

## Day 1 Recap

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### SECTOR REVIEW

## Aerospace & Defense Conference

Below are key highlights and takeaways from speaker presentations.

### General Dynamics (GD)

- CEO not yet ready to give formal 2008 guidance, but gave color by segment – expecting Marine volume up modestly and ~20 bps margin expansion; Combat, high-single digit growth and 40-50 bps of margin expansion; IS&T will grow ~4% with flattish margins; and Aerospace we think can do ~10-12% with continued margin expansion.
- One or Two large cabin aircraft may defer into 2008.
- GD expects to announce one new model in H1 2008.
- War funding still pressuring IS&T IT volume but there is improvement. Classified area (AIS) still a headwind. UK Bowman troughs in 2008.
- CEO Chabraja still bullish about long-term defense outlook.
- Can't predict bizjet cycle, but thinks Aero will have growth through 2010.

### Precision Castparts (PCP)

- **Organic sales drivers going forward include:**  
Strong aerospace cycle: 787 full scale production (\$4.5-5M per plane); 777/737/A320 strong; fastener market share gain (\$ weakness impact on Airbus makes PCP well-positioned there).  
IGT opportunities include growth in 9 series engines. Very tight demand. Mkt share gains and robust aftermkt also drive growth.  
Seamless pipe: >\$500M backlog is 18+ months of production. Strong growth opportunity in China.  
Non-aero growing demand for special metals (PCP has less market share here and wants to grow).
- **Margin drivers going forward include:**  
Looking to reduce costs core business costs by ~2% / quarter.  
Contract pass-throughs have expanded to other metals.  
Increased use of revert (Caledonian for example) adds value.  
Continue to guide to ~30% incremental margins.
- **Acquisition Strategy:** Targeting 50/50 aero to non-aero, but will err on side of former. Controlling raw material stream is of great value.
- **Strategy for Downturn:** PCP looks at each capital project with downside case scenario of 30% shortfall from assumed demand.
- **Supply Chain Still Tight in Fasteners:** Still not giving customers all they want yet. IGT (industrial gas turbine) still tight. Some airframe component supply equal to or worse than fasteners.

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**BE Aerospace (BEAV)**

- Distribution business margins continue to expand due to IT assets helping to price orders appropriately and salesforce profit incentives.
- Fastener distribution business focused more on aftermarket and subcontract manufacturers vs. OE's.
- 787 and A380 make up about 13% of backlog.
- Airline consolidation a slight positive for BEAV as airlines need to standardize fleet, leading to some retrofit activity.

**Private Equity Panel**

- Valuations still high - used to purchase at 6-8x cash flow, now doing transactions at 11-12x, so valuations remain high.
- Return requirements remain high.
- M&A activity remains robust, but less involvement from private equity players.
- Not as much competition in auctions, generally, but high quality deals still attract a lot of competition.
- Deal quality - seeing increase in poorer quality companies on market. More second or third tier suppliers who were lifted by rising tide.
- Issue of cycle duration - global growth stats suggests we are on a multi-leg stool which could argue for extended cycle. Expansion of middle class results in geometric air travel growth. But remain cautious given historical significance of weak US market. Would prefer more aftermkt leverage at this stage of the cycle.
- Hardest to buy due to demand - niche players with proprietary products and aftermarket exposure.
- Deal size smaller in A&D than 1990's. Most deals will be under \$1B or even under \$500M.

**Spirit AeroSystems (SPR)**

- Would expect Airbus A350 structural supplier selection to be announced soon.
- Will neither confirm nor deny allegations of SPR's discussions with Airbus regarding facilities transaction. Acknowledged the risks and complexity of such a transaction.
- Aftermkt growth initiatives small. Aftermkt ~\$100M in revenues but will not be a huge part of the business.
- Production ramp-up takes some time. 737 would take a year to increase rates. Would look to break bottlenecks and make incremental investments. Doesn't need another whole production line.
- Received incentives from Malaysian government to locate facility there.

**AAR Corp (AIR)**

- Airlines continue to outsource non-core activities.
- Defense mkt has growing focus on Performance Based Logistics (PBL) programs - AAR operates 10 PBL programs and has helped improve dispatch reliability.
- Recently entered agreements with TXT and AH for ground-based vehicle maintenance.

- Starting to get a lot of calls from Europe for maintenance outsourcing due to \$ weakness.
- Continues to seek growth opportunities in leasing business.
- Greatest competitive advantage is in Supply Chain business because of unparalleled tracking ability, speed, service, internally developed logistics and IT systems.
- Increasing capacity in Indianapolis by improving turnaround times and supporting auxiliary functions/facilities.
- Summa acquisition is to be center of part manufacturing in Structures and Systems. AAR looking to integrate more of the supply chain.

### **Ducommun (DCO)**

- Becoming increasingly global with locations in Taiwan, India, Mexico. Did not win L/T contract with BA for 737 spoilers until matched competitor prices. Needed to reduce costs so opened Mexico facility to do final assembly and paint (all direct labor) for 737 spoilers.
- Vision is to grow to \$1B in sales by 2012, implying it will grow significantly by acquisitions (has done 13 since 1994). Goal is to increase design engineered content.
- Three acquisitions in 2006, none in 2007 due to valuation (competition from private equity).
- Now focused on Lean and Six Sigma to improve margins.
- Top 5 programs are: Apache, 737 (spoilers), C-17, F-18, Blackhawk. Plans on replacing C-17 revenue stream with 3 programs and has already won two of the three with positions on Eclipse and Carson programs.
- DCO would also consider being acquired for right price. Most acquirers only focused on one part of the business.

### **RTI International (RTI)**

- Presentation was very bullish on growth across the board. Emphasized value of downstream integration and growth opportunities with Fabrication & Distribution business, which makes up 2/3 of sales.
- RTI expects global titanium consumption growth of ~35% from 2006-2010, primarily driven by the commercial aerospace (~42% of total consumption), defense (10% of consumption), and industrial/consumer markets (~48% of consumption). Market drivers include changing world demographics, industrial and consumer products growth, developing energy applications (ie not just aerospace), and obviously the commercial aircraft build schedules.
- Listed six L/T contracts with Airbus, FHI, KHI, LMT (on JSF), and BA that are expected to drive over \$4.9B of revenues. Take or pay contracts are self-sourced through 2012 for titanium sponge.
- Latest Airbus contract (\$1.1B) to provide for up to 35% of Airbus' titanium requirements (including A350).
- Latest BA contract on 787 for seat tracks should start in 2008 and reach FRP in 2010.
- New \$300M greenfield sponge facility to provide capacity of up to 20M lbs (supporting over \$3B in L/T agreements) expected to be operational by 2010.
- Capital expansion plans:

- Annc'd 2006 - invest \$78M to increase mill product capacity from 17M to 23M lbs annual capacity, effective 2009
  - Annc'd 2007 - invest \$100M to increase mill product capacity from 23M lbs to 35M lbs annual capacity.
  - However after completion of the facility RTI will still be less than 50% self-sufficient in sponge capacity for its Titanium Group requirements (RTI will still need to buy sponge from outside suppliers).
- When asked about buy-to-fly ratio assumption, RTI's response was that lower buy-to-fly ratio would benefit the Fabrication business and that RTI has the flexibility to use scrap more efficiently. It would take years before a lower buy-to-fly ratio will negatively impact strong, growing demand given increase in content, platforms, and production.

#### **AerCap (AER)**

- Company does not provide guidance, but management said used aircraft availability as of March 2007 was at lowest point in five years. Also said that there has been a significant shift amongst airlines away from ownership to leasing.
- Has 325 aircraft in its fleet or on order with A320s making up the largest portion (70 on order through 2010). Said they like to buy new to get pricing discounts. Also said new aircraft lease terms are >25% longer than used aircraft leases currently.
- Purpose of China JV is to access capital not just to place aircraft in China.
- Sees softness in aircraft market at beginning of next decade.

#### **DRS Technologies (DRS)**

- CEO seemed bullish on outlook for defense budgets and DRS organic growth the next few years.
- Sticking to 10-12% long-term margin outlook.
- Wouldn't speak much to opportunity set, but confirmed looking at UK FRES and border opportunities in the Middle East.
- Said wanted to move international sales from 8% to 15-20% and that this is doable. Mentioned targets as India, Israel, Africa. (probably UK, too).
- Said spending on MRAP sensors helping to get unit costs down so that can sell into other platforms.

#### **SI International (SINT)**

- Mgmt. noncommittal on when double-digit organic growth would return, but believes it will at some point in 2008, particularly when Iraq pull out happens.
- Said 10% margin is real opportunity when organic revenue growth returns.
- Expects DOD "bridge" supplemental fund before year is out. Omnibus bill for civilian federal agencies could come by February/March.
- Thinks the GSA Alliant protest could be resolved by late December or early January.
- Still looking for acquisitions, particularly in military health care; tends to pay 8-9x or less. Pricing is high in the intel area and for assets in Huntsville, AL due to BRAC.
- Said order activity has been a bit slow in Q4, but this is due to seasonality.

**Companies Mentioned** *(Price as of 28 Nov 07)*

AAR Corp. (AIR, \$30.28)

BE Aerospace Inc. (BEAV, \$42.93, OUTPERFORM [V], TP \$52.00, MARKET WEIGHT)

DRS Technologies, Inc. (DRS, \$57.89, OUTPERFORM, TP \$63.00, MARKET WEIGHT)

Ducommun Incorporated (DCO, \$38.05)

General Dynamics Corporation (GD, \$87.30, NEUTRAL, TP \$94.00, MARKET WEIGHT)

Lockheed Martin (LMT, \$108.17, NEUTRAL, TP \$112.00, MARKET WEIGHT)

Precision Castparts (PCP, \$137.38, OUTPERFORM, TP \$152.00, MARKET WEIGHT)

Rti International Metals, Inc. (RTI, \$65.58)

SI International Inc. (SINT, \$27.20)

Spirit AeroSystems (SPR, \$32.74, RESTRICTED, MARKET WEIGHT)

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