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Bank of America Merrill Lynch 2009 Defense Outlook Forum

THE CHANGING AEROSPACE/DEFENSE ENVIRONMENT

**PIERRE CHAO
MANAGING PARTNER**

New York, NY



1300 Wilson Boulevard, Suite 320
Arlington, VA 22209
(703) 504-9300
pchao@rsadvisors.net

THE MACRO ENVIRONMENT

Cyclical trends vs. long term trends vs. discontinuities

- The fiscal crisis (“the black swan appeared”)
 - Started as a banking/liquidity crisis, spread into the general economy, bottoming out
 - Banking/liquidity crisis a discontinuity in post-War II context, very routine in 18th and 19th century America (reforms of the 1930s were meant to stop them)
 - The liquidity crisis abated, environment still fragile
 - The economic slowdown working its way through in normal cycle
 - Started as a US problem, spread globally (Iceland, Ireland, Hungary), recovery in Asia first
- Impact on the aerospace/defense industry
 - Shifting focus of government to domestic issues
 - Triggered the next downcycle in commercial aerospace
 - Reminded everyone that business jet industry is cyclical
 - Aerospace/defense firms with heavy leverage/finance exposure vulnerable



THE MACRO ENVIRONMENT

Second order consequences of the fiscal crisis

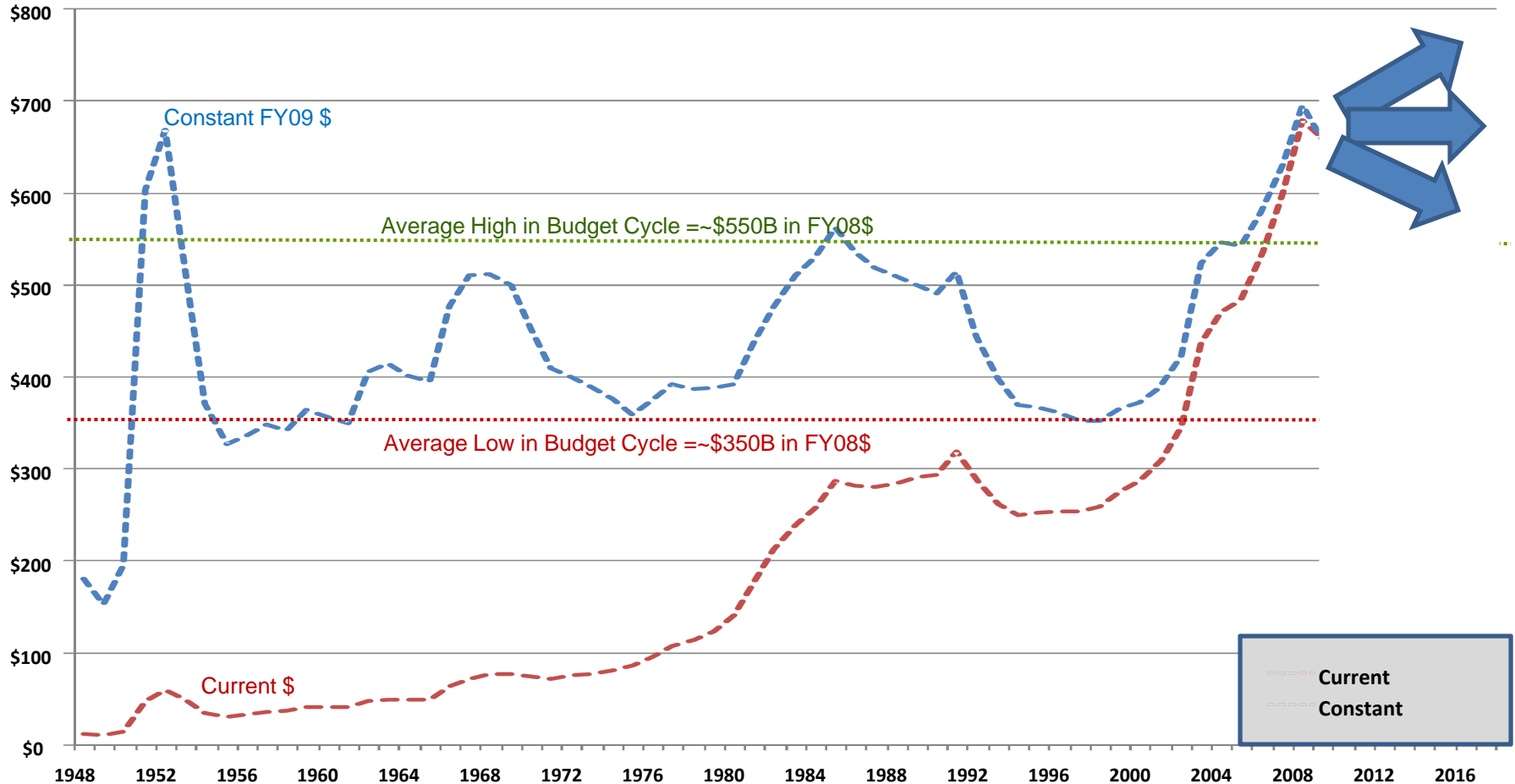
- Slowing economies and collapsing commodity prices as drivers of global instability
- Complexity of China relationship placed into stark relief
- Fundamental rethink of role of government in economy?
- Impact on the aerospace/defense industry
 - Demand for national security/security constant
 - Complexity of national security challenges driving imperative for “whole of government solutions” and multilateral solutions
 - A more benign view of near peer threat?
 - Increased demands on financial resources of government – “buy stability” or “impose stability”



THE DEFENSE BUDGET ENVIRONMENT

Cyclical? Does the old band function or a discontinuity?

U.S. Defense Budget, 1948-present

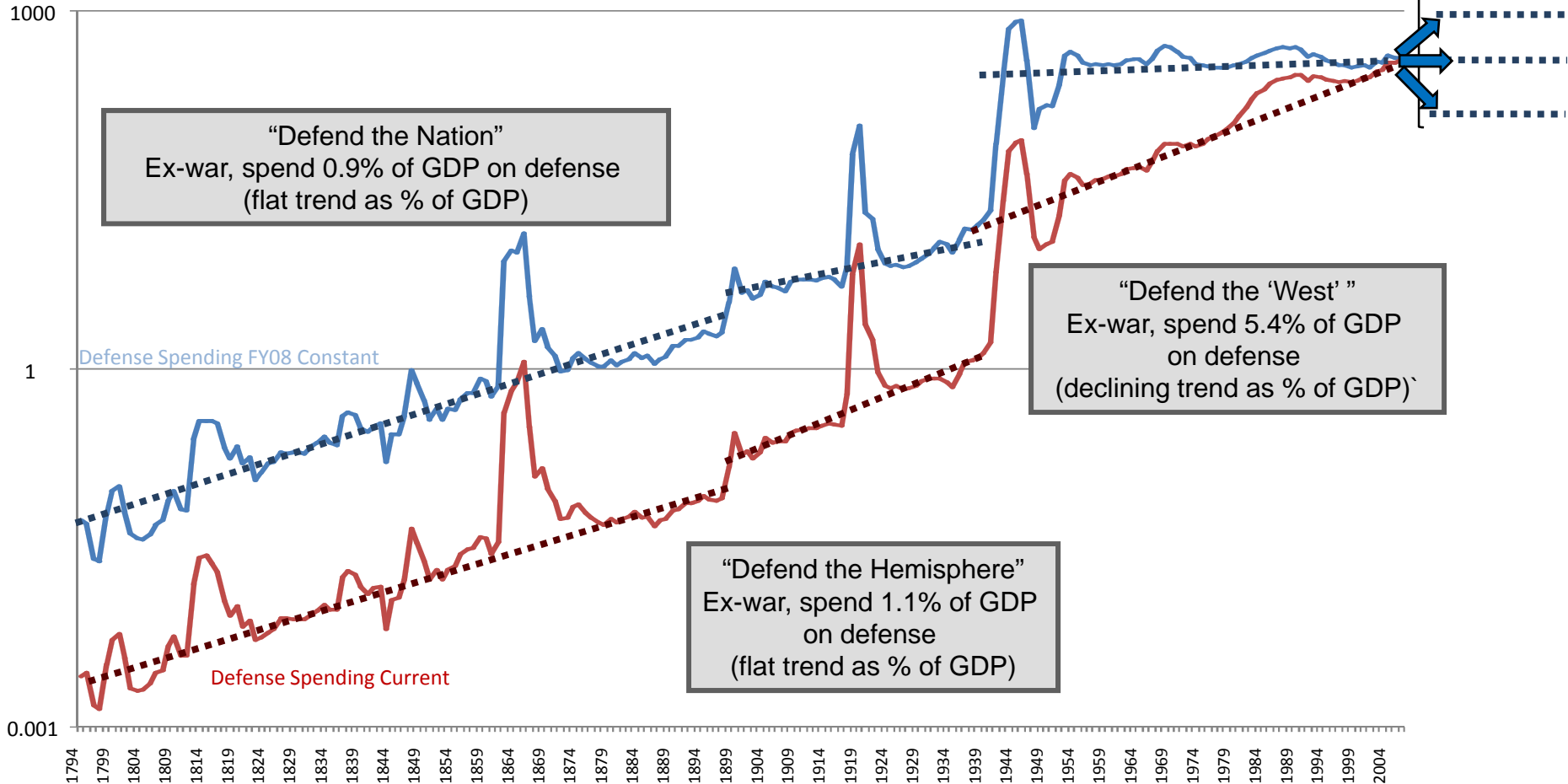


Source: DoD, RSAdvisors Analysis

THE DEFENSE BUDGET ENVIRONMENT

The Very Long View – A Fourth Band or Not?

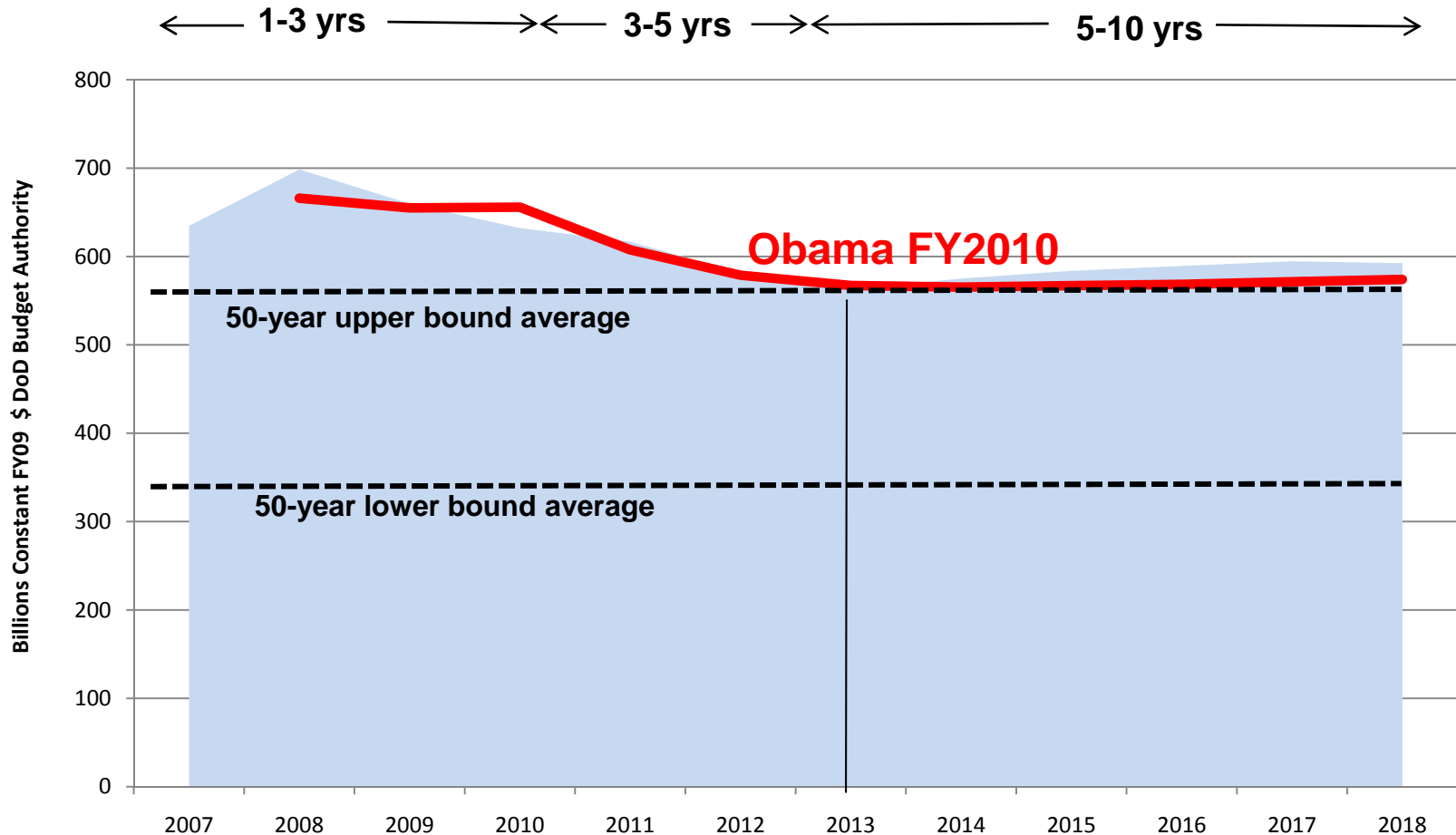
U.S. Defense Spending 1794-2007
Current and FY08 Constant \$ Defense Spending, 1794-2007



Source: Dept. of Commerce, DoD, RSA Analysis

THE DEFENSE BUDGET ENVIRONMENT

Obama Administration's long range defense plan at upper end of range



- How much will change given the economic slowdown (catalyst for change or catalyst for status quo)

US DEFENSE MARKET

Gates talks about the 50/40/10 defense enterprise = the barbell

“Bar-bell” Shaped Markets



The Long War: rapid acquisition,
Off the shelf/short development,
quick response is key, COCOM centric

Dissuade: very long cycle,
Technology development, platform
oriented but limited production,
service centric

“Slice” #2

Reset/Retrofit: Install “black
boxes” in existing equipment to
plug into network,
maintenance/repair

“Transformation”: Desire for
large, horizontally integrating
networks, leverage the IT
revolution

**Strategic Question: How Do You Organize to Address
Is it one or two industrial bases? Can they be the same suppliers?**

DEFENSE ENVIRONMENT

Cycles...Trends...Discontinuities

- **Cycles**
 - Defense budgets
 - Emphasis on particular military service/capability
 - Acquisition reform
 - Industry knows how to handle...many current executives forged in last cycle
- **Trends**
 - Demographics/human capital (actually a very long cycle)
 - Technology
- **Discontinuities (wild cards)**
 - An event that puts at risk large capital investments/forces recapitalization
 - Also technology
 - The only significant changes in the structure of the defense industry over the last 130 years driven by technology – introduction of aircraft, electronics, IT – or “business processes” – contracted services

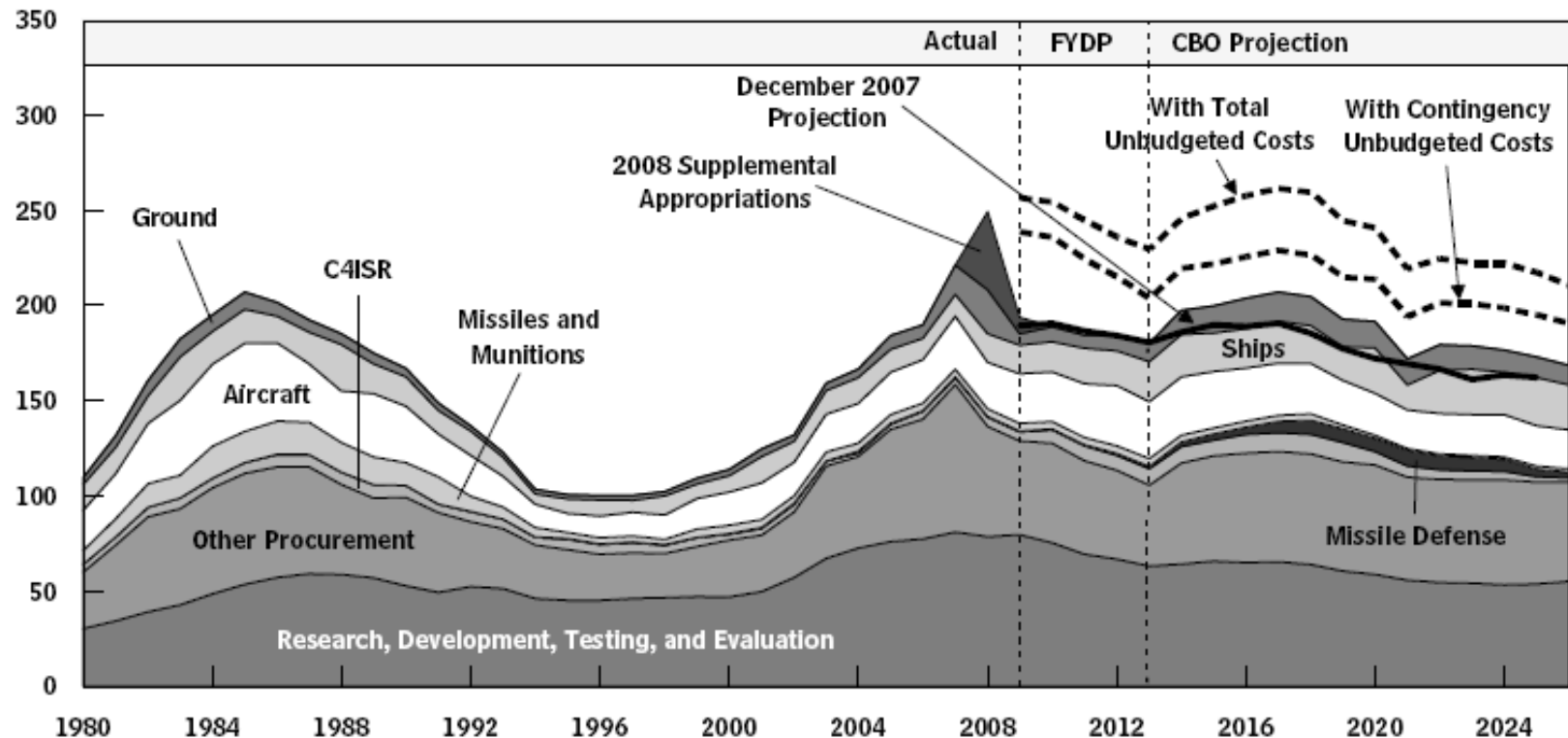
Industry adapts/survives – more broadly based, more services, moving into other government, better run as a business

DEFENSE BUDGET DEEPER DIVE

By Budget Category – CBO View

Past and Projected Resources for Defense Investment

(Billions of 2009 dollars)



Source: Congressional Budget Office.

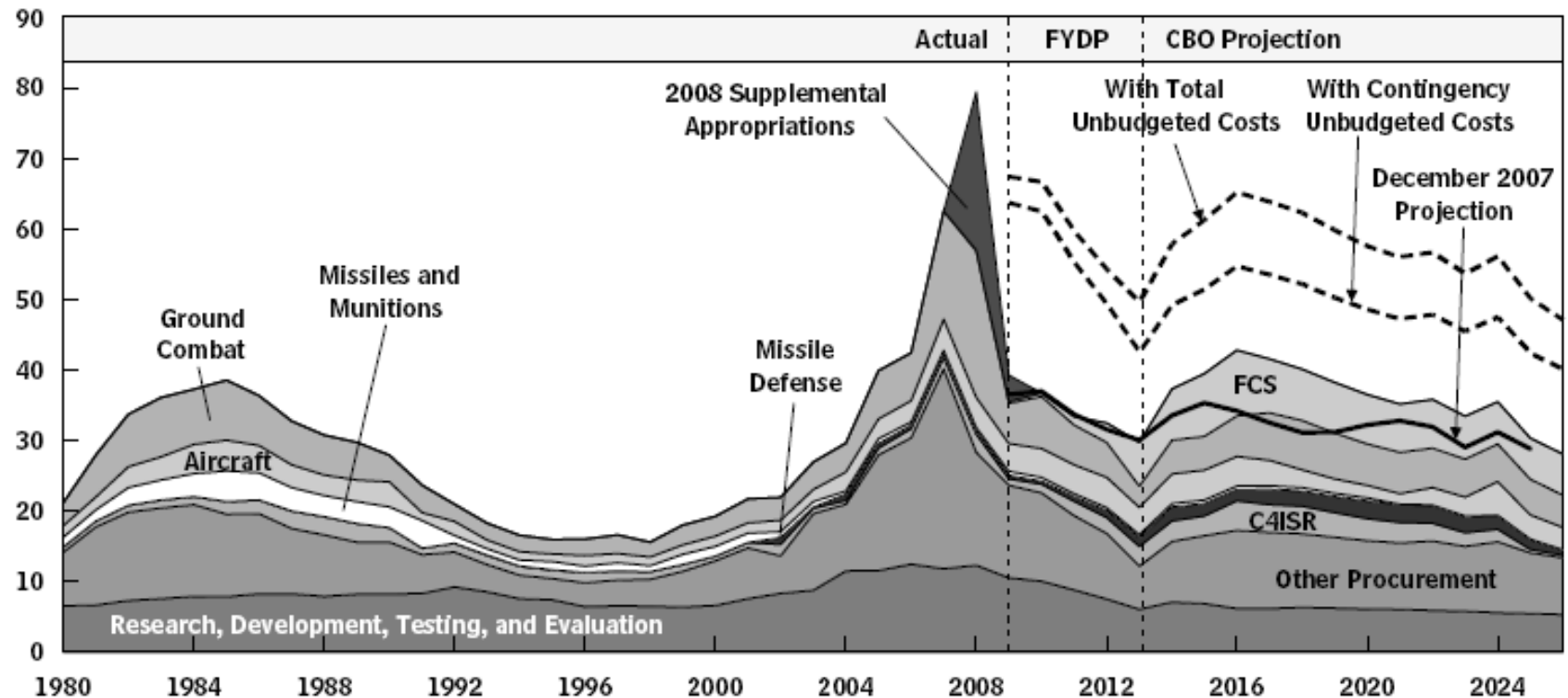
Note: FYDP = Future Years Defense Program; C4ISR = command, control, communications, computers, intelligence, surveillance, and reconnaissance.

DEFENSE BUDGET DEEPER DIVE

Army – driven by the war

Past and Projected Resources for Army Investment

(Billions of 2009 dollars)



Source: Congressional Budget Office.

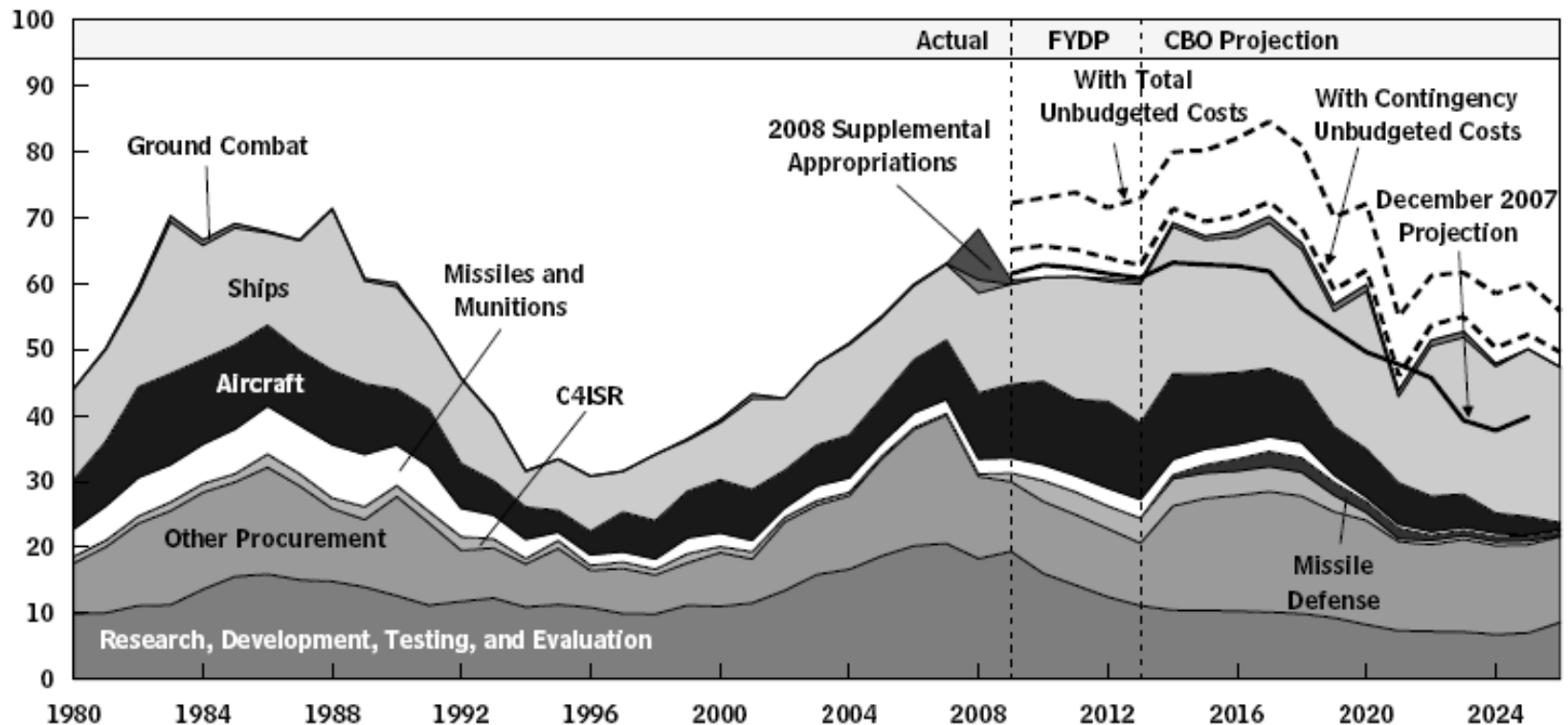
Note: FYDP = Future Years Defense Program; C4ISR = command, control, communications, computers, intelligence, surveillance, and reconnaissance; FCS = Future Combat Systems.

DEFENSE BUDGET DEEPER DIVE

Navy – dual needs of war and recapitalization

Past and Projected Resources for Navy and Marine Corps Investment

(Billions of 2009 dollars)



Source: Congressional Budget Office.

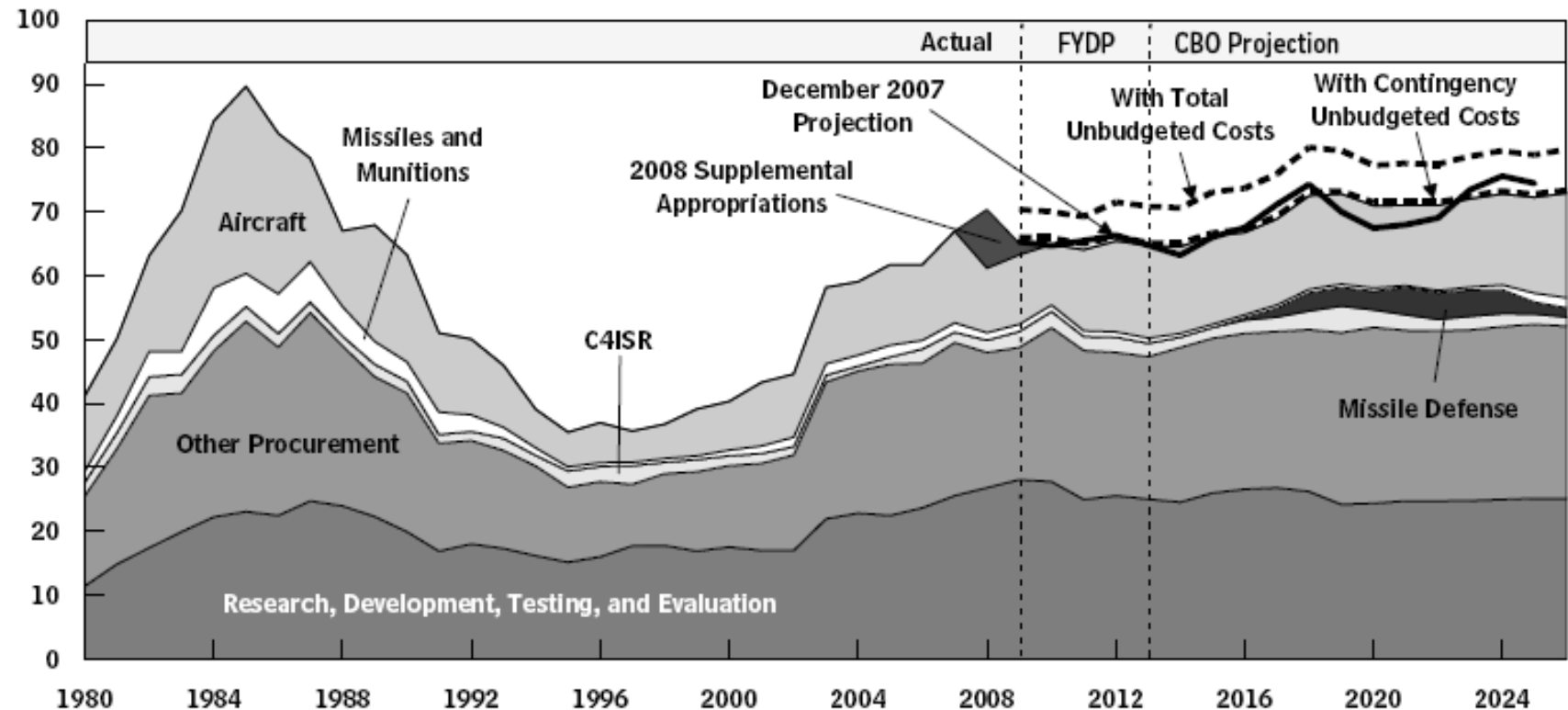
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DEFENSE BUDGET DEEPER DIVE

Air Force – recapitalization is key

Past and Projected Resources for Air Force Investment

(Billions of 2009 dollars)



Source: Congressional Budget Office.

Note: FYDP = Future Years Defense Program; C4ISR = command, control, communications, computers, intelligence, surveillance, and reconnaissance.

THE INDUSTRY

Industry healthier going into peak...market pricing in downturn

	Korean War	Vietnam	Reagan Buildup	Current
Conflict/Upramp Period	1950-1953	1961-1975	1980-1991	2001-
Trough-Peak Spending	1949-1952	1960-1968	1979-1985	1998-2010?
DoD Trough Spending - % GDP	4.1%	8.0%	4.6%	2.9%
DoD Trough Spending - % Fed Budget	28.9%	45.0%	22.5%	15.3%
DoD Peak Spending - % GDP	11.1%	8.9%	6.0%	~4.5%
DoD Peak Spending - % Fed Budget	57.2%	43.4%	26.8%	~19%
Trough/Peak Spending % Increase – Constant	285%	42%	50%	~ 80%
Trough/Peak Spending % Increase – Current	477%	88%	129%	~ 160%
Proc/R&D Trough/Peak % Increase – Constant	1333%	44%	103%	125%
Proc/R&D Trough/Peak % Increase – Current	1466%	77%	192%	185%
% Change Industry Revenues (Trough-Peak)	352%	107%	104%	~60%
Trough Industry Operating/Net Income Margins	5.1% / 3.2%	3.0% / 0.6%	7.0% / 5.0%	7.3% / 3.6%
Peak Industry Operating/Net Income Margins	6.2% / 2.3%	6.2% / 2.1%	4.7% / 3.1%	11%/~5%
Government/Industry Relations Environment		Negative	Negative	TBD
Interest Rates (Fed Funds/10-yr)	N/A	~ 6%	~ 13%	~ 5%
S&P 500 Multiple (p/e)	N/A	18.0x	9.2x	11x
Defense Platform Multiples (p/e)	N/A	13.3 - 20.5x	9.6 - 13.5x	8.5-20.3x
Defense Electronics Multiples (p/e)	N/A	18.3 - 40.4x	12.4 - 26.6x	14x-23.6x

Source: DoD, AIA, CSFB, Bernstein

Adaptive Strategies For a Peak

Future uses of cash and balance sheets

- Broaden and Diversify
- Push International
- Focus Internally, Generate Cash, “Ride the Wave”
- Focus and Expand in the Sector
- Any other clever ideas?

- Last cycle said, figure it out, roll out aggressively
 - Those who did, shares outperformed peers 2x
 - Being passive was poor strategy

MULTI-DISCIPLINARY

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