The Wall Street Perspective…

... and other rants from an interested observer

Presented to: 2015 NDIA Munitions Executive Summit
Parsippany, NJ
Topics for Discussion

What hasn’t changed since my remarks last year

What is new and potentially noteworthy

What we need to figure out for the future *(at least some of the things!)*
Topics for Discussion

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What we need to figure out for the future (*at least some of the things!*
I will still talk out of both sides of my mouth

“On the one hand...”

“On the other...”

... because you have to when talking about the financial community and its intersection with the defense sector
“Wall Street” is Still Part of Our Everyday Life

**Banks**
- Investment Banks
- Commercial Banks
- Federal Reserve

**Rule Makers**
- Exchanges
- Regulators

**Info Sources**
- Analysts & Advisors
- Credit Agencies

**Investors**
- Hedge Funds
- Private Equity
- Institutional
- Individuals
... and It Affects Contractors in Multiple Ways

- **Direct impacts:**
  - Provides capital (e.g., working capital loans, equity, senior debt, bonds, etc.)
  - Creates incentives and reward system (e.g., part of comp package, pension)
  - Sets price of capital (e.g., share price, interest rate, covenants, etc.)
  - Shapes perception of a supplier’s value (e.g., buy/sell recommendations)
  - Change agent (e.g., mechanism for owner exit/entry, activist shareholders, etc.)

- **Indirect impacts:**
  - Influences size of DoD budget (e.g., interest rates ↑ on USG debt, DoD $$ ↓)
  - Creates context to compare (e.g., defense sector against other areas to invest)
  - Creates a “rule set” (e.g., drives accountability among buyers and sellers)
  - Many others....
DoD Needs to Understand Wall St. Too Because it Impacts all Stakeholders Shaping the Industrial Base

“Why should I care?”

Wall Street

Owners

Management & Board of Directors

Politicians

Regulators

Employees

Taxpayers

Owners

Management & Board of Directors

Democrats
Wall St. Still Doesn’t Really Care About the Sector...
... it Only Cares About the Ability to Make Money
Wall Street Continues to Ignore DoD Budget Trends....

Strong Defense Firm Share Price Performance Despite Shrinking Budget

Defense Company shares outperformed the general economy despite Sequestration!

Source: FactSet, 20-day moving averages

Defense Primes: GD, LLL, LMT, NOC, and RTN

Defense Mid-Tier: COL, CUB, FLIR, HRS, Ktos, MRCY, TDY, and XLS
...and Instead Focuses on Following the Money


(Light & Dark Blue indicates Cash Returned to Shareholders)

- Decrease Net Debt
- Other (Uses)
- Acquisitions
- Capex
- IRAD
- Share Buybacks
- Dividends

<table>
<thead>
<tr>
<th>Prime</th>
<th>IRAD as % of revenues</th>
<th>Net Debt/LTM EBITDA</th>
</tr>
</thead>
<tbody>
<tr>
<td>FNC</td>
<td>5.2%</td>
<td>5.6x</td>
</tr>
<tr>
<td>AIR</td>
<td>5.5%</td>
<td>(0.1x)</td>
</tr>
<tr>
<td>HO</td>
<td>4.8%</td>
<td>(0.1x)</td>
</tr>
<tr>
<td>BA</td>
<td>3.8%</td>
<td>(0.1x)</td>
</tr>
<tr>
<td>GD</td>
<td>1.1%</td>
<td>(0.3x)</td>
</tr>
<tr>
<td>LLL</td>
<td>2.0%</td>
<td>2.6x</td>
</tr>
<tr>
<td>LMT</td>
<td>1.4%</td>
<td>0.5x</td>
</tr>
<tr>
<td>RTN</td>
<td>1.9%</td>
<td>0.2x</td>
</tr>
<tr>
<td>LDOS</td>
<td>0.6%</td>
<td>1.9x</td>
</tr>
<tr>
<td>BAE</td>
<td>1.0%</td>
<td>0.6x</td>
</tr>
<tr>
<td>NOC</td>
<td>2.0%</td>
<td>0.7x</td>
</tr>
</tbody>
</table>

Investing or improving margins or balance sheet

Returning cash to shareholders

Net Debt/LTM EBITDA

(0.1x) to (0.3x)

Renaissance Strategic Advisors
Topics for Discussion

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What we need to figure out for the future (at least some of the things!)
On a Personal Level, I Invested in the Munitions Sector...

... and it is a blast!!!

(I don’t think I am making any $$$ on this investment and this fact clearly doesn’t fall into the “Noteworthy” category I said I’d talk about)
We See the Nature of the Conversation Changing in Corporate Boardrooms ...

**Context**
- Ability to Cut Costs Decreasing
- Shareprices at Historic Highs, Downward Bias
- Y-o-Y Financial Metrics Harder to Beat with Same Strategy

**Implications**
- Profitability growth becomes more challenging
- Share prices stagnate
- Corporate leadership focus shifts from returning case to fundamentals (invest in firm)

**Outcomes**
- Pursuit of Smaller M&A (acquisitions & divestitures)
- Small Increases in IRAD / CAPEX Spending
- ‘Needle-Mover’ Sized Acquisitions

“Easier” to position with shareholders
“Harder” but more valuable
... And Greater Use of Cash for M&A Being Rewarded

Recent Transactions Over $1B in Enterprise Value*

<table>
<thead>
<tr>
<th>Announced</th>
<th>Acquirer</th>
<th>Target</th>
<th>Target EV as % of Acquirers EV</th>
<th>Stock Price 5 Day Reaction</th>
</tr>
</thead>
<tbody>
<tr>
<td>Feb 2015</td>
<td>Harris</td>
<td>Exelis</td>
<td>55%</td>
<td>10.2% ↑</td>
</tr>
<tr>
<td>Oct 2014</td>
<td>Engility</td>
<td>TASC</td>
<td>125%</td>
<td>15.4% ↑</td>
</tr>
<tr>
<td>July 2014</td>
<td>AECOM</td>
<td>URS</td>
<td>136%</td>
<td>11.5% ↑</td>
</tr>
<tr>
<td>April 2014</td>
<td>Orbital</td>
<td>ATK</td>
<td>237%</td>
<td>7.5% ↑</td>
</tr>
</tbody>
</table>

Is Wall Street telling suppliers to “go big & go early” in terms of restructuring now that the budget has bottomed out?

* Enterprise Value = market capitalization + net debt
Also, the World Reminded Us Yet Again That Freedom isn’t Free...

... and that the most committed actor in the neighborhood with the biggest and most guns usually gets what they want
Thus, DoD Wants to Allocate More to High End Threats

“Third Offset” Strategy as an Example

- “3rd Offset” follows the “1st Offset New Look” strategy under Eisenhower and the late 1970s “2nd Offset strategy based on PGM/stealth/ISR

- DoD organizing concept for a sustained effort to create decisive advantage via:
  - Adoption of innovative technology
  - New operational concepts
  - Take advantage of enduring US advantages in technology generation

- Built around a “Global Surveillance & Strike” network relying on US leadership in:
  - Unmanned Operations
  - Long Range / Low Observable Air Ops
  - Undersea Operations
  - Complex Systems & Engineering

Investors may find this focus “sexy”, but how should “dull & dirty” munitions suppliers play this DoD trend?
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We Have to Leverage Commercial R&D Spending Better

Eight US Tech Firms R&D Expenses versus DoD RDT&E Funding ($B)

- **Facebook**: $1 in 2012, $3 in 2013, $5 in 2014
- **Oracle**: $5 in 2012, $5 in 2013, $5 in 2014
- **Apple**: $3 in 2012, $6 in 2013, $7 in 2014
- **IBM**: $6 in 2012, $6 in 2013, $7 in 2014
- **Amazon**: $5 in 2012, $9 in 2013, $9 in 2014
- **Google**: $6 in 2012, $10 in 2013, $10 in 2014
- **Intel**: $10 in 2012, $10 in 2013, $11 in 2014
- **Microsoft**: $10 in 2012, $11 in 2013, $11 in 2014

**8 US Tech Firms**
- **2014 Spend ($B)**: $46
- **3 year CAGR**: -7%

**DoD**
- **2014 Spend ($B)**: $72
- **3 year CAGR**: 16%

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How does a niche but critical sector like munitions do this?
Need to Manage “Holistically” Over Next 5 – 10 Years

Decisions necessary about long term role it will play in a potentially smaller but more innovative supplier base

Organic USG Industrial Base  Large Diversified Businesses  Small Businesses

Growing in relative importance to supply chain, but how best to nurture and sustain if taking permanent share from Large Businesses

Wall Street influences may shape behavior in near term …

…. that could create exit and/or consolidation which might generate long term supply problems for DoD

Who will be the steward of the DoD / Industry Munitions Enterprise as these decisions are made during the transition from the Obama Administration to a new one?
Thank you