

Salem Partners – Aerospace & Defense

Quarterly Review

Introduction

First Quarter 2011

Dear Friends,

As we had anticipated, the first quarter of 2011 marked a continuation of many of the positive M&A and industry trends that characterized a strong 2010. As a whole, economic conditions continue to show signs of gradual improvement with unemployment levels falling slowly, improving consumer confidence and growing corporate profits. Global equity markets have continued their march upward pushing aside any concerns regarding nascent inflation, rising national debt or the ongoing tragedy in Japan. These elements provide support to the capital and M&A markets as both strategic and financial sponsors remain active and continue to pursue attractive assets.

From an M&A perspective, we are seeing deal flow consistent with last years' levels with the mix of higher-quality businesses accessing the capital raising and M&A markets increasing. The first quarter was marked by several high-profile public companies announcing pending transactions (Vector Aerospace, SRA) which corresponded to a steady stream of lower profile deal activity among middle-market, family-owned businesses. Privately-held businesses continue to be in strong demand by potential acquirers despite an increase in the number of businesses (especially defense-focused) pursuing a liquidity event.

For commercial aerospace, the key news event during the first quarter was the investigation into the air-worthiness of legacy aircraft in the B737 fleet after fuselage degradation was discovered mid-flight. This unfortunate incident only served to highlight the need to recapitalize aging fleets, particularly among our North American carriers. In support of that need, Airbus announced plans for a next-generation A320 (NEO) as a stop-gap measure ahead of a full re-design of its narrow body offering.

On the defense side, unrest in the Middle East has captured the attention of the worldwide media as conflict has spread disturbingly rapidly through the region with multiple regime changes and revolutions over the period of a few months. Hopefully, these conflicts serve as a reminder to our elected representatives that despite slowing operations in Iraq and Afghanistan, the need for rapid and decisive American military force can develop at a moment's notice. After a considerable wait and substantial political rhetoric the FY2011 budget was agreed upon (six months late), but now the focus has turned to the FY2012 budget as the near-term future of defense spending will be outlined.

Please enjoy the remainder of our industry review and, as always, we welcome your comments and questions.

Sincerely,



Trevor Bohn
Managing Director



Sean Walker
Managing Director



Capital Markets

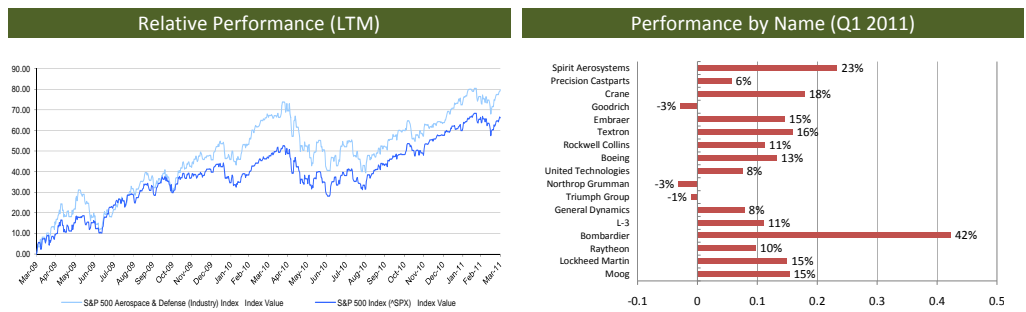
HIGHLIGHTS

Capital Markets Commentary

Capital Markets

The first quarter of 2011 saw significant gains for aerospace and defense companies in, with names such as Bombardier, Spirit Aerosystems, and Crane, leading the way with share price improvements over the quarter of 42%, 23%, and 18%, respectively. Defense focused names such as Lockheed and L-3 also saw improved investor sentiment after struggling much of the fourth quarter of 2010.

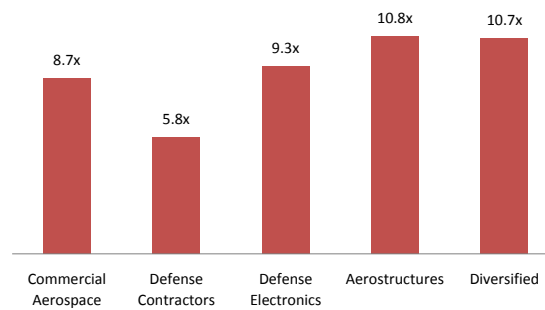
The S&P Aerospace & Defense Index was up 25% for the first quarter of 2011, while the S&P 500 Index improved 15% for the same period.



Source: Analyst Research

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Enterprise Value/EBITDA by Subsector



Source: Analyst Research

A&D M&A Activity

A&D M&A Activity					
Date	Target	Acquirer	Enterprise Value	Multiples	
				EV/ Rev	EV/ EBITDA
1-Apr-11	SRA International Inc. (NYSE:SRX)	Providence Equity Partners LLC	\$1,795	1.1x	11.9x
31-Mar-11	Microtecnica S.r.l.	Goodrich Actuation Systems Limited	468	2.1x	11.5x
30-Mar-11	Weaver Manufacturing, Inc.	Synchronous Aerospace, Inc.	-	-	-
28-Mar-11	Damar Machine Company	Senior plc (LSE:SNR)	-	-	-
28-Mar-11	Vector Aerospace Corporation (TSX:RNO)	EADS NV (EAS:TPA:EAD)	616	1.1x	8.7x
24-Mar-11	Graco Supply	Stony Point Group; Cotton Creek Capital Management LLC	-	-	-
2-Mar-11	GE Aviation Systems LLC (legacy fuel measurement business)	BBA Aviation plc (LSE:BBA)	64	1.5x	6.6x
28-Feb-11	Cirrus Design Corporation	China Aviation Industry General Aircraft Co., Ltd.	210	-	-
13-Feb-11	AML Communications Inc. (OTCBB:AMLJ)	Anaren Inc. (NasdaqGS:ANEN)	22	1.4x	8.4x
7-Feb-11	Herley Industries Inc.	Kraton Defense & Security Solutions, Inc. (NasdaqGS:KSTOS)	261	1.4x	7.8x
18-Jan-11	ARTUS S.A.S.	Meggitt plc (LSE:MGIT)	-	-	-
12-Jan-11	LNX Corporation	Mercury Computer Systems, Inc. (NasdaqGS:MRCY)	36	-	-
10-Jan-11	Avcenter, LLC	Precision Avionics and Instruments	-	-	-
9-Jan-11	SenDEC Corporation	API Technologies Corp. (OTCBB:ATNY)	-	-	-
7-Jan-11	Predator Systems, Inc.	Curtiss-Wright Corp. (NYSE:CW)	13	1.7x	-

(\$ in millions)

Source: Analyst Research & Salem Partners estimates

HIGHLIGHTS

❖ Aging Fleets

❖ NEOs

Industry Headlines - Aerospace

Rethinking Fleet Planning

The April 1st emergency landing of a Southwest 737 due to a hole incurred in the fuselage 20 minutes after takeoff served as a reminder to concerned passengers that current commercial fleets are beginning to show their age. The average age of U.S. commercial aircraft is a relatively young 11 years (compared to 10 years for the average international aircraft), but nearly a quarter of those aircraft are older than 15 years¹. Contributing to the concerns over fleet age is the lack of knowledge surrounding aircraft longevity. Carriers and manufacturers alike were surprised to discover that the majority of hull structural problems occurred in aircraft that had 30,000 or more landing cycles, significantly less than the anticipated 60,000 landing cycles. While North American carriers continue to lag behind international competitors in fleet investment, public sentiment towards newer and safer options in light of recent maintenance and aging issues may force North American carriers to reconsider fleet planning and the replacement of aging aircraft sooner than anticipated.

Commercial Aerospace: The New Narrowbody Generation

Rising fuel prices, coupled with headline-grabbing signs of wear, are forcing carriers to begin to examine alternatives to supplement and eventually replace the current narrowbody aircraft that comprise the largest component of their fleets. While Boeing has suggested that it intends to hold-off on designing a modified 737 aircraft, Airbus is taking orders the A320NEO, scheduled for delivery at the end of 2015. Airbus has suggested that the NEO will deliver notable improvements, including a 15% reduction in fuel costs, additional payload and extended range, that could translate into tangible cost savings for customers. Customers' desire for new narrowbody aircraft is tempered by cautious skepticism over the proposed cost advantages of the NEO, combined with current satisfaction in the performance of existing A320s and 737s. The majority of potential customers have placed modest orders NEOs in combination with orders for the existing A320 and 737 models, and are waiting to make larger fleet replacement decisions.

Airbus A320NEO Orders

Customer	Region	Fleet Size	Order Size
ILFC	Leasing	930	75
IndiGo	Asia Pacific	43	150
Lufthansa	Europe	467	25
TAM	Latin America	146	22
Virgin America	North America	38	30

*Does not include A321NEO model
Data as of March 8, 2011*

Source: Analyst Research

Salem Partners Analysis

Recent accelerations of narrowbody build rates have been heralded by the global supply chain as welcome news, as narrowbody production volumes have provided a consistent source of revenue for the aerospace and defense supply chain for over a decade. On the other hand, pessimists could argue that Airbus and Boeing are maximizing production of current narrowbodies ahead of formally announcing plans for the next generation of narrowbody aircraft. In our view, the next generation of Boeing 737's and Airbus A320's will be a major event and opportunity for the global supply chain in the second half of the decade.

¹ Source: Forbes.com

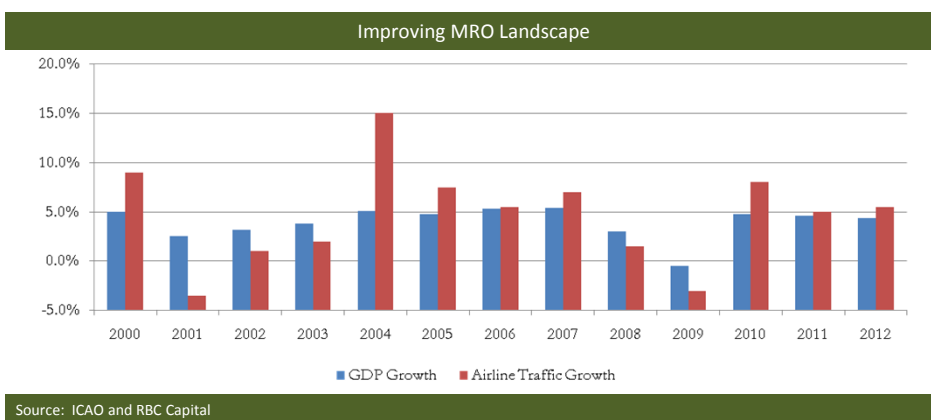
HIGHLIGHTS

❖ Macro Drivers

MRO – 2012 Looks Bright

MRO

Owners and operators of Maintenance, Repair and Overhaul (MRO) businesses are optimistic that operating conditions are improving despite a recent rise in the price of jet fuel. According to TeamSAI, the global market for MRO is \$46.9 billion, 10.8% higher than 2010. This growth will be driven by several factors, most notably increased airline traffic. As economic conditions improve (albeit slowly), both business and recreational travelers have begun to spur demand for airline traffic growth. The below chart illustrates the positive correlation between improving economic conditions (GDP growth) and airline traffic:



❖ Changing Fleet Mix

Changing Fleet Dynamics

MRO operators are continuing to adapt to a shifting fleet make-up as less efficient legacy aircraft (B737 Classics, DC-9, MD-80s) are being retired at an accelerating pace to make way for newer, more efficient next-generation aircraft. This change in mix has decreased the average maintenance spend on aircraft from \$2.8mm in 2008 in to \$2.1mm in 2010² as the newer aircraft require less spending at this stage in their useful life. As fuel prices continue to rise, TeamSAI expects that 46% of the entire fleet will be retired over the next ten years to be replaced by next generation aircraft.

❖ MRO Geography Shift

Shift in Geography

Over the past several years, fleet operators from the Asia Pacific region have made headlines with sizable orders for next generation aircraft. This ordering binge (29% of all aircraft orders in 2010) will have a “waterfall” effect on the aftermarket. Analysts expect the Asia Pacific region to grow significantly over the next decade and soon eclipse both the North American and European MRO markets.

Salem Commentary

For our clients and prospects in the MRO space, multiple important decision points are forthcoming over the next several years. From an investment perspective, a strategy must be formed to be positioned for the maintenance cycles of next generation aircraft. Providers must have a plan to replace revenue from legacy aircraft with expected future MRO needs on the B787, CSeries, etc. From an M&A perspective, interest in the MRO space is strong with headline transactions such as Vector Aerospace driving strong equity valuations in the space. Financial buyers remain interested in the aftermarket as consistent revenue growth appears achievable for the next several years.

² Source: TeamSAI

HIGHLIGHTS

❖ *Unrest and Libya*

Industry Headlines - Defense

Armed Conflict and Military Spending

The recent sweep of political unrest and armed conflict across Africa and the Middle East has highlighted the persistent dangers that exist abroad, and catalyzed increased international military action in the Gulf. Growing uncertainty in Egypt, Yemen, Ivory Coast, Syria, Libya in a matter of weeks reemphasizes the need for a sustained U.S. military presence in the region, both to address international conflict and to secure valuable natural resources.

The conflict in Libya particularly has emerged as a point of emphasis. In an attempt to discourage escalating militarized attacks by Gaddafi government forces on Libyan citizens, the UN passed resolution 1973 to enact a no fly zone and allow the international community to provide aerial protection for Libyan citizens. U.S. and international involvement in the situation continues to gain momentum. As of March 28, U.S. spending in Libya had totaled \$550 million, including \$4 million daily to operate 50 fighter jets and supporting aircraft.

Becoming ever more apparent, however, are the limitations that Resolution 1973 places on foreign intervention, and a subsequent stalemate has surfaced between an impassioned civilian population and better-equipped and better-trained pro-government forces. Additional international efforts to intervene are complicated by Resolution 1970 which places an embargo on all arms shipments into Libya. Further resolutions with more substantive authorizations, including potential troop deployments, are what seem necessary to permit the kind of substantive foreign intervention capable of defeating the stalemate.

Until an effective roadmap toward resolution can be created, militarization in the region will continue to mount, and uncertainty will continue to buoy oil prices, already up ~25% since the Libya conflict began.

Refueling Tanker Saga Produces Outcome

❖ *Tanker Contract*

The Pentagon announced that the contract to produce an estimated 179 next generation aerial refueling tankers, with a potential value of \$30 billion, has been awarded to Boeing. Rival bidder EADS has appeared to accept the decision after a long and tumultuous struggle that included the contract being previously awarded to Boeing in 2003, and then to EADS in 2008, each before being revoked and the bidding process resumed. Subcontractors and suppliers for Boeing can expect significant workflow as the first 18 of Boeing's KC-46A are scheduled to be delivered by 2017.

Joint Strike Fighter Update

❖ *Joint Strike Fighter*

The development of the next U.S. military jet workhorse seems to finally be getting back on track. After numerous technical and funding issues for the F-35 Joint Strike Fighter, including the all-but-scraped second engine option, Lockheed Martin reported encouraging results for JSF testing through the first quarter of 2011. All together, the program completed 199 test flights and satisfied 1,482 test points through March 31, surpassing 142 test flights and 1,011 test points planned for the period. Notable was the improvement in testing for the STOVL F-35B model, which has experienced the most technical problems throughout development. The improvement in testing performance for the F-35 provides encouragement for continued investment in the program, and preserves Tier 2 and Tier 3 contractor expectations for significant work related to eventual production.

HIGHLIGHTS

❖ Government Halt?!

Defense Budget – Pressure Continues to Mount

Update on Continuing Resolution

Through the first quarter, Americans watched in horror as it appeared that our democratically elected government would be unable to reach agreement on a go-forward budget and be forced to shut-down. Thankfully, this crisis was averted at the last moment, but lost in the shuffle was the key budgetary issue that has been adversely affecting the global A&D supply chain, the Continuing Resolution (CR). Since the end of the US Government's fiscal year (September 2010), the Department of Defense has been operating out of a CR. The resolution essentially halted funding at FY2010 levels while the budget for the current year was debated. The effect on the supply chain has been severe as all new programs were halted and working capital issues slowed procurement of necessary items. The core budget for FY2011 has now been set at \$526bn which represents a \$23bn reduction from the President's Request and a reduction of \$9bn from 2010 levels.

With FY2011 just recently decided, the defense budget for FY2012 is already being discussed. The initial request from the Pentagon has been for \$670.6bn (\$553bn for core and \$117.8bn for OCO) which would be a 3% decline from FY2010 and the lowest level of defense spending since FY2006. Though this budget has a long way to go before being approved by Congress, it is clear the political focus on deficit reduction we touched on last quarter is now in full effect.

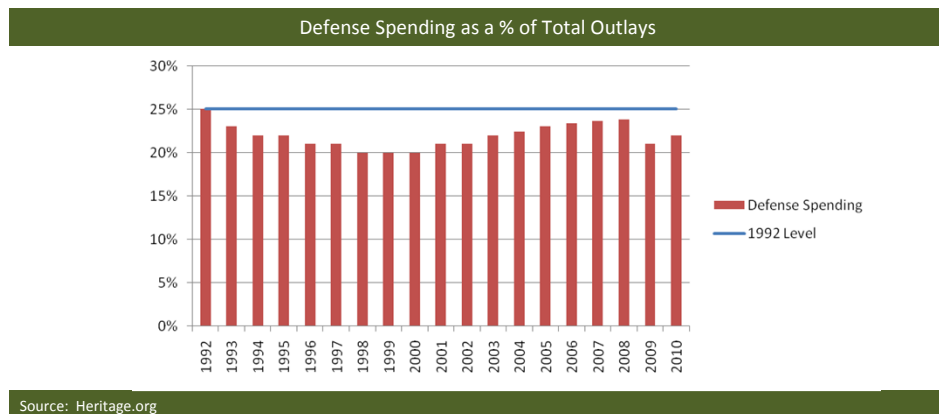
We are entering into a new period of uncertainty for defense spending where the political environment is supportive of reducing government spending at any cost, without full appreciation of the effect on national security. The following is a quote from Defense Secretary Gates:

"Suggestions to cut defense by this or that large number have largely become exercises in simple math, divorced from serious considerations of capabilities, risk, and the level of resources needed to protect this country's security and vital interests around the world."

In Support of Defense Spending

❖ Defense Spending Argument

In the current fiscal debate framed by a growing fiscal deficit, defense spending is often vilified as a key driver of government excess and out of control spending. While it is true that defense spending has grown substantially since 9/11, it has not been the sole culprit for our current fiscal situation. The chart below shows that defense spending has remained below 1992 levels as a proportion of total government spending:



To borrow from Secretary Gates again, "Defense is not like other discretionary spending. This is something we've got to do and that we have a responsibility to do. And so the two shouldn't be equated."

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