-09	Structural Composites Industries	Producer of high pressure cylinders used in A&D and commercial applications	Worthington Industries	n/p	\$36	n/p	n/p	n/p
Sep-09	BBN Technologies	Diversified R&D company with multiple network centric warfare applications	Raytheon	n/p	n/p	n/p	n/p	n/p
Aug-09	Cyrocam Systems	Producers of gyrostabilized optical surveillance systems	Lockheed Martin	n/p	n/p	n/p	n/p	n/p
Aug-09	Carlton Forge Works	Manufacturer of seamless rolled rings for aerospace applications	Precision Castparts	\$850	\$680	\$94	1.2x	9.0x
Aug-09	AeroMech Engineering	Designs and develops production UAVs	Chandler May	n/p	n/p	n/p	n/p	n/p
Aug-09	Hampson Machining	Offers precision machined parts for the aerospace industry	Darwin Private Equity	\$39	n/p	n/p	n/p	n/p
Aug-09	Woodward Governor's Fuel and Pneumatics Line	Provides off-turbine fuel management and pneumatic actuation components	Transdigm	\$48	\$16	n/p	3.0x	n/p

Source: Analyst Research & Salem Partners estimates

HIGHLIGHTS

- ❖ *Future of Unmanned Flight*
- ❖ *Rapid Technology Improvements*
- ❖ *Budget Dollars Hot for UAV's*

Takeaways from AUVSI



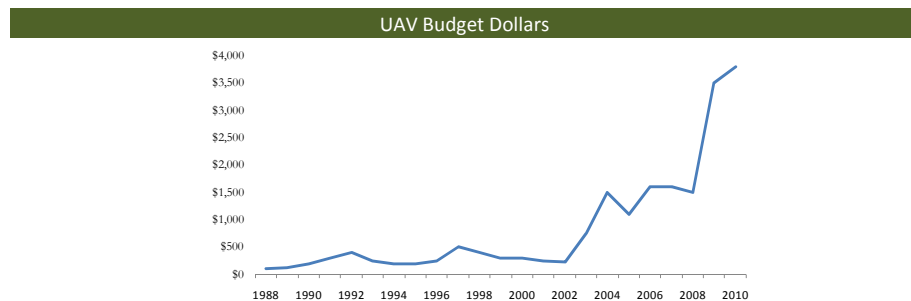
Within the Aerospace & Defense industry, few markets have shown as much innovation and growth as the Unmanned Aerial Vehicle space. The Salem Team travelled to Washington DC to attend the AUVSI trade show. While at the show, we met with several middle market component, system and platform suppliers to discuss industry trends including consolidation, the defense budget and new technological developments. A few quick take-aways from our trip illustrate why we remain incredibly enthusiastic over the future of this exciting niche.

Rapid Innovation & Game Changing Technology

The exhibition hall was literally full of high technology companies looking to address the unique software and system requirements that have emerged within the UAV space as mission packages and capabilities have expanded. Addressing interoperability has become a high priority as the potential for dynamic cooperation between multiple, complimentary UAV platforms has become increasingly vital. Also, remarkable advances in flight control software and systems have allowed for UAV's to diversify towards smaller and more autonomous platforms without sacrificing ease of use or capabilities.

Budget Dollars

The UAV sector is positioned to see increased budget dollars as successful applications in both the Global War on Terror and Homeland Security have driven increased demand. Despite growing at a CAGR of 29% over the past ten years, the future of UAV funding looks bright with the Obama Administration requesting \$3.8 billion for UAV platforms in the FY2010 defense budget.



Source: Analyst Research

The combination of innovation, growing budget dollars and a dynamic market have led to increased interest from both strategic and financial investors within the space. Aggressive M&A interest from prime contractors has been rampant, driven by unique technology and a market that continues to evolve as the dominant primes (General Atomics, Northrop, AeroVironment) seek to defend their market share from new entries (Textron, Raytheon, L-3) and other smaller, privately held businesses.

Salem Perspective – Pillars of Success



Spotlight: Hi-Shear Technologies acquired by Chemring Group plc

Announced Date: 09/16/09
Enterprise Value: \$139mm
EV/Revenue: 4.8x
EV/EBITDA: 10.8x

Takeaways:

- 1) Premium valuations are available to high-quality assets given the lack of quality deals in the market
- 2) International buyers remain active and willing to pay attractive multiples
- 3) Unique, highly-engineered product portfolio generates strong strategic demand

Assembling the Perfect Tier III Supplier

In today's dynamic environment, management of Tier II and III suppliers are constantly being forced to make nuanced capital allocation decisions that permanently effect the direction of their business. These decisions can come in many forms including aggressively bidding the correct work packages, developing new capabilities or constructing additional facility space. The uniting factor among each of these questions is that making the correct investment decision is essential to attracting a premium valuation in a capital raising or M&A process. Whether the business is family or institutionally-owned, capital allocation decisions are vital to positioning for an exit or continuing financial success. Through conversations with multiple strategics and financial investors, Salem has established five attributes of A&D suppliers attracting premium valuations in today's market:

1) *Engineering Capability*

For most suppliers, engineering capability can be divided into two categories, manufacturing and design engineering. The ability to manufacture complex, sophisticated parts is key to sustain strong margins as well as prevent work packages from being re-bid. While manufacturing engineering capabilities are key to successfully winning and complying to build-to-print work, investors hold design engineering skills in higher regard due to the ability to own the design for proprietary parts.

2) *Platform Mix*

When analyzing platform mix, diversity is the key to success. Events of the past several years such as the delays of the 787, business jet's slashed build-rates and the cancellation of the F-22 have illustrated why it is vital to have a mix of commercial vs. military; fixed wing vs. rotorcraft and a few non-standard platforms such as space or ground vehicles. While it may be easier said than done, platform diversification is a key risk mitigation tool.

3) *New Build vs. Aftermarket*

In addition to platform diversification, de-risking can be achieved through a healthy mix of OEM new build parts and spares or aftermarket parts. While production line parts are key to reaching sufficient volumes for manufacturing efficiency, investors are partial to aftermarket parts where the counter-cyclical nature can off-set any weakness in the end-user or reduced build-rates at the OEM.

4) *Low-Cost Manufacturing Capability*

As middle – market companies grow and require additional manufacturing space, management should consider expanding into a low-cost manufacturing center as opposed to simply adding-on to an existing facility. While China and Eastern Europe have made recent headlines, the most straightforward route for middle-market companies is normally to build a facility in Mexico. With an expanding aerospace savvy workforce at reduced wages, cities such as Chihuahua and Guaymas are becoming important manufacturing bases for basic production while leaving the final assembly and engineering to the US-based work force. Importantly, Tier 1 suppliers are increasingly mandating a low-cost manufacturing facility as a requirement for bidding on long-term work packages.

5) *Range of Material Capabilities*

While not relevant to all types of A&D suppliers, the capability to manufacture from differing materials is a key value driver. Companies with a full range of metallic (both hard and soft metals) as well as composite capabilities are seeing premium values not only due to their uniqueness but also because Tier I suppliers are increasingly bidding work packages out that include both the metallic and composite components.

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