“Wall Street” Perspective

Presented to: 2019 Munitions Executive Summit
Parsippany, NJ
Topics to Discuss

Wall St. ... what is it and why should we care?

The Defense sector and munitions segment through Wall St’s eyes

Quick look back to see if we can learn from past predictions

What should a supplier (and also DOD) take away from this?
Topics to Discuss

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What should a supplier (and also DOD) take away from this?
“Wall St.” is many things, people and places in the US...

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

**Rule & Market Makers**
- Exchanges (e.g., NASDAQ, NYSE, etc.)
- Regulators

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

**Investors**
- Hedge Funds
- Private Equity
- Institutional
- Individuals
... but there are many Wall St.’s, all interconnected and trading trillions of $$ each day using AI and analytics.

China: Shanghai Exchange

England: the “City”

Germany: Frankfurt BÖRSE

Japan: Tokyo
Wall St. is a key stakeholder in industry and DoD...
... that influences the Munitions sector every day

- Directly...
  - 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.)

- Indirectly...
  - Influences size of budgets
  - 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)
  - ... and many more
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What should a supplier (and also DOD) take away from this?
First, “defense” is small scale by Wall St. standards.
Second, defense companies don’t move the market

S&P 500 Market Cap, ~$25,000B

Defense Top 10 Market Cap, ~$714B (~3% of S&P 500)

Not: image not to scale; S&P 500 % allocation by industry is based on the index’s industry average
Sources: S&P 500, RSAdvisors research and analysis
Third, most ordnance & munitions businesses don’t move the needle for their own Companies
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I have spoken to you in 2014, 2015 and 2017... what did I get right / wrong and what can we learn from it?

Highly Plausible Scenario for DoD Total Budget Authority

DoD “Breaking” under O&S, reset, fixed & organic infrastructure costs;
Contractor Cash Flows at Low Point, can’t cut more costs;
Wall St. gets “activist” and kills off weak contractors
I have spoken to you in 2014, 2015 and 2017… what did I get right / wrong and what can we learn from it?

Companies Are Being Rewarded for Using Cash for M&A  
(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>
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<tbody>
<tr>
<td>Feb 2015</td>
<td>Harris</td>
<td>Exelis</td>
<td>55%</td>
<td>10.2% ↑</td>
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<td>Oct 2014</td>
<td>Engility</td>
<td>TASC</td>
<td>125%</td>
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<td>ATK</td>
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Is Wall Street telling suppliers to “go big & go early” in terms of restructuring now that the budget has bottomed out?
I have spoken to you in 2014, 2015 and 2017… what did I get right / wrong and what can we learn from it?

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...the pattern general has held true, but to a lesser degree

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<td>L-3</td>
<td>Harris</td>
<td>122%</td>
<td>9.9% ↑</td>
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<tr>
<td>Sept 2018</td>
<td>SAIC</td>
<td>Engility</td>
<td>45%</td>
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<tr>
<td>Feb 2018</td>
<td>GD</td>
<td>CSRA</td>
<td>13%</td>
<td>7.0% ↑</td>
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<tr>
<td>Sept 2017</td>
<td>Northrop</td>
<td>Orbital ATK</td>
<td>18%</td>
<td>2.0% ↑</td>
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We noted valuation patterns can be counterintuitive...

Strong DoD budget and company revenue growth ...  
... but flat to declining share valuation metrics

“Normal” expected relationship b/w budget, sales & price

Declining DoD budget and corporate revenue growth ...  
... yet investors are willing to pay higher premiums to buy shares
...but actually appear to predict of future trends...

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**Observation Made at 2017 MES**

**DoD Budget - Forward 3-Year CAGR**

- EV/EBITDA Primes Trading Multiple

- **3 yr DoD budget forecast was flat, so multiples stayed flat...**

- **... and as DoD budgets were projected to grow, investors were willing to pay more for shares...**

**EV / EBITDA vs. 10-Year Average**

- Post-Election Impact

- **Primes**
  - (+1.2x)
  - (+4.9x)

- **Defense Mid-Tier**
  - (+1.7x)
  - (+3.8x)

- **Gov’t Services**
  - (+0.3x)
  - (+3.0x)

**... but is Wall St. going to be disappointed with reality of DoD budgets?**
... which if true, tells us that budgets will be flattening

Observation Made at 2017 MES

**Strong DoD budget and company sales growth ...**
**... but flat to declining share valuation metrics**

Valuation Multiples Drop by >15%

Sustained DoD budget growth...but investor uneasiness with shutdowns, deficits

Declining DoD budget and corporate revenue growth ...
**... yet investors are willing to pay higher premiums to buy shares**
What does this look back tell us?
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What should a supplier (and also DOD) take away from this?
So what is my overall message to you about Wall St.?

• For Suppliers…
  – **Publicly-Traded**: be mindful of the financial community, but realize that you likely won’t be singled-out as a driver of share price unless they stand-out negatively
  – **Small Private Companies**: focus on availability of capital and interest rates and how they respond to broader market trends
  – **All Companies**: Focus on managing **three factors** to avoid standing-out negatively
    ▪ **Cash**
      » Be very efficient and a strong contributor to the total company’s free cash flow / ROIC
    ▪ **CAPEX**
      » Invest as needed, but avoid being “drain” on parent, seek to gain customer funding if possible
    ▪ **Capability**
      » Success will be based on Capacity, Quality and Performance

• For DoD…
  – Understand the financial incentives and market forces your supplier partners face
  – Continue to use creative acquisition strategies (e.g., OTA) when appropriate, but be mindful that consistency of message and funding is most helpful
One last thing...

These are three types of US Government Spending... anybody guess what they are? Is this a good slide or scary slide?

Forecast

‘19-29 CAGR: 5.5%

‘19-29 CAGR: 1.4%

‘19-29 CAGR: 9.3%
If we as a country can’t control this, Wall St. and its global peers will do it for us... and we will regret it.

Forecast

- '19-29 CAGR: 5.5%
- '19-29 CAGR: 1.4%
- '19-29 CAGR: 9.3%

Will drive large deficit increases at projected GDP growth rates.

USG ability to decide how to spend will get crowded out.

Approaching historic high and will exceed DoD budget.