

8 April 2015

# The Wall Street Perspective...

*... and other rants from an interested observer*

*Presented to:*            **2015 NDIA Munitions Executive Summit**  
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# 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!)***

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# I will still talk out of both sides of my mouth

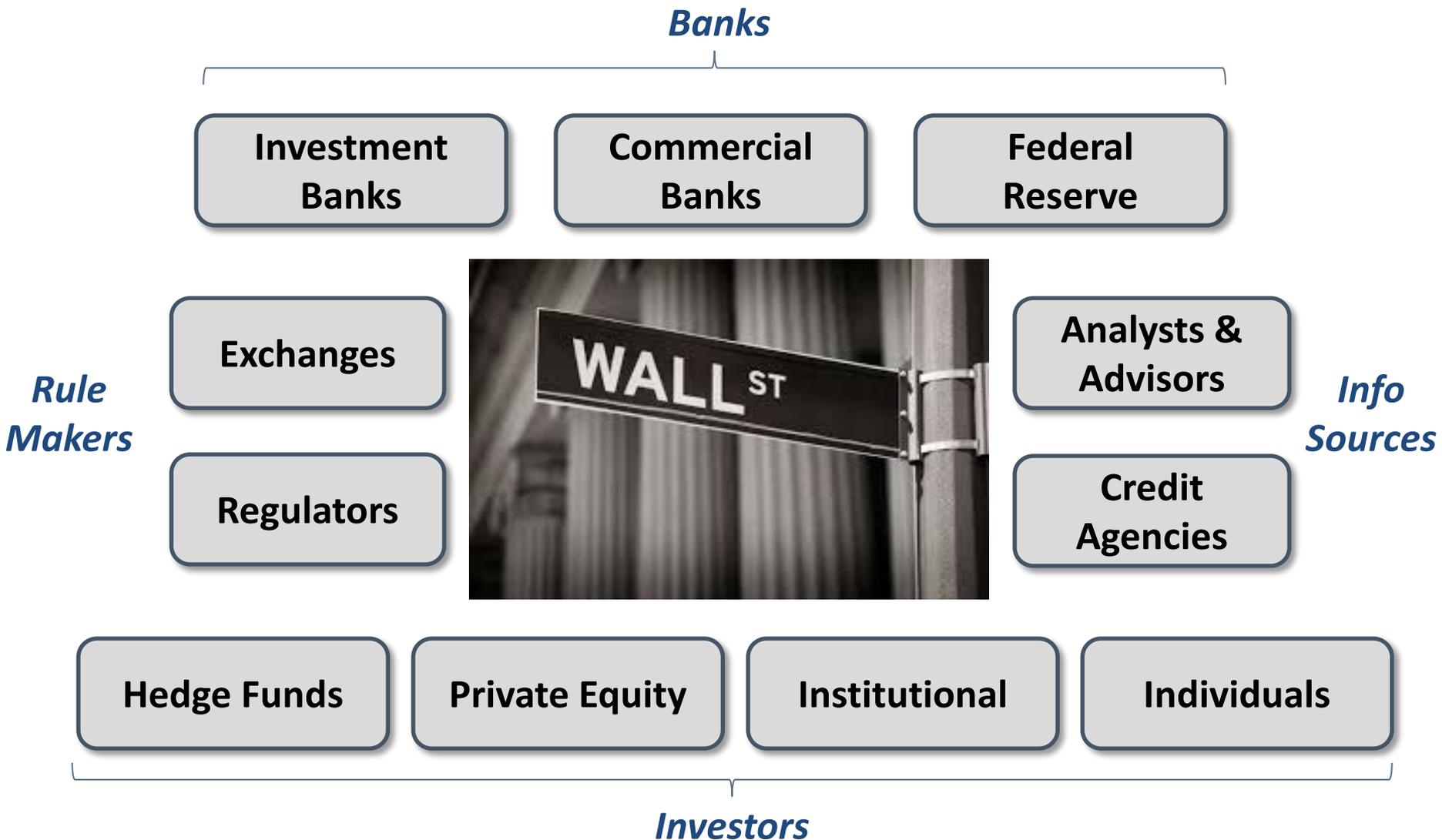
“On the one hand...”



“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 ...



# ... and It Affects Contractors in Multiple Ways

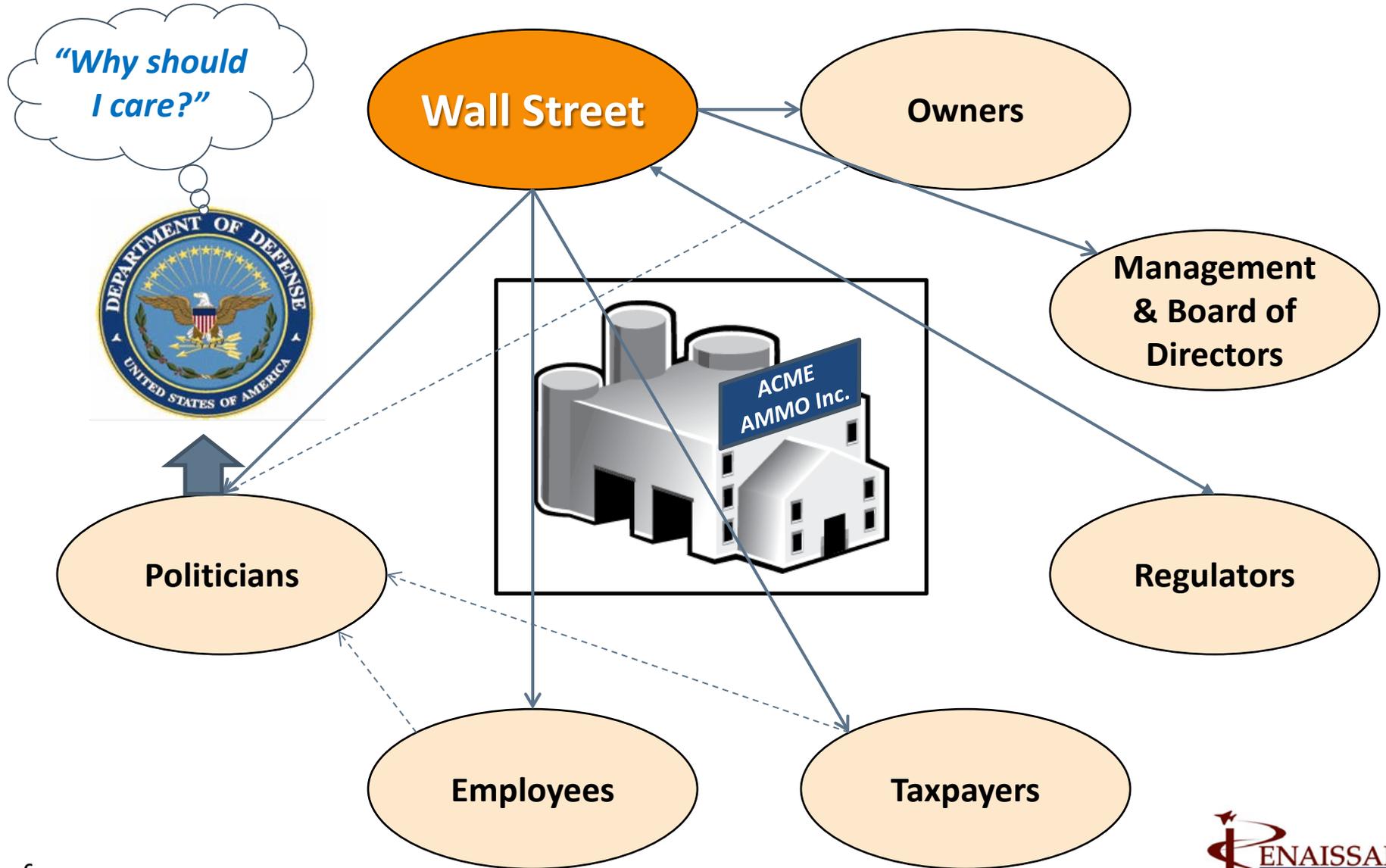
- **Direct impacts:**

- **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.)

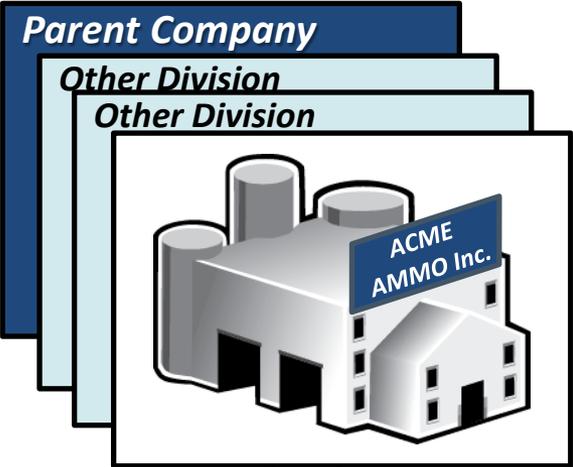
- **Indirect impacts:**

- **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



# Wall St. Still Doesn't Really Care About the Sector...

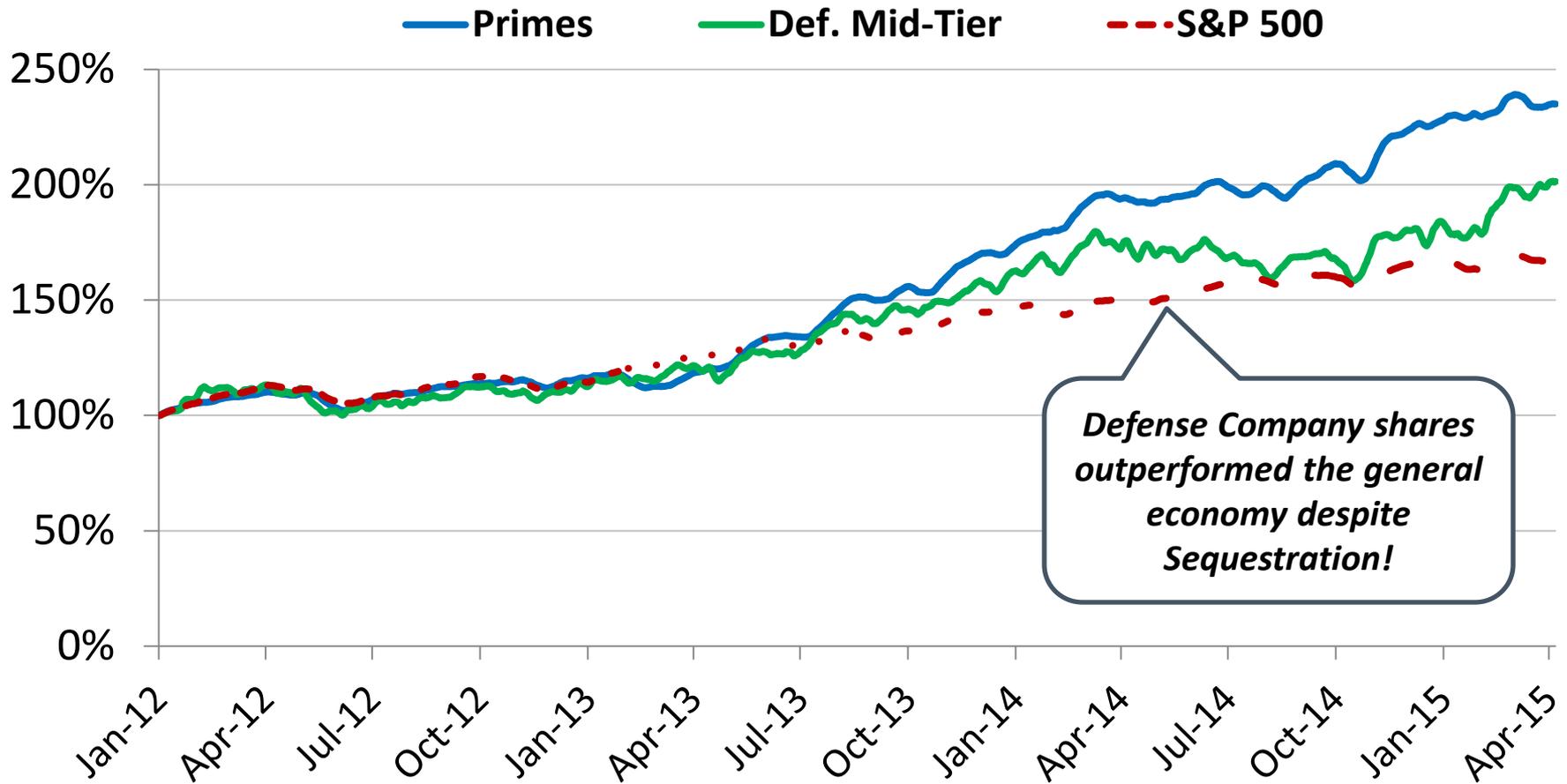


**... it Only Cares About the Ability to Make Money**



# Wall Street Continues to Ignore DoD Budget Trends....

## Strong Defense Firm Share Price Performance Despite Shrinking Budget



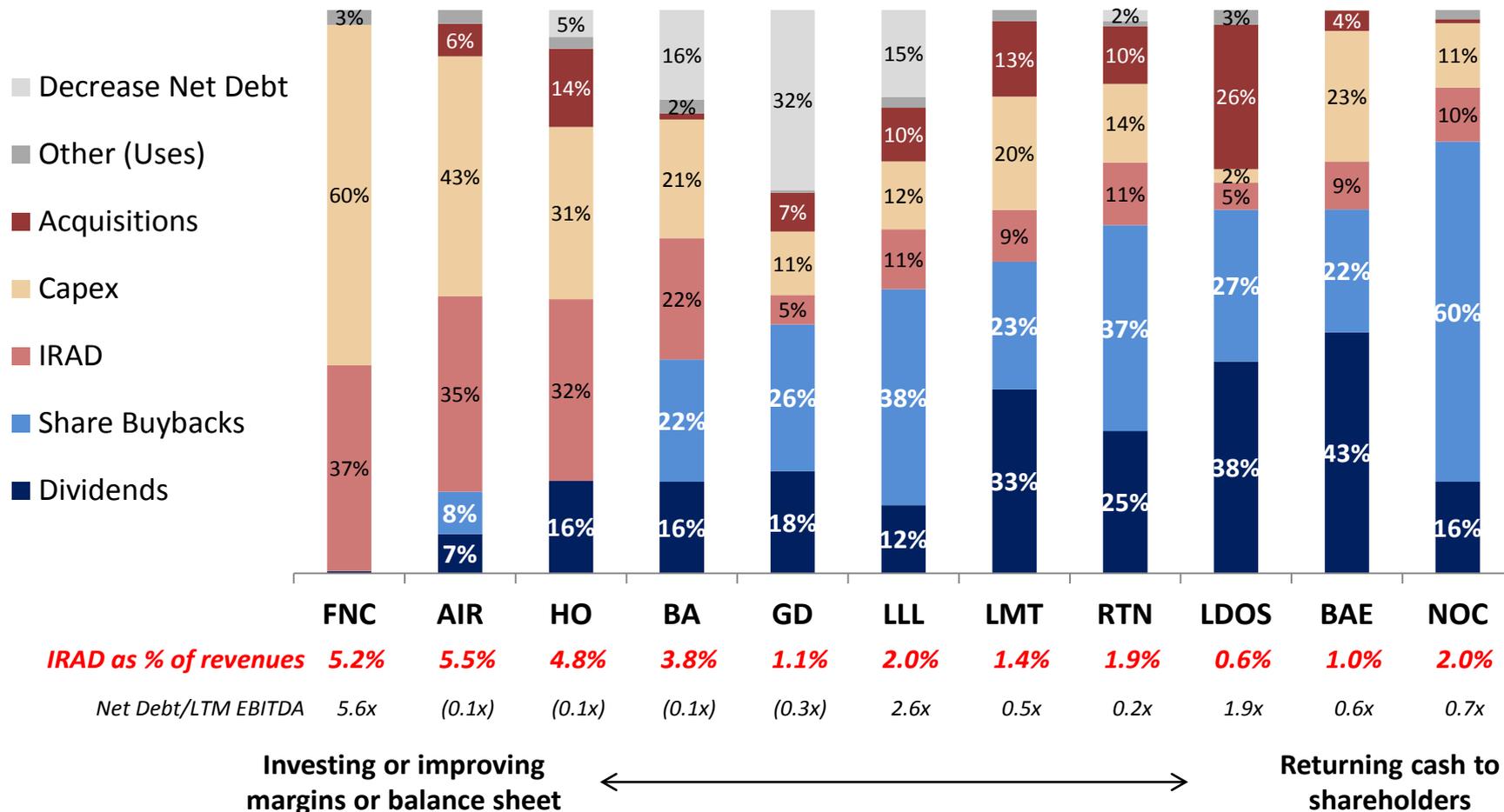
Source: FactSet, 20-day moving averages

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

Allocation of Total Cash Generated by 11 Global Defense Primes 2012 – 2014  
*(Light & Dark Blue indicates Cash Returned to Shareholders)*



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# 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\*

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

**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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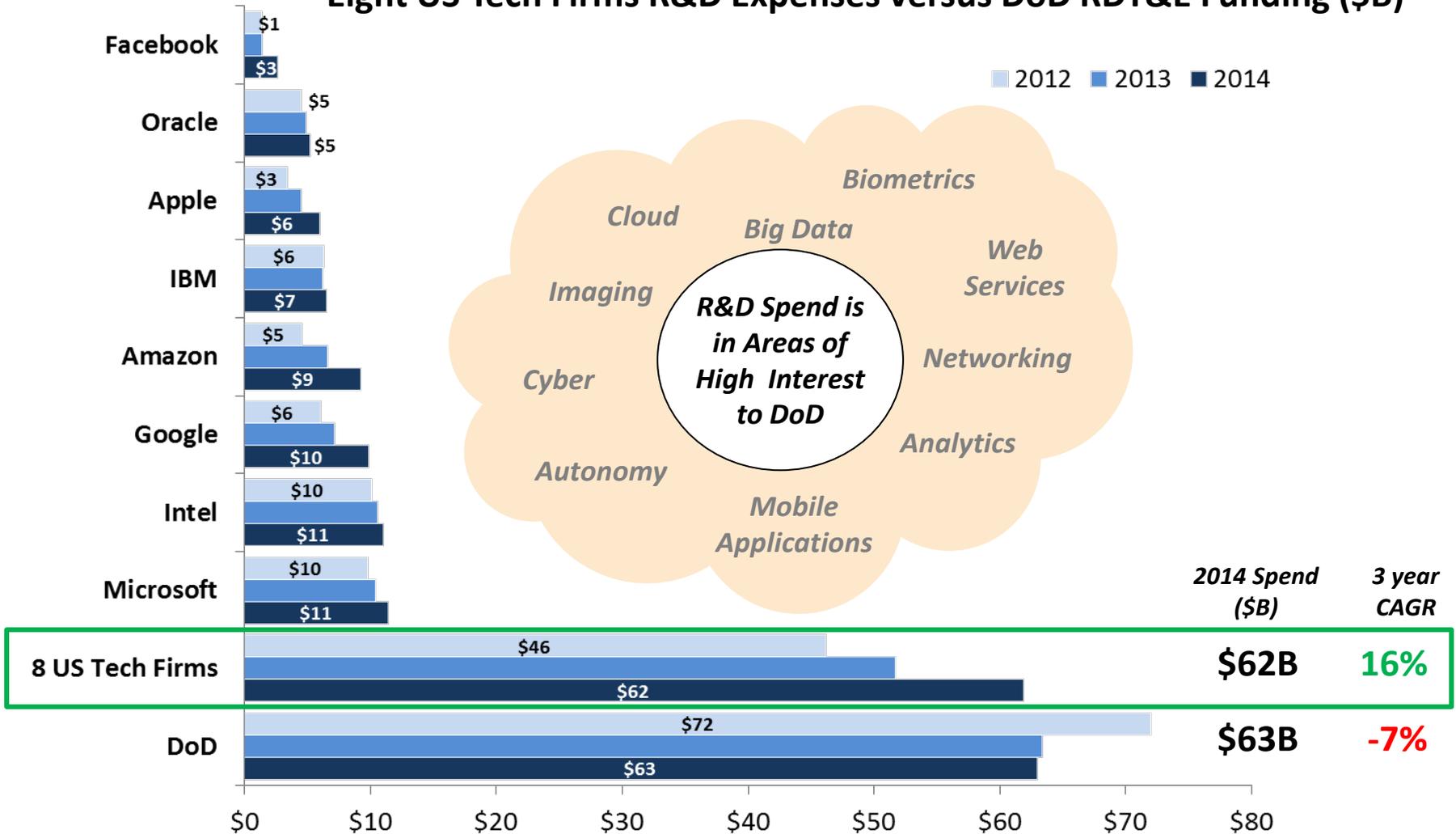
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# We Have to Leverage Commercial R&D Spending Better

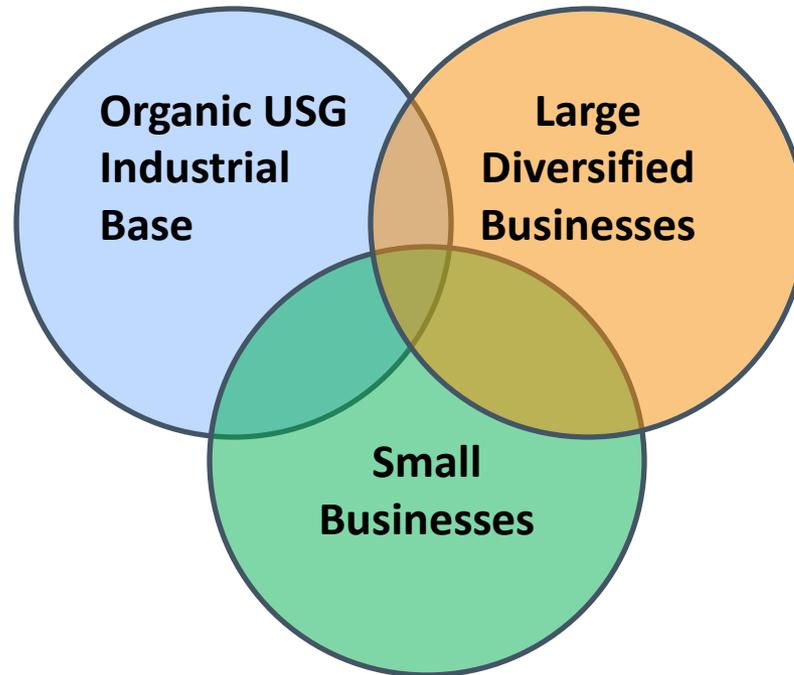
Eight US Tech Firms R&D Expenses versus DoD RDT&E Funding (\$B)



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



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

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

**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**