

# FOCUS Government, Aerospace and Defense Group

Winter 2010 Report

Vol. 2, No. 1



## FOCUS

Investment Banking

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### Investment Banking and Advisory Services

The FOCUS government, aerospace, and defense practice provides three highly tailored investment banking services to emerging middle market and larger GAD sector firms:

**Sellside Assignments**

**Buy Engagements**

**Capital Formation**

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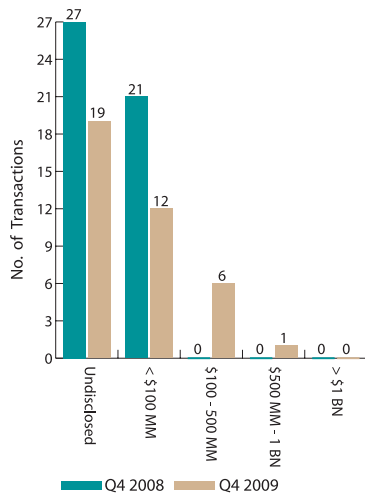
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# At a Strategic Inflection Point

By Manan Shah, FOCUS Partner, and Government, Aerospace and Defense Team Leader

The fourth quarter M&A deal activity carries potent signs of a revival. In comparison to the first half of 2009, the second half witnessed deal activity picking up in terms of both deal numbers and transaction values. The fourth quarter produced six transactions ranging between US\$100 million and US\$500 million and one transaction valued at US\$500 million although most deal activity remained concentrated in small and mid-cap companies. Transactions, constrained by poor credit markets and overall economic uncertainty, were biased towards creative structures including minority stake purchases and joint ventures. Interestingly, while the the number of transactions declined considerably in 2009, the average transaction sizes were more or less comparable to 2008 levels. For most of the year, however, overall economic uncertainty forced investors to exercise caution, which in turn restricted blockbuster deals in the GAD sector. Investors and targets adopted a wait and watch policy, focusing primarily on strategic options to improve existing operations and support overall growth.

## Announced Transactions by Size



Source: Capital IQ

In 2010, we expect increased availability of credit to facilitate the return of blockbuster deals. According to Reuters, many companies attending the Reuters Aerospace and Defense Summit<sup>1</sup> reported that they might spend up to US\$1 billion each on acquisitions in the coming year. Both L-3 Communications Holdings, Inc. and Goodrich Corporation expect to spend between US\$500 million and US\$1 billion while Pratt & Whitney (a unit of United

Technologies Corporation) expects to spend US\$3 billion on M&A activity in 2010. Most of these companies are interested in advanced technology areas such as precision-guided weapons, intelligence surveillance, and cyber security, in addition to specialized components.

Many sector players implemented cost restructuring and deleveraged their balance sheets in 2009, resulting in better liquidity and stronger positioning for inorganic growth in 2010. In addition, industry consolidation and focus on restructuring is expected to result in a continued flow of small and mid-sized deals. We therefore, expect an uptick in the average transaction sizes along with an upward trend in transaction volumes.

## Public Market Valuation Trends

We have created a representative group for the three sectors, Government, Aerospace, and Defense (GAD), to analyze and track the public market valuation trends. Market valuations of GAD companies have shown mixed results with some low valuations counterbalanced by higher valuations in niche technologies. While still down on a year-over-year basis, current valuations seem more in-line with long-term historical norms and appear to have bottomed out in early 2009.

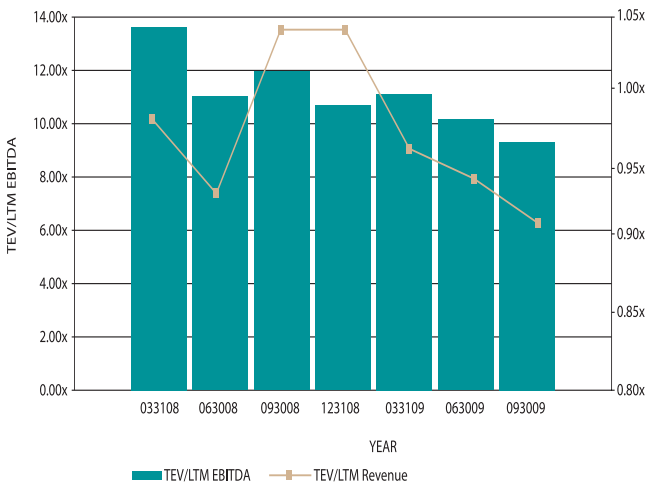
Market multiples in the Government sector have declined steadily over the last few quarters with steady EBITDA and improving balance sheets. TEV/EBITDA multiple in Q3 2009 was 9.3x compared to 12.0x in the corresponding period in 2008. Aerospace is a cyclical market and was adversely affected by the economic slowdown, which affected EBITDA margins. Multiples have been volatile reflecting the difficult operating environment exacerbated by the poor credit markets. TEV/EBITDA multiples now stand at attractive levels ranging between 5.7x and 6.7x. Defense sector multiples have been strong on the back of expected robust military spending. Sector multiples have been relatively stable in the range of 8.5x-10.5x EBITDA.

Deal valuations in the Aerospace & Defense (A&D) sector range from 7x-10x LTM EBITDA, with companies in high-growth areas and in niche technologies commanding higher multiples. We expect valuations of specialized companies to rise, with most sector constituents showing interest in strategic acquisitions to supplement/complement organic growth.

<sup>1</sup> Held in Washington on 15th Dec, 2009

# GAD Market Trading Metrics

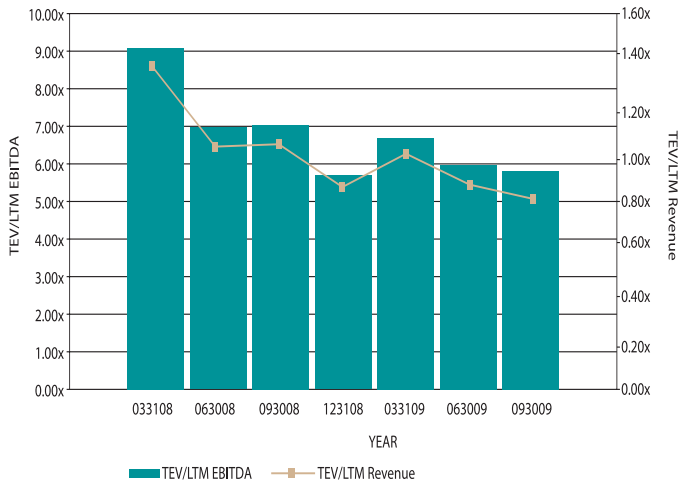
## Government



**Companies included in Government Chart:**

American Science & Engineering Inc., CACI International Inc., GTSI Corp., MAXIMUS, Inc., NCI, Inc., SRA International Inc., Stanley, Inc., Todd Shipyards Corp.

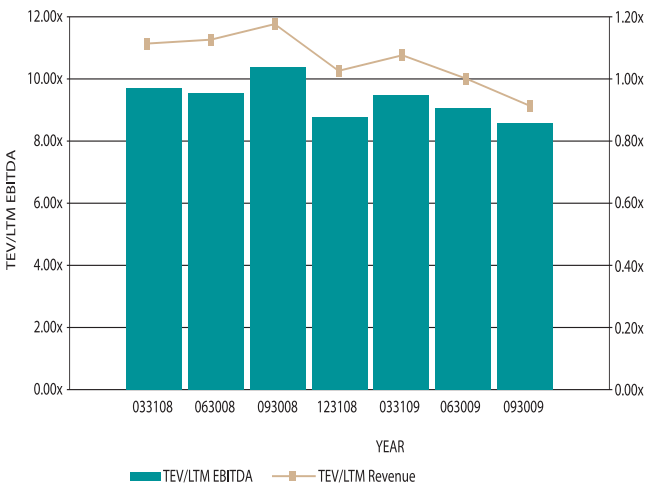
## Aerospace



**Companies included in Aerospace Chart:**

AAR Corp., Astronics Corp., HEICO Corp., Kreisler Manufacturing Corp., Ladish Co. Inc., Orbital Sciences Corp., Triumph Group Inc.

## Defense



**Companies included in Defense Chart:**

AeroVironment, Inc., Allied Defense Group Inc., Applied Signal Technology, Inc., Argon ST, Inc., Breeze-Eastern Corporation, Cubic Corp., Ducommun Inc., Dynamics Research Corp., GenCorp Inc., Kratos Defense & Security Solutions, Inc., ManTech International Corp.

These graphs are based on publicly available information from a representative group of companies participating in each of the three markets: Government Aerospace and Defense. Each report will update this information to the latest available financial quarter. These companies have been chosen because they are middle market companies with over half of their revenue from the particular market segment in which they are listed.

## Unlocking Value in Turbulent Times

Strategic investments in niche and futuristic technologies will provide fresh impetus to deal making, quicken the pace and increase the volume of activities in the GAD space in 2010. While adapting to the rapidly changing business environment, companies will exploit opportunities to fill gaps in their portfolios, diversify operating bases, and/or create competitive advantage through tactical acquisitions.

The commercial aerospace sector, continues to attract investments as companies seek alternative and stable revenue sources. Fitch forecasts aftermarket spending to be the first component in the aerospace industry to recover from the economic downturn and expects 5% growth in 2010. International players seeking to capitalize on the weakness in the dollar may also prove to be opportunistic buyers.

In the defense sector, the shift in focus from traditional weapon systems will prompt acquirers to fill capability gaps in their portfolios. Fitch's outlook for the defense sector is favorable in the near term with continued increase in defense spending in 2010. The core DoD budget is expected to grow by approximately 4% while modernization spending (procurement plus R&D) is expected to increase by 2-3%. High US DoD spending levels will continue to support defense sector credit quality.

According to Fitch ratings, credit metrics for many A&D companies deteriorated in 2009 but they are likely to be steady in 2010. Profit margins and cash flows are expected to grow, driven by improvement in the high-margin aftermarket, full-year impact of 2009 cost reductions, and defense expenditure growth, partially offset by higher pension expense and weak commercial OE markets. Cash deployment is also expected to increase in 2010, particularly for acquisitions and pension contributions.

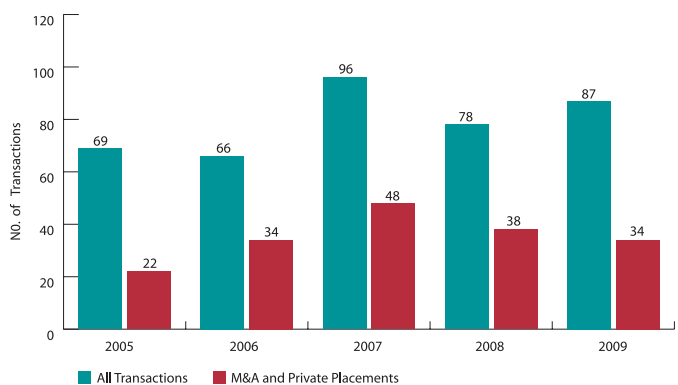
## About The FOCUS GAD team

Since 1982, our team of investment bankers has advised numerous clients in the government, aerospace & defense

sector with M&A and corporate finance services. FOCUS LLC's GAD team consists of six investment bankers and one senior advisor that includes former C-level operators, who come with years of experience in the government, aerospace & defense sector – both domestically and abroad. The team personally manages all transactions from inception to a successful close. We are located in Washington DC, Memphis, and Los Angeles, in geographical proximity to a large concentration of our clients in this sector. Also, please visit our website at [www.focusbankers.com/gad](http://www.focusbankers.com/gad).

The winter 2010 edition of the FOCUS Government, Aerospace, and Defense Group newsletter focuses on foreign investment in the US Defense sector. US is the global leader for military spending comprising more than 48% of the world total spending. The defense sector promises significant growth opportunities and has attracted increased foreign investments over the last few years. Last year deal activity dropped globally due to the economic recession, and foreign investors have not been immune to the same.

## 2005-2009 | Foreign Transactions in the US Defense Sector



Source: Capital IQ

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# Foreign Investment in U.S. Defense Sector

By Chris Griner, Farhad Jalinous, and Chris Brewster

Through good economies and bad, U.S. defense contractors generally weather the storm. Though armed conflict clearly fuels national security spending, technology developed for the defense market often proves to have significant and wide ranging commercial applications in peacetime. For all of these reasons, many investors have found the U.S. defense industry a haven in difficult times. Some foreign investors, however, may be reluctant to enter the U.S. defense market for fear that the investment will be blocked by the U.S. government -- and, even if the transaction clears regulatory hurdles, that their investment will make it difficult, if not impossible for the target company to win or hold classified contracts. The reality can be quite different.

The foreign acquisition of a U.S. defense contractor generally comes under review by the multi-agency Commission on Foreign Investment in the United States ("CFIUS"). Following CFIUS review, transactions are cleared unless they are found to present a threat to the national security. Acquisitions that pose a threat may be blocked by the president, but they are almost always withdrawn by the parties short of presidential review. Many transactions are restructured to meet national security concerns, but one way or another the overwhelming majority (roughly 90%) survive the review process. Moreover, although conventional wisdom holds that only investments from a small number of allied nations pass muster, CFIUS has considered investments from some 57 nations, with most garnering approval.

Of course, not all of the cases reviewed by CFIUS involve defense contractors (some involve investment in "critical infrastructure") and not all involve cleared defense contractors. Nevertheless, even foreign investment in cleared defense contractors is possible, if properly mitigated. Longstanding Pentagon policy, through Republican and Democratic Administrations, allows foreign investment in cleared defense contractors "consistent with the national security interests of the United States." Foreign investment is therefore possible if measures are in place "to protect against foreign interests gaining unauthorized access to classified information, adversely affecting the performance of classified contracts, or undermining U.S. security and export controls." The regulations implementing this policy are found in the National Industrial Security Program Operating Manual ("NISPOM").

Under the NISPOM, a U.S. company is deemed under "Foreign Ownership, Control, or Influence" ("FOCI") whenever a foreign person "has the power, direct or indirect (whether or not exercised, and whether or not exercisable through the ownership of the U.S. company's securities, by contractual arrangements or other means), to direct or decide matters affecting the management or operations of the company in a manner that may result in unauthorized access to classified information or may adversely affect the performance of classified contracts." Once a company is determined to be under FOCI, the security agencies (usually the Defense Security Service ("DSS")) must determine the appropriate form of FOCI mitigation. Although the government has the authority to impose unilaterally any security requirement it believes necessary to protect classified information and programs, the principal forms of FOCI mitigation are:

- The Special Security Agreement ("SSA"), when a foreign interest effectively owns or controls a company. Under an SSA, among other requirements, U.S. citizens approved by the U. S. Government must serve as independent Outside Directors on the SSA company's board. Under a new Pentagon directive, the number of Outside Directors must exceed the number of "Inside Directors," i.e., the directors who represent the shareholder). A company under an SSA may access highly classified information (e.g., "Top Secret"), but only after a National Interest Determination -- a finding that the disclosure will not harm the national security interests of the United States. Foreign government-controlled corporations under SSAs may be awarded such contracts only with the approval of the Secretary of Defense or the Secretary of Energy.
- Voting Trust or Proxy Agreement, when a foreign interest effectively owns or controls a company or corporate family. Under either arrangement, the foreign owner gives up most rights associated with ownership to cleared U.S. citizens approved by the Government. Under a Voting Trust, the foreign owner transfers legal title to the trustees. Under a Proxy Agreement, only voting rights are conveyed to the proxy holders. Both arrangements involve significant restrictions on the foreign owner, but impose no restrictions on the company's eligibility to access classified information and compete for classified contracts. The Voting Trust and Proxy Agreements are generally reserved for cases involving

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highly classified programs, especially where the investing country has a record of industrial espionage or the investor is foreign government-controlled. (Secretarial approval is not required, however, for foreign government controlled corporations to receive highly classified contracts if they are operating under Proxy Agreements or Voting Trusts.)

- Security Control Agreement (“SCA”), when a foreign interest does not effectively own or control a company but is nevertheless entitled to representation on the board. In such cases, among other requirements, one independent U.S. citizen (or more, depending on security risk factors), approved by the government, must serve as Outside Director(s).

FOCI is readily determined when ownership translates to board representation. When foreign ownership does not entitle the investor to a seat on the board, however, the Government may still require the company to adopt mitigation measures, such as a board resolution acknowledging FOCI and barring foreign control of classified contracts or programs, assigning oversight duties and responsibilities to independent board members, modifying or terminating loan agreements, contracts, and other understandings with foreign interests, physical or organizational separation of the component performing

on classified contracts, and similar, targeted constraints on FOCI.

Companies operating under FOCI mitigation arrangements are also expected to implement a Technology Control Plan and to monitor visits and communication with the foreign investor and its affiliates (including other U.S. companies) to guard against unauthorized release of classified and export-controlled information and to ensure that the performance of classified contracts is not compromised by FOCI.

Foreign acquisitions of defense contractors are therefore possible -- and foreign investment in the U.S. defense sector is welcome and, in some cases, even encouraged -- but investments must address FOCI mitigation to meet U. S. Government approval and to allow the contractor to work on classified contracts and programs. This requires careful planning in the acquisition process.

\*(Chris Griner (cgriner@kayescholer.com), Farhad Jalinous (fjalinous@kayescholer.com), and Chris Brewster (cbrewster@kayescholer.com) are all members of the National Security Group at the global law firm Kaye Scholer LLP, resident in the Washington, D.C. office.)

# Aerospace and Defense Q4 2009 Transactions

Date Announced	Target	Buyers/Investors	Transaction Types	Deal Size (\$USDmm)	Domicile
<b>A&amp;D COMMERCIAL</b>					
12/21/2009	Global Aeronautica, LLC	Boeing Co. (NYSE:BA)	Merger/Acquisition	NA	D
12/16/2009	Bender Shipbuilding & Repair Co., Inc., Mobile Shipyard	VT Systems, Inc.	Merger/Acquisition	21	D
12/15/2009	Defense Solutions Holding, Inc.	Seaside 88, LP	Private Placement	NA	D
12/15/2009	Orion Propulsion, Inc.	Dynetics, Inc.	Merger/Acquisition	NA	D
12/09/2009	Clipper Windpower Plc	United Technologies Corp.	Private Placement	205.09	CB
12/02/2009	Dukes Inc.	TransDigm Group Incorporated	Merger/Acquisition	156.0	D
12/02/2009	Harbin Aerospace Company	Pinnacle Energy Corp.	Merger/Acquisition	1.96	D
11/30/2009	Lumexis Corporation	Perseus, L.L.C.; Zone Ventures Management Company, LLC; PAR Capital Management, Inc.	Private Placement	15.0	D
11/18/2009	CAVU Resources Inc.	-	Private Placement	5.0	D
11/16/2009	21st Century Airships Team Inc.	E-Green Technologies, Inc.	Merger/Acquisition	NA	CB
11/12/2009	Arnold Engineering, Inc.	Hammond, Kennedy, Whitney & Company Inc.	Merger/Acquisition	NA	D
11/04/2009	Triumph Group Inc.	-	Private Placement	172.48	D
10/31/2009	Herndon Products, Inc.	Thayer I Hidden Creek	Merger/Acquisition	NA	D
10/27/2009	Northstar Machine & Tool Co., Inc.	-	Private Placement	1.0	D
10/10/2009	Domestic Energy Corp.	The Avalon Group Limited	Merger/Acquisition	NA	F
<b>A&amp;D ELECTRONICS</b>					
12/21/2009	Skyquest Systems Limited	Curtiss-Wright Corp. (NYSE:CW)	Merger/Acquisition	16.07	CB
12/17/2009	Tactical Runflat Systems, Inc.	Defense Venture Group, Ltd.	Merger/Acquisition	NA	D
12/15/2009	Triton Imaging, Inc.	ECA SA	Merger/Acquisition	NA	F
12/14/2009	GenCorp Inc.	-	Private Placement	150.0	D
11/20/2009	Lasertel Inc.	Selex Sensors And Airborne Systems (Us) Inc.	Merger/Acquisition	10.0	D
11/16/2009	Atlantic Inertial Systems, Inc.	Goodrich Corp.	Merger/Acquisition	375.0	D
11/03/2009	Colt Defense LLC	-	Private Placement	246.48	D
10/19/2009	OmniTech Partners, Inc.	FLIR Systems, Inc.	Merger/Acquisition	42.0	D
10/15/2009	Wingspeed Corporation	AeroMechanical Services Ltd.	Merger/Acquisition	0.25	F
<b>A&amp;D INFORMATION TECHNOLOGY</b>					
12/30/2009	Master Solutions, LLC	Stinger Ghaffarian Technologies	Merger/Acquisition	NA	D
12/21/2009	ISO GROUP, Inc.	-	Private Placement	6.0	D
12/02/2009	Goodrich ISR Systems	EOS Defence Systems, Inc.	Merger/Acquisition	NA	D
12/02/2009	Optics 1, Inc.	Vectronix AG	Merger/Acquisition	NA	F
10/21/2009	Dukane Seacom, Inc.	HEICO Electronic Technologies Corp.	Merger/Acquisition	NA	D
10/19/2009	Scytale, Inc.	Ultra Electronics Holdings plc	Merger/Acquisition	9.3	F
10/01/2009	Veritas Analytics, Inc.	Camber Corporation	Merger/Acquisition	NA	D
<b>A&amp;D SERVICES</b>					
12/16/2009	Alcoa-SIE Cargo Conversions, LLC	Pemco World Air Services, Inc.	Merger/Acquisition	NA	D
12/14/2009	Sky Holding Company, LLC	Oaktree Capital Management, L.P.	Private Placement	500.0	D
11/24/2009	Air Routing Group, Inc.	Rockwell Collins Inc.	Merger/Acquisition	NA	D
11/23/2009	Naverus, Inc.	GE Aviation	Merger/Acquisition	NA	D
10/09/2009	Bio-Clean International, Inc.	-	Private Placement	0.3	D
10/01/2009	Pegasus Aircraft Maintenance, LLC	Akima Management Services, Inc.	Merger/Acquisition	NA	D

Source: Capital IQ

Legend: D = Domestic (US) Transaction, CB = US Investor acquiring abroad, F = Foreign investor acquiring in the US

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# Recently Closed Transactions

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HAS SECURED TERM AND WORKING CAPITAL FINANCING OF \$6,419,000 FROM



THE UNDERSIGNED INITIATED THIS TRANSACTION, ASSISTED IN THE NEGOTIATIONS, AND ACTED AS FINANCIAL ADVISOR TO NEXTEK, INC.



This announcement appears as a matter of record only




Has Been Acquired By



The Undersigned Initiated This Transaction, Assisted In The Negotiations And Acted As Financial Advisor to Newtek International, Inc.




This announcement appears as a matter of record only




Has Been Acquired By


**APSE Holdings, LLC**  
An Affiliate Of




And




The Undersigned Initiated This Transaction, Assisted In The Negotiations And Acted As Financial Advisor to Aerospace Products S.E., Inc.




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HAS ACQUIRED




THE UNDERSIGNED INITIATED THE TRANSACTION, ACTED AS FINANCIAL ADVISOR TO, AND ASSISTED WITH THE NEGOTIATIONS AS THE REPRESENTATIVE OF CAMBER CORPORATION




This announcement appears as a matter of record only



has acquired



We originated this transaction, acted as financial advisor to and assisted with the negotiations as the representative of Cambridge Systems, Inc.



This announcement appears as a matter of record only



has been recapitalized by

**ISLINGTON CAPITAL PARTNERS, LLC**

We initiated the transaction, acted as financial advisor to, and assisted with the negotiations as the representative of Library Systems and Services, LLC



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HAS BEEN SOLD TO




THE UNDERSIGNED INITIATED THIS TRANSACTION, ASSISTED IN THE NEGOTIATIONS, AND ACTED AS FINANCIAL ADVISOR TO AVIALEC INTERNATIONAL.




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HAS BEEN SOLD TO



THE UNDERSIGNED INITIATED THIS TRANSACTION, ASSISTED IN THE NEGOTIATIONS, AND ACTED AS FINANCIAL ADVISOR TO VERTEX SOLUTIONS.



“After 29 years of building a successful business, we were ready to retire and pursue personal interests. We wanted to put GeoCentral under the wing of a larger organization with the financial resources required to realize the opportunities of our strong brand and reputation in the industry. Given their proven M&A expertise, FOCUS was the ideal firm to help us find the best acquirer and negotiate excellent terms that met our expectations.”

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## FOCUS Government, Aerospace and Defense Team

### Manan K. Shah



*Partner and Government, Aerospace and Defense Team Leader, Washington, DC*  
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Manan K. Shah has over eighteen years of consulting, management and M&A advisory experience in the government, aerospace, defense, business process outsourcing, software and information technology sectors. Manan has represented numerous clients in the GAD sector ranging from multi billion dollar corporations to small minority owned companies.

### Eric Oganessoff



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Eric Oganessoff, during the past twenty-five years, has conducted over fifty M&A, debt and capital raise transactions in information technology, manufacturing, government contracting and wireless technologies. He received a White House appointment to NASA in 1983 and has served as the CEO or President of six companies.

### Paul K. Richey



*Regional Managing Director, Southwest, Los Angeles*  
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Paul Richey, a seasoned executive with more than 40 years in investment banking, has led M&A activities for privately held companies, several of which have annual revenues in excess of \$250 million.

### John Slater



*Partner, Memphis*  
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404-963-8255

John Slater, a M&A and capital raising veteran of twentythree years, has managed more than 200 M&A and capital raising transactions with aggregate values in excess of \$3 billion.

### Douglas E. Rodgers



*Chief Executive Officer, Washington, DC*  
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Douglas E. Rodgers, CEO and Managing Partner of FOCUS since early 2002, has executive level management experience in software, information technology, aerospace, e-commerce, real estate and construction, manufacturing and distribution, serving both commercial and government clients. Mr. Rodgers is an Airline Transport rated pilot with over 7,000 flight hours. He was educated at the US Air Force Academy and earned a BS in Aerospace Engineering at the University of Kansas.

### Gerald Turner



*Managing Director, Washington, DC*  
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Gerald Turner has over twenty-five years of executive level experience in a wide range of sectors including building and roofing materials, diverse financial services, and commercial data base management. He also is an entrepreneur and angel investor. Educated at Oxford University, Mr. Turner is Investment Director of Seraphim Capital, a London-based early stage venture capital fund.

### Bruce J. Holmes, D.E.



*Senior Advisor, Washington, DC*  
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Dr. Bruce J. Holmes, after 33 years with NASA, is a consultant to industry, government, and universities in strategy, technology, aviation systems development, and public-private partnerships. He is known domestically and internationally for his strategic leadership in the engineering and technological transformation in air transportation. Dr. Holmes is a commercial, multi-engine, Citation type-rated pilot with forty years of civil aviation experience.

### About FOCUS LLC

FOCUS, LLC provides a range of middle market investment banking services across the U.S. and internationally with an emphasis on mergers, acquisitions, divestitures and corporate finance. FOCUS specializes in businesses with transactions or revenues in the \$5-300 million range, serving entrepreneurs, corporate owners and various types of investors across a broad range of industries.

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