# Salem Partners – 2011 Outlook

## Introduction

Fourth Quarter 2010

Dear Friends,

Happy New Year! We hope that you had a restful holiday and enjoyed spending some time with family and friends.

At this time of year it is important to both reflect back on 2010 as well as look forward into the new year. Looking back, 2010 will be remembered fondly as M&A and capital raising activity rose significantly over 2009 levels. In the A&D space, we saw a surge in deal activity as a variety of family and institutionally owned business took advantage of the improved market conditions and moved to get ahead of (now delayed) changes in capital gains treatment. For our practice, the fourth quarter of 2010 marked a successful strategic review and recapitalization for a privately held provider of engineering and precision machining services to the defense and power generation markets.

At Salem, we believe that the positive momentum established in 2010 will continue through next year, and sellers of A&D businesses will once again receive strong interest from both strategic and financial buyers. This optimism is tempered by major shifts in the political environment regarding the appetite and support of the defense budget. The combination of an unprecedented fiscal deficit and decreasing troop levels have created a concerning dynamic where politicians from both sides of the aisle are increasingly calling into question the need and sustainability of current US defense spending. For our clients with significant defense-related revenue, a reversal of the last ten years of spending growth is likely to have unpleasant consequences for both top-line revenue and equity valuations. The good news is that structural changes to the defense budget will likely be gradually phased in through 2012 – 2015 leaving 2011 as a year of spending growth.

In our opinion this dynamic will be the major theme of Aerospace & Defense M&A activity in 2011 as business owners face the tough decision between riding out a seismic change in the macro environment over the next five years or capitalizing on the window of opportunity that 2011 is presenting.

Without a doubt, it is an interesting time in our industry. We are, as always, available for any questions and would welcome a conversation with you!

Sincerely,

Trevor Bohn
Managing Director

Sean Walker
Managing Director

HIGHLIGHTS

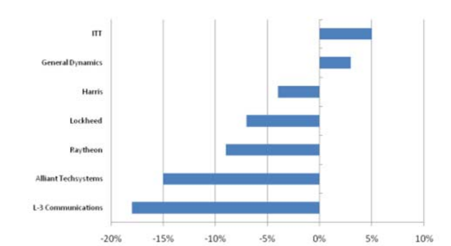
- Defense vs. Commercial Aerospace
- M&A Activity

# 2010 in Review

**Defense vs. Commercial Aerospace**

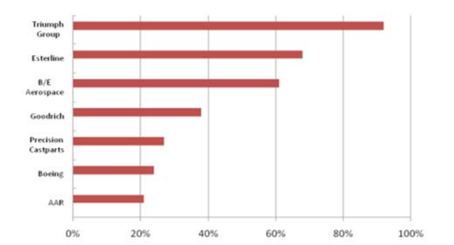
Investor sentiment has turned to favor commercial aerospace over defense end-market exposure. This differentiation was illustrated through public market performance of notable A&D names over the course of 2010 as illustrated below:

Defense Focused




Source: Capital IQ

Commercial Aerospace Focused



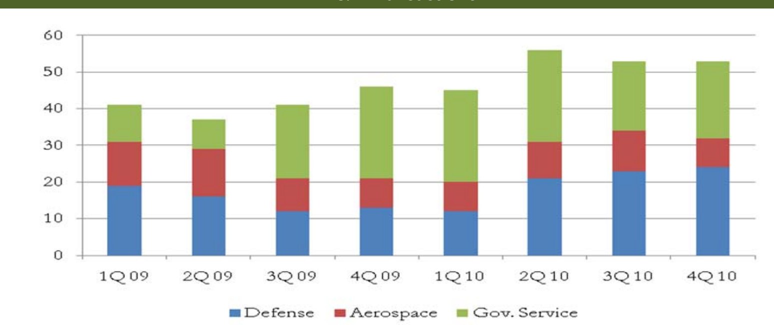

Source: Capital IQ

As mentioned in our previous Industry Review, a bifurcation has been created between defense and commercial aerospace public companies. The bright future of commercial aerospace with increasing build-rates on multiple platforms (B777, B737) contrasts with the significant uncertainty surrounding the defense budget. It is interesting to note that the names that have struggled the most (L-3, ATK) have significant exposure to the conflicts in Iraq and Afghanistan. Also, the recent delays and uncertainty around future procurement levels of the Joint Strike Fighter have negatively impacted the share price of Lockheed Martin.

Across all industries, middle-market M&A activity was up significantly in FY2010 over the previous year. From a volume perspective, deals less than $50 million were up ~20% and deals from $50 - $250 million were up ~43%. This rebound in transaction volume reflects a broader trend of increased demand from both strategic and financial buyers due to pent-up demand from the inactivity of previous years.

For A&D transactions, the improved market conditions led to a similar spike in transaction volumes. From our perspective, 2010 was characterized by two trends. First, many privately-held owners entered the market with the intent to transact ahead of changes in capital gains tax treatment. Though the tax cuts were extended, the marked increase in supply of transactions and corresponding challenges in valuation provided a valuable lesson to those considering waiting until the 2012 deadline arrives. Secondly, many owners missed the window of the 2006 – 2007 time period and took advantage of the improved conditions in 2010. The below chart illustrates the number of A&D deals over the past two years:

A&D Transactions




Source: Analyst Research

HIGHLIGHTS

- Valuations are baaack!
- Pick Your Spots
- Group Thinking in 2012

# 2011 Outlook: M&A Drivers

Substantial momentum has been established in the M&A market over the past twelve months, and we eagerly anticipate the positive trends in improving valuations and increasing volumes continuing into 2011. For the upcoming year, we expect the following to be the key drivers of M&A activity in the aerospace and defense space:

**Valuations Have Rebounded to Near Peak Levels**

After dipping substantially in 2008 and 2009, valuations have snapped back to pre-recession levels leaving many buyers frustrated and sellers thrilled. While valuations have rebounded across the board, there remains a great deal of scrutiny around program exposure, backlog and technology. In evaluating the proper time to initiate a liquidity event, market timing and conditions always play a significant role but can be likened to reading tea leaves or a crystal ball. All we can say with certainty is at this moment, market conditions are receptive and sellers are receiving premium valuations. Hopefully this dynamic lasts for the foreseeable future, but as illustrated in the 2008 – 2009 period, sentiment can change in an instant and disrupt demand for M&A for years.

**Have & Have Not's**

*Defense*

The remainder of the industry review focuses on the overall negative sentiment surrounding the outlook for defense spending, but it is important to be reminded that many businesses are positioned to continue growing and have incredibly bright futures. Areas like C4ISR, cybersecurity and UAVs will be aggressively pursued as strategic buyers look to take advantage of high-growth areas. Simply put, a premium has been placed on growth and technology as the limiting factor of the budget environment reduces the supply of these opportunities. In contrast, we have also seen increased M&A around businesses with less than ideal program exposure, more commoditized services and technologies and uncertain outlooks beyond 2011. Transactions in this vein are less opportunistic by the sellers and instead initiated as a more defensive action. Many sellers are acknowledging in a declining budget environment it may be advantageous to partner with a larger businesses to monetize equity value now and allow the business to benefit from being part of a larger organization.

*Commercial Aerospace*

A similar dynamic has emerged in commercial aerospace as both backlog and production rates from both Airbus and Boeing increase. Recent rate hikes on the B737, A320 and B777 have the supply chain and investors alike excited for improved volumes. The improving global economy has benefitted the operating condition and access to financing of the end customers for these aircraft as both the airlines and leasing companies are adding to the OEMs' backlog. On the other side of the coin, the latest in the series of delays in the B787 may finally result in pulled orders and reduced full-rate production volumes as customers may reconsider order plans.

**A Rush for the Door in 2012**

With the market beginning to feel a bit like 2006 – 2007, there is increased interest in pursuing a transaction across the entire range of our relationships as owners feel more confident about their businesses and the M&A market. Additionally, much like at the end of this year, many conversations have focused on transacting ahead of upcoming changes in capital gains tax treatment. While after-tax proceeds should certainly be a consideration, we worry that many owners are tempted to delay a transaction until the 2nd half of 2012 allowing them to preserve their tax treatment and to continue receiving the benefits of strong operating conditions. Unfortunately, after witnessing the flood of transactions that came to market towards the end of this year, we have concerns that there could be a supply glut of middle-market targets in the fall and winter of 2012.

# Defense Budget: Belt Tightening

**HIGHLIGHTS**

- *Defense Fundamentals Shifting*
- *US Government Spending*
- *Deficit (% of GDP)*

Over the past ten years, many suppliers in the defense industry have benefitted from a rapidly growing defense budget that allowed for investment in new technologies, high quantity procurements and a range of next-generation platforms. This beneficial macro-level backdrop attracted a substantial amount of institutional investment as well as strategic M&A activity in the space as many privately and publically held defense suppliers were experiencing growing revenue and profitability.

Unfortunately, the industry is now beginning to experience a fundamental shift as the spigot of defense spending is being rapidly turned off. This change brought on by both decreased operating tempo and increased scrutiny of federal deficits will have an adverse effect on the financial results of the supplier base as well as on acquisition valuations.

The remainder of the industry review will explore the primary drivers of defense spending, the fiscal environment and operating tempo, as well as the effect on M&A activity.

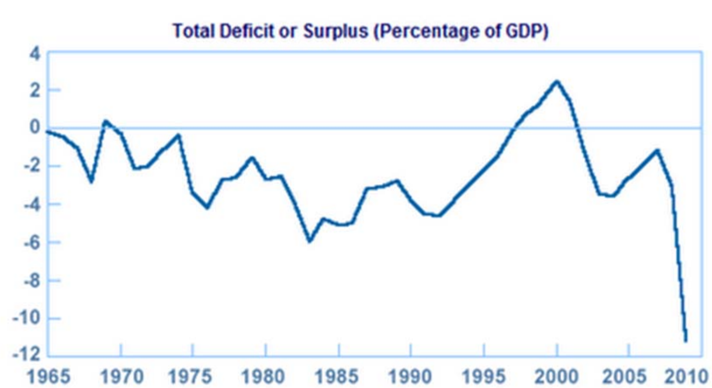
**Fiscal Environment**

As a result of a range of fiscal stimulus measures and declining tax revenue, the federal budget has reached the point where the sustainability of and ability to fund future deficits have come into doubt. Efforts to reduce the size of the deficit have moved to the forefront of the political consciousness and addressing the issue is likely to be a major political theme in 2011.

The recent findings by the congressional deficit commission (Simpson-Bowles) have provided limited definition around future plans to address the fiscal imbalance, but they do illustrate that a key aspect of addressing the deficit will be reducing both mandatory (Medicare, Social Security, etc) and discretionary (military) spending. Political pressure to reduce overall levels of fiscal spending is likely to bring unwelcomed scrutiny on the defense budget due to its status as a substantial item in the discretionary piece of the federal budget.

In Salem's view, the political environment presents an unsettling backdrop for the industry and for our clients. Reducing the fiscal deficit has the potential to become one of the rare issues that bridges political divides, and it is certain that slashing the defense budget will be a proposed solution. From a timing perspective, major changes in the way our government spends money will be slow coming; however, rhetoric and posturing ahead of a presidential election in 2012 could cause uncertainty among investors and slow M&A activity.

US Fiscal Deficit




Source: Congressional Budget Office

# Defense Budget: Belt Tightening

HIGHLIGHTS

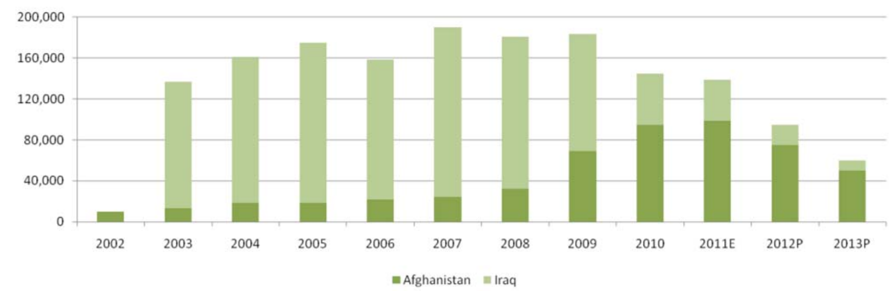
❖ *Troops in Theater*

**Shift in Operating Tempo**

Since 2002, with the beginning of Operations Enduring and Iraqi Freedom our nation has been at war. To support global wartime operations, Congress has approved a total of $1.21 trillion for military operations, base security, reconstruction, foreign aid, embassy costs and veterans' health care. In addition to supporting our US Military, these dollars created a new market for an incredible variety of goods and services provided by the Aerospace & Defense supply chain, increasing demand for everything from logistics services to rotorcraft components to UAV ground stations.

While there remains substantial work to be done, the tempo of both the conflicts in Iraq and Afghanistan have peaked and have begun to wind down. The operating tempo is best illustrated by troops on the ground figures shown below:

Average Troops in Theater




Source: Congressional Budget Office & Salem Estimates

The troop levels are representative of the ongoing shift in prioritization from Iraq to Afghanistan fully implemented in 2009. In FY2010, war costs in Afghanistan accounted for 61% (vs. 39% for Iraq) a nearly full reversal from the previous year; this brings the total funding for Iraq to $751bn and Afghanistan to $336bn. With an agreement in place with the Iraqi government for a full US troop withdrawal by the end of 2011, the focus of our global conflicts will clearly be Afghanistan.

❖ *Implications of Declining Troop Levels*

For our clients there are a few key takeaways from the discussion on operating tempo. First, the correlation between defense spending and operating tempo is a direct and very real relationship. Simply put, declining troop levels will reduce the need for a wide range of procurement items. The effect of slowing operating tempo will be felt throughout the supply chain including reduced procurement spend for new systems, lower need for repair of war-worn equipment and reduced spending on Research & Development.

For FY2011, the effect of declining troop levels will only have a moderate effect on the supply chain as the growth in troop levels and spending in Afghanistan will continue to help to offset the slowing of operations in Iraq. Material changes in operating tempo are expected to occur in FY2012 and beyond as Iraq deployment ends and the political appetite for a sustained conflict in Afghanistan wanes.

HIGHLIGHTS

- Defense Budget

- Salem Conclusion

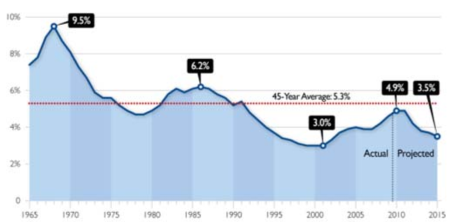
# Defense Budget: Belt Tightening

**Defense Budget**

In what is likely the first move of many, the White House announced in early January 2011 that the Pentagon must reduce funding needs and begin addressing the size of the defense budget. The initial cut totals $78 billion consisting of many seemingly innocuous changes including reducing fuel consumption, consolidating email, etc. That said, the cuts introduce the concept of real threats to the supply chain including $4 billion of reduced JSF spending, eliminating 1,000 civilian contractors and reducing the purchase of $1.3 billion worth of Navy aircraft.

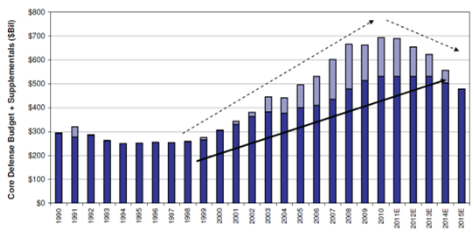
The combination of a challenging fiscal environment and declining operating tempo have combined to put the outlook for defense spending in a tenuous position. With Defense Secretary Gates set to retire later this year, major changes are likely in order. We at Salem Partners expect defense spending to decline materially (both nominally and as a % of GDP) beginning in FY2012 with cuts continuing through FY2015. Unfortunately, the cuts announced in January are likely to be a precursor to more serious reductions over the next several years.

Defense Spending as a % of GDP




Source: White House Office of Management and Budget

US Defense Spending




Source: Analyst Research

**Conclusion**

It is undeniable that the current outlook for defense spending over the medium-term is challenging. Many defense-heavy businesses will struggle to replicate the financial success of the 2005 – 2010 time frame. The transition from a rapidly growing defense budget to one that is gradually declining will be an entirely new operating environment for business owners that have grown accustomed to operating in war-time conditions. While there will certainly be a wide range of opportunities for growth, many defense businesses will see downward pressure on both top-line revenue as well as profitability.

On the other hand, a sense of perspective and a few thoughts on timing are important to keep in mind. Even in the most bearish scenario, defense spending is expected to decline to 2003 levels. By most any comparison (especially in the mid-1990's) this is not too shabby! Our intention is only to point out that the era of spending growth and loose procurement dollars has come to an end.

For business owners considering an M&A event, FY2011 will be a pivotal year to consider initiating a transaction. In many ways, this year will be a tipping point as over the next twelve months the budget dollars continue to flow and drive revenue and profitability for many businesses. As the budget begins a shrinking process in 2012, the M&A environment for defense businesses will be clouded by uncertainty around the future of defense spending. Unfortunately, concerns over the major macro-level driver of the industry will likely translate into downward pressure on valuations and acquisition premiums in 2012 and beyond.

At Salem Partners we believe that 2011 will be a strong year for M&A activity as owners and investors who are able to "see the forest through the trees" and understand the implications of the upcoming changes in the industry capitalize on the window of opportunity that exists today.

HIGHLIGHTS

- Capital Markets Commentary
- A&D M&A Activity

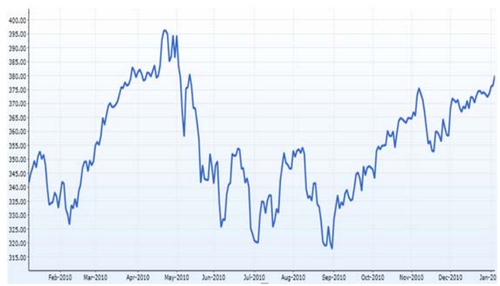
# Capital Markets

## Capital Markets

Both the equity and capital markets finished 2010 strongly with a fourth quarter that saw equity valuations rise and credit spreads tighten.  The S&P 500 continued its new two year old march upwards and has nearly completed a full return from the 2008 credit crisis.  For the debt markets, spreads have continued to tighten and are now approaching levels not seen since 2007.

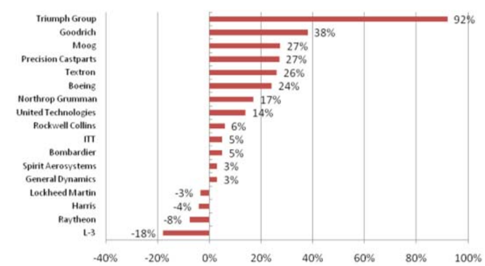
For our clients, the strength of the equity and debt markets is helpful for in terms of both risk appetite for strategic and financial buyers as well as securing premium valuations from buyers.

S&P 500 A&D Index (FY2010)



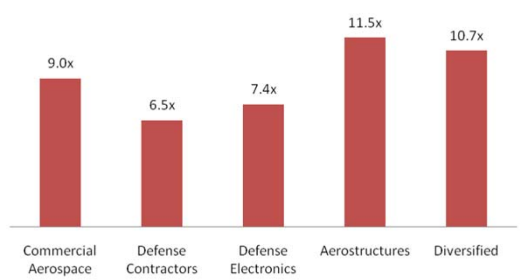
Source: Analyst Research

Performance by Name (FY2010)




Source: Analyst Research

Current Market Valuations (Enterprise Value/EBITDA by Subsector)




Source: Analyst Research

A&D M&A Activity

| ($ in millions) Date | Target | Acquirer | Enterprise Value | Valuation EV/ Rev | EV/ EBITDA |
|---|---|---|---|---|---|
| 23-Dec-10 | Arden Engineering, Inc | PRV Aerospace, LLC | - | - | - |
| 22-Dec-10 | Todd Shipyards Corp. (NYSE:TOD) | Vigor Industrial, LLC | 90 | 0.4x | 3.4x |
| 18-Dec-10 | Applied Signal Technology, Inc (NasdaqGS:APSG) | Raytheon Space & Airborne Systems | 476 | 2.1x | 14.6x |
| 15-Dec-10 | M7 Aerospace L.P. | Elbit Systems Of America, LLC | 85 | - | - |
| 13-Dec-10 | Trident Space & Defense, LLC | TeleCommunication Systems Inc (NasdaqGS:TSYS) | - | - | - |
| 11-Dec-10 | Teledyne Continental Motors, Inc | AVIC International Holding Corporation | 186 | - | - |
| 29-Nov-10 | Whitcraft, LLC | Linsalata Capital Partners | - | - | - |
| 28-Nov-10 | Telair International Inc, Actuation Business | TransDigm Group Incorporated (NYSE:TDG) | 94 | 3.9x | - |
| 16-Nov-10 | Ladish Co. Inc (NasdaqGS:LDSH) | Allegheny Technologies Inc (NYSE:ATI) | 806 | 2.1x | 14.7x |
| 2-Nov-10 | Swissport International AG | PAI partners | 1,235 | 0.8x | 10.9x |
| 12-Oct-10 | ALEXCO, LLC | Kaiser Aluminum Corporation (NasdaqGS:KALU) | 90 | - | - |
| 6-Oct-10 | Laingsdale Engineering Ltd. | Rheinmetall Defence | - | - | - |

Source: Analyst Research & Salem Partners estimates

SALEM PARTNERS | CLIENTS KNOW.


Salem Partners LLC
11111 Santa Monica Blvd
Los Angeles, CA
(310) 806 – 4200
Member FINRA and SIPC



Trevor Bohn
Managing Director
(310) 806 – 4218
tbohn@salempartners.com



Sean Walker
Managing Director
(310) 806 – 4215
swalker@salempartners.com



Ryan Murphy
Associate
(310) 806 – 4209
rmurphy@salempartners.com



Erik Einwalter
Associate
(310) 806 – 4211
eeinwalter@salempartners.com