

M&A in defense space heating up

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NEW YORK (Reuters) - Merger and acquisition activity in the defense industry is heating up, and is expected to far surpass the deal volume last year as larger companies target smaller ones with niche technologies. The Obama administration's decision to move funding from traditional weapons to areas of unmanned war is pushing prime contractors to buy smaller companies in that sector.

While merger discussions were rampant last year, poor visibility on stock prices, valuation gaps and tight credit kept most talks from ending in a deal. This year, stable stock prices over many months has made executives more confident, leading to more agreement on valuations between buyers and sellers.

Valuations in the defense space now range from 7 to 9 times EBITDA, or earnings before interest, taxes, depreciation and amortization, but can be lower for some companies or higher for other businesses with highly specialized technology and strong potential for growth, many investment bankers said. "Valuations have firmed up a bit; things were very depressed last year," said Michael Richter, co-head of Aerospace and Defense at Lazard Ltd (LAZ.N: Quote, Profile, Research, Stock Buzz). "We have seen many more deals so far this year than so far last year."

Valuations ranged from 8 to 16 times EBITDA in 2007, but plunged in the next two years as the credit market collapsed. "We are now 20 percent below the top, and I think we'll be here for a while," said William Alderman, founder and president of Alderman & Company Capital, LLC. "We are not going to go back to the high or the low for a while. Buyers and sellers feel that, and deals are getting done."

Companies that offer intelligence, surveillance and reconnaissance, secured communication, optical imaging and infrared technology are in well-funded areas and are likely acquisition targets. "I think the deals we are going to see have much less to do with buying factories that build weapons and much more to do with the old industrial base acquiring specialized people, know-how and modern warfare technologies to quickly move their offerings to where the

Department of Defense will have procurement needs," said Alderman.

TUCK-INS, NOT TRANSFORMATIONALS

Consolidation is unlikely in the top tier of defense companies, but second- and third-tier suppliers are likely to consolidate, bankers and analysts said. "You are likely to see tuck-ins as opposed to transformational deals," Richter said. Private equity firms are also contributing to the increased activity. Many private equity firms have been motivated to sell ahead of an expected hike in the tax paid on "carried interest" -- the cut they take from their funds' profits. The carried interest issue is being hotly debated in Washington. Richter said that aside from the private equity rush to sell assets in this year, the firms are also becoming active as credit markets are easing. "An improvement in credit markets has brought about higher leverage available to financial sponsors and that presents a new floor value, which improves overall valuation," Richter said.

Foreign companies such as BAE Systems (BAES.L: Quote, Profile, Research, Stock Buzz) and EADS (EAD.PA: Quote, Profile, Research, Stock Buzz) are also seeking acquisitions overseas, particularly in the United States, as they face budget crises at home. France, Germany and Spain have growing budget pressure and Britain, Europe's largest arms market, faces both a budget crisis and a defense review. However, the U.S. defense budget remains the world's largest at \$706 billion for fiscal 2011. Global aerospace and defense deal volume fell to \$3.7 billion in 2009 from \$14.1 billion in 2008, according to Thomson Reuters data. The 168 deals in 2009 only slightly exceeded the 150 in 2008.

In the past few months, Argon ST (STST.O: Quote, Profile, Research, Stock Buzz), Carlyle's Arinc Inc, DynCorp, Xe Services (formerly known as Blackwater) and two units at Lockheed Martin Corp (LMT.N: Quote, Profile, Research, Stock Buzz) are among many defense companies that have gone up for sale. Cerberus Capital Management in April agreed to buy DynCorp for about \$1 billion in cash. BAE, Boeing Co (BA.N: Quote, Profile, Research, Stock Buzz) and Raytheon Co (RTN.N: Quote, Profile, Research, Stock Buzz) have completed

management presentations for Argon ST, sources have told Reuters.

Lockheed is selling its Enterprise Integration Group (EIG) unit, which provides systems engineering and integration services, given growing government concerns about perceived organizational conflicts of interest. Lockheed also plans to sell Pacific Architects and Engineers Inc (PAE), which offers services in mission readiness, peacekeeping, global infrastructure support and disaster relief activities.

Aside from the prime contractors, SAIC Inc (SAI.N: Quote, Profile, Research, Stock Buzz), a

provider of technical services for defense and homeland security, is also well-positioned to make a sizable acquisition. With about \$1 billion on the balance sheet, new Chief Executive Walter Havenstein has a renewed focus on larger acquisitions to accelerate growth.

Some potential matches for SAIC are American Science & Engineering Inc (ASEI.O: Quote, Profile, Research, Stock Buzz) and Cogent (COGT.O: Quote, Profile, Research, Stock Buzz), both of which have exceptional profit margins and strong growth trajectories.