

Salem Partners – Aerospace & Defense

Quarterly Review

Introduction

First Quarter 2010

Dear Friends,

After writing optimistically about the possibility of an improving M&A environment, we can finally safely say that our prognostications were correct (though admittedly slightly premature). The volume of deals both in the market and completed has increased dramatically for transactions of all sizes. The announcement of Triumph Group's \$1.4 billion acquisition of Vought Aircraft was welcome proof of both improving debt and equity capital markets and the returning of aggressive M&A mindsets by strategic acquirers.

In addition to increased deal flow, we have seen valuations for A&D middle-market businesses improve, buoyed by near-record setting improvements in public equity valuations (see pg. 5) and access to bank financing. After two years of choppy market conditions, middle-market lenders have re-energized the financial sponsor community by aggressively providing access to acquisition financing. Activity in the high-yield market is bringing back memories of 2006 with over \$31.5 billion of new high-yield debt being issued in March (surpassing the previous monthly record of November 2006).

In addition to these broader industry trends, Salem Partners has a unique perspective into the strong demand for A&D middle-market transactions with several active buy and sell-side mandates. We are pleased that our clients have received strong interest from a range of strategic buyers (both domestic and international) and financial sponsors. We look forward to sharing details in early summer!

We can say with certainty that the market for high-quality A&D transactions is improving and individuals or institutions considering an exit or a liquidity event should strongly consider testing the market. We would be pleased to provide a tailored analysis of your business and end-markets as well as the M&A market.

We will once again be active on the trade show circuit and welcome the opportunity to meet with you and to discuss our deal pipeline.

Creating and Financing New A&D Technologies: Thursday, April 8th (Broomfield, CO)

MRO Americas: April 20th – 23rd (Phoenix, AZ)

SAMPE 2010: May 18th – 20th (Seattle, WA)

Sincerely,



Trevor Bohn
Managing Director



Sean Walker
Managing Director



Capital Markets

HIGHLIGHTS

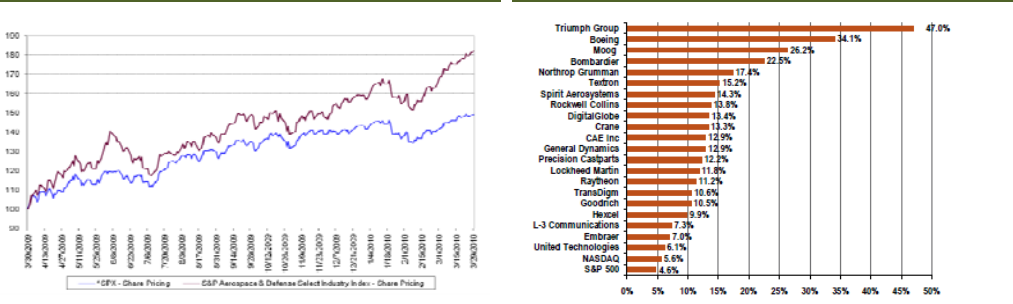
Capital Markets Commentary

Capital Markets

A broad index of A&D companies continues to outperform the S&P500 by a wide margin. In terms of valuations, companies in the commercial aerospace and aerostructure sub-segments have seen valuations increase dramatically in Q1. Names with significant commercial aerospace exposure including Triumph Group, Boeing and Moog have seen increases of 20%+.

Triumph Group's acquisition of Vought was a strong signal of stabilization in both the equity and credit markets as the \$1.4 billion acquisition was funded through a combination of cash, equity and debt.

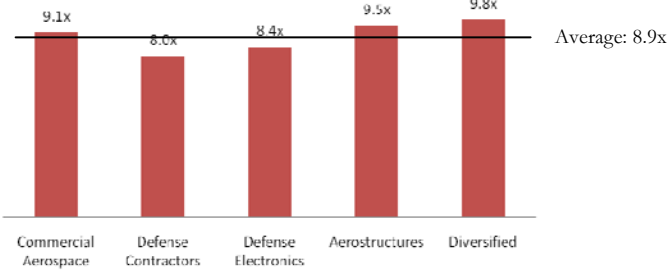
Relative Performance (YTD) | Performance by Name (YTD)



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	EV/Rev	EV/EBITDA
Pending	White Electronics Design	Provider of multi-chip-on-board solutions for A&D applications	Microsemi	\$100	\$65	\$8	1.5x	13.3x
Mar-10	SkyTerra Communications	Developer and supplier of mobile SATCOM communication services	Harbinger Capital Partners	\$1,534	\$35	(\$86)	n/a	n/a
Mar-10	DASSEL Cabin Interiors	Subsidiary of Airbus providing aircraft interior solutions including lavatories and wash rooms	Diehl Stiftung & Co	n/p	n/p	n/p	n/p	n/p
Mar-10	Aviation Worldwide Services	Subsidiary of Xe Services providing forward transport and modification services	AAR Corp	\$200	n/p	n/p	n/p	n/p
Mar-10	Nova Analytics Corp	Manufacturer of analytical instruments used in water, wastewater, and environmental applications	ITT Corp	\$135	n/p	n/p	n/p	n/p
Mar-10	Vought Aircraft	Manufacturer of aerostructures for commercial, military and business jet aircraft	Triumph Group	\$1,440	\$1,900	n/p	.8x	5.8x
Mar-10	VT Group	Manages assets and provides services for the marine and aerospace markets	Babcock International Group	\$2,100	\$1,645	\$171	1.3x	12.3x
Feb-10	Insight Technologies	Develops and manufactures night vision and electro-optical equipment including laser aiming and illumination	L-3 Communications	n/p	n/p	n/p	n/p	n/p
Feb-10	Survitec Group	Provides survival and safety equipment to the military, marine and aviation markets	Warburg Pincus	\$452	\$240	n/p	1.9x	n/p
Jan-10	HDT International	Developer of troop support systems including parachutes and aerial delivery systems	Airborne Systems Group	n/p	n/p	n/p	n/p	n/p
Jan-10	Allied Defense Group	Provides medium and large caliber ammunition as well as load, assemble, pack and procurement services	Chemring Group plc	\$71	\$143	\$2	.5x	n/p

Source: Analyst Research & Salem Partners estimates

HIGHLIGHTS

❖ FY2011 Defense Budget

❖ Increased Production Rates

❖ Decreased Production Rates

❖ In the News

Industry Headlines - Defense



FY 2011 Presidential Request

The Obama Administration released initial detail for the DoD budget request for FY2011. The total request amounts to \$708 billion with \$549 billion allocated to the base budget and the remainder to Overseas Contingency Operations (formerly known as the Supplemental). This request represents a 3.4% increase in spending over the FY2010 budget.

	FY2010A		FY2011E	
	Total	% Growth	Total	% Growth
Military Personnel	\$135.0	7.4%	\$138.5	2.6%
Ops & Maintenance	\$184.5	3.0%	\$200.2	8.5%
Procurement	\$104.8	3.9%	\$112.9	7.7%
RDT&E	\$80.1	0.9%	\$76.1	-5.0%
Other	\$3.1	-1.2%	\$2.4	-23.7%
DoD Budget	\$507.5	4.0%	\$530.2	4.5%
Military Construction	\$21.0	-4.0%	\$16.9	-19.5%
Housing	\$2.3	-28.6%	\$1,822	-19.3%
Total Budget	\$530.8	3.4%	\$548.9	3.4%

Winners & Losers

With limited exception, the FY2011 budget offered few dramatic changes from the previous year and continued the Administration's policy of favoring proven solutions over more developmental projects. The below chart highlights selected programs with changes in procurement funding:

Winners			
Programs	FY2010A	FY2011E	Notes
AH – 64	8	16	Rotor funding remains high for all platforms
C-130J	7	17	Administration favors C-130 over C-17
F-35	30	43	Several set-backs in testing and cost overruns but no viable alternative
Losers			
Programs	FY2010A	FY2011E	Notes
RQ-7	1,375	328	Slow down in ordering volume after surge
EA-18G	22	12	Initial need has been met
C-17	10	0	Annual attempt to halt production

Next-Gen Tanker: Competition for the replacement air-to-air tanker remains in the news as Northrop has dropped out of the competition while its former partner, EADS, contemplates bidding as a prime

Wheeled Vehicles: Oshkosh secured the \$3bn FMTV contract despite the challenge made by the incumbent BAE consortium. As production rates of the M-ATV prepare to slow, Oshkosh will rely on the FMTV to continue to drive growth.

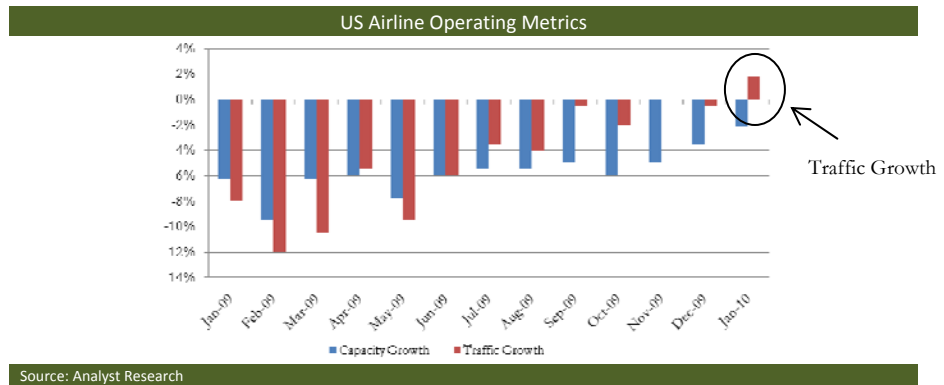
HIGHLIGHTS

❖ *Aftermarket Showing Signs of Improvement*

Industry Headlines - Aerospace

Aftermarket Recovery – Finally

Declining global capacity, airline destocking and deferral of discretionary maintenance combined to make 2009 a forgettable year for the aerospace aftermarket. While global airline capacity was reduced by 2% in 2009, revenue for many providers of aftermarket parts and services declined by 10 – 20%. Thankfully, the outlook for 2010 looks far brighter. Leading indicators for aftermarket sales have turned positive with expectations for continued growth in airline capacity, cargo traffic and business jet flight operations. Additionally, accelerated growth may be a possibility as a reversal of the effects of airline destocking may be in its early stages. At this point, the aftermarket will continue to benefit from increased airline traffic and capacity and has the possibility of benefitting from deferred spending by the airlines.



❖ *OEM Cycle on the Upswing*

Commercial Aerospace – OEM Cycle

Despite challenging operating conditions, both Boeing (B777 & B747-8) and Airbus (A320) announced planned production hikes for large aircraft. A combination of record backlogs and modest production increases during the up-cycle allowed both Boeing and Airbus to successfully navigate the most difficult market environment since 9/11. That said, the analyst community expects narrow body production cuts for both OEM's that coincide with the announcement of major re-engining plans as customers will delay orders in anticipation of a more cost-effective solution. Regardless of future minor adjustments to build-rates, the global supply chain is expressing sincere relief that the OEM's have been able to stabilize their order books and maintain reasonably consistent production rates through the worst of the down cycle.

❖ *Dreamliner Testing - Progressing*

First Flight & Flight Testing for the Dreamliner and B747 Freighter

The first quarter of 2010 held several landmark events for Boeing as both the Dreamliner and 747 Freighter successfully completed first flights. The global supply chain had eagerly anticipated both events in the hopes that the series of delays that plagued the development of both aircraft may soon be nearing an end.

For the B787, the aircraft is currently undergoing a series of tests to certify airworthiness with expected FAA-certification to begin in late-April. The initial testing of the aircraft has been a mixed bag. Tests got off to a rough start when there was a mid-flight engine failure during a mid-February test, but other tests have been more successful including the well publicized "ultimate-load" wing testing.

HIGHLIGHTS

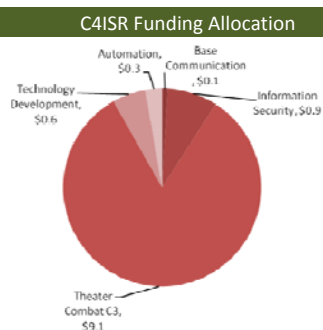
❖ FY2011 Budget – C4ISR

Industry Spotlight – C4ISR

C4ISR Budget Continues Growth

The FY2011 Budget Request continues to devote substantial funding allocations to continue the transformation and development of new capabilities that are interconnected through a network of sensors, shooters, command, control and intelligence. Funding enables building joint communication architectures and roadmaps for integrating joint networking capabilities. Applications of C4ISR technology are varied but include software defined radio, VoIP processing, UAV's, RF link analysis, embedded software, etc.

Total funding for C4ISR programs in FY2011 will total \$11.1 billion (up from \$10.5 billion). The below chart illustrates the allocation among C4ISR categories with theater combat receiving the majority of dollars:



Source: Analyst Research

❖ Key C4ISR Programs

When looking at the C4ISR funding landscape there are a few headline programs which have seen strong funding support from the DoD:

	FY2009	FY2010	FY2011
Joint Tactical Radio System	\$855	\$955	\$1,063
WIN-T	\$790	\$723	\$621
Brigade Combat Team Mod.	\$3,483	\$2,616	\$3,186

❖ C4ISR M&A

M&A activity around companies with significant C4ISR revenue whether with the government direct or as a sub-contractor has been robust with multiple private sellers as well as corporate divestitures. Strategic and financial buyers are aggressively pursuing activities in the space to capture the available growth opportunities and large budget dollars.

C4ISR M&A Transactions

Date	Target	Target Description	Buyer	Enterprise Value	Revenue	EBITDA	Multiples	
							EV/Rev	EV/EBITDA
Pending	Cyber Aerospace	Designer and manufacturer of UAV Systems	Vought Defense Systems Corp	n/p	n/p	n/p	n/p	n/p
Mar-10	RaySat Antenna Systems	Development of in-motion, low-profile, 2-way satellite antenna systems	Glit Satellite Networks	\$25	n/p	n/p	n/p	n/p
Feb-10	Sensor Technologies Inc.	Provider of mission-critical systems engineering and C4ISR services and solutions	ManTech International Corp	\$242	\$340	\$31	.7x	7.8x
Jan-10	dB Control	Provider of high-power microwave amplifiers, radar transmitters and power supplies	Heico	n/p	n/p	n/p	n/p	n/p
Jan-10	Science, Engineering and Technology Corp	Creates and commercializes information technologies including video and radar technologies	SAIC	n/p	n/p	n/p	n/p	n/p
Dec-09	Integrated Systems Improvement Services (ISIS)	Provider of contract support services to the DoD and contractors for C4ISR	KCB Management	n/p	n/p	n/p	n/p	n/p

Source: Analyst Research

HIGHLIGHTS

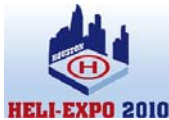
❖ *Composites World Investment Form*

Takeaways from Industry Events



Trevor Bohn of Salem was invited to speak at the annual Composites World Investment Forum at the Hilton La Jolla Torrey Pines, California. Attendees consisted of a range of executives and engineers from key composite industry leaders. The conference focused on high-growth composite industry niches as well as evolving trends in composite technology and applications. Trevor was pleased to share his thoughts on the current M&A environment and to opine on future trends in valuation and investment criteria for strategic and financial buyers.

Composites and Advanced Materials is a focus of our Salem Aerospace & Defense practice, and we plan to continue providing thought leadership in this rapidly growing component of aerospace & defense.



❖ *Heli-Expo*

With a slight increase in exhibitors and over 18,000 visitors, HeliExpo 2010 held guarded optimism after a challenging 2009. Despite 105 order cancellations in 2009, Euro Copter was able to finish its year without laying off a single US worker. Conversely, Sikorsky announced that it had grown revenues by almost \$1 billion, improving from \$5.37 billion in 2008 to \$6.32 billion in 2009. Show organizers attributed the mixed financial results to the diversity of missions (55 in all) that rotary aircraft serve.

The growing obsolescence of the current helicopter fleet provided the HeliExpo floor with 3 major themes (3 R's):

1. **Retrofit and Modification** - There were multiple providers on the floor that were armed with supplemental type certificates that would improve the specifications on any number of airframes. OEMs also got into the act - Bell and Rolls Royce signed an MOU to evaluate the possibilities retrofitting the Bell 206B Jet Ranger with the new RR500TS engine. With over 5,000 Jet Rangers in the market, this retrofit could be very lucrative for a number of third party suppliers.
2. **Replacements Running the Gambit** - OEMs defied the economy by displaying a host of new airframes at the show - and those airframes garnered significant interest from a diverse set of customers. Robinson Helicopters' first turbine powered R-66 appealed to the cost-conscious investors and training markets, for less than \$800,000. Eurocopter's versatile EC-175 was mocked up in an air ambulance attire, while Augusta Westland was booking orders for its "Grand New" from corporate and transportation buyers.
3. **Research and Development** - Sikorsky is reinvesting some of its \$6.3 billion revenues into its Innovation Division where it undertaking several DARPA projects along with a unique pusher-prop design. Likewise, Eurocopter continues to make progress with its "Bluecopter" initiative, seeking to improve fuel efficiency, reduce emissions and reduce noise levels.

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