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Note: All monetary amounts are in US dollars.
Executive summary

Tepid economic growth will challenge the US aerospace and defense (A&D) industry in both 2013 and 2014. While large backlogs and geographic diversity support the industry in the short term, defense spending is expected to moderate and then decline. As defense budgets shrink, commercial aerospace growth is expected to be robust. The global A&D industry reflects gains driven by higher production rates and commercial aircraft deliveries, which somewhat offset the impact of reduced defense spending. Despite pressure on margins, Moody’s Investors Service expects the total industry operating profit to grow 6% to 8% through 2014, even though it anticipates global defense spending to fall 5% to 10%.

Large military suppliers face billions of dollars in Pentagon budget cuts and are repositioning their companies. The Pentagon will buy less equipment and pressure contractors to lower prices. Opportunities for foreign sales will remain despite a tougher market. Companies can be successful amid global austerity, but they will have to change how they do business. Defense companies, which have grown accustomed to reimbursements from the Pentagon for overhead, will be scrutinized for their ability to complete programs on budget and on schedule. They will compete for fixed-price contracts, which favor leaner suppliers.

Defense budget cuts are also rippling across the supply chain to smaller, specialized equipment and government services providers, which may have less financial resources to handle the impact. Some contractors are experiencing declines in defense revenue coupled with margin pressure. Some have experienced declines in organic sales amid pricing pressure and delays in government awards. Earnings and cash flow pressures could eventually lead to ratings downgrades. More restructuring charges are expected as companies reduce payrolls.

Defence suppliers, which are more diversified via commercial products or geographic regions, will face fewer challenges as US military spending continues to fall. Certain large contractors, such as Boeing, Textron and United Technologies, have commercial businesses that mitigate their exposure.

For commercial aircraft makers, opportunities are improving. World airline traffic is increasing, US airlines returned to profitability and capacity reductions among major airlines indicate a need for aircraft retirements. Since high operating costs, such as energy and labor, squeeze profits, the airlines are purchasing more fuel-efficient aircraft. This effort to improve fleet fuel efficiency as well as Asian and Middle Eastern demand are driving order backlogs to record highs. However, the fragile economy (especially in Europe and North America), the impact of taxes and regulations on the airlines, and the airlines’ ability and willingness to maintain capacity discipline could dampen market optimism. Excessive business jet manufacturing capacity for lower-priced, smaller aircraft could lead to industry restructuring, with possible mergers or the elimination of some aircraft lines.

A&D executives face a tough question: how will they reinvent their companies to find success in this changing landscape? The industry is likely to follow conservative cash deployment strategies to enhance liquidity. While diversification will help A&D companies manage risks and sustain revenues, firms should still be looking to have a preservation and optimization strategy for their capital.

The following are strategies that leading companies may consider in evaluating their growth opportunities:

Financials
• Enterprise cost reduction to preserve margins: back office, corporate and program cost control; plant closures; increased use of common shared service centers; and data center consolidation
• Supply chain rationalization: vertically integrate suppliers, anticipate parts and component shortages, eliminate inefficiencies and streamline procurement
• Stockpiling cash: provide flexibility to use for acquisitions, dividend payments, pension contributions or stock buybacks in the short term

Markets
• Geographic diversification: expand internationally into Latin America, Asia and the Middle East
• Expansion into new or adjacent markets: maintenance, repair and overhaul services; commercial satellites and services; unmanned aerial systems; defense electronics; and cybersecurity
• Rebalancing portfolio: invest in commercial markets, spin off noncore business unit or sell assets with inadequate returns
• Services growth: shift investments to emerging demand in intelligence, logistics and cybersecurity, as well as the energy, health care and environmental areas

Technology
• Business combinations strengthen company: mergers and acquisitions involving smaller tier-two players to support revenue, gain access to new or adjacent markets and/or technologies, and increase cost efficiencies
• Alliances and joint ventures: collaborations to increase access to technology and capital as well as new market opportunities
• Focus research and development (R&D) spending: all new products versus derivative programs to respond to customer needs
The 2012 dip in Western nations’ defense spending, the first in real terms since 1998, comes as global military spending dropped by 0.5% to $1.75 trillion, equal to 2.5% of global GDP. According to the Stockholm International Peace Research Institute, while spending by the US and Western Europe contracted China and Russia increased military expenditures in 2012. Government austerity and the Afghanistan conflict drawdown ultimately pushed down expenditures in the US, England and France. 

The US share of world spending dropped below 40% for the first time since 1991. In 2012, China upped its spending by 7.8%, which made it the second-biggest spender ahead of Russia, which increased by 16%. The US declined by 6% to $682 billion but still remained the leader. While spending fell in Western Europe, Australia, Canada and Japan, the impact of the decline was offset by higher expenditures in Asia, the Middle East, Latin America and Eastern Europe, driven mostly by rearmament programs or regional tensions. The Middle East rose by 8.4%, accounting for 8% globally. Military spending by the US and its NATO allies is expected to continue to level off and perhaps decline in 2013 and 2014. In June the US House of Representatives passed the FY2014 defense authorization bill, including a $552.1 billion base defense budget and $85.8 billion in overseas contingency operations war funding, but not the $500 billion in sequestration cuts. The White House budget office directed its department heads to plan for cuts in FY2015 and prepare proposals that assume 5% and 10% reductions. Such cuts, if applied, could slash military spending by as much as $54 billion, which would effectively make these plans compliant with discretionary spending reductions mandated by the 2011 Budget Control Act’s sequestration provision.

According to the US “Green Book” national defense budget estimates, which forms the basis of long-term modernization plans, future procurement increases outpace the projected rise of about 1.5% annually in the overall budget but does not reflect sequestration cuts. The Pentagon’s spending plans boosted annual weapons procurement by almost 3% above inflation over the next five fiscal years, from $99.3 billion in FY2014 to $114.2 billion in FY2018. The military’s pivot to the Asia-Pacific region is expected to continue regardless of widespread budget cuts for
the current fiscal year and lower overall spending in the future.

For US companies, foreign military sales (FMS) are unlikely to make up for lower US defense spending. In spite of increased military spending from emerging markets, such as South Korea, India, Saudi Arabia and Taiwan, FMS in the next few years are expected to be too low to compensate. US companies face intense competition from traditional European competitors as well as companies from emerging markets. Export markets, such as Brazil, Russia, India and China, are expected to become more competitive as global contractors seek more international business. The Middle East offers opportunities where the US is the dominant arms supplier. Between 2008 and 2011, the US provided 54% of the arms deliveries, according to the Congressional Research Service. As a leading indicator of future deliveries, the Middle East led globally in arms transfer agreements in 2011. Saudi Arabia ranked first in the value of transfer agreements among all developing nations that buy weapons. India was second.

Production alliances between developed countries and partners in emerging economies in Asia and South America are underway. Winning large export contracts to offset slowing domestic growth is a long, political process with an uncertain outcome. Ongoing US export reform, intended to cut through the bureaucracy and provide better controls, could help US contractors increase exports, although progress seems to be slow.

Defense prime contractors, looking for better yields, are investing in new, game-changing technologies, including directed energy and laser equipment, UAVs and intelligence, surveillance and reconnaissance. Large companies may continue to acquire such new technology companies. At the same time, these A&D companies may want to divest underperforming assets, which could lead to more industry consolidation.

Since government budgets face substantial reductions, federal government contractors will likely face contract terminations, diminishing funding for active government projects, and/or fewer new contract and grant opportunities. Government contractors will see a long period of deficit-cutting policy through reduced federal spending. Contracts and grants will continue to be more cost competitive. More future contracts and grants will be awarded on a lowest-priced technically acceptable basis. Greater competition for fewer government dollars along with more contracts awarded on a lowest-price technically acceptable basis will result in an increase in bid protests. This emphasizes the importance of cost proposal adequacy and meeting the minimum solicitation requirements. The US government customer is emphasizing low-cost, technically acceptable awards in lieu of the highest value or technically superior awards. In response, contractors are focused on reducing overhead and other cost-saving measures.
The large commercial aerospace market consists of two major players, Boeing and Airbus SAS (a unit of European Aeronautic Defence and Space Co. NV, or EADS). Robust demand from emerging markets such as Asia, the Middle East, Eastern Europe and Latin America, as well as the need to replace developed countries’ aging planes that are not very fuel efficient, is driving demand.

Boeing projects a $4.8 trillion market for 35,280 new airplanes over the next 20 years, with the current world fleet doubling in size, according to the Boeing 2013–32 Current Market Outlook. The forecast reflects the strength of the market, which continues to be resilient in spite of a sluggish global economy. Airline traffic and cargo is forecast to grow at an annual rate of 5% through 2032. The single-aisle market is robust. Widebodies are expected to account for almost $2.5 trillion of new airplane deliveries, with 40% of the demand for these long-range airplanes coming from Asian airlines.

New competition exists in the narrow-body segment with the introduction of products such as the Comac C919, Bombardier CSeries and the Irkt MC-21. The CSeries is a family of the 100- to 145-seat airliners built to compete at both the top end of the commercial aircraft outlook improving; Boeing and Airbus duopoly challenged

Potential competitive landscape in the next 10 years

Source: Rupinder S. Vig, “Aerospace & defense takeoff,” Morgan Stanley, 22 May 2013, via Thomson
Maintenance, repair and overhaul (MRO) offers higher margins

Commercial aerospace suppliers realize better profit margins from aftermarket sales, where sales volume is directly related to aircraft utilization. Drivers of long-term growth include aging regional jets and Boeing and Airbus fleets, global air traffic, growth of low-cost carriers, and outsourcing by airlines and governments. A long-term issue, on the other hand, is the growth of low-cost parts manufacturer approval (PMA) material, which could cut into the revenues and margins of original equipment aftermarket providers. The world market for PMA parts authorized by the Federal Aviation Administration (FAA) is projected to be worth $749 million by 2017. The growth will be partially driven by strong demand in Southeast Asia, Eastern Europe and South America. Leasing companies, which have historically been slow to adopt PMA parts, are expected to continue being a barrier to growth.

The largest MRO providers include Singapore Airlines Ltd. and Deutsche Lufthansa AG; the jet engine division of General Electric Co. (GE); Pratt & Whitney (United Technologies Corp. unit); Honeywell Aerospace (Honeywell International Inc.); Rolls-Royce plc; UTC Aerospace Systems division (combination of Hamilton Sundstrand and Goodrich); and Boeing’s aviation support services division. Smaller pure-play MRO companies include Triumph Group Inc., AAR Corp., and Heico Corp. MROs are keen to strike service agreements, which lead to more predictable cash flow and the delivery of long-term value-add to their customers. M&A activity grew, with the inking of notable acquisitions in the past year. These include GE’s Avio deal and Precision Castparts’ Timet acquisition.

Aviation Week’s forecast, which is not as bullish, predicts strong growth for civil MRO worldwide, to $68.5 billion by 2022. Key findings include: compound annual growth across all segments is 3.2% during the 10-year forecast; passenger-to-freighter conversion and in-flight entertainment components lead among growth markets, both exceeding 10% CAGR; and engine maintenance dominates with spending growth from 39% in 2013 to 41% in 2022 at a 3.9% annual growth during the period.

The worldwide military MRO market is experiencing significant uncertainty and is expected to decline by 3% from 2013-14, according to aviation consultancy

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* TeamSAI forecast
ICF SH&E. Middle East drawdown and sequestration will suppress the North American military market over the next 10 years. Providers will look at the North America as a large but declining base from which to address growth in Asia, the Middle East and Latin America, Aviation Week’s latest military MRO forecast suggests. The installed base of tankers worldwide is growing, supporting strong MRO spending in that category, and overall, makers of airlifters, fighters, bombers, special-mission aircraft and helicopters are forecast to deliver some 11,000 military aircraft of all types during the next 10 years. Asia-Pacific is expected to lead growth in trainer/light-attack MRO spending for the next decade as requirements increase more in that region than any other. European demand in the trainer/light-attack category is expected to drop more than in any other region.

Asia drives growth*

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* TeamSAI forecast
The business jet market is in slow recovery mode. The market bore the brunt of the global economic slump but is recovering slowly. At the Paris Show, there were only 32 firm orders and 20 options for Bombardier jets, potentially valued at a maximum of $1.84 billion, as compared with nearly $150 billion of firm orders for commercial jetliners. Book-to-bill ratios have struggled to reach 1x.

In the recent months some players have discussed joint ventures (JV) or signed agreements to expand their business in China. In late 2012, Cessna entered into a JV with China Aviation Industry General Aircraft Co. Ltd. (CAIGA), a unit of Aviation Industry Corp. of China (AVIC), to carry out the final assembly of Cessna Citation XLS+ aircraft, for sale in the Chinese market. Honeywell International signed five agreements in 2011 with Chinese aerospace companies to develop general aviation cockpit controls and to supply other aerospace products.

Demand from emerging markets (such as China, the Middle East and India) is contributing to industry growth. Orders for large jets are significantly outpacing those for smaller ones. Large jets are expected to contribute 65% of deliveries, in value terms, over the next 10 years.

Improved corporate capital spending in the US and the launch of new models are likely to stimulate demand for business jets. Gulfstream began delivering the new ultra-large-cabin G650 in the fourth quarter of 2011 and the “super mid-size” G280 in November 2012. Cessna is developing the Citation M2 light jet, while Bombardier is developing several new ultra-long-range models. Forecast International predicts that around 10,431 business jets worth an estimated $232 billion (in constant 2012 US dollars) will be manufactured between 2012 and 2021. Honeywell also forecasts nearly 10,000 new business jet deliveries from 2012 to 2022.
According to the Satellite Industry Association, world satellite industry revenues showed 7% revenue growth in 2011 compared with 2010. Globally, 2012 revenues totaled $189.5 billion. All four satellite industry segments (satellite services, satellite manufacturing, launch industry and ground equipment) saw growth in 2012, with launch revenues increasing the most (by $6.5 billion, or 35%) because of higher commercial and heavy government launches. Satellite manufacturing revenues jumped by 23% to $14.6 billion, while satellite services revenues went up 5% to $113.5 billion and ground equipment revenues increased by 4% to $54.9 billion.

For 2012 manufacturing revenues, the US share totaled nearly 60%. US satellite manufacturing revenues increased by 30%, from $6.3 billion to $8.2 billion. The US manufacturers won 12 of the 18 orders for commercial geostationary orbit satellites placed last year. The US launch industry revenues grew to $2.2 billion, a 35% market share. The top manufacturers of commercial communications satellites during the next 10 years include Space Systems/Loral, Thales Alenia Space, EADS Astrium, Boeing and Lockheed Martin.

Annual revenue from commercial data sales to defense customers, such as the National Geospatial-Intelligence Agency, is expected to grow to $2.2 billion by 2022, according to Euroconsult.

US companies got a boost when the President recently signed legislation that reclassifies some satellites as civilian technology. The National Defense Authorization Act for FY2013 provided for the removal of satellites and related items from the US Munitions List with the aim of stimulating the commercial space sector. The act stipulated that no satellites or related items may be exported, re-exported or transferred to China, North Korea or any other country that is a state sponsor of terrorism.

In 2012, government spending worldwide on outer space peaked at $72.9 billion, but Euroconsult expects such spending to drop due to global fiscal austerity pressures. For the first time in 12 years, 2013 is expected to mark a global decrease in government space program funding. Last year saw a very small increase over 2011, attributed to Russia, China, India and regional leaders, which offset budget uncertainties affecting North America and Europe.
US UAV manufacturers and sensor makers have experienced problems addressing the export market. The United Arab Emirates’ purchase of the Predator XP, designed to be compliant with the Missile Technology Control Regime (MTCR), was a breakthrough for the US entry into the Middle East unmanned aerial vehicle (UAV) market. The sale is the largest to date for the US and the first US sale of a medium-altitude, long-endurance UAV in the region. The contest was among General Atomics Aeronautical Systems’ modified Predator, BAE Systems’ Mantis and a Chinese offering. BAE Systems hoped to gain R&D funding, according to industry sources, which the US saw as a technology, putting US companies at a disadvantage.

Expectations that US would dominate the UAV market in the Middle East and worldwide have not materialized, despite the systems’ effectiveness in Iraq and Afghanistan. Competitive advantages over rivals in Israel, Europe and China have not resulted in export strength. The US market will account for 62% of the $28.5 billion spent on R&D and represent 55% of the $60.6 billion in procurement from 2012 to 2021, according to the Teal Group, which believes there will be no shortage of demand. The US should have advantages in its ability to fund research and in economies of scale. Tough export restrictions threaten to undermine advantages that US manufacturers enjoy.

Frost & Sullivan’s global military UAV market analysis predicted total sector sales between 2011 and 2020 will reach $61.37 billion, an increase of more than 60% from 2010. The US will remain the largest producer and operator of UAVs throughout the decade, accounting for about 45% globally. The 2013 Aerospace America Global UAV Roundup contains 57 countries and 270 companies responsible for more than 960 distinct UAVs, with 144 of them in the US.

Commercial UAVs could be a windfall for the industry and the US economy. While drones have proven effective on the battlefield, commercial demand is weak because of privacy concerns. In less restrictive countries, such as Japan, unmanned aircraft aid farmers, first responders and fishermen. Under FAA restrictions, companies are uncertain that the agency will make relevant rule changes by the Obama Administration’s 2015 deadline. The Association for Unmanned Vehicle Systems International projects an $82.1 billion infusion into the US economy over the 10 years following 2015 if these new rules take hold. Agricultural applications could add $75.6 billion over the decade.
Over the next 10 years, the Teal Group’s overall defense electronics market forecast points out that funding available to US manufacturers will continue to go up slowly. The largest defense electronics market segment is expected to be command, control, communications, computers and intelligence (C4I), followed by radar, electronic warfare (EW), and electro-optics (EO). Lockheed Martin, Northrop Grumman and Raytheon are likely to dominate defense electronics through FY2021, with emphasis may shift back somewhat to high-altitude sensors. Teal Group believes this change will encourage development of new sensors for a variety of current longer-range intelligence, surveillance and reconnaissance aircraft.

According to Forecast International, although the total market value of major western command, control, communications, computers, intelligence, surveillance and reconnaissance (C4ISR) programs over the next decade will reach around $50.76 billion, the C4ISR market is projected to fall from almost $7 billion in sales in 2013 to $3.71 billion annually in 2022. As countries tighten their defense budgets, the forecast considers the top five companies in terms of sales volume and market share to be Raytheon, General Dynamics, Harris, Northrop Grumman and Lockheed Martin.

Cybersecurity is considered one of the few growth opportunities for defense contractors. While cyber is growing, it will not reach the scale of aircraft or ship programs. Defense contractors have bolstered their capabilities and marketed their successes. While contractors have to be cost competitive, the differentiator is the implementation of a functional quality product with scarce expert resources.

Regardless of uncertain budgets, federal agencies need to protect mission-critical data and systems. Recent US regulations require agencies to implement continuous monitoring of their network operations, since hackers and unfriendly groups pose an increasing threat to infrastructure integrity. The Department of Homeland Security issued a request for quotes in late 2012 for a blanket purchase agreement to acquire continuous diagnostic and mitigation tools and monitoring services. The preferred acquisition method of the Department of Defense (DoD) was a large multiagency contract, with nearly $4 billion in cybersecurity-related purchases over the last five years. Some analysts have estimated that cybersecurity growth within DoD will increase around 9% over the next five years, but others are skeptical of such a boom. The Pentagon has spent billions of dollars across a number of indefinite delivery/indefinite quantity contracts, enterprise license and blanket purchase agreements related to cybersecurity. Quantifying the size of the US federal cybersecurity market is difficult, if not impossible.
Investment analysts tend to favor government services companies in communication, cybersecurity and higher-end technology services markets, as well as those with significant commercial or civilian agency exposure. Higher revenue growth rates in certain areas of federal civilian, commercial, health care and energy work may provide for attractive acquisition targets for A&D companies challenged to find revenue growth. Service contractors that derive most of their revenue from operations and maintenance (O&M) authorizations could be the most vulnerable. O&M funds are spent faster than procurement funds, leaving service contractors more immediately exposed to the impact of spending cuts.

After peaking in FY2011 and FY2012, US spending on defense and information technology (IT) will bottom out in FY2014 and FY2015 and increase 1%-2% annually through the rest of the decade, according to Deltek. Agencies are likely to require continued contractor support to converge their infrastructure, along with moving to shared services and more effective data management.

Although DoD continues to fund IT initiatives, contractors may find the market shrinking. Defense agencies will spend $58.6 billion in 2017 on IT products and services, down from $68.4 billion in 2012, according to Deltek. As DoD tries to balance growing IT needs with a decreasing budget overall, it will concentrate on consolidation, cybersecurity and programs that increase interoperability and efficiency. Overall, IT contracts are expected to become shorter, since long-term contracts tend to go over budget and become hard to manage, which can increase competition costs for contractors. Since 2010, DoD closed 380 data centers and plans to eliminate another 315 in 2013.

The Pentagon is seeking $39.6 billion for IT in the upcoming fiscal year with an eye toward increasing defensive cyberspace capabilities and developing the joint cyber force. The most common threats included malicious code, improper usage and unauthorized access. DoD will be looking for better forensic tools to alert personnel to a threat in real time. The Pentagon’s 2012 cloud computing strategy called for an infrastructure that would cover the entire department. According to the framework, multiple providers are intended to develop applications and software for its data centers.

DoD is also looking for IT solutions that will increase efficiency. With UAVs and other devices providing a constant stream of information, analytic tools to help monitor data are likely to expand. DoD started its data-to-decisions program to invest $250 million annually across the services to make systems more autonomous and improve situational awareness. The Pentagon is looking for solutions that can extract information from text in any language and increase the amount of data an intelligence analyst can handle. The Defense Advanced Research Projects Agency wants to develop better algorithms for processing data and create human-computer interaction tools to help process data faster.
# Aerospace and defense leaders

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Endnotes


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