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MERRILL LYNCH DEFENSE OUTLOOK FORUM 2008

THE DEFENSE & AEROSPACE INDUSTRY – STRATEGIC CHALLENGES AND OPPORTUNITIES



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Four Key Strategic Challenges Facing the Defense/Aerospace Industry

- **How to redeploy capital?**
- **How to find areas of high growth? Are there any white spaces?**
- **How to find and develop the necessary human capital?**
- **What will be the future nature of the government-industry relationship?**

#1: HOW TO REDEPLOY EXCESS CAPITAL?

- **The major aerospace/defense firms have extremely low net debt levels**
 - About \$5 billion of net debt according to company reports and Wall Street analysis, or about 2% of enterprise value
- **The industry now generating \$20 billion of free cash flow**
- **Current use of the cash up until meltdown**
 - About 1/3 to acquisitions
 - About 1/4 to share repurchases
 - About 1/5 to dividends
 - Remainder to reinvestment in the business
- **Went from “what are you doing with the cash, to “whew!”, will soon return to “what are you doing with the cash”**

HOW TO REDEPLOY EXCESS CAPITAL?

Future uses of the cash and balance sheets

- Acquisitions
- Hand it back to shareholders
- Diversify
- Reinvest (IR&D)
- Any other clever ideas?

#2: FINDING AREAS OF HIGH GROWTH

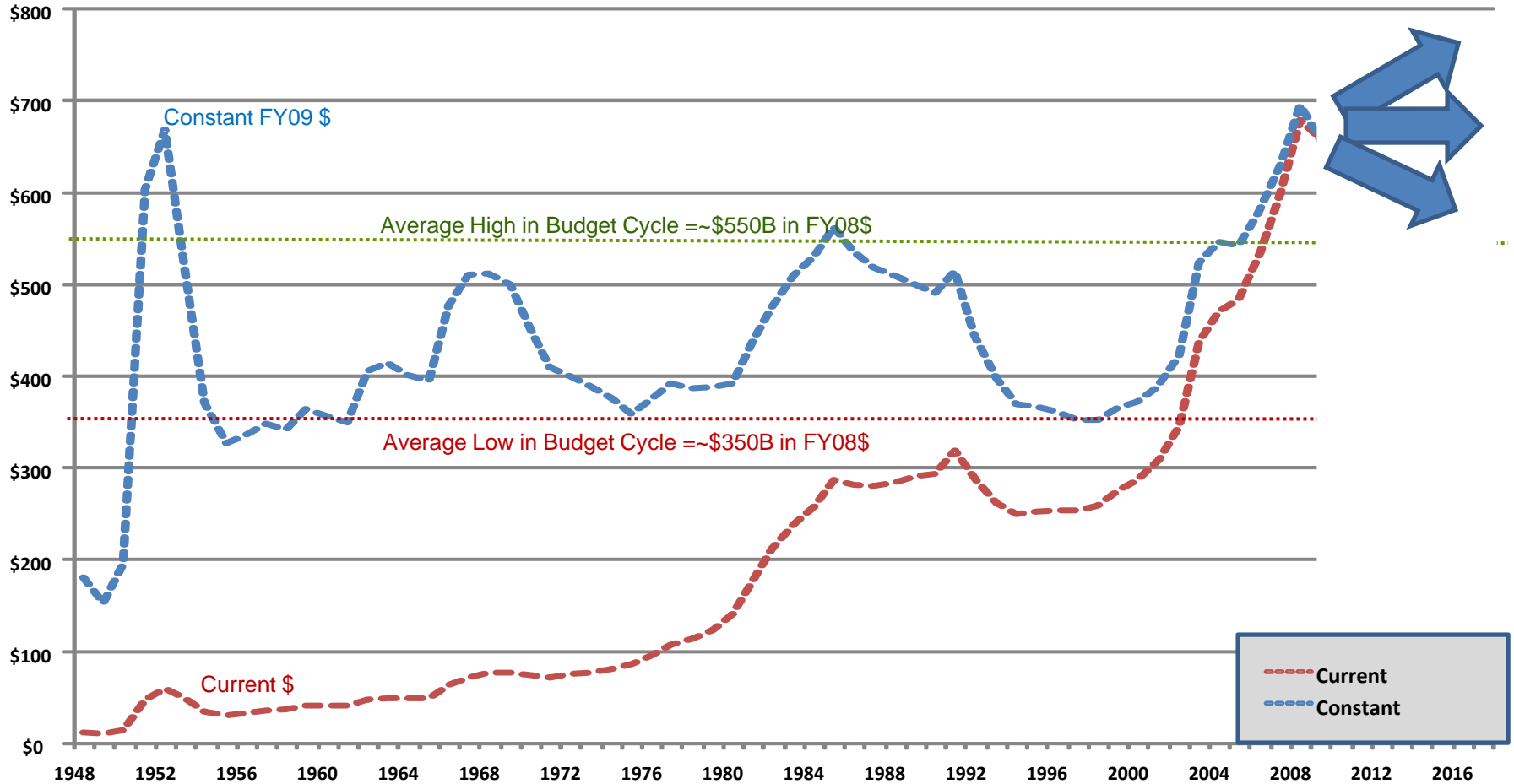
The debate under way – is there any “white space” in the defense market?

What will be the future areas of high growth?

What is the overall budget environment?

FINDING AREAS OF HIGH GROWTH

U.S. Defense Budget, 1948-present



Source: DoD, RSAdvisors Analysis

#3: FINDING AND DEVELOPING HUMAN CAPITAL

Bow wave of retirements coming

Shrinking pool of US graduate engineers

Lockheed Martin hired 5% of all available engineers

Security clearances taking longer

Increasing complexity of systems requires more systems engineers/architects – they take a decade to grow

The big battles will be as much over talent as programs

#4: GOVERNMENT/INDUSTRY RELATIONS

A pause to look at outsourcing

Rebuilding of the acquisition cadres

The end of the “LSI” as a term (fundamental need remains) – to be replaced by what?

Anti-incumbency sentiment (no safe positions) – opportunity and threat

Globalization remains problematic to government

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