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# SRI 8th Annual Defense & Aerospace Investor & Corporate Development Conference

## The Defense & Aerospace Industry – Strategic Challenges and Opportunities

Renaissance Strategic Advisors

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

# Overview

**Four Key Strategic Challenges Facing the Defense/Aerospace Industry**

- **How to redeploy excess 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 JPMorgan analysis, or about 2% of enterprise value

**The industry now generating $20 billion of free cash flow**

**Current use of the cash**

- About 1/3 to acquisitions
- About 1/4 to share repurchases
- About 1/5 to dividends
- Remainder to reinvestment in the business

# 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?

# HOW TO REDEPLOY EXCESS CAPITAL?

## The last cycle says that there are advantages to doing something and being first

Strategies Adopted by the Top 20 Defense Firms
1991-1994

| Strategy | Revenue Growth | Earnings Margin | P/E 1991 | P/E 1994 | EV/EBIT 1991 | EV/EBIT 1994 | Share Performance |
|---|---|---|---|---|---|---|---|
| M&A | 26% | 4.1% | 7.5x | 17.6x | 5.3x | 5.8x | 153% |
| Commercial Diversification | 1% | 4.2% | 9.4x | 14.2x | 4.5x | 5.8x | 55% |
| Ride the Wave | -8% | 1.4% | 13.9x | 16.4x | 5.1x | 5.6x | 88% |

Strategies Adopted by the Top 20 Defense Firms
1994-1999

| Strategy | Revenue Growth | Earnings Margin | P/E 1994 | P/E 1999 | EV/EBIT 1994 | EV/EBIT 1999 | Share Performance |
|---|---|---|---|---|---|---|---|
| M&A | 56% | 4.5% | 18.4x | 18.2x | 5.5x | 7.7x | 88% |

# #2: Finding Areas of High Growth

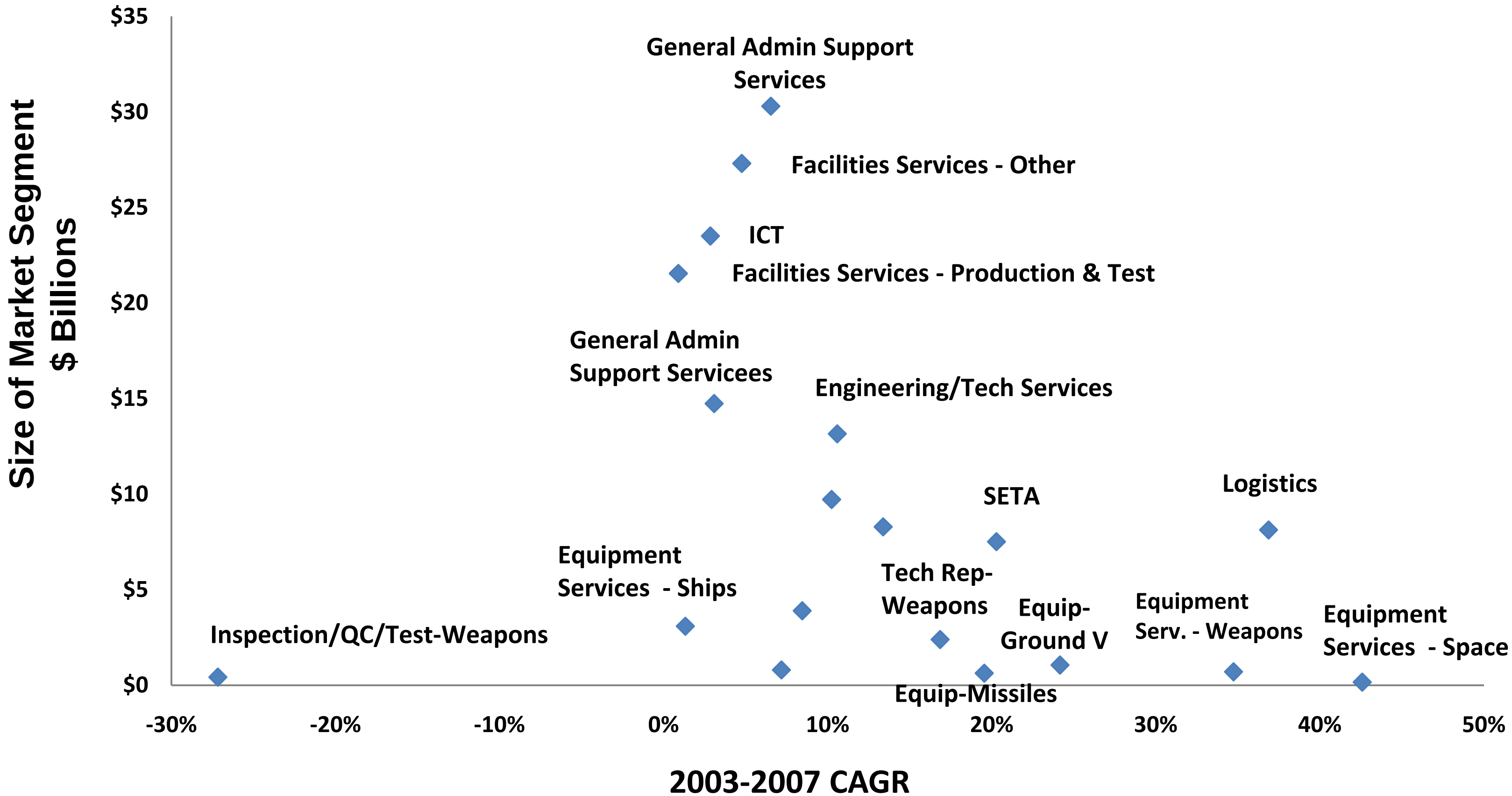
**The debate under way – is there any "white space" in the defense market?**

**What will be the future areas of high growth?**

**What will be the enduring markets vs the scenario-dependent markets vs "option" markets**

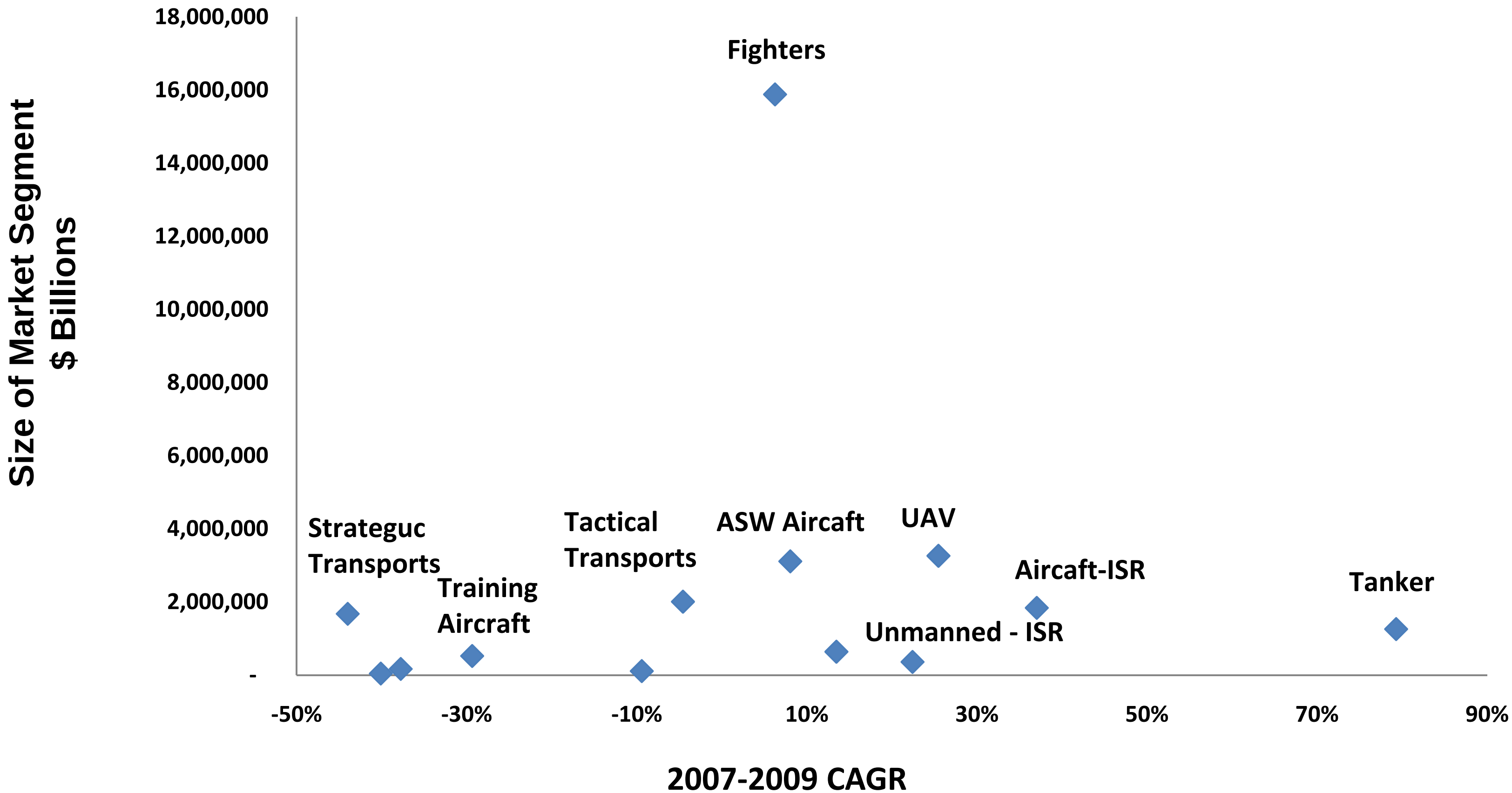
# Finding Areas of High Growth

## Example – the Services and Support market (2003-2007)



# Finding Areas of High Growth

## Example – the Aircraft Market (2007-2009)



# #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

The end of the LSI – to be replaced by what?

Anti-incumbency sentiment (no safe positions)

Continued attempts at capability-based/portfolio-oriented analysis and trades

Globalization remains problematic to government

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