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Aerospace & Defense 2012 Industry Outlook Survey:

Anticipating Consolidation. Targeting M&A.

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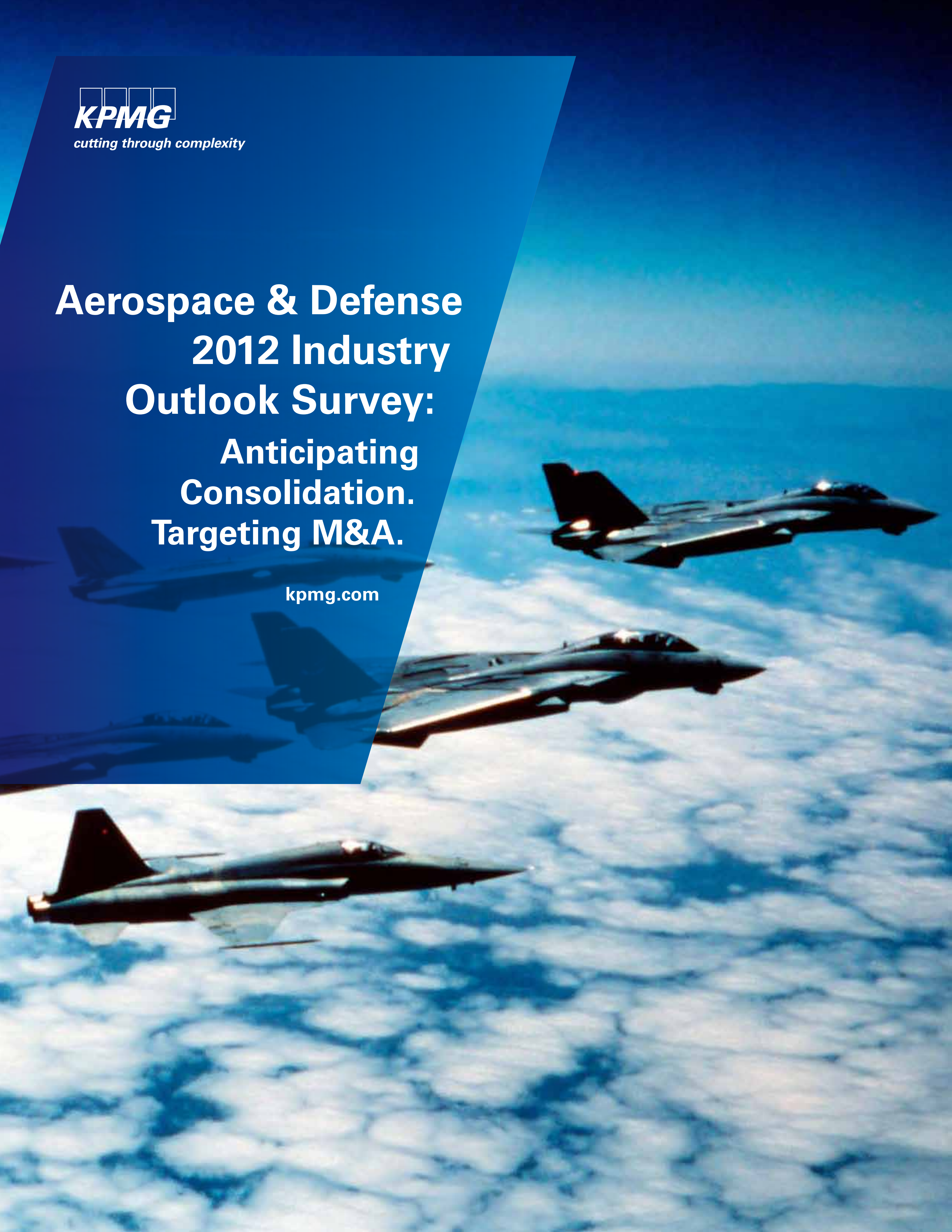

KPMG's Industry Outlook Survey

KPMG LLP (KPMG), the audit, tax and advisory firm, surveyed more than 100 C-suite and other top-level executives in the aerospace and defense (A&D) industry during the second quarter of 2012.

Participants were asked about business conditions in their sector, the most significant revenue growth opportunities, and any barriers to growth that may exist. They were also asked a variety of questions about the economy, including factors they perceive might impede or support their sector's recovery as well as the impact of regulatory reform on their businesses and potential areas of investment.

These responses were compared to the findings of a similar survey conducted among executives in the second quarter of 2011.

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Foreword

I am pleased to present KPMG LLP's 2012 Aerospace & Defense Industry Executive Outlook Survey, which provides candid perspectives and insights from more than 100 CEOs and other C-level executives in the aerospace and defense (A&D) sector.

Defense contractors are facing unprecedented times. Despite having significant cash on their balance sheets and hundreds of billions of dollars in defense contracts, the possibility of sequestration budget cuts is casting a dark cloud over the industry not seen since the end of World War II. One hears it in recent earnings calls as company executives seek to manage stakeholder expectations by issuing warnings of a dim future for A&D.

The way we see it, there's a day of reckoning coming, and many A&D executives are telling us that this may spur an industry response similar to what drove major industry consolidation in the 1980s and 1990s, or perhaps an even more dramatic response. Accordingly, executives say they are ready to aggressively pursue strategic acquisitions. In fact, nearly three-quarters of the executives surveyed believe their company will be involved in a merger or acquisition over the next two years. Additionally, they are looking to new product development, but the real question is, are they directing their efforts toward "traditional market" product development for projects that may be eliminated because of cuts in defense spending, or are they looking to leverage their product development into new adjacent markets?

While the majority of respondents have indicated that they expect increases in revenues and headcount, we think their expectations may be overstated. The sequestration issue has escalated since this survey took place, and the A&D landscape has become more unsettled. Coming off $500 billion in budget cuts last year, the industry faces the potential of yet another $500 billion in cuts, and has already begun cost cutting and reducing headcount. One A&D industry study estimates one million American jobs would be at risk if cuts to defense reach $1 trillion[1].

If the picture looks grim in the United States, the next logical question is whether the solution lies off shore. While the international marketplace is still important to executives, given the declines in the budgets of developed markets and the less-than-expected foreign military sales from high-growth markets, respondents are not seeing foreign markets as the obvious solution for near-term growth. In the current climate, the primary focus is on growing inorganically, according to respondents. The mindset appears to be, "Better to gamble in your own backyard."

On behalf of KPMG, I would like to thank those who participated in this survey and hope the findings are useful to you in addressing market challenges and opportunities. I hope you agree that the value in gaining insight into the strategies and competitive priorities of your peers cannot be overestimated. I also welcome the chance to discuss this study and its implications for your business in what promises to be a milestone year ahead.

Marty Phillips
Global Sector Leader, Aerospace and Defense
KPMG LLP

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[1] http://www.prnewswire.com/news-releases/analysis-projects-one-million-jobs-at-risk-from-defense-cuts-132545243.html

Key Findings from KPMG's Aerospace & Defense Industry Survey

Companies must find a way to break through to new customers and markets, which in many cases will be possible only through partnerships, joint ventures, or pure acquisitions. In this era of continued belt tightening, we also must not ignore just how attractive some of our domestic assets look to foreign investors, especially as A&D companies look to divest from underperforming assets.

Doug Gates, KPMG LLP

KPMG's survey reflects the responses of more than 100 A&D sector executives from large, U.S.-based companies with $100 million+ annual revenues. More than one-third of respondents (39 percent) worked for companies with annual revenues of more than $10 billion, while 38 percent represented companies with annual revenues between $1 billion and $10 billion, and 23 percent with revenues in the $100 million to $1 billion range. Eighty percent of these companies are publicly held and 20 percent are privately held.

Key findings from the A&D sector survey include:

- Nearly three-quarters (72 percent) of A&D executives expect their companies will be involved in a merger or acquisition during the next two years.
- Survey respondents believe acquisitions/joint ventures (50 percent), new product development (50 percent), and international expansion into new geographies (40 percent) will serve as the top drivers of revenue growth over the next three years.
- Sixty-four percent of survey respondents report having significant cash on their balance sheet. Of that number, 31 percent acknowledge new investment is already significantly underway. Top investment priorities cited by executives include business acquisitions (49 percent), new products and services (42 percent), and R&D (41 percent) over the next year.
- Forty-five percent of A&D executives surveyed said their company's revenue has increased over the last year, and 62 percent predict continued revenue growth a year from now.
- Just 15 percent of A&D executives said their company currently derives more than 40 percent of revenue from non-U.S. operations or customers. However, looking ahead to the next 1–3 years, this number increases five percentage points to 20 percent.
- When asked about their expectations for the U.S. economy a year from now, 62 percent of sector executives expect some improvement, while 28 percent believe it will essentially remain the same. Long term, however, 54 percent believe a substantial economic recovery will not occur until 2014–2015 or later.

Driving Sector Growth through M&A

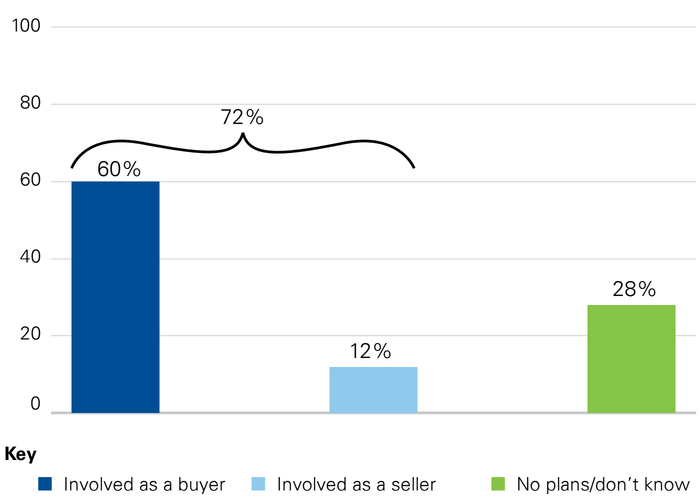
Over the next two years, A&D executives are betting on aggressive mergers and acquisitions strategies to help drive growth in their sector, which has been increasingly challenged by sluggish economic conditions, looming budget cuts, and increased competition. With many companies ready to spend the significant cash that has built up on their balance sheets, executives see investments in M&A and new products and services as top priorities over the next year. Executives say they are also focused on international growth, continuing to list it among key growth strategies for the future. Meanwhile, executives expect to rely on providing high-quality products and services, strengthening customer relationships, and increasing innovation to help gain competitive advantage. Overall, executives expect modest gains in revenues and hiring over the next year, but are less optimistic in the long term, predicting a substantial economic recovery will not occur until 2014 or later.

Aggressively pursuing M&A

Armed with significant cash on their balance sheets, and faced with federal defense budget cuts, A&D executives cite strategic acquisitions as the highest-priority investment area to spur company growth.

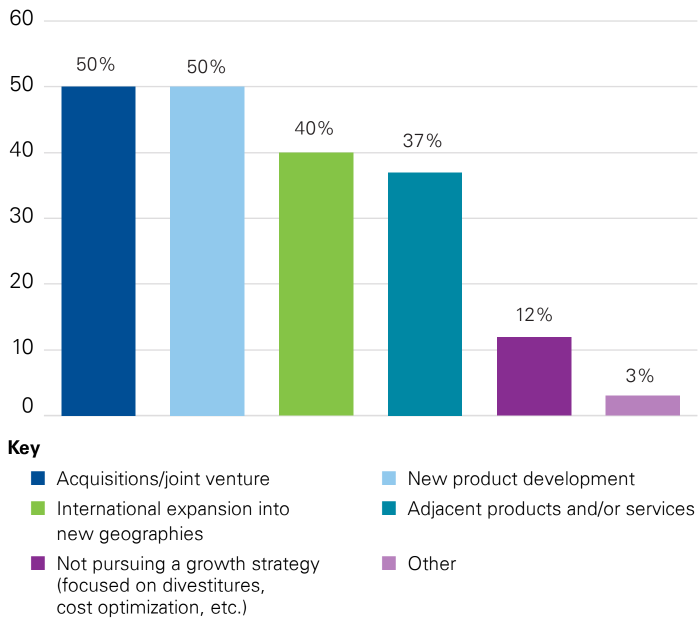
Nearly three-quarters (72 percent) of survey respondents predict that their companies will be involved in a merger or acquisition in the next two years, and a full 60 percent expect to be in the role of buyer.

Likelihood of M&A activity



In fact, strategic acquisitions and joint ventures are at the heart of driving revenue growth in the A&D sector. Survey respondents cite acquisitions/joint ventures (50 percent) and new product development (50 percent) as their company's top revenue growth drivers during the next three years, followed by international expansion (40 percent).

Biggest drivers of company's revenue growth: next 1–3 years



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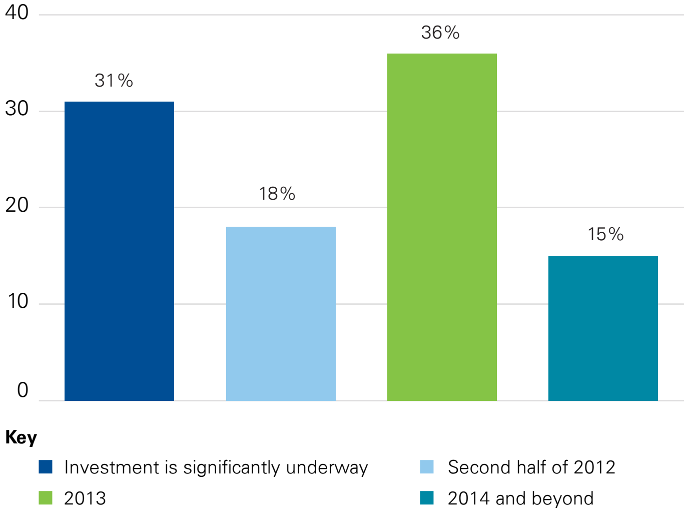
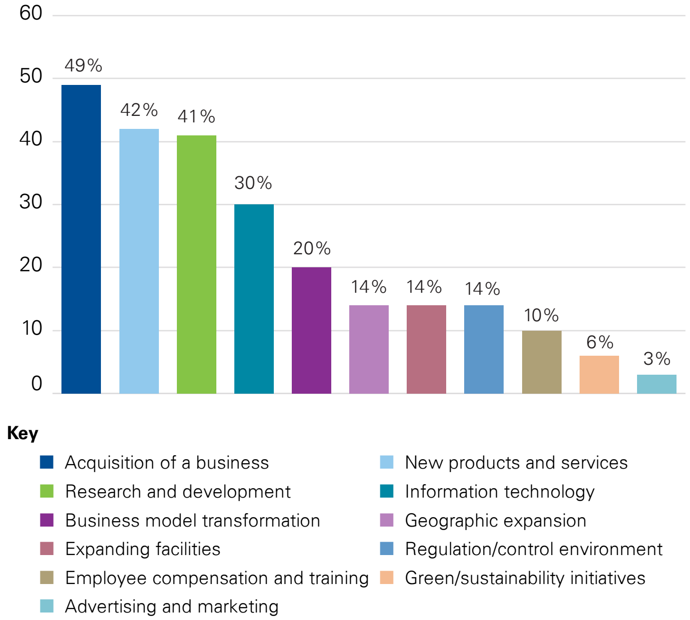
Sixty four percent of A&D executives indicate that their companies have significant cash on their balance sheets, of which 31 percent acknowledge that investment is significantly underway.

Investment time frame



More than half (53 percent) say they will increase capital spending over the next year. Much of this spending is expected to be attributed to M&A activity (49 percent), followed by new products and services (42 percent), and for research and development (41 percent) purposes.

Areas of increased spending over the next year



Multiple responses allowed.

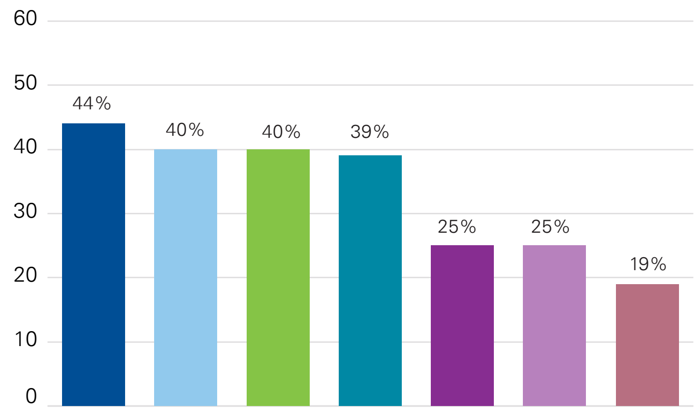
U.S. government contracts are dwindling, companies are becoming more global, and foreign investors are looking to move into the "non-government" A&D sector. All of these factors set the stage for much more aggressive M&A, product strategies and international growth initiatives.

Terry Yeh, KPMG LLP

Seeking Competitive Advantage

When it comes to gaining competitive advantage in the A&D industry, innovation/new products and services (44 percent) top the list of factors, according to A&D executives. Price competitiveness (40 percent) and customer relationships (40 percent) are also noted as key components toward achieving a competitive advantage.

Competitive advantage in today's marketplace



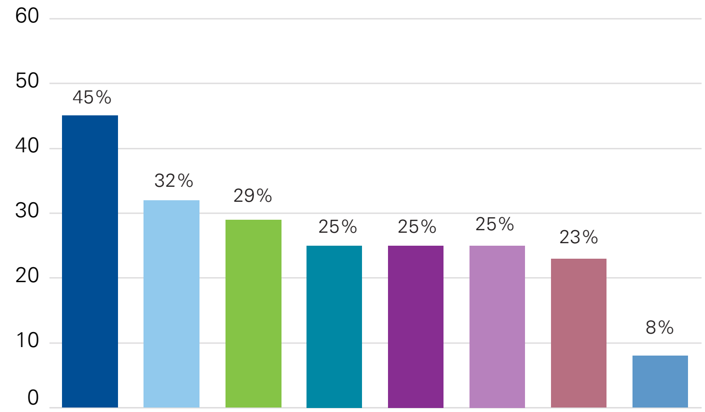
Key

- Innovation/new products and services
- Price competitiveness
- Customer relationships
- Quality of product and service delivery
- Cost management
- Product uniqueness
- Strength of supply chain

Multiple responses allowed.

Meanwhile, total product costs (45 percent), along with innovation and the ability to keep ahead of market trends (32 percent), are highlighted as posing the greatest limitations on gaining an advantage over the competition.

Constraints to achieving a competitive advantage



Key

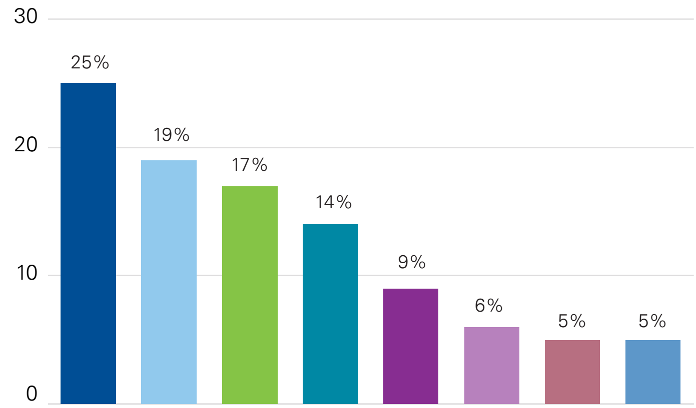
- Total product costs
- Innovation and the ability to keep ahead of market trends
- Customer-facing challenges (sales and marketing)
- Company structure and alignment
- Supplier base or capabilities
- Workforce skills and experience
- Underperforming business units
- Back-office costs

Multiple responses allowed.

Initiatives Garnering Attention

Asked about the top initiatives on the mind of management, one quarter of survey respondents cite the need to improve operational processes and related technology.

Top initiatives on the mind of management



Key

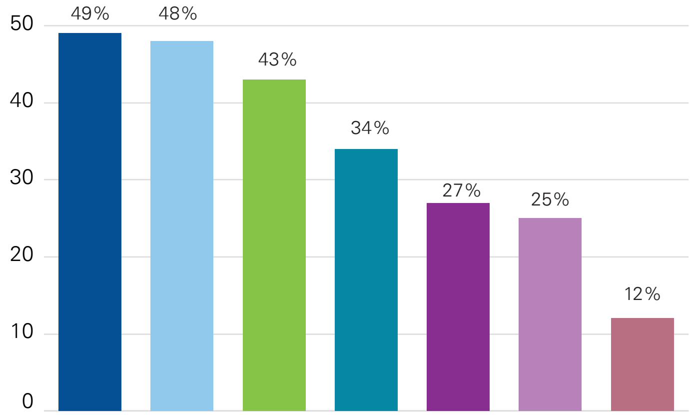
- Significant improvement of operational processes and related technology
- Significant cost reduction initiatives
- Merger/acquisition
- Significant investment in organic growth[2]
- Significant changes in business model
- Strategic divestiture of current assets
- Navigating significant changes in the regulatory environment
- Improve enterprise risk management programs/processes

[2] i.e., new product development, pricing strategies, geographic expansion

Adapting to Changing Conditions

Nearly half (49 percent) of respondents cite federal defense budget pressures as a leading factor in changing their business strategies. Other key factors include competitive pressures (48 percent) and customer/pricing pressures (43 percent).

Factors driving changes in business strategies



Key

- Federal defense budget pressures
- Competitive pressures[3]
- Customer/pricing pressures
- New market opportunities
- Underperforming business units
- Increased transfer of risk from the government to contractors[4]
- Other economic factors

Multiple responses allowed.

[3] i.e., competitors adopting a "grow or die" philosophy in a declining defense budget market

[4] i.e., U.S. government's move to reduce use of cost-plus contracts

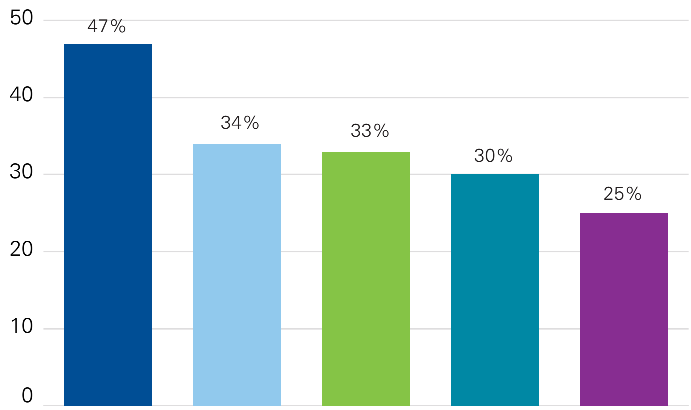
With increasing pressure on defense budgets globally, it is clear that achieving top-line growth only through organic means is going to be a challenge. Companies need to brace themselves for this reality and aggressively look to managing costs to protect their bottom line margins.

Phil Schimmel

Adapting to Changing Conditions (continued)

Almost half of A&D executives (47 percent) say that execution of their strategy will require changes to the functional structure of the company. Thirty-four percent expect to reconsider whether to outsource more manufacturing.

Changes required for executing strategy



Key

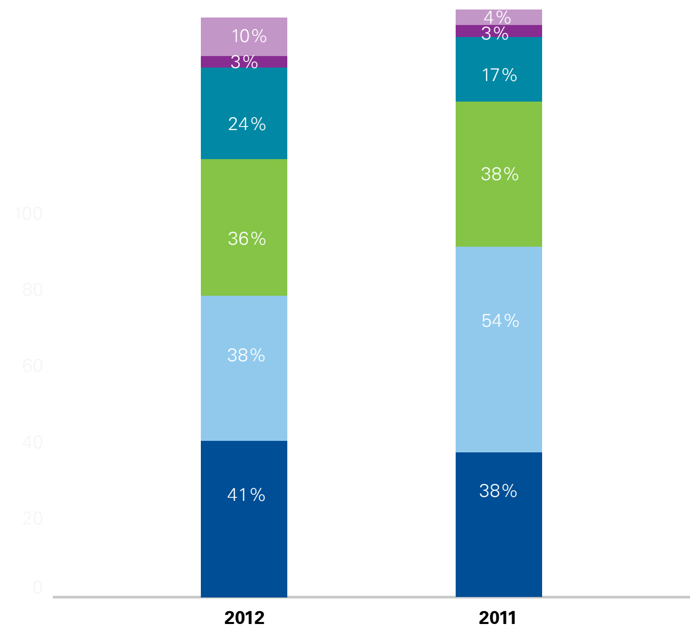
- Changes to functional structure
- Additional consideration of make vs. buy/outsource
- Training/education of workforce
- Divestiture of noncore assets
- Centralization of core processes

Multiple responses allowed.

Foreign Markets Play a Role

Respondents cite four main strategies to fuel growth: partnerships and joint ventures (41 percent), foreign military sales (38 percent), international expansion (36 percent), and acquisitions (24 percent). It is noteworthy that the number of respondents who cited foreign military sales as a strategy was down 16 percentage points from 2011 (from 54 percent in 2011 to 38 percent in 2012).

Main strategies for international growth



Key

- Partnerships/joint ventures
- Foreign military sales
- International expansion
- Acquisitions
- Other
- N/A – not pursuing

Multiple responses allowed.

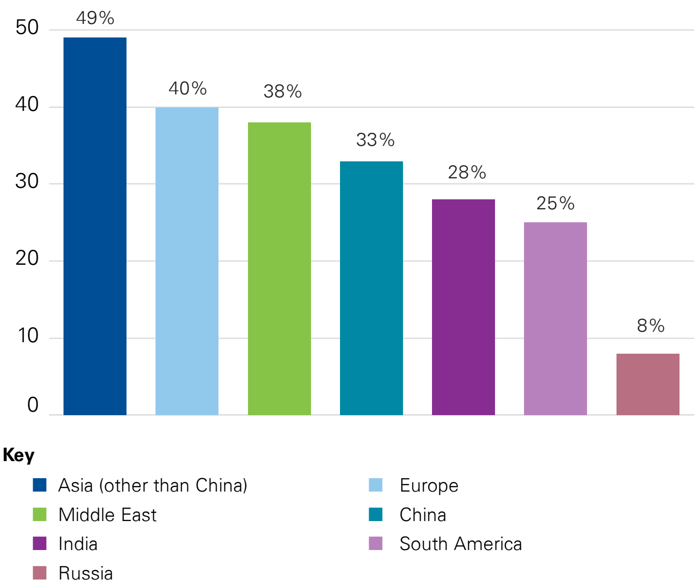
Last year, 54 percent of executives identified foreign military sales as the key strategy, but the drop in the results this year appears to indicate a realization that the foreign opportunities these companies are pursuing take several years to materialize. We continue to hear about India and Brazil, but looking at it realistically, you see that foreign military orders have been minimal to date.

Marty Phillips, KPMG LLP

International Growth

Nearly half (49 percent) of A&D executives see Asian countries (excluding China) offering the greatest potential of international growth for their company. Europe (40 percent) and the Middle East (38 percent) round out the top three international growth markets, as cited by executives.

Top markets for international growth

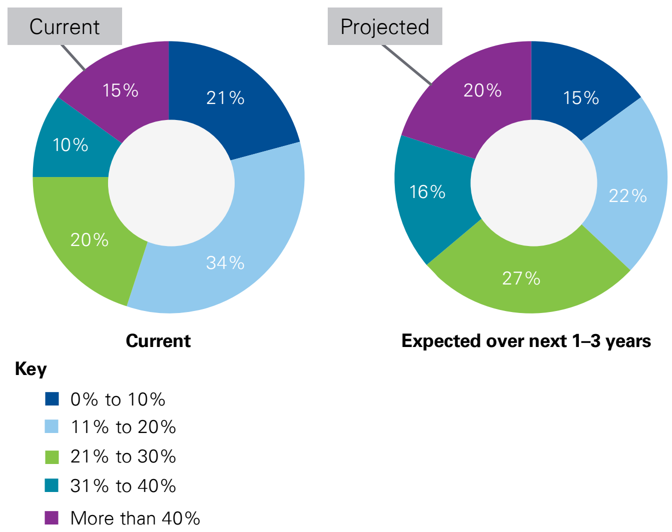


Multiple responses allowed.

Offshore revenues

Looking ahead three years, 20 percent of the executives surveyed believe that, despite foreign sales challenges, non-U.S. operations or customers will account for more than 40 percent of revenues, up from the 15 percent currently derived from non-U.S. operations.

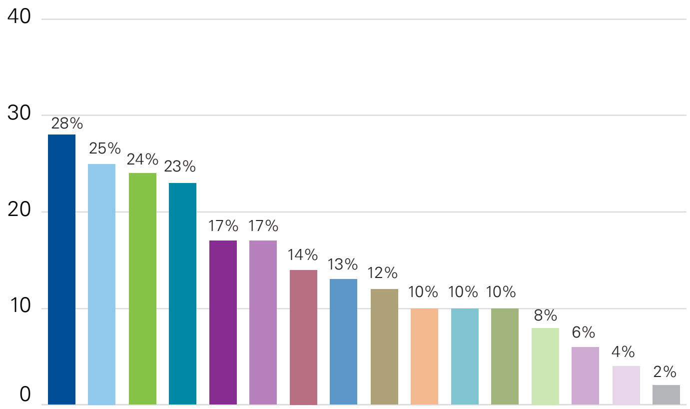
Percent of revenues from non-U.S. operations or customers



Risk and Regulatory Challenges

Twenty-eight percent of A&D executives cite regulatory and legislative pressures as the most significant barrier to growth over the next year. Energy prices (25 percent) and lack of consumer demand (24 percent) were also named as significant obstacles.

Barriers to growth: next 1–3 years



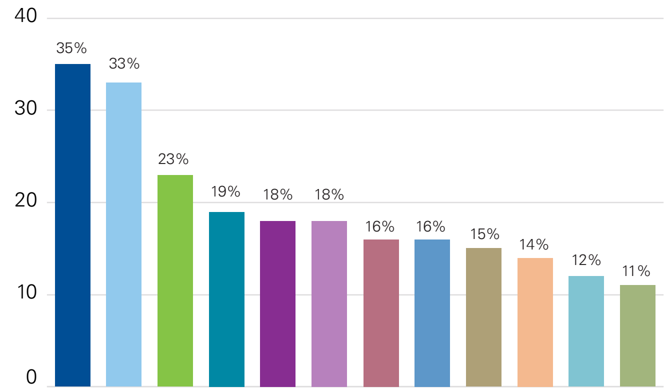
Key

- Regulatory and legislative pressures
- Energy prices
- Lack of customer demand
- Pricing pressures
- U.S. dollar strength
- Staying on top of emerging technologies
- Lack of qualified workforce
- Foreign competition
- Increased taxation
- Access to and managing capital
- Risk management issues
- Other
- Labor costs
- Volatile commodity/input prices
- Exchange rate fluctuations
- Inflation

Multiple responses allowed.

When asked about the top challenges to global operations and expansion efforts, regulatory matters (35 percent) and intellectual property protection risks (33 percent) topped the list.

Top challenges to global operations and expansion efforts



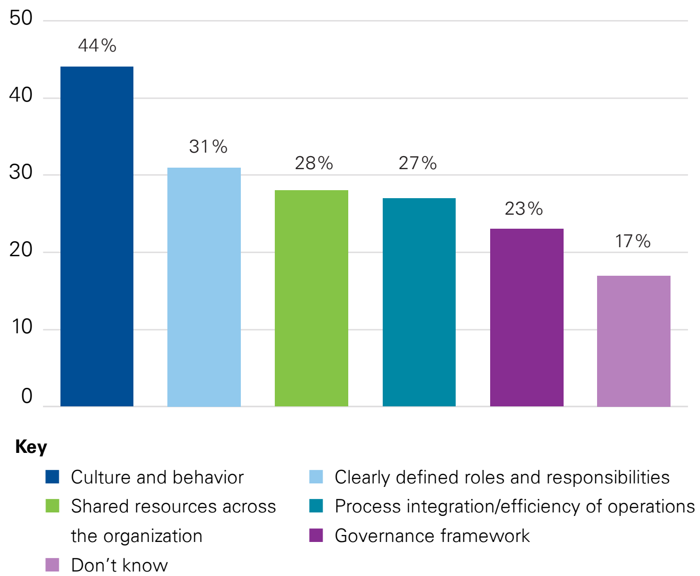
Key

- Regulatory matters
- Intellectual property protection risks
- Selection of a foreign alliance/joint venture partner
- Search for clear, actionable information to support expansion decision-making
- Management of "far-flung" operations
- Maneuvering cultural and language differences
- Offset requirements
- Ability to develop local supply chain
- Risks of fluctuation in foreign currencies
- Availability of skilled local resources
- Tax risks on repatriation of profits
- Foreign direct investment limitations

Multiple responses allowed.

Evolving regulation and changing marketplace dynamics have added to the need for companies to implement a strong internal risk framework. When asked to identify any existing challenges preventing the adoption of a formal risk policy, 44 percent of survey respondents said culture and behavior pose significant obstacles.

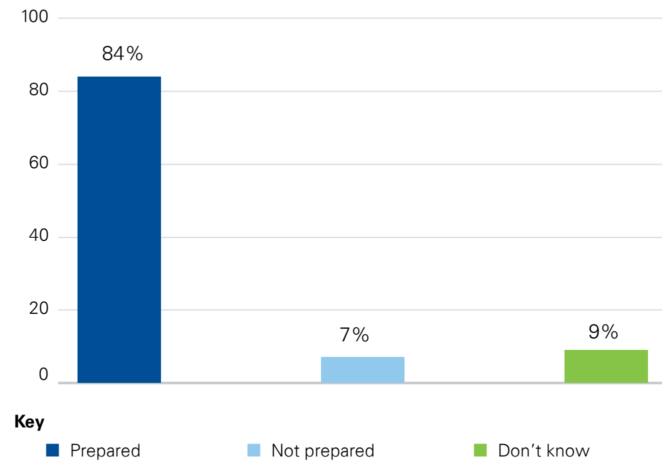
Challenges preventing the adoption of a formal risk policy



Multiple responses allowed.

Despite significant challenges, 84 percent of the A&D executives surveyed believe their company is prepared to seize opportunities as a result of public policy and regulatory reform.

Ability to seize opportunities from regulatory change

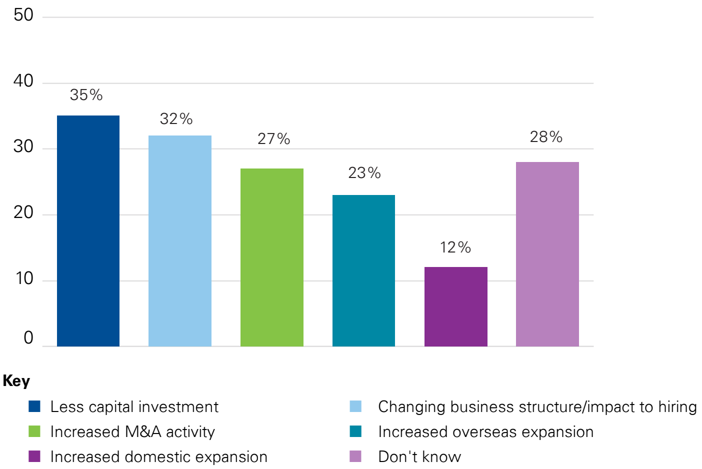


As previously mentioned, regulatory matters rank highest among top challenges to global operations and expansion efforts and among barriers to growth. These regulations can take multiple forms, from foreign direct investment limitations to tax incentives/deterrents.

Tax Regulation

According to the executives surveyed, evolving tax regulation is expected to affect business strategies, with 35 percent believing it will result in less capital investment.

Impact of federal tax policy on business strategy

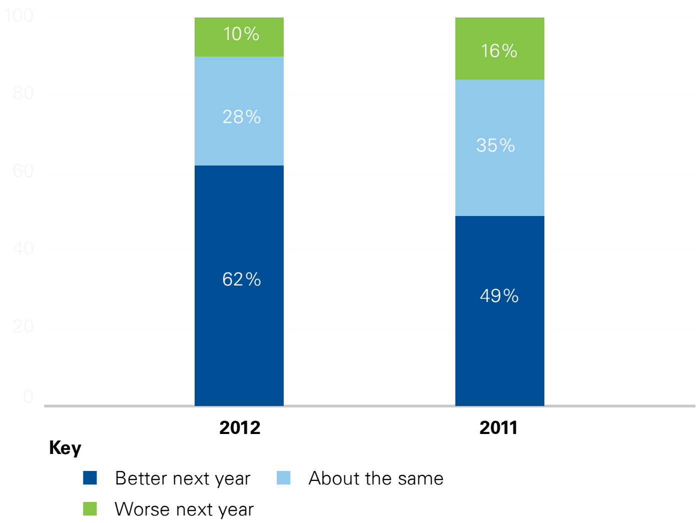


Multiple responses allowed.

Business Conditions

When asked to think purely about their business conditions in the near-term, 62 percent of A&D executives surveyed believe the economy will improve over the next year. This is an increase over the 2011 results, when only 49 percent expected the economy to improve in a year's time. Twenty-eight percent of respondents expect the economy to remain flat over the next year, as compared to 35 percent in the 2011 survey.

Expectations of business conditions in one year



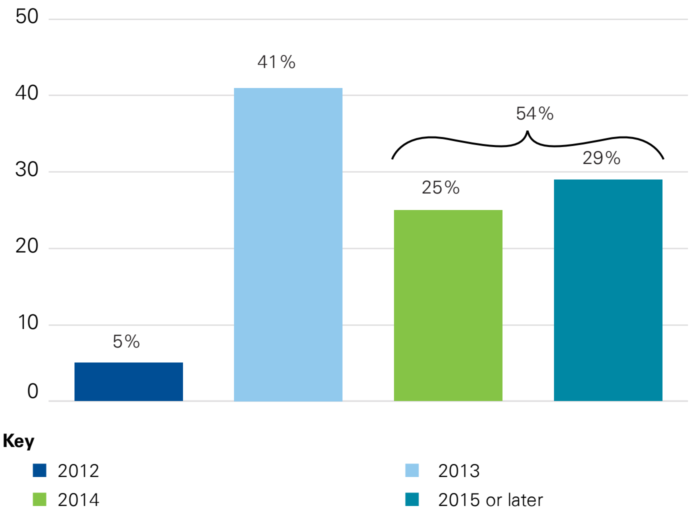
Although not always top-of-mind from an operational perspective, tax is an important consideration that should be factored into a company's overall business strategy. Failure to do so could impact future earnings.

Jerry Pierce, KPMG LLP

Hopes for Recovery Remain on Horizon

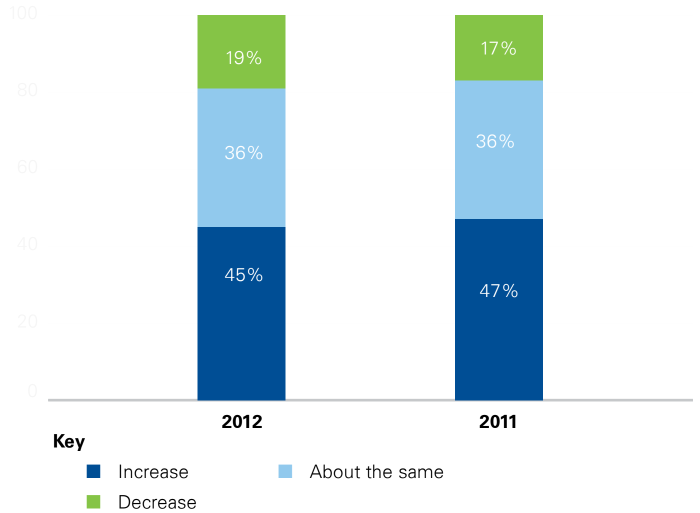
Hopes for a full U.S. economic recovery seem to have been pushed back a few years, according to the A&D executives surveyed. The majority (54 percent) believe that it will not actually occur until 2014–2015 or beyond.

Time line for recovery



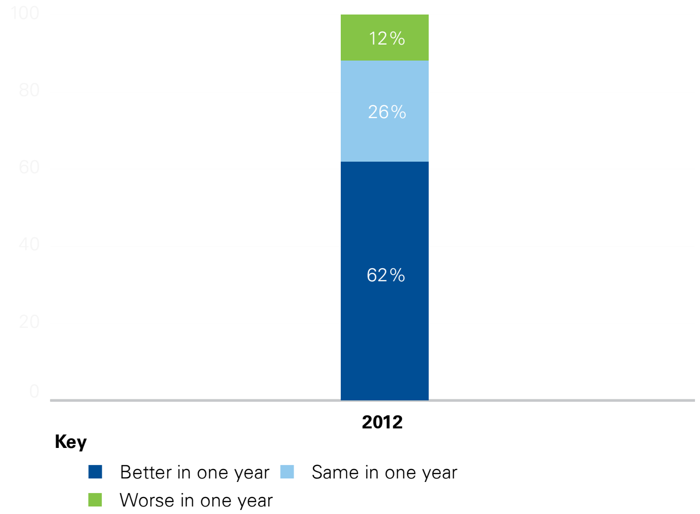
Revenues

When asked about year-to-date revenue, A&D executives report revenues that closely mirrored the prior year. While 45 percent report higher revenues, 36 percent say revenues stayed the same, and 19 percent acknowledged a decrease.



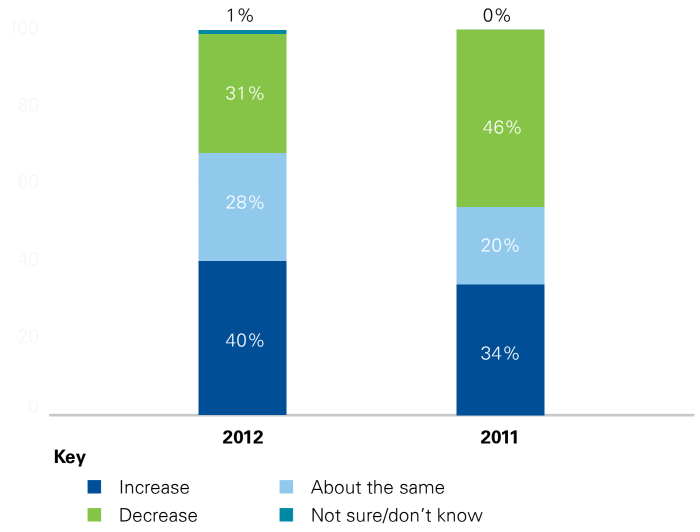
Revenues (continued)

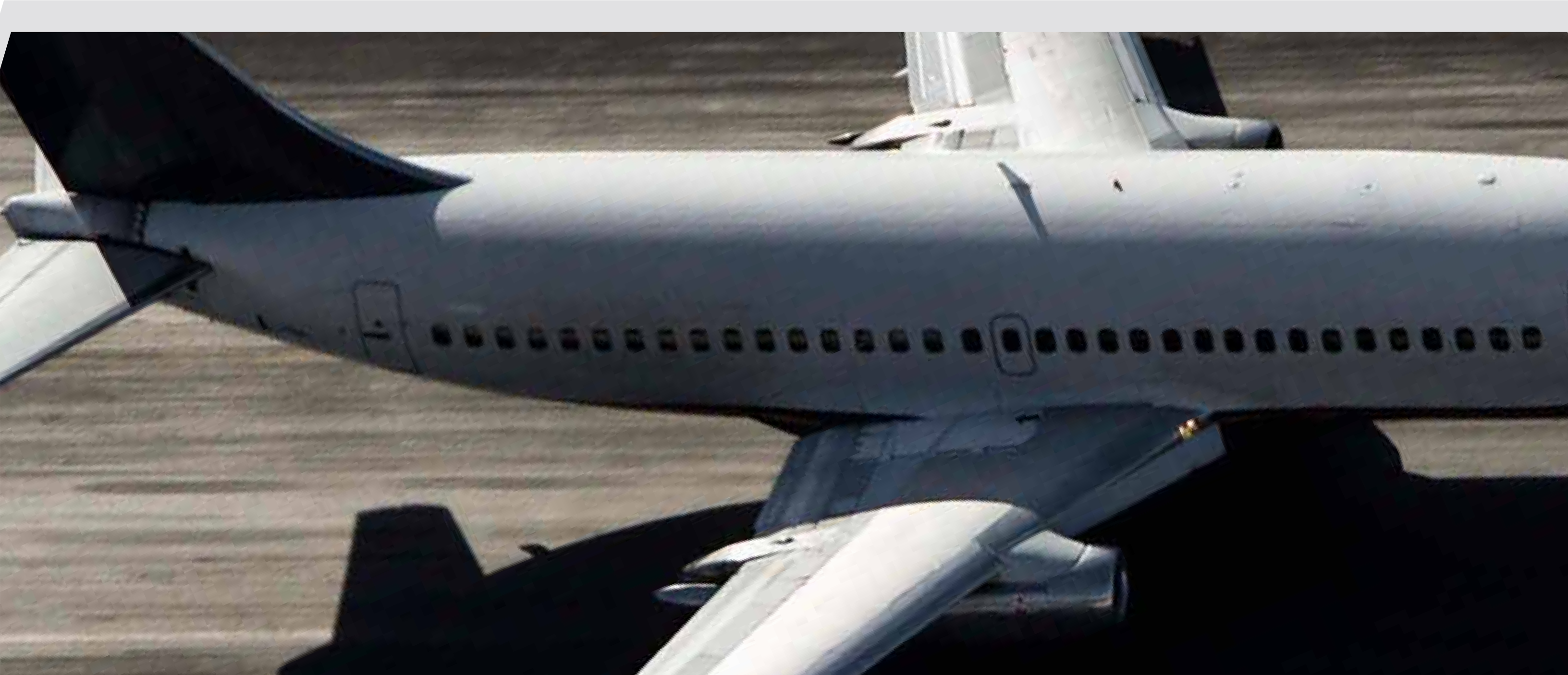
Asked to describe their revenue expectations a year from now, 62 percent of executives predict an increase in revenues. Twenty-six percent of executives anticipate revenues will stay flat.



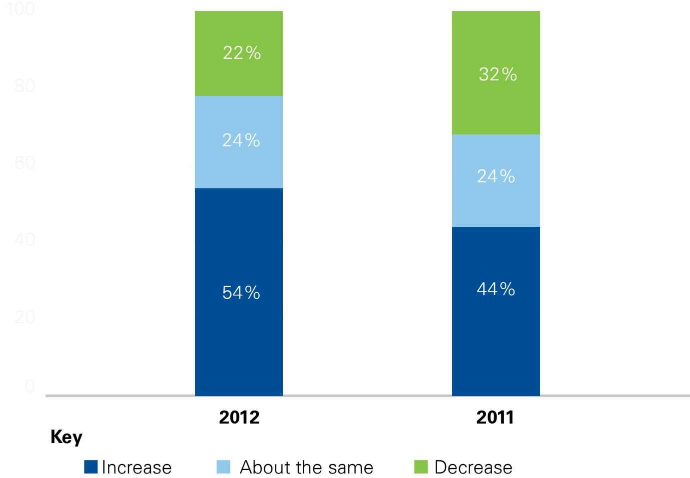
Headcount

A&D executives added more U.S. employees over the last year, with 40 percent of respondents reporting an increase in headcount, up from 34 percent the previous year.



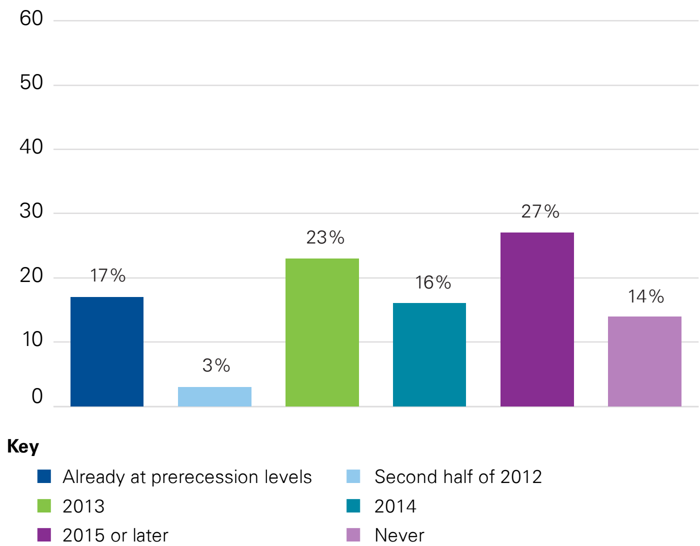


More than half (54 percent) of A&D executives plan to add headcount during the coming year, up 10 percentage points from last year's survey (44 percent).



Interestingly, 17 percent of survey respondents say their U.S. headcount has already reached or is greater than prerecession levels, but 14 percent believe it will never return to those levels.

Headcount: Return to pre-recession levels



Conclusion

Mergers and acquisitions will be the primary driver of growth in the aerospace and defense industry, according to the executives in this year's survey. Armed with significant cash on their balance sheets, most executives are ready to spend aggressively in the areas of business acquisitions and new products and services. As a result, major industry consolidation is likely as companies rethink their strategies and increase their competitive advantages in the global marketplace.

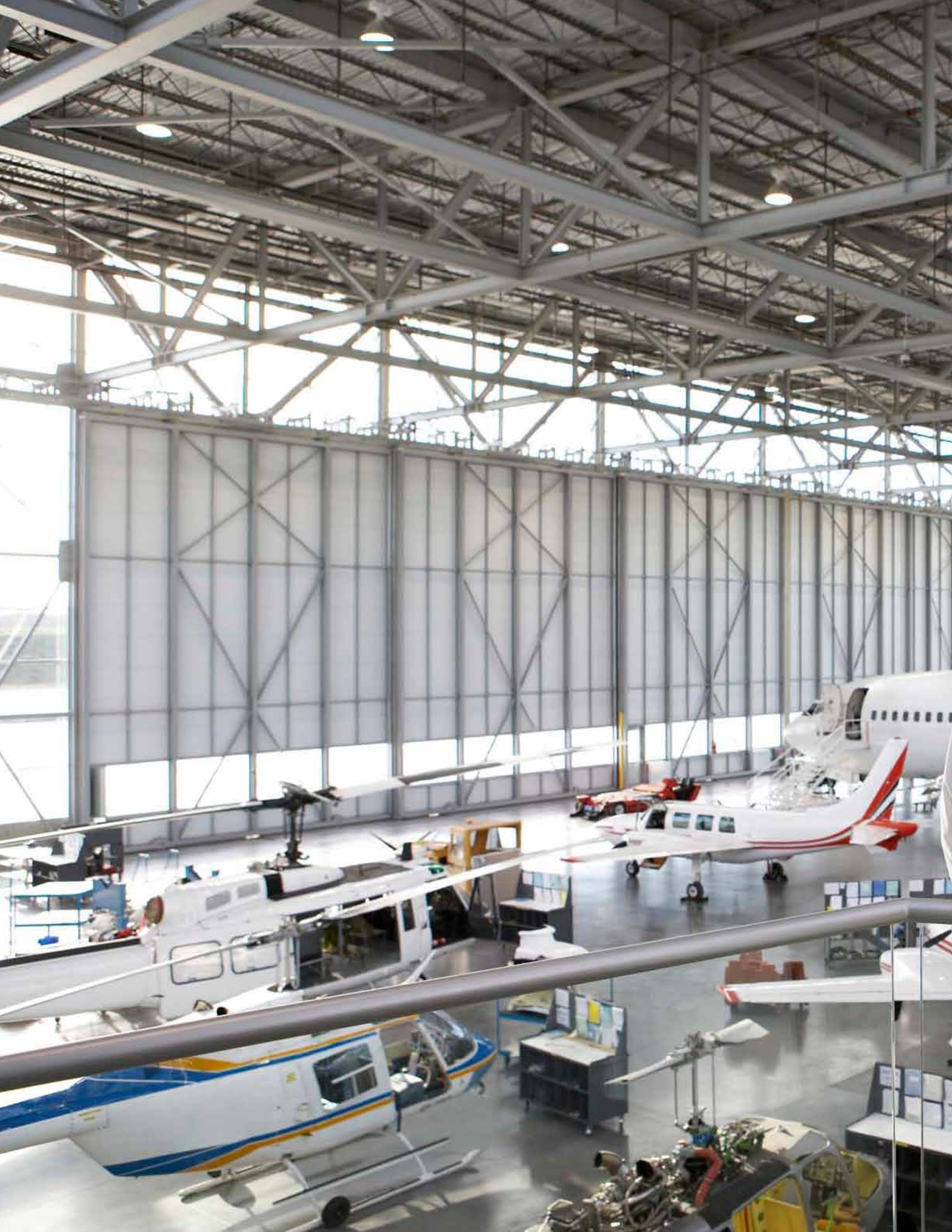
International growth remains a key strategy, although executives indicated they have a more realistic expectation of the time it takes for such opportunities to materialize. While modest revenue and headcount gains are expected in the sector over the next year, concerns over the U.S. economy are evident, as many executives have pushed back their expectations for a substantial economic recovery until 2014–2015 or later.

The A&D sector continues to face a demanding market environment that requires companies to adjust and actively manage change that may affect sales and performance.

Having the right professional services firm—one with the industry depth, knowledge, and insight to help clients address their most pressing issues and achieve their goals—is critical. KPMG's Aerospace & Defense practice includes professionals with the knowledge, experience, and skills to help our clients address their challenges, sort through today's complex business problems, and achieve their goals.

Working with our international network of member firms, we serve clients worldwide, developing insights into major business trends and helping to enhance plans for the future. Our long-term experience in A&D enables us to offer the company-specific guidance our clients need to leader their markets.

KPMG: A Leader in Serving the A&D Industry



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