

## DSEi: Feedback and thoughts Delegations and deliberations

Following the defence trade show DSEi last week, we look back at the key themes that have emerged and outline our thoughts on the general mood ahead of a detailed update to our report on the sector, Sensors for investors. With budget uncertainty a key topic and areas of growth at a real premium, we believe that M&A could well accelerate to reposition companies in niche technology areas.

### Budget uncertainty in US the biggest unknown

Most companies appear realistic about prospects for a slowdown in the US and recognise that while uncertainty remains over the deficit reduction plans, investment in programmes will remain slow. With the political gloves off, we feel that agreement on where the axe falls may take time and, as a result, we could well see additional blanket defence budget cuts kick in. Because of this, companies are seeking international export deals as the industry searches for growth-sustaining contracts outside home markets.

### Solid growth areas in niches: Supporting mid caps

With the key areas of growth relatively small niches – cyber security, battlefield communications, counter-IEDs and unmanned vehicles – those that stand to benefit most are companies that tend to be smaller and more agile, that can adjust quickly and already have established niches in such areas.

### Sentiment poor: M&A to accelerate?

With general sentiment poor, potential earnings stagnation, certain niches set to beat cuts and with strong balance sheets in general, we expect M&A to accelerate across the sector. United Technologies' potential interest in Goodrich could signal the start of further consolidation. There is clear read-across to Meggitt from such interest in Goodrich.

### Potential winners in the mid caps

Through a combination of solid growth prospects, positioning in strategic areas and the potential of bid interest, we view the mid-cap players as being the relative winners in the current environment. In particular, we favour the likes of Chemring and Ultra, where technology leadership and a track record of identifying and targeting future drivers are combined with a position as potential acquisition targets.

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#### COMPANIES IN THIS REPORT

[Avon Rubber](#)  
BAE Systems  
Chemring  
Cohort  
QinetiQ  
Thales  
Ultra Electronics

## DSEi feedback: Delegations and deliberations

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We met with a series of companies during the course of Defence and Security International (DSEi) exhibition, including BAE Systems, Thales, Chemring, QinetiQ, Ultra Electronics, Cohort and Avon Rubber, as well as attending several industry-wide events. With budgets tight and exports key, the show provided an opportunity for companies to showcase the latest technologies and products and meet with customers from around the globe. In the context of increasing competition and uncertainty, DSEi provided an ideal opportunity to glean the mood in the industry and identify key themes for further consideration which we will explore fully in our forthcoming update to [Sensors for investors](#). Our initial thoughts from the show are below.

### Budget uncertainty in US; UK visibility improving?

With the continued uncertainty regarding the US defence budget, many companies are preparing themselves ahead of the slowdown and acknowledge the possibility that defence spending may well be cut. However, the overriding concern at the moment, in our view, is the fact that, with the political gloves off in the US, agreement over an orderly reduction in expenditure in line with the terms agreed at the time of raising the debt ceiling may be impossible to achieve. As a result, we see the environment in the US as echoing that in the UK ahead of the SDSR, with few programmes beyond critical short-term ones being approved.

In the UK there are signs that programme visibility is improving. However, with further funding constraints and an unexpected conflict in the form of Libya since the SDSR, we do not believe challenges are fully over. We feel companies are remaining vigilant and ready to move with any recommended changes in approach to procurement.

### International export deals increasingly competitive

With home markets tight on both sides of the Atlantic, companies are putting even greater emphasis on the export market. Indeed, governments are playing their own part with a level of support to exporters that certainly appears to be matching the rhetoric from the top. While there was a feeling that international delegations at the show were perhaps smaller in size, this was more than compensated for by an increase in quality, with key decision makers attending from around the world.

The flipside is that competition for exports is becoming increasingly fierce. Despite this, the UK industry managed a creditable £9.5bn of export sales in 2010 (source: ADS's UK Defence Survey 2011), accounting for 43% of total revenues, of which 21% was non-EU/US revenues. This highlights why UK companies are less reliant on home markets than many international peers.

### Prominent technologies at the show

While the most high profile products at the show were armoured vehicles, and given the significant export potential for such vehicles that is to be understood, in our view the most interesting areas on show were related to more niche technologies. In particular:

- **Cyber security.** With the growing cyber security threat being recognised by governments around the globe, many companies showcased their expertise and ability in this rapidly evolving area. We see a parallel between today's understanding of the cyber security

market and the homeland security market of a decade ago, with a recognised danger yet a misunderstood contracting mechanism and diverse funding. However, this is beginning to change, as evidenced in the UK's national security strategy, and we believe that a number of defence companies have core capabilities that are set to feature in the long-term.

- **Counter-IED.** As a result of recent experiences in conflict and the growing prevalence of insurgency warfare, we believe that the counter-IED market will continue to expand. Whether this be through route clearance for convoys, dismounted soldier protection, or post conflict clean-up operations, we believe the area is one of constant innovation as new threats are derived and new countermeasures required.
- **Battlefield communications/C4ISR.** With information superiority a key enabler to force multiplication and safe operation, battlefield communications and intelligence reconnaissance and surveillance remain well supported. Indeed, as fewer boots on the ground or large platforms are available, the need for information becomes ever greater. In addition, with more information from sensors, the ability to process, analyse, interpret and decide upon a course of action becomes key, meaning increasing demand for data fusion capabilities.
- **Unmanned systems.** The combined focus on increasing information flows and removing personnel from harm's way where possible is driving the development of unmanned systems. Whether this be in the Air, Land or Naval field, we believe that investment will continue. Throughout the show there were examples of unmanned ground systems, whether bomb disposal robots, troop support or unmanned ground vehicles. While many are still in early development, we feel the drive towards increasing unmanned and increasingly autonomous vehicles will continue.

We believe the above areas represent the major growth drivers over the coming years, a factor that will be compounded by tighter budgets and a need to do more with less. This inherently increases the need to deliver "force multipliers" to allow a wider range of missions to be undertaken with increasing sophistication at a time of reducing manpower and tight budgets for new procurement programmes. As a result, we feel that those companies that are agile in decision making and already have a position in these developing niches stand to fare better over the coming years.

## Potential for M&A to accelerate

With the combination of factors described above and with balance sheets across the industry generally in a healthy position, we believe the potential for M&A to accelerate is significant. This could be to enhance an existing position in a niche, or to provide an entirely new strand to a business to reposition it to substitute elements of decline. Over the past year we have seen such moves made by BAE (several cyber acquisitions), Cobham (augmenting existing capabilities), Chemring (enhancing international sales), and Ultra (technology add-ons). We do not anticipate this to slow down and we could easily see this accelerate.

We view UK as acquirers for the main part. However, with US companies also seeing the same issues, and seeking to gain greater international access, there could be potential deal interest in UK

companies with a broad international exposure and key technology positions. As witnessed with the potential interest of United Technologies in Goodrich, there appears to be appetite for deals. In this respect alone, a clear read-across could be Meggitt, which has a very similar profile to that of Goodrich.

## Winners in this environment tend to be the agile

We believe that in the current defence environment it is those companies that are adaptable and agile, who invest in understanding the demand trends and can act quickly to address emerging opportunities that tend to fare best of all. In this respect we like the positioning of Chemring, Ultra Electronics and Avon Rubber in particular.

We believe that sentiment will continue to weigh on the larger broad-based players such as BAE and Thales, where macro concerns outweigh ability to innovate. If larger global players continue to see market erosion, we could see a situation where the niche mid caps could be put into play as acquisition targets, as larger companies strive to find the growth.

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