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Overview

The Obama administration may be a mixed bag for dealmaking in the aerospace and defense industry.

In the wake of 9/11 and two wars, aerospace and defense contractors enjoyed strong growth throughout the Bush years. The previous administration's 2009 fiscal year budget gives the Pentagon $184 billion for defense procurement and weapons research, an amount which has risen 15% over two years.

Likewise, completed M&A among aerospace, defense and related services firms enjoyed a steady rise through the last administration. Completed deals topped out at $19.9 billion in deals in 2007, according to FactSet Mergerstat. But in 2008, the credit crunch slowed M&A to just $9.6 billion. (See chart below.)

Now, the Obama administration says the Pentagon will have to do with less. The White House as well as Congress is looking more skeptically at big budget programs like the Air Force's F-22 Raptor, the Navy's Littoral Combat Ship program, and the Army's Future Combat System.

Those cuts threaten to crimp revenue for the big defense contractors. Yet as it takes with one hand, the White House will give out with the other through stimulus spending. While deals among firms that cater to the U.S. government will not rise to previous levels, dealmakers are cautiously optimistic that new spending initiatives will prove a spur to more deals during the year.

"The tier 1 contractors have healthy, robust balance sheets, so they are not going anywhere," said Luca Salvi, a partner specializing in aerospace and defense deals at **Sheppard Mullin**. "They have lots of opportunities to get into other types of government work."

Worries about the fate of defense spending have pushed down the value of the biggest companies in the sector by 28% over the past year, according to a report from middle-market M&A advisor **Aronson Capital Partners**. Yet firms that specialize in more general types of government services have only seen their value decline 1% over the same period.

That divergence means that investors are still bullish on growth in government spending, says Aronson Managing Partner Larry Davis. Aside from the new stimulus plan, an aging government workforce will require more outsourcing and modernization.

Davis says that while big defense projects will get cut, defense contractors can make up some of the revenue losses through providing other types of work.

"Revenue diversification is going to be the key for prime contractors," Davis said. "The hardware side is going to be under a lot of pressure. But they can really count on the services side of their business growing."

While hardware and weapons will continue to bring in most of the cash for the prime defense contractors, the incremental growth is more likely to come through areas outside the Pentagon, Salvi said.

"A lot of aerospace companies already have businesses in those areas," Salvi said. "They will want to grow those sides of business with the new spending planned."

The recently passed American Recovery and Investment Act also promises new sources of revenue in those non-defense areas. Among the areas of spending outlined are new initiatives to modernize government buildings, boost spending on IT-related to healthcare and government operations, and new spending on energy and transportation infrastructure. A Jeffries report says that the new stimulus creates an addressable market of $143 billion for government contractors.

Deals by Year

Date Period Ending	Base Eq. Price ($mm)	No. of Deals	Price Disclosed	Price Not Disclosed	% of Total
*23-Feb-2009	17.9	8	1	7	0.02
31-Dec-2008	9,626.6	150	49	101	10.73
31-Dec-2007	19,912.5	149	65	84	22.20
31-Dec-2006	15,323.1	156	71	85	17.08
31-Dec-2005	17,755.9	167	78	89	19.80
31-Dec-2004	18,044.9	162	70	92	20.12
*31-Dec-2003	9,015.3	164	92	72	10.05
Total	**89,696.2**	**956**	**426**	**530**	

* *May represent incomplete date periods*

Prime defense contractors will likely be beneficiaries of this new spending thanks to previous deals for contractors that worked in non-defense areas. **General Dynamics** Corp. snapped up government IT services firm **Anteon International** and last year added healthcare data management company **ViPS**. **Lockheed Martin** Corp. bought the federal government business of **Affiliated Computer Services**. Military radio maker **L-3 Communications** Corp. bought **Titan** Corp. in a move to expand into services.

The new spending will also benefit the remaining independent government contractors. Engineering services and IT consulting firms such as **SAIC** Inc., **ICF International** Inc., **Perot Systems** Corp., and **SRA International** Inc. are poised to benefit from the new spending, according to the Jefferies report.

Although spending on large defense projects will shrink, Davis says other areas may enjoy growth due to efforts to modernize the military. That includes areas like logistics, training, retrofitting and maintenance. Hardware priorities include unmanned aircraft, surveillance and electronic systems.

The Jeffries report says that defense-focused firms such **CACI International** Inc., **Dynamics Research** Corp., **DynCorp** Inc. and **NCI** Inc. could benefit from Pentagon efforts to streamline the military.

"There's a lot of focus on those kinds of areas," Davis said. "We see that continuing."

Davis says the disappearance of private equity buyers and the overall credit crunch has dampened M&A in the sector. Yet he is encouraged by the fact that valuations for companies in the sector has held up, suggesting that buyers are still willing to pay up for government contractors.

"Relative to other industries, defense and government contractors are holding up pretty well," Davis said. (See chart on next page.)

Agricultural Production

Canadian agricultural-chemicals maker **Agrium** Inc. made an unsolicited $3.9 billion bid for fertilizer producer **CF Industries** Inc. Agrium is offering $31.70-per-share in cash and one of its shares for each share of CF Industries. The deal would give Agrium greater market share in the North American nitrogen, phosphate and crop nutrient markets. Agrium said that this deal would create more value than

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