

# Mission control

First-quarter 2010 aerospace and defense industry mergers and acquisitions analysis

Making smarter deals in a changing environment: Due diligence



Welcome to the first-quarter 2010 edition of *Mission control*, PricewaterhouseCoopers' quarterly analysis of mergers and acquisitions (M&A) in the global aerospace and defense industry. In addition to a detailed summary of M&A activity in the first quarter of 2010, we supplement this issue with a special report on performing better M&A due diligence in a recovering economy and the always important consideration of how cultures will mesh and function financially, technologically, and operationally. The discussion includes emerging and existing areas that might call for more careful attention in today's due diligence process such as healthcare, climate change, changing tax laws, information technology, and human resources.

## Special report:

# Making smarter deals in a changing environment: Due diligence

As the global economy begins to recover, deal making might offer the leverage aerospace and defense (A&D) companies need to push ahead of the competition. Companies with strong balance sheets and robust cash reserves are in the best position to seek strategic M&A opportunities.

As strategic buyers take advantage of their ability to maneuver in a challenging environment, PricewaterhouseCoopers (PwC) believes they will pursue deals with a focus on emerging markets and technologies. “The focus is likely to be on the growth in Asia, particularly China and India, in both commercial aviation and general aviation,” said Scott Thompson, PwC’s Aerospace and Defense practice leader. “Defense companies may emphasize emerging technologies, particularly cyber security and adjacent markets, such as energy security, infrastructure security, and healthcare privacy. In addition, companies should seek acquisitions that will enhance productivity and enable cost-savings, such as low-cost sourcing strategies focused on Eastern Europe and Asia. Some companies may seek to expand their core businesses into new areas, taking advantage of opportunities resulting from the financial crisis, including some attractive companies held by private equity firms.”

“The companies that have built their balance sheets for a rainy day might come out of last year’s storm to find the rainbow, and at the end of it, nicely valued acquisition targets that provide opportunities for revenue growth and enhanced productivity,” said Bob Filek, partner with PwC’s Transaction Services practice. “As a result, M&A activity in 2010 is expected to be driven by strategic buyers who have access to capital and the strategic vision to capitalize on some of the best values we have seen in recent times.”

To make the right deal, A&D companies must consider how the past two years of economic contraction have possibly altered customer contracts and significantly changed and elevated the importance of due diligence. Healthcare, climate change, commodity prices, pension plan structures, changing tax laws, company culture, and the role of human resources must be factored into today’s due diligence process. And because the A&D industry relies heavily on government-sponsored programs, the profitability and sustainability of a target’s customer contracts can be at risk if these programs are terminated or restructured. Buyers should analyze the target’s underlying programs and platforms to assess the impact of any changes on projected revenue and income.

Prior to the economic collapse, sellers had the leverage to pressure buyers to close quickly. The current deal

environment dictates a slower pace for many reasons, including tighter credit markets and scrutiny by lending banks. However, an important reason is the additional diligence required to properly assess the value and risks associated with a transaction. Analyzing a deal has become more complicated in the wake of a recession that has lessened the reliability of historical results and led to permanent changes in some segments because capacity has been taken offline and may or may not return. Consequently, the need to analyze the target as well as the entire value chain is essential.

Still, M&A activity inevitably generates a certain amount of urgency, so it pays to be prepared. A&D companies that might be a little rusty in the area of due diligence because fewer deals were completed during the past two years may need to polish up their existing processes and make sure they are ready and in place when opportunities arise.

“First, assess your M&A processes that were in place before the downturn because when deals become available, you won’t have time to include new processes,” said Brian Vickrey, a PwC Transaction Services partner. “Next, make sure you know where to turn for additional resources and assistance, if needed. Trying to decide how to run your M&A process in the middle of a deal may result in inefficiencies and lack of focused execution and may lessen your ability to be competitive in a managed auction process.”

## The recession alters the M&A landscape and creates new areas for diligence

During the downturn, many companies cut production capacity, reduced workforce, and slashed inventory to make their operations as efficient as possible and to maintain cash flow. Although the recovery is expected to be slow, there is a risk that the “snap-back” may catch companies off guard, particularly those that aggressively reduced capacity and inventory. Now that the overall economy is improving, the question is whether the supply chain is prepared for the snap-back. These companies feel pressured to make tactical and operational business decisions about when to open a closed line, add a second or third shift, lift a hiring freeze, or how much raw material to order. These scaled-down supply chains may lack the flexibility and depth to meet the needs of increasing demand. More than ever, A&D companies need to be close to their suppliers and ensure they are prepared to perform. Along with financial due diligence, these circumstances create an additional area of emphasis for due diligence.

### Healthcare and climate change

Governmental influence in the form of legislation on climate change and healthcare is also new to the M&A landscape since the recession. Two years ago, most did not consider healthcare or climate change as influential in making or breaking a deal. But today, both issues create material uncertainty that should be considered as part of a buyer's due diligence process.

Supply chain initiatives to cut greenhouse gas emissions are of particular interest to the A&D industry. The federal government's plan that would require government suppliers and contractors to cut carbon emissions 28 percent by 2020 is a major initiative that creates the kind of uncertainty that demands additional diligence.

With a history of offering generous health and pension benefits, many of which have evolved through collective bargaining processes, A&D industry due diligence regarding healthcare and benefits can become complex. The uncertainty associated with new US healthcare regulations in the context of existing benefit plans may result in additional liabilities that may not have yet been recognized by a target or included in the target's projections.

Anticipated consolidation within the health industry because of healthcare reform in the United States may also need to be evaluated to determine whether there will be an effect on a company's employee benefits. This trend, and its potential to affect the target and acquirer alike, should be considered during the due diligence process.

### Commodity price volatility

Commodity price fluctuations may also present complexities to acquirers, who must understand the impact on the target company's financial statements related to commodity price volatility and the target's ability to pass on commodity price increases to customers. It is becoming increasingly apparent that raw material constraints and rising global demand have the potential to exacerbate price volatility and underscore the risk that companies may not have access to the necessary raw materials to continue operations.

### Tax and information technology (IT) due diligence

Two years of recession was compounded by dramatic changes to the US tax code and to tax regimes around the world. This required A&D companies to rethink their tax strategy and the recognition of taxes. Furthermore, in today's corporate environment, acquisition transactions often are on an aggressive time schedule, and tax practitioners are

sometimes not consulted about tax-sensitive aspects of the transaction until the final stages of the deal. For this reason, familiarity with the basic tax framework for analyzing acquisition documents can be important.

Tax due diligence generally focuses on the tax returns and tax examinations of the acquisition candidate and serves to satisfy the buyer that the tax liabilities of the business being acquired are properly stated on the seller's books. In addition, the tax review should focus on the buyer's ability to amortize a portion of its investment through proper tax planning strategies and utilize the seller's tax attributes and similar tax opportunities.

In conducting the tax portion of the purchase investigation, a prospective buyer should consider not only hidden liabilities of the target, but also hidden assets or planning opportunities, of which the target and other competitive bidders may not be aware.

Buyers also need to thoroughly evaluate the IT platform of the target business early in the due diligence process. Effectively planning an integration of the platform requires significant lead time because of the complexities involved. Not only must buyers gain an understanding of the major business systems that support and automate core operating processes, they must also consider the role IT plays in financial and management reporting, the business supply chain, sales and marketing, services execution, manufacturing, and human resources and payroll. An acquiring company must also understand whether the target's systems and respective hardware platforms have the stability and scalability to support management's current and future business plans.

The IT due diligence process also includes analysis of significant, capital-intensive existing and planned IT projects. The analysis should evaluate the project timing and budget to identify areas of potential risk of failure and the effect on the acquirer if the acquisition is successfully completed.

### Human resources due diligence

Human resources issues have changed dramatically during the past two years. Acquirers should be aware of a target company's record on compensation and consider whether raises and bonuses were curtailed to cut costs or whether employees are doing multiple jobs to compensate for laid-off co-workers. Often, acquirers focus only on melding the two company compensation structures into one without considering how that might change the financial statements. Companies in the A&D industry need to pay close attention

to pension funds and other postemployment benefit plans, particularly how they are funded, because they commonly provide these employee benefits.

#### Overseas acquisition or partnership due diligence

During the prolonged recession, companies grew accustomed to doing business in survival mode. But as a recovery begins to look imminent, investors and stakeholders soon will likely be asking companies how they intend to grow. Consequently, many companies are expected to incorporate M&A activity into their growth strategies. Because of the higher growth potential in emerging markets, companies may need an understanding of foreign entity due diligence, which can often be elusive in emerging economies.

Along with economic opportunity and an increasing need for global operating and delivery models, A&D companies considering an investment or partnership in an emerging country should weigh the risks and the work required to ensure the integrity of compliance. Significant issues include ensuring that the deal falls into line with the International Traffic in Arms Regulations (ITAR), the US Foreign Corrupt Practices Act (FCPA), and a wide range of foreign laws relating to critical areas such as taxes, labor practices, exports, trade, and the environment. When acquiring a foreign entity, buyers must also consider fluctuations in foreign currency and the effect on the transaction. Currency fluctuations can complicate the analysis of a target company's historical earnings.

"The question boils down to whether a company is prepared for an overseas acquisition and what that means," Vickrey said. The key issues companies address, he said, are the ability to oversee the operations after the transaction, adopt policies and procedures to meet the buyer's requirements, and handle financial reporting requirements under different generally accepted accounting principles.

#### Lender and capital market due diligence considerations

As lenders consider changes forced by two years' worth of economic contraction, they may ask the following questions as they go through an enhanced due diligence process:

#### A&D industry considerations

- How strongly was the GDP decline amplified in the A&D sector? Based on this, what are expectations of timing and strength of recovery?

- What stage of the business cycle is the A&D industry in? Do downturns in the A&D industry typically lead or lag the general economy? How long do downturns typically last in the A&D industry relative to the macro-economy? What can we learn from this in terms of revenue and production planning?
- What is the level of excess capacity in the A&D industry? Where will normalized demand levels fall? Depending on the company's cost position, what are the implications for the company's total capacity? What investments are required to reactivate idle capacity or what are the costs of dismantling inefficient plants?

#### Company-specific considerations

- Based on its customer base and the macro-environment, are the company's volume projections reasonable? How do they compare to independent projections?
- What is the outlook for the company's specific customer, platform and geographic portfolio?
- Is the company well positioned to take full advantage of the up-cycle? Is the company either advantaged or disadvantaged from a cost standpoint compared with its key competitors? Are the advantages sustainable or the disadvantages reversible?

#### Beyond perfunctory due diligence

To further enhance efficiency and meet stakeholder demands for growth, A&D companies may be challenged to seek combinations of similar players to drive scale and enhance productivity. These types of mergers will likely be a driving force behind deal activity in 2010 as companies look to increase revenue and enhance margins.

Successful acquirers within the A&D industry may supplement their financial due diligence by directing it toward understanding how the cultures will mesh and how the two companies will function operationally, technologically, and financially. They should look at human resource due diligence, including external and internal stakeholders. By focusing on how to resolve issues that will arise when the businesses come together to form the new, larger business entity, leading A&D companies lay the groundwork for more accurate competitive pricing, more potential synergies, and faster, smoother post merger integration than achieved by companies that treat the process in a purely perfunctory manner.

## Perspective: Thoughts on deal activity in the first quarter of 2010

There is a saying in the capital markets that roughly says, “As January goes, so goes the year.” The translation being, if January is a strong month, the rest of the year will follow suit and vice versa. If this axiom holds true for the A&D mergers and acquisitions market, 2010 is likely to be a good year. The first quarter of 2010, in terms of total deal value, showed its strongest performance relative to the past five quarters. Total deal value for the A&D sector is now roughly 4.5 times that of the lows experienced in the first quarter of 2009. Average transaction value was approximately 3.5 times that of the lows experienced in the first quarter of 2009. On the flip side, there was a 10.5 percent sequential decrease in the total number of deals. However, it is worth noting that the 68 deals in the first quarter still fall comfortably in the range of historical norms. So, while small has been the name of the game, given the underlying trends in the market, the middle market may soon take this title.

As depicted in our third-quarter 2009 edition of *Mission control*, historically, M&A activity within the A&D sector has been strong in post-recessionary environments. The economy may be entering such a period, as credit markets are easing and the overall economy continues to show improvement. Larger companies with solid balance sheets and less room for organic growth may take advantage of easing credit and look to acquire smaller companies to fill gaps in their current business mix. This will be especially true

for well-established, smaller companies with high-demand, niche products. The notable increase in the participation rate of financial investors reflects the easing of access to the credit markets and financial investors’ increased appetite to participate in the recovering aerospace and defense market.

During the past quarter, the White House released the 2011 Presidential Budget Proposal and the Department of Defense (DoD) released the Quadrennial Defense Review (QDR), which sets the department’s long-term course. The QDR focused on the need for operational flexibility and the ability to respond effectively to asymmetrical and unconventional threats. Given the shifting priorities of the US government and the DoD, the A&D mergers and acquisitions market is likely to continue gaining strength as companies seek strategic acquisitions to realign and bolster their current business mixes.

So, the main question now is, will this trend continue? While there are many unknowns (e.g., the effects of healthcare reform, the increasing US debt), we believe there are many catalysts in place that support continued strength in the A&D mergers and acquisitions market. The trend is now toward more deals in the middle market and, with many larger companies deleveraging and shoring up their balance sheets during the recession, there is a lot of dry powder waiting to be put to use.

# Commentary

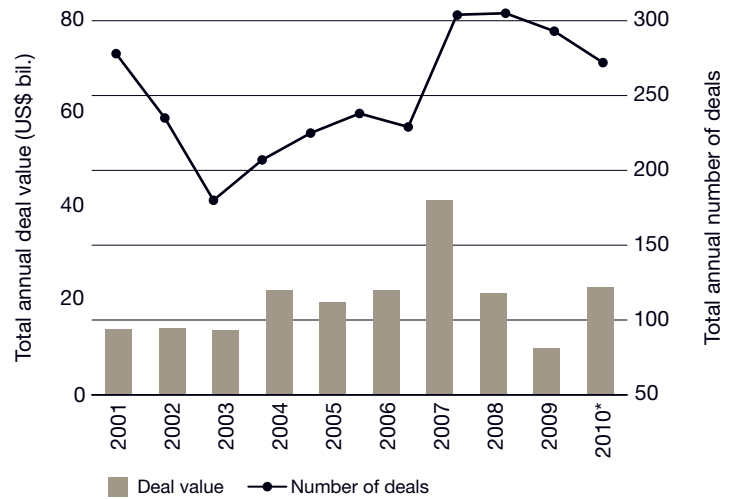
## Environment continues to improve

Although the number of deals in the first quarter of 2010 declined compared with the fourth quarter of 2009, the annualized activity level remains at the higher end of the historical average. On a year-over-year basis, the total number of deals increased 7.9 percent to 68 deals in the first quarter of 2010 from 63 in the first quarter of 2009.

The real improvement in the quarter was in the total transaction value and average transaction value for deals with a disclosed value. The average transaction value from 2001 through 2009 was \$188 million. This compares with an average transaction value of \$244 million for the first quarter of 2010. Since reaching its lows in the first quarter of 2009, the average transaction value has increased each quarter except for the fourth quarter of 2009, when it declined by roughly 4.7 percent.

Total transaction value for deals with a disclosed value has followed roughly the same path as average transaction value. After reaching a low of \$1.13 billion in the first quarter of 2009, total transaction value has increased every quarter except for the fourth quarter of 2009, when it declined by approximately 20 percent. Total transaction value for the first quarter of 2010 is now roughly 4.5 times the lows of the first quarter of 2009, yet remains well below the quarterly highs achieved in 2007. Given factors such as the shifting DoD focus and potential activity from Asia (in particular China), we believe the current trend is not only likely to continue, but also strengthen.

Historical transaction value and volume



## Historical deal value and volume (2001-2010)

	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010*
Total number of transactions	235	180	207	225	238	229	297	302	291	272
Total disclosed transaction value (US\$ bil.)	13.99	14.20	13.74	22.36	19.68	22.45	41.47	21.71	10.32	20.52

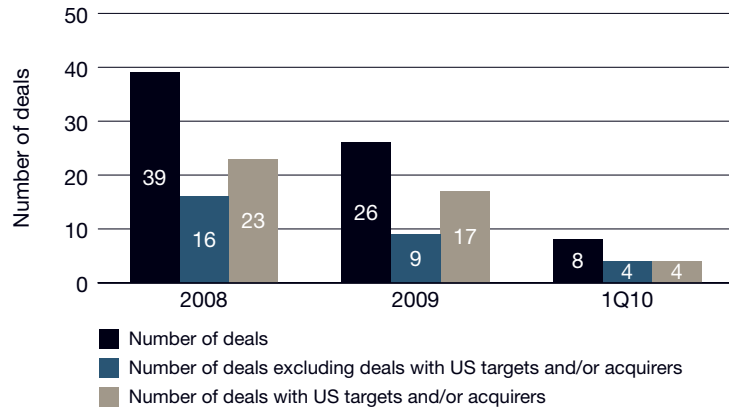
  

	2007				2008				2009				2010
	1Q	2Q	3Q	4Q	1Q	2Q	3Q	4Q	1Q	2Q	3Q	4Q	1Q
Total number of transactions	69	68	68	92	71	84	68	79	63	90	62	76	68
Total disclosed transaction value (US\$ bil.)	11.08	8.92	11.75	9.72	3.54	10.04	5.27	2.86	1.13	2.98	3.46	2.75	5.13
Avg. transaction value for transactions with disclosed value (US\$ mil.)	461.7	297.4	345.7	220.9	107.3	304.2	229.0	114.5	70.9	129.5	144.3	137.5	244.3

\*2010 estimated annualized number of deals

### Deal activity by number of deals

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

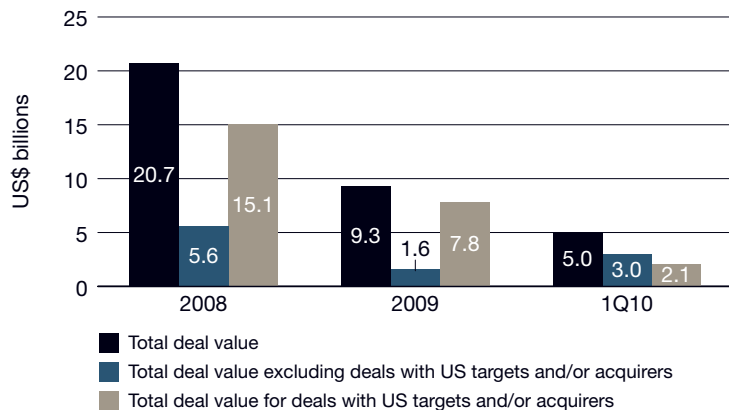


### Year-over-year deal value moves upward

Sequentially, activity for deals greater than \$50 million in the first quarter of 2010 was up slightly, from six deals to eight. The uptick is in line with the second and third quarters of 2009, where both quarters saw eight deals greater than \$50 million. The strength in the first quarter is demonstrated in the total value of deals greater than \$50 million. This category included two deals greater than \$1 billion in the first quarter of 2010, with a total quarterly deal value of \$5.0 billion, compared with the third and fourth quarters of 2009, when total quarterly deal value was \$3.2 billion and \$2.5 billion, respectively. On a year-over-year quarterly basis, total transaction value increased 345 percent from \$906 million to \$5.0 billion. This significant increase confirms the underlying strength and momentum of the current A&D mergers and acquisitions market.

### Deal activity by total deal value

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



While the number of deals is split evenly between US and non-US participants, the majority of the value of deals resides with non-US participants. This is a drastic change from both 2008 and 2009, when US participants dominated the A&D mergers and acquisitions market.

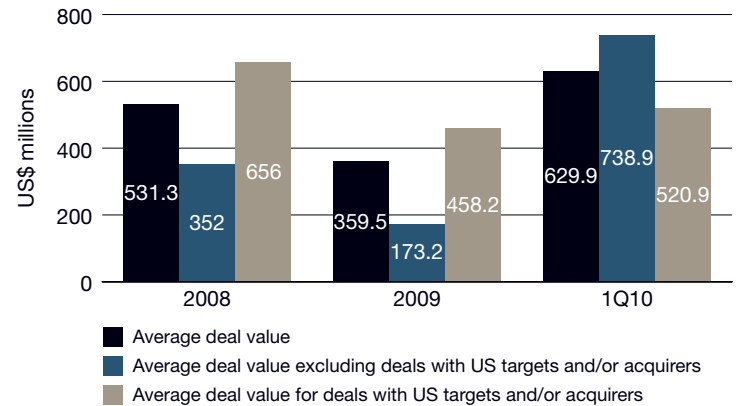
## Average deal values rise

Average deal value of transactions greater than \$50 million for the first quarter of 2010 increased 51.5 percent compared with the previous quarter. Compared with 2008 and 2009, the average deal value of \$629.9 million is higher by 18.5 percent and 75.2 percent, respectively. Along with showing progress in higher transaction value, there was a significant shift in the first-quarter average deal value for the transactions excluding deals with US targets and/or acquirers. The average deal value for non-US targets/acquirers increased to \$738.9 million from \$104.5 million in the fourth quarter, reflecting a significant shift in activity outside the United States. The level achieved in the first quarter was also significantly higher than those for 2008 and 2009.

Along with an increase in the average deal value for deals greater than \$50 million, the first quarter of 2010 also saw a 33 percent increase in the number of deals greater than \$50 million. The most notable sequential shift came for deals greater than \$500 million. The first quarter experienced three deals greater than \$500 million, with two being greater than \$1 billion and a third deal at \$720 million. There was just one deal greater than \$500 million during the fourth quarter of 2009, with a value of \$1.65 billion. The next-highest value deal in the fourth quarter of 2009 was \$375 million. So there has been a clear shift toward larger deals from the fourth quarter 2009 to the first quarter 2010, likely owing to the easing of access to credit markets for established firms and increased participation by financial investors.

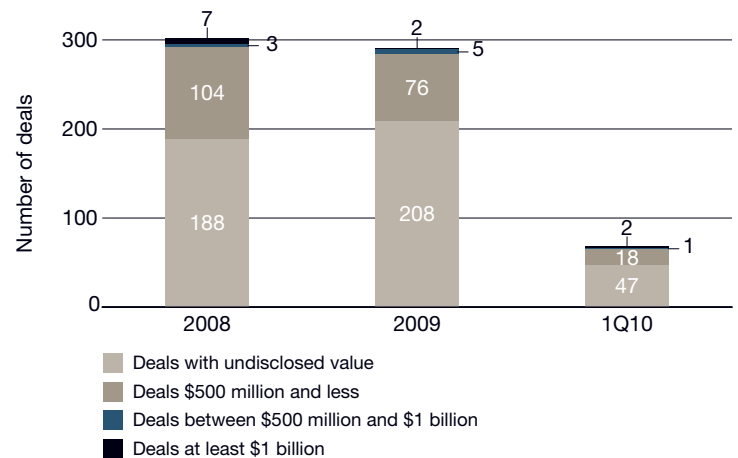
## Deal activity by average deal value

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



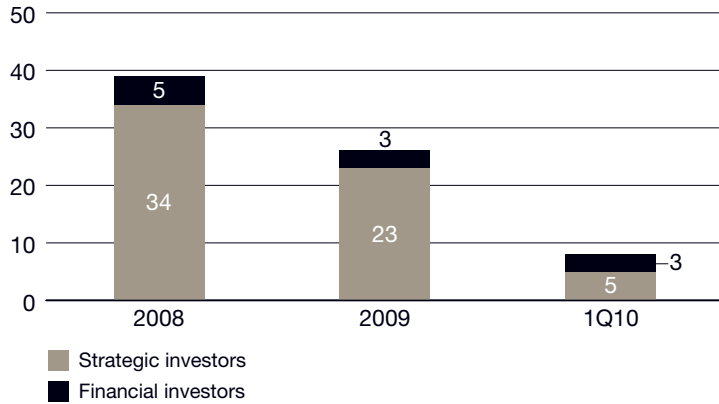
## Deal activity by number and range of deal value

Measured by number of deals



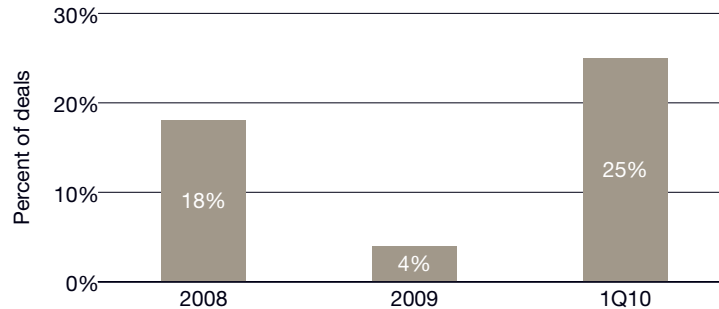
### Deal activity by investor group

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



### Minority stake purchases

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



### Creative deal structures continue as financial buyers become more active

The most notable shift in the A&D mergers and acquisitions market is the increased participation of financial investors, who for the most part had remained on the sidelines since the third quarter of 2008. But in the first quarter of 2010, financial investors accounted for 37.5 percent by deal value of total deals worth \$50 million or more. This compares with approximately 12.8 percent in 2008 and 11.5 percent in 2009. During this time, when the credit markets were severely constrained, financial investors (like most strategic investors) primarily focused their attention in-house and tended their existing holdings.

Nonetheless, a single improved data point doesn't necessarily indicate a trend. Although given the increased access to credit and financial investors' unwillingness to be left out of the game, we believe that participation in the A&D mergers and acquisitions market by financial investors will continue to increase. This will most likely be sustained by continued cheap credit and financial investor's ability to lure experienced senior military personnel into their fold in order to gain experience, insight, and invaluable networks.

It is also interesting to note that the increase in the participation of financial investors was associated with an increase in minority stake purchases. With the capital markets still in repair-and-heal mode, buyers and sellers are likely seeking creative structures, including minority stake purchases and joint ventures, to complete deals.

## Summary of large deals

### Large deals in 2008 (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
May	DRS Technologies Inc	United States	Finmeccanica SpA	Italy	Completed	5.14	SDNGA & NS, I&E*
Aug	Jet Aviation International SA	Switzerland	General Dynamics Corp	United States	Completed	2.25	Aircraft & Parts
Oct	Thales SA	France	Dassault Aviation SA	France	Completed	1.98	Missiles, Space Vehicles, & Parts
Jan	MacDonald Dettwiler & Associates Ltd-Information Systems	Canada	Alliant Techsystems Inc	United States	Withdrawn	1.32	Computer integrated systems design
Apr	Norcross Safety Products	United States	Honeywell International	United States	Completed	1.22	Rubber and plastics footwear
Jun	Honeywell International Inc-Consumable Solutions Business	United States	BE Aerospace Inc	United States	Completed	1.06	Aircraft & Parts
Jul	Detica Group	United Kingdom	BAE Systems	United Kingdom	Completed	1.02	Computer programming services

### Large deals in 2009 (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
Nov	TASC, Inc.	United States	General Atlantic/KKR	United States	Completed	1.65	Computer Facility Management
Jul	Vought Aircraft Industries Inc - Facility, North Charleston, SC	United States	Boeing Co	United States	Completed	1.00	Aircraft & Parts

### Large deals in first-quarter 2010 (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
Feb	VT Group	United Kingdom	Babcock International Group	United Kingdom	Pending	2.00	Ship building and repairing
Mar	Vought Aircraft Industries	United States	Triumph Group	United States	Pending	1.57	Aircraft & Parts

## Large deals start to show a presence

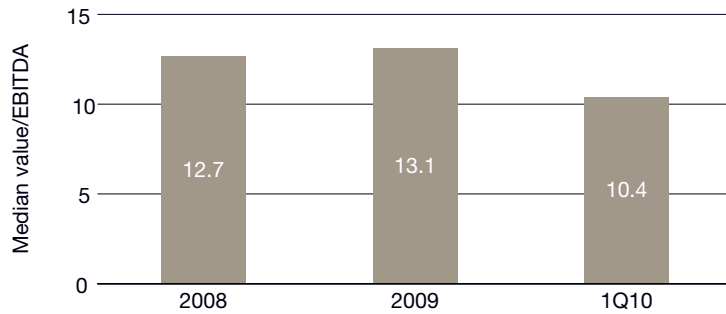
In 2009, deals valued at \$1 billion or greater were largely absent. Only two deals during the year came in at \$1 billion or greater—one at \$1 billion and the other at \$1.65 billion. This compared with 2008, when there were seven deals greater than \$1 billion. The largest deal, which involved the acquisition of DRS Technologies by Finmeccanica, was valued at \$5.1 billion.

Large deal activity in the first quarter of 2010 compares very favorably against 2009. There were two deals larger than \$1 billion in the first quarter alone, matching all of 2009. With easing credit and both financial investors and strategic investors more open to participating in larger deals, it is likely total deals at \$1 billion or greater in 2010 could match or exceed those experienced in 2008; although, as noted in our last report, for this to happen capital markets will need to continue their return to normalcy.

\*Search, Detection, Navigation, Guidance, Aeronautical and Nautical Systems, Instruments and Equipment

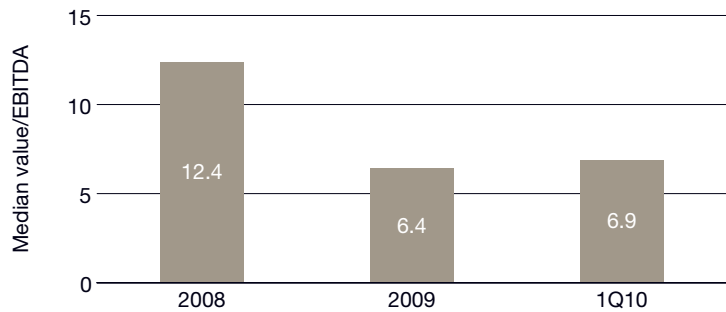
### Deal valuation by median deal value to EBITDA

Median value to EBITDA for deals worth \$50 million or more



### Deal valuation by median deal value to EBITDA

Median value to EBITDA for deals worth \$50 million or less



### Multiples continue contraction in smaller deals

Valuations for transactions worth \$50 million or more, represented by median deal value to EBITDA multiples, decreased in the first quarter of 2010 relative to 2008 and 2009—10.4 times compared with 12.7 times and 13.1 times, respectively.

Median value to EBITDA for deals worth \$50 million or less is a different story. Median values for these deals increased to 6.9 times compared with the 2009 level of 6.4 times, but remain significantly below the 2008 level of 12.4 times. With smaller deals still accounting for a vast majority of transactions, this may reflect the effects of pure supply and demand. Smaller targets can now demand higher multiples as deal pace increases while valuation multiples in larger deals remain low relative to recent history given the less-than-equal increase in larger transactions. Note that other factors, such as the target's capital requirements and pension obligations, should also be considered when comparing multiples.

# Regional analysis

## UK and Eurozone deals decline

Considering deals by target region, North America (particularly the US) continues to represent a significant portion of deals measured by both number of deals and value of deals greater than \$50 million. In the first quarter of 2010, North America represented 41 percent of deal value by target and accounted for 50 percent of the number of deals by target.

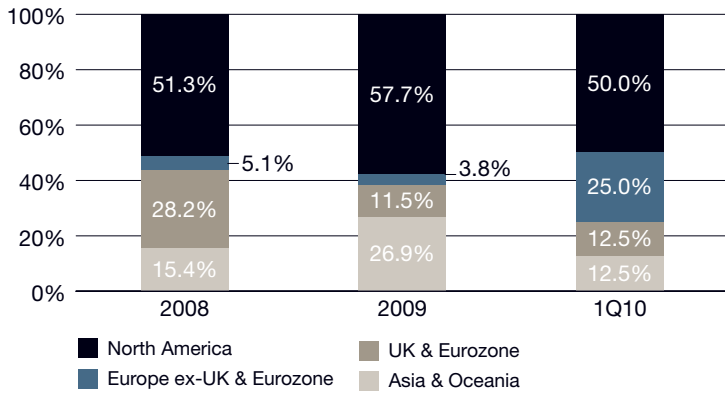
In terms of acquisitions, the regional participation rate is mixed, with multiple regions actively involved in the M&A market. North America continues to represent the largest portion of number of deals worth \$50 million or more at 37.5 percent. The UK and Eurozone, and Europe ex-UK and Eurozone both accounted for 25 percent of the number of deals, with Asia and Oceania accounting for the remaining 12.5 percent. In terms of value of deals, the UK and Eurozone and North America regions accounted for the majority of deal value at 40.9 percent and 40.2 percent, respectively. Europe ex-UK and Eurozone accounted for 17.3 percent of deal value during the quarter with Asia and Oceania at 1.7 percent.

In the first quarter of 2010, 87.5 percent of deals (7 out of 8) took place within local markets. The only cross-border deal was UK-based Chemring Group's pending acquisition of Alliance Defense Group. Given the current landscape of the A&D mergers and acquisitions market, we believe that as the capital markets continue to improve, cross-border deals will increase. The US remains the largest spender on defense by a significant margin. Given the recovering market, it is our opinion that foreign defense companies could be eager to tap into the US market via smaller to mid-market acquisitions of US companies. Purchasing into the US market gives foreign companies access to a market that will not only enable them to increase their market share, but access technology that will support organic growth.

We hold to our belief that, as we stated in earlier reports, the Asia and Oceania region will likely become a more active source of both acquirers and targets due to the region's relatively high growth prospects, as key countries such as China and India continue to see gross domestic product growth outpace other regions. China, in particular, is likely to become a major source of acquisitions within the commercial aircraft market as it continues an aggressive push into the aerospace industry.

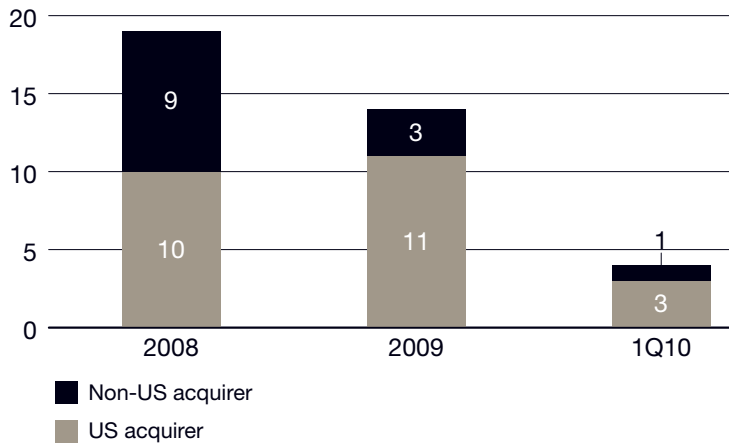
### Regional distribution of all deals by target region

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



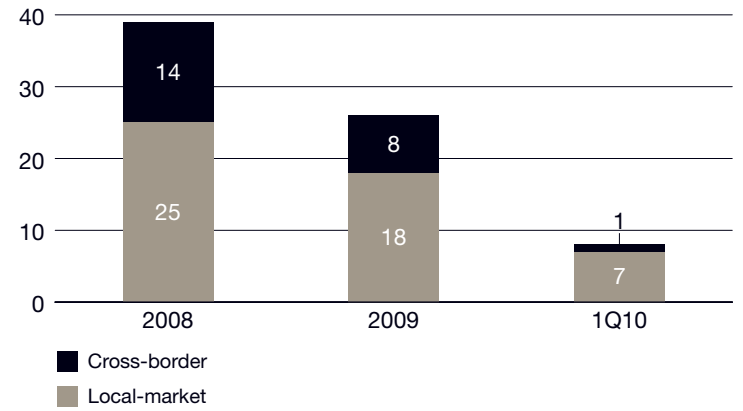
### US vs. non-US acquirers of US targets

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



### Local-market vs. cross-border deals (all nations)

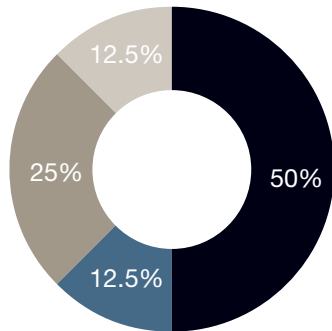
Measured by number of deals worth \$50 million or more



## Regional distribution of first-quarter 2010 deals

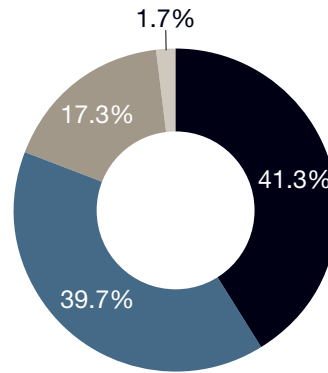
### Regional distribution of deals by target region

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



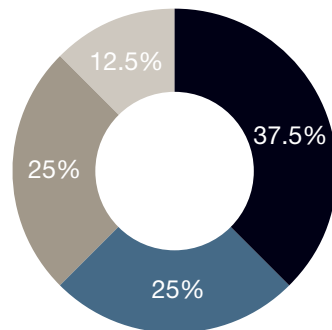
### Regional distribution of deals by target region

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



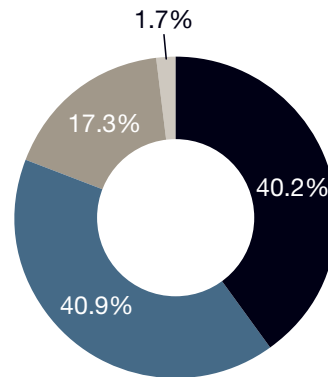
### Regional distribution of deals by acquirer region

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



### Regional distribution of deals by acquirer region

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



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

# A look ahead

## Increased participation of middle-market and foreign firms in aerospace and defense M&A activity

We believe the A&D mergers and acquisitions market has turned the corner and is well positioned for a solid year of activity. While small deals continue to account for a majority of deals, we see an increased level of participation in the middle markets and by foreign players. As the economy continues to improve and works its way back to a more customary growth rate, credit will continue to ease, allowing firms better access to capital. As a result, financial investors will continue to increase their participation, which will likely result in the middle-market accounting for a greater percentage of transactions.

We also expect foreign firms will continue to account for a greater percentage of acquirers of US targets. As the global economy improves, foreign firms will look to the US as a means to support growth. With the United States sporting the largest defense budget in the world, foreign companies will look to smaller, US-based niche companies as a route to access the US market.

Particularly in aerospace, China is making a concerted effort to become a player in both the business and commercial aircraft markets. As a result, we expect Asia to become more active in seeking strategic acquisitions focused on technology and supply chain to enable growth and improve efficiency.

# PricewaterhouseCoopers spotlight

Despite the recession, M&A remains a priority on senior executive agendas worldwide. Seen as a powerful growth mechanism, M&A can offer a stronger cash position, a broader customer base, a diversified platform base, higher market share, opportunities to reduce overcapacity, and access to better technology, products, and distribution channels. Looking forward, factors that will drive deal activity include a downward adjustment of prices, greater industry consolidation, increased competition, larger companies refocusing and divesting noncore operations, and more semi-distressed small or mid-size companies opting to sell themselves.

Because all the indicators for increased M&A activity appear to be present, companies that might have been out of the market during the downturn may benefit from reassessing their due diligence processes.

Leading aerospace and defense companies take a complete and integrated approach to due diligence. Team members represent a cross section of different functional areas and comprise not only finance experts but legal, marketing, and operational specialists, as well as compliance and regulatory specialists, who all work as one group. Together, they identify hidden operational, business, financial, and market risks. The team conducts not only financial due diligence, but also human due diligence, including a thorough look at external and internal stakeholders. The team also conducts soft due diligence, which is strategic rather than tactical, focusing on how to resolve issues that might arise when the businesses come together to form the new, larger business entity.

By following through with due diligence, leading A&D companies lay the groundwork for a deal's long-term success.

## Steps to take toward better due diligence

To potentially enhance a company's due diligence process, A&D companies may consider taking the following steps<sup>1</sup>:

- Engage the due diligence team in the deal process before due diligence begins.
- Strike a balance between making sure the due diligence team is close to the people doing the deal, yet remains independent and objective enough to be good corporate stewards, uninfluenced by the potential for others' desires to get the deal done no matter what.
- Determine the target's financial strength.
- Review and document results of the target company's three previous years' audited financial statements, public registrations statements, tax returns, and management letters. While this review typically includes a comprehensive reading of all annual and quarterly reports, financial statements with generally accepted accounting principles may not provide sufficient detail to evaluate deal drivers.
- Identify and address the most common deal killers.

Look for potential warning signs that may signal the need for a deeper analysis, such as:

- How well does the target company support the company's corporate strategy?
- What cultural clashes might arise as the two companies come together?
- How competent is the target company's management? How easy will it be to work with?

- How skilled are the workers?
- Was revenue restated, and if so, why?
- Is the brand name listed as a major asset, and if so, who assessed its value?
- Is the company involved in litigation?
- Are there any inconsistencies in the numbers, such as artificially ramped up revenue at the end of the year from the sale of excess inventory at deep discounts to customers?
- Is a significant amount of the target's projections/backlog unfunded?
- Are there any warranties—written statements from the seller that confirm a key fact about the target's business?
- Are there any indemnities—commitments from the target company to fully reimburse the buyer in certain situations?
- What is the potential for product cannibalization?
- How effective is the target's anticorruption compliance program?
- Can the company mitigate its risk through deal structuring or contractual protection?
- Does the buyout or merger plan spell out offshore sourcing issues?
- If a massive system upgrade is planned, will the legacy systems run parallel until the new system is running smoothly? Are the risks of the technology expenditures clearly laid out and thought through?

<sup>1</sup> PricewaterhouseCoopers, Global Best Practices, 2010.

- Emphasize customer due diligence.

Due diligence teams can gain a better understanding of the solidity of customer relationships and of the mix of customers whose relationships were strong (loyal), moderate (neutral), or weak (vulnerable). This understanding helps them better predict revenue streams.

- Analyze how the new company will impact workers' performance.

After announcing the transaction, create specific goals for the postmerger integration and communicate those goals to the target company's employees so that they will have a clear understanding of how the transaction will impact them, including whether they will retain their jobs and, if so, whether their pay and benefits will change.

#### **A successful deal**

Gaining a true picture of a target company requires overcoming deal biases. Successful acquirers also must avoid overconfident synergy estimates by assessing their projections for the current deal against those completed in the past. The more deals they close, the better the data they accumulate to arrive at a realistic set of expectations.

These companies also seek out expert external advice. They know even the most well intentioned due diligence specialists may occasionally, perhaps even unconsciously, become partisan in their thinking.

#### **How PricewaterhouseCoopers can help**

Deciding which acquisitions will create shareholder value may depend on the rigor and quality of due diligence performed. The PwC Transaction Services team's approach to diligence goes beyond traditional accounting and financial analysis to assess the key assumptions underlying the deal.

Our experienced teams help clients:

- Gain a deeper understanding of the total performance of the target business
- Negotiate favorable deal terms
- Uncover real opportunities for capturing value post-deal
- Address key tax and financial reporting implications and the related impact on the communications strategy for the transaction
- Make purchase price adjustments post-acquisition

Buy-side (and sell-side) due diligence services include:

- **Financial due diligence**—identifying historical run-rate revenue and earnings—and how they bridge to the projections—and identifying on- and off-balance sheet future cash calls on the business are critically important in properly valuing a target.

- **M&A tax due diligence**—whether it is a stock or an asset transaction, understanding the tax implications of the proposed deal and determining the optimal tax structure are critical to creating deal value.

- **Human resources due diligence**—adequately evaluating the impact of human resources on a potential transaction is crucial to assessing the viability of a deal.

- **Insurance risk management**—insurable risks such as workers' compensation and product liability, insured or not, affect the immediate and prospective economics of a transaction.

- **Commercial due diligence**—identifying commercial risks or upsides in a deal will frequently have a material impact on either price negotiation or deal viability.

- **IT and operations due diligence**—identifying systems and processes can influence deal price and viability.

# PricewaterhouseCoopers' aerospace and defense experience

## Deep aerospace and defense experience

PwC's Aerospace and Defense 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 authors 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) and American Conference

Institute (ACI). Our involvement in these organizations reflects our commitment to addressing industry needs and the furthering of industry 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 Aerospace and Defense 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 more than 1,200 professionals who serve the A&D industry, our team is part of an extensive Industrial Products group that consists of 31,000 professionals, including approximately 15,800 providing assurance services, 9,000 providing tax services, and 6,200 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

## PricewaterhouseCoopers global Aerospace and Defense practice

PwC's Aerospace and Defense practice provides industry-focused assurance, tax, and advisory services. Through our global network, we can draw upon the in-depth industry experience of specialists 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.

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# Methodology

*Mission control* is an analysis of mergers and acquisitions in the global aerospace and defense industry. Information was sourced from Thomson Financial and includes deals for which targets and 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 March 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*.

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, and China, when referenced separately, includes Hong Kong.





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