

29 March 2017

A “Wall Street” Perspective

(and other hopefully interesting observations)

Presented to: **2017 Munitions Executive Summit**
Parsippany, NJ



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Topics to Discuss

Wall Street Musings

Messages for Executives in the Munitions Industrial Base

Parting Thoughts on the New Administration and Our World

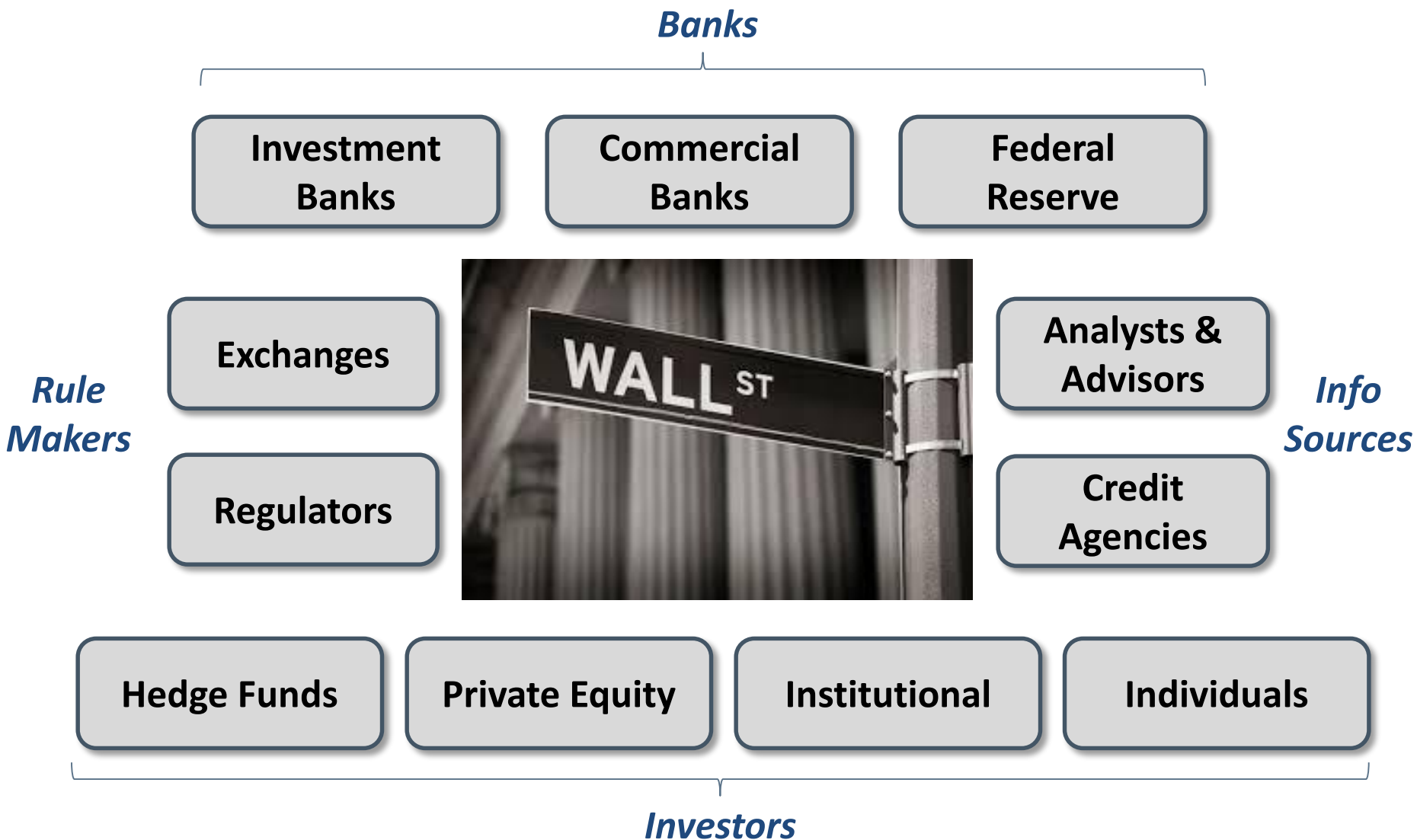
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“Wall St.” is everywhere and part of our daily lives...



... in 2017 Wall St. even came to the White House



(more on this later)

Wall St. influences Munitions contractors every day...

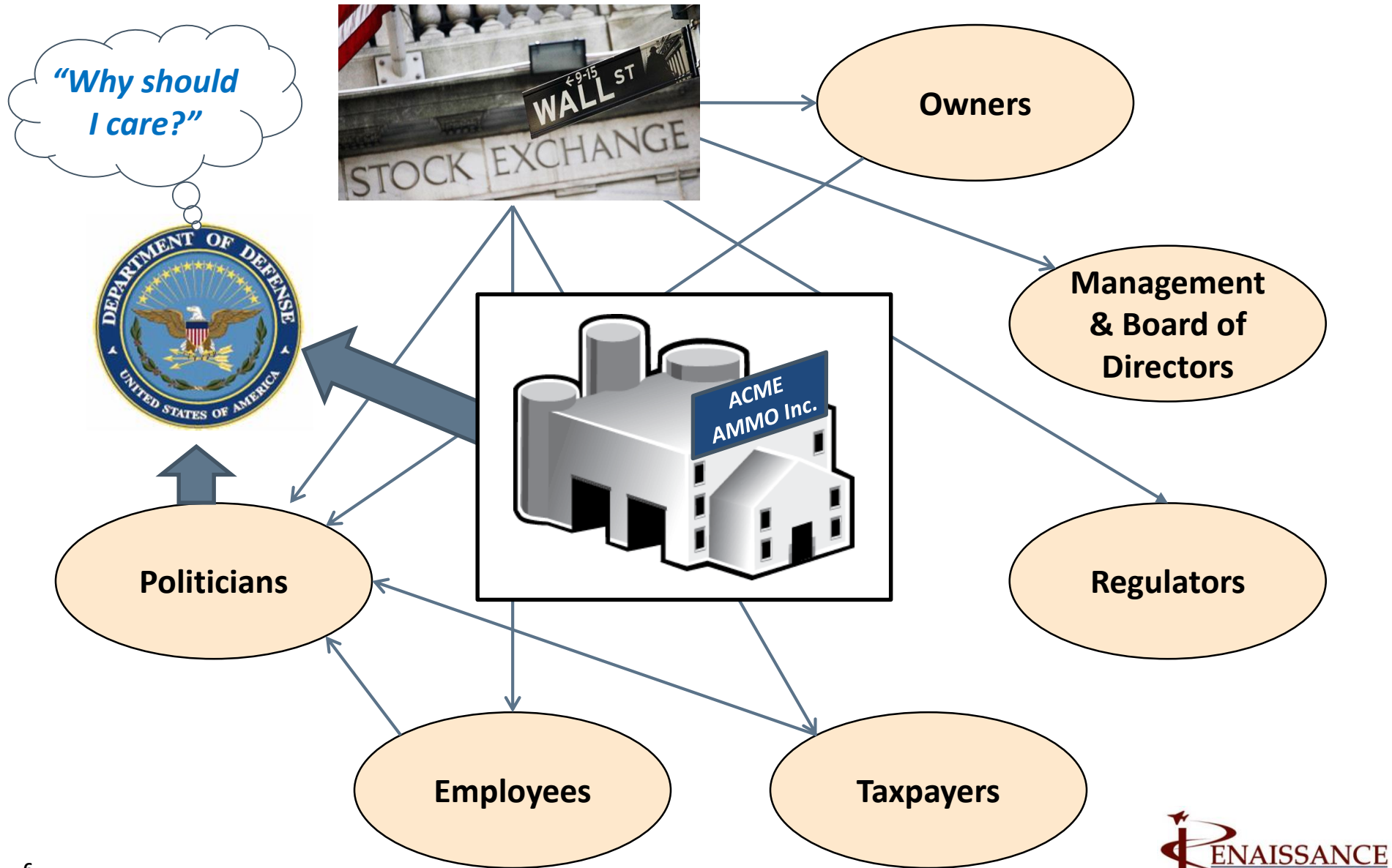
- **Directly...**

- **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.)

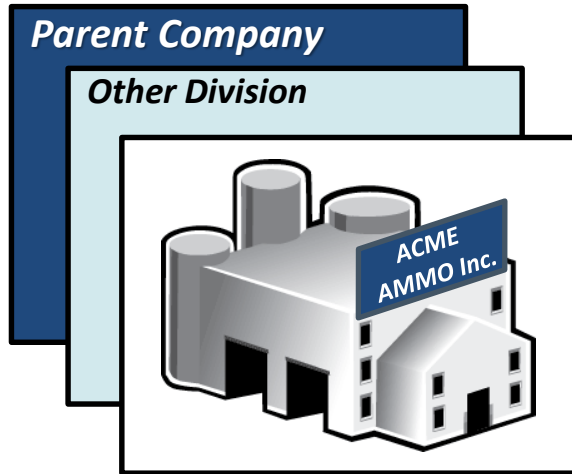
- **Indirectly...**

- **Influences size of customer 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)
- **Many others....**

... and DoD too since Wall St. shapes the industrial base



However, Wall St. doesn't really care about the Munitions suppliers or their critical mission...

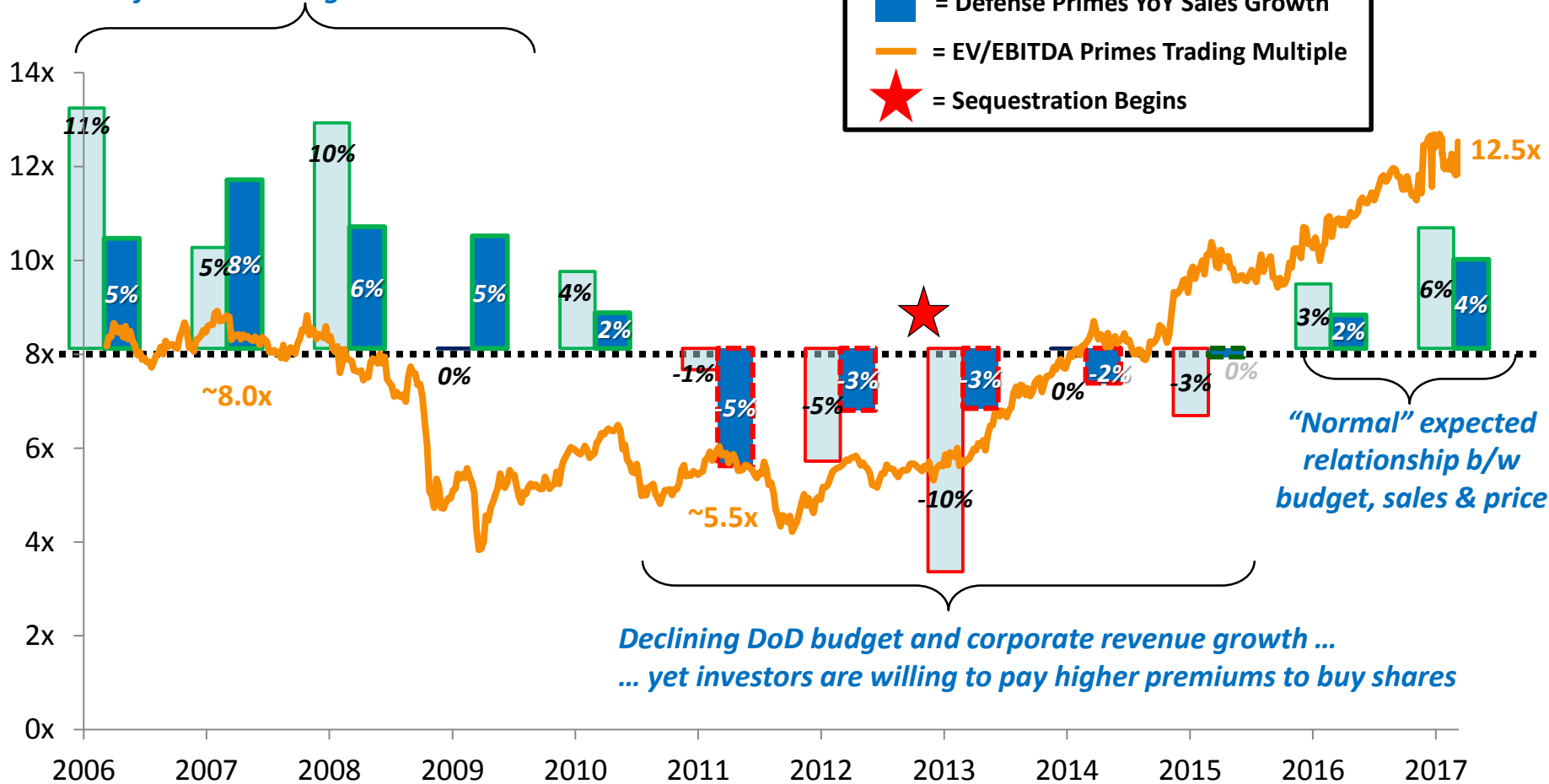


... it only cares about money and how to make it ...



... which means it sometimes appears to act illogically

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



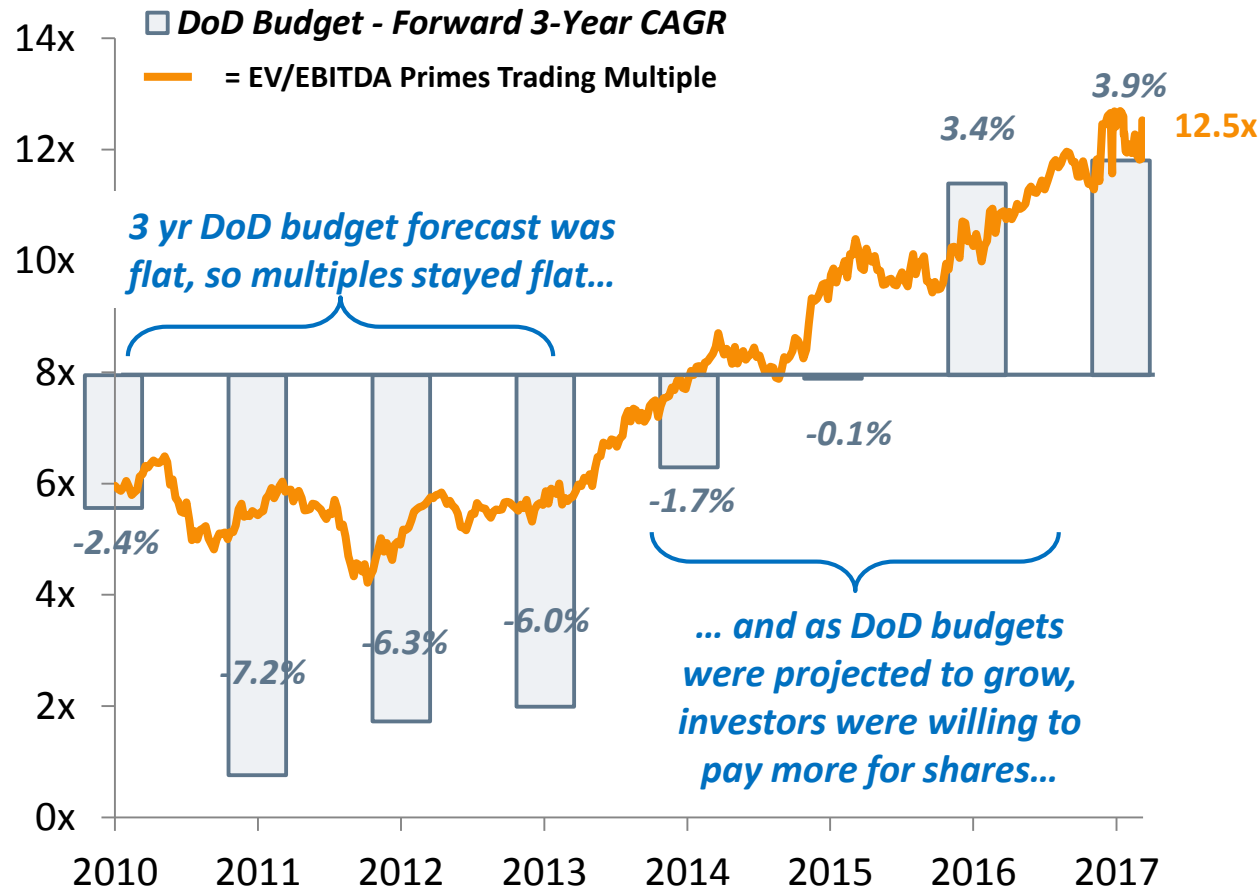
*Declining DoD budget and corporate revenue growth ...
... yet investors are willing to pay higher premiums to buy shares*

Sources: PBR, FactSet, RSAdvisors analysis

Notes: Primes = GD, LMT, NOC, RTN

DoD Budget includes Base + OCO, Discretionary BA, in current \$B; : FY17 projection based on base budget of \$583B + \$30B Trump investment increase; FY18 projection based on Trump budget request; FY19-FY21 assume ~4% FY17-FY21 CAGR based on midpoint of RSAdvisors estimates

Viewed differently, Wall St. seems to anticipate trends



Sources: PBR, FactSet, RSAdvisors analysis

Notes: Primes = GD, LMT, NOC, RTN; Defense Mid-Tier = FLIR, HII, HRS, LLL, OA; Gov't Services = BAH, CACI, CSRA, EGL, LDOS, MANT, SAIC

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Strategies for generating portfolio and/or M&A-based growth are more important now than in recent past



Notional Defense Prime Contractor

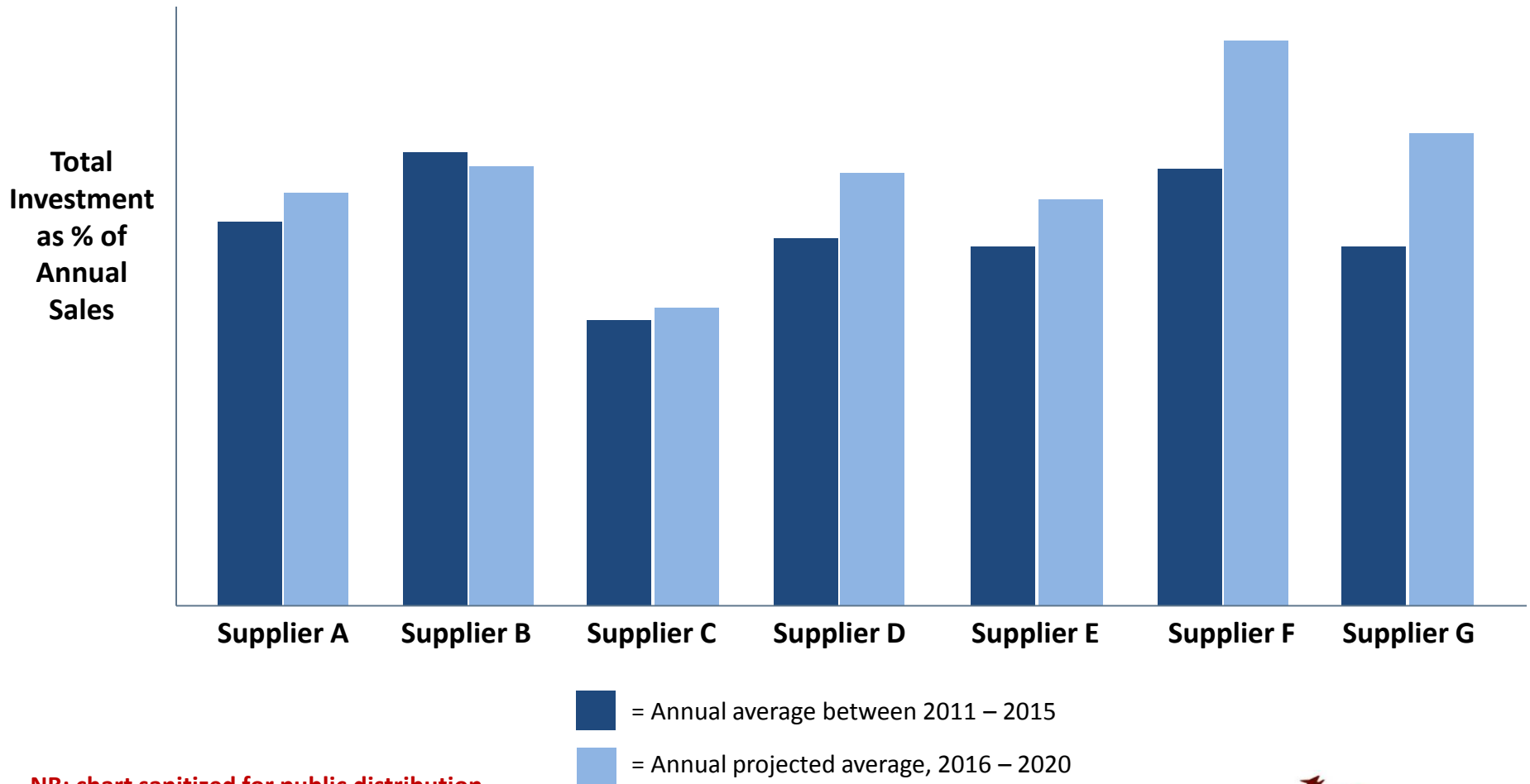
- Investors historically expect annual returns of ~8-9% relative to share price
- Policy to return ~100% of FCF to shareholders every year
- 2013 share price is \$100, doubles to \$200 in 2017
- Sales and profits grow since 2013, but much less than 100% share price growth

Sources: Company filings, FactSet, RSPartners analysis

Notes: Expected Return on Equity based on Capital Asset Pricing Model (CAPM) and takes into account interest rates, equity risk premium, sector beta, and typical firm financial leverage. Based on medians from US Defense Primes - GD, LLL, LMT, NOC, and RTN

The costs of winning business have increased over time

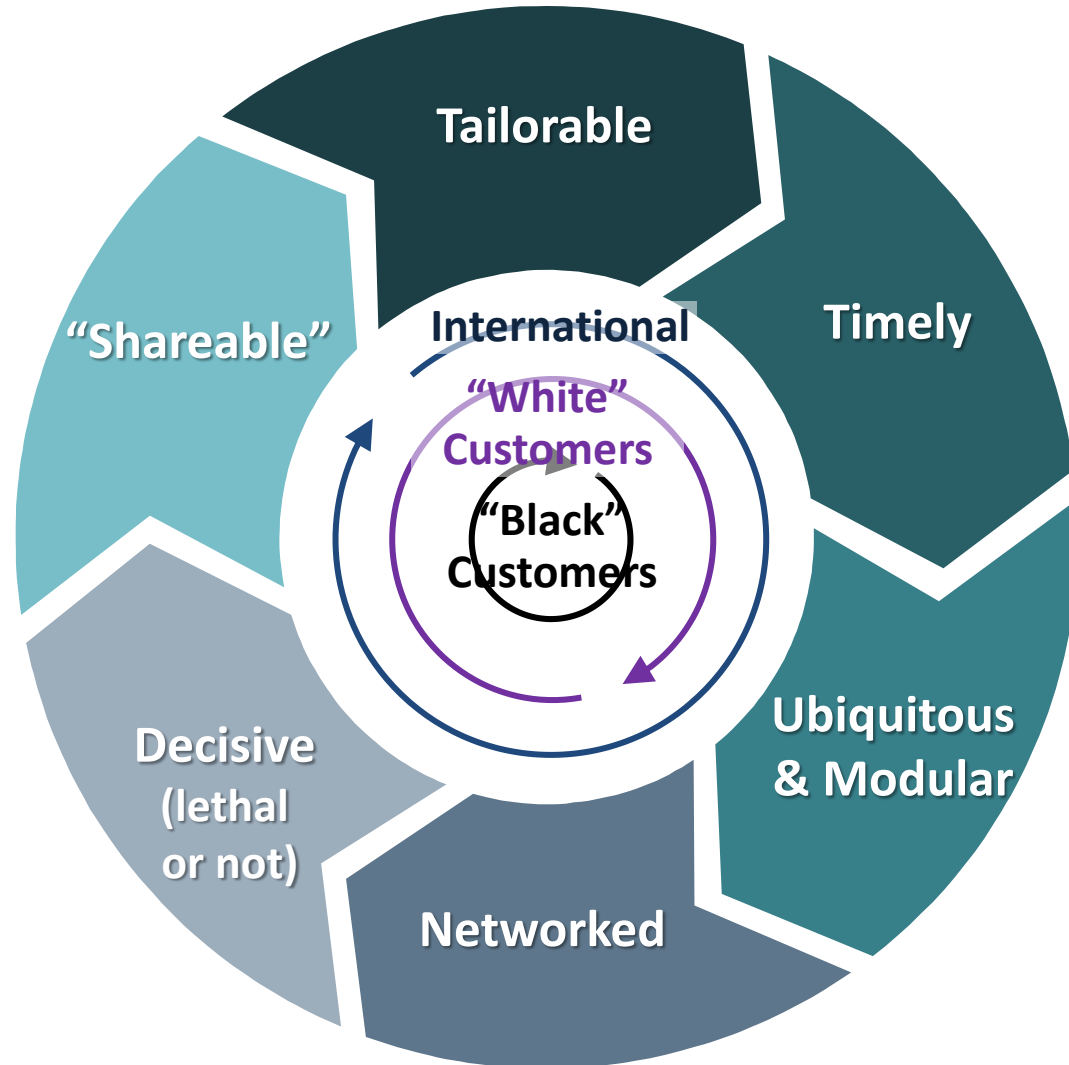
Change in Total Annual Spend on IRAD, B&P and CAPEX
(actual and estimated 2011 to 2020)



NB: chart sanitized for public distribution

Sources: RSAvisors benchmarking database

Figure out how your business supports the creation of a “Guaranteed Effects” competitive flywheel



Plan and act now to ensure you don't become obsolete

- Future could significantly disrupt today's munitions market paradigm
 - The “Long War” is a reality, but the battleground and required weapons are changing
 - Growing need for low cost precision from modular munition families to fight in urban areas
 - Swarming CONOPS will create entirely new weapon requirements
 - Encroachment of non-kinetic effectors on market space will only grow over time
- Successful competitors will need to access new technology, ideas and talent
- Today's attributes of our munitions industrial base may be counterproductive
 - Close knit, niche community often “stove-piped” within larger corporations
 - Experienced but aging human capital base
 - Sometimes community can be an “enabler” of risk-averse or “not invented here” behavior

Challenge for ICAP → How can you ensure that the enterprise accesses the youth and commercial technologies to innovate, and is culturally prepared to listen, try and fail, then try and succeed

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Prior to making any prediction, ask and answer some basic questions that could have major impacts on the result

- **What is the date of the chart or analysis being used to support a position?**
 - If policy, data or forecasts generated before Nov 8th be very careful
- **Have you checked all your primary base assumptions about the issue & stakeholders?**
 - Classic tenet of Socratic analysis, validate the core individual motivations and goals
- **Who are the people involved?**
 - People = policy to a large extent
- **Which Republicans? (corollary: which Democrats?)**
 - “New Trump” Republicans, Tea Party Republicans, Traditional Republicans, etc.
- **Will the defense spending increase be fast or slow?**
 - History says faster than we think, but “structural” impediments may slow this upcycle

Be mindful of the structural, global “fragmentation” trend

- Economic and political dislocation within societies (e.g., becoming bipolar)
- Nation-states and countries breaking up (e.g., Ukraine, Libya, Iraq, Syria)
- Fragility of strategic economic and military alliances (e.g., NATO, EU, etc.)
- Non-state instability and rivalry (Shia vs. Sunni, urban vs. rural)
- Political cohesion within formerly stable parties (e.g., populists vs. elites)
- Virtualization of everything and eroding sense of “physical” community
- Technology / AI-enabled mass individuation, customization & automation
- Globalization (etc., capital, knowledge, people)

Complicates planning, reduces predictability and increases the possibility for strategic surprise but also creates opportunity

**Thank you
&
Good luck**