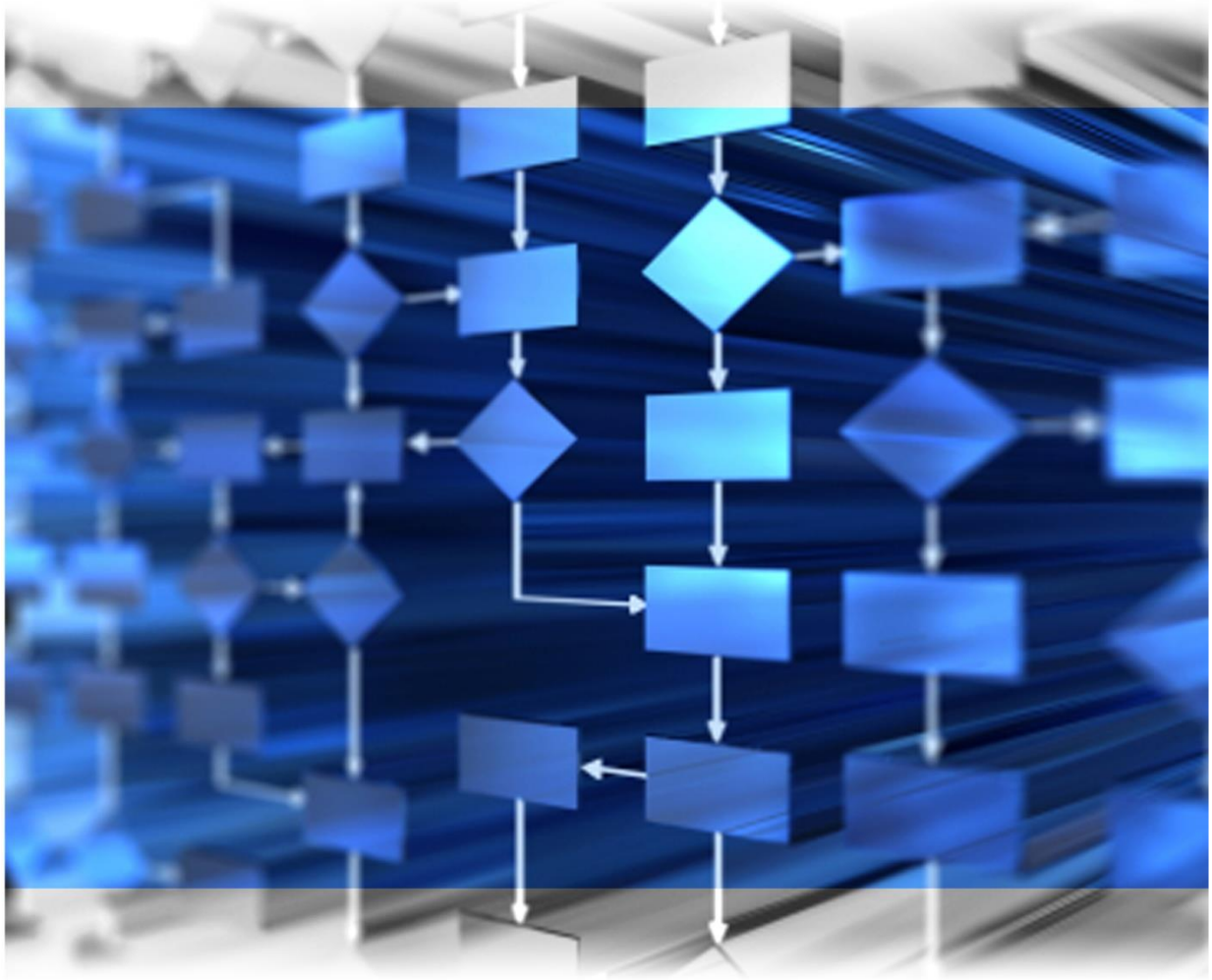
LONE STAR

THE RIGHT ANSWER



Defense and Aerospace Outlook For Mergers, Acquisitions, and Divestitures

March 2015

Defense and Aerospace Outlook For Mergers, Acquisitions, and Divestitures

What 2015 May Bring, How to Shape a Good Deal, and Avoid Bad Ones

2015 seems poised to be a year of significant activity for M&A. This follows 2014, with M&A activity driven by strong cash reserves and low cost of capital. Corporate debt in particular has been cheap.

Corporate leadership teams, with compensation designed to incent earnings growth have turned to M&A. Slow organic growth leads CEOs to equity transactions as a faster, cheaper, and lower risk way to boost earnings. This includes both acquiring desirable targets, and stock buyback programs.

2015 seems poised to be a year of significant activity for Mergers and Acquisitions. This follows 2014, with M&A activity driven by strong cash reserves and low cost of capital.

For some segments, M&A activity is likely to accelerate in 2015. Companies are still flush with cash. A U.S. tax reform deal could move still more money into the U.S. markets. Share prices continue to drift upward, providing enhanced currency for stock swap based deals.

What is a "Bad Deal?" What is a "Good Deal?"

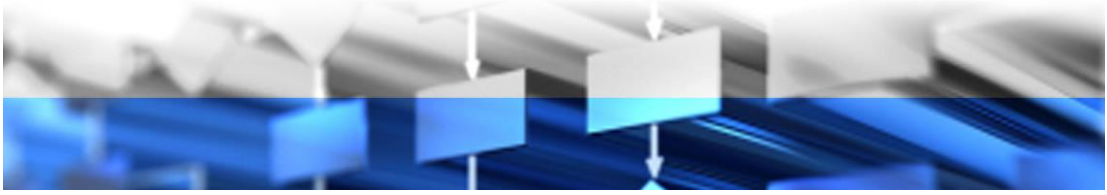
Most M&A experts focus on two kinds of "bad deals." These are overpaying and poor integration. We think there is an important third kind of "bad deal." But, first consider the two most experts agree on.

The first type is paying too much. When an acquirer overpays, a number of bad things can happen. In some cases this turns out to be bad for the seller, too. We know of transactions which drove the buyer into bankruptcy and left sellers holding bad debt or equity. Business failure is an extreme outcome; overpaying is usually not deadly.

The second type of "bad deal" is poor pre-integration planning and post-transaction integration. Even if the price was right, it was based on assumptions. These can seem very logical in spreadsheets before a deal is closed. They later prove to be challenging. Benefits from "synergy" often prove elusive.

Both challenges have been explored extensively by others and in prior Lone Star papers. Some excellent material is available. But a third type of "bad deal" is more common and less documented.

The third type of "bad deal" is an attempted transaction which never occurs. The effort to seriously pursue a transaction is an enormous distraction for corporate leadership. Two or three promising opportunities can take a transaction team an entire year, and can end without a closing.



When M&A teams work for months on transactions which don't close, pathologies emerge. Within the corporation, pressure builds to "get one done." This leads to other types of bad deals. Outside the corporation, markets reshaped by competitors become difficult to navigate. And markets, observing these problems punish a firm with smaller market share, lower stock prices and higher costs of capital.

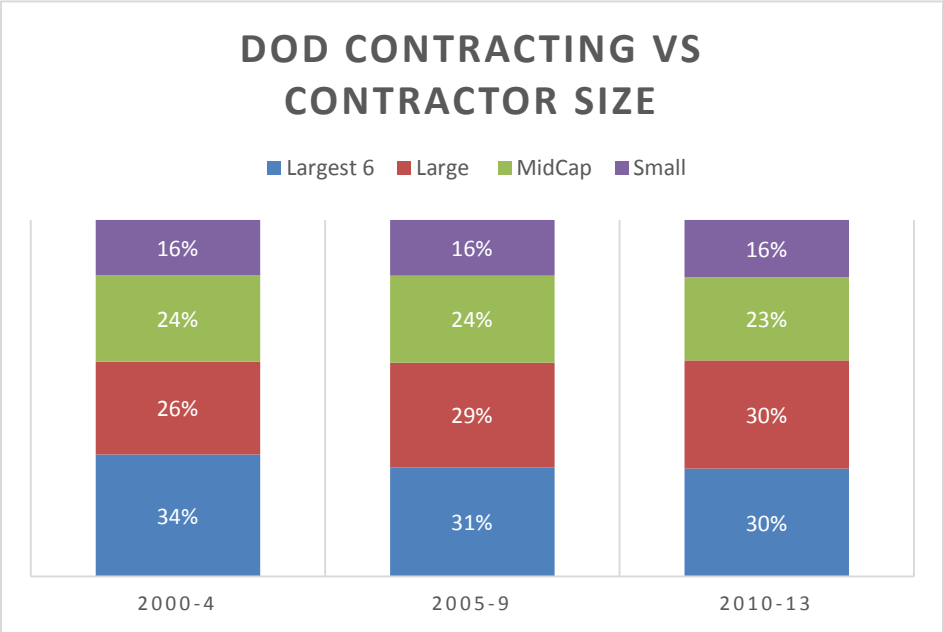
So, a "Good Deal" is a transaction which achieves its goals, at a rational price. Usually, these occur in the context of quickly passing on other deals with poorer prospects. *Clients call on Lone Star to help close "Good Deals" and quickly avoid all three types of bad ones.*

2015 activity seems likely to be heavy in several sectors: Technology, Health, Energy/Oil& Gas, and Defense/Aerospace. This paper deals with Defense and Aerospace.

2015 M&A Transaction Trends and Challenges for Defense and Aerospace

Within Aerospace and Defense, some unique market characteristics shape M&A prospects, in addition to the market trends which span industry segments.

Aerospace and Defense has had a significant emphasis on equity transactions, to an extent which exceeds some other market segments. There has been a record number of stock buybacks, whether measured by the number of major firms doing buybacks, or by the ratio of cash used for buybacks. In addition, several firms are acquisitive, targeting mid-cap and small companies for growth and strategic fit. Private equity firms are also in the market, notably doing rollups.



As seen in this figure the market share of a few large firms remains about 60% of DoD Contracting. With 60% of the market served by many small and midcap companies, a good deal of the transaction activity will happen in the small and midcap markets.

Entering 2015, three market trends seem likely to shape M&A prospects. First, is the widespread belief the U.S. Defense Market is the best place for global A&D participants, even if some niches decline for a while. Second, the prospects for low cost of capital, enabling acquisitions seems likely to continue. Third, the last decade saw very low rates of Independent Research and Development (IRAD) investing among large firms. Many R&D programs went to small firms due to low IRAD in large firms, and government policies favoring small firm. This leads larger firms to acquire small technology leaders, essentially putting their R&D investments on the balance sheet.

Based on these three factors, we expect U.S. based firms to acquire equity. They will continue to buy back their own stock, to acquire high growth Mid-Market Firms, and to acquire key capabilities in small firms, as they did in a flurry of cybersecurity motivated transactions in 2012-2014.

Generally there are four strategies A&D firms used in 2013 and 2014. Some were exclusively buyers. These include Lockheed Martin, BAE, Boeing, Raytheon, Thales, and Sierra Nevada. Some focused on repositioning as the defense market and space markets draw down. Sellers included Rockwell Collins, GD, and Orbital. Some firms, like Northrop Grumman have practiced M&A abstinence doing no U.S. deals in 2014. Among the major firms, only L3 took the fourth option, both buying and selling.

There are structural and strategic finance rationale which drive these behaviors, and only a few U.S. firms are likely to adopt different actions in 2015. Since few firms practiced M&A abstinence in 2014, we expect most will be active in 2015.

We also expect significant International Interest in U.S. A&D equities. This may challenge for U.S. firms who faced limited international M&A competition in 2014.

Japan has revised limits on exports and international activity for its defense firms. Japan's defense spending is increasing, unlike other G-8 democracies. So, Japanese firms seeking growth have both domestic and global ambitions. The U.S. is the first place to shop for these corporations.

Japanese buyers will be challenged by a number of unfamiliar features of North American Defense and Aerospace markets. On example is the extent to which U.S. firms fail to form stable relationships, repeated over many projects, compared to the stronger relationships between firms in Japan.

India expects several U.S. firms to continue to expand in India and the government is signaling it welcomes globalization. But it is also likely some Indian firms will seek reciprocation in the U.S.

Indian defense spending increased faster than any other democracy in 2014. Defense spending and growth in air transport drives these firms to seek competitive advantage, credibility, technology, and capacity from other markets.

Indian firms will face both currency and regulatory challenges. The U.S. Foreign Corrupt Practices Act is one example. Routine business practices seen as simple necessities in India are not legal here, and some corporate structures require worldwide compliance with U.S. law.

It seems likely that Indian and Japanese entrants will look for partnerships, fractional ownership and joint ventures. These strategies have served them well in consumer markets, semiconductors, and automotive markets. However, U.S. defense and aerospace firms have limited experience and success with these arrangements. Foreign firms should craft these deals carefully.

In Europe, there are firms with dollars to spend and "value shoppers." The "value shoppers" largely missed the last round of trans-Atlantic deal making when some others may have paid too much (type 1 bad deals). Niches of the U.S. market and targets with good strategic fit will appeal to some of these firms in 2015. EU firms with dollars to spend can overcome currency valuation challenges of the moment, and may also seek acquisitions. In particular, European firms seeking growth are attracted to the size of the U.S. market, and challenged by ongoing declines in spending by their home nations.

In addition to these national and regional issues, international market trends in A&D further drive 2015 prospects. Both civil and military aerospace have become more global. Rapid growth in air travel and air transport demand in Asia is an example; Asian markets are buying more aircraft, support, training and making more investment. In 2014, global defense spending increased by nearly 2%, while U.S. spending declined. Although America is the largest national market for defense goods and services, its place in the world market is declining. In the past five years U.S. defense spending has fallen from about half of the world's total to less than 40%. The market is increasingly global.

How Lone Star Helps Clients Avoid Bad Deals and Close Good Ones

Timing and value are the characteristics of M&A success. Value creation, pricing, and the ability to make decisions faster than other players in the market; these create success. We offer a range of M&A solutions and services all aimed at creating value and agility. These M&A offerings are part of larger solution sets in Strategic Transformation, and in Competitive Differentiation. Often, our highest value offering is a tech-enabled solution; auction modeling of M&A (AM/M&A).

M&A auction modeling provides a simulation of an equity transaction from the perspective of all the participants (potential buyers and sellers). The considerations of each participant (or "player") is represented in the model. These include different valuation measures, different sources of synergy and strategic advantage, different costs of capital, market and capacity factors, and other issues.

AM/M&A quickly leads our clients to focus on the few most critical factors of a transaction, and to understand how these compare with other players in the auction. In many cases some other player is much more likely to prevail in the auction. When this is the case, we want to avoid expending energy in a transaction which won't happen (Type 3 bad deal).

When a transaction is appropriate, our clients understand the critical success factors, long before closing and are able to build these considerations into the transaction. They also avoid conflicting synergy assumptions (need to both cut and retain key staff, for instance).

Lone Star's AM/M&A is supported by a number of our tools and processes. In particular, Lone Star has developed AM/M&A model architectures supporting the rapid creation of a deal-specific model. Our methods include the best of breed techniques in Game Theory, Prospect Theory, Modern Portfolio Analysis, and 5th Generation Decision Analysis. Our M&A offerings include more general tools for Opportunity/Capability Analysis, Portfolio Analysis and others.

In addition to tools and tech-enabled processes, Lone Star provides critical services including Competitive Intelligence, Market Research, Market Analysis, and Financial/Forensic Finance assessments. Lone Star also maintains a large roster of several hundred Subject Matter Experts (SMEs). These relationships allow us to quickly create a firewalled team, with talent chosen for the specific engagement, who have credibility with client decision makers.

This combination of tools, processes and talent allow our clients to move faster than their competition, to choose better M&A targets, to conduct deals designed to succeed, and, to have confidence about the key success factors for management focus after the closing.

About Lone Star

Lone Star Analysis is a trusted provider of enhanced decision analysis, business modeling and simulation, and executive advisory support. Lone Star is committed to delivering improved operational and financial performance, as well as reduced cost and risk. We do this through accurate and actionable solutions to clients' most critical strategic and tactical challenges. Headquartered in Dallas, Texas, Lone Star provides support to clients in the Military & Intelligence, Aerospace & Defense, Oil & Gas, and Communications & Technology.

Lone Star ● 4555 Excel Parkway ● Suite 500 ● Addison, TX 75001

Tel: 972-690-9494 Fax: 972-690-9495 www.lone-star.com