

Mission control *2010 annual and fourth-quarter* *review*

Merger and acquisition activity in the global aerospace and defense industry

*Special report:
Repositioning for growth:
The implications of
expanding into an
emerging global market*



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Introduction

Welcome to *Mission control*, our review of merger and acquisition (M&A) activity in the global aerospace and defense (A&D) sector. The *Mission control* series provides a quarterly window on A&D deal activity and this annual edition combines fourth-quarter data with a review of the whole of 2010. Deal activity has recovered strongly in 2010, as companies responded to a challenging procurement environment in the defense sector and an improving competitive environment in commercial aerospace. We are seeing a continuation of the high volume of deal activity coupled with a significant increase in average deal value.

We examine both the rationale behind the overall trends and key individual deals. We look at the year under review, the context of the preceding year, and look ahead to the future direction of deal-making in the sector. We also highlight, in a special report, the factors companies need to take into account as they expand into an emerging global market. In the “Spotlight” and “Specialty case study” sections, we look at how PwC can help companies address the tax challenges of operations in different jurisdictions and assist entry into emerging markets, drawing on our experience as an adviser to the global A&D industry.

We wrap up our report with a look ahead, in which we share our expectations for M&A activity for 2011. We see several factors underpinning the environment in the coming 12 months. Defense companies will continue to reposition their portfolios to better grapple with the headwinds created by substantial budget pressures. These companies will look to expand products and services in their core markets as well as invest in emerging technologies and adjacent markets, particularly in the wider security domain. Meanwhile, they will shed

underperforming business. While consolidation among the top ten global defense contractors is unlikely, for competitive and security reasons, it is possible we could see some consolidation of large companies beyond that group.

Commercial aerospace has recovered from the Great Recession faster and stronger than nearly anyone predicted. That sector is looking to capitalize on a growing market and a changing landscape, as the customer base shifts toward the Asia Pacific region and the industry responds to new competitors, particularly Comac (Commercial Aircraft Corporation of China) in China. There are many diversified industrial companies with attractive aerospace and defense segments. We may see some pressure from investors, as well as appetite from the market, to break those aerospace assets away from their diversified parent companies. Company break-ups have been a growing trend recently, including the A&D sector, with the announced break-up of ITT.

Greater defense cooperation in Europe and continued interest in the US defense market, owing to its relative size, should contribute to the potential for cross-border deals. Conditions are in place for financial investors to become more active in the market, and China’s and India’s efforts to build domestic aerospace industries will provide impetus for additional deals. These influences are likely to be augmented by the dry powder of substantial cash positions within the sector and better capital market conditions, leading to our upbeat outlook for aerospace and defense M&A in 2011.



Neil Hampson
*Global Aerospace &
Defense Leader*



Scott Thompson
*US Aerospace &
Defense Leader*

Special report: Repositioning for growth

The implications of expanding into an emerging global market

Globalization is accelerating within the aerospace and defense industry. With an established international customer base, A&D is positioned to overcome inherent globalization challenges and reap benefits in commercial markets in Asia Pacific and defense markets in the Middle East and Asia. Additionally, A&D supply chain markets are opening up in India, Brazil, Mexico, and Turkey, as well as China for commercial aerospace.

As military alliances evolve and create opportunities for North American and European companies outside their home markets, defense exports from North America and Western Europe have increased dramatically to Saudi Arabia, the United Arab Emirates, Turkey, Pakistan, Singapore, the Baltic States, Qatar, Malaysia, and Japan.

In Saudi Arabia, military and defense spending as a percentage of GDP is the highest in the world. It is set to maintain this position and Saudi Arabia is currently negotiating with the United States for the purchase of \$60 billion worth of advanced fighter jets and military helicopters, following similar earlier deals with other nations. Delivery of the weapons would take place over a 15- to 20- year period. The initial phase includes 85 new F-15s and upgrades to 70 additional F-15s, 70 Apache helicopters, 72 Black Hawk helicopters, and 36 Little Bird helicopters. Boeing and United Technologies/Sikorsky are the primary suppliers.

China's military build-up and investment in the J-20 'fifth generation' stealth fighter is also boosting sales of US military aircraft. Reports of the aircraft's capabilities have sparked global interest in the US-led next-generation F-35¹ joint strike fighter. Japan, South Korea, and Singapore are said to be engaged in discussions with the US government about the F-35, a project that targets international markets and includes several members of the North Atlantic Treaty Organization and Australia as partners.

China is also contributing to significant commercial aircraft demand. During his January 2011 US trip, Chinese president Hu Jintao confirmed orders for 200 Boeing 737s and 777s with an estimated value of \$19 billion. Just as industrial products companies have turned their attention toward Vietnam, Indonesia, South Africa, Turkey, and Argentina for new opportunities, A&D companies are looking at China, India, Mexico, Poland, and the Ukraine as the next wave of global markets.

South Africa and Turkey are also of growing interest to A&D companies. Research shows new policies and initiatives are driving changes in the South African aerospace industry. South Africa had previously developed and manufactured

Globalization — Many manufacturing industries are clearly global in nature, including aerospace

Measures

- Degree of import/export relative to total industry trade
- Degree of offshore production either directly or via supply chain
- Degree of globalization of technology/R&D content

Ranking

1. Computers
2. Basic chemicals
3. Pharmaceuticals
4. Electronic equipment
5. Instruments
6. Electrical machinery
7. Automotive
8. **Aerospace**
9. Petrochemicals
10. Oil/gas exploration and refining
11. Textiles/apparel
12. Basic metals
13. Minerals/mining
14. Other transport equipment
15. Food

Source: PwC

complete aircraft. However, changes in government spending and in global supply chain dynamics led to a greater emphasis in specialized lower-tier suppliers for international leaders. Although the change in strategy resulted in competition with other emerging economies, cooperation between regions may be possible to limit competition among them as global suppliers. Recent initiatives within the country promote the development of skills and integration of the sector into domestic and international value chains. The rapid growth in domestic commercial airlines, and in tourism, helps to increase potential market opportunities for the aerospace industry. However, socioeconomic factors such as a high unemployment rate, social problems, and the migration of technical skills present hurdles for companies hoping to capitalize on those opportunities.

In addition to high GDP growth, second wave emerging markets such as Turkey and South Africa have favorable foreign investment policies. For instance, Turkey has implemented tax breaks for capital investments, subsidies for new businesses, and low-cost financing to attract new foreign business. Turkey also offers free trade zones, where normal trade barriers such as tariffs and quotas are eliminated and bureaucratic requirements are lowered to attract international investors. At the geographic crossroads for Europe, the Middle East, and Asia, Turkey has a large F-16 fleet and a significant defense budget. The country's strategic location gives it a competitive advantage in airline maintenance, repair, and operations, as well as cargo and air taxi services in the region.

Most emerging-country governments also view foreign investment as an important source of capital for their economies. In contrast, China and Russia give advantages

¹ Wall Street Journal, Chinese plane spurs interest in US fighter, Jan. 18, 2011

to local businesses over outsiders. Both countries have enacted policies that restrict foreign companies from investing in “strategic” sectors and both provide preferential loans to domestic players. It should also be noted that an increasing number of contracts include specific “transfer of technology” clauses to make sure the emerging country benefits from the latest technological developments that can then be used to improve capabilities within their own industries.

Factors to consider for successful globalization

A range of factors must be weighed in assessing the growth potential of an emerging market. While India and China tend to offer developed infrastructure in selected locations along with a relatively sophisticated market structure, this is not the case for many other emerging markets. Without a developed infrastructure, rapid growth is difficult. Additionally, every country offers a mix of opportunities and risks. Economic and political stability, varying business regulations, possible inflation, and competition among countries are also factors to consider when assessing whether an investment in an emerging market country will bring disappointment or long-term success. Defense budget pressures are also growing in Europe where exporting is no longer a choice, but a requirement for sustained growth within the A&D industry.

Additional areas where A&D companies should exercise caution include the expansion of offset requirements, increases in financial risk due to a more international supply chain, different interpretations of business ethics across cultures, the cost and complexity of export control compliance and the potential loss of intellectual property (IP).

Safeguarding intellectual property

To minimize exposure to intellectual property theft, A&D companies can consider moving some functions to locations with acceptable risk levels. Research and development functions, for example, may not be appropriate in countries where IP laws or enforcement are weak.

Benefiting from export controls

Because supply exports are where most growth opportunities exist for emerging markets, and also for US and Western European companies, it is important for A&D companies to be aware of the risks as well as the opportunities. Many A&D executives believe the ability to demonstrate compliance with export control regulations can be a competitive advantage. To avoid a breach of export control regulations, organizations must monitor and control communication and business activity within geographically and culturally diverse environments. Employees and partners must be able to work together worldwide and share information without breaking regulations.

Creating ethical cultures

As is the case with other business risks, the potential damage from ethical risks is much greater if they are neglected until a crisis strikes. The best strategy for mitigating ethical risks is to establish a risk and compliance process that includes risk identification, assessment, mitigation (including prevention) and, critically, ongoing reporting and monitoring that tracks emerging and evolving risks.

Managing financial risk

Because globalization increases the number of political, legal, and economic environments in which A&D companies operate, there is financial risk. Companies that develop local partners and operations in markets outside the US face currency exposure over long project durations. Liquid financial mechanisms are available for hedging currency risk for short periods, generally up to three years. Contractual mechanisms become more important as timelines can extend up to ten years and beyond. Adding a currency adjustment clause to a contract, for example, is one common strategy. Over ten or more years, large-scale strategic decisions are particularly vulnerable to currency risk.

Evaluating offsets

Offsets are a cost of winning business and are likely to remain so for the foreseeable future. They do create value for customers but may be inefficient investments that expose contractors to significant risks. More transparency would help customers create greater value for money and help contractors reduce their legal and reputational risks. When designed and managed transparently and effectively, offsets can demonstrate a company’s commitment to good corporate citizenship and deliver real benefits to the communities in which it operates.

A&D’s race for globalization

Most industries are globalizing at increasing speed and A&D is no exception. For most A&D companies, the customer base, sources of production, and research and development are already international. Operations and the supply chain, however, remain less global than in other industries. Part of the reason is that globalization introduces new risks and greater complexity into the supply chain. Many strategies for coping with these challenges are already in use within the industry. A&D companies that adjust their leadership tactics and their approaches to risk management can create competitive advantage.

Perspective:

Overview of deal activity

Deal values rise significantly

Deal value in the A&D sector bounced back strongly in 2010 after the trough of the previous year. Total disclosed deal value nearly doubled year-on-year, from \$10.9 billion in 2009 to \$20.2 billion in 2010. While low compared to the \$42.1 billion transacted at the peak of M&A activity in 2007, the 2010 level saw M&A in the sector back to the levels of 2008 and years prior to 2007. Deal volume has remained high and is running at levels slightly higher than the peak year of 2008. Average deal value, of deals worth \$50 million or more with disclosed values, was up 17%, from \$310 million to \$364 million. However, valuations relative to EBITDA or sales have not moved above historical norms and, indeed, declined slightly at the end of 2010. Valuation gaps between buyers and sellers continue to linger.

Large deal sizes edge upwards

There was a return of larger deals in 2010, with the largest deal sizes tracking a definite upward trend. There were four deals of \$1 billion or more in 2010. Taken together, the value of all deals in the 2010 A&D top ten was \$10.5 billion, up almost 60% from the 2009 top ten total of \$6.7 billion. The quarterly progression of A&D deal announcements continues to improve from their lows of late-2008/early-2009. The 17 announced deals over \$50 million during the fourth quarter of 2010 represented the highest quarterly total during the past three years. Acquirers are being bolder and more likely to pursue majority stakes or outright buy-outs. The proportion of deals worth \$50 million or more that were for minority stakes shrank from 16% in 2009 to 4% in 2010 and zero in the last quarter of 2010.

Deal momentum comes from a number of fronts

With competition and security concerns giving limited opportunity for further consolidation among the largest companies, the deal spotlight remains on lower tier consolidation and moves by private equity investors. The largest 2010 deal saw consolidation in the UK military outsourcing market with Babcock International's \$2 billion takeover of VT Group. A series of private equity sales and purchases accounted for half of the total value of the top ten A&D deals of 2010. Technology targets in the cybersecurity, civil security, surveillance and intelligence sectors also provided a key focus for much deal activity. Such targets accounted for the two largest inbound deals for US companies – French company Safran's purchase of L-1 Identity Solutions and Canadian CGI Group's move for Stanley – which is significant given the importance of the US market from a demand perspective. Divestitures and spin offs appear to be a major theme for 2011, with the announced spin off of ITT's defense business and Northrop Grumman's plan to exit shipbuilding. In addition, consolidation in the European mid-tier aerospace market, which has many smaller players, is likely.

Further deal growth likely in 2011

Some strong themes will continue to assert themselves in 2011: divestiture of non-core assets, consolidation between mid-tier companies in the security and aircraft production sectors, realignment around new priorities such as cybersecurity, and strengthening of new technology capabilities. This realignment in the industry could potentially drive some mega transactions in 2011. We also expect the changing dynamics in defense to create more options for financial investors. We believe that conditions are ripe for an increase in cross-border deals in 2011, as companies pursue growth in fast-growing and adjacent markets and, possibly, in Europe with defense cooperation between countries (e.g., the recent UK-France defense agreement signed in November 2010) becoming a stronger theme.

Commentary on 2010

Deal totals

2010 saw a continuation of a high number of deals combined with a strong bounce-back in deal value after the 2009 low. Total disclosed deal value in the sector rose from \$10.9 billion in 2009 to \$20.2 billion in 2010. Deal volume rose slightly year-on-year and, indeed, was slightly higher than the level of activity recorded in the most recent peak deal year of 2008. Total deal value nearly doubled, returning to just short of half the level reached in 2007 and broadly on a par with the totals reached in 2008 and years prior to 2007 (see chart).

There was a pick-up in the number of mega deals (with values of \$1 billion or above). Four such deals were announced in 2010 compared with two in 2009. It is likely that 2009 represented a trough for aerospace and defense M&A activity, with 2010 marking the beginning of a new cycle. This meets our previous expectation for recovery in sector M&A during 2010, driven by significant cash positions and capital markets that are more conducive to financing new deals.

The quarterly progression of A&D deal announcements continues to improve from late-2008/early-2009 lows. The 17 announcements during the fourth quarter of 2010 was the highest quarterly total during the past three years. However, the recovery in deal value has been more uneven. Deal value announced during the fourth quarter was the lowest quarterly total of the year, yet easily surpassed quarterly total deal values during 2009. This difference in the trajectories of recovery (deal volume improving in excess of deal value) has limited the recovery in average deal values.

While macro factors strongly support additional overall M&A, it is likely that most activity will occur in the middle-market segment. Over the near term, it appears that anti-trust uncertainties will favor defense portfolio realignments over mega-mergers. These types of realignments allow A&D acquirers to take advantage of pockets of growth within the sector. For example, Boeing and Lockheed Martin executives have in recent months indicated interest in cybersecurity acquisitions. In addition, the growth in demand for unmanned vehicles may drive additional M&A for related targets.

Annual aerospace and defense deal activity

Measured by number and value of all deals (2001-2010)

	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010
Number of deals	232	179	209	231	240	229	296	302	296	308
Total announced deal value (\$ billions)	13.8	14.2	14.7	24.6	15.9	22.4	42.1	21.6	10.9	20.2

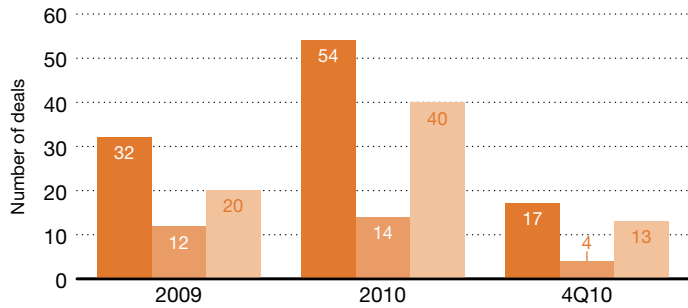
Quarterly A&D deal activity

Measured by number and value of deals worth \$50 million or more (1Q08-4Q10)

	2008				2009				2010			
	1Q	2Q	3Q	4Q	1Q	2Q	3Q	4Q	1Q	2Q	3Q	4Q
Number of deals	12	13	9	5	4	9	9	10	10	13	14	17
Total deal value (\$ billions)	3.3	9.8	5.1	2.6	0.9	2.5	3.4	3.1	5.7	5.2	4.6	4.2
Average deal value (\$ billions)	0.3	0.8	0.6	0.5	0.2	0.3	0.4	0.3	0.6	0.4	0.3	0.2

Deal activity by number of deals

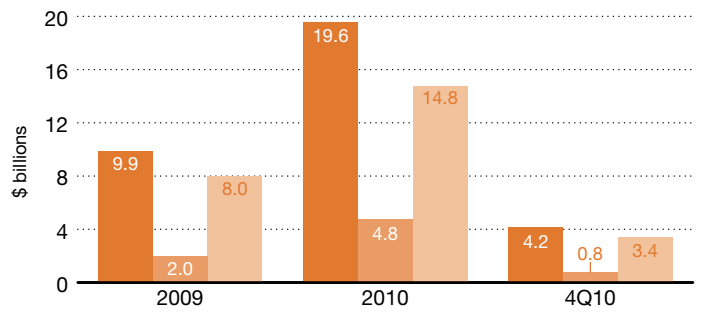
Measured by number of deals worth \$50 million or more



- Number of deals
- Number of deals excluding deals with US targets and/or acquirers
- Number of deals with US targets and/or acquirers

Deal activity by total deal value

Measured by value of deals worth \$50 million or more

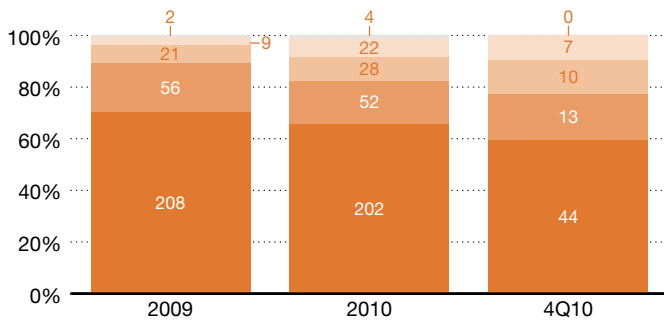


- Total deal value
- Total deal value excluding deals with US targets and/or acquirers
- Total deal value for deals with US targets and/or acquirers

Note: Columns may not sum to total due to rounding

Deal activity by number and range of deal value

Measured by number of deals



- Mega deals (at least \$1 billion)
- Large deals (at least \$250 million up to \$1 billion)
- Middle-market deals (\$50 million up to \$250 million)
- Small deals (less than \$50 million)
- Deals with undisclosed value

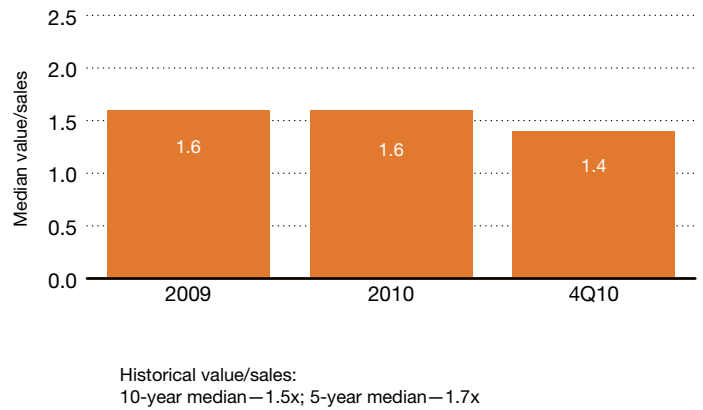
Valuation trends

Average deal value of deals with disclosed values of \$50 million or more, rose strongly from \$310 million in 2009 to \$364 million in 2010. Despite the increase in deal size, valuations have not moved above historical norms, as indicated by an analysis of the announced A&D deals with publically disclosed information over the last ten years. In fact, valuations declined slightly during the fourth quarter. This was the case for both value-to-sales (see chart) and deal value-to-EBITDA.

It is somewhat surprising that valuations remain restrained even though minority stake purchases have dwindled. Normally, purchases of controlling interests are associated with valuation premiums. This is likely to be the result of a lingering valuation gap between buyers and sellers. Anecdotal evidence of this gap was evident in recent months. For example, reports in early January 2011 indicate that BAE Systems has decided not to sell its US commercial aerospace business after buyers did not meet the company's value expectations.

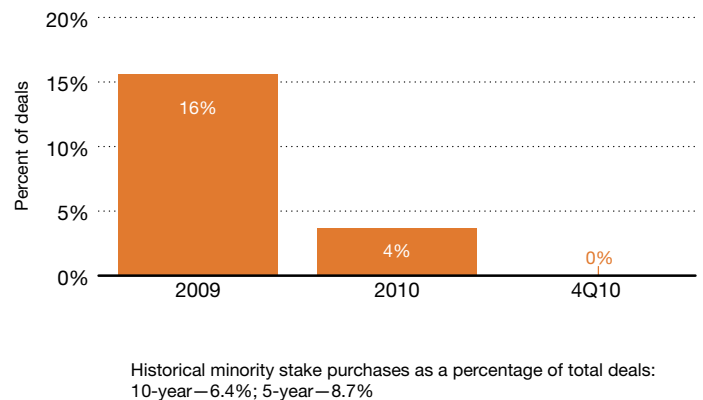
Deal valuation by median value/sales

Measured by value/sales for deals worth \$50 million or more



Minority stake purchases

Measured by percent of deals worth \$50 million or more for less than 50% ownership



Deal makers

The 2010 top ten deals table reflects an upward trend in the size of the largest deals. The two biggest 2010 deals, Babcock International's \$2 billion takeover of VT Group and Triumph's \$1.57 billion acquisition of Vought Aircraft Industries, compared to the \$1.65 billion and \$1 billion values of 2009's largest deals, General Atlantic's \$1.65 billion move for TASC and Boeing's \$1 billion takeover of a Vought production facility. Taken together, the value of all the deals in the 2010 top ten was \$10.5 billion, up 70% from the 2009 top ten total of \$6.2 billion.

The largest 2010 deal took place in the UK with the move by Babcock International for rival VT Group. The purchase comes at a time of UK defense budget pressure and strengthens Babcock's ability to secure a share of increased outsourcing work from the government. The combined company has operations across defense, engineering, and nuclear energy.

Conditions favor a continuation of, and perhaps an increase in, private equity participation in the sector. These investors were active in four of the top ten deals in 2010 with two private equity acquisitions of defense services companies, DynCorp International and Enterprise Integration Group, and two private equity sales of commercial aerospace suppliers, Vought Aircraft Industries and McKechnie Aerospace. Capital market conditions have improved significantly since the end of the leverage bubble, which should help private equity companies to pursue larger targets in the sector in 2011.

On the private equity sell list, the \$1.57 billion acquisition by Triumph Group of Vought from the Carlyle Group creates a leading tier-one supplier with strong positions in commercial and military markets. TransDigm's \$1.27 billion move for rival McKechnie from private equity firm JLL Partners marries the former's actuators and controls, ignition systems, audio systems, and cockpit security devices with the latter's production of sensing rods,

fasteners, and latching systems. The other two private equity deals in the top ten both involved New York-based Veritas Capital. In the spring of 2010, it sold DynCorp International, a provider of programs in logistics, platform support and training for operations in remote and high risk areas, to Cerebrus Capital Management. Later in the year, Veritas bought Enterprise Integration Group (EIG), which provides military platform system engineering services and advice, from Lockheed Martin.

The divestiture of EIG by Lockheed Martin was part of the company's review of non-core assets, which is expected to result in other sales. It also came in response to new US Department of Defense (DoD) conflict of interest rules. The revised Pentagon rules, released at the end of 2010, are designed to remove potential organizational conflicts of interest caused when contractors advise the government on weapons system programs for which they bid for the implementation and/or production work. This change has forced contractors to reevaluate their systems development and program consulting services to avoid potential bid protests from competitors. The Lockheed Martin sale, and Northrop Grumman's earlier 2009 \$1.6 billion TASC divestiture, typify deals motivated by the new rules. We believe that the revised conflict of interest rule may not continue to act as a driver of deal activity since it is narrower in scope than previously expected and contractors have already had time to anticipate it and take action.

Elsewhere in the top ten, security and surveillance technology companies attracted bidder interest as defense companies continue to diversify into cybersecurity, civil security, surveillance, and intelligence. In a \$1.1 billion deal, French group Safran bought US iris and facial identification specialist L-1 Identity Solutions. The deal includes a break-up of the target with UK defense group BAE acquiring three L-1 subdivisions. Canada's CGI Group was another company that boosted its presence in the US biometrics and security market with a \$0.94 billion move for Stanley. The deal provided a fit between CGI's strengths on the civilian side and Stanley's defense, cybersecurity,

and intelligence expertise. Similar moves to acquire cybersecurity and reconnaissance technologies included the purchases of rival companies Argon ST and Applied Signal by Boeing and Raytheon, respectively. A broader example of diversification came with Harris Corporation's acquisition of CapRock Communications. The deal gave Harris an entry into the energy market as it seeks to extend its secure communications footprint across a wider range of sectors.

The overall outlook for mega deals is trending favorably. As contractors react to budget pressures in many developed countries, they are likely to continue to look to M&A for opportunities to divest lower growth, non-core capabilities while considering acquisitions of higher growth capabilities. For example, Northrop Grumman will likely spin off its shipbuilding unit during the first quarter of 2011.

In addition, companies with unmanned vehicles and intelligence, surveillance, and reconnaissance (ISR) technologies will continue to be potential acquisition targets.

Ongoing budget pressures may increase the attractiveness of horizontal consolidation between large prime contractors, as a longer-term option to create shareholder value, but substantial uncertainty remains as to whether these deals would pass anti-trust muster. This uncertainty should be mitigated once the defense industrial policies in major defense markets such as the US and the UK are updated. These updates will ultimately drive the characteristics of future mega deals in the sector for the next several years.

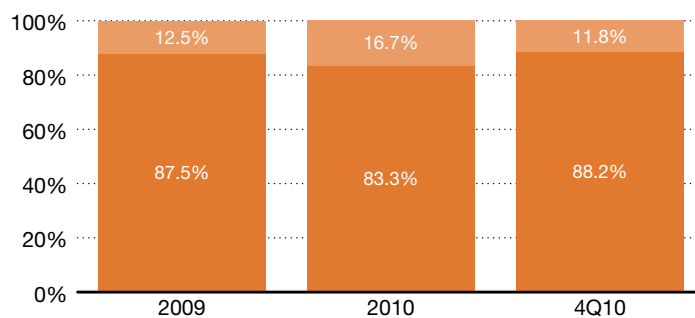
Top ten A&D deals 2010

Rank	Target	Target description	Acquirer	Target nation	Acquirer nation	Value of transaction in \$ billions
1	VT Group PLC	Ship building and repairing	Babcock International Group PLC	United Kingdom	United Kingdom	2.00
2	Vought Aircraft Industries Inc	Aircraft parts, equipment	Triumph Group Inc	United States	United States	1.57
3	McKechnie Aerospace	Aircraft parts, equipment	TransDigm Group Inc	United States	United States	1.27
4	L-1 Identity Solutions Inc	Computer integrated systems design	Safran SA	United States	France	1.13
5	DynCorp International LLC	Business services, not elsewhere classified	Cerberus Capital Management LP	United States	United States	0.99
6	Stanley Inc	Computer integrated system design	CGI Group Inc	United States	Canada	0.94
7	Enterprise Integration Group Inc (Lockheed Martin)	Business consulting services, not elsewhere classified	Veritas Capital Partners LP	United States	United States	0.82
8	Argon ST Inc	Measuring & controlling devices	Boeing Co	United States	United States	0.75
9	CapRock Communications Corp	Radiotelephone communications	Harris Corp	United States	United States	0.53
10	Applied Signal Technology Inc	Radio & TV broadcasting & communications equipment	Raytheon Co	United States	United States	0.51

Note: In addition to the top ten deals above, the GK Bank razvitiya i vnesheekonomicheskoy deyatel'nosti (Vnesheconombank) acquisition of a minority stake in aerospace company Ob'yedinennaya aviastroitel'naya korporatsiya OAO (United Aircraft Corporation OJSC) for \$719 million was not included in the table as it was a minority stake purchase of 11.49%, however it is included in all other deal analysis. Also, the \$734 million Allegheny Technologies acquisition of Ladish, announced during November 2010, may be considered an A&D deal due to the end-markets of the target, however this deal was not included in the table or deal analysis due to industry classification as defined in the methodology section of this report.

Deal activity by investor group

Measured by number of deals worth \$50 million or more



Financial investor
Strategic investor

Average financial investor percentage of total deals: 10-year—16.9%; 5-year—17.3%

A high profile return for private equity

Financial investor involvement in the A&D sector, as measured by deal numbers, declined in the fourth quarter but increased for the year overall (see chart). Private equity companies and groups were behind many of the largest deals. Indeed, private equity deals accounted for around half of the total value of the top ten deals in the sector. Private equity exits led to two of the three largest deals during 2010. Our expectations were that the private equity sales would eventually be followed by more purchases within the sector and this was the case with the majority of acquisitions announced in the second half of the year. In total, there were five completed private equity acquisitions with disclosed values over \$50 million during the year.

Conditions that support financial investment are improving, including reductions in risk premiums. Because of this, financial investor participation is likely to at least approach longer-term historical levels in 2011. Alongside the services divested by strategic players (owing to the DoD conflict of interest rules mentioned earlier), private equity buyers were also involved in deals with a variety of commercial aerospace and defense targets. Defense companies will continue to reposition themselves to cope with what is likely to be a moribund defense spending environment. In addition, the expected relatively high growth in commercial demand is likely to make aerospace suppliers attractive investment opportunities. These factors suggest that private equity acquirers are likely to be significantly engaged in the deal market in 2011, albeit with different motivations regarding the commercial aerospace versus defense segments of the sector.

Top five private equity A&D deals 2010

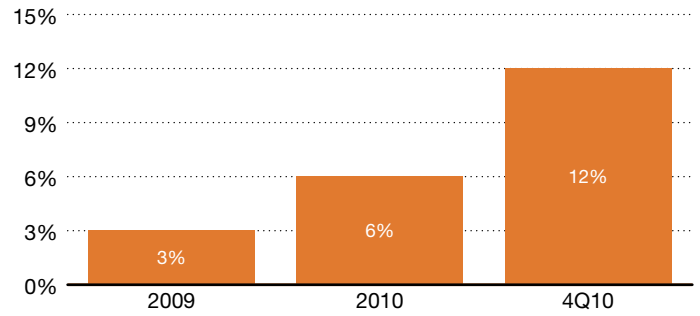
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2	McKechnie Aerospace	Aircraft parts, equipment	TransDigm Group Inc	United States	United States	1.27
3	DynCorp International LLC	Business services, not elsewhere classified	Cerberus Capital Management LP	United States	United States	0.99
4	Enterprise Integration Group Inc (Lockheed Martin)	Business consulting services, not elsewhere classified	Veritas Capital Partners LP	United States	United States	0.82
5	Survitec Group Ltd	Fabricated rubber prod, not elsewhere classified	Warburg Pincus LLC	United Kingdom	United States	0.45

A promising deal finance climate

The financing environment has grown more conducive to A&D M&A activity. The increase in leveraged buyouts (see chart) is a clear signal that improved credit conditions are favorably affecting sector deal activity. In addition, strategic investors have plenty of liquidity with which to initiate new deals. Our research on the top 50 global A&D companies indicates that they have held an average cash position of approximately \$1 billion over the course of the last year.

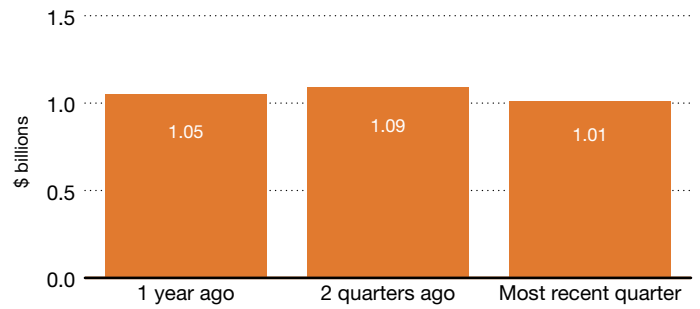
Aerospace and defense leveraged buyouts

Measured by number of deals worth \$50 million or more



A&D sector liquidity

Measured by average of top 50 global public competitors



Source: Company Reports

Deal places

North American firms have become more active as both acquirers and targets, with deals involving UK and Eurozone companies showing a slight decline as a share of all deals. This pattern reflects changes in the US defense industry — companies have updated their portfolios in response to overseas contingency operations and have begun to restructure in anticipation of expected constraints on defense spending.

While the relative level of cross-border acquisitions increased slightly in the fourth quarter, the level of cross-border acquisitions for US targets actually declined. This trend is both somewhat surprising and unlikely to continue in 2011. The US faces substantial defense budget pressure. Yet the market still accounts for roughly half of global defense spending — a factor that will continue to attract foreign players to US targets. Recent public comments by executives at leading non-US defense companies, including EADS, support this view, and the US government's Committee on Foreign Investment in the United States has been willing to approve many of these cross-border deals in recent years. In addition, European commercial aerospace companies are likely to continue to be drawn to US targets based upon the benefit of matching US dollar production costs with global sales that are denominated in the same currency.

In addition to potential transatlantic deals, growing defense cooperation between countries in Western Europe could lead to more intra-Europe deals to address collective priorities. Historically the desire to support national defense industries has been a barrier to deals, but sustained reductions in defense spending could increase the rationale for consolidation within the region.

While there has not been much activity in Asia in terms of deals with disclosed values of at least \$50 million, there is a considerable amount of commercial aerospace deal activity for undisclosed values happening in this region. China's continuing push to enter both the regional and the large commercial aircraft segments remains a major driver of activity in the region. China's efforts have led to many joint ventures with foreign suppliers that help it secure access to desired technologies. While there are no publicly disclosed values for these deals, it remains a safe assumption that China's desire to build its domestic aerospace industry will continue to be a big part of the M&A story in Asia.

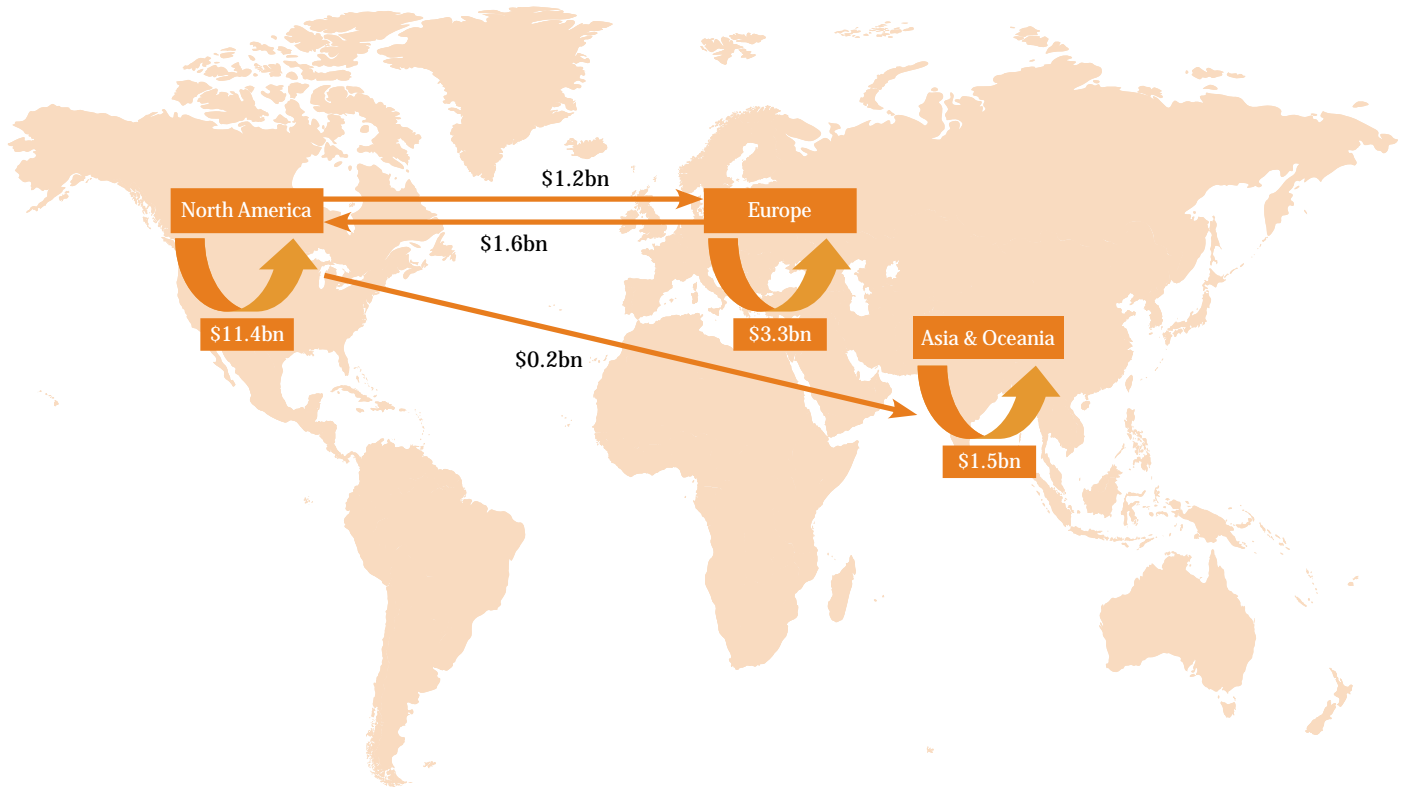
International deal flow

Cross-border deals as a share of all A&D M&A maintained a similar level in 2010 to the previous year. Intercontinental deal flows revived after a near-complete lull in 2009. In that year, there had been just \$0.3 billion of inbound deals in Europe and \$0.7 billion in North America. These increased to \$1.2 billion and \$1.6 billion respectively in 2010. But this is still way down on the 2007 peak year of M&A activity when a combined total of \$12.6 billion of deal flow moved between Europe and North America, split more or less equally between European and North American buyers.

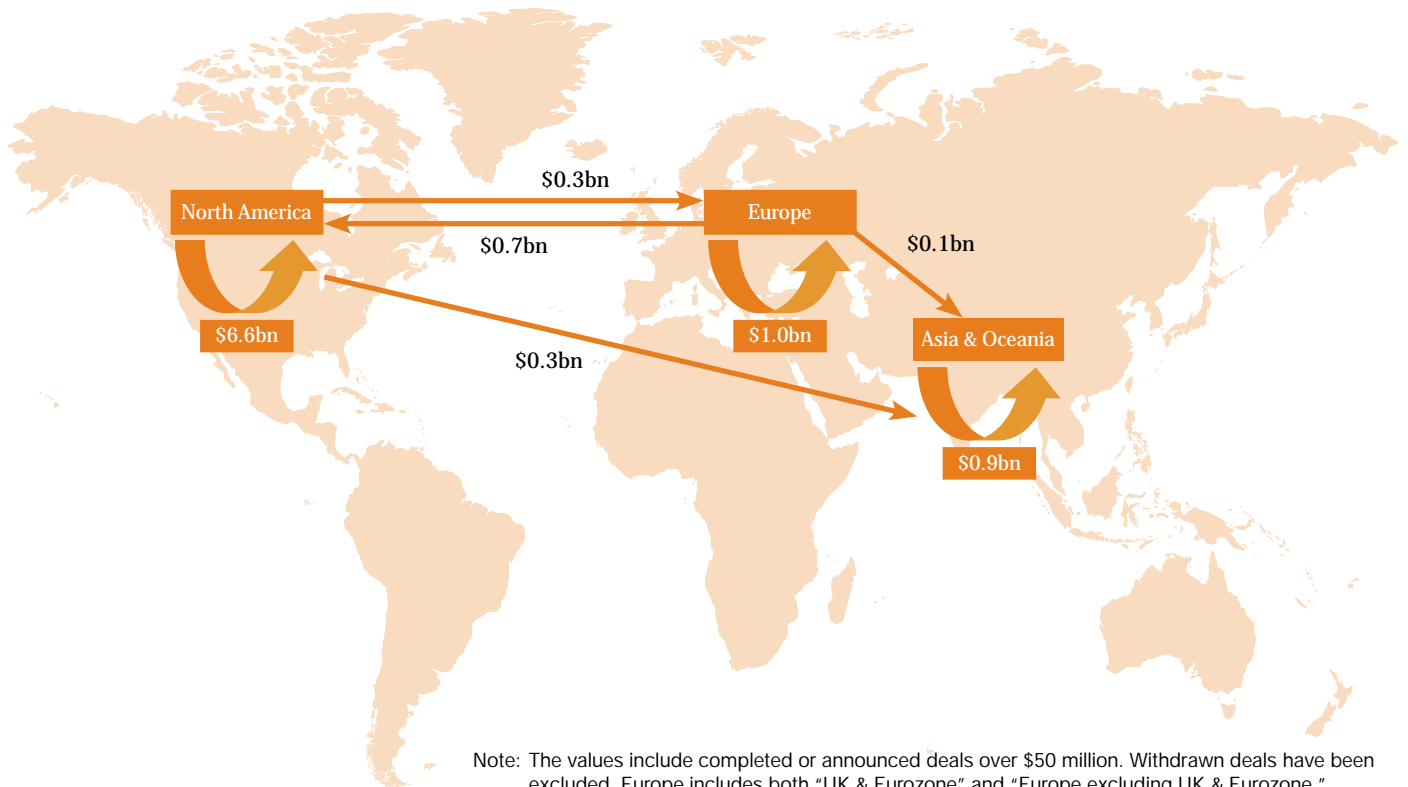
The largest inbound deal in Europe saw US private equity group Warburg Pincus acquire Survitec Group for \$0.45 billion. Survitec is a UK company with worldwide positions in marine, defense, and aerospace survival technology. In another US-UK move, Harris Corporation bought the satellite communications unit of oil field services company Schlumberger in a \$0.2 billion deal that gives the US company further diversification into energy markets, complementing its purchase of CapRock (see deal makers). The only transatlantic move by an aerospace company into Europe came with BE Aerospace of the US acquiring original equipment manufacturer activities from Satair, a Danish wholesaler of aircraft spare parts, for \$0.162 billion.

The \$1.7 billion of inbound deal value in North America was largely accounted for by Safran's \$1.1 billion purchase of L-1 Identity Solutions (see deal makers). Much of the remainder came from BAE Systems' acquisition of ship builder and repairer Atlantic Marine Holding for \$0.35 billion. The deal strengthens BAE Systems' already substantial non-nuclear ship repair presence in the US defense market.

Acquisition money flows
2010

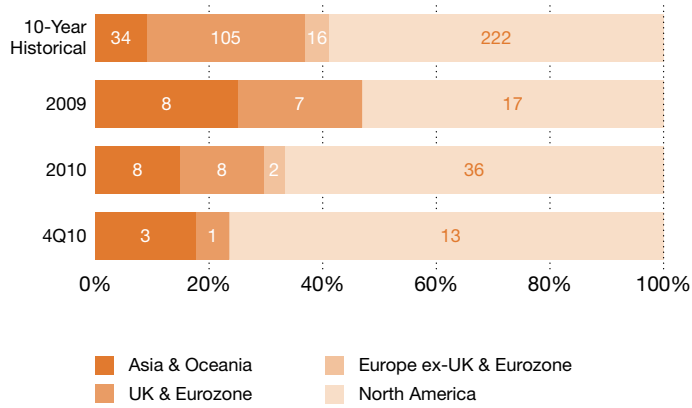


Acquisition money flows
2009

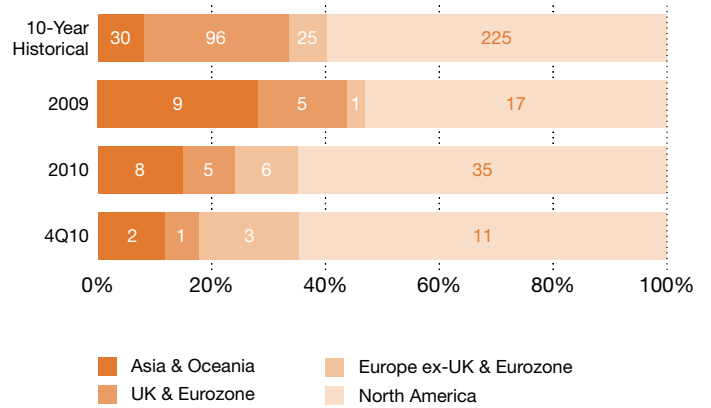


Note: The values include completed or announced deals over \$50 million. Withdrawn deals have been excluded. Europe includes both "UK & Eurozone" and "Europe excluding UK & Eurozone."

Regional distribution of all deals by acquirer region
Measured by number of deals worth \$50 million or more

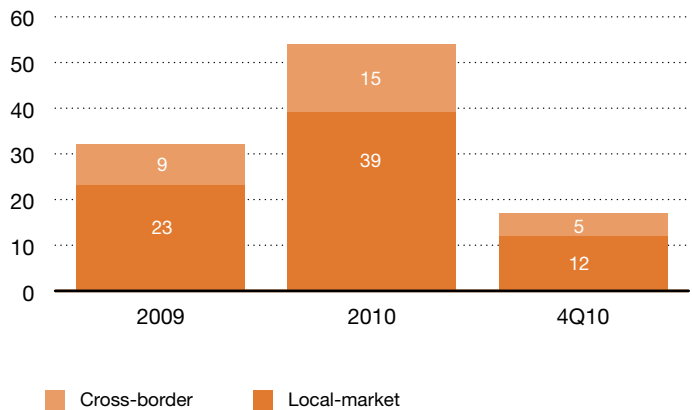


Regional distribution of all deals by target region
Measured by number of deals worth \$50 million or more

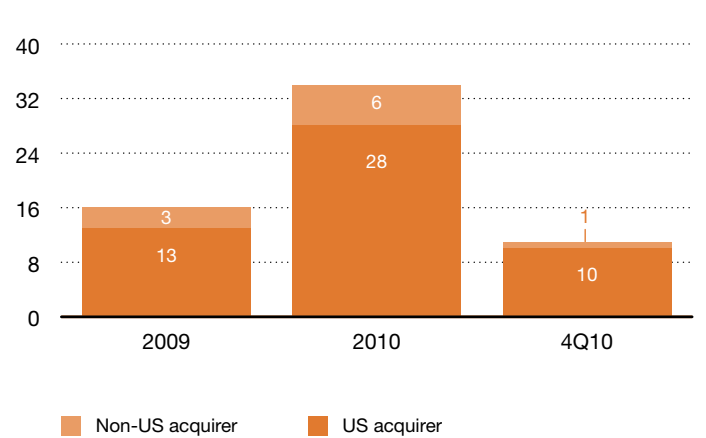


Note: Chart does not include one historical deal for a target in the Africa/Undisclosed region

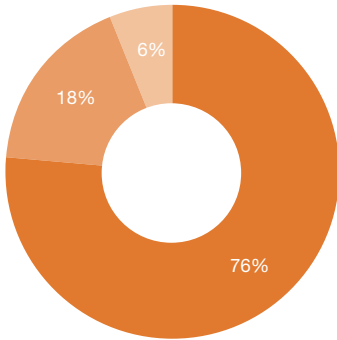
Local-market versus cross-border deals, all nations
Measured by number of deals



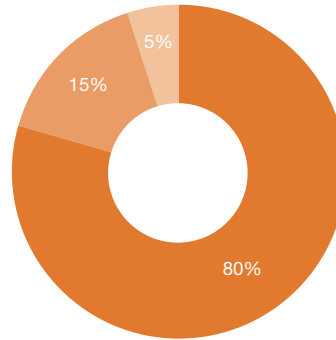
US versus non-US acquirers of US targets
Measured by number of deals worth \$50 million or more



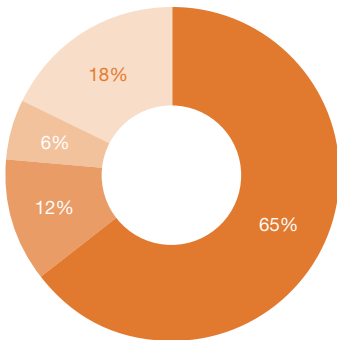
Regional distribution of deals by acquirer region
 Measured by number of deals worth \$50 million or more (4Q10)



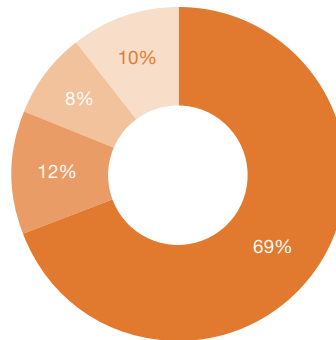
Regional distribution of deals by acquirer region
 Measured by value of deals worth \$50 million or more (4Q10)



Regional distribution of deals by target region
 Measured by number of deals worth \$50 million or more (4Q10)



Regional distribution of deals by target region
 Measured by value of deals worth \$50 million or more (4Q10)



North America
 Asia & Oceania
 UK & Eurozone
 Europe ex-UK & Eurozone
 South America
 Africa/Undisclosed

Looking ahead at 2011

As we enter 2011, uncertainty still clouds the defense industry. Many developed countries are grappling with fiscal constraints resulting from the cyclical downturn while, also, facing increasing pressure from rising health care and other social expenditures. It is clear that these public spending challenges carry negative implications for defense spending although any raising of threat levels to nations can quickly change this outlook.

Industry constituents are in the midst of a realignment that focuses on new priorities, such as cybersecurity and unmanned vehicles, and includes the divestiture of businesses with lower expected growth. There is potential for valuation to remain an impediment to certain divestitures. For those units that can't be auctioned, cost reduction and restructuring will remain a focus.

This realignment in the industry could potentially drive some very large transactions in 2011, and we may look back at Northrop Grumman's plan to exit the shipbuilding business as just the first deal leading many more over the horizon. However, even as defense industrial policies are being adjusted to reflect the new spending environment, significant horizontal consolidation among prime contractors appears unlikely. This is due to concern over the impact of major consolidation on long-term competition. In effect, there is limited consolidation headroom in developed markets, leaving companies with divestment of non-core assets, diversification, or acquisitions in new territories as the major M&A choices. Ultimately, these strategies will determine how successful the industry will be in repositioning itself for the rest of the decade.

Budgetary concerns are contributing to more defense cooperation agreements in Europe, which could ultimately drive consolidation of the industry within the region. In addition, while overall defense spending trends are not positive, the absolute level of US defense spending will keep foreign entities looking for deals that allow them to enter or expand in the market. While we expect that the desire to maintain national defense industry capabilities will remain a consideration, the desire alone is unlikely to trump

overarching fiscal concerns. In addition, European commercial aerospace companies can benefit from buying US suppliers as this supports a natural hedge of US dollar production costs with dollar-denominated sales. We believe that conditions are ripe for an increase in cross-border deals in 2011.

We expect the changing dynamics in defense will create more options for financial investors in 2011. With credit markets on a much more solid footing than a year ago, private equity firms are already showing an increased interest in A&D bids. Private equity firms are likely to look for new turnaround opportunities in the very businesses that the larger, strategic companies want to exit. In addition, firms with technology expertise are likely to compete with strategic investors for targets in this part of the sector.

On the commercial aerospace side of the sector, China's foray into the regional and large aircraft segments is a mega-trend that will continue to reverberate for some time. Chinese entities have set up agreements with many Western companies to access the necessary technologies for these ventures. These Western entities face the risk of helping to build their partners into future global competitors. Nonetheless, they are expected to continue to seek these deals based on the growth opportunity offered by the rapid expansion of aircraft fleets in this part of the world.

We believe that the overall level of aerospace and defense M&A will continue to grow for a number of reasons. Weak organic defense trends will require companies to look to the deal market to find new ways to grow, including in ancillary businesses. Also, shifting competitive dynamics in commercial aerospace are creating new opportunities for business combinations. In addition, cash positions in the sector are substantial and capital market conditions have improved significantly from the post-leverage bubble aftermath. The deal market in the A&D sector may not be firing on all cylinders yet, but key factors are in place to support its continuing recovery.

PwC spotlight

With constant legislative, regulatory, and judicial changes, companies operating across borders are challenged to follow and comprehend ever-changing developments. Similarly, globalization, economic realities, operational adjustments, and corporate mandates require tax departments to follow and comprehend internal initiatives.

The combination of these equally important streams requires tax departments to be agile, well-versed in internal and external developments, and able to deal with competing goals and interests. Understanding the tax impact on business operations and transactions in multiple jurisdictions is vital for a company's success.

How PwC can help

PwC's International Tax Services (ITS) group has experience helping companies address their cross-border needs. We help multinational businesses achieve their business goals in a tax-efficient manner, both locally and globally. Our professionals help companies:

- Stay abreast of developments within the international arena that may affect their business
- Formulate effective and tax-efficient cross-border strategies for both US and overseas investments
- Manage their global structural tax rate
- Respond to inquiries from regulatory authorities

We've also collaborated with the World Bank and the International Finance Corporation's (IFC) Doing Business study to produce our *Paying Taxes* report.

The purpose of the *Paying Taxes* study is to provide quantitative data to stimulate and inform discussion on tax policy and tax administration — and to inspire tax reform. The *Paying Taxes* results enable governments and investors to compare tax systems with others on a like-for-like basis and to identify best practices. The report is free and can be accessed at the following Web address: www.pwc.com/gx/en/paying-taxes

Specialty case study

Client:
Global aerospace
company

Client
issue

A global aerospace company wanted to develop a manufacturing footprint in Turkey to meet a growing demand from its customers. The company had already identified several potential suppliers and sites for a new manufacturing plant but wanted additional information on existing companies within the Turkish aerospace manufacturing industry, which could be integrated into the company's supply chain. The company also needed objective information on Turkish manufacturing costs along with insights into Turkey's culture and business environment.

PwC
approach

PwC Turkey conducted research on more than 300 companies selected by the client in order to identify companies that met specific criteria that included having annual revenues of more than 20 million Turkish lira, or \$12.5 million. In addition to the research, PwC interviewed several companies and then organized the results into a format that could be easily used and understood by the client. The PwC Turkey engagement team also gathered payroll costs, operating expenses, and freight and customs expenses. Finally, research was done to determine projected inflation and foreign exchange rates over the next 20 years.

The
impact

PwC's research helped identify several strong candidates that met the client's criteria in addition to nearly 50 Turkish companies with the potential to serve as client suppliers. Additionally, the firm identified Turkish companies that are not currently a manufacturer for the aerospace industry, but have the capabilities to shift their production to meet the industry's requirements. As a result of the research, the client is able to make informed decisions regarding potential suppliers for its proposed operations in Turkey.

The work will now enter a second phase that involves assisting in the operational reviews of companies of interest to the client and continued help in understanding Turkey and Turkish culture.

PwC's aerospace and defense experience

Deep aerospace and defense experience

PwC's A&D practice is a global network of 1,200 partners and client service professionals who provide industry-focused assurance, tax, and advisory services to leading A&D companies around the world. This A&D experience is enhanced by our Public Services practice, which includes an additional 600 partners and 9,000 professionals focused on assisting federal, state, and local governments, international agencies, and healthcare entities. We help A&D companies address a full spectrum of industry-specific challenges across areas such as assurance, tax, operational improvement, supply chain management, program management effectiveness, IT effectiveness and security, compliance, export control, and government contracting.

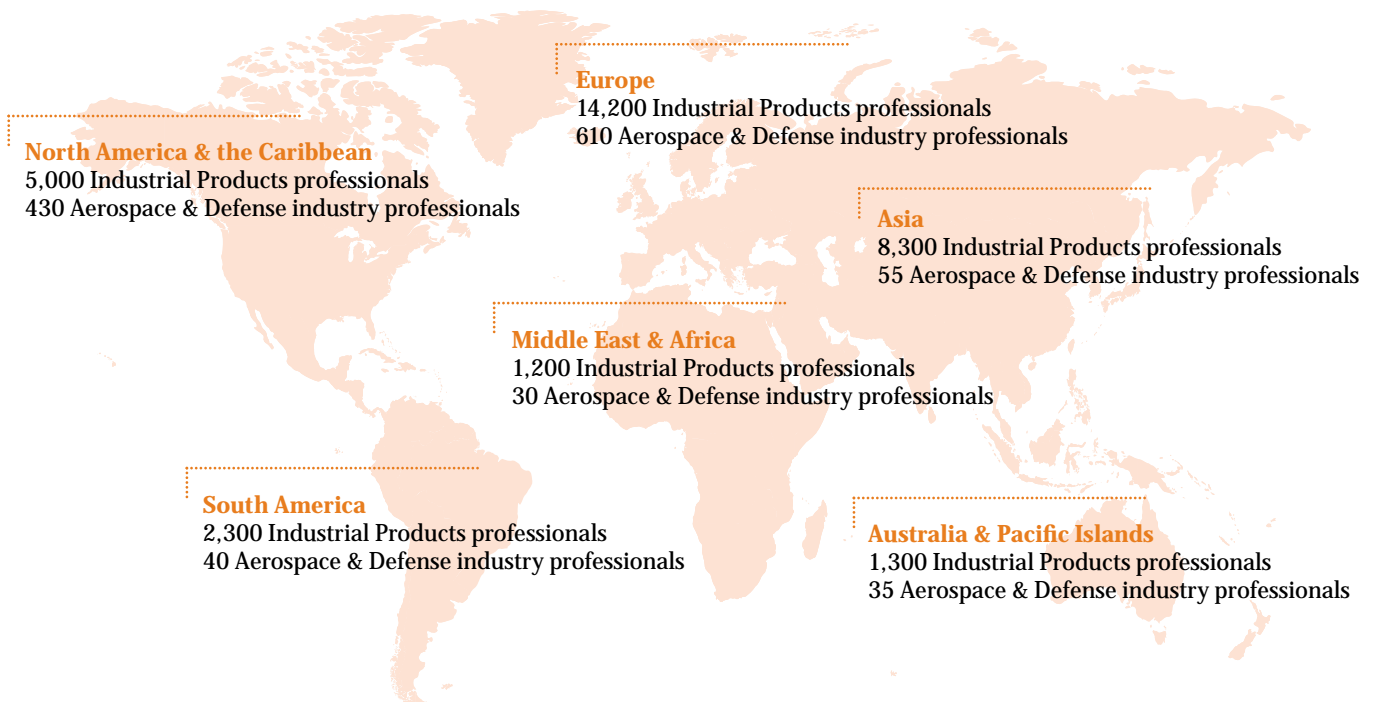
PwC's A&D client service professionals are committed—both individually and as a team—to the relentless pursuit of excellence, building insights, and advancing leadership on a wide range of the most critical challenges and issues confronting A&D organizations. PwC is a sponsor of leading industry conferences and frequently writes articles for, or is quoted in, leading industry publications. We are proud of our relationships with Aviation Week and Flight International as well our participation in industry conferences and associations, such as the Aerospace Industries Association (AIA), AeroSpace, Defense, Security Group (A|D|S), and American Conference Institute (ACI). Our involvement in these organizations reflects our commitment to addressing industry needs and the furthering of dialogue with A&D industry leaders.

Quality deal professionals

PwC's Transaction Services practice, with approximately 6,500 dedicated deal professionals worldwide, has the right industry and functional experience to advise you on all factors that could affect a transaction, including market, financial accounting, tax, human resources, operating, information technology, and supply chain considerations. Teamed with our A&D practice, our deal professionals can bring a unique perspective to your transaction, addressing it from a technical as well as industry point of view.

Local coverage, global connection

In addition to the 1,200 professionals who serve the A&D industry, our team is part of an extensive Industrial Products group that consists of more than 32,000 professionals, including approximately 17,000 providing assurance services, 8,300 providing tax services, and 7,000 providing advisory services. This expands our global footprint and enables us to concentrate efforts in bringing clients a greater depth of talent, resources, and know-how in the most effective and timely way.



Contacts

PwC's global Aerospace and Defense practice

PwC's A&D practice provides industry-focused assurance, tax, and advisory services. Through our global network, we can draw upon the in-depth industry experience of professionals in every country where your company operates. Our people can help you deal with the challenges of today, and they understand the implications for tomorrow.

PwC Global

Global Aerospace and Defense Leader
Neil Hampson — + 44.20.7804.9405
neil.r.hampson@uk.pwc.com

Global Aerospace and Defense Marketing Director
Katrine Ellingsen — + 1.514.205.5066
katrine.ellingsen@ca.pwc.com

Brazil Aerospace and Defense Leader
Augusto Assuncao — + 55.19.3794.5408
augusto.assuncao@br.pwc.com

Canada Aerospace and Defense Leader
Mario Longpre — + 1.514.205.5065
mario.longpre@ca.pwc.com

China Aerospace and Defense Leader
Malcolm MacDonald — + 86.11.6533.2266
malcolm.macdonald@cn.pwc.com

France Aerospace and Defense Leader
Guillaume Rochard — + 33.1.56.57.8208
guillaume.rochard@fr.pwc.com

Germany Aerospace and Defense Leader
Jurgen Seibertz — + 49.211.981.2845
jurgen.seibertz@de.pwc.com

India Aerospace and Defense Leader
Dhiraj Mathur — + 91.11.4115.0309
dhiraj.mathur@in.pwc.com

Italy Aerospace and Defense Leader
Corrado Testori — + 39.06.5702.52442
corrado.testori@it.pwc.com

Middle East Aerospace and Defense Leader
Matthew Alabaster — + 44.20.7804.9642
matt.alabaster@ae.pwc.com

Turkey Aerospace and Defense Leader
Orhan Cem — + 90.212.376.5310
orhan.cem@tr.pwc.com

PwC US

US Aerospace and Defense Leader
Scott Thompson — + 1.703.918.1976
scott.thompson@us.pwc.com

US Aerospace and Defense Transaction Services Leader
Bob Long — + 1.703.918.3025
bob.long@us.pwc.com

US Aerospace and Defense Transaction Services Director
Dale McDowell — + 1.703.918.4475
dale.a.mcdowell@us.pwc.com

US Aerospace and Defense Advisory Leader
Charles Marx — + 1.602.364.8161
charles.a.marx@us.pwc.com

US Aerospace and Defense Tax Leader
James Grow — + 1.703.918.3458
james.b.grow@us.pwc.com

US Industrial Products Marketing Director
Neelam Sharma — + 1.973.236.4963
neelam.sharma@us.pwc.com

US Aerospace and Defense Marketing Manager
Gina Reynolds — + 1.973.236.4648
gina.reynolds@us.pwc.com

US Industrial Products Sector Analyst
Tom Haas — + 1.973.236.4302
thomas.a.haas@us.pwc.com

US Aerospace and Defense Research Analyst
Michael Portnoy — + 1.813.348.7805
michael.j.portnoy@us.pwc.com

Methodology

Mission control is an analysis of mergers and acquisitions in the global aerospace and defense industry. Information was sourced from Thomson Reuters and includes deals for which targets or acquirers have primary SIC codes that fall into one of the following SIC industry groups: 1) ordnance and accessories, except vehicles and guided missiles; 2) aircraft and parts; 3) national security; 4) guided missiles, space vehicles, and parts; 5) search, detection, navigation, guidance, aeronautical and nautical systems, and instruments and equipment (SDNGN&NS, I&E); and 6) space research and technology.

This analysis includes all individual mergers and acquisitions for disclosed or undisclosed values, leveraged buyouts, privatizations, minority stake purchases, and acquisitions of remaining interest announced between January 1, 2001, and December 31, 2010, with a deal status of completed, intended, partially completed, pending, pending regulatory approval, unconditional (i.e., initial conditions set forth by the acquirer have been met but deal has not been completed), or withdrawn. The term *deals*, when referenced herein, is used interchangeably with transactions and announcements. Unless otherwise noted, the term *deals* refers to all deals with a disclosed value of at least \$50 million. Data for previous years may be slightly different from that reported in earlier publications due to data updates.

Regional categories used in this report approximate United Nations (UN) Regional Groups as determined by the UN Statistics Division, with the exception of the North America region (includes North America and Latin and Caribbean UN groups), the Asia and Oceania region (includes Asia and Oceania UN groups), and Europe (divided into United Kingdom plus Eurozone and Europe ex-UK and Eurozone regions). The Eurozone includes Austria, Belgium, Cyprus, Finland, France, Germany, Greece, Ireland, Italy, Luxembourg, Malta, Netherlands, Portugal, Slovenia, and Spain. Oceania includes Australia, New Zealand, Melanesia, Micronesia, and Polynesia. Overseas territories were included in the region of the parent country. China, when referenced separately, includes Hong Kong.

Acknowledgements

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