The McLean Group



DEFENSE & GOVERNMENT SERVICES M&A

2010 YEAR IN REVIEW

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2010 YEAR IN REVIEW CONTENTS

2010: HEDGING RISK OR DOUBLING DOWN?

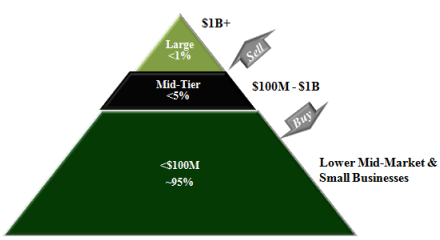
The Defense and Government Services sector faced an uncertain climate in early 2010, but a variety of factors saw the year end with levels of M&A activity not seen since the 2006/2007 peak years. We tracked 253 federal M&A deals in 2010, a 35% year-over-year increase vs. 2009. Transaction multiples for federal contractors generally declined in many sub-sectors in 2010 compared to their mid-decade highs, yet the industry has held up remarkably well in light of the continuing global economic, political and financial challenges. While many drivers influenced this highly dynamic market, in this report we will focus on what we believe to be five of the most prominent macroeconomic and industry-specific trends stimulating defense and government services M&A activity in 2010: (1) the US Fiscal Environment, (2) The Public Market Recovery, (3) The Middle Market Crunch and set-aside concerns, (4) Asymmetric Warfare and (5) Organizational Conflicts of Interest.

(1) THE US FISCAL ENVIRONMENT

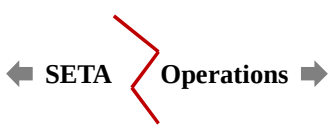
(2) THE PUBLIC MARKET RECOVERY

(3) ASYMMETRIC WARFARE

(4) THE MIDDLE MARKET CRUNCH & SET-ASIDE CONCERNS



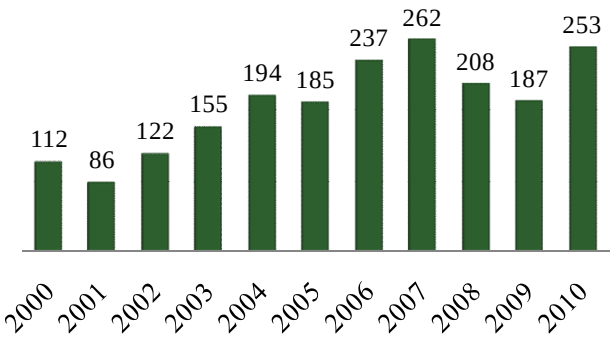
(5) ORGANIZATIONAL CONFLICTS OF INTEREST



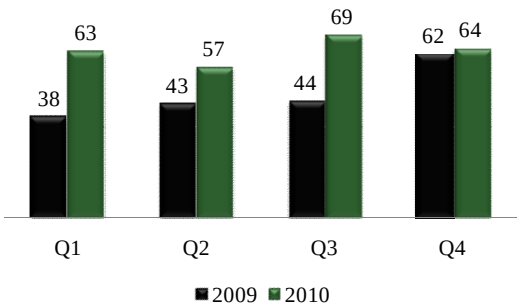
2010 DEFENSE & GOVERNMENT SERVICES M&A ANALYSIS

Defense and Government Services sector M&A activity increased year-over-year for the first time since 2007. 2010 saw 253[1] reported transactions, up more than 35% from 2009 (and back to 2006/2007 M&A levels). Building on the momentum of 2009's second half, 1Q2010 deals rose to 63 transactions, slowed a bit to 57 in 2Q2010, and steadily picked up in 3Q2010 to 69 and to 64 in 4Q2010. Disclosed transaction valuation multiples also increased in 2010: the median EV/EBITDA (trailing) multiple was 11.9x vs. 8.2x in 2009 and EV/Revenue (trailing) was 1.5x vs. 1.1x in 2009.

# of Deals (Annually)

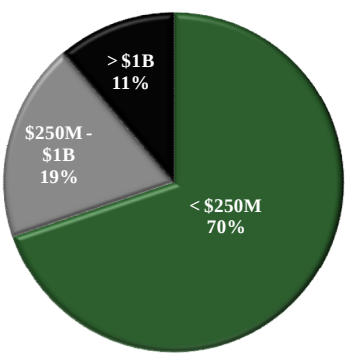


# of Deals (2010 vs. 2009)

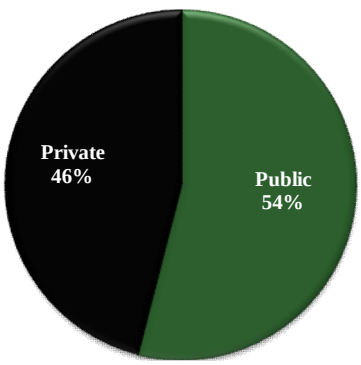


Of the 253 disclosed transactions, 70% were less than $250 million in enterprise value, 19% fell between $250 million and $1 billion in enterprise value, and 11% exceeded $1 billion in enterprise value. Among buyers, public and private companies accounted for 54% and 46% of these transactions, respectively. Public and private *sellers* accounted for approximately 5% and 95% of transactions, respectively.

Enterprise Value of Disclosed Deals



Buyer Profile



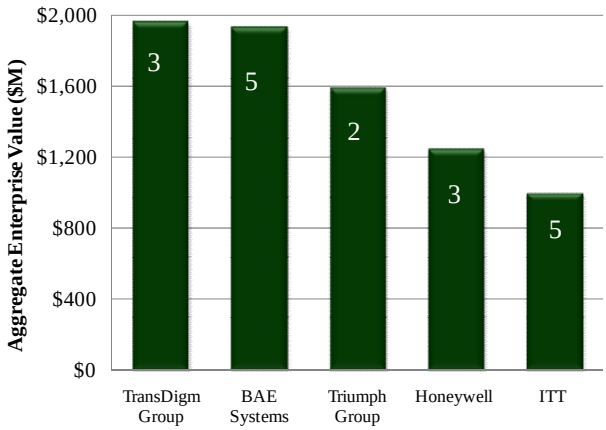
Private equity activity increased in 2010 year-over-year on an absolute basis with 66 reported deals vs. 60 in 2009, while decreasing on a relative basis with private equity buyers accounting for 25% of total 2010 deals (including both direct platform investments and bolt-ons to existing portfolio companies) vs. 32% in

[1] Sources: TMG, InfoBase, Capital IQ

2009. Strategic buyers maintained the lion's share of 2010 deal activity (75%). Notably, financial sponsors also were active 2010 sellers, with 41 exits. Foreign buyers also played a prominent role, driving 28% of 2010 deals.

With ample "dry powder" available for acquisitions—from both cash reserves and better access to financing—larger public companies played a major role as buyers in 2010. BAE Systems, SAIC, ITT, and Ametek each completed 5 transactions, leading the sector. By dollar value, TransDigm Group led with a total aggregate transaction value of $2 billion in enterprise value[2], with BAE Systems, Triumph Group, Honeywell and ITT rounding out the top five.

Top Buyers by $ Value and # of Relevant Deals



[2] HP's $2.2 billion acquisition of 3Par was excluded from this calculation.

2010 MACROECONOMIC TRENDS & COMMENSURATE M&A ACTIVITY

I. (a) Macro Trend: US Fiscal Environment

While early 2004 through late 2007 was a boom time for both the macro economy and the federal contracting community and the 2008 through mid-2009 period brought a very abrupt market downturn, 2010 was marked by vast uncertainty and is significantly more difficult to categorize. The US economy kicked off the year unsteadily. The Dow, having leveled off following a strong recovery during the second half of 2009, proceeded to fluctuate drastically throughout 2010 before closing the year up 10%.

In 2010, US officials and the American public shifted focus from the financial and mortgage turmoil of the prior three years to the US' ballooning federal deficits and the commensurate interest expense to service the national debt. Keeping in mind lessons learned from the economic downturn, many in Congress and the media called on the federal government to rein in spending and balance the budget. Continuing fiscal imbalance was compounded by the expiring Bush-era tax cuts at year-end 2010 and potential repercussions of extending capital gains (and other) tax cuts for middle and upper income taxpayers. Concerned about an imminent capital gains tax once Bush-era tax cuts expired in 2010, many middle market business owners pursued sell-side M&A options when they otherwise might have deferred an exit or liquidity event. However, in the wake of the 2010 elections, political compromise led to the extension of tax cuts passing Congress and being signed by the President in December 2010.

Fiscal austerity drove lawmakers and federal planners to evaluate annual budget items that could be trimmed or deferred. In short order, the Department of Defense (DoD) budget came under scrutiny. While defense spending as a percentage of GDP has declined during the last several decades and stayed relatively flat since 9/11 (at 4% - 5% of annual GDP), US military spending on a relative and absolute basis remains larger than that of such key allies as Germany, Britain and France[3]. The US' global role and responsibilities obviously are far more significant than its allies' but the US' budget deficit has forced lawmakers to closely evaluate global military operations to determine which efforts are sustainable and which must be curtailed or eliminated. Ongoing engagements in Afghanistan/Pakistan and Iraq and contingency planning against the eventuality of hostilities in Iran, North Korea, Yemen, Somalia, Mexico and elsewhere drive the DoD budget in large part. Toward year-end 2010, Defense Secretary Gates clarified that the DoD would pursue a focused, rifle shot approach to budget cuts, targeting specific large programs and systems (e.g. the Expeditionary Fighting Vehicle and F-35 Joint Strike Fighter) rather an across-the-board percentage reduction. As a result, funded contract backlog became critical this year. Having a core presence in one or more of those DoD realms most likely to experience continued funding growth—the Intelligence Community (IC), cyber security, data analytics, soft power, logistics, secure communications among many other mission-critical, close-to-the-warfighter functions—became no less crucial. (These topics will be explored in depth in the Asymmetric Warfare section of this report).

During 2010, the government prioritized base relocation and consolidation (BRAC) to cut costs and maximize efficiency wherever possible. The government also sought to insource top contractor talent to: (theoretically) reduce contractor expenses on "inherently governmental functions," and help solve a "brain drain" arising as retirements of baby boomer government workers accelerate. While insourcing

[3] SIPRI research and Christian Science Monitor, "Cuts to US Defense Budget Look Inevitable", June 2010.

received a great deal of attention in the media and federal community, by year-end 2010, it had become apparent that the actual net impact of insourcing likely had been overestimated.

Finally, budget austerity and a cheap US dollar drew attention from foreign buyers this year. Foreign firms, most having an established US government presence, jumped at the chance to win greater penetration with one of the world's largest and most reliable customers.

I. (b) US Fiscal Environment: Representative M&A Activity

Facing an uncertain budget climate while recognizing their reliance on large contracts and weapons programs that likely faced targeted cuts, large prime contractors spent much of 2010 evaluating short- and long-term strategic plans and attempting to align them with the best-funded federal budget priorities. In most cases, this meant divesting certain business units to revert to core product/service offerings going forward. Divestitures sometimes coincided with spin-offs related to Organizational Conflict of Interest (OCI) concerns (to be discussed later in this report). Orbital Sciences acquired General Dynamics' spacecraft development business in April 2010 for $55 million.[4] Lockheed Martin sold its EIG business to Veritas Capital for $815 million in November and announced that it would sell its PAE development and engineering business in June. In September and October, respectively, CSC sold its Mission Solutions Engineering business to ASRC Federal and QinetiQ sold its Security and Intelligence business to ManTech ($60 million). Also in October, IT Solutions bought NetStar-1's IT Services division for $75 million. In November, SRA International sold its Airport Operations Solutions business to ITT.

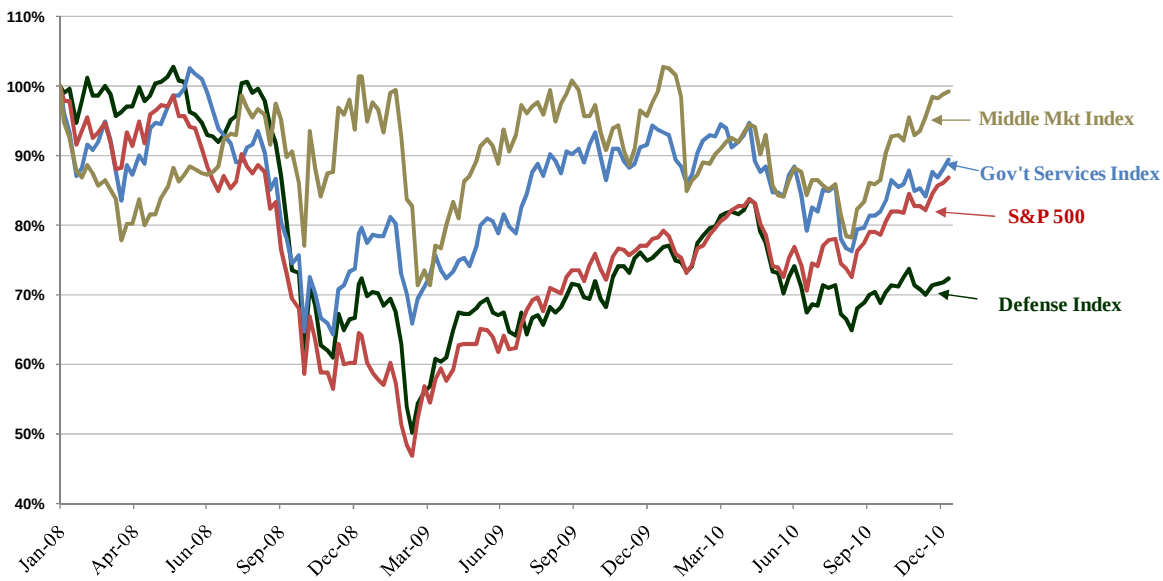
Notable foreign buyers during 2010 included French aerospace and defense conglomerate SAFRAN and UK-based BAE Systems with their respective deals for L-1's Identity Solutions business ($1.6 billion) and Intelligence Consulting business ($303 million). Canadian contractor CGI acquired Stanley for $1.1 billion in August 2010 while Chemring, a British weapons firm, acquired Allied Defense Group for $67 million in September. Foreign-owned firms' acquisitions of US defense and Intelligence Community contractors generally face intense scrutiny by the US Treasury's Committee for Foreign Investments in the US (CFIUS). However, many large foreign-owned firms, and most of those discussed above, have established requisite proxy boards and security agreements to enable their US government contracting divisions to act independently, thereby ensuring that classified US information and technology is not compromised.

[4] All transaction data courtesy of Capital IQ.

II. (a) Macro Trend: The Public Market Recovery

US equity markets closed 2010 on an upswing, driving the Dow Jones Industrial Average up 10%, the S&P 500 up 13%, and the NASDAQ up 17%. Our Defense index tracked the S&P through the first half of the year before falling behind in the third and fourth quarters to finish slightly below January levels. While our Middle Market Contractor and Government Services indices outperformed benchmark indices throughout 2009 as investors came to appreciate the federal sector's steady growth and transparent cash flows, 2010 brought a number of global challenges, including the European debt crisis, slower-than-expected jobs and housing recoveries, and such unexpected shocks to the system as May 2010's "flash crash", where the Dow sank 1,000 points in minutes (though it wound up recovering most of those losses during that same trading day). Such events gave investors pause, triggering a mid-year overall market correction. Reassurances from Federal Reserve chairman Ben Bernanke and aggressive quantitative easing helped bring the markets back in line to finish the year strong. The Defense index finished below the S&P on a relative basis for the year, while the Middle Market and Government Services indices closed the year roughly in line with the benchmark indices.

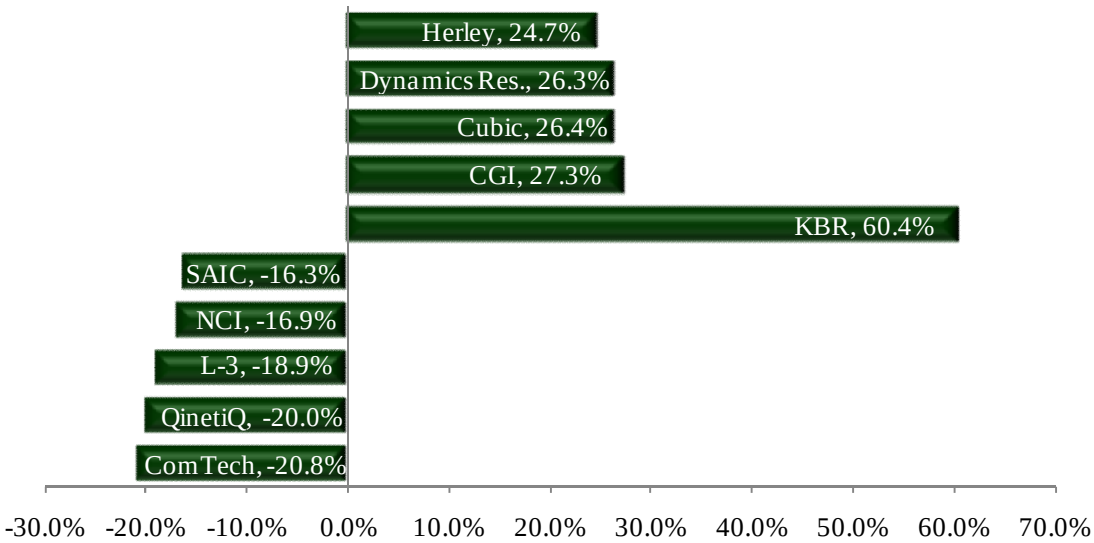
Relative Performance of the Defense, Government Srvcs. and Mid-Market Contractor Indices[5]



Cubic and KBR, two members of our Defense and Government Services indices, ended 2010 up 26.4% and 60.4%, respectively. Cubic had positive acquisition news from the Abraxas and XIO Strategies transactions while KBR continued providing infrastructure support in Iraq and Afghanistan and leveraged its diversified revenue stream. Firms like ManTech, which ended the year down 14.5%, faced increasing pressure from Wall Street analysts and investors during 2010 on their reliance on overseas or OCONUS contracts to support Iraq and Afghanistan.

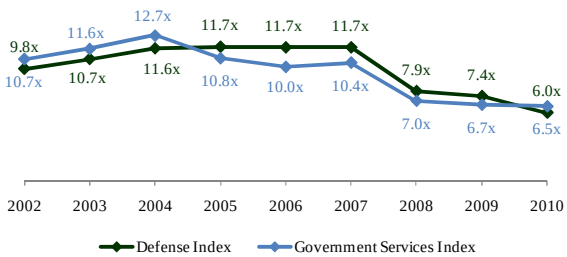
[5] All data from Capital IQ, Defense Index components: ATK, FLIR, GD, HRS, ITT, LLL, LMT, LSE:BA., LSE:QQ., NOC, RTN; Government Services Index components: CACI, CSC, GIB, KBR, MANT, NYSE:SAI, SRX; Middle Market Index components: AVAV, CMTL, CUB, DRCO, GTEC, HRLY, ICFI, KEYW, NCIT

Defense & Government Services Firms – Best and Worst Performers (Top 5)

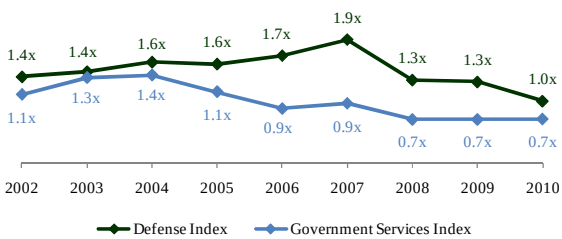


Trading valuations across the sector indices were adversely affected by uncertainties surrounding prospective Obama administration budget cuts. While mean EV/EBITDA multiples (trailing) are historically low (6.0x for Defense and 6.5x for Government Services), the Defense and Government Services companies completed initial cost cutting measures, and resulting improvements likely will be reflected in increased 2011 profit margins and valuation metrics.

EV/EBITDA Trading Multiples (2002-2010)



EV/Revenue Trading Multiples (2002-2010)



Defense Index[6]

Company ($ Millions)	Enterprise Value	LTM Revenue	EBITDA Margin	EV / LTM Rev	EV / LTM EBITDA	EV / FY11 Rev	EV / FY11 EBITDA	Proj. EBITDA Growth FY11	Proj. EBITDA Growth FY12	Cash	Assets	Net Debt	Book Value
General Dynamics Corp.	$28,165.7	$31,763.0	13.8%	0.9x	6.4x	0.8x	6.2x	2.2 %	3.0 %	$1,843.0	$31,483.0	$1,361.0	$13,582.0
Lockheed Martin Corporation	26,772.6	46,406.0	10.8%	0.6x	5.3x	0.6x	5.7x	(6.3)%	8.1 %	3,423.0	35,551.0	1,596.0	3,918.0
Northrop Grumman Corporation	20,535.0	35,075.0	10.4%	0.6x	5.6x	0.6x	5.3x	6.3 %	1.4 %	2,589.0	30,176.0	1,620.0	13,194.0
Raytheon Co.	17,196.9	24,965.0	11.8%	0.7x	5.9x	0.7x	5.3x	8.6 %	5.7 %	2,149.0	22,852.0	177.0	10,100.0
BAE Systems plc	12,450.2	32,102.4	13.9%	0.4x	2.8x	0.4x	3.0x	1.9 %	3.4 %	4,528.1	37,235.2	1,127.2	6,210.6
L-3 Communications Holdings Inc.	11,560.5	15,633.0	12.5%	0.7x	5.9x	0.7x	6.0x	(3.2)%	(1.2)%	650.0	15,382.0	3,492.0	6,910.0
ITT Corporation	10,298.4	10,999.5	14.4%	0.9x	6.5x	0.9x	6.2x	9.7 %	4.8 %	912.0	12,460.0	731.0	4,329.0
Harris Corp.	6,919.0	5,408.5	22.1%	1.3x	5.8x	1.2x	5.7x	9.8 %	(1.1)%	344.7	5,206.7	1,107.4	2,293.7
FLIR Systems, Inc.	4,338.3	1,262.5	32.4%	3.4x	10.6x	2.6x	9.0x	13.7 %	11.6 %	379.9	1,733.1	(379.9)	1,440.1
Alliant Techsystems Inc.	3,712.8	4,802.0	13.6%	0.8x	5.7x	0.8x	5.8x	(1.7)%	(1.0)%	265.7	4,103.8	1,225.1	993.0
QinetiQ Group Plc	1,375.3	2,645.1	9.9%	0.5x	5.3x	0.5x	4.9x	11.4 %	3.5 %	70.7	2,314.6	523.8	612.0
Low	1,375.3	1,262.5	9.9%	0.4x	2.8x	0.4x	3.0x	(6.3)%	(1.2)%	70.7	1,733.1	(379.9)	612.0
Mean	13,029.5	19,187.4	15.0%	1.0x	6.0x	0.9x	5.7x	4.8 %	3.5 %	1,559.5	18,045.2	1,143.7	5,780.2
Median	11,560.5	15,633.0	13.6%	0.7x	5.8x	0.7x	5.7x	6.3 %	3.4 %	912.0	15,382.0	1,127.2	4,329.0
High	28,165.7	46,406.0	32.4%	3.4x	10.6x	2.6x	9.0x	13.7 %	11.6 %	4,528.1	37,235.2	3,492.0	13,582.0

Government Services Index[6]

Company ($ Millions)	Enterprise Value	LTM Revenue	EBITDA Margin	EV / LTM Rev	EV / LTM EBITDA	EV / FY11 Rev	EV / FY11 EBITDA	Proj. EBITDA Growth FY11	Proj. EBITDA Growth FY12	Cash	Assets	Net Debt	Book Value
Computer Sciences Corporation	$9,015.4	$16,107.0	14.5%	0.6x	3.9x	0.5x	3.7x	(6.2)%	7.2 %	$2,657.0	$16,887.0	$1,290.0	$6,971.0
SAIC, Inc.	6,357.0	11,031.0	9.5%	0.6x	6.0x	0.6x	6.1x	9.1 %	(1.3)%	644.0	5,538.0	460.0	2,485.0
CGI Group, Inc.	5,612.9	3,614.6	18.8%	1.6x	8.3x	1.2x	6.5x	24.9 %	5.5 %	136.6	4,462.2	981.0	2,084.9
KBR, Inc.	3,548.8	10,623.0	5.3%	0.3x	6.3x	0.4x	5.5x	2.1 %	8.6 %	1,175.0	5,466.0	(1,068.0)	2,331.0
CACI International Inc.	1,917.0	3,243.6	7.8%	0.6x	7.6x	0.5x	6.7x	15.7 %	6.7 %	110.1	2,119.6	295.1	1,187.5
ManTech International Corporation	1,551.3	2,448.2	9.4%	0.6x	6.8x	0.5x	5.9x	9.3 %	1.6 %	152.1	1,504.0	47.9	925.6
SRA International Inc.	1,067.3	1,673.8	9.0%	0.6x	7.1x	0.6x	6.5x	8.2 %	8.6 %	100.6	1,047.5	(100.6)	792.1
Low	1,067.3	1,673.8	5.3%	0.3x	3.9x	0.4x	3.7x	(6.2)%	(1.3)%	100.6	1,047.5	(1,068.0)	792.1
Mean	4,152.8	6,963.0	10.6%	0.7x	6.5x	0.6x	5.9x	9.0 %	5.3 %	710.8	5,289.2	272.2	2,396.7
Median	3,548.8	3,614.6	9.4%	0.6x	6.8x	0.5x	6.1x	9.1 %	6.7 %	152.1	4,462.2	295.1	2,084.9
High	9,015.4	16,107.0	18.8%	1.6x	8.3x	1.2x	6.7x	24.9 %	8.6 %	2,657.0	16,887.0	1,290.0	6,971.0

Middle Market Index[6]

Company ($ Millions)	Enterprise Value	LTM Revenue	EBITDA Margin	EV / LTM Rev	EV / LTM EBITDA	EV / FY11 Rev	EV / FY11 EBITDA	Proj. EBITDA Growth FY11	Proj. EBITDA Growth FY12	Cash	Assets	Net Debt	Book Value
Cubic Corporation	$901.0	$1,194.2	10.0%	0.8x	7.5x	0.7x	7.3x	3.1 %	3.0 %	$379.5	$856.1	(359.0)	$488.3
ICF International Inc.	593.5	745.9	9.2%	0.8x	8.7x	0.7x	7.3x	14.1 %	9.5 %	6.5	567.7	93.5	344.4
AeroVironment, Inc.	428.2	262.2	13.5%	1.6x	12.1x	1.5x	10.9x	0.8 %	26.7 %	157.3	276.2	(157.3)	231.6
The KEYW Holding Corporation	399.2	90.7	6.1%	4.4x	NA	1.8x	13.1x	199.7 %	36.5 %	1.3	140.4	28.9	80.6
Comtech Telecommunications Corp.	360.0	822.5	18.7%	0.4x	2.3x	0.6x	3.0x	(11.8)%	(21.8)%	602.7	1,028.9	(402.7)	701.5
NCI, Inc.	338.1	535.5	7.9%	0.6x	8.0x	0.6x	6.9x	11.4 %	8.2 %	1.9	265.5	26.6	145.2
Herley Industries Inc.	236.8	189.4	16.5%	1.3x	7.6x	1.2x	7.1x	18.8 %	13.4 %	18.2	222.9	(6.4)	162.8
Global Defense Technology & Systems, Inc.	145.7	206.3	6.2%	0.7x	11.4x	0.5x	5.0x	52.1 %	7.5 %	8.6	114.7	(8.6)	91.5
Dynamics Research Corp.	136.6	268.1	9.9%	0.5x	5.2x	0.5x	4.8x	7.9 %	5.9 %	22.5	198.9	2.0	104.4
Low	136.6	90.7	6.1%	0.4x	2.3x	0.5x	3.0x	(11.8)%	(21.8)%	1.3	114.7	(402.7)	80.6
Mean	393.2	479.4	10.9%	1.2x	7.8x	0.9x	7.3x	32.9 %	9.9 %	133.2	407.9	(87.0)	261.1
Median	360.0	268.1	9.9%	0.8x	7.8x	0.7x	7.1x	11.4 %	8.2 %	18.2	265.5	(6.4)	162.8
High	901.0	1,194.2	18.7%	4.4x	12.1x	1.8x	13.1x	199.7 %	36.5 %	602.7	1,028.9	93.5	701.5

[6] Figures from Capital IQ as of December 31, 2010 or latest quarterly financials.

II. (b) The Public Market Recovery: Representative M&A Activity

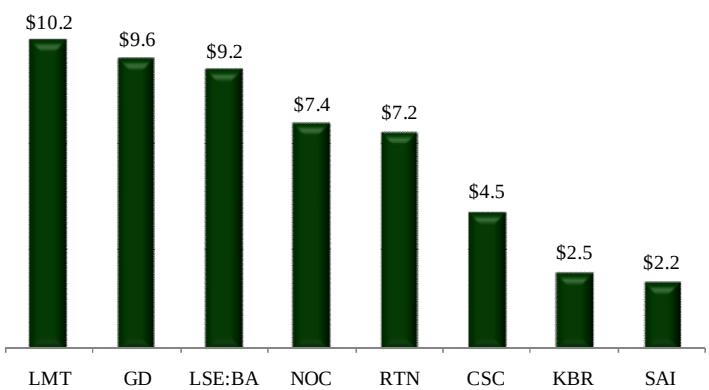
As US public markets recovered in 2010, Wall Street analysts came to expect better performance out of the defense and government services community. These expectations, combined with increasing likelihood of a flat defense budget environment, drove M&A activity levels higher in 2010. Publicly-traded defense and government services sector firms face constant pressure to demonstrate quarterly growth, while simultaneously facing long sales cycles that require complex strategic planning and positioning. With long-term growth targets likely out of reach through organic growth alone, large and mid-tier contractors leveraged M&A as an economical method to deploy investment capital. Meanwhile, rising stock prices provided a cheaper acquisition currency, further motivating buyers to strike while the stars remained aligned.

As more and more executives gravitated to defense and government services M&A for growth, competition for available properties heated up. Competitive auctions drove up prices for attractive acquisition candidates having a core presence in cyber security, data analytics, healthcare IT, environmental services and the Intelligence Community, among other growing government activities. While large public-to-public M&A transaction premiums increased seller expectations industry-wide, buyers remained resilient and deals got done. Low EV/EBITDA trading multiples historically produced a ceiling for private market acquisition valuations but in 2010, buyers were willing to pay multiples that exceeded their own valuations based on their convictions that such transactions would prove accretive to earnings immediately or in short order.

Recent adverse economic events and seemingly imminent budget cuts led to a flurry of buying and selling as many companies took preemptive action to maintain shareholder value. Public defense and government services firms aggressively built up cash balances, cut costs, reduced debt, and adjusted strategic plans in response to the rapidly changing economic conditions. Many firms in the sector now are flush with cash while debt loads are extremely low (the Defense and Government Services indices boast debt-to-capital ratios of 0.5x and 0.3x, respectively). This should continue to spur a healthy M&A environment in 2011.

Also, companies in these indices have the ability to pay down debt quickly if necessary, with both Defense and Government Services having Net Debt to EBITDA ratios of 0.2x. Strong cash balances and low existing debt, alongside increased senior and mezzanine lending, translate into ample amounts of "dry powder"—enabling many contractors to make acquisitions to complement organic growth and put capital to work.

Estimated Acquisition Capacity of Large Primes ($B)[7]



[7] Acquisition capacity estimated as debt capacity (2.5x LTM EBITDA) plus existing cash on balance sheet, less current debt balance (cash and debt balance as of 12/31/10).

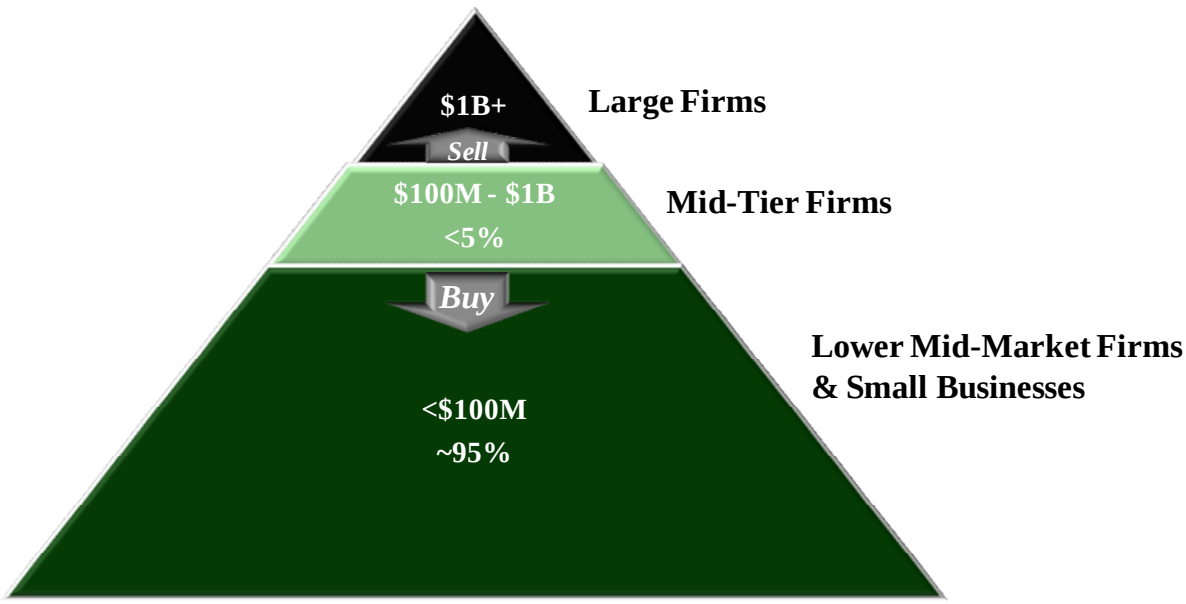
2010 saw the IPO market improve slightly for the defense and government services market. GTEC's IPO in late 2009 ended a long drought for the sector. In 2010, KeyW Corp. and Booz Allen successfully completed IPOs. These IPOs came at a crucial time for the sector as several prominent, publicly-traded middle market players were taken out through M&A during the year, including Stanley (CGI), ICx (FLIR Systems), Argon ST (Boeing), L-1 (BAE Systems & SAFRAN), and Applied Signal (Raytheon).

For owners, IPOs generally represent capital raising or debt repayment strategies as opposed to exits or liquidity events. IPOs generally are not an appropriate—or practicable—strategy for most lower middle market firms. Compliance costs and increased pressure to perform and achieve consistent quarterly growth place heavy and unnecessary burdens on many companies that are far better suited to grow and/or exit through M&A. Nonetheless, such middle market government services firms as GTEC, KeyW and Booz Allen have demonstrated their ability to grow rapidly on organic and inorganic bases while attracting both institutional and private investors.

III. (a) Macro Trend: Middle Market Crunch

The trend of mid-tier federal contractor consolidation continued in 2010. Middle market firms generating between $100 million and $1 billion in annual revenue account for fewer than 5% of all federal contractors. Companies generating more than $1 billion in annual revenue constitute less than 1% of all federal contractors. Thus, the overwhelming majority (~95%) of federal contractors is made up of lower middle market firms and small businesses. Middle market contractors are squeezed on the one hand by large prime contractors (wielding substantially more human capital, financial resources and past performance qualifications) and on the other by small businesses leveraging very strong customer relationships and, in many cases, eligibility for SBA set-aside advantages unavailable to mid-tier firms. Accordingly, middle market firms often are forced to become buyers or sellers in the pursuit of strategic growth or an eventual exit. Mid-tier firms routinely acquire smaller companies to gain scale, key capabilities and/or customers while making themselves more attractive acquisition candidates for larger firms seeking transformative acquisitions that will "move the needle".

The Middle Market Crunch



In 2010, middle market firms experienced increased pressure from the top as the government pursued a more cost-effective procurement process by making bundled contracts much more commonplace. Agencies rolled numerous contracts with similar scopes of work into larger IDIQ solicitations often worth hundreds of millions of dollars or more. This caused difficulties for to mid-tier firms lacking both inherent advantages of SBA set-asides and the business development/program management expertise of larger firms. In addition, the federal government made public its preference for Firm Fixed Price (FFP) contracts versus Time & Materials (T&M) awards that in prior years were more prevalent. FFP contracts enable the government to more closely control and budget annual expenditures by shifting risks primarily to contractors. Contractors are granted the ability to increase profit margins by completing the work faster and/or less expensively than planned or lose money in the case of inefficiencies and unforeseen delays or expenses. In the case of professional services contracts with unclear scopes and/or

requirements, many contractors believe T&M solicitations historically have provided the government the flexibility required for its most mission critical programs. Striking a balance between systematic procurement planning and the versatility to customize contracts for mission critical national security and intelligence programs was a key theme in 2010 and will prove no less important in 2011.

Pressure from the bottom continued in 2010 for middle market companies as well. Small businesses with access to Small Business Administration (SBA) set-aside contracts have a significant competitive advantage in the marketplace over their mid-tier competitors, who often face-off against much larger contractors in Full & Open procurements. Government agencies are required by law to award a percentage of contracts to small and/or disadvantaged businesses annually (usually in the area of 25% of all contract spending). However, small firms themselves face a difficult contracting environment, often forced to compete against Alaskan Native Corporations (ANCs) that can be several billion dollars in revenue and still receive sole source SBA 8(a) set-aside awards with no size limits. ANCs were created in 1971 to settle land claims and help improve quality of life for thousands of impoverished Alaskan native people. According to the Washington Post[8], roughly 300 ANC subsidiaries have been created to pursue federal work that have received $29 billion during the past decade, most through sole-source awards without competition.

Amid budget cuts and stretched contracting dollars in 2010, lawmakers began to take a stand against any procurement processes that could potentially limit competition and that may not be in the best interests of American taxpayers. In November, Senator Claire McCaskill, chairwoman of the Senate Homeland Security and Governmental Affairs contracting oversight subcommittee, proposed a bill that would require ANCs to adhere to the same rules and regulations as other 8(a) firms. Under the new law, ANCs would have to: (1) justify their status as socially and economically disadvantaged businesses (2) could no longer receive sole source awards exceeding the caps applicable to other 8(a) firms and (3) could no longer pass through a majority of awarded work to subcontractors.

In addition to a potential crack down on ANC advantages, lawmakers also took a closer look during 2010 at veteran-owned and service-disabled veteran-owned (SDVOSB) small business set-aside contracts. Historically, veterans could self-certify their service disabled veteran status with the SBA to qualify for set-asides, but this led to abuse during the last several years—the Government Accountability Office (GAO) stated that at least 10 fake SDVOSBs had earned roughly $100 million from SBA set-aside contracts. Going forward, the SBA will work closely with the Veterans Affairs Department to use its database of veterans information to better identify who actually qualifies as a SDVOSB.

To enhance shareholder value, public or privately-owned mid-tier contractors should seek aggressive organic growth while pursuing inorganic M&A strategies and/or considering other strategic opportunities, such as a sale to a larger firm or financial buyer.

[8] Washington Post, "Alaska Native Status Gave Tiny, Inexperienced Firm a $250 million Army contract", November 26, 2010

III. (b) Middle Market Crunch: Representative M&A Activity

In 2010, mid-tier contractors were very active in the M&A marketplace as buyers and sellers. Mid-tier buyers acquired smaller or similarly-sized firms to more rapidly approach critical mass than would be possible through organic growth and to obtain key technologies and/or agency customers. GTEC, which successfully completed its IPO in late 2009, bolstered its Intelligence Community presence with back-to-back acquisitions of Zytel ($27 million) and Signature Government Solutions ($53 million) in 3Q2010 and 4Q2010, respectively. KeyW Corp., which completed its IPO in 3Q2010, closed four key 2010 acquisitions of niche cyber security firms with established customer relationships and strong technical capabilities: The Analysis Group ($62 million), Insight Information Technology ($11 million), Sycamore Inc. ($28 million) and Everest Technology Solutions ($30 million). Kratos Defense & Security, an engineering and IT services firm with $363 million in annual revenue, also was an active buyer in 2010, picking up Gichner Systems Group for $133 million and publicly-traded security technology provider Henry Brothers Electronics for $59 million. Other 2010 middle market buyers included Jacobs Engineering Group (which acquired Tech Team Government Solutions for $68 million), AECOM (which acquired McNeil Technologies from private equity firm Veritas Capital for $355 million), Cubic Corp. (which acquired IC support firm ABRAXAS) and GeoEye (which acquired SPADAC for $46 million).

Mid-tier contractors were also active sellers in 2010. Boeing paid $799 million (13x LTM EBITDA) to acquire ArgonST. FLIR Systems bought surveillance technology provider ICx for $226 million, BAE Systems and SAFRAN agreed to acquire L-1's Intelligence Consulting Business ($303 million) and Identity Solutions Business ($1.6 billion), respectively. Raytheon won a highly-publicized auction for Applied Signal, paying $476 million (15x LTM EBITDA).

Size Premium

In addition to profitability, growth, core capabilities and customers, a size premium impacts middle market deal valuations. Increased critical mass typically reflects stronger relationships, business development practices and contract backlog, all of which create more stability and transparency when it comes to future cash flows. In the case of Intelligence Community contractors, lower middle market firms generating less than $100 million in revenues may sell for 9x - 11x LTM EBITDA, on average, while mid-tier players can attract 12x - 15x LTM EBITDA valuations. In addition, publicly-traded firms benefit from a liquidity premium: their shares are much more easily bought and sold than those of privately-held firms.

Ultimately, a buyer's unique growth objectives and access to capital will determine the purchase multiple it is willing to pay. While such public firms as KeyW and GTEC leveraged their ability to access capital to close rapid-fire acquisitions, this strategy may not be as appropriate for similarly sized private firms that may be better suited to consummate an acquisition and then carefully integrate employees, customers and capabilities before proceeding to the next target.

Private Equity

Private equity remained very active buyers and sellers throughout 2010. Platinum Equity acquired OAO Technology Solutions, Francisco Partners bought EF Johnson Technologies for $56 million, Providence Equity acquired Kroll Inc. for $1.1 billion and the especially busy Veritas Capital announced its intent to purchase PerkinElmer's Illumination and Detection Solutions Business ($500 million), Johnston McLamb

(Size N/A), CPI International ($570 million), and Lockheed Martin's Enterprise Integration Group ($815 million). Veritas also benefited from Cerberus Capital Management's $1.6 billion take-private transaction of DynCorp by liquidating its remaining equity stake in the publicly-traded company.

Financial buyers also were active sellers in 2010, validating roll-up strategies executed during the past several years to attain critical mass and achieve size premiums. DC Capital Partners sold National Interest Security Company (NISC) to IBM. NISC was formed in 2007/2008 by the roll-up of seven intelligence companies with capabilities ranging from sophisticated technical IT services to more high-level strategic advisory and consulting. NISC's sale to IBM presents a good middle market size premium case study: seven loosely integrated companies bundled together garnered significantly more M&A marketplace value than the sum total of the individual firms. A key element in creating such value in the availability of a buyer—like IBM—that is willing to pay a premium for a "needle-moving" acquisition that immediately would deliver a significant presence in the IC. Veritas' sale of portfolio company McNeil Technologies to AECOM for $355 million offers further evidence of size premiums in 2010 financial sponsor exits.

Small Business Set-asides

Small and mid-sized firms with SBA set-aside contracts have become more difficult to acquire following the regulation changes of 2007 that require small businesses to recertify with the SBA after a change in control. While this does not automatically mean the Company loses all of its set-aside contracts, the SBA will notify the relevant agency of the change in status to let them know that the agency can no longer receive small business credit for that particular work—a factor that carries varying levels of weight with different agencies. Middle market firms that have graduated or will soon graduate from the SBA's 8(a) program, or that have outgrown (or soon will) small business size thresholds but still have runway left on legacy set-aside contracts, can still be attractive acquisition targets in the M&A marketplace. Buyers will look for a proven track record that sellers can compete for and win work in Full & Open competition. In some cases, for many Intelligence Community customers for example, set-aside credit is far less important to an agency procuring mission critical work than assurance that the agency is filling the requirement with the best firm for job. In these instances, buyers may be able to look past legacy set-aside work as it pertains to their valuation of the target and have some confidence that the target will be able to maintain historical growth rates in a competitive environment.

In addition, successful smaller firms with access to set-asides can acquire or merge with their peers and maintain set-aside status (as long as the combined firm does not exceed revenue or employee thresholds). Now that debt markets have thawed, this option has become a feasible method of growth for many small firms with cash on their balance sheets that need additional scale or access to new markets. ANCs also have been active buyers of lower mid-market firms with set-asides due to their perpetual 8(a) status and ability to hold unlimited subsidiaries under their umbrella. ANCs are among a very limited buyer universe for small 8(a) companies or those that had recently graduated from the program but had not demonstrated their ability to transition to Full & Open competition. However, Senator McCaskill's proposed law would likely put an end to this trend. ANCs also face difficulties in acquiring small firms, since the expense and effort to acquire and integrate a $5 million contractor is often comparable to that of a firm 5 or 10 times larger—leading ANCs to pursue larger deals (e.g. ASRC's acquisition of Mission Solutions Engineering in September). The outlook for sellers with set-asides in 2011 and beyond is that

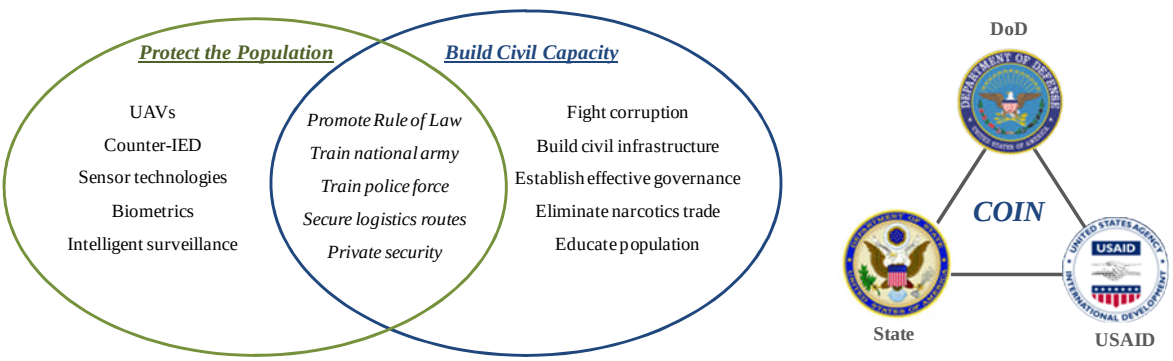
while the rules certainly have become more complex, there remains demand for selected small businesses in the federal M&A marketplace.

IV. (a) Macro Trend: Asymmetric Warfare

Despite much uncertainty throughout 2010, one thing became clear as day: the manner in which the US and the world historically addressed military and social conflict no longer was an effective deterrent. Since 9/11 in particular, the rise of asymmetric warfare has required the US and its allies to reassess military and homeland security strategies and tactics—both offensive and defensive—to develop new approaches. Counterinsurgency (COIN) doctrine was not new in 2010 when it was resurrected for use in Afghanistan following its success under General Patraeus in Iraq. General Patraeus himself was tapped to implement the COIN strategy in Afghanistan after public relations gaffes triggered General McChrystal's 2010 resignation as Commander, US Forces Afghanistan.

COIN doctrine has two fundamental goals: protect local populations and stand up effective civil institutions/security infrastructure to empower self-governance. To protect local populations, the US answered evolving asymmetric threats with advanced military technologies, UAVs and sensor technologies in particular. UAV use—whether for surveillance purposes or direct missile strikes—increased substantially in 2010 throughout Afghanistan and Pakistan. Demand for such security technologies as biometrics identification and intelligent video surveillance increased significantly as US and International Security Assistance Force (ISAF) officials sought methods to protect civilians from attackers while also reducing warfighter risk/casualties. These technologies also enable the military to protect more area with fewer resources, which likely will become increasingly important as the imperative to establish and maintain peace confronts inevitable budget cut and/or force reduction realities.

Contractor Support of COIN Doctrine in 2010



COIN doctrine's second objective, fighting endemic corruption to establish sound civil capacity and build an effective national army and police force, required engagement of a large group of civilian government personnel and contractors in 2010.

The core mandates of the US' military arm (DoD), its diplomatic arm (Department of State) and its development arm (Agency for International Development) in international conflicts became more obvious

throughout 2010, as military, political and budgetary pressures increased. State and USAID released their first Quadrennial Diplomacy and Development Review (QDDR), in which USAID announced plans to increase its headcount as required to accomplish its mission while increasing budget and program accountability agency-wide. COIN doctrine relies on a large, diverse group of experts in economics, agriculture, commerce, communications and other social infrastructure to guide nations emerging from conflict into a state of successful self-governance. In 2010, experienced contractors, the backbone of this "soft power" support system, played crucial roles in Afghanistan and many other nations worldwide.

During 2010, private security contractors and military/police trainers drew a significant amount of attention. Security contractors engaged in Afghanistan to protect US diplomats while training local police and national army forces saw some success but faced problematic media attention. US firms are heavily involved in this field, but local national security contractors engaged in Afghanistan to secure critical logistical supply routes, who also play a role, seldom exercise the same restraint or expertise as American (or Western-based) security firms. Local national security contractors also have earned a reputation for corruption and, in some cases, close linkage to the Taliban. In response to civilian killings and other transgressions, Afghanistan's President Hamid Karzai in 3Q2010 threatened to ban all private security firms from Afghanistan. This posed an immediate threat not only to US military personnel who rely on goods and fuel transported through the supply roads guarded by private security firms, but also to all US civilian diplomatic and development personnel guarded by American security contractors. Without private security, diplomatic and development missions so critical to the US' COIN strategy could not operate safely. President Karzai eventually softened his ban by year-end, but private security oversight and accountability remains a hot button issue.

Military and police trainers in Afghanistan enjoyed some success during 2010. Some US defense officials and legislators argue that a fundamental challenge implementing COIN doctrine in Afghanistan is the population's inability and/or lack of desire to defend its own country from insurgents. The numbers appear to show that trainers in Afghanistan have seen some success in both quantity and quality of the local security forces. As of late 2010 there were approximately 145,000 local nationals in the Afghan National Army, versus 100,000 in 2009 and 70,000 in 2008 (year-over-year growth exceeding 40%). The Afghan police force also is growing consistently, although at a less rapid rate, reaching a headcount of 115,000 in 2010 versus 95,000 in 2009[9].

The quality of the Afghan army and police forces has improved significantly as well. In 2008, only 5% of Afghan forces met basic marksmanship standards. This figure increased to 35% in 2009 and 97% in 2010. In 2008, 39% of Afghan civilian deaths were caused by local or ISAF forces. This figure fell to 24% in 2009 and 12% in 2010[10]. However, increased US and ISAF troop levels starting in early 2010 and a large Afghan national army brought increased troop causalities. Approximately 710 ISAF warfighters were killed in action in 2010, versus 514 in 2009. Afghan security force deaths increased to 1,200 in 2010 from 930 in 2009[11].

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[9] The New York Times, "States of Conflict: An Update" December 27, 2010.
[10] This is attributable in part to more accurate US drone strikes and more reliable intelligence.
[11] Afghan troop deaths in 2007 and 2008 were 1,010 and 1,105, respectively. The 2009 figure represented a reduction in deaths which could be attributed to better trained and managed soldiers, the increase in 2010 came amidst some of the most deadly battles fought during the four year period.

Despite gains made in Afghanistan in 2010, there were some very notable setbacks. The theme of uncertainty rang especially true for the conflict in Afghanistan. Political, military and economic factors have combined to create a difficult environment for contractors that are heavily reliant on programs supporting engagements in Afghanistan and Iraq.

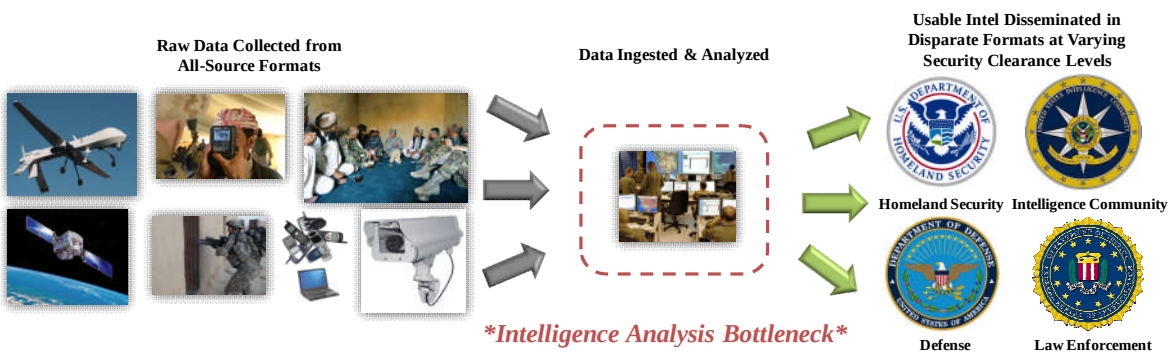
IEDs

Improvised Explosive Devices (IEDs), the insurgents' weapon of choice, remained a major threat to American and ISAF troops and Afghanis alike. The US military's use of Mine Resistant Ambush Protected Vehicles (MRAPs) has helped the cause somewhat—the military estimates a 30% year-over-year reduction in IED-related deaths and injuries. The Pentagon has deployed approximately 12,000 MRAPs in Afghanistan in support of some 100,000 troops.[12]

Intelligence Analysis

Sensor technologies continued to advance in 2010, becoming more available for use in UAVs, biometrics devices, surveillance equipment and other applications. Accordingly, raw data collection increased measurably and intelligence analysts struggled to ingest and make sense of the sheer volume of multi-source intelligence (e.g. GEOINT, SIGINT, HUMINT, etc.). As identified in the figure below, there is an intelligence analysis "bottleneck" in the human pipeline between the massive volume of raw data collected daily in the field and the usable intelligence that is shared with IC, DoD, homeland security and law enforcement agencies.

The Intelligence Analysis "Bottleneck"



Unfortunately, this human bandwidth bottleneck grew narrower in 2010 as a function of the aforementioned evolving sensor technologies delivering more and more raw data to a relatively static analyst workforce. The IC and DoD turned to contractors to provide best-in-class data analytics technologies and security-cleared, skilled engineers and analysts that could augment government staff to analyze raw field data and implement and support the new analytics systems.

During 2010, the IC reiterated its intent to establish methods to collaborate with other independent agencies more frequently and effectively across disparate systems and varying security clearance levels. This issue was a prime target of the Washington Post's multi-part exposé on the IC, titled "Top Secret

[12] Army Times, *"MRAPs Reducing IED deaths in Afghanistan"*, December 13, 2010.

America", released in July 2010. The Post focused on contractors, identifying and organizing the firms into groups by capabilities and agencies that they support. The articles received a good deal of media coverage and drew attention to some of the more controversial details, including photographs and speculations on the locations of some of the most secure government installations. However, as time passed, media attention tapered off.

Also of note, the WikiLeaks website released thousands of classified government documents obtained illegally from various internal military sources. Several of the documents created awkward situations for diplomats and foreign policy makers that may reverberate for some time, but on the whole, many of the documents showed the US' unwavering commitment to its military and diplomatic missions overseas, possibly proving beneficial to certain relationships in the long term.

Cyber Threats

General Keith Alexander was appointed the first commander of the new US Cyber Command (CYBERCOM) in May 2010. Headquartered at Fort Meade, CYBERCOM coordinates, integrates and synchronizes activities to defend DoD networks and perform offensive attacks on enemy systems as required. By centralizing all defense and intelligence cyber operations, CYBERCOM improves US capabilities and consolidates expertise[13]. The stand-up of CYBERCOM came at a critical time for the US, as cyber threats from nations and non-state actors increase in volume and severity and leading cyber security technologies and expertise are in especially high demand. Global infrastructure (e.g. communications, energy, weapons facilities, etc.) was a prime target in 2010 and remains quite vulnerable. Most prominent was the Stuxnet computer worm, which was designed specifically to target industrial systems. In November, Iran confirmed that a Stuxnet cyber attack had, in fact, damaged its nuclear facility in Natanz. Some experts across the globe referred to the Stuxnet attack on Iran as the first real act of cyber warfare.

Cyber attacks are perhaps the most quintessential form of irregular warfare, enabling small countries, non-state actors, or even individuals to unleash catastrophic, crippling attacks on much larger, militarized opponents from locations across the globe.

Emerging Hot Spots

The US military faced a diverse array of threats in 2010 from offensive and defensive perspectives. Iran, Yemen and Sudan posed immediate threats to the US and its allies and will require attention from defense and development standpoints, as will such non-state actors such as Hezbollah, Hamas, Mexican drug cartels in Mexico and pirates off the coast of Africa. The US inevitably will develop strategies to address these evolving, multi-faceted threats while also paying attention to emerging conflict areas worldwide. Budget austerity aside, the US and its allies must confront these threats to global security and undoubtedly will rely on contractors to provide human capital and technological innovation to accomplish these tasks.

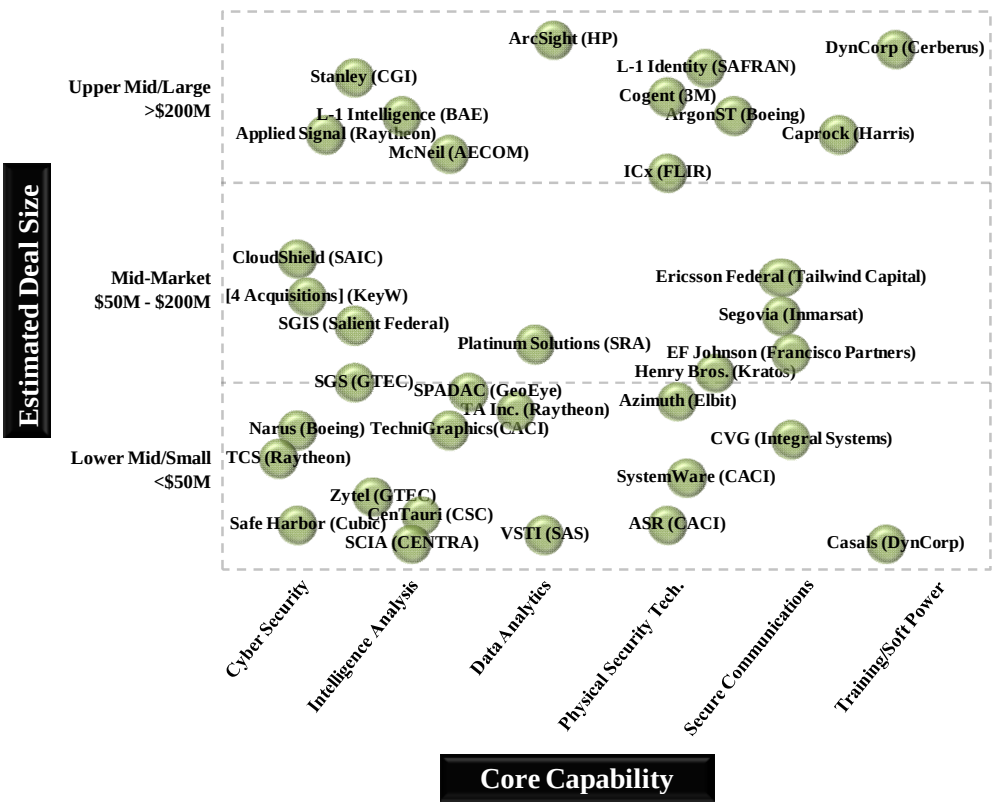
[13] US DoD Cyber Command Fact Sheet

IV. (b) Asymmetric Warfare: Representative M&A Activity

The most likely victims of imminent DoD budget cuts are large, sprawling weapons systems programs and IT platforms. Accordingly, large prime contractors leading such programs face the most adverse impacts, far more so than mid-tier or lower middle market firms (though budget cuts doubtless will trickle down to smaller contractors as well). During 2010, prime contractors were very active middle market buyers seeking to realign their capabilities and customer bases with new strategic growth objectives. Larger firms targeted key federal government activities most likely to receive increasing appropriations, including: cybersecurity, data analytics, sensors and physical security, secure wireless communications, soft power and the IC as a whole.

Asymmetric warfare was a key theme of 2010, driving significant defense and government services M&A activity. Large and mid-tier contractors targeted firms with leading technologies, capabilities and customers to reposition themselves strategically within well-funded areas of the federal budget. In the figure below, we plotted a selected group of key 2010 transactions by core capability and estimated deal size. Collectively, , these transactions demonstrate the essential role contractors play in support of mission critical defense and intelligence programs and the "ripple effect" of geopolitical events and policies on private industry.

Selected 2010 Asymmetric Warfare-Driven M&A Activity



Cyber Security

The lion's share of cyber security M&A occurred in the lower middle market, where mid-tier and large contractors acquired niche technologies and services and key customer relationships. KeyW Corp. spent $131 million in 2010 acquiring Everest Technology, Sycamore, Insight Information and The Analysis Group. Raytheon acquired Trusted Computer Solutions and announced the acquisition of Applied Signal (which itself had purchased Seismic LLC in 2010 for $30 million). Boeing acquired Narus, Inc. to complement its 2009 acquisition of eXMeritus. Cubic acquired Safe Harbor Systems and ABRAXAS. GTEC purchased Zytel and Signature Government Solutions for $27 million and $53 million, respectively. These represent a small cross-section of 2010 cyber security M&A.

Data Analytics

With ample cyber security overlap, leading data analytics firms also were hot targets during mid- and late-2010. Government and commercial business intelligence firm SAS, Inc. acquired Vision Systems and Technology to bolster its federal and IC presence. HP acquired 3Par ($2.3 billion) and ArcSight ($1.7 billion). Raytheon acquired Technology Associates for $42 million and SRA closed the purchase of Platinum Solutions for $90 million. Satellite imagery firm GeoEye acquired geospatial predictive analytics firm SPADAC for $46 million.

Physical Security Technology

Large primes scooped up middle market physical security technology companies to align themselves with heavily funded biometrics, surveillance and sensor programs in the US and overseas. CACI acquired SystemWare ($32 million) and Boeing acquired Argon ST ($775 million, 18x trailing EBITDA). L-1, the leading pure play biometrics technology company, announced the sale of its Identity Solutions business to French conglomerate SAFRAN ($1.6 billion, 19x trailing EBITDA) and its US Intelligence Consulting business to BAE Systems ($303 million, 9x trailing EBITDA). L-1 was formed during the second half of the decade through a series of strategic technology and services acquisitions to capitalize on increasing civilian and military demand for global identity solutions expertise. The valuation multiple disparity between the 19x EBITDA paid by SAFRAN and the 9x paid by BAE most likely is attributable to a size premium and also to SAFRAN's eagerness to penetrate the US federal (and global) biometrics market. Substantially all of L-1's hardware/products were included with its Identity Solutions business. Hardware technology companies tend to sell at a premium to pure professional services businesses. Continuing this trend in the biometrics space, 3M acquired hardware technology supplier Cogent ($935 million, 21x trailing EBITDA). Cogent is primarily a hardware/product business.

The intelligent video surveillance market also saw an especially large volume of transaction activity in 2010. Intelligent surveillance systems integrate the latest video and sensor hardware with sophisticated software platforms that can analyze visual data in real-time, run it through algorithms and then disseminate useful information to intelligence analysts and security personnel. These Physical Security Information Management Systems (PSIMs) have civilian sector applications monitoring and protecting critical infrastructure (e.g. fire detection and hazardous material leaks). In defense and homeland security sectors, PSIMs protect US facilities. Most notably, FLIR Systems acquired publicly-traded ICx Technologies for $264 million (11x forward EBITDA). This "needle-moving" acquisition positions FLIR as the premier provider of integrated thermal imaging hardware and intelligent physical security systems.

Other selected transactions include ELBIT Systems' acquisition of fellow Israeli firm Azimuth Technologies for $58 million, Kratos Defense & Security's acquisition of Henry Bros. Electronics for $61 million and ITT's acquisition of video and data management firm EchoStorm Worldwide.

Secure Communications

To support ongoing US operations overseas in less developed terrain, military and civilian personnel need deployable, reliable and secure wireless networks to enable in-theatre and overseas communication. Such adversaries as the Taliban have interrupted Afghanistan's (limited) communications infrastructure to disrupt and disorient US and allied forces prior to and during attacks. US forces also require secure networks to communicate and transmit classified data without risk of enemy interception. Mobile, terrestrial and satellite communications technologies have advanced significantly in recent years. Larger primes and financial buyers have targeted niche hardware and software providers on the basis of their potential for strong growth and continuing demand in coming years.

During 2010, Raytheon announced that it would acquire Applied Signal for $512 million (14x trailing EBITDA) and Harris Corp. closed its purchase of facilities-based satellite and ground communications firm CapRock Communications for $525 million (10x trailing EBITDA). Private equity was also active: Francisco Partners acquired EF Johnson Technologies ($47 million) and Tailwind Capital acquired Ericsson's federal unit.

Furthermore, given the scope and requirements of the massive Future Commercial Satellite Communications Services Acquisition (FCSA) that will bundle and replace all expiring Defense Information Systems Agency (DISA) and GSA SATCOM contracts, larger satellite players acquired mid-tier services and technology companies to diversify their expertise and position themselves to bid. To be competitive, bidders likely will need to demonstrate capabilities and past performance in three core areas: transponded capacity, subscription services and "end-to-end" solutions. Inmarsat acquired Segovia ($110 million, 1.6x revenue), Integral Systems acquired CVG ($34 million) and GeoEye acquired SPADAC ($46 million).

Soft Power

Asymmetric warfare demands hybrid strategic plans from US forces and their supporting contractors. To arm themselves with the requisite capabilities and customer relationships, some large contractors used M&A to alter their posture in the global spotlight and reposition themselves for future, larger programs. Programs supporting COIN doctrine likely will address objectives spanning DoD, the State Department and USAID. Security contractor DynCorp recently confronted unwanted media focus due to the transgressions of a small number of its private security personnel overseas. Its security contracts to defend diplomatic compounds overseas were good business, but Dyncorp would benefit from softening its public image and gaining capabilities from smaller firms that would enable it to bid on development and diplomacy programs in coming years. DynCorp thus acquired Casals and Associates for $7.4 million. While this was quite a small deal in dollar value for the $3.7 billion DynCorp, it added invaluable expertise in international development, anti-corruption and strategic communications. Shortly thereafter, DynCorp itself agreed to be taken private by Cerberus Capital Management for $1.6 billion (6x trailing EBITDA). DynCorp may prosper as a private company more so than as a publicly traded one given the sometimes controversial nature of its work and the long-term strategic planning necessary to

win and maintain large government contracts so often at odds with the quarterly earnings pressures imposed on publicly-traded companies by analysts and investors. Xe Services, formerly Blackwater, is another military training and security firm that received a lot of media attention in recent years: it was sold in 2010 to private equity investors Forte Capital and Manhattan Capital.

Other notable transactions in the soft power space include the Australian development firm Coffey International's acquisition of both Global Justice Solutions and Libra Advisory Group for $5 million and $3 million, respectively.

Intelligence Community

As a capstone to the discussion of asymmetric threats' impact on M&A in 2010, it is essential to explore the explosive growth in demand for US Intelligence Community contractors. Demand and transaction multiples have grown in the past few years as larger firms and financial buyers stepped back to identify where future year federal government expenditures most likely would grow in the face of fiscal austerity. The IC's 16 independent agencies provide fundamental homeland security and defense support necessary to execute operations worldwide. Elite, niche contractors supporting the IC in turn provide mission critical technologies and services that have made them extremely attractive acquisition candidates. Penetrating the IC market through inorganic, M&A-driven growth is a particularly effective strategy given the sector's high barriers to entry. The market is quite fragmented, with many small firms providing best-in-class products and services while relying on relationships built over many years of successful program delivery. Larger firms lacking such track records view M&A as a significantly more economical and timely growth strategy than attempting to break into the IC on their own.

Deal activity at the upper end of the market included CGI's $1.1 billion acquisition of Stanley (for 12x trailing EBITDA) but most such transactions have targeted lower middle market firms. CGI's acquisition represented a major paradigm shift in the IC for the Canadian firm that historically provided civilian government support. Other major entrées into the IC included Korn/Ferry's acquisition of SENSA Solutions giving the large human capital consulting firm a significant IC presence and growing markets for its executive coaching and consulting service offerings. During 2010, two private equity firms sold IC-space portfolio companies they had nurtured for several years. DC Capital Partners sold National Interest Security Company (NISC) to IBM and Veritas Capital sold McNeil Technologies to development and engineering firm AECOM for $355 million (1.4x trailing revenue). These two deals saw two large prime contractors that traditionally had minimal IC presence, targeting middle market intelligence analysis firms to break into the IC.

Middle market IT services and intelligence analysis deals included Salient Federal's acquisition of SGIS from parent company SkillStorm and GTEC's acquisition of Signature Government Solutions from parent company Signature Consultants ($53 million). During 2010, parent companies like SkillStorm and Signature Consultants recognized strong marketplace demand and valuations for intelligence companies whose unique expertise and focus could drive IC sector growth, generating opportunities that were fundamentally different from those in commercial professionals services or even civilian federal government agency support. GTEC also closed its Zytel acquisition in 2010 ($27 million). BAE Systems acquired L-1's intelligence consulting business when SAFRAN agreed to acquire L-1's Identity Solutions

division. ManTech acquired QinetiQ's Intelligence and Security division ($55 million) while KeyW Corp. closed on four IC cyber security contractors.

On the product side, large contractors acquired niche, best-in-class technologies with a sticky IC presence. SAIC bought Cloudshield Technologies ($141 million) from a syndicate of financial backers. CACI acquired geospatial technology company TechnoGraphics and CSC closed on its purchase of Centauri Solutions.

V. (a) Macro Trend: Organizational Conflicts of Interest (OCI)

During 2010, government regulators scrutinized many of the US' massive weapons and IT systems and contractors for potential organizational conflicts of interest (OCI). Government regulators paid particular attention to contractors providing systems engineering and technical assistance (SETA) services to design or recommend systems for which they subsequently performed integration work or supplied technology.

The government's OCI focus became official in April 2010 when DoD issued amendments to the Defense Federal Acquisition Regulation Supplement (DFARS) in accordance with the Weapons Systems Acquisition Reform Act of 2009, section 207, which mandated that government officials implement more stringent OCI policies. This drove many large prime contractors to re-evaluate their positions on myriad contracts to ensure compliance moving forward. By December 2010, these DFARs amendments were finalized following an opportunity for comments after the initial announcement in April. The policy focuses fundamentally on avoiding OCI issues, while maintaining competition among contractors to ensure the government does not sacrifice quality or talent in procurement. In addition, the new rule applies only to large defense programs and does not affect most of the professional services and IT procurements that are targeted by lower middle market and mid-tier contractors.

V. (b) OCI: Representative M&A Activity

Large prime contractors reacted to 2009 rumblings that preceded the OCI April 2010 announcement by rushing to divest business units that potentially could raise conflicts with higher priority divisions. In nearly every case, this involved SETA business divestitures, creating an interesting marketplace dynamic. Although often substantial in size and attractive in capabilities and customers, these SETA divisions had a very limited buyer universe. Larger units such as Northrop Grumman's TASC division and Lockheed Martin's EIG division were too big a bite for peers while other large primes could not acquire them without confronting the very issues their competitors were trying to mitigate.

Private equity firms, on the other hand, found these businesses incredibly attractive platform investments. With ample size and critical mass, transparent government contract backlog revenue streams and strong relationships with the world's largest customer, these businesses fit the financial sponsor model perfectly. The only potential setback would be limited exit opportunities, since a sale to a strategic buyer after a 5- to 7-year holding period (on average) would be unlikely unless the OCI climate changes dramatically. By default, then, IPOs constitute the most likely exit option, and one that would be attractive to Wall Street investors and analysts for the same reasons financial sponsors liked these deals in the first place.

The limits financial sponsors face—access to deal leverage among other considerations—make it difficult for them to compete in M&A auctions against strategic buyers that can price in synergies and other value

premiums. Without a significant pool of strategics for OCI-conflicted targets, private equity jumped on the opportunity to scoop up valuable federal properties in 2010. Furthermore, with a SETA platform in place, financial sponsors can continue to build critical mass by acquiring smaller OCI divestitures from mid-tier firms as well as lower middle market niche companies.

2010 OCI-related M&A is summarized in the table below. Financial sponsors are included in parentheses alongside their portfolio companies.

Selected 2010 OCI-Related M&A Activity

Date Closed	Seller	Company/Division	Buyer	Enterprise Value
11/23/2010	Lockheed Martin	Enterprise Integration Group	Veritas Capital	$815 million
10/26/2010	NetStar-1 (Lake Capital)	IT Services & Commercial Sales Business	IT Solutions (Snow Phipps)	$75 million
10/8/2010	QinetiQ	Security & Intelligence Solutions Business	ManTech	$60 million
9/30/2010	CSC	Mission Solutions Engineering	ASRC	N/A
9/8/2010	ITT	CAS	Wyle (Court Square)	$235 million

APPENDIX A. – SELECTED 2010 M&A TRANSACTIONS

Date	Acquirer	Target	Enterprise Value $US millions	EV/EBITDA	EV/REV
12/31/2010	Tailwind Capital LP	Ericsson Federal Inc.	NA	NA	NA
12/31/2010	CENTRA TECH, Inc	SCIA, LLC	NA	NA	NA
12/22/2010	BAE Systems plc	ETI A/S	1,200.0	NA	3.5x
12/22/2010	Teledyne Technologies Inc.	DALSA Corp.	333.8	9.7x	1.7x
12/22/2010	Vigor Industrial, LLC	Todd Shipyards Corp.	89.9	3.4x	0.4x
12/21/2010	Rockwell Collins Inc.	Blue Ridge Simulation, Inc.	NA	NA	NA
12/20/2010	CDI Corp.	DSPCon, Inc.	NA	NA	NA
12/20/2010	Computer Sciences Corporation	Centauri Solutions, LLC	NA	NA	NA
12/18/2010	Raytheon	Applied Signal Technology, Inc.	476.1	14.6x	2.1x
12/17/2010	Manhattan Capital Investors, LLC; Forte´ Capital LLC	Xe	NA	NA	NA
12/11/2010	AVIC International Holding Corporation	Teledyne Continental Motors, Inc.	186.0	NA	NA
12/7/2010	Gichner Systems Group, Inc.	SCT Acquisition, LLC	16.0	NA	NA
12/6/2010	Computer Sciences Corporation	Image Solutions, Inc.	NA	NA	NA
12/4/2010	GeoEye, Inc.	SPADAC Inc.	46.0	NA	NA
12/1/2010	ABM Industries Inc.	The Linc Group, Inc.	301.0	NA	0.5x
12/1/2010	The KEYW Holding Corporation	Everest Technology Solutions, Inc.	29.9	NA	NA
11/29/2010	The KEYW Holding Corporation	Sycamore.US, Inc.	27.7	28.2x	1.3x
11/29/2010	BAE Systems plc	stratsec.net Pty Ltd.	24.0	NA	NA
11/28/2010	TransDigm Group Incorporated	Telair International Inc., Actuation Business	94.0	NA	3.9x
11/24/2010	Veritas Capital	CPI International, Inc.	527.6	9.0x	1.5x
11/22/2010	ManTech International Corporation	MTCSC, Inc.	75.0	NA	NA
11/16/2010	Allegheny Technologies Inc.	Ladish Co. Inc.	806.5	14.7x	2.1x
11/15/2010	Cubic Corporation	ABRAXAS CORPORATION	124.0	NA	2.1x
11/11/2010	ITSolutions, LLC	Peace Technology, Inc.	NA	NA	NA
11/8/2010	Quest Software Inc.	Bakbone Software Inc.	44.4	7.0x	0.8x
11/6/2010	CapRock Services Corp.	Schlumberger Information Solutions, GCS Business	397.5	NA	NA
11/4/2010	Global Defense Technology & Systems, Inc.	Signature Government Solutions, LLC	52.5	NA	NA
10/26/2010	ITSolutions, LLC	NetStar-1 Holdings LLC, IT Services Business	75.0	NA	NA
10/26/2010	CACI International Inc.	Applied Systems Research, Inc.	NA	NA	NA
10/18/2010	CACI International Inc.	TechniGraphics, Inc.	NA	NA	NA
10/13/2010	Veritas Capital; Veritas Capital Fund IV, L.P.	Lockheed Martin Corporation, EIG	815.0	NA	1.3x
10/13/2010	Gilat Satellite Networks Ltd.	Wavestream Corporation	136.8	NA	NA
10/11/2010	Systems Research And Applications Corporation	Platinum Solutions, Inc.	89.5	NA	NA
10/7/2010	Torch Hill Investment Partners, L.L.C.	Jameson LLC	NA	NA	NA
10/5/2010	Kratos Defense & Security Solutions, Inc.	Henry Bros. Electronics, Inc.	58.7	19.7x	1.0x
10/4/2010	BE Aerospace Inc.	TSI Group, Inc.	310.0	NA	NA
10/4/2010	Raytheon Co.	Technology Associates, Incorporated	42.0	NA	2.0x
10/4/2010	Computer Sciences Corporation	Vulnerability Research Labs, LLC	NA	NA	NA
10/2/2010	Microsemi Corp.	Actel Corporation	424.9	23.6x	2.1x
9/29/2010	Danaher Corp.	Keithley Instruments Inc.	326.0	23.1x	2.9x
9/29/2010	ManTech International Corporation	Analex Corp., Security and Intelligence Solutions	60.0	NA	1.1x
9/29/2010	Six3 Systems Inc.	Novii Design, LLC	NA	NA	NA
9/25/2010	TransDigm Inc.	McKechnie Aerospace DE, Inc.	1,797.7	19.2x	5.7x
9/24/2010	Deltek, Inc	INPUT, Inc.	60.0	NA	2.3x
9/19/2010	Safran SA	L-1's Identity Solutions Division	1,585.0	22.4x	2.5x
9/19/2010	BAE Systems Information Solutions, Inc.	L-1's Intelligence Division	303.0	9.3x	1.3x
9/19/2010	Battery Ventures	RAE Systems Inc.	88.3	NM	1.0x
9/17/2010	L-3 Communications Holdings Inc.	3Di Technologies, LLC	11.0	NA	NA
9/13/2010	Hewlett-Packard Company	ArcSight, Inc.	1,503.4	59.4x	7.7x
9/13/2010	Global Defense Technology & Systems, Inc.	Zytel Corporation	24.0	8.9x	1.4x
9/13/2010	ITT Corporation	OI Corp.	23.6	10.1x	1.1x
9/10/2010	Honeywell International Inc.	Sperian Protection	1,110.3	12.2x	1.6x
9/7/2010	BAE Systems plc	OASYS Technology, LLC	55.0	NA	NA
8/31/2010	Veritas Capital; Veritas Capital Fund III, L.P.	Illumination and Detection Solutions Business	482.0	10.0x	NA
8/29/2010	3M Co.	Cogent Inc.	662.5	20.9x	5.7x
8/19/2010	VSE Corp.	Akimeka LLC	43.3	NA	1.1x
8/19/2010	EADS Defence And Security Systems S.A.	Kercado Ltdl	NA	NA	NA
8/16/2010	FLIR Systems, Inc.	ICx Technologies, Inc.	226.2	NA	1.3x
8/10/2010	Chemring Group plc	Roke Manor Research Limited	55.0	NA	1.2x
8/9/2010	Wyle	CAS, Inc.	235.0	NA	NA

APPENDIX A. (CONT'D) – SELECTED 2010 M&A TRANSACTIONS

Date	Acquirer	Target	Enterprise Value $US millions	EV/EBITDA	EV/REV
8/9/2010	Kratos Defense & Security Solutions, Inc.	DEI Services Corporation	21.3	NA	NA
8/6/2010	TransDigm Group Incorporated	Semco Instruments Inc.	70.6	10.8x	1.8x
8/5/2010	Vangent, Inc.	Buccaneer Computer Systems and Service, Inc.	69.7	11.4x	1.1x
8/2/2010	SAIC, Inc.	Reveal Imaging Technologies, Inc.	218.0	NA	NA
8/1/2010	WS Atkins plc	PBSJ Corp.	298.7	13.0x	0.4x
7/30/2010	AECOM Government Services, Inc.	McNeil Technologies, Inc.	355.0	NA	1.4x
7/19/2010	DA Acquisition Corp.	Research and Engineering Development, Inc.	NA	NA	NA
7/16/2010	SRA International Inc.	SENTECH, Inc.	25.2	NA	NA
7/9/2010	MCR, LLC	Alion Science and Technology Corp., EPM & TS Business	NA	NA	NA
7/7/2010	Boeing Co.	Narus, Inc.	NA	NA	NA
7/6/2010	Hexagon AB	Intergraph Corporation	2,125.0	11.2x	2.8x
6/30/2010	Boeing Co.	Argon ST, Inc.	774.7	18.1x	2.3x
6/30/2010	Aeroflex Holding Corp.	Radiation Assured Devices, Inc.	14.0	NA	NA
6/24/2010	Chemring Group plc	Allied Defense Group Inc., Substantially All Assets	67.1	NA	NA
6/22/2010	Cubic Defense Applications, Inc.	Safe Harbor Systems LLC	NA	NA	NA
6/15/2010	CIBER, Inc.	Segmenta Consulting A/S	NA	NA	NA
6/14/2010	NTT Data International, L.L.C.	Intelligroup, Inc.	173.8	10.7x	1.3x
6/6/2010	Altegrity, Inc.	Kroll, Inc.	1,130.0	NA	1.7x
6/4/2010	ViaSat Inc.	Stonewood Group Ltd.	20.0	NA	NA
6/3/2010	Jacobs Technology Inc.	TechTeam Government Solutions, Inc.	67.6	9.5x	0.9x
5/21/2010	Harris Corp.	CapRock Services Corp.	518.0	9.6x	1.4x
5/20/2010	Kontron America, Inc.	AP Labs, Inc.	42.0	NA	NA
5/17/2010	BAE Systems, Inc.	Atlantic Marine Property Holding Company, Inc.	352.0	NA	1.1x
5/17/2010	Harris Corp.	SignaCert, Inc.	NA	NA	NA
5/15/2010	Francisco Partners Management LLC	EF Johnson Technologies, Inc.	42.1	NM	0.4x
5/14/2010	FLIR Systems, Inc.	Raymarine	180.0	33.3x	1.2x
5/14/2010	Cubic Corporation	Impeva Labs, Inc.	NA	NA	NA
5/12/2010	Honeywell International Inc.	Matrikon, Inc.	131.6	18.6x	1.6x
5/7/2010	Honeywell International Inc.	Akuacom, Inc.	NA	NA	NA
5/6/2010	CGI Federal Inc.	Stanley, Inc.	1,059.9	11.6x	1.2x
4/15/2010	Oracle Corp.	Phase Forward Inc.	591.1	19.5x	2.7x
4/12/2010	Kratos Defense & Security Solutions, Inc.	Gichner Systems Group, Inc.	133.0	NA	NA
4/11/2010	Cerberus Capital Management, L.P.	DynCorp International Inc.	1,439.2	5.6x	0.4x
4/9/2010	Alliant Techsystems Inc.	Blackhawk Industries Products Group LLC	172.3	NA	NA
3/29/2010	Microsemi Corp.	White Electronic Designs Corp.	103.7	13.9x	1.6x
3/23/2010	Triumph Group, Inc.	Vought Aircraft Holdings, Inc.	1,587.0	NA	0.8x
3/23/2010	Babcock International Group plc	VT Group plc	1,526.9	12.3x	1.3x
3/22/2010	Smiths Interconnect, Inc.	Interconnect Devices, Inc.	185.0	NA	NA
3/17/2010	Spacenet, Inc.	RaySat Antenna Systems LLC	30.7	NA	NA
3/15/2010	Babcock & Wilcox	GE Energy, ESP and EM Business Units	22.0	NA	NA
3/12/2010	The KEYW Holding Corporation	Insight Information Technology, LLC	10.5	NA	2.0x
3/5/2010	Integral Systems Inc.	CVG, Incorporated	33.7	NA	NA
3/1/2010	UTC Fire & Security Corporation	GE Security, Inc.	1,820.0	NA	NA
2/22/2010	The KEYW Holding Corporation	The Analysis Group, LLC	62.0	NA	NA
2/19/2010	L-3 Communications Holdings Inc.	Insight Technology Incorporated	613.0	NA	NA
2/17/2010	ITT Corporation	Nova Analytics Corporation	385.0	NA	2.9x
2/17/2010	HDT Engineered Technologies	Nordic Air Incorporated	NA	NA	NA
1/28/2010	Warburg Pincus LLC	Survitec Group Ltd.	280.0	NA	1.9x
1/27/2010	HDT International Holdings	Airborne Systems, Ltd	NA	NA	NA
1/26/2010	IPG Photonics Corporation	Photonics Innovations, Inc.	NA	NA	NA
1/24/2010	Elbit Security Systems Ltd.	Azimuth Technologies Ltd.	57.7	NA	2.0x
1/22/2010	DynCorp International Inc.	Casals & Associates, Inc.	7.4	NA	NA
1/20/2010	API Technologies Corp.	Kuchera Industries, Inc. and Kuchera Defense Systems	29.3	NA	2.0x
1/20/2010	International Business Machines Corp.	National Interest Security Company, LLC	NA	NA	NA
1/19/2010	Thermo Fisher Scientific, Inc.	Ahura Scientific, Inc.	172.0	NA	3.8x
1/19/2010	CACI International Inc.	SystemWare, Inc.	32.0	NA	2.0x
1/14/2010	SAIC, Inc.	CloudShield Technologies, Inc.	140.0	NA	NA
1/13/2010	Sun Capital Partners, Inc.	Protective Products of America Inc.	27.1	NA	NA
1/12/2010	VMware, Inc.	Zimbra, Inc.	100.0	NA	NA
1/11/2010	EADS North America	Trig-Tek Incorporated	NA	NA	NA
1/1/2010	Korn/Ferry International	SENSA Solutions	NA	NA	NA

APPENDIX B. – THE MCLEAN GROUP DEFENSE & GOVERNMENT SERVICES PRACTICE

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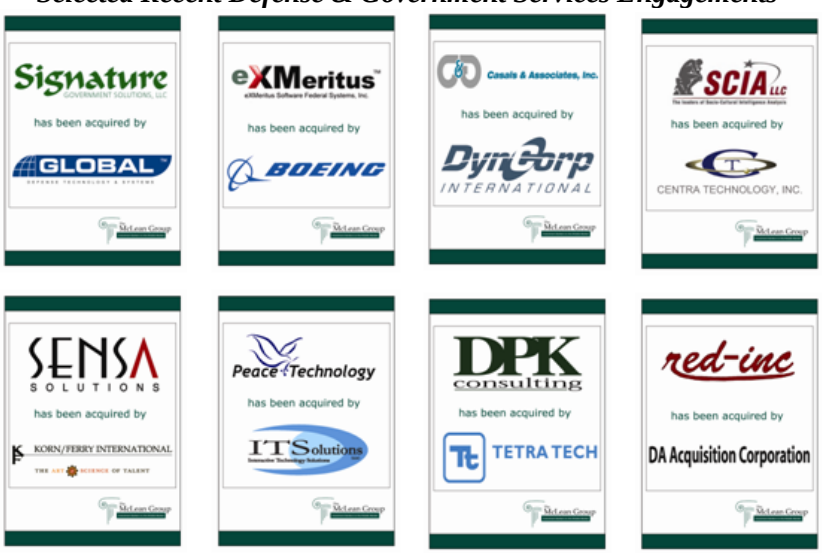
The McLean Group's Defense and Government Services (DGS) practice provides sell-side and buy-side mergers & acquisitions advisory and corporate finance services to middle market companies. Led by a seasoned group of senior industry executives and former military officers, our DGS team understands the unique qualitative and quantitative value drivers that impact federal contractors in the marketplace. These factors include: set-aside contracts, security clearances, contract backlog, government audits/compliance and prime/sub issues, among others.

The McLean Group has completed transactions with many of the industry's most prominent strategic buyers and defense/government-focused private equity firms. In addition, we maintain close working relationships with key decision makers at all of the sector's large and mid-tier public and private firms.

Selected Recent Defense & Government Services Engagements



"By keeping DSI's goals and considerations in front at all times, The McLean Group team truly showed client commitment is paramount. Your expertise was especially appreciated during the negotiation phase and the difficult hurdles of due diligence."

- Ken Jensen, President & Co-Founder, Defense Systems, Inc.

"The McLean Group's ability to test the possibilities in multiple markets and expertise in the acquisition process was truly instrumental in helping Abraxas make the first of hopefully multiple acquisitions in the future."

-Wes Husted, CFO, Abraxas Corp.

"Working with The McLean Group team was an enjoyable experience as all of the members displayed solid expertise and whose trustworthiness and good judgment gave us comfort that we were receiving the best transaction advisory services available."

-David Eldred, President, Practical Imagineering, Inc.

APPENDIX C. – THE MCLEAN GROUP FIRM OVERVIEW

Services

MERGERS & ACQUISITIONS

The McLean Group has an experienced team of senior investment bankers with a legacy of successful advisory transactions. Our seasoned professionals combine in-depth industry knowledge with M&A best practices to help middle market companies achieve their strategic objectives. We work closely with our clients to develop a comprehensive set of strategic alternatives and then evaluate and execute the most suitable approach.

BUSINESS VALUATION

As a core competency and complement to its merger & acquisition business, The McLean Group provides business valuation services, including intangible asset and financial security valuations for a variety of transaction, financial reporting and tax purposes.

CORPORATE FINANCE

The McLean Group helps clients determine and implement the most desirable capital structure to support future growth while managing risk effectively.

MARKET INTELLIGENCE

McLean, Markowitz & McNaughton (M|M|M) delivers more than powerful information tools – it provides the validated foundation required for business executives to create and implement winning strategies. By leveraging superior competitive analyses, M|M|M supplies executives with comprehensive market intelligence reports that reduce risk and uncertainty in strategic decision making.

Industry Groups

- Defense & Government Services
- Agriculture & Food Processing
- Business Services
- Consumer, Retail & Entertainment
- Diversified Industrials
- Education Services
- Energy & Clean Technologies
- Healthcare & Life Sciences
- Real Estate
- Technology & Telecommunications
- Transportation and Logistics
- Travel & Hospitality