

Mission control

Fourth-quarter 2014 aerospace and defense industry mergers and acquisitions analysis

Highlights

Deal market characteristics

Large deals in 2014



To our aerospace and defense readers



Chuck Marx
US Aerospace &
Defense Leader

A handwritten signature of Chuck Marx in black ink.



**Guillaume
Rochard**
Global Aerospace &
Defense Leader

A handwritten signature of Guillaume Rochard in black ink.

Welcome to *Mission control*, PwC's analysis of deal activity in the aerospace and defense (A&D) sector. In our fourth quarter edition, we provide an overview of deal activity for the full year, as well as expectations for deal activity in 2015.

The past year witnessed a significant improvement in transaction activity after a lackluster 2013, with a notable pickup in defense-related transactions. The total deal value, \$22.3 billion, was slightly above the 10-year rolling average of \$21.2 billion. The number of megadeals, or transactions of \$1 billion or greater, doubled from 2013 and included the first defense-oriented megadeal since the Budget Control Act of 2011. Much of the year's activity occurred among smaller and privately owned companies, and average deal size remained below historical averages. However, the M&A activity in the sector showed a supply chain consolidation trend that seems to be gaining momentum.

Cyber surveillance, security, intelligence, and reconnaissance emerged as a major theme, particularly in the fourth quarter. For example, the 4Q14 megadeal between Engility and TASC, both previously spun-off companies of prime defense contractors, is expected to broaden Engility's service offering in the areas of intelligence analysis, space systems architecture, cyber forensics, and cybersecurity. Other examples include Raytheon's acquisition of Blackbird Technologies, and BAE Systems' announced plans to acquire SilverSky and Eclipse Electronic Systems. The businesses of these acquisition targets are in line with major budgetary priorities of governments across the globe.

We expect further acquisition activity for companies with advanced, niche technologies with high growth potential. Attractive markets include cyber, electronics, and niche players in autonomous and unmanned aerial vehicles (UAV). These markets have commercial applications, which allow for a diversified revenue stream as defense budget challenges persist.

Divestitures and spin-offs remain popular among aerospace and defense companies. The most common driver for the divestitures has been a desire to exit businesses directly impacted by decreased military spending, including units that produce vehicles and electronics, and provide communications services. Spin-offs have helped create more focused business portfolios as aerospace and defense companies offload some of their small industrial units.

The fragmented and high-margin maintenance, repair, and overhaul (MRO) business saw an increase in M&A including the acquisition of four MRO focused business units by VSE Corporation in the fourth quarter. Companies are strengthening their MRO services to enhance capabilities, expand geographic reach, and improve the bottom line. Rising passenger traffic and higher utilization rates in growing regions are trends that support more spending, and activity, for MRO services. In defense, budget constraints have a direct impact on the service life of the different platforms and therefore on MRO.

2015 has gotten off to a strong start with an announced acquisition that could be the biggest transaction in the A&D sector since 2011.

Cross-border deals rebounded slightly, but local deals accounted for 72% of transactions for the year and 80% in the fourth quarter. Some increase in cross-border deals seems likely as austerity improves the rationale for Western cross-border defense consolidation and joint ventures. However, industrial policies can limit some of these deals due to security considerations regarding defense technology and technological capabilities. We also expect that transnational defense cooperation agreements will improve export competitiveness.

PwC's Aerospace & Defense practice is monitoring several additional trends expected to affect the characteristics of deals in the sector:

- **Financial investors remain active in the sector.** Private equity and other financial investors showed renewed interest in the A&D space due to stable revenue and strong orders in the commercial space. Private equity sellers were among the primary drivers of M&A activity, motivated by a desire to exit investments acquired prior to the financial crisis and benefiting from strong order books.
- **Advanced technology with commercial potential.** Deals related to cyber and electronics gained momentum, while UAV emerged as a potential area for M&A. These niche technologies have the added benefits of non-defense applications and potential for commercial revenue streams. They are also often protected in defense budgets.
- **Supply chain consolidation.** With the US Department of Defense frowning upon megamergers of prime contractors and the difficulty in Europe to trigger mergers among the key players, deal activity remains more likely among suppliers. These companies, as well as those in commercial aerospace, are generally under pressure to more efficiently manage supply chains and distinguish themselves through higher quality and timeliness.

While 2014 activity improved from the year before, lack of suitable opportunities, high valuations, and an uncertain budget outlook have restrained M&A deals in the A&D sector. Though companies have deployed cash on organic growth investments, much of the focus has been on cash return to shareholders through share repurchase and dividend payouts. We expect share buybacks to remain a priority along with niche acquisitions in specialized areas of technology.

Going forward, aerospace and defense companies will continue to evaluate their portfolios with a longer-term perspective, and we expect them to invest and divest to remain competitive. In fact, 2015 has already gotten off to a very strong start with the announced acquisition of Exelis by Harris Corporation, two mid-tier suppliers of advanced military technology. At nearly \$5 billion, the megadeal is the largest transaction in the A&D sector since United Technologies' acquisition of Goodrich in 2011 and among the top 5 largest in the last 10 years. We expect that consolidation among small- and mid-tier suppliers will continue to drive transaction activity in the A&D sector.

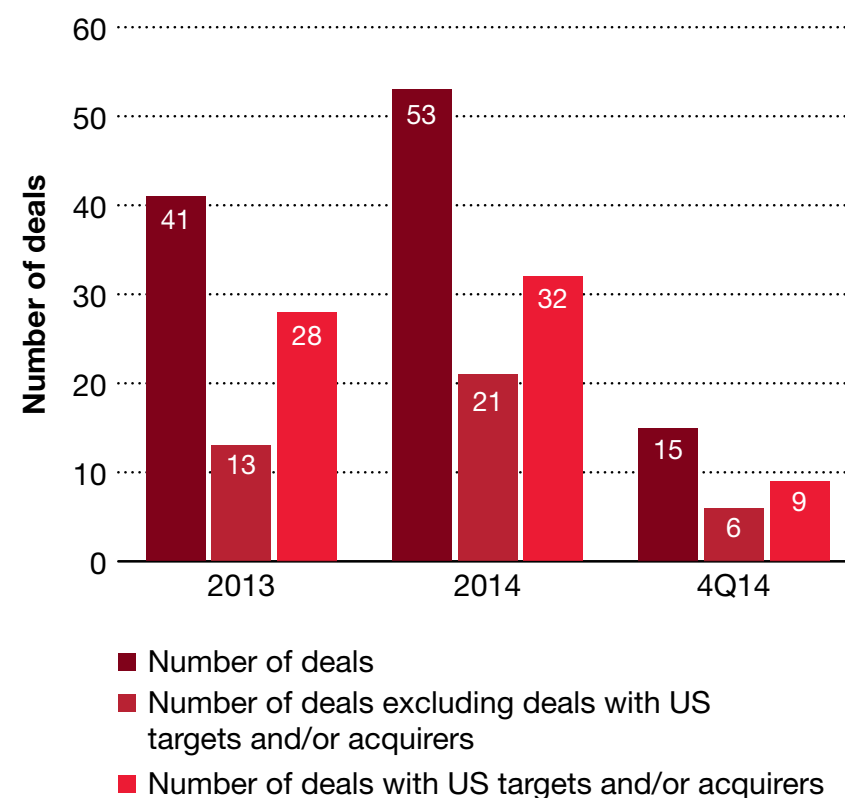
We are pleased to present our 2014 analysis as part of our ongoing commitment to help you understand M&A trends and prospects in the industry. For a deeper dive into the data, launch the data explorer at <http://www.pwc.com/us/en/industrial-products/publications/mission-control.jhtml> or contact us to further discuss our insights.

Deal activity

In 2014, deal activity increased by 29% in volume and 61% in value compared to the prior year.

Deal activity by number of deals

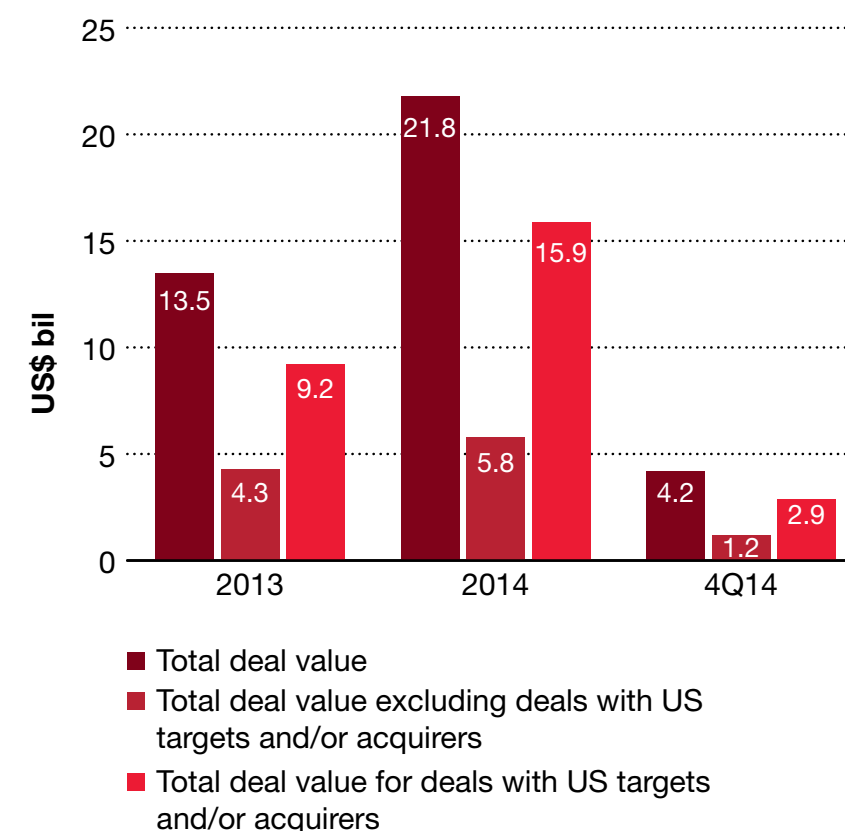
Measured by number of deals worth \$50 million or more



Source: Thomson Reuters/ PwC Analysis

Deal activity by total deal value

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



Source: Thomson Reuters/ PwC Analysis

2014 was an average year in terms of overall volume, though there was a pickup in the number of deals exceeding the \$50 million value threshold. The total value of deals exceeded the 2013 total by a comfortable margin but was on par with the prior 10-year average. As a result, average M&A size was low by historical standards. Private equity and other financial investors showed renewed interest in the sector, on both the buy- and sell-side, due to stable revenue and strong backlog of orders in the commercial space.

Divestitures and spin-offs remain popular among aerospace and defense companies, as companies continue to realign their portfolios instead of going for larger, transformational deals. M&A valuations remain robust across the sector. These high valuations, as well as investor pressures in some cases, have helped drive a high rate of divestitures among defense companies. In fact, the volume of these types of deals was high by historical standards in 2014.

Yearly aerospace and defense activity - Measured by number and value of deals (2005-2014)

	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014
Number of deals	236	228	291	306	270	289	299	297	258	289
Total deal value (\$bil.)	14.5	22.2	41.3	23.1	9.1	13.4	30.0	22.0	14.3	22.3

Source: Thomson Reuters/ PwC Analysis

Deal market characteristics

Local deals dominated M&A activity in 2014.

M&A global map for 2014

Deals with \$50 million or more*



* Sum of inbound and outbound deal value may not equal due to rounding.

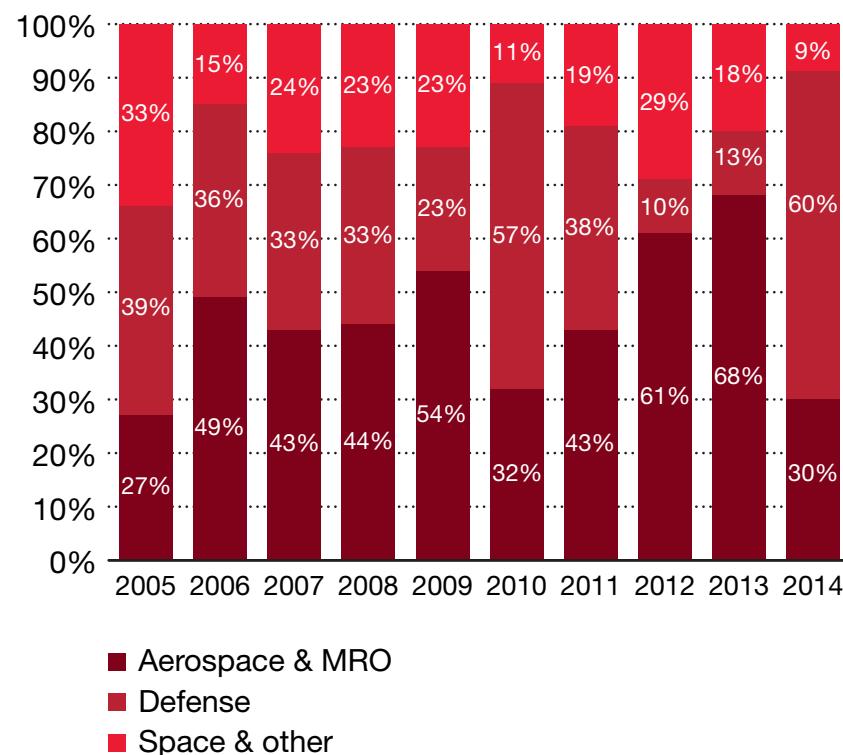
Source: Thomson Reuters/ PwC Analysis

Cross-border deals rebounded slightly, but local deals remained the dominant theme, accounting for 72% of transactions for the year and 80% in 4Q14. There is increasing interest in transatlantic deals for aerospace and defense targets, but national industrial policies can hinder some cross-border deals in defense, with strict standards regarding location and reliability for foreign suppliers. Regional distribution of acquirers and targets remained largely stable relative to prior years, with a slight drop in share from Asia and Oceania. The number of transatlantic deals rebounded after last year's near record low total as European transaction activity bounced back.

Deals by Aerospace & Defense category

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

Volume

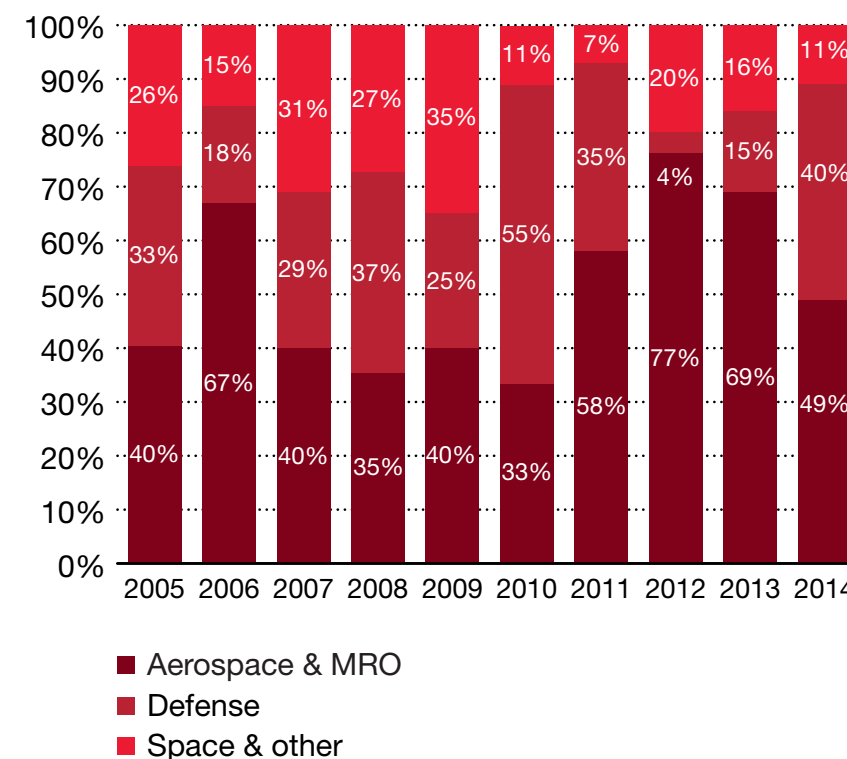


Source: Thomson Reuters/ PwC Analysis

Deals by Aerospace & Defense category

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

Value



Source: Thomson Reuters/ PwC Analysis

The Bipartisan Budget Act of 2013 has helped to clarify overall defense demand, thus contributing to a modestly better deal environment. Similarly, the global outlook for defense budget constraints and priorities has become less uncertain and companies can better assess their portfolio needs. Share of the A&D sector's volume driven by the defense segment reached its highest level in 10 years while share based on value trailed only the 2010 high. Deal flow in the highly fragmented and high-margin aerospace MRO segment remained robust. Companies are strengthening their MRO services to enhance capabilities, expand geographic reach, and improve the bottom line.

Horizontal industry mergers, consolidation of smaller-tier suppliers and, to a lesser extent, product portfolio expansion or divestment are some of the primary drivers of strategic deals. In certain cases, companies are aiming to gain synergies through complementary products acquisition. Some of the transaction volume is being driven by companies looking to restructure their portfolio and reduce exposure to the defense market in favor of other commercial areas with more robust growth prospects. However, lower energy prices have added some uncertainty to the demand outlook for commercial aerospace. Improving free cash flows could support continued strength in overall industry spending but could also delay orders as operators look to squeeze more profitability out of older, less efficient, models.

Large deals

Megadeals doubled in 2014 with 6 compared to 3 from the prior year.

Megadeals in 2014—deals with a disclosed value of at least \$1 billion

Month announced	Target name	Target nation	Acquirer name	Acquirer nation	Status	Value of transaction in US\$ bil.	Category
Jun	Firth Rixson Ltd.	United Kingdom	Alcoa Inc.	United States	Completed	3.00	Aerospace
Jun	Aerospace Inc-Distribution, Logistics, technical Services Business	United States	Shareholders	United States	Completed	2.24	Aerospace
May	Shenyang Aircraft Industrial (Group) Co. Ltd.	China	Sichuan Chengfei Integration Technology Corp. Ltd.	China	Pending	2.19	Defense
Apr	Orbital Sciences Corp.	United States	Alliant Tech Systems Inc.	United States	Pending	1.87	Defense
May	Aeroflex Holding Corp.	United States	Cobham PLC	United Kingdom	Completed	1.43	Defense
Oct	TASC Inc.	United States	Engility Holdings Inc.	United States	Pending	1.30	Defense

Megadeal activity was on the rise in 2014, doubling the total from the prior year. This activity occurred even as the US Department of Defense reaffirmed its stance against prime contractor consolidation earlier in the year and pointed to M&A as a viable option for smaller companies. The merger of Orbital Sciences and ATK was the first defense-oriented megadeal since the Budget Control Act of 2011, nearly three years before. However, it remains unlikely that large transformational deals among defense contractors will be permitted under current industrial policies. The 4Q14 deal between Engility and TASC, the previously spun-off companies of prime defense contractors, is expected to broaden the service offerings of Engility in the areas of intelligence analysis, space systems architecture, cyber forensics, and cybersecurity.

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, 2005 and December 31, 2014, 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.

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, Estonia, Finland, France, Germany, Greece, Ireland, Italy, Latvia, Lithuania, Luxembourg, Malta, Netherlands, Portugal, Slovakia, 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.

Resources

PwC Aerospace and Defense practice

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. We help A&D companies address the full spectrum of industry-specific challenges across such areas as assurance, tax, operational improvement, supply chain management, program management effectiveness, IT effectiveness and security, compliance, export control, and government contracting. PwC's Deals practice, with approximately 6,500 dedicated deal professionals worldwide, has the 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 an industry point of view.

PwC US

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

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

US Aerospace and Defense Deals Partner
Joe Michalczyk—+1.703.918.1480
joe.michalczyk@us.pwc.com

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

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

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

US Aerospace and Defense Corporate Finance Director
Robert Ashcroft—+1.312.298.2364
r.ashcroft@us.pwc.com

US Industrial Products Marketing Director
Thomas Waller—+1.973.236.4530
thomas.a.waller@us.pwc.com

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

US Aerospace and Defense Research Analyst
Jeremy Maryles—+1.646.471.6364
jeremy.maryles@us.pwc.com

PwC Global

Global and France Aerospace and Defense Leader
Guillaume Rochard—+33.1.56.57.8208
guillaume.rochard@fr.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
Huw Andrews—+86.21.2323.8800
huw.andrews@cn.pwc.com

Germany Aerospace and Defense Leader
Martin Theben—+49.201.438.1524
martin.theben@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—+939.06.5702.52442
corrado.testori@it.pwc.com

Middle East Aerospace and Defense Leader
Masood Hassan—+971.4.304.3314
masood.hassan@ae.pwc.com

UK Aerospace and Defense Leader
Dean Gilmore—+44.20.721.35699
dean.gilmore@uk.pwc.com

**Visit our aerospace and defense industry website
at www.pwc.com/us/industrialproducts**

